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

For the year ending December 31, 2008

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OVERVIEW

International Fidelity Insurance Company ("IFIC") is the largest privately owned, independent Insurance Company that specializes exclusively in surety. The Company operates through a network of approximately 25 Regional Profit Centers located throughout the continental United States utilizing the independent agency system that specializes in surety.

The company is licensed in 50 states, Puerto Rico and the District of Columbia. The company is treasury listed by the United States Treasury Department and is an authorized surety in all Federal Courts.

IFIC writes five different lines of surety: Contract, Commercial, Bail, Customs and Subdivision accounting for 43%, 23%, 22%, 7% and 5%, respectively of the company's total direct written premium for 2008. Surety bonds written in each of these lines is written across the United States.

HISTORY

IFIC was formed in 1904 with the first surety license issued by the State of New Jersey. The company was initially formed as a subsidiary of the Singer Sewing Company as its captive provider of fidelity coverage.

In 1964 IFIC was purchased by a group of investors led by agents specializing in surety bail bonds. Upon this sale, the company became a writer of surety bail bonds. Over the years, IFIC expanded into other types of non-bail or in other words "civil" surety bonds.

Through out 1970's, 1980's and most of the 1990's the company was a low capacity, non-standard (secured) surety that operated primarily through one location writing both bail and civil surety. While the company's bail business had always been profitable, its civil surety business was not consistently profitable. Therefore, in the late 1990's the company changed the type of civil surety business it wrote from non-standard (collateralized) to standard (unsecured/uncollateralized). Thus, as a result of this redirection, the company began a long-term process of developing a regional office network of underwriters.

STRATEGY

The medium, long-term strategy of the company is to develop as many meaningful long-term relationships with reputable agents that specialize in surety as possible. Within less than the last five years, half of the company's regional office locations have been established. Over half of these newer regional profit centers have been established during the last quarter to two years. Opening new regional profit center offices increases the number of new surety agency relationships. Thus, management believes this recently expanded regional profit center network will provide a platform of profitable growth over the next decade. This approach requires a commitment of additional overhead that over the short-run drags slightly on the company's overall profitability. However, it positions the company to grow revenues over a long period of time without attempting to attract new business by engaging in lowering underwriting standards and, or lowering pricing.

In the short run the company's strategy is to successfully manage the challenges of the financial crisis and recession. Management believes it is important in a recession or an expansion to be a consistent underwriting company. Therefore, the company will not engage in "re-underwriting" business while at the same time adjusting underwriting practices with changing market conditions. The company continues to develop and enhance its risk management discipline across its total spectrum of business including underwriting, investments, and collateral management. This includes the development of a process to underwrite the banks for which we have material counterparty exposure both in our collateral held and in our underwriting. We are also establishing an enhanced audit process to measure compliance with the underwriting authority structure, underwriting guidelines and required monitoring of outstanding exposures. In addition to these core business risk management processes, the company is implementing enhanced portfolio management techniques to actively manage both the credit and market risk in our investment portfolio. We expect these enhanced processes to significantly mitigate any additional risks associated with current economic conditions.

FINANCIAL CONDITION

The Company's Policyholders' Surplus at 12/31/08 is \$92,492,878 compared to \$86,332,753 for the prior year. This is an increase of \$6,160,125 or 7.1%. This increase comes entirely from retention of all of the company's \$12,882,575 of net income less approximately a net \$6,722,000 in charges against surplus of primarily unrealized losses on investments in marketable equity securities and non-admitted assets.

The company's policyholder surplus is made up of a very liquid balance sheet with very little leverage. Cash and invested assets comprised 94.6% of net admitted assets at December 31, 2008, and 94.2% as of December 31, 2007. Net admitted assets increased 21.0% from \$170,693,907 in 2007 to \$206,530,260 in 2008, due to continued positive cash flow from operations and an increase in cash collateral held.

At 12/31/08, liabilities increased 35.2% from \$84,361,155 to \$114,037,382 as of the current period. This is mainly due to a significant increase in unearned premium resulting from the growth in premium writings and the increase in Collateral Funds Held. Reserves for losses, loss adjustment expenses and unearned premiums continue to comprise the significant balance sheet liability accounts.

