Employers Holdings, Inc.
Form 10-K
March 14, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007

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 001-33245

EMPLOYERS HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

NEVADA	
(State or other jurisdiction of incorporation or organization)	04-3850065 (IRS Employer Identification No.)

9790 Gateway Drive, Reno, Nevada 89521

(Address of principal executive offices and zip code)

(888) 682-6671

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $0.01 par value per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2007 was $1,134,050,137.

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

	Class
February 29, 2008	Common Stock, $0.01 par value per share 49,616,635 shares outstanding

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Definitive Proxy Statement relating to the 2008 Annual Meeting of Stockholders are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III of this report.

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FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and 21E of the Securities Exchange Act of 1934. You should not place undue reliance on these statements. These forward-looking statements including statements regarding our expected financial position, business, financing plans, litigation, future premiums, revenues, earnings, pricing, investments, business relationships, expected losses, loss reserves, competition and rate increases with respect to our business and the insurance industry in general. These forward-looking statements reflect our views with respect to future events and financial performance. The words ‘‘believe,’’ ‘‘expect,’’ ‘‘plans,’’ ‘‘intend,’’ ‘‘project,’’ ‘‘estimate,’’ ‘‘may,’’ ‘‘should,’’ ‘‘will,’’ ‘‘continue,’’ ‘‘potential,’’ ‘‘fo similar expressions identify forward-looking statements. Although we believe that these expectations reflected in such forward-looking statements are reasonable, we can give no assurance that the expectations will prove to be correct. Actual results may differ from those expected due to risks and uncertainties, including those discussed in ‘‘Risk Factors’’ in Item 1A of this report and the following:

- adequacy and accuracy of our pricing methodologies;
- our dependence on a concentrated geographic area and on the workers’ compensation industry;
- developments in the frequency or severity of claims and loss activity that our underwriting, reserving or investment practices do not anticipate based on historical experience or industry data;
- changes in rating agency policies or practices;
- negative developments in the workers’ compensation insurance industry;
- increased competition on the basis of coverage availability, claims management, safety services, payment terms, premium rates, policy terms, types of insurance offered, overall financial strength, financial ratings and reputation;
- changes in regulations or laws applicable to us, our policyholders or the agencies that sell our insurance;
- changes in legal theories of liability under our insurance policies;
- changes in general economic conditions, including interest rates, inflation and other factors;
- effects of acts of war, terrorism or natural or man-made catastrophes;
- non-receipt of expected payments, including reinsurance receivables;
- performance of the financial markets and their effects on investment income and the fair values of investments;
- possible failure of our information technology or communications systems;
- adverse state and federal judicial decisions;
- litigation and government proceedings;
- possible loss of the

services of any of our executive officers or other key personnel;

- cyclical nature of the insurance industry;
- investigations into issues and practices in the insurance industry;
- changes in interest rates; and
- changes in demand for our products.

The foregoing factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included in this report.

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These forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical or anticipated results, depending on a number of factors. These risks and uncertainties include, but are not limited to, those listed under the heading ‘‘Risk Factors’’ in Item 1A of this report. All subsequent written and oral forward-looking statements attributable to us or individuals acting on our behalf are expressly qualified in their entirety by these cautionary statements. We caution you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. Before making an investment decision, you should carefully consider all of the factors identified in this report that could cause actual results to differ.

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PART I

Item 1. Business

Overview

Employers Holdings, Inc. (EHI) is a Nevada holding company and is the successor to EIG Mutual Holding Company (EIG), which was incorporated in Nevada in 2005. EHI's principal executive offices are located at 9790 Gateway Drive, Suite 100 in Reno, Nevada. Our two insurance subsidiaries, Employers Insurance Company of Nevada (EICN) and Employers Compensation Insurance Company (ECIC) are domiciled in Nevada and California, respectively. Unless otherwise indicated, all references to ''we,'' ''us,'' ''our,'' the ''Company'' or similar terms refer to EHI together with subsidiaries.

We are a specialty provider of workers' compensation insurance focused on select small businesses engaged in low to medium hazard industries. Workers' compensation is a statutory system under which an employer is required to provide coverage for its employees' medical, disability, vocational rehabilitation and death benefit costs for work-related injuries or illnesses. Our business has historically targeted small businesses located primarily in several western states, with a concentration in California and Nevada. We distribute our products almost exclusively through independent agents and brokers and our strategic distribution partners. We operate in a single reportable segment with 13 territorial offices serving 11 states in which we are currently doing business.

During 2006 based on direct premiums written, we were the second, eighth and eighteenth largest non-governmental writer of workers' compensation insurance in Nevada, California and the United States, respectively, as reported by A.M. Best Company (A.M. Best). As of the date of this filing, EHI's subsidiaries were assigned a group letter rating of ''A–'' (Excellent), with a ''positive'' financial outlook, by A.M. Best. This A.M. Best rating is a financial strength rating designed to reflect our ability to meet our obligations to policyholders. This rating does not refer to our ability to meet non-insurance obligations and is not a recommendation to purchase or discontinue any policy or contract issued by us or to buy, hold or sell our securities. The outlook reflects the expectation that operating performance and capitalization will continue to be sustained at the strong levels reported in recent years. We have applied for and are in the process of receiving assigned credit ratings from Moody's Investor Services (Moody's) and Standard & Poor's (S&P) to have the ability to access the capital markets as needed in the future.

As of February 1, 2008, we had 665 full-time employees, five of whom were executive officers, and six part-time employees. None of our employees is covered by a collective bargaining agreement. We believe our relations with our employees are excellent.

History

On January 1, 2000, our Nevada insurance subsidiary (EICN) assumed all the assets, liabilities and operations of the Nevada State Industrial Insurance System (the Fund), including in force policies and historical liabilities associated with the Fund for losses prior to January 1, 2000, pursuant to legislation enacted in the 1999 Nevada legislature. In connection with that assumption, our Nevada insurance subsidiary assumed the Fund's rights and obligations under a retroactive 100% quota share reinsurance agreement (referred to as the LPT Agreement) which the Fund had entered into with third party reinsurers. The LPT Agreement substantially reduced the exposure to losses for pre-July 1995 Nevada insured risks. The Fund, which was an agency of the State of Nevada, had over 80 years of workers' compensation experience in Nevada. Subsequently, through July 2002, we operated exclusively in Nevada.

We formed a wholly owned stock corporation incorporated in California, ECIC, and on July 1, 2002 we acquired the renewal rights to a book of workers' compensation insurance business, and certain other tangible and intangible assets from Fremont Compensation Insurance Group and its affiliates, or collectively, Fremont. This book of business is now administered by ECIC. The book of business we acquired from Fremont was primarily comprised of accounts in California and, to a lesser extent, in Colorado, Idaho, Montana and Utah.

Because of that transaction, we were able to establish our important relationships and distribution agreements with ADP, Inc. (ADP), and Blue Cross of California, an operating subsidiary of Wellpoint,

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Inc. (Wellpoint). The Fremont transaction also involved the acquisition of certain in force policies that were written through a fronting facility with Clarendon Insurance Group (Clarendon), and the entry by ECIC into a fronting facility with Clarendon. The fronting facility was placed into run off in the fourth quarter of 2003. For further discussion of the Clarendon fronting facility, see ‘‘—Reinsurance— Clarendon Fronting Facility.’’

In 2003, EICN and ECIC, as well as our wholly-owned subsidiaries Employers Occupational Health, Inc. (EOH), and Elite Insurance Services, Inc. (Elite), began to operate under the Employers Insurance Group trade name. On April 1, 2005, we reorganized into a mutual insurance holding company, EIG Mutual Holding Company, wholly-owned by the policyholders of EICN.

Effective February 5, 2007, we completed an initial public offering (IPO), which occurred in conjunction with our conversion from a mutual insurance holding company owned by our policyholder members to a Nevada stock corporation owned by our public stockholders and changed our name to ‘‘Employers Holdings, Inc.’’ and all of the membership interests in EIG were extinguished. In exchange, eligible members of EIG received shares of our common stock or cash.

Results

We had net premiums written of $338.6 million and $387.2 million, total revenues of $429.9 million and $520.3 million and net income of $120.3 million and $171.6 million for the years ended December 31, 2007 and 2006, respectively. Our combined ratio on a statutory basis was 83.6% for the year ended December 31, 2007 (elsewhere in this report, unless otherwise stated, the term ‘‘combined ratio’’ refers to a calculation based on U.S. generally accepted accounting principles (GAAP). Our average combined ratio on a statutory basis for the five years ended December 31, 2006 was 91.6%. This ratio was lower than the industry composite combined ratio calculated by A.M. Best for U.S. insurance companies having more than 50% of their premiums generated by workers’ compensation insurance products. The industry combined ratio on a statutory basis for these companies was 102.5% during the same five years. Companies with lower combined ratios than their peers generally experience greater profitability. We had total assets of $3.2 billion at December 31, 2007.

Our Strategies

Since commencing operations in Nevada in 2000, we have expanded our operations to California, were able to establish important strategic distribution relationships with ADP, Wellpoint, E-chx, Inc. (E-chx) and Intego Insurance Services, LLC (Intego), entered nine other states, obtained licenses in six additional new states, and entered into a definitive agreement to purchase all of the outstanding common stock of AmCOMP Incorporated (AmCOMP).

The planned acquisition of AmCOMP, announced on January 10, 2008, will provide an enhanced opportunity to pursue our second through fourth strategic goals and achieving our vision of being a leader in the property and casualty insurance industry specializing in workers’ compensation.

