

**HOUSTON INTERNATIONAL INSURANCE
GROUP LTD. AND SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS
WITH INDEPENDENT AUDITOR'S REPORT**

As of and for the Years Ended December 31, 2018 and 2017

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
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INDEPENDENT AUDITOR'S REPORT

To the Audit Committee of the Board of Directors
Houston International Insurance Group, Ltd.:

We have audited the accompanying consolidated financial statements of Houston International Insurance Group, Ltd. and Subsidiaries, (the "Company"), which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of operations and comprehensive income (loss), changes in stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2018 and 2017 and the consolidated results of its operations and its cash flows for the years ended December 31, 2018 and 2017 in accordance with accounting principles generally accepted in the United States of America.

Houston, Texas
March 14, 2019



HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2018 AND 2017

(In thousands, except for share and per share amounts)

	<u>2018</u>	<u>2017</u>
ASSETS		
Investments:		
Fixed maturity securities at fair value (amortized cost \$279,906 and \$247,721, respectively)	\$ 277,270	\$ 249,286
Equity securities at fair value (cost \$63,971 and \$56,031, respectively)	54,640	57,081
Receivable for securities sold	784	6,740
Investment in separately managed accounts	68,187	53,741
Investment in limited partnerships	37,265	34,087
Other invested assets	20,079	20,412
Short-term investments	<u>57,611</u>	<u>130,975</u>
Total investments	515,836	552,322
Cash and cash equivalents	65,456	36,508
Restricted cash	42,984	24,337
Premiums receivable, net of allowance	99,917	80,362
Reinsurance recoverables	382,246	298,054
Ceded unearned premium	158,425	130,848
Deferred policy acquisition costs	48,471	39,781
Federal income taxes receivable	662	615
Deferred federal income taxes	34,264	34,291
Goodwill and intangible assets, net	144,637	125,653
Other assets	<u>50,971</u>	<u>51,638</u>
Total assets	<u>\$ 1,543,869</u>	<u>\$ 1,374,409</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Losses and loss adjustment expenses (LAE)	\$ 599,386	\$ 534,501
Unearned premiums	282,798	231,295
Deferred ceding commission	39,145	31,201
Reinsurance and premium payables	94,847	93,751
Funds held for others	30,366	13,038
Accounts payable and accrued liabilities	27,445	29,780
Notes payable	81,000	63,000
Trust debenture securities, net of debt issuance costs	<u>58,944</u>	<u>58,896</u>
Total liabilities	<u>1,213,931</u>	<u>1,055,462</u>
Stockholders' equity:		
Common stock, par value \$0.01 per share; 170,000,000 shares authorized; 66,908,816 and 66,760,738 shares issued and 66,182,559 and 66,251,845 shares outstanding as of December 31, 2018 and 2017, respectively	669	668
Treasury stock, at par value, 726,257 and 508,893 shares as of December 31, 2018 and 2017, respectively	(7)	(5)
Additional paid-in capital	478,427	478,186
Stock notes receivable	(3,842)	(4,699)
Accumulated other comprehensive income (loss)	(9,012)	1,653
Accumulated deficit	<u>(136,297)</u>	<u>(156,856)</u>
Total stockholders' equity	<u>329,938</u>	<u>318,947</u>
Total liabilities and stockholders' equity	<u>\$ 1,543,869</u>	<u>\$ 1,374,409</u>

The accompanying notes are an integral part of these consolidated financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
FOR THE YEARS ENDED DECEMBER 31, 2018 AND 2017
(In thousands)