For the year ended December 31, 2008, IFIC had Total Adjusted Capital of \$92,492,878 and an Authorized Control Level RBC of \$11,515,211. Adjusted Capital represents approximately 803% of the Authorized Control Level RBC, considerably above any threshold requiring company or regulatory action. For the year ended December 31, 2007, the Company had Adjusted Capital of \$86,332,752 and an Authorized Control Level RBC of \$11,939,656. Adjusted Capital represented 723% of the Authorized Control Level RBC.

RESULTS OF OPERATIONS

In 2008, the company reported an increase of direct written premium and direct earned premium of approximately 4% and 9%, respectively. Earnings before taxes and net income after taxes decreased by 3% and 4%; respectively. The disparity between the growth rates in revenue verses the lesser rate growth in earnings are due primarily to the net decrease in investment income.

Commission expenses to agents and company operating expenses remained unchanged in 2008 from 2007 as a percent of earned premium. As a percent of direct earned premium, net reinsurance expenses increased 120 basis points in 2008 vs. 2007. This is despite an improving ceding commission rate. This is due to the company's average bond size increasing and therefore more premium being ceded to reinsurers. Net losses increased as a percent of direct earned premium by 200 basis points. While this is a material increase, it is more a reflection of the losses in 2007 being extraordinarily low as the level of losses in 2008 are about half of the industry norm. All of this resulted in the company posting record underwriting profit for the third year in a row in 2008. Underwriting profit grew from \$17.4 million in 2007 to \$19.8 million in 2008. As a percentage of direct earned premium, underwriting profit increased 60 basis points from 16.2% in 2007 to 16.8% in 2008.

Net Investment Income decreased, as a percentage of direct earned premiums, by 323 basis points in 2008 as compared to 2007. This was due to an approximate \$1 million write down of an investment in a corporate bond as well a material decrease in interest rates for cash and short-term interest bearing investments in 2008 as compared to 2007.

The Company's combined ratio at 12/31/08 was 79.0% a slight increase from 76.8% for the prior year. The Company's net written premium to surplus continues at a very acceptable level. For 2008 it was 1.1.

CASH FLOW

Cash flow from operations was a positive \$17.3 million, which is up from \$14.3 million in the prior period. The increase is due to over \$4 million of increased premium collections. Cash flow from operations was in excess of the \$12.9 million of net income. This is due, in large part, to the amount of premiums collected but not yet earned.

Cash flow from investments was a negative \$8.5 million. Cash flow from investments has been negative due to the company retaining all of its earnings and cash flow and using these monies to fund increases in its investments. In 2008, cash and invested assets increased from over \$160 million to over \$195 million.

Cash flow from financing and miscellaneous sources was a positive \$26.7 million, up from \$5.5 million for the prior period. This increase is mostly related to cash collateral received from bonded principals (policyholders).

Management believes that future cash needs can be met from general operating cash flow and that the mix of short-term investments and maturity of fixed investments will provide adequate liquid resources to meet its cash needs. Furthermore, the company has no significant material commitments or plans for future capital expenditures.

INVESTMENTS

The company's investment strategy is to maximize its return on invested assets at a level of risk where it can be reasonably expected that any short-term volatility would not have a negative

material impact on the company's expected annual earnings. With this strategy in mind the company maintains contracts with two professional money management firms, one to manage its fixed income investments and the other its equity investments. Investment in equities, limited to no more than 20% of total invested assets, are made through a portfolio of diversified open-end mutual funds. The company has also engaged a professional investment consultant to assist in its oversight of the two professional money management firms as well as consult on general issues of asset allocation.