We also plan to continue to pursue profitable growth by executing upon the following strategies:

Maintain Focus on Underwriting Profitability

We are committed to disciplined underwriting, and will continue this approach in pursuing profitable growth opportunities. We will carefully monitor market trends to assess new business opportunities, only pursuing opportunities that we expect to meet our pricing and risk standards. We will seek to underwrite our portfolio of low to

medium hazard risks with a view toward maintaining long-term underwriting profitability across market cycles.

Continue to Grow in Our Existing Markets

We plan to continue to seek profitable growth in our existing markets by addressing the workers' compensation insurance needs of small businesses, which we believe represent a large and profitable market segment and by entering additional strategic distribution agreements such as our agreement with E-chx.

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In October 2007, we announced a new strategic partnership with Intego, a distributor of payroll and insurance products including workers' compensation insurance. This new, non-exclusive partnership will allow us to offer our workers' compensation products with a billing that is integrated with Intego's payroll products for small businesses in Texas, Florida and Illinois. We expect to start writing business through Intego in late first quarter 2008.

In the states in which we operate, the workers' compensation market for small businesses is not highly concentrated, with a significant portion of premiums being written by numerous insurance companies with small individual market shares. We believe that our focus on workers' compensation insurance, our disciplined underwriting and risk selection, and our loss control and claims management expertise for small businesses position us to profitably increase our market share in our existing markets.

Enter New Markets Through Our Existing Distribution Relationships

We intend to evaluate entry into new markets, taking into account the adequacy of premium rates, market dynamics, the labor market, political and economic conditions and the regulatory environment. Our strategic distribution partnerships with ADP and Wellpoint have allowed us to access new customers and to write attractive business in an efficient manner. For example, we entered Illinois in the fourth quarter of 2006 and entered Florida and Oregon in 2007 primarily due to our existing strategic relationships. We are actively pursuing other strategic partnership opportunities. Additionally, we will seek to leverage our existing independent agent and broker relationships to enter new states.

Capitalize on the Flexibility of Our New Corporate Structure

We believe that our conversion to a publicly traded stock corporation gives us enhanced financial and strategic flexibility. This allows us to consider opportunistic acquisitions such as AmCOMP, joint ventures and other strategic transactions, as well as new product offerings that make strategic sense for our business while achieving our goal of profitable growth.

Maintain Capital Strength

We intend to manage our capital prudently relative to our overall risk exposure, establishing adequate loss reserves to protect against future adverse developments while seeking to grow profits and long-term stockholder value, maintain our financial strength, fund growth and invest in our infrastructure or return capital to stockholders, which may include stock repurchases. We will target an optimal level of overall leverage to support our underwriting activities and are committed to maintaining our financial strength and ratings over the long term.

Leverage Infrastructure, Technology and Systems

We will continue to invest in scalable, cost-effective infrastructure and systems. In 2006, we introduced a new automated underwriting system, EACCESS®, which over time will replace two legacy underwriting systems, DCO/UWS and Tropics. DCO/UWS and Tropics are still used for policy administration, however, these systems are no longer used for new or renewal business. These legacy systems will be phased out in 2010. AIMS is currently used for policy administration of the business generated by one of our strategic distribution partners. We anticipate that EACCESS will, over time, reduce transaction costs and support future profitable growth. In the third quarter of 2008, we expect to implement a new claims system, EPIC, designed to enhance our ability to support best-in-class claims processing.

Industry

Workers' compensation is a statutory system under which an employer is required to provide coverage for its employees' medical, disability, vocational rehabilitation and death benefit costs for work-related injuries or illnesses. Most businesses comply with this requirement by purchasing workers' compensation insurance. The principal concept underlying workers' compensation laws is that an employee injured in the course of his or her employment has only the legal remedies available under

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workers' compensation laws and does not have any other recourse against his or her employer. Generally, workers are covered for injuries that occur within the course and scope of their employment. An employer's obligation to pay workers' compensation benefits does not depend on any negligence or wrongdoing on the part of the employer and exists even for injuries that result from the negligence or wrongdoings of another person, including the employee. The level of benefits varies by state, the nature and severity of the injury or disease and the wages of the injured worker.

Workers' compensation insurance policies generally provide that the insurance company will pay all benefits that the insured employer may become obligated to pay under applicable workers' compensation laws. Each state has a statutory, regulatory and adjudicatory system that sets the amount of wage replacement to be paid, determines the level of medical care required to be provided, establishes the degree of permanent impairment and specifies the options in selecting healthcare providers. These state laws generally require two types of benefits for injured employees: (a) medical benefits, which include expenses related to diagnosis and treatment of an injury and/or disease, as well as any required rehabilitation; and (b) indemnity payments, which consist of temporary wage replacement, permanent disability payments and death benefits to surviving family members. To fulfill these mandated financial obligations, virtually all businesses are required to purchase workers' compensation insurance or, if permitted by state law or approved by the U.S. Department of Labor, to self-insure. The businesses may purchase workers' compensation insurance from a private insurance company such as EICN or ECIC, a state-sanctioned assigned risk pool, a state agency, a self-insurance fund (an entity that allows businesses to obtain workers' compensation coverage on a pooled basis, typically subjecting each employer to joint and several liability for the entire fund) or, may self insure, thereby retaining all risk.

Workers' compensation was the fourth largest property and casualty insurance line in the U.S. in 2006, on a net written premium basis, according to the National Council on Compensation Insurance (NCCI). According to NCCI, net premiums written in 2006 for the workers' compensation industry (excluding governmental writers) were approximately $38.6 billion, or 8.7% of the estimated $443.8 billion in net premiums written for the property and casualty insurance industry as a whole. Our direct premiums written in 2006 were $392.7 million or 1.0% of the non-governmental workers' compensation industry market share. This makes us the eighteenth largest non-governmental workers' compensation writer in the United States as reported by A.M. Best.

Premium volume in the workers' compensation industry was up 2.2% in 2006 compared to 2005, while the entire property and casualty industry experienced a 4.3% increase in net premium written for the same time period, according to the NCCI.

The workers' compensation insurance industry has classified risks into seven hazard groups based on severity, with businesses in the first or lowest group having the lowest cost claims. Insureds in the first and second lowest hazard groups include restaurants, stores and educational institutions. Insureds in the third and fourth lowest hazard group include physician offices, dentist offices and clothing manufacturers, machine shops, automobile and automobile service or repair centers and drivers.

Industry Developments

In 2007, the workers' compensation sector continued to see medical and indemnity claims costs rise and claim frequency decline. We believe the current environment to be characterized by decreased, but still profitable, operating margins caused primarily by a combination of decreasing premiums, which recognize some claim cost improvements due to beneficial benefit reforms, increased price competition, and in some markets, deteriorating economic conditions evidenced by decreases in employment. The period is also characterized by market concerns over subprime investments and financial guarantors credit risk. We believe these market conditions, while challenging, are still

favorable to us.

Competition and Market Conditions

The market for workers' compensation insurance policies is highly competitive and to some extent, influenced by general economic conditions. Our competitors include, but are not limited to, other specialty workers' compensation carriers, state agencies, multi-line insurance companies, professional

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employer organizations, third-party administrators, self-insurance funds and state insurance pools. Many of our existing and potential competitors are significantly larger and possess considerably greater financial and other resources than we do. Consequently, they can offer a broader range of products, provide their services nationwide, and/or capitalize on lower expense to offer more competitive pricing. In Nevada, our three largest competitors are American International Group, Inc., Nevada Contractors Group and Liberty Mutual Insurance Companies. In California, our three largest competitors are the California State Compensation Insurance Fund, Berkshire Hathaway Insurance Group, and American International Group, Inc.

Competition in the workers' compensation insurance industry is based on many factors, including:

- pricing (either through premium rates or participating dividends);
- level of service;
- insurance ratings;
- capitalization levels;
- quality of care management services;
- the ability to reduce loss ratios;
- effective loss prevention; and
- the ability to reduce claims expense.

Our A.M. Best Company rating of ''A–'' (Excellent), allows us to compete for our target customers, select small businesses engaged in low to medium hazard industries. In addition, we believe our competitive advantages include our strong reputation in the markets in which we operate, excellent claims service, experienced and professional independent agents and brokers, and our strategic partner relationships. We also strive to maintain the quality of our care management services, and to provide consultation services to clients to educate on loss prevention and loss reduction strategies. Where indicated and as appropriate, we also compete on price based on our actuarial analysis of current and anticipated loss cost trends. We have observed increasing price competition as the property and casualty insurance industry strives to utilize capital attributable to recent periods of profitability.

California Market

California is the largest workers' compensation insurance market in the United States. In 2006, California accounted for an estimated $11.2 billion in direct premiums written according to the 2007 Best's State/Line Report for property casualty lines of business, or approximately 20.7% of the entire U.S. workers' compensation market. Our direct premiums written in 2006 were $288.5 million or 3.8% of the non-governmental workers' compensation market share in California. This makes us the eighth largest non-governmental writer of workers' compensation in California, as reported by A.M. Best.

California is our largest market and can be characterized as increasingly competitive, as private carriers continue to position for increased market share and to offset revenue declines attributable to rate decreases. While we continue to see an increase in new business submittals, our success at converting these submittals to written premium is not as great as it has been in previous periods.

California has recently been through a cycle of substantial rate increases, followed by equally substantial rate decreases. Regulatory changes in the early 1990's created intense price competition in the workers' compensation business from about 1995 to 1999 during which overall profitability seriously declined. By 2002, rates in California had increased significantly, driven by an expensive benefit delivery system, claims which resulted in higher than normal litigation and a lack of insurance capital within the state. Since 2002, three key pieces of workers' compensation legislation were enacted which reformed medical determinations of injuries or illness, established medical fee schedules, allowed for the use of medical provider panels, modified benefit levels, changed the proof needed to file claims, and reformed many additional areas of the workers' compensation benefits and delivery system. Workers' compensation insurers in California responded to these reforms by reducing their rates.