	2018	2017
Revenues:		
Net premium earned	\$ 277,607	\$ 265,645
Commission and fee income	4,994	2,478
Net investment income	17,862	17,238
Net realized gains	2,805	8,436
Acquisition adjustment income	11,255	6,473
Total revenues	314,523	300,270
Expenses:		
Losses and loss adjustment expenses, net	196,484	185,359
Policy acquisition costs	17,764	22,956
Other operating expenses	67,035	63,660
Interest expense	6,031	4,827
Amortization expense	1,462	1,462
Total expenses	288,776	278,264
Income before federal income tax expense	25,747	22,006
Federal income tax expense	(4,833)	(5,363)
Federal income tax reform expense	-	(22,120)
Net income (loss)	20,914	(5,477)
Other comprehensive income (loss):		
Unrealized gains and losses on investments:		
Net change in unrealized gains and losses on investments, net of income tax benefit (expense) of \$3,370 and \$(131), respectively	(12,772)	245
Reclassification adjustment for gains and losses on securities no longer held, net of income tax (expense) benefit of \$(331) and \$26, respectively	1,244	(49)
Foreign currency translation adjustment, net of income tax benefit (expense) of \$(146) and \$(161), respectively	508	298
Total other comprehensive income (loss)	(11,020)	494
Comprehensive income (loss)	\$ 9,894	\$ (4,983)

The accompanying notes are an integral part of these consolidated financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2018 AND 2017
(In thousands, except share amounts)

	<u>Common Stock</u>	<u>Treasury Stock</u>	<u>Additional Paid-In Capital</u>	<u>Stock Notes Receivable</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Accumulated Deficit</u>	<u>Total</u>
Balance at December 31, 2016	\$ 671	\$ (5)	\$ 480,072	\$ (5,834)	\$ 1,159	\$ (151,379)	\$ 324,684
Employee share activity	(3)	-	(1,886)	1,135	-	-	(754)
Net loss	-	-	-	-	-	(5,477)	(5,477)
Other comprehensive income, net of tax	-	-	-	-	494	-	494
Balance at December 31, 2017	668	(5)	478,186	(4,699)	1,653	(156,856)	318,947
Employee share activity	1	(2)	241	857	-	-	1,097
Net income	-	-	-	-	-	20,914	20,914
Reclassification of certain tax effects from accumulated other comprehensive income	-	-	-	-	355	(355)	-
Other comprehensive income (loss), net of tax	-	-	-	-	(11,020)	-	(11,020)
Balance at December 31, 2018	<u>\$ 669</u>	<u>\$ (7)</u>	<u>\$ 478,427</u>	<u>\$ (3,842)</u>	<u>\$ (9,012)</u>	<u>\$ (136,297)</u>	<u>\$ 329,938</u>

The accompanying notes are an integral part of these consolidated financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2018 AND 2017
(In thousands)

	<u>2018</u>	<u>2017</u>
Cash flows from operating activities:		
Net income (loss)	\$ 20,914	\$ (5,477)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Net realized gains	(2,805)	(8,436)
Depreciation and amortization expense	5,686	6,344
Stock-based compensation expense	366	(85)
Acquisition adjustments	(11,255)	(6,473)
Provision for bad debts	238	536
Earnings on separately managed accounts	(3,890)	(3,221)
Equity in earnings on limited partnerships	(3,547)	(5,114)
Equity in earnings on affiliates	(923)	(710)
Deferred income tax, net	4,835	27,196
Changes in operating assets and liabilities:		
Premiums receivable, net	(18,893)	(11,308)
Reinsurance recoverables	(84,017)	(69,518)
Ceded unearned premium	(27,576)	(32,645)
Deferred policy acquisition costs	(8,690)	(4,459)
Other assets	1,611	(22,438)
Federal income tax receivable	(48)	171
Losses and loss adjustment expenses	63,742	29,420
Unearned premiums	50,566	24,648
Deferred ceding commission	7,944	10,686
Reinsurance and premium payables	(6,486)	31,813
Funds held for others	17,328	(3,644)
Accounts payable and accrued liabilities	(4,439)	6,011
Net cash provided by (used in) operating activities	<u>661</u>	<u>(36,703)</u>
Cash flows from investing activities:		
Purchase of investment securities	(131,814)	(146,185)
Purchase of investment in affiliate	(500)	(3,670)
Investment in separately managed accounts	(9,908)	(29,280)
Purchase of investment in partnership	-	(222)
Net cash paid for acquisitions	(2,181)	-
Capital expenditures	(4,228)	(3,149)
Sales and maturities of investment securities	97,838	131,890
Distributions from limited partnerships	369	4,459
Distributions from investment in affiliate	1,040	-
Advance on notes receivable from related party	(1,734)	(500)
Change in short-term investments	73,364	98,587
Receivable for securities sold	5,956	(6,740)
Other	-	126
Net cash provided by investing activities	<u>28,202</u>	<u>45,316</u>
Cash flows from financing activities:		
Employee share purchases (forfeitures)	732	(668)
Proceeds from revolving line of credit, net	18,000	500
Net cash provided by (used in) financing activities	<u>18,732</u>	<u>(168)</u>
Net increase in cash and cash equivalents and restricted cash	47,595	8,445
Cash and cash equivalents and restricted cash at beginning of year	<u>60,845</u>	<u>52,400</u>
Cash and cash equivalents and restricted cash at end of year	<u>\$ 108,440</u>	<u>\$ 60,845</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 5,771	\$ 4,445
Cash paid for federal income taxes, net of refunds	-	-