The cash and invested assets as of December 31 for 2007 and 2008 are as follows:

<u>Invested Assets</u>	<u>2008</u>	<u>%</u>	<u>2007</u>	<u>%</u>
Taxable Fixed Maturities	\$61,854,398	31.7%	\$55,087,227	34.2%
Cash & cash collateral	77,449,815	39.6%	46,453,412	28.9%
Tax Exempt Fixed Maturities	31,637,668	16.2%	33,825,994	21.0%
Marketable Equity Securities	11,589,564	5.9%	18,170,832	11.3%
Short Term Investments	8,568,232	4.4%	4,039,006	2.5%
Misc Invested Assets	3,843,939	2.0%	2,245,354	1.4%
Mortgage Loans	443,000	0.2%	1,111,500	.7%
Cash Equivalents	0	0.0%	0	0.00%
Cash & Invested Assets	195,386,616	100.0%	\$160,933,325	100.00%

At the 2008 FYE the company's cash and invested assets increased 21.4% from the prior period. This is due to the company's continued positive cash flow. Total gross investment income earned for 2008 and 2007 was \$5,718,516 and \$5,635,620; respectively. The fixed income portfolio is comprised mostly of securities with maturities of ten years or less, as shown below:

EXPECTED MATURITY	<u>Adjusted Carrying Value</u>	
	<u>2008</u>	<u>2007</u>
One year or less	\$17,483,921	\$11,163,379
One year through five years	47,673,116	37,686,290
Five years through ten years	31,679,467	32,780,889
Ten years through twenty years	4,983,296	10,339,114
Twenty years or greater	240,498	982,554
TOTAL Fixed Income Portfolio	<u>\$102,060,298</u>	<u>\$92,952,226</u>

The overall duration of the fixed income portfolio is 3.6 years with an overall credit quality of Aa2/AA+. Limited exposure to mortgage backed-securities and credit sectors help the portfolio to weather turbulent periods in the fixed-income markets.

Management believes that the mix of investments, in both type and length of maturity is appropriate in order to preserve capital, take advantage of investment opportunities, and provide the Company with sufficient liquidity to react to changing economic conditions and support business operations.

The equity holdings, invested in both exchange traded funds and open-ended mutual funds provide diversified style-neutral exposure to both domestic and international markets. The portfolio currently has approximately 72% invested in domestic equity and 28% in international equity.

LOSS AND LOSS EXPENSE

In 2008, the loss and loss expense ratio was 10.7%. Net pure loss ratios for the last eight years are as follows:

<u>Year</u>	<u>Net Pure Loss Ratio</u>
2008	6.2%
2007	5.7%
2006	9.0%
2005	17.4%
2004	20.2%
2003	17.3%
2002	16.3%

The Company maintains a conservative level of Incurred But Not Reported Reserves ("IBNR") and recognizes more than 5% of inforce premiums. These reserves are adjusted each year based on an actuarial analysis of the historical loss data and ultimate net loss projections. In 2008, the Company's net loss and loss expense reserves included approximately \$10,000,000 in net IBNR.

The liabilities for unpaid losses and loss expenses are determined using case basis evaluations, and represent estimates to the ultimate net cost of all unpaid losses and loss expenses for each year. Anticipated salvage and subrogation is used to reduce the liability for unpaid losses. A conservative method is used to calculate anticipated salvage, producing redundancies in later years. These estimates are continually reviewed as historical experience develops. The liabilities are adjusted based on management's best estimate of the ultimate net loss, with such adjustments being charged to current year operations.

For 2008, Schedule P-Part 2 - Summary displayed a redundancy of \$5,517,000 and \$9,017,000 for the One Year and Two Year Developments, respectively. As of December 31, 2007, the One-Year Development of Schedule P exhibited a redundancy of \$6,426,000 and the two-year development a redundancy of \$6,718,000. As shown in the attached exhibit, "Historical Redundancy of Incurred Losses", IFIC's reserves are consistently redundant after 11 years. No trends have been identified that are considered non-recurring or abnormal as of December 31, 2008, the most recent evaluation date.