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Despite subsequent rate decreases from 2004 through 2007, we believe that California remains a profitable operating environment. These reductions in rates in California were in response to the legislative reforms of 2003 and 2004, which have reduced claim costs. According to the Workers' Compensation Insurance Rating Bureau (WCIRB), total estimated ultimate losses in California were down to $6.1 billion in accident year 2006 compared to $12.2 billion in 2002, a reduction of 50%. Indemnity claim frequency was down 36% during that same time period. We believe that the impact of reforms will continue to result in loss costs that are supportable by current rate levels.

Nevada Market

In 2006, Nevada accounted for an estimated $513.3 million in direct premiums written according to the 2007 Best's State/Line Report for property casualty lines of business, or 1.3% of the workers' compensation industry (excluding governmental writers). Our direct premiums written were $76.0 million or 14.8% of Nevada's market share in 2007. This makes us the second largest writer of workers' compensation insurance in Nevada as reported by A.M. Best. There are no governmental writers of workers' compensation insurance in Nevada.

The Nevada workers' compensation insurance market has changed dramatically over the past decade. A fully competitive, private market is a relatively recent phenomenon in Nevada. From 1913 until July 1999, the workers' compensation market was served by a monopolistic state fund. In July of 1999, the Nevada workers' compensation insurance market was opened to competition by private carriers, and the state fund was privatized in January of 2000.

Nevada has adopted a ''loss cost'' rate regulation system, under which insurance companies are permitted to file deviations upwards or downwards from the benchmark rates set by the Insurance Commissioner. As a result, the primary way in which private carriers compete with one another is based on expense differentiation and dividends. In 2007, we saw indications that the self insurance market was attracting increasing numbers of employers from the private carrier market.

In 2007, Nevada's economy was also impacted by the subprime crisis and its impact on the residential real estate market. The subprime mortgage crisis was created by a sharp rise in home foreclosures that started in the United States in late 2006 as high default rates materialized on subprime and other adjustable rate mortgages (ARMs) made to higher-risk borrowers. Thirteen percent of our business as of December 31, 2007, was in contracting classes and, due to the economic slowdown, payrolls of some of our insureds have decreased primarily in the fourth quarter.

Other Markets

Rate reductions or increases have been proposed in other states in which we operate. Overall, we expect to see declining total premiums in 2008, with policy count growth reducing, but not offsetting, the decline in total premiums written. It is uncertain how these trends in our markets will impact our future financial position and results of operations.

Customers

Our target customers are select small businesses engaged in low to medium hazard industries. The workers' compensation insurance industry classifies risks into seven hazard groups based on severity of claims, with businesses in the first, or lowest, hazard group having the most predictable and least costly claims and those in the seventh, or highest, hazard group having the least predictable and most costly claims. All references to hazard groups are to the seven hazard groups as defined by the NCCI. Our historical loss experience has been more favorable for lower hazard groups than for higher hazard groups. Further, we believe it is generally more costly to service and manage the risks

associated with higher hazard groups, thereby comparatively reducing the profit margin derived from underwriting business in higher hazard groups. By targeting lower hazard groups, we believe that we improve our ability to generate profitable underwriting results. In 2007, 83.3% of our base direct premiums written were generated by insureds in the four lowest industry defined hazard groups. This is consistent with our strategy to target insureds in low to medium hazard businesses. Insureds in the first and second lowest

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hazard groups include restaurants, stores and educational institutions. Insureds in the third and fourth lowest hazard groups include physician offices, dentist offices, clothing manufacturers, machine shops, automobile and automobile service or repair centers and drivers. Within each hazard group, our underwriters use their local market expertise and disciplined underwriting to select specific types of businesses and risks that allow us to generate attractive returns. We underwrite these businesses and risks on an individual basis, as opposed to following an occupational class-based underwriting approach. For example, while we insure many physician offices, our underwriting guidelines do not allow us to insure offices that we believe have a higher risk profile, such as psychiatrist offices and drug treatment centers. In addition, our underwriters are selective in markets where our knowledge and approach allows us to realize attractive returns.

The following table sets forth our base direct premiums written by type of insured for our top ten types of insureds and as a percentage of our total base direct premiums written for the year ended December 31, 2007:

Type of Employer	Hazard Group Level	Base Direct Premiums Written	Percentage of Total
(in thousands, except percentages)			
Restaurants	A	$ 22,292	6.4 %
Physicians and physician office clerical	C	20,402	5.8
Store: Wholesale not otherwise classified	B	16,917	4.8
Store: Retail not otherwise classified	B	10,411	3.0
College: Professional employees and clerical	B	9,114	2.6
Clothing manufacturers	C	8,349	2.4
Clerical Office Employees	C	8,166	2.3
Machine shops not otherwise classified	D	7,558	2.2
Automobile service or repair center and drivers	D	6,183	1.8
Dentists and dental surgeons-all employees including clerical	C	6,142	1.8
Total		$ 115,534	33.1 %

The following table sets forth our base direct premiums written by hazard group and as a percentage of our total base direct premiums written for the applicable year ended December 31:

Hazard Group	2007	Percentage of 2007 Total	2006	Percentage of 2006 Total
(in thousands, except percentages)				
A	$ 35,739	10.3 %	$ 41,409	10.6 %
B	83,875	24.1 %	91,344	23.4 %
C	125,805	36.1 %	138,768	35.6 %
D	44,667	12.8 %	48,596	12.4 %
E	34,498	9.9 %	39,129	10.0 %
F	22,803	6.5 %	29,344	7.5 %
G	1,208	0.3 %	1,754	0.5 %
Total	$ 348,595	100.0 %	$ 390,344	100.0 %

In 2007, our insureds had average annual premiums of approximately $10,275. We are not dependent on any single employer or type of employer and the loss of any single employer or type of employer would not have a material adverse effect on our business.

We currently write policies for insureds located primarily in the western United States, with a concentration in California and Nevada. In 2007, we generated 71.7% and 17.4% of our direct premiums written in California and Nevada, respectively. In addition, we write business in nine other states (Arizona, Colorado, Florida, Idaho, Illinois, Montana, Oregon, Texas and Utah) and are licensed to write business in six additional states (Georgia, Maryland,

Massachusetts, New Mexico, New York, and Pennsylvania).

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The following table sets forth our direct premiums written by state and as a percentage of total direct premiums written for the last three years ended December 31:

States	2007	Percentage of 2007 Total	2006	Percentage of 2006 Total	2005	Percentage of 2005 Total
(in thousands, except percentages)						
California	$ 248,211	71.7 %	$ 288,529	73.5 %	$ 350,039	77.7 %
Nevada	60,257	17.4	76,016	19.4	82,428	18.3
Colorado	12,639	3.6	13,466	3.4	11,093	2.5
Utah	7,912	2.3	7,164	1.8	4,681	1.0
Idaho	6,755	1.9	3,849	1.0	1,263	0.3
Montana	4,901	1.4	3,141	0.8	1,236	0.2
Arizona	2,637	0.8	189	—	—	—
Texas	1,376	0.4	322	0.1	—	—
Illinois	1,276	0.4	—	—	—	—
Other	310	0.1	—	—	—	—
Total	$ 346,274	100.0 %	$ 392,676	100.0 %	$ 450,740	100.0 %

We commenced writing business in Illinois in the fourth quarter of 2006 and in Florida and Oregon in 2007. We believe there are significant opportunities for growth in additional markets We are optimistic that we will be able to enter the workers' compensation insurance market successfully in other states and to increase our writings in our existing states if we so choose.

The number of policies in force, at the specified dates, was as follows:

December 31, States	2007	2006	2005
California	24,986	21,359	19,207
Nevada	6,147	6,523	6,943
Other	2,566	1,860	1,536
Total	33,699	29,742	27,686

At December 31, 2007, we experienced an increase of 3,957, or 13.3%, in the total number of policies in force over December 31, 2006. In California, we experienced an increase of 3,627, or 17.0%, in the total policies in force over December 2006. Also, for states other than California and Nevada in which we operate, we experienced an increase of 706 or 38.0% in the total policies in force over December 2006. This policy growth was insufficient to offset the decline in premiums written we have experienced in California principally due to declining rate levels. In Nevada, we experienced a decline of 376 or 5.8% in the number of policies in force. The decline in the number of policies in force in Nevada in 2007 was the result of adherence to our underwriting guidelines, which are designed to minimize the underwriting of classes of business that do not meet our target risk profiles, and due to competitive pressures.

Marketing and Distribution

We market and sell our workers' compensation insurance products through independent local, regional and national agents and brokers, and through our strategic distribution partners, including our principal partners ADP and Wellpoint. Policies underwritten directly or through our independent agents and brokers generated $242.3 million and $267.1 million, or 69.5% and 68.4%, of our base direct premiums written for the years ended December 31, 2007 and 2006, respectively. Policies underwritten through our strategic relationships generated $99.5 million, and $114.9 million, or 28.5%, and 29.4% of our base direct premiums written for the years ended December 31, 2007 and 2006.

Independent Insurance Agents and Brokers

We have established long-standing, strong relationships with independent local, regional and national agents and brokers by emphasizing personal interaction, offering responsive service and competitive

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commissions and maintaining a focus on workers' compensation insurance. We use these long-standing relationships to identify new business opportunities. Our sales representatives and field underwriters continue to work closely with independent agents and brokers to market and underwrite our business, regularly visit their offices and participate in presentations to customers, which results in enhanced understanding of the businesses and risks we underwrite and the needs of prospective customers.

