<u>International Fidelity Insurance Company</u>

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

For the year ending December 31, 2007

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OVERVIEW

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

IFIC writes five different lines of surety: Contract, Bail, Commercial, Customs and Subdivision accounting for 38%, 24%, 22%, 10% and 6%, respectively of the company's total direct written premium for 2007. Surety bonds written in each of these lines is written across the United States, making IFIC one of the most diversified writers of surety.

The company enjoys an established track record of steadily improving results. For each of the last eight years the company's combined ratio has improved. In each of the last three years the company has achieved record growth in both written premiums and earnings. IFIC 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.

HISTORY

IFIC was formed in 1904 with the first surety license in the State of New Jersey. At that time the company was established as a subsidiary of the Singer Sewing Company. Its purpose was to provide fidelity coverage as a captive insurer to the Singer Sewing Company.

In 1964 IFIC was purchased by a group of investors led by agents specializing in surety bail bonds. Over the years, IFIC expanded into other types of surety bonds. Today the company remains privately owned and, as stated earlier, has become one of the most diversified sureties. The company's shareholders continue to demonstrate a high level of capital commitment. The company has never paid a common shareholder dividend and has never purchased any of its own common stock.

During the course of IFIC's history 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. In the late 1990's the company made the strategic decision to establish itself as a standard (unsecured) writer of surety with a "field-based" operating structure. This decision was made because the company developed difficulties in both growing and operating profitably as a non-standard writer.

During the late 1990's and early 2000's the company established and staffed its field upper management with "standard underwriters". The timing of this change was good, due to the surety industry moving from one of its "softest" markets to one of its "hardest" markets in late 2001, early 2002. By 2005 the company established a track record and reputation as a standard underwriting company. Since then, the company has expanded its operating geographic territory to include most of the major metropolitan areas across the United States. Concurrently, a more structured, streamlined underwriting process has been put in place, run by an expanded and more skilled home office and regional office underwriting management team.

STRATEGY

The company's mission is delivering the shareholders required return on its investment through the building of long-term rewarding relationships with its employees, agents and reinsurers. The company defines successful achievement of this mission when it is progressing toward and eventually obtaining an upgrade of its AM Best rating from the current A- VII to A VIII through a long term track record of retaining net income above peer company levels.

The company's strategy is simple. It is to build as many profitable, long-term agency relationships as possible where the agency regards the company as one of its leading choices of middle market sureties over the long-term. The company's strategy is to do this through a network of Regional Offices staffed with surety underwriting professionals. Management believes this strategy is best supported by a market profile of being a standard generalist surety. The company uses this profile in order to offer as much capacity as it responsibly can within its treaty limits of $15 million in single surety bonds and $40 million in an aggregate surety program.

The company uses a business model with a large investment of overhead in regional offices because it supports two critical areas: consistent low loss ratios and growing agency relationships. By having underwriters "close" to the surety accounts the company writes, the company is able to know its accounts well and thus can be responsive to their needs and therefore develop long term relationships with its surety accounts. Doing this also enables the regional offices underwriters to make meaningful underwriting evaluations, decisions and recommendations to the home office, which results in consistent, profitable underwriting results.

The company has opened and will continue to open Regional Offices only when an opportunity presents itself to hire a Regional Manager who has good relationships with reputable agents who specialize in surety. Management feels that the more geographic diversification to its business the more stable it's overall underwriting results will be. However, with that said, the company does not actively look to open offices in new territories.

The company has established an underwriting structure that empowers its Regional Office Managers with authority to make decisions on new account opportunities. The company's reporting structure fosters a culture where its home office and regional office underwriters work in a partnership in both underwriting and managing agency relationships. All underwriting decisions are guided by underwriting guidelines that are used consistently across all of the territories in which the company operates.

The company feels that most of its Regional Offices have not yet reached their full potential market share given IFIC's capacity and risk aversion limitations. Therefore, management feels that the company is positioned to continue to grow profitably. Management at all levels of the company is dedicated to being a consistent underwriting company through both soft and hard markets and times of economic expansion or contraction.

FINANCIAL CONDITION

The Company's Policyholders' Surplus at 12/31/07 is $86,332,753 compared to $73,246,833 for the prior year. This is an increase of $13,085,920 or 17.8%. This increase comes entirely from retention of all of the company's $13,403,104 of net income less approximately a net $318,000 in changes in three items: unrealized capital gains, deferred taxes 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 94.2% of net admitted assets at December 31, 2007, and 94.5% as of December 31, 2006. Net admitted assets increased 14.1% from

$149,565,807 in 2006 to $170,693,907 in 2007, due to continued positive cash flow from operations.

At 12/31/07, liabilities increased 10.5% from $76,318,974 to $84,361,155 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, 2007, IFIC had Total Adjusted Capital of $86,332,752 and an Authorized Control Level RBC of $11,939,656. Adjusted Capital represents approximately 723% of the Authorized Control Level RBC, considerably above any threshold requiring company or regulatory action. For the year ended December 31, 2006, the Company had Adjusted Capital of $73,246,833 and an Authorized Control Level RBC of $12,251,099. Adjusted Capital as of December 31, 2006, represented 598% of the Authorized Control Level RBC.

