Surety Bonds Since 1904
International Fidelity
INSURANCE COMPANY

One Newark Center
Newark, New Jersey 07102
(973) 624-7200

1 1 5 9 2 2 0 0 5 3 5 0 0 0 1 0 0
Management's Discussion and Analysis of Operations
International Fidelity Insurance Company
Entity:11592 Yr:2005 Doc:350 Type:NAIC Annual

NAIC Group Code: 000 NAIC Company Code: 11592

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

JANUARY 1, 2004 DECEMBER 31, 2005

Contact Person:

Lee T. Hartmann, CPA

Chief Financial Officer

April 1, 2006

CORPORATE OVERVIEW

International Fidelity Insurance Company ("IFIC") is the largest privately owned, independent surety writer in the industry. The Company operates through a network of branches made up of 18 Regional Profit Centers. The Company is dedicated to the independent agency system that specializes in surety. IFIC provides a wide range of surety bonds: performance & payment, license & permit, court & commercial, customs and bail bonds. The Company is licensed in 50 States, District of Columbia, Puerto Rico and listed by the United States Treasury.

In 2005, IFIC achieved a combined ratio of 89.8% on $86 million in direct written premium. The Company posted an underwriting profit and net income after taxes of $5.8 million and $5.6 million, respectively. Due to this profitability and the placement of $10 million in surplus notes, the statutory capital and surplus of the Company increased from $48 million to $63 million during the year. IFIC is forecasting growth in 2006 writings and further improvement in its combined ratio, underwriting profit and net income.

While the Company has not been looking to expand geographically, it was presented with the opportunity to hire two talented surety professionals with strong reputations in two different locations. As a result, two Regional Profit Center Branches have recently been opened: one in Baltimore, Maryland in July 2005 and Birmingham, Alabama in February 2006.

The Company continues to be led by Francis Mitterhoff, Chairman, President and Chief Executive Officer. In April 2005, the Company appointed its Chicago Regional Manager, Robert Minster as Senior Vice President and Chief Underwriting Officer. Mr. Minster has 21 years experience in the surety industry. He opened IFIC's Chicago Office which has posted the lowest loss ratios in the Company. Mr. Minster has previous experience in working in the home office of another major surety writer. In January 2006 Bogda Clarke, Senior Vice President was appointed General Counsel. She has been with the Company as head of its claim department for the last 17 years. Lee T. Hartmann continues to oversee the Company's financial affairs as Senior Vice President and Chief Financial Officer.

The Company's mission is to be a dynamic, leading middle market surety that delivers the required return on investment to its shareholders by providing long-term rewarding relationships with its employees, agents and reinsurers.

FINANCIAL POSITION

As discussed in the Corporate Overview, the Company's reorganization efforts over the past several years have resulted in a positive trend in its ability to compete within the market. In addition, the financial results for 2005 continue to demonstrate a positive trend and significant improvement in the results since 1998. The Company's Policyholders' Surplus at 12/31/05 was $63,400,350 compared to $48,094,364 for the prior year an increase of $15,305,986 or 31.8%. This increase was due to profitable underwriting results, increased investment income and a surplus note issued in the amount of $10,000,000. Other than the surplus notes, the Company continues, as it has for the last thirty years to be debt free and has no intention to incur any future debt. The Company is not leveraged, with net written premium at 1.2 of policyholder's surplus. The Company's combined ratio at 12/31/05 was 89.8%, demonstrating a continued improving trend compared to the 12/31/04 ratio of 93.1%, 12/31/03 ratio of 93.5% 12/31/02 ratio of 99.3%, 12/31/01 ratio of 106.3% and the 12/31/00 ratio of 112.8.

International Fidelity maintains a diversified, liquid portfolio of high quality securities. Cash and invested assets comprise 93.1% of net admitted assets at December 31, 2005, and 93.2% as of December 31, 2004. No other assets are individually material nor did any other asset balances change significantly during the year. Assets increased 23.5% from $89,542,550 in 2004 to $110,615,985 in 2005, partially due to increased cash flow from collections, the investment of those dollars in bonds and $10,000,00 in surplus notes issued in 2005.

At the same time liabilities increased 13.9% from $41,448,186 to $47,215,635 as of the current period. This is mainly due to a significant increase in unearned premium resulting from the growth in premium writings and a reversal of ceding commission adjustments for two older developed loss years. Reserves for losses, loss adjustment expenses and unearned premiums continue to comprise the significant balance sheet liability accounts.