As of December 31, 2007, we marketed and sold our insurance products through approximately 3,000 independent insurance agents and brokers in approximately 950 appointed agencies. Those agents and brokers produced $242.3 million, $267.1 million and $324.2 million of base direct premiums written for the years ended December 31, 2007, 2006 and 2005, respectively. We pay commissions which we believe are competitive with other workers' compensation insurers and we also believe that we deliver prompt, efficient and professional support services. We generally pay 10.0% to 12.5% commission on new and renewal business.

No single independent agent or broker representing us accounted for more than 2.1%, 2.8% and 2.0% of base direct premium written in 2007, 2006 and 2005, respectively.

Our marketing efforts directed at agents and brokers are implemented by our field sales marketing representatives and underwriters. We establish and maintain long-term relationships with independent agents and brokers that will actively market our products and services as well as provide quality application flow from prospective policyholders that are reasonably likely to accept our quotes. We believe that the decision by agents and brokers to place business with an insurer depends in part upon the quality of services offered by the insurer to the agents and brokers and policyholders, as well as the insurer's expertise and dedication to a particular line of business. Accordingly, we have sought to enhance the ease of doing business with us and to provide superior service. For example, our recently introduced automated underwriting system, EACCESS®, enables agents and brokers to directly input data and the system then prices the risk and binds the coverage without human intervention. We do not delegate underwriting authority to agents or brokers that sell our insurance.

Strategic Distribution Partners

To expand our distribution, we have developed important strategic distribution relationships with companies that have established sales forces and common markets. Since 2002, we have jointly marketed our workers' compensation insurance products with ADP's payroll services primarily to small businesses in California, Colorado, Florida, Idaho, Texas, and Utah and with Wellpoint's group health insurance plans in California. Additionally, we have entered into additional strategic partnerships with E-chx in California and Intego in Florida, Illinois and Texas. We are actively pursuing other strategic partnership opportunities.

We do not delegate underwriting authority to our strategic distribution partners. Our field underwriters continue to work closely with our partners to market and underwrite our business, regularly visiting their offices and participating in presentations to customers.

Wellpoint. The Wellpoint Integrated MedicompSM joint marketing program includes two agreements, a small group health insurance plan (for businesses with 1 to 50 employees) and a large group health insurance plan (for businesses with 51 to 250 employees). The large group health insurance plan was effective July 1, 2006. These two group health insurance plans are offered with our standard workers' compensation insurance policy. This exclusive relationship allows us, to distribute an integrated group health/workers' compensation product in California through Wellpoint's life and health agents. During the years ended December 31, 2007 and 2006, we wrote approximately $58.8 million and $70.9 million, respectively, in base direct premiums through the Integrated MediComp program. The primary benefit

to the employer is a single bill for their group health and workers' compensation insurance coverages and a discount on workers' compensation premiums. We believe that, in general, when businesses purchase this combination of coverages, their employees make fewer workers' compensation claims because those employees are insured for non-work related illnesses or injuries and thus are less likely to seek treatment for a non-work related illness or injury through their employers' workers' compensation insurance policy. We believe another key benefit to this program is the increased satisfaction from employees who are able to use the same medical network for occupational and non-occupational illness and injury. As the largest

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group health carrier in California, Wellpoint has negotiated favorable rates with its medical providers and associated facilities, which we benefit from through reduced claims costs.

We pay Wellpoint fees which are a percentage of premiums paid for services provided under the Integrated MediComp program.

Although our distribution agreements with Wellpoint are exclusive, Wellpoint may terminate its agreements with us if we are not able to provide coverage through a carrier with an A.M. Best financial strength rating of ''B++'' or better. Wellpoint may also terminate its agreements with us without cause after giving us 60 days notice. The small group and large group agreements are for initial two-year periods running through January 1, 2008 and July 1, 2008, respectively. Thereafter, they automatically renew for subsequent one-year periods unless terminated by either party with at least 60 days notice prior to the expiration of the current term. The small group agreement has automatically renewed through January 1, 2009 as of the date of this filing.

ADP. ADP is a payroll services company which provides services to small and medium-sized businesses, and is the largest payroll service provider in the United States with over 450,000 clients. As part of its services, ADP sells our workers' compensation insurance product along with its payroll and accounting service through ADP's insurance agency and field sales staff primarily to small businesses in six states (California, Colorado, Florida, Idaho, Texas, and Utah). During the years ended December 31, 2007 and 2006, we wrote approximately $40.4 million and $44.0 million, respectively, in base direct premiums written through ADP. We pay ADP fees which are a percentage of premiums for services provided to us by ADP.

Within the ADP insurance agency, there are two group programs: accounts with 1 to 50 employees, known as the small business unit, and accounts with 51 to 100 employees, known as the major account unit. The majority of business we write is written through ADP's small business unit.

ADP utilizes innovative methods to market workers' compensation insurance including the Pay-by-Pay® (PBP) program. An advantage of ADP's PBP program is that the policyholder is not required to pay a deposit at the inception of the policy. Rather, the workers' compensation premium is deducted each time ADP runs the policyholder's payroll along with their appropriate federal, state, and local taxes. These characteristics of the PBP program enable us to competitively price the workers' compensation insurance written as a part of that program.

Although we do not have an exclusive relationship with ADP, we believe we are a key strategic distribution partner of ADP for our selected markets and classes of business. Nevertheless, there are some classes of business that ADP provides payroll services for that do not fall within our underwriting criteria. If the risk does not fit our underwriting criteria, ADP may submit that risk to another insurer. Our agreement with ADP may be terminated without cause upon 120 days notice.

E-chx. We entered into a joint sales, services and program administration agreement with E-chx and Granite Professional Insurance Brokerage, Inc. in November 2006, pursuant to which E-chx, a payroll solutions company providing payroll outsourcing solutions for small businesses, markets our workers' compensation insurance product with its payroll services. The program is only available in California and generated $0.2 million in base direct premiums written in 2007. Although we do not have an exclusive relationship with E-chx, we are its only strategic partner in California. E-chx offers products and services in all 50 states. For its services, we pay E-chx fees which are a percentage of premiums paid through the program.

E-chx offers an E-PAYSM program. Policies sold through this program do not require the policyholder to pay a deposit at the inception of the policy, unlike a traditional workers' compensation insurance policy. In addition, the workers' compensation premium is deducted each time E-chx runs the policyholder's payroll along with their appropriate federal, state, and local taxes. We believe that these characteristics of the E-PAY program allow us to competitively price the workers' compensation insurance written as a part of that program.

The agreement with E-chx is for an initial two-year period running through November 2008 and is automatically renewable for subsequent two-year periods. E-chx may terminate the agreement without cause upon 90 days written notice.

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Intego. On October 25, 2007, we entered into a Partner Program and Agency Agreement with Intego, a full service insurance brokerage that works with approved, independent payroll service companies to identify potential business leads. Pursuant to this agreement, Intego will market our workers' compensation insurance product in Texas, Florida and Illinois to business customers of the independent payroll service companies with a billing that is integrated with their payroll products.

Our agreement with Intego is not exclusive, and Intego may terminate the agreement without cause upon 90 days written notice. The agreement is for an initial one-year period and is automatically renewable for subsequent one-year periods.

Direct Business

We write a small amount of business that comes to us directly without using an agent or broker or one of our strategic distribution partners. This direct business is a legacy of our assumption of the assets and liabilities of the Fund. Although we do not market any direct business, we intend to maintain this book of business because it is very well known by our underwriters and profitable. In the years ended December 31, 2007 and 2006, we wrote approximately $6.8 million and $8.3 million, respectively, in base direct premiums written attributable to this direct business.

Underwriting and Product

Disciplined Underwriting

We target select small businesses engaged in low to medium hazard industries. We employ a disciplined, conservative underwriting approach designed to individually select specific types of businesses, predominantly those in the four lowest of the seven workers' compensation insurance industry hazard groups, that we believe will have fewer and less costly claims relative to other businesses in the same hazard groups.

Our underwriting guidelines are designed to minimize underwriting of classes and subclasses of business which have historically demonstrated claims severity that do not meet our target risk profiles. We price our policies based on the specific risks associated with each potential insured rather than solely on the industry class in which a potential insured is classified. In 2007, policyholders in the four lowest industry defined hazard groups generated approximately 83.3% of our base direct premiums written. This is consistent with our strategy of targeting insureds in low to medium hazard businesses. Our statutory losses and loss adjustment expense (LAE) ratio, a measure which relates inversely to our underwriting profitability, was 46.5% and 38.0% in 2007 and 2006 respectively, 25.8 and 34.3 percentage points below the 2006 statutory industry composite losses and LAE ratio calculated by A.M. Best for U.S. insurance companies having more than 50% of their premiums generated by workers' compensation insurance products. Our statutory losses and LAE ratio was at least ten percentage points below the A.M. Best composite losses and LAE ratio for the industry for each of the five years ended December 31, 2006. Our disciplined underwriting approach is a critical element of our culture and has allowed us to offer competitive prices, diversify our risks and achieve profitable growth.

We provide workers' compensation insurance coverage to several homogeneous groups of business such as physicians, dentists, restaurants and retail stores. We review the premium, payroll, and loss history trends of each group annually and develop a schedule rating modification that is applied to all policyholders that meet the qualification standards for a given group. Qualification standards vary between groups and may include factors such as management experience, loss experience, and nature of operations conducted by the insured and/or other exposures specific to the class of business. Each insured's experience modification is also applied in the determination of their premium.

