IFIC Surety GROUP

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Management's Discussion and Analysis of Operations
INTERNATIONAL FIDELITY INSURANCE COMPANY
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International Fidelity Insurance Company
One Newark Center
Newark, NJ 07102

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

For the year ending December 31, 2016

March 23, 2017

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NAIC Group Code: 4705
NAIC Company Code: 11592

CORPORATE OVERVIEW

International Fidelity Insurance Company (IFIC) is the largest US privately owned, independent insurance company that specializes exclusively in surety. The Surety and Fidelity Association of America (SFAA) reports on United States surety writings ranking. The IFIC Surety Group is ranked number eight by the SFAA. The Company operates through a network of 32 Regional Profit Centers located throughout the continental United States utilizing an independent agency system that specializes in surety. IFIC is rated A- ("Excellent") by A.M. Best.

The company is licensed in 50 states, Puerto Rico, Guam, US Virgin Islands 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 provides a wide range of surety bonds through five lines of business: Standard Contract, Commercial, Bail, Specialty Contract and Subdivision, accounting for 36.0%, 30.0%, 13.6%, 9.3% and 11.1%, respectively of the company's total direct and assumed premium for 2016.

IFIC has a wholly-owned subsidiary, The Chestnut Group which has a wholly-owned subsidiary, Allegheny Casualty Company (ACC). ACC is also a New Jersey domiciled insurance company which writes essentially the same lines of surety as its parent, IFIC. In 2015, ACC was redomesticated from the state of Pennsylvania to the state of New Jersey. Bonds written in Specialty Contract line are issued in the name of ACC, while the risk is transferred to IFIC by way of a reinsurance agreement between IFIC and ACC. ACC maintains capital and surplus in excess of $22 million and is rated A- ("Excellent") by AM Best. ACC's "Management's Discussion and Analysis of Financial Condition and Results of Operations" provides a more detailed analysis of this company.

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.

Throughout the 1970's, 1980's and most of the 1990's the company was a contract specialty 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 specialty contract to standard contract. This change also included its business being marketed, underwritten and processed through a network of regional profit centers. Since then, the company has expanded its civil surety business from one line of business to the five lines of business it has today (mentioned in the overview section of this report.) In 2009, IFIC acquired ACC. This enabled IFIC to expand its bail franchise with its existing and current bail MGA, AIA Holdings, Inc. It also enabled the company to have different rates and brands to differentiate its standard contract line from its specialty contract line.

STRATEGY

The company's mission is delivering to shareholders the required return on its investment and building a long-term rewarding relationships with its employees, agents and reinsurers.

The strategy is to be a consistent underwriting company throughout volatile markets and in times of economic contraction and expansion. 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 encourages a culture where its home office and regional office underwriters work in partnership in both underwriting and managing agency relationships. This business model supports two critical areas: consistent low loss ratios and growing agency relationships.

Company management has also evaluated its reinsurance program and decided to adjust the coverage of its variable quota share treaty and purchase a new XOL treaty. The 2016 - 2017 variable quota share treaty is designed to cover the layers of premium that historically have generated a larger loss ratio. In addition, management decided to supplement our reinsurance program with an XOL treaty to cover large losses aggregated by principal.

To better evaluate the company's expenses, in 2016, the company appointed a Budget Committee. The function of this committee is to establish a yearly budget for each regional office and for each home office department and to oversee the operating expenses. This will improve the yearly projections and promote improvements in the financial results and expense ratio.

The company believes that this combined strategy of continuing to improve the company loss and expense ratios is the key to improve profits.

FINANCIAL CONDITION

Assets
Cash and invested assets increased by $12,883,308 to $200,401,323 in 2016 and comprise 93.5% and 92.3% of total admitted assets in 2016 and 2015, respectfully. This increase is due to the current year's positive cash flow results from insurance operations. The company's bond portfolio also increased by 18.4% and the cash and short term assets have decreased, as the company's investment manager Prime Advisors, Inc., continues to invest in a safe portfolio.

Total admitted assets increased by $11,320,663 to $214,415,720 in 2016. The increase in total admitted assets is primarily due to the current years' positive cash flow from insurance operations.

Liabilities
In 2016, total liabilities increased by 5.1% to $125,306,898. This is primarily due to an increase of $3.5 million in losses and loss adjustment expenses reserves, an increase in other expenses payable of $1.5 million and an increase in unearned premiums of $1.5 million. The company is retaining more UPR premium due to a change in the company's reinsurance structure.

Surplus
The Company's policyholders' surplus increased by $5.2 million or 6.2% to $89,108,820 from $83,877,024 for the prior year. This is due to increases in net underwriting gain, net investment gain and from a net investment in the company's treasury stock in the amount of $846,630. The company's policyholders' surplus is made up of a very liquid balance sheet with very little leverage.

The Company's ratio of net written premium to surplus is at a very conservative level. For 2016 and 2015 it was 110.6% and 120.8% respectively.

For the year ended December 31, 2016, IFIC had Total Adjusted Capital of $89,108,820 and an Authorized Control Level RBC of $16,811,829 Adjusted Capital represents approximately 530.0% of the Authorized Control Level RBC. For the year ended December 31, 2015, the Company had Adjusted Capital of $83,877,024 and an Authorized Control Level RBC of $17,715,462 and Adjusted Capital represented 473.5% of the Authorized Control Level RBC.

RESULTS OF OPERATIONS

The Company's net income after tax increased 293% to $5.3 million in 2016 from $1.3 million in 2015. The major components of the 2016 net income are as follows:

Premiums
In 2016, the Company reported a decrease in direct written premium of $3.2M from $114.4M in 2015 to $111.2M in 2016 and a decrease of $5.2M in direct earned premium from $116.5M in 2015 to $111.3 M in 2016. Net earned premiums decreased by $5.6M from $102.6 in 2015 to $97.0M in 2016. These decreases are due to soft market conditions.