The accompanying notes are an integral part of these consolidated financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Nature of Operations

Houston International Insurance Group, Ltd., (the “Company”, “HIIG” and collectively we, us or our), an insurance holding company, is a Delaware corporation that was organized in 2006. We underwrite select property and casualty, surety and accident and health insurance coverages through our subsidiaries.

Insurance Companies

We conduct operations principally through five insurance companies. Houston Specialty Insurance Company (“HSIC”), a subsidiary and largest insurance subsidiary, writes multiple lines of insurance on a surplus lines basis in 50 states and the District of Columbia. Imperium Insurance Company (“IIC”), a subsidiary of HSIC, writes on an admitted basis in all 50 states and the District of Columbia. Great Midwest Insurance Company (“GMIC”), a subsidiary of IIC writes multiple lines of insurance on an admitted basis in all 50 states, the District of Columbia and is T-listed with the Department of Treasury. Boston Indemnity Company (“BIC”), a subsidiary of GMIC, writes surety business in 28 states and is T-listed with the Department of Treasury. Oklahoma Specialty Insurance Company (“OSIC”), a subsidiary of BIC, and is an approved surplus lines company in 35 states.

Non-insurance Companies

HIIG Underwriting Agency, Inc. (“HIIGU”), a subsidiary of HIIG, is a managing general insurance agent and reinsurance broker for property and casualty and accident and health risks in specialty niche markets. HIIG Service Company (“HSC”), also our subsidiary, provides various administrative services to our subsidiaries.

2. Summary of Significant Accounting Policies

Basis of Presentation

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”), and include the accounts of the Company and its subsidiaries as of and for the years ended December 31, 2018 and 2017. All significant intercompany transactions and balances have been eliminated in consolidation.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid short-term investments. We consider all short-term investments purchased with an original maturity of three months or less to be cash equivalents.

Restricted Cash

HIIGU, an insurance agent, collects premiums from clients, and after deducting commissions and any applicable fees, remits these premiums to insurance companies. We hold unremitted insurance premiums in a fiduciary capacity, as restricted cash with the related liability reported as premium payable. Interest on these unremitted funds is generally reported as investment income.

We are required by state regulations to maintain assets on deposit with certain states and hold cash as collateral for certain reinsurance balances. Cash that we hold in a depository account for others or which is restricted by a state is recorded as restricted cash.