Our underwriting strategy involves continuing our disciplined underwriting approach in pursuing profitable growth opportunities. We carefully monitor market trends to assess new business opportunities, only pursuing opportunities that we expect to meet our pricing and risk standards. We seek to underwrite our portfolio of low to medium hazard risks with a view toward maintaining long term underwriting profitability across market cycles.

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We execute our underwriting processes through automated systems and through seasoned underwriters with specific knowledge of local markets. Within these systems, we have developed underwriting templates for specific, targeted classes of business that produce faster quotations when all underwriting criteria are met by a specific risk. These underwriting guidelines consider many factors such as type of business, nature of operations, risk exposures and other employer-specific conditions, and are designed to minimize underwriting of certain classes and subclasses of business such as chemical manufacturing, high-rise construction and long-haul trucking, which have historically demonstrated claims severity that do not meet our target risk profiles. Our systems price our policies based on the specific risks associated with each potential insured rather than solely on the industry class in which such potential insured is classified.

While our underwriting systems are automated, we do not delegate underwriting authority to agents or brokers that sell our insurance or to any other third party. To create efficiency and standardization, on July 1, 2006, we implemented a new underwriting and policy administration system, EACCESS®. As a result, three of our legacy underwriting systems are currently being phased out. Our field underwriters continue to work closely with independent agents, brokers and our strategic distribution partners to market and underwrite our business, regularly visiting their offices and participating in presentations to customers.

Our underwriting guidelines are defined centrally by our Corporate Underwriting Department. The average length of underwriting experience of our current underwriting professionals exceeds ten years. Our chief underwriting officer, who is responsible for supervision of the underwriting conducted at all of the business units, has the authority to permit a business unit to underwrite particular risks that fall outside the classes of business specified in our underwriting guidelines on a case-by-case basis. Also, our chief underwriting officer directly oversees the writing of business in the case of certain of our larger customers.

Loss Control

Our loss control professionals assist our underwriting personnel in evaluating potential and current policyholders and are an important part of our loss control strategy. The purpose of our loss control group is to provide consultation to policyholders to aid them in preventing losses before they occur and in containing costs once claims occur.

Premium Audits

We conduct premium audits on all of our voluntary business policyholders annually, upon the expiration of each policy, including when the policy is renewed. The purpose of these audits is to comply with applicable state and reporting bureau requirements and to verify that policyholders have accurately reported their payroll expenses and employee job classifications, and therefore have been invoiced the premium required under the terms of their policies. In addition to annual audits, we selectively perform interim audits on certain classes of business if significant or unusual claims are filed or concerns are raised regarding projected annual payrolls which could result in substantial variances at final audit. Prior final audit results, as available, are considered when pricing policy renewals.

Principal Products and Pricing

Our workers' compensation insurance product is written primarily on a guaranteed cost basis, meaning the premium for a policyholder is set in advance and varies based only upon changes in the policyholder's class and payroll. Class and specific risk credits are formulated to fit the needs of targeted classes and employer groups.

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The premiums we charge are established when coverage is bound. Premiums are based on the particular class of business and our estimates of expected losses, LAE and other expenses related to the policies we underwrite. Generally, premiums for workers' compensation insurance policies are a function of:

- the amount of the insured employer's payroll;
- the applicable premium rate, which varies with the nature of the employees' duties and the business of the insured;
- the insured's industry classification; and
- factors reflecting the insured employer's historical loss experience.

In addition, our pricing decisions take into account the workers' compensation insurance regulatory regime of each state in which we conduct operations, because such regimes address the rates that industry participants in that state may or should charge for policies. In approximately sixteen states, including Florida and Idaho, workers' compensation insurance rates are set by the state insurance regulators and are adjusted periodically. This style of rate regulation is sometimes referred to as ''administered pricing.'' In some of these states, insurance companies are permitted to file rates that deviate upwards or downwards from the benchmark rates set by the insurance regulators. In the vast majority of states, workers' compensation insurers have more flexibility to offer rates that reflect the risk the insurer is taking based on each employer's profile. These states are often referred to as ''loss cost'' states. Except for Florida and Idaho, all of the states in which we currently operate, including California and Nevada, are ''loss cost'' states.

In ''loss cost'' states, the state first approves a set of loss costs that provide for expected loss and, in most cases, LAE payments, which are prepared by an insurance rating bureau (for example, the WCIRB in California and the NCCI in Nevada). An insurer then selects a factor, known as a loss cost multiplier, to apply to loss costs to determine its insurance rates. In these states, regulators permit pricing flexibility primarily through: (a) the selection of the loss cost multiplier; and (b) schedule rating modifications that allow an insurer to adjust premiums upwards or downwards for specific risk characteristics of the policyholder such as:

- type of work conducted at the premises or work environment;
- on-site medical facilities;
- level of employee safety;
- use of safety equipment; and
- policyholder management practices.

In all of the loss cost states in which we currently operate, we use both variables (i.e., both (a) and (b) above) to calculate a policy premium that we believe will cover the claim payments, losses and LAE, and company overhead and result in a reasonable profit for us.

State legislative actions relating to the benefits payable to injured workers can affect the premium rates that we charge for our insurance products. For example, during the period September 2003 to December 31, 2007, we have reduced our rates by 62.3% in California, in response to cost savings realized from the 2003 and 2004 legislative reforms, such

as new controls on medical costs and changes in the state's permanent disability compensation formula. Although the California Insurance Commissioner (California Commissioner) does not set premium rates, he adopts and publishes advisory ''pure premium'' rates, which are rates that would cover expected losses and LAE but do not contain an element to cover operating expenses or profit. Our California rates continue to be based upon our actuarial analysis of current and anticipated cost trends.

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Claims and Medical Case Management

Our claims operations consists of five units that provide regional coverage and claims support. These units are located in Henderson, Nevada; Newbury Park, Glendale and San Francisco, California; Denver, Colorado and Boise, Idaho. The role of our claims units is to actively investigate, evaluate and pay claims efficiently, and to aid injured workers in returning to work in accordance with applicable laws and regulations. We have implemented rigorous claims guidelines, reporting and control procedures in our claims units. We also provide medical case management services for all claims that we determine will benefit from such involvement.

Our claims department also provides claims management services for those claims incurred by the Fund and assumed by our Nevada insurance subsidiary in connection with the LPT Agreement with a date of injury prior to July 1, 1995. We receive a fee from the third party reinsurers equal to 7% of the loss payments on these claims.

In Nevada, we have created our own medical provider network, and we make every appropriate effort to direct injured workers into this network. In the other states in which we do business, we utilize networks affiliated with WellPoint and Coventry Health Care, Inc., formerly Concentra Operating Corporation. In addition to our medical networks, we work closely with local vendors, including attorneys, medical professionals and investigators, to bring local expertise to our reported claims. We pay special attention to reducing costs in each region and have established discounting arrangements with the aforementioned service providers. We use preferred provider organizations, bill review services and utilization management to closely monitor medical costs and to verify that providers charge no more than the applicable fee schedule, or in some cases what is usual and customary.

We actively pursue subrogation and recovery in an effort to mitigate claims costs. Subrogation rights are based upon state and federal laws, as well as the insurance policy issued to the insured. Our subrogation efforts are handled through our subrogation department.

Losses and Loss Adjustment Expense Reserves

We are directly liable for losses and LAE under the terms of insurance policies our insurance subsidiaries underwrite. Significant periods of time can elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of that loss. Loss reserves are reflected in our balance sheets under the line item caption ‘‘unpaid losses and loss adjustment expenses.’’ As of December 31, 2007, our reserve for unpaid losses and LAE, net of reinsurance, was $1.2 billion. The process of estimating reserves involves a considerable degree of judgment by management and, as of any given date, is inherently uncertain. For a detailed description of our reserves, the judgments, key assumptions and actuarial methodologies that we use to estimate our reserves and the role of our consulting actuary, see ‘‘Item 7—Management’s Discussion and Analysis of Financial Condition and Results of Operations— Critical Accounting Policies—Reserves for Losses and Loss Adjustment Expenses.’’

The following table provides a reconciliation of the beginning and ending loss reserves on a GAAP basis for the following periods:

December 31,	2007	2006	2005
	(in thousands)		
Unpaid losses and LAE at beginning of period	$ 2,307,755	$ 2,349,981	$ 2,284,542
Less reinsurance recoverables excluding bad debt allowance on unpaid losses	1,098,103	1,141,500	1,194,728
Net unpaid losses and LAE at beginning of period	1,209,652		

1,208,481 1,089,814 Losses and LAE, net of reinsurance, incurred in: Current year 221,347
256,257 333,497 Prior years (60,011) (107,129) (78,053) Total net losses and LAE incurred
161,336 149,128 255,444
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December 31,	2007	2006	2005
(in thousands) Deduct payments for losses and LAE, net of reinsurance related to:			
Current year	44,790	41,098	40,116
Prior years	109,129	106,859	96,661
Total net payments for losses and LAE during the current period	153,919	147,957	136,777
Ending unpaid losses and LAE, net of reinsurance	1,217,069	1,209,652	1,208,481
Reinsurance recoverable excluding bad debt allowance on unpaid losses and LAE	1,052,641	1,098,103	1,141,500
Ending unpaid losses and LAE, gross of reinsurance	$ 2,269,710	$ 2,307,755	$ 2,349,981

Our estimates of incurred losses and LAE attributable to insured events of prior years have decreased for past accident years because actual losses and LAE paid and current projections of unpaid losses and LAE were less than we originally anticipated. We refer to such decreases as favorable developments. The reductions in reserves were $60.0 million, $107.1 million and $78.1 million for the years ended December 31, 2007, 2006 and 2005, respectively. Estimates of net incurred losses and LAE are established by management utilizing actuarial indications based upon our historical and industry experience regarding claim emergence and claim payment patterns, and regarding claim cost trends, adjusted for future anticipated changes in claims-related and economic trends, as well as regulatory and legislative changes, to establish our best estimate of the losses and LAE reserves. The decrease in the prior year reserves was primarily the result of actual paid losses being less than expected, and revised assumptions used in projection of future losses and LAE payments based on more current information about the impact of certain changes, such as legislative changes, which was not available at the time the reserves were originally established. While we have had favorable developments over the past three years, the magnitude of these developments illustrates the inherent uncertainty in our liability for losses and LAE, and we believe that favorable or unfavorable developments of similar magnitude, or greater, could occur in the future. For a detailed description of the major sources of recent favorable developments, see ‘‘Item 7—Management’s Discussion Analysis of Financial Condition and Results of Operations—Critical Accounting Policies—Reserves for Losses and Loss Adjustment Expenses’’ and Note 7 in the Notes to our Consolidated Financial Statements which are included elsewhere in this report.