Incurred Losses and LAE
In 2016, the loss and loss expense ratio was 14.3% compared to 19.3% for the prior year. This is due to the company increased emphasis on writing good business. The net pure loss ratios, which excludes loss adjustment expenses, for the past five years are as follows:

Year	Net Pure Loss Ratio
2016	6.4%
2015	11.8%
2014	14.2%
2013	11.6%
2012	13.9%

The Company maintains a level of Incurred but Not Reported Reserves ("IBNR") at more than 5% of in-force premiums. These reserves are adjusted each year based on an actuarial analysis of the historical loss data and ultimate net loss projections. In 2016, the Company's net loss and loss expense incurred included an increase in IBNR reserves of approximately $435,000; the increase is due to the change in the reinsurance program.

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. Collateral, Contract Balances and Salvage Accruals are used to reduce the liability for unpaid losses. A conservative method is used to calculate anticipated Collateral, Contract Balances and Salvage Accruals, 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 2016, Schedule P-Part 2 Summary displayed a redundancy of $6,876,000 and $11,801,000 for the One Year and Two Year Developments, respectively. As of December 31, 2015, the One-Year Development of Schedule P exhibited a redundancy of $7,898,000 and the two-year development a redundancy of $6,442,000, please see attached schedule of historical loss development.

Net underwriting gain increased by $3,728,000, from $4,131,000, in 2015 to 7,860,000 in 2016.

Investment Income

The company's investment policy is very conservative. During 2016, much of the portfolio was invested in government bonds, yielding very little income. As the year progressed, Prime Advisors, the company's investment manager, continued to invest the excess cash generated by the company in longer duration securities and a small portion in equities. As a result the portfolio reported an increase in its yield as the year went on. The Company's net investment income is $116,449 an increase, when compared to previous year of ($77,450).

In 2017, the Company working with its investment advisor, a leading US insurance portfolio manager, is expected to continue to increase its yield through investments in longer duration securities and a small portion in equity securities.

In 2016, the Company recognized net capital gains of $962,370 versus capital losses of $78,269 in 2015.

CASH FLOW and LIQUIDITY

Net cash flow from operations increased by $6,759,029 or 104% from $6,448,230, in 2015 to $13,207,259, in 2016. This increase is due mainly from improvements in loss related items.

Cash flow from investments decreased due to the company retaining all of its earnings and cash flow and using these monies to fund increases in its investments. In 2016, cash and invested assets increased from $187 million to $200 million in 2016. During 2016, a large portion of the cash and short term securities were invested in high grade bonds and therefore the net change Cash Flow decreased by $8.6 million from the prior year.

The fixed income portfolio (including short-term securities) is comprised primarily of securities with maturities of five years or less, as shown below:

	Adjusted Carrying Value	
	2016	**2015**
One year or less	$34,921,426	$32,435,656
One year through five years	69,538,797	65,096,712
Five years through ten years	27,125,024	15,354,680
Ten years through twenty years	649,513	1,146,390
Twenty years or greater	0	99,213
TOTAL Fixed Income Portfolio	**$132,234,760**	**$114,132,651**

Management believes that future cash needs can be met from general operating cash flow and improved investment income derived from new investment management and more diversification in 2017. The company has no material commitments or plans for future capital expenditures.

CONCLUSION

In the years 2015 and 2016 IFIC continued to write good solid business with excellent core underwriting results and will operate in the same manner during 2017. This will ensure continued financial stability for the Company.

INTERNATIONAL FIDELITY INSURANCE COMPANY
LOSS DEVELOPMENT AS OF **DECEMBER 2016**

Historical Redundancy of **NET** Incurred Losses

Deficiency/(Redundancy)

('000's OMITTED)

YEARS LOSSES WERE INCURRED	Prior	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	ONE YEAR	TWO YEAR	THREE YEAR	FOUR YEAR	FIVE YEAR	SIX YEAR	SEVEN YEAR	EIGHT YEAR	NINE YEAR	TEN YEAR
Prior	11,029	11,736	9,144	8,691	4,939	2,653	2,710	2,920	2,503	2,443	2,379	(64)	(124)	(541)	(331)	(274)	(2,560)	(6,312)	(6,765)	(9,357)	(8,650)
2007		11,692	8,767	6,909	6,336	6,335	6,520	6,629	6,317	6,164	6,093	(71)	(224)	(536)	(427)	(242)	(243)	(816)	(2,674)	(5,599)	
2008			12,751	9,807	8,408	7,579	7,605	7,570	7,522	7,527	7,532	5	10	(38)	(73)	(47)	(876)	(2,275)	(5,219)		
2009				20,100	19,445	16,910	15,584	15,712	15,299	15,296	15,276	(20)	(23)	(436)	(308)	(1,634)	(4,169)	(4,824)			
2010					24,415	29,940	26,767	26,122	26,488	28,041	27,818	(223)	1,330	1,696	1,051	(2,122)	3,403				
2011						23,820	21,595	19,623	18,745	18,478	18,607	129	(138)	(1,016)	(2,988)	(5,213)					
2012							24,579	23,456	21,769	19,935	20,297	362	(1,472)	(3,159)	(4,282)						
2013								20,169	19,488	17,876	17,177	(699)	(2,311)	(2,992)							
2014									22,285	16,756	13,436	(3,320)	(8,849)								
2015										22,600	19,625	(2,975)									
2016											15,506										
DEFICIENCY/(REDUNDANCY)												(6,876)	(11,801)	(7,022)	(7,358)	(9,532)	(4,445)	(14,227)	(14,658)	(14,956)	(8,650)