INTERNATIONAL FIDELITY INSURANCE COMPANY
INTERNATIONAL FIDELITY INSURANCE COMPANY
HISTORICAL REDUNDANCY OF INCURRED LOSSES
EXPANDED LOSS DEVELOPMENT AS OF 12/31/08
(000 OMITTED)

YEARS LOSSES WERE INCURRED	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	ONE YEAR	TWO YEAR	THREE YEAR	FOUR YEAR	FIVE YEAR	SIX YEAR	SEVEN YEAR	EIGHT YEAR	NINE YEAR	TEN YEAR	ELEVEN YEAR	TWELVE YEAR	THIRTEEN YEAR	FOURTEEN YEAR	FIFTEEN YEAR	SIXTEEN YEAR	SEVENTEEN YEAR	EIGHTEEN YEAR			
1980 & Prior	2,409	2,412	2,462	2,637	2,562	2,425	2,395	2,481	2,439	2,345	2,355	2,357	2,358	2,358	2,326	2,326	2,326	2,326	2,326	-	-	-	-	(32)	(32)	(31)	(29)	(19)	(113)	(155)	(69)	(99)	(236)	(311)	(136)	(86)	(83)			
1981	1,820	1,779	1,766	1,763	1,756	1,769	1,746	1,750	1,750	1,750	1,736	1,736	1,736	1,736	1,736	1,736	1,736	1,736	1,736	-	-	-	-	-	-	-	-	(14)	(14)	(14)	(10)	(33)	(20)	(27)	(30)	(43)	(84)			
1982	1,361	1,367	1,319	1,337	1,305	1,323	1,278	1,281	1,281	1,262	1,262	1,232	1,232	1,232	1,232	1,232	1,232	1,232	1,232	-	-	-	-	-	-	-	(30)	(30)	(49)	(49)	(46)	(91)	(73)	(105)	(87)	(135)	(129)			
1983	2,261	2,263	2,276	2,427	2,205	2,374	2,127	2,110	2,165	2,138	2,138	2,088	2,091	2,091	2,091	2,091	2,097	2,097	2,097	-	-	6	6	6	6	9	(41)	(41)	(68)	(13)	(30)	(277)	(108)	(330)	(179)	(166)	(164)			
1984	2,748	2,521	2,560	2,527	2,321	2,507	2,369	2,350	2,352	2,335	2,335	2,335	2,335	2,335	2,335	2,335	2,335	2,335	2,335	-	-	-	-	-	-	-	-	-	(17)	(15)	(34)	(172)	14	(192)	(225)	(186)	(413)			
1985	6,739	6,564	6,544	6,674	6,339	6,253	6,162	6,142	6,161	6,158	6,148	6,149	6,149	6,148	6,148	6,148	6,148	6,154	6,137	(17)	(11)	(11)	(11)	(11)	(12)	(12)	(11)	(21)	(24)	(5)	(25)	(116)	(202)	(537)	(407)	(427)	(602)			
1986	5,566	4,985	4,947	5,374	4,601	4,473	4,434	4,436	4,440	4,466	4,457	4,458	4,272	4,271	4,271	4,271	4,272	4,272	4,272	-	-	1	1	1	-	(186)	(185)	(194)	(168)	(164)	(162)	(201)	(329)	(1,102)	(675)	(713)	(1,294)			
1987	11,074	9,926	9,984	10,133	9,625	9,170	9,065	9,057	8,905	8,910	8,806	8,704	8,702	8,698	8,698	8,693	8,636	8,639	8,639	-	3	(54)	(59)	(59)	(63)	(65)	(167)	(271)	(266)	(418)	(426)	(531)	(986)	(1,494)	(1,345)	(1,287)	(2,435)			
1988	15,287	14,771	14,148	14,497	13,504	13,085	13,309	13,405	13,298	13,400	13,415	13,419	13,422	13,394	13,440	13,448	13,448	13,447	13,501	54	53	53	61	107	79	82	86	101	203	96	192	416	(3)	(996)	(647)	(1,270)	(1,786)			
1989	14,160	13,748	11,698	11,878	11,345	10,774	10,619	10,287	9,977	9,909	9,881	9,933	9,889	9,867	9,853	9,855	9,856	9,856	9,856	-	-	1	3	(11)	(33)	(77)	(25)	(53)	(121)	(431)	(763)	(918)	(1,489)	(2,022)	(1,842)	(3,892)	(4,304)			
1990	21,601	19,798	18,621	16,676	14,900	14,721	14,558	14,645	14,255	14,652	14,723	15,481	15,492	15,520	15,520	15,510	15,508	15,509	15,509	-	1	(1)	(11)	(11)	17	28	786	857	1,254	864	951	788	609	(1,169)	(3,112)	(4,289)	(6,092)			