Our reserve for unpaid losses and loss adjustment expenses (gross and net), as well as our case and IBNR were as follows:

December 31,	2007	2006	2005
(in thousands) Case reserves	$ 740,133	$ 753,102	$ 772,544
IBNR	1,235,124	1,261,521	1,290,029
LAE	294,453	293,132	287,408
Gross unpaid losses and LAE	2,269,710	2,307,755	2,349,981
Reinsurance recoverables on unpaid losses and LAE, gross	1,052,641	1,098,103	1,141,500
Net unpaid losses and LAE	$ 1,217,069	$ 1,209,652	$ 1,208,481

Loss Development

The following tables show changes in the historical loss reserves, on a gross basis and net of reinsurance, for our insurance subsidiaries for the eight years ended December 31, 2007. These tables are presented on a GAAP basis. The paid and reserve data in the following tables is presented on a calendar year basis. We commenced operations as a non-governmental mutual insurance company on January 1, 2000

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when our Nevada insurance subsidiary assumed the assets, liabilities and operations of the Fund. Paid and reserve data for the years 1995 through 1999 has not been included in the following tables because (i) prior to December 31, 1999, the Fund was not required to include reserves related to losses and LAE for claims occurring prior to July 1, 1995 in its annual statutory financial statements filed with the Nevada Division of Insurance (NDOI) (consequently, the financial statements made no provision for such liabilities and complete information in respect of those years is not available in a manner that conforms with the information in this table) and (ii) for claims occurring subsequent to July 1, 1995 and prior to the Company's inception on January 1, 2000, we believe that the loss development pattern was uniquely attributable to Nevada workers' compensation reforms adopted in the early 1990s, which pattern is not indicative of development that would be expected to be repeated in our prospective operations.

The top line of each table shows the net reserves and the gross reserves for unpaid losses and LAE recorded at each year-end. Such amount represents an estimate of unpaid losses and LAE occurring in that year as well as future payments on claims occurring in prior years. The upper portion of these tables (net and gross cumulative amounts paid, respectively) present the cumulative amounts paid during subsequent years on those losses for which reserves were carried as of each specific year. The lower portions (net reserves re-estimated) show the re-estimated amounts of the previously recorded reserve based on experience as of the end of each succeeding year. The re-estimate changes as more information becomes known about the actual losses for which the initial reserve was carried. An adjustment to the carrying value of unpaid losses for a prior year will also be reflected in the adjustments for each subsequent year. For example, an adjustment made in the 2000 year will be reflected in the re-estimated ultimate net loss for each of the years thereafter. The gross cumulative redundancy (deficiency) line represents the cumulative change in estimates since the initial reserve was established. It is equal to the difference between the initial reserve and the latest re-estimated reserve amount. A redundancy means that the original estimate was higher than the current estimate. A deficiency means that the current estimate is higher than the original estimate.

	2000	2001	2002	2003	2004	2005	2006	2007
	(in thousands)							
Net reserves for losses and loss adjustment expenses								
Originally estimated	$ 936,000	$ 887,000	$ 908,326	$ 962,457	$ 1,089,814	$ 1,208,481	$ 1,209,652	$ 1,217,069
Net cumulative amounts paid as of:								
One year later	108,748	81,022	80,946	91,130	96,661	106,859	109,129	
Two years later	161,721	120,616	130,386	150,391	161,252	175,531		
Three years later	191,453	149,701	165,678	193,766	207,868			
Four years later	215,015	173,204	194,400	226,127				
Five years later	235,613	194,980	218,453					
Six years later	255,772	215,507						
Seven years later	275,750							
Net reserves re-estimated as of:								
One year later	896,748	875,522	847,917	924,878	1,011,759	1,101,352	1,149,641	
Two years later	885,221	781,142	805,058	886,711	975,765	1,049,628		
Three years later	800,959	742,272	779,373	884,426	954,660			
Four years later	766,204	719,912	788,262	877,151				
Five years later	743,997	730,112	788,481					
Six years later	754,447	730,456						
Seven years later	754,462							
Net cumulative redundancy:	181,538	156,544	119,845	85,306	135,154	158,853	60,011	0
Gross reserves – December 31	2,326,000	2,226,000	2,212,368	2,193,439	2,284,542	2,349,981	2,307,755	2,269,710
Reinsurance recoverable, gross	1,390,000	1,339,000	1,304,042	1,230,982	1,194,728	1,141,500	1,098,103	1,052,641
Net reserves – December 31	936,000	887,000	908,326	962,457	1,089,814	1,208,481	1,209,652	1,217,069
Gross re-estimated reserves	2,082,287	2,009,480	2,028,211	2,072,428	2,110,481			

2,170,292	2,233,176	2,269,710	Re-estimated reinsurance recoverables			1,327,825	1,279,024
1,239,730	1,195,277	1,155,821	1,120,664	1,083,535	1,052,641		

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	2000	2001	2002	2003	2004	2005	2006	2007
(in thousands) Net re-estimated reserves	$ 754,462	$ 730,456	$ 788,481	$ 877,151	$ 954,660	$ 1,049,628	$ 1,149,641	$ 1,217,069
Gross reserves for losses and adjustment expenses								
Originally estimated	2,326,000	2,226,000	2,212,368	2,193,439	2,284,542	2,349,981	2,307,755	2,269,710
Gross cumulative amounts paid as of:								
One year later	160,978	128,066	128,462	137,968	142,632	152,006	152,879	
Two years later	260,995	215,176	224,740	243,203	252,379	264,430		
Three years later	338,243	291,099	306,006	331,731	342,748			
Four years later	408,643	360,535	379,881	407,845				
Five years later	475,174	427,307	447,687					
Six years later	540,329	490,296						
Seven years later	602,371							
Gross reserves re-estimated as of:								
One year later	2,280,978	2,211,566	2,121,867	2,148,829	2,178,514	2,233,077	2,233,176	
Two years later	2,266,495	2,089,850	2,072,205	2,088,437	2,138,648	2,170,292		
Three years later	2,157,647	2,049,340	2,024,790	2,084,764	2,110,481			
Four years later	2,121,397	2,000,560	2,032,553	2,072,428				
Five years later	2,072,866	2,009,608	2,028,211					
Six years later	2,082,409	2,009,480						
Seven years later	2,082,287							
Gross cumulative redundancy:	$ 243,713	$ 216,520	$ 184,157	$ 121,011	$ 174,061	$ 179,689	$ 74,579	$ 0

Reinsurance

Reinsurance is a transaction between insurance companies in which an original insurer, or ceding company, remits a portion of its premiums to a reinsurer, or assuming company, as payment for the reinsurer assuming a portion of the risk. Reinsurance agreements may be proportional in nature, under which the assuming company shares proportionally in the premiums and losses of the ceding company. This arrangement is known as quota share reinsurance. Reinsurance agreements may also be structured so that the assuming company indemnifies the ceding company against all or a specified portion of losses on underlying insurance policies in excess of a specified amount, which is called an ‘‘attachment level’’ or ‘‘retention’’ in return for a premium, usually determined as a percentage of the ceding company’s primary insurance premiums. This arrangement is known as excess of loss reinsurance. Excess of loss reinsurance may be written in layers, in which a reinsurer or group of reinsurers accepts a band of coverage up to a specified amount. Any liability exceeding the coverage limits of the reinsurance program is retained by the ceding company. The ceding company also bears the credit risk of a reinsurers’ insolvency. In accordance with general industry practices, we purchase excess of loss reinsurance to protect against the impact of large individual, irregularly-occurring losses, and aggregate catastrophic losses from natural perils and terrorism, which would otherwise cause sudden and unpredictable changes in net income and the capital of our insurance subsidiaries.

Reinsurance is used principally:

- to reduce net liability on individual risks;
- to provide protection for catastrophic losses; and
- to stabilize underwriting results and preserve working capital.

Excess of Loss Reinsurance

Our current reinsurance treaty applies to all loss occurrences during and on policies which are in force between 12:01 a.m. July 1, 2007 and 12:01 a.m. July 1, 2008. The treaty consists of two master interests and liabilities agreements, one excess of loss agreement and one catastrophic loss agreement, entered into between EICN and its current and future affiliates and the subscribing reinsurers. We have the ability to extend the term of the treaty to continue to apply to policies which are in force at the

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expiration of the treaty generally for a period of 12 months. We may cancel the treaty upon 60 days written notice, generally, if any reinsurer ceases its underwriting operations, becomes insolvent, is placed in conservation, rehabilitation, liquidation, has a receiver appointed or if any reinsurer is unable to maintain a rating by A.M. Best and/or Standard and Poor's of at least ''A–'' throughout the term of the treaty. Covered losses which occur prior to expiration or cancellation of the treaty continue to be obligations of the reinsurer, subject to the other conditions in the agreement. The subscribing reinsurers may terminate the treaty only for our breach of the obligations of the treaty. We are responsible for the losses if the reinsurer cannot or refuses to pay.