Available for Sale

Our investments in fixed maturity securities and equity securities are classified as available for sale and are reported at fair value based on quoted market prices or dealer quotes with unrealized gains and losses excluded from earnings and reported in stockholders’ equity, net of taxes, as a component of accumulated other comprehensive income (loss). If quoted market prices or dealer quotes are not available, we estimate fair value based on recent trading. Premiums and discounts on mortgage-backed securities are amortized using the retroactive method adjusted for anticipated prepayments and the estimated economic life of the securities. Adjustments related to changes in prepayment assumptions are included in investment income.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Summary of Significant Accounting Policies, continued

Investments

Investment Income and Realized Gains

Investment income consists of interest, dividends and equity in earnings (losses) of investees net of investment expenses. Interest income is recognized on the accrual basis, and dividends as earned at the ex-dividend date. Interest income on mortgage-backed and asset-backed securities is recognized using the effective-yield method based on estimated principal repayments. Included in interest income is the amortization of premium and accretion of discounts on debt securities.

We recognize realized gains and losses on investments in income based upon the specific identification method.

Other-than-Temporary Impairments

We evaluate declines in the market value of invested assets below cost, for other-than-temporary impairment losses, on a quarterly basis. Impairment losses for declines in the value of our fixed income, equity securities, collateralized loans and commercial mortgage loans below cost attributable to issuer-specific events are based on all relevant facts and circumstances for each investment and are recognized when appropriate. For all our investments with unrealized losses due to market conditions or industry-related events where we do not have the intent to sell the security and we have the ability to hold the investment for either a period of time sufficient to allow a market recovery or to maturity, declines in value below cost are not assumed to be other-than-temporary. When we consider the impairment of the value of an investment to be other-than-temporary, we report the decrease in value in earnings as a realized investment loss and establish a new basis.

Investment in Separately Managed Accounts

Our investments in separately managed accounts ("SMAs") are comprised primarily of direct or indirect investments in collateralized loans and commercial mortgage loans. We record directly owned collateralized loans and commercial mortgage loans at cost and recognize interest on the loans as interest receivable which we include in other assets on the balance sheet. As of December 31, 2018 and 2017, no allowance for loan losses was required.

Investments in Limited Partnerships

We have investments in certain limited partnerships. We use the equity method to account for our investments in limited partnerships. Under the equity method, our initial investment is recorded at cost and is subsequently adjusted based on our proportionate share of distributions and net income or loss of the partnership.

Other Invested Assets

Our other invested assets include investments in affiliates which are investments in primarily insurance agencies and managing general underwriters ("MGUs"). We principally use the equity method to account for these investments.

Short-Term Investments

Our short-term investments consist primarily of money market accounts carried at fair value.

Reinsurance

We report ceded unearned premium and reinsurance balances recoverable, on paid and unpaid losses and settlement expenses, separately as assets, instead of netting them with the related liabilities, since reinsurance does not relieve us of our legal liability to our policyholders.

We continuously monitor the financial condition of our reinsurers. As part of our monitoring efforts, we review their annual financial statements. We also review insurance industry developments that may impact the financial condition of our reinsurers. We analyze the credit risk associated with our reinsurance balances recoverable by monitoring the A.M. Best ratings of our reinsurers. We also assess the adequacy of collateral obtained, where applicable. We have \$100.3 million and \$68.1 million of collateral from various reinsurers as of December 31, 2018 and 2017, respectively. When our review indicates the existence of uncollectible amounts from reinsurers, our policy is to charge earnings and provide an allowance for estimated unrecoverable amounts. As of December 31, 2018 and 2017, we determined that no allowance was required.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Summary of Significant Accounting Policies, continued

Deferred Policy Acquisition Costs

Policy acquisition costs consist of commissions and premium taxes that vary with and are primarily related to the production of new or renewal business. We defer policy acquisition costs and related ceding commissions and charge or credit them to earnings in proportion with the premium earned.