The Company has prepared and submitted the required Risk-Based Capital Report as of December 31, 2005, and has reported those results in its Annual Statement. For the year ended December 31, 2005, International had Total Adjusted Capital of $63,400,350 and an Authorized Control Level RBC of $10,522,304. Adjusted Capital represents approximately 602% of the Authorized Control Level RBC, considerably above any threshold requiring company or regulatory action. For the year ended December 31, 2004, the Company had Adjusted Capital of $48,094,364 and an Authorized Control Level RBC of $11,164,433. Adjusted Capital as of December 31, 2004, represented 431% of the Authorized Control Level RBC.

On December 16, 2005, the Company issued $10,000,000 of Floating Rate Surplus Notes due December 15, 2035 pursuant to a purchase agreement between International Fidelity Insurance Company and Alesco Preferred Funding IX, LTD. All interest and principal payments must be approved by the Commissioner of the New Jersey Department of Banking and Insurance before payment can be made.

Investments, losses and loss adjustment expenses are discussed in more detail in subsequent sections.

CAPITAL AND SURPLUS ACCOUNTS

HISTORICAL ANALYSIS OF CAPITAL AND SURPLUS INCREASES
(in thousands)

YEAR	CAPITAL & SURPLUS	INCR/(DECR) IN CAPITAL & SURPLUS	% INCREASE OR (DECREASE	
1986	5,756	1,327	43.5%	
1987	7,442	1,686	36.0%	
1988	10,527	3,085	35.7%	
1989	12,902	2,375	20.3%	
1990	16,004	3,102	22.0%	
1991	20,228	4,224	17.6%	
1992	24,978	4,749	23.5%	
1993	27,650	2,672	10.7%	
1994	27,078	(573)	(2.1%)	
1995	30,354	3,276	12.1%	
1996	33,773	3,419	11.3%	
1997	36,945	3,172	9.4%	
1998	38,592	1,647	4.5%	
1999	38,979	387	1.0%	
2000	36,004	(2,974)	(7.6%)	
2001	33,615	(2,390)	(6.6%)	
2002	31,212	(2,403)	(7.1%)	
2003	43,599	12,387	39.7%	**(1)**
2004	48,094	4,495	10.3%	
2005	63,400	15,306	31.8%	**(2)**

Note (1): $6,000,000 of the increase in surplus is due to Floating Rate Surplus Notes due 2034 issued on December 16, 2003.

Note (2) $10,000,000 of the increase in surplus is due to Floating Rate Surplus Notes due 2035 issued on December 16, 2005.

CASH FLOW AND LIQUIDITY

Cash flow is generated from collections of premiums, reinsurance recoveries and from investment income. Cash is utilized primarily to pay claims and underwriting expenses, and to purchase investments.

Net cash from operations continues to be positive for the fifth consecutive year. Cash generated from operations at 12/31/05 was $9,933,988 versus $7,517,241 at 12/31/04, $6,982,786 at 12/31/03 and $6,255,157 at 12/31/02. This improvement is a reflection of the increased collections of premiums as well as significant recoveries from reinsurance on losses and reductions in reinsurance costs.

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 cash needs.

The Company has no significant material commitments for future capital expenditures.

INVESTMENTS

Management has maintained a conservative investing philosophy. During 2004 International hired an outside investment advisor, Conning Asset Management, to manage its fixed income portfolio. At December 31, 2005, International Fidelity's cash and invested assets increased 23.4% as compared with December 31, 2004 due to the Company's increased cash flow from underwriting and the issuance of $10,000,000 in Surplus Notes on December 16, 2005. At December 31, 2004, International Fidelity's cash and invested assets increased 11.4% as compared with December 31, 2003 due to the Company's increased cash flow from underwriting. The cash and invested assets were as follows:

Invested Assets	2005	Percent	2004	Percent
Tax Exempt Fixed Maturities	$13,309,843	12.9%	$6,332,135	7.6%
Taxable Fixed Maturities	47,860,936	46.5%	47,129,221	56.5%
Short Term Investments	1,893,445	1.8%	23,772	0.0%
Cash Equivalents	7,982,031	7.7%	749,361	0.9%
Bank Deposits	21,071,302	20.5%	17,359,281	20.8%
Mortgage Loans	2,337,200	2.3%	2,556,550	3.1%
Marketable Equity Securities	6,494,860	6.3%	7,512,584	9.0%
Misc. Invested Assets	2,048,562	2.0%	1,784,205	2.1%
CASH & INVESTED ASSESTS	$102,998,178	100.0%	$83,447,109	100.0%

Investments in Cash, Cash Equivalents and Short Term Instruments are 30.0% of the International's current portfolio, as compared with 21.7% in the prior year, facilitating the timely payment of claims. Bonds now comprise 59.4% versus 64.1% in 2004. Marketable equity securities are 6.3% of the Company's total cash and invested assets at December 31, 2005, versus 9.0% at the end of 2004. The management of International has opted to invest primarily in stocks of well rated pharmaceutical, utility, financial services, industrial and other United States companies in order to benefit from the consistent, long term appreciation of stocks in these industries.

At year end 2004, the change in the net unrealized capital gains on stocks was $610,394 and at 12/31/05 the change was an unrealized loss of $345,395. The Company experienced an unrealized loss on bonds of $147,763 during 2005, because the rating of a GMAC issue it owned dropped to NAIC Class 3.

Except for this bond, which was less than 1% of International's invested assets, all other fixed maturity instruments were rated Class 1 and 2 by NAIC standards. Due to strict application of Statutory Accounting Principles at December 31, 2005, International wrote down to fair value certain issues of its common stock portfolio by $128,245, compared to a $289,642 write-down as of December 31, 2004. Net realized capital gains from sales or calls of securities were $481,151 for 2005 and $157,586 for 2004. These gains, together with the write-downs, produced a net capital gain of $352,906 for 2005 and a net capital loss of $132,055 for 2004 on Page 4 Line 9.

Total gross investment income earned on Page 12, Line 10 increased $467,189 in 2005 to $3,570,818 from $3,103,629 in 2004. This 15.1% increase was due to the Company's expanded asset base and underwriting cash flow during the second half of 2005. Before tax, cash flow from underwriting was $9,717,877 for the year.

The Company increased its holdings of tax exempt securities by $6,977,708 in 2005 and $3,124,911 in 2004 for tax purposes. The average tax exempt yield before expenses was 4.8% for 2004 and 2.9% for 2005. The 2005 yield was skewed because almost all bonds were purchased in November & December.

Treasury yields trended slightly higher during 2004 for a few months and remained essentially flat during 2005. During 2004, the Company increased its average duration in investments in bonds from three to nine years. At the same time the issuers called many bonds with higher rates and longer terms. During 2005, short term investments increased by almost $10 million, from the issuance of new surplus notes at year end, while bonds due from three to nine years went up by almost $5 million. The fixed income portfolio (long and short term) is primarily comprised of securities with durations of ten years or less, as shown below:

EXPECTED MATURITY (i.e., Duration)	Adjusted Carrying Value 2005	2004
One year or less	$16,127,677	$6,165,667
One year through five years	26,279,133	23,632,270
Five years through ten years	22,640,761	20,307,725
Ten years through twenty years	5,871,634	3,379,467
Twenty years or greater	127,050	0
TOTAL BOND PORTFOLIO (Schedule D, Part 1A Section 1, Ln 10.7)	$71,046,255	$53,485,129

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.

LOSS AND LOSS EXPENSE

The loss and loss expense ratio continues to show a positive trend with 22.8% for 2005 compared to 23.2% for 2004, 24.5% for 2003, 22.3% for 2002, 28.8% for 2001, 33.4% for 2000, 37.7% for 1999 and 44.1% for 1998.

Net pure loss ratios for the last six years are as follows:

Year	Net Pure Loss Ratio
2005	17.4%
2004	20.2%
2003	17.3%
2002	16.3%
2001	19.0%
2000	16.7%

As discussed earlier, International has improved results due to its tightening of the underwriting control environment and geographic expansion. In addition, the Company has continued to add to the in-house claims staff as well as create an in-house Litigation & Salvage Unit, to increase salvage collection and reduce costs for outside attorneys. In 2001, a highly sophisticated AS400 based computerized claims system was implemented, which allowed the Claims Department to operate with increased efficiency and economy.