For the treaty, or contract, year beginning July 1, 2007, we have purchased reinsurance up to $200 million. We would be solely responsible for any losses we suffer above $200 million except those covered by the Terrorism Insurance Program Reauthorization Act of 2007. Our loss retention for the treaty year beginning July 1, 2007 is $5 million. This means we have reinsurance for covered losses we suffer between $5 million and $200 million, subject to an aggregate loss cession limitation in the first layer ($5 million in excess of $5 million) of $20 million. Additionally, any loss to a single person involving the second through sixth layers of our reinsurance program is limited to $10 million, and the second through sixth layers ($190 million in excess of $10 million) are limited to one mandatory reinstatement with an additional premium.

The treaty includes certain exclusions for which our reinsurers are not liable for losses, including but not limited to, losses arising from the following: war, strikes or civil commotion; nuclear incidents (other than incidental or ordinary industrial or educational pursuits or the use, handling or transportation of radioisotopes for medical or industrial use or radium or radium compounds); underground mining except where incidental; oil and gas drilling, refining and manufacturing; manufacturing, storage and transportation of fireworks or other explosive substances or devices; asbestos abatement, manufacturing or distribution; excess policies attaching excess of a self-insured retention or a deductible greater than $25,000; and commercial airlines personnel. The reinsurance coverage includes coverage for acts of terrorism other than losses directly or indirectly caused by, contributed to, resulting from, or arising out of or in connection with nuclear, radiological, biological or chemical pollution, contamination or explosion. We have underwriting guidelines which generally require that insured risks fall within the coverage provided in the reinsurance treaty. Any risks written outside the treaty coverage require the review and approval of our chief underwriting officer and/or chief operating officer.

The treaty includes a mandatory commutation (a contractual obligation where the reinsurer makes a final payment of the present value of unpaid ultimate losses covered during the treaty period and is relieved from any additional obligations on those losses) at 84 months following the expiration or cancellation of the agreement for the reinsurance layer (the reinsurance treaty is comprised of a series of insurance coverages by one or more reinsurers that are stacked on top of each other to bring the total reinsurance coverage to a maximum of $200 million) to $10.0 million and commutation by mutual agreement in the layers above $10.0 million provide for a single reinstatement of the coverage upon exhaustion of the respective layers of coverage.

The significant changes between years from the reinsurance program commencing July 1, 2006 to the reinsurance program commencing July 1, 2007 are as follows:

- risks related to catastrophic losses have been reduced by increasing the related reinsurance coverage from $175 million to $200 million;
- our retention of risk increased from $4.0 million to $5.0 million; and
- our coverage for

any loss to a single person involving the second through sixth layers of our reinsurance program increased from $7.5 million to $10.0 million.

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Our practice is to select reinsurers with an A.M. Best rating of ‘‘A−’’ or better at treaty inception as indicated in the table below, which provides information about our reinsurers and their participation in our reinsurance program:

All treaties are Per Occurrence Excess of Loss with a term of July 1, 2007 to June 30, 2008

	$5m excess of $5m	$10m excess of $10m	$20m excess of $50m	$50m excess of $100m	$100m excess of $150m	$150m excess of $5m	$5m Reinsurers	A.M. Best Ratings
ACE Property & Casualty Insurance Company	A+	— %	— %	5.00 %	5.00 %	— %	— %	Allied World Assurance Company, Ltd.	A	—	—	—	—	15.00	—	Arch Reinsurance Company	A	—	—	—	8.00	5.00	5.00	Aspen Insurance UK Limited	A	7.40	8.40	8.50	8.50	8.75	12.50	Axis Specialty Limited	A	—	7.50	7.50	7.50	7.50	7.50	Endurance Specialty Insurance Ltd	A−	—	5.00	5.00	12.50	10.00	10.00	Federal Insurance Company	A++	—	—	2.00	5.00	—	—	Hannover Re (Bermuda) Ltd	A	—	—	—	5.00	7.50	7.50	Hannover Rueckversicherung-AG	A	25.00	15.00	15.00	—	—	—	Lloyds Syndicate #0435 FDY(1)	A	—	5.00	—	4.00	—	4.00	Lloyds Syndicate #0570 ATR(1)	A	1.00	3.25	3.25	2.50	1.00	—	Lloyds Syndicate #0623 AFB(1)	A	—	0.81	—	0.57	—	—	Lloyds Syndicate #0727 SAM(1)	A	—	2.00	2.00	2.00	—	1.50	Lloyds Syndicate #0780 ADV(1)	A	—	—	—	—	2.75	3.00	Lloyds Syndicate #0958 GSC(1)	A	—	3.00	3.00	3.75	3.00	—	Lloyds Syndicate #1084 CSL(1)	A	—	—	—	—	1.79	2.08	Lloyds Syndicate #1301 BGT(1)	A	—	—	—	—	0.96	1.12	Lloyds Syndicate #2000 HAR(1)	A	5.00	5.10	5.80	5.50	4.50	5.00	Lloyds Syndicate #2001 AMLIN(1)	A	—	—	—	—	2.50	3.00	Lloyds Syndicate #2003 SJC(1)	A	40.50	22.00	25.00	12.25	5.00	5.00	Lloyds Syndicate #2623 AFB(1)	A	—	3.44	—	2.43	—	—	Lloyds Syndicate #2987 BRT(1)	A	6.20	4.50	5.45	5.00	3.75	7.80	Lloyds Syndicate #4472 LIB(1)	A	7.40	—	—	3.00	3.50	5.00	Munich Reinsurance America, Inc.	A	7.50	—	—	—	—	—	Odyssey America Reinsurance Corporation	A	—	5.00	5.00	—	—	—	Swiss Reinsurance America Corporation	A+	—	—	—	—	15.00	15.00	Tokio Millenium Re Ltd	A+	—	10.00	5.00	5.00	—	—	Validus Reinsurance, Ltd	A−

—	—	2.50	2.50	2.50	5.00	100.00 %	100.00 %	100.00 %	100.00 %	100.00 %
100.00 %										

(1) The overall rating of Lloyds from a security standpoint is called the market or ‘‘floor’’ rating. The existence of this market rating reflects the ‘‘chain of security’’ and, in particular, the role of the Lloyd’s Central Fund which ensures that each syndicate is backed by capital consistent with a financial strength rating of at least that of the ‘‘Lloyds’’ market. These syndicates are rated under the overall rating of Lloyds. Some syndicates have their own separate rating which is higher than the floor rating.

LPT Agreement

On July 1, 1999, the Nevada legislature enacted Senate Bill 37 (SB37). The provisions of SB37 specifically stated that the Fund could take retroactive credit as an asset or a reduction of liability, amounts ceded to (reinsured with) assuming insurers with security based on discounted reserves for losses related to periods beginning before July 1, 1995, at a rate not to exceed 6%.

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As a result of SB37, the Fund entered into the LPT Agreement, a retroactive 100% quota share reinsurance agreement, in a loss portfolio transfer transaction with third party reinsurers. (the LPT Agreement). The LPT Agreement commenced on June 30, 1999 and will remain in effect until all claims for loss and outstanding loss under the covered policies have closed, the agreement is commuted, or terminated, upon the mutual agreement of the parties, or the reinsurer's aggregate maximum limit of liability is exhausted, whichever occurs earlier. The LPT Agreement does not provide for any additional termination terms. The LPT Agreement substantially reduced the Fund's exposure to losses for pre-July 1, 1995 Nevada insured risks. On January 1, 2000, our Nevada insurance subsidiary assumed all of the assets, liabilities and operations of the Fund, including the Fund's rights and obligations associated with the LPT Agreement.

Under the LPT Agreement, the Fund initially ceded $1.525 billion in liabilities for the incurred but unpaid losses and LAE related to claims incurred prior to July 1, 1995, for consideration of $775 million in cash. The LPT Agreement, which ceded to the reinsurers substantially all of the Fund's outstanding losses as of June 30, 1999 for claims with original dates of injury prior to July 1, 1995, provides coverage for losses up to $2 billion, excluding losses for burial and transportation expenses. As of December 31, 2007 and 2006, the estimated remaining liabilities subject to the LPT Agreement were approximately $971.7 million, and $1.0 billion, respectively. Losses and LAE paid with respect to the LPT Agreement totaled approximately $405.7 million and $364.5 million through December 31, 2007 and 2006, respectively.

The reinsurers agreed to assume responsibilities for the claims at the benefit levels which existed in June 1999. The LPT Agreement required the reinsurers to each place assets supporting the payment of claims by them in individual trusts that require that collateral be held at a specified level. The level must not be less than the outstanding reserve for losses and a loss expense allowance equal to 7% of estimated paid losses discounted at a rate of 6%. If the assets held in trust fall below this threshold, we can require the reinsurers to contribute additional assets to maintain the required minimum level. The value of these assets as of December 31, 2007 and 2006 was $838.3 million and $1.0 billion, respectively. One of the reinsurers has collateralized its obligations under the LPT Agreement by placing the stock of a publicly held corporation, with a value of $556.5 million at December 31, 2007, in a trust to secure the reinsurer's losses of $539.9 million. The value of this collateral is therefore subject to fluctuations in the market price of such stock. The other reinsurers have placed treasury and fixed income securities in trusts to collateralize their losses.