We recognize a premium deficiency if the sum of expected losses, loss adjustment expenses and unamortized acquisition costs exceed our related unearned premiums. We first recognize a premium deficiency by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If our premium deficiency is greater than unamortized acquisition costs, we accrue a liability for the excess deficiency. We consider anticipated investment income in the determination of premium deficiencies. Based on the analysis performed by management, we believe that no premium deficiency existed at December 31, 2018 or 2017.

Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of the assets acquired and liabilities assumed. We amortize identifiable intangible assets with a finite useful life over the period that the intangible asset is expected to contribute directly or indirectly to our future cash flows. We do not amortize indefinite lived intangible assets. We assess goodwill and identifiable intangible assets for recoverability annually or whenever events or changes in circumstances indicate that a carrying amount may not be recoverable. We recognize an impairment loss if our testing indicates that the carrying value of an intangible asset is not recoverable and its carrying amount exceeds its fair value.

We review goodwill and intangible assets on a reporting unit basis by first assessing qualitative factors to determine whether it is more likely-than-not that an intangible asset is impaired. If the more likely-than-not threshold is met, we perform a quantitative impairment test by comparing the estimated fair value with the carrying value. Our impairment test is based on a comparison of the fair value, as determined by estimating the future discounted cash flows associated with the asset, to the asset's carrying value to determine if an impairment of such asset and its carrying value exists. If we determine that asset impairment exists, we recognize impairment expense for the difference between the fair value of such asset and its carrying value.

Property and Equipment

We record property and equipment, which is included in other assets in the consolidated balance sheets, at cost less accumulated depreciation and recognize depreciation expense on a straight-line basis for financial statement purposes over periods ranging from four to eight years for software and equipment and for leasehold improvements over the life of our lease. The net book value of property and equipment at December 31, 2018 and 2017 was \$12.3 million and \$11.7 million, respectively. Depreciation expense for the years ended December 31, 2018 and 2017 was \$3.6 and \$4.0 million, respectively.

Losses and LAE Reserves

Losses and LAE reserves represent our best estimate of the ultimate net cost of all reported and unreported losses that are unpaid as of the balance sheet dates. Our estimated reserves for losses and LAE include the accumulation of estimates for claims reported and unpaid prior to the balance sheet dates, estimates (based on projections of relevant historical data) of claims incurred but not reported, and estimates of expenses for investigating and adjusting all incurred and unpaid claims. We estimate our reserves on an undiscounted basis, using individual case-basis valuations, statistical analyses, and various actuarial procedures. We project future claim payments and reporting based on an analysis of our historical experience, supplemented by analyses of industry loss data.

The amounts we report are subject to uncertainty from various sources, including changes in reporting patterns, claims settlement patterns, judicial decisions, legislation, and economic conditions. Therefore, our actual loss experience may not conform to the assumptions used in determining the estimated amounts for such liability at the balance sheet dates. Management believes that, subject to the inherent variability in any such estimate, the reserves are within a reasonable and acceptable range of adequacy. We continually monitor and review reserves, and as settlements are made or reserves adjusted, the differences are reported in the current year.

Because of the nature of business we have historically written, management believes that we have limited exposure to environmental and other toxic tort type claim liabilities.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Summary of Significant Accounting Policies, continued

Premiums

We earn and recognize property and casualty premiums on a pro-rata basis over the terms of the policies. We earn accident and health premiums as billed, based on census data. Our premiums receivable include deferred premiums, which represent installment payments we are due from insureds under the payment terms of their policies. We recorded an allowance for estimated uncollectible premiums receivable of approximately \$1.2 million and \$0.9 million as of December 31, 2018 and 2017, respectively.

Unearned premiums represent the portion of premiums written which is applicable to the unexpired terms of insurance policies or reinsurance contracts in force. These unearned premiums are calculated on a pro-rata basis over the terms of the policies for direct and ceded amounts.