The Company's financial strength and ability to meet its contractual obligations lies with its more than sufficient reserves. The Company has maintained a more conservative stance with regard to Incurred But Not Reported Reserves ("IBNR") and posts significantly more than the industry standard of 5% of inforce premiums. These reserves have been adjusted each year based on an actuarial analysis of the historical loss data and ultimate net loss projections. In 2005, the Company's net loss and loss expense reserves included almost $6,000,000 in net IBNR to further protect the Company's surplus against future losses.

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 through December 31 of each year. Anticipated salvage and subrogation is used to reduce the liability for unpaid losses. A very conservative method is used to calculate anticipated salvage, producing redundancies in later years. These estimates are continually reviewed and refined as historical experience develops, new information becomes known and the effects of trends in future claim severity and frequency are considered. 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 2005, Schedule P-Part 2 - Summary displayed a redundancy of $1,391,000 and $4,976,000 for the One Year and Two Year Developments, respectively. As of December 31, 2004, the One-Year Development of Schedule P exhibited a redundancy of $969,000 and the two-year development, a redundancy of $1,984,000. These current redundancies have been realized due to the success of recoveries received through the efforts of the salvage and litigation unit.

The current reinsurance program provides for variable quota share treaty coverage for contract, commercial and fidelity bonds. A pro-rata share of each bond is ceded according to a cession schedule based on bond size.

No trends have been identified that are considered non-recurring or abnormal as of December 31, 2005, the most recent evaluation date. The attached exhibit shows the Company's Historical Development of Incurred Losses since 1989.

INTERNATIONAL FIDELITY INSURANCE COMPANY

INTERNATIONAL FIDELITY INSURANCE COMPANY

HISTORICAL REDUNDANCY OF INCURRED LOSSES

EXPANDED LOSS DEVELOPMENT AS OF 12/31/05

(000 OMITTED)

YEARS LOSSES WERE INCURRED	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
1980 & Prior	2,474	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
1981	1,860	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
1982	1,408	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
1983	2,111	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
1984	2,288	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
1985	6,650	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
1986	4,997	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
1987	10,664	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
1988	16,363	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
1989	17,747	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
1990		21,601	19,798	18,621	16,678	14,900	14,721	14,558	14,645	14,255	14,652	14,723	15,481	15,492	15,520	15,520	15,510
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
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
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
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
1995							10,952	11,601	11,418	10,382	10,363	10,299	10,263	10,658	11,025	10,832	10,822
1996								8,248	8,506	8,318	9,351	9,353	9,576	9,407	9,636	9,426	9,430
1997									10,686	15,170	15,083	14,274	15,390	15,604	15,211	15,969	15,955
1998										11,381	9,513	9,418	8,978	8,715	8,753	8,915	8,925
1999											8,179	8,251	10,257	10,323	10,551	11,174	10,564
2000												7,815	6,691	7,589	6,680	6,532	6,604
2001													6,871	6,462	7,469	7,325	7,064
2002														8,610	5,496	4,537	2,814
2003															14,314	13,494	12,114
2004																13,529	16,147
2005																	15,929
DEFICIENCY/(REDUNDANCY)																	