1991		20,143	24,855	20,959	18,686	17,110	15,876	16,122	16,004	16,023	15,902	15,675	15,643	15,586	15,671	15,668	15,668	15,641	15,641	-	(27)	(27)	(30)	55	(2)	(34)	(261)	(382)	(363)	(481)	(235)	(1,469)	(3,045)	(5,318)	(9,214)	(4,502)				
1992			18,459	20,045	18,511	16,231	15,567	14,884	15,302	15,354	16,165	16,744	16,775	17,500	17,504	17,498	17,491	17,523	17,523	-	32	25	19	23	748	779	1,358	2,169	2,221	2,639	1,956	1,292	(988)	(2,522)	(936)					
1993				15,184	19,417	16,262	15,728	16,060	15,974	16,006	16,075	15,856	15,671	15,666	15,633	15,628	15,602	15,596	15,595	-	(7)	(33)	(38)	(71)	(76)	(261)	(480)	(411)	(379)	(465)	(133)	(667)	(3,822)	411						
1994					16,237	19,356	19,559	18,484	17,561	17,644	18,210	18,117	17,779	17,856	17,765	17,687	17,677	17,684	17,684	-	7	(3)	(81)	(172)	(95)	(433)	(526)	40	123	(800)	(1,875)	(1,672)	1,447							
1995						10,952	11,601	11,418	10,382	10,363	10,299	10,283	10,658	11,025	10,832	10,822	10,785	10,717	10,717	-	(68)	(105)	(115)	(308)	59	454	418	354	335	(701)	(884)	(235)								
1996							8,248	8,506	8,318	9,351	9,353	9,576	9,407	9,636	9,426	9,430	9,432	9,430	9,416	(14)	(16)	(14)	(10)	(220)	9	(160)	63	65	1,098	910	1,168									
1997								10,686	15,170	15,083	14,274	15,390	15,604	15,211	15,969	15,955	16,260	16,048	16,042	(6)	(218)	87	73	831	438	652	1,768	959	872	5,356										
1998									11,381	9,513	9,418	8,978	8,715	8,753	8,915	8,925	8,935	8,935	8,935	-	-	10	20	182	220	(43)	(483)	(578)	(2,446)											
1999										8,179	8,251	10,257	10,323	10,551	11,174	10,564	10,635	10,781	10,790	9	155	226	(384)	239	467	533	2,539	2,611												
2000											7,815	6,691	7,589	6,680	6,532	6,604	6,645	6,557	6,491	(66)	(154)	(113)	(41)	(189)	(1,098)	(200)	(1,324)													
2001												6,871	6,462	7,469	7,325	7,064	6,899	6,809	6,689	(120)	(210)	(375)	(636)	(780)	227	(182)														
2002													8,610	5,496	4,537	2,814	3,054	3,050	3,418	368	364	604	(1,119)	(2,078)	(5,192)															
2003														14,314	13,494	12,114	11,579	11,707	11,699	(8)	120	(415)	(1,795)	(2,615)																
2004															13,529	16,147	15,551	13,853	13,798	(55)	(1,753)	(2,349)	268																	
2005																15,929	14,751	11,846	11,001	(845)	(3,750)	(4,928)																		
2006																	11,029	9,383	7,495	(1,888)	(3,534)																			
2007																		11,692	8,767	(2,925)																				
2008																			12,751																					
DEFICIENCY/(REDUNDANCY)																				(5,513)	(9,013)	(7,415)	(3,878)	(5,113)	(4,333)	853	3,456	5,142	2,078	6,154	(425)	(3,985)	(9,231)	(15,714)	(18,835)	(16,996)	(17,386)			