The current reinsurers party to the LPT Agreement include ACE Bermuda Insurance Limited, XL Mid Ocean Reinsurance Company Ltd. and National Indemnity Company (NICO). The contract provides that during the term of the agreement all reinsurers need to maintain a rating of no less than ''A−'' as determined by A.M. Best.

The original reinsurers party to the LPT Agreement were ACE Bermuda Insurance Limited, XL Mid Ocean Reinsurance Company Ltd. and Gerling Global International Reinsurance Company Ltd. (Gerling). The contract provides that during the term of the agreement all reinsurers need to maintain a rating of no less than ''A−'' as determined by A.M. Best. On October 18, 2002, the rating of Gerling dropped below the mandatory ''A−'' rating to ''B+''. Therefore, on May 28, 2003, EICN entered into an agreement with NICO and Gerling. Under the terms of this agreement Gerling was released from its percentage participation (55%) on LPT Agreement and NICO assumed such participation. The cost to EICN of the novation was $32.8 million.

Clarendon Fronting Facility

Effective July 1, 2002, ECIC entered into a fronting facility with Clarendon in connection with the Fremont transaction, pursuant to which we effectively acted as a reinsurer and provided administrative and claims services. Under the Clarendon fronting facility, ECIC assumed liability for 100% of the post-June 30, 2002 losses under

Fremont policies in force as of July 1, 2002 and new and renewal policies written through Clarendon on and after July 1, 2002. Effective July 1, 2003, the agreement was amended such that ECIC assumed liability of 90% of the losses on new and renewal policies written through Clarendon on and after July 1, 2003. This arrangement was necessary because, at the time of the Fremont transaction, ECIC did not have a financial strength rating, which is typically required by market

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participants, such as agents and brokers, and, accordingly, we could not write policies directly in California. Clarendon had such a financial strength rating and, because of the fronting facility, ECIC was able to utilize Clarendon's rating to write policies indirectly in California. ECIC obtained the relevant financial strength rating in the third quarter of 2003 and, as a result, was able to issue new and renewal policies on its own without the fronting facility after that date. Our obligations to Clarendon under the fronting facility were initially collateralized with assets placed in a trust. In October 2006, the trust agreement with Clarendon was terminated and the funds were released to us.

Recoverability of Reinsurance

Reinsurance makes the assuming reinsurer liable to the ceding company, or original insurer, to the extent of the reinsurance. It does not, however, discharge the ceding company from its primary liability to its policyholders in the event the reinsurer is unable to meet its obligations under such reinsurance. Therefore, we are subject to credit risk with respect to the obligations of our reinsurers. We regularly perform internal reviews of the financial strength of our reinsurers. However, if a reinsurer is unable to meet any of its obligations to our insurance subsidiaries under the reinsurance agreements, our insurance subsidiaries would be responsible for the payment of all claims and claims expenses that we have ceded to such reinsurer. We do not believe that our insurance subsidiaries are currently exposed to any material credit risk. In addition to selecting financially strong reinsurers, we continue to monitor and evaluate our reinsurers to minimize our exposure to credit risks or losses from reinsurer insolvencies. The Company obtains collateral to mitigate the risks related to reinsurance insolvencies. At December 31, 2007, $838.3 million was in a trust account for reinsurance related to the LPT Agreement and an additional $1.2 million was collateralized by cash or letter of credit.

The availability, amount and cost of reinsurance are subject to market conditions and to our experience with insured losses. There can be no assurance that our reinsurance agreements can be renewed or replaced prior to expiration upon terms as satisfactory as those currently in effect. If we were unable to renew or replace our reinsurance agreements:

- our net liability on individual risks would increase;
- we would have greater exposure to catastrophic losses;
- our underwriting results would be subject to greater variability; and
- our underwriting capacity would be reduced.

Certain information regarding our ceded reinsurance recoverables as of December 31, 2007 for reinsurance programs incepted prior to June 30, 2007 is provided in the following table:

Name of Reinsurer	Rating(1)	Total Paid Losses and LAE	Total Unpaid Losses and LAE	Total
		(in thousands)		
ACE Bermuda Insurance Limited	A+	$ 992	$ 97,172	$ 98,164
Ace Property & Casualty Insurance Company	A+	—	1,693	1,693
American Healthcare Indemnity Co	B+	—	3,619	

3,619 Aspen Insurance UK Limited A+ — 5,709 5,709 Converium Reinsurance (North America) Inc B+ — 5,551 5,551 Hannover Rueckversicherung-AG A — 2,987 2,987 Munich Reinsurance America, Inc. A 1 3,986 3,987 National Indemnity Company A++ 5,458 534,445 539,903 Odyssey America Reinsurance Corp A — 1,146 1,146 ReliaStar Life Insurance Company A+ 37 3,136 3,173 RSUI Indemnity Company A — 2,067 2,067 St. Paul Fire & Marine Insurance Company A+ 11 5,402 5,413 Swiss Reinsurance America Company A+ 48 12,163 12,211 Tokio Millenium Re Ltd. A+ 86 6,901 6,987 XL Reinsurance Limited A+ 3,474 340,102 343,576 Lloyds Syndicates A — 18,963 18,963 All Other Various 111 6,291 6,402 Total $ 10,218 $ 1,051,333 $ 1,061,551

(1) A.M. Best’s highest financial strength ratings for insurance companies are ‘‘A++’’ and ‘‘A+’’ (superior) and ‘‘A’’ and ‘‘A−’’ (excel

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We review the aging of our reinsurance recoverables on a quarterly basis. At December 31, 2007, 0.8% of our reinsurance recoverables on paid losses were 90 days overdue.

Inter-Company Reinsurance Pooling Agreement

Our insurance subsidiaries are parties to an inter-company pooling agreement. Under this agreement, the results of underwriting operations of ECIC are transferred to and combined with those of EICN and the combined results are then reapportioned. The allocations under the pooling agreement are as follows:

- EICN – 53%
- ECIC – 47%

The pooling percentages are set forth in the inter-company pooling agreement and do not change between periods. The pooling percentages were established July 1, 2003, the effective date of the agreement. The allocation percentages were based upon the relative amount of unconsolidated company statutory surplus of the respective companies at the time of the agreement.

ECIC and EICN rely on the capacity of the entire pool rather than just on their own capital and surplus. Transactions under the pooling agreement are eliminated on consolidation and have no impact on our consolidated GAAP financial statements.

Investments

We derive investment income from our invested assets. We invest our insurance subsidiaries' total statutory surplus and funds to support our loss reserves and our unearned premiums. As of December 31, 2007, the amortized cost of our investment portfolio was $1.65 billion and the fair market value of the portfolio was $1.73 billion.

We employ an investment strategy that emphasizes asset quality and the matching of maturities of fixed maturity securities against anticipated claim payments and expenditures or other liabilities. The amounts and types of our investments are governed by statutes and regulations in the states in which our insurance subsidiaries are domiciled. Our investment portfolio is structured so that investments mature periodically over time in reasonable relation to current expectations of future claim payments. Currently, we make claim payments from positive cash flow from operations and invest excess cash in securities with appropriate duration targets to balance against anticipated future claim payments.

At December 31, 2007, our investment portfolio, which is classified as available-for-sale, was made up almost entirely of investment grade fixed maturity securities whose fair values may fluctuate due to the latest interest rate changes. We strive to limit interest rate risk by managing the duration of our fixed maturity securities. As of December 31, 2007, our investments (excluding cash and cash equivalents) had a duration of 5.82 as compared to 5.89 as of December 31, 2006. To minimize interest rate risk, our portfolio is weighted toward short-term and intermediate-term bonds; however, our investment strategy balances consideration of duration, yield and credit risk. Our investment guidelines require that the minimum weighted average quality of our fixed maturity securities portfolio shall be ''AA.'' As of December 31, 2007, our fixed maturity securities portfolio had an average quality of ''AA+,'' with approximately 93.0% of the carrying value of our investment portfolio rated ''AA'' or better. Our investment portfolio is comprised of less than 0.03% of subprime mortgage debt securities or derivative securities relating thereto. The subprime mortgage crisis was created by a sharp rise in home foreclosures that started in the United States in late

2006 as high default rates materialized on subprime and other adjustable rate mortgages (ARMs) made to higher-risk borrowers.

We classify our portfolio of equity securities as available-for-sale and carry these securities on our balance sheet at fair value. Accordingly, changes in market prices of the equity securities we hold in our combined investment portfolio result in increases or decreases in our total assets. In order to minimize our exposure to equity price risk, we invest primarily in equity securities of mid-to-large capitalization issuers and seek to diversify our equity holdings across several industry sectors. Our objective during the past few years has been to reduce equity exposure as a percentage of our total portfolio by increasing our fixed maturity securities. Our investment strategy allows a maximum exposure of 20% of our total combined investment portfolio in equity securities, with our current equity allocation at 6.2% of the total portfolio at December 31, 2007.

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Our equity allocation at September 30, 2006 was above our current selected target of 6% and at the maximum exposure of 15% of our total combined investment portfolio. We evaluated our portfolio equity allocation during the fourth quarter of 2006 and elected to reduce the amount allocated to equity securities to our current target level of 6% during that period. Reducing our equity allocation has the effect of decreasing expected surplus volatility (because under statutory accounting principles, equity securities are carried at fair value with the unrealized gains/losses charged directly to surplus, in contrast to fixed income securities which are carried at amortized cost with no impact on surplus due to changes in fair value). Equity sales of $169.2 million related to the portfolio reallocation generated taxable gains of $49.2 million in the fourth quarter of 2006. Previous to the sales, these equity securities were recorded on the balance sheet at fair value, with unrealized gains recognized as a component of accumulated other comprehensive income in the consolidated