RESULTS OF OPERATIONS

In 2007, the company reported an increase of direct written premium and direct earned premium of approximately 18% and 15%, respectively. Earnings before taxes and net income after taxes increased by 40% and 30%; respectively. The disparity between the growth rates in revenue verses the greater rate growth in earnings are outlined below.

Net losses, as a percentage of direct earned premium, improved by 470 basis points. Direct agency scheduled commissions, as a percentage of direct earned premiums, improved by 140 basis points. Accrued commission income from the company's various reinsurance treaties improved by 60 basis points. These three items represent a total of 670 basis points of additional retention before taxes of earned premiums.

These improvements were offset by two items. The largest was Net Investment Income. Net Investment Income decreased, as a percentage of direct earned premiums, by 100 basis points. This was due primarily to increased interest expense of the company's two surplus notes due to increases in the interest rate market. The company's G&A expenses, as a percentage of direct earned premiums, increased by 40 basis points due to the increased overhead required by a more disciplined underwriting structure and territorial expansion into the Houston, San Diego and Denver markets.

The net effect of the items outlined in the previous two paragraphs is a net improvement of 550 basis points of direct earned premium. This improvement was enhanced by the increase in direct earned premium by $14 million from $93 million to $107 million. Thus, the net 550 basis point improvement from the items just outlined herein against $107 million in direct earned premium represents $5.7 million of increased earnings before taxes, which approximates the total of the increase of the company's 2007 earnings before taxes over the prior period.

The Company's combined ratio at 12/31/07 was 76.8% an improvement from 83.9% for the prior year. 2007 is the eighth consecutive year of an improving combined ratio. Management does not expect this trend to continue as it believes its combined ratio is more likely to level off rather than continuing to decrease. The Company's net written premium to surplus continues at a very acceptable level. For 2007 it was 1.1.

CASH FLOW

Cash flow from operations was a positive $14.3 million, which is down from $17.8 million in the prior period. The decrease is due to over $5 million of direct losses from one claim case that was both reserved and paid for during 2007. Cash flow from operations was in excess of the $13.4 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 $14.8 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 2007, cash and invested assets increased from $141 million to over $160 million.

Cash flow from financing and miscellaneous sources was a positive $5.5 million, down from $19.6 million for the prior period. This decrease is mostly related to cash collateral received from bonded principals (policyholders).

Infrequently, the company's underwriting requires it to secure bonds with collateral. The company promises to return the collateral once the bonded principal (policyholder) completes their obligations under the bond policy. Prior to 2006, the cumulative balance of cash collateral was accounted for as an asset in the write-in section of the statutory annual statement with an offsetting liability. In 2006 IFIC was directed by the state of New Jersey to classify these cash collateral funds as cash, with the offsetting liability as "Amounts Withheld for the Account of others". Due to the 2006 reclassification, the entire amount of cash collateral was reported in the cash flow from financing section of the statement of cash flows. Thus, the 2007 $5.5 million in cash flow from financing and miscellaneous sources reflects the change in cash collateral during 2007.

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 managements 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 2006 and 2007 are as follows:

Invested Assets	2007	%	2006	%
Taxable Fixed Maturities	$55,087,227	34.2%	$49,863,633	35.27%
Cash & cash collateral	46,453,412	28.9%	40,521,944	28.66%
Tax Exempt Fixed Maturities	33,825,994	21.0%	33,189,931	23.48%
Marketable Equity Securities	18,170,832	11.3%	7,928,132	5.61%
Short Term Investments	4,039,006	2.5%	4,250	0.00%
Misc Invested Assets	2,245,354	1.4%	2,395,495	1.69%
Mortgage Loans	1,111,500	.7%	2,492,000	.1.76%
Cash Equivalents	0	0.00%	4,987,989	3.53%
Cash & Invested Assets	**$160,933,325**	100.00%	**$141,383,374**	100.00%

At the 2007 FYE the company's cash and invested assets increased 13.8% from the prior period. This is due to the company's continued positive cash flow. Total gross investment income earned for 2007 and 2006 was $5,635,620 and $4,770,661; respectively. The fixed income portfolio is comprised mostly of securities with maturities of ten years or less, as shown below:

EXPECTED MATURITY	**Adjusted Carrying Value**	
	2007	**2006**
One year or less	$11,163,379	$11,852,450
One year through five years	37,686,290	28,501,575
Five years through ten years	32,780,889	37,655,292
Ten years through twenty years	10,339,114	9,704,911
Twenty years or greater	982,554	331,575
TOTAL Fixed Income Portfolio	**$92,952,226**	**$88,045,803**

The overall duration of the fixed income portfolio has steadily declined to 3.3 years with an overall credit quality of Aa1/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 2007, the loss and loss expense ratio was at a historical low of 9.4%. Net pure loss ratios for the last six years are as follows:

Year	Net Pure Loss Ratio
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 2007, the Company's net loss and loss expense reserves included more than $9,600,000 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 2007, Schedule P-Part 2 - Summary displayed a redundancy of $6,426,000 and $6,718,000 for the One Year and Two Year Developments, respectively. As of December 31, 2006, the One-Year Development of Schedule P exhibited a redundancy of $1,937,000 and the two-year development a redundancy of $2,149,000. As shown in the attached exhibit, "Historical Redundancy of Incurred Losses", IFIC's reserves are consistently redundant after 10 years. No trends have been identified that are considered non-recurring or abnormal as of December 31, 2007, the most recent evaluation date.