YEARS LOSSES WERE INCURRED	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
1980 & Prior	-	(32)	(32)	(31)	(29)	(19)	(113)	(155)	(69)	(99)	(236)	(311)	(136)	(86)	(83)	(148)
1981	-	-	-	-	-	(14)	(14)	(14)	(10)	(33)	(20)	(27)	(30)	(43)	(84)	(124)
1982	-	-	-	-	(30)	(30)	(49)	(49)	(46)	(91)	(73)	(105)	(87)	(135)	(129)	(176)
1983	-	-	-	3	(47)	(47)	(74)	(19)	(36)	(283)	(114)	(336)	(185)	(172)	(170)	(20)
1984	-	-	-	-	-	-	(17)	(15)	(34)	(172)	14	(192)	(225)	(186)	(413)	47
1985	-	-	(1)	(1)	-	(10)	(13)	6	(14)	(105)	(191)	(526)	(396)	(416)	(591)	(502)
1986	-	-	(1)	(187)	(186)	(195)	(169)	(165)	(163)	(202)	(330)	(1,103)	(676)	(714)	(1,295)	(726)
1987	(5)	(5)	(9)	(11)	(113)	(217)	(212)	(364)	(372)	(477)	(932)	(1,440)	(1,291)	(1,233)	(2,381)	(1,971)
1988	8	54	26	29	33	48	150	43	139	363	(56)	(1,049)	(700)	(1,323)	(1,839)	(2,915)
1989	2	(12)	(34)	(78)	(26)	(54)	(122)	(432)	(764)	(919)	(1,490)	(2,023)	(1,843)	(3,893)	(4,305)	(7,892)
1990	(10)	(10)	18	29	787	858	1,255	865	952	789	610	(1,168)	(3,111)	(4,288)	(6,091)	
1991	(3)	82	25	(7)	(234)	(355)	(336)	(454)	(208)	(1,442)	(3,018)	(5,291)	(9,187)	(4,475)		
1992	(6)	(2)	723	754	1,333	2,144	2,196	2,614	1,931	1,267	(1,013)	(2,547)	(961)			
1993	(5)	(38)	(43)	(228)	(447)	(378)	(346)	(432)	(100)	(634)	(3,789)	444				
1994	(78)	(169)	(92)	(430)	(523)	43	126	(797)	(1,872)	(1,669)	1,450					
1995	(10)	(203)	164	559	523	459	440	(596)	(779)	(130)						
1996	4	(206)	23	(146)	77	79	1,112	924	1,182							
1997	(14)	744	351	565	1,681	872	785	5,269								
1998	10	172	210	(53)	(493)	(588)	(2,456)									
1999	(610)	13	241	307	2,313	2,385										
2000	72	(76)	(985)	(87)	(1,211)											
2001	(261)	(405)	602	193												
2002	(1,723)	(2,682)	(5,796)													
2003	(1,380)	(2,200)														
2004	2,618															
2005																
DEFICIENCY/(REDUNDANCY)	(1,391)	(4,975)	(4,610)	1,180	3,408	4,981	2,143	6,229	(263)	(3,837)	(9,188)	(15,674)	(18,828)	(16,964)	(17,381)	(14,427)

STATEMENT OF OPERATIONS

The year 2005 has been a year of positive trends and continued capture of market share. Direct premiums written increased 12.3% to $86,699,000 from $77,196,000 for the previous year ended 12/31/04. Part of this increase is due to a continuing emphasis on commercial surety writings. This is driven by the Company's desire to further diversify the book of business, thereby reducing the underlying risk of a mono-line company. The Company's bail class of business increased 16.1% in 2005 with anticipated continued growth in 2006 as a result of reorganization.

Net premiums written for 2005 increased to $72,983,000 from $64,164,000 or 13.7%. International Fidelity's expense ratio at 12/31/05 was 67.0% down from 69.8% for the 2004 year. The Company's expense ratio is distorted as compared to the surety industry due to the nature of the bail business, a class of surety, which comprises approximately 24.6% of International's total writings. Typically, bail writings carry a high expense ratio and zero loss ratio. Historically, the Company's bail operation has provided financial strength to the Company's results by providing loss free experience and profitability despite these high expense factors. In addition, the increase in commercial writings carry a higher expense factor due to the higher commission rate on this class of business. This factor is offset by the low loss ratio that this class of business develops. The Company has made substantial investments in decentralizing operations by opening regional offices to create a geographic presence nationally. However, the trend as demonstrated this year will continue to reflect a decrease in the expense ratio, as the market hardens, and the Company increases its market share. Additionally, further reductions will be realized through the efforts of disciplined expense management controlled through the budgeting process and continued efforts toward reductions in commission expense.

In July 2001, the Company expanded its reinsurance program to include all contract and commercial business (except bail) on a variable quota share basis. Fidelity coverage was added to the program beginning July 1, 2002. Each bond is ceded according to a defined percentage based on bond size. In addition, the program includes an adjustable commission rate based on loss ratio results. We have evaluated the program and determined that it has risk transfer.

STATEMENT OF OPERATIONS (continued)

The Company continues to exhibit very low leverage by virtue of the stricter underwriting standards applied. The ratio of net premiums written to surplus was 1.15 at 12/31/05 and 1.33 at 12/31/04. These low leverage ratios also reflect the Company's conservative management philosophy.

Management is not aware of any known trends that have had or could reasonably be expected to have a material favorable or unfavorable impact on future net income.