Fee and Commission Income

We generally recognize commissions on the effective date of the policies or the billing date, whichever is later. We recognize any subsequent premium adjustments, including policy cancellations, upon notification from the insurance carriers, or insured, as applicable. We record an allowance for estimated return commissions and fees that may be required to be repaid based on early termination of policies. As of December 31, 2018 and 2017, we determined that no allowance was required.

Profit Commissions

We have entered into contractual agreements with program managers that transfer a limited amount of a program's profits or losses through contingent commissions. Contingent commissions for the years ended December 31, 2018 and 2017 were \$0.6 million and \$1.8 million, respectively.

Income Taxes

We accrue income tax expense for the tax effects of transactions reported in the consolidated financial statements and this provision for income taxes consists of taxes currently due plus deferred taxes resulting from temporary differences between amounts reported for financial statement and income tax purposes. We establish a valuation allowance for any deferred tax asset not expected to be realized.

We measure deferred tax assets and liabilities using enacted tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in income in the period that includes the enactment date.

We record a liability for uncertain tax positions where it is more likely-than-not that the tax position will not be sustained upon examination by the appropriate tax authority. Changes in the liability for uncertain tax positions are reflected in income tax expense in the period when a new uncertain tax position arises, judgment changes about the likelihood of an uncertainty, the tax issue is settled or the statute of limitation expires. Any potential net interest income or expense and penalties related to uncertain tax positions are recorded in the consolidated statements of operations.

We file a consolidated federal income tax return in the United States and certain other state tax returns. Our admitted insurance subsidiaries pay premium taxes on gross written premiums in lieu of most state income or franchise taxes. Premium taxes are recorded as policy acquisition costs in the consolidated financial statements.

Stock Based Compensation

We currently grant common stock to our employees and non-employee directors under our Equity Incentive Program. The Equity Incentive Program requires a minimum investment from the participant once the participant has committed to a specified amount. The remainder is issued as a note receivable to us and is recorded as stock notes receivable within Stockholders Equity. Additionally, once the grant amount has been confirmed, we match 100% of the grant. We recognize compensation costs over the applicable vesting period for share-based payments to employees, former employees and non-employee directors at fair value of the common stock on the grant date.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Summary of Significant Accounting Policies, continued

Risk and Uncertainties

Certain risks and uncertainties are inherent to our day-to-day operations and to the process of preparing our consolidated financial statements. The more significant risks and uncertainties, as well as our attempt to mitigate, quantify and minimize such risks, are presented below and throughout the notes to the consolidated financial statements.

Use of Estimates

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ materially from these estimates.

Insurance Risks

Our loss and LAE reserves are based on estimates and may be inadequate to cover our actual insured losses, which would negatively impact our profitability. As of December 31, 2018, we had \$599.4 million of total gross loss and LAE reserves. Significant periods of time often elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of that loss. As part of the reserving process, we review historical data and consider the impact of various factors such as trends in claim frequency and severity, emerging economic and social trends, inflation and changes in the regulatory and litigation environments. If the actual amount of insured losses is greater than the amount we have reserved for these losses, our profitability could suffer. See further discussion in Note 11.

Reinsurance Risk

Reinsurance does not discharge us from our primary liability to policyholders, and to the extent that a reinsurer is unable to meet its obligations, we would be liable. We continuously monitor the financial condition of prospective and existing reinsurers. As a result, we purchase reinsurance from a number of financially strong reinsurers. We provide an allowance for reinsurance balances deemed uncollectible. See further discussion of reinsurance exposures in Note 13.

Investment Risk

Our investment portfolio is subject to market, credit, liquidity and interest rate risks. Our equity portfolio will fluctuate with movements in the overall stock market, while our bond portfolio is affected by interest rate changes and movement in credit spreads. We attempt to mitigate our interest rate and credit risks by constructing a well-diversified portfolio with high-quality securities with varied maturities. Downturns in the financial markets could have a negative effect on our portfolio. However, we attempt to manage this risk through asset allocation, duration and security selection. Our investment in separately managed accounts, investments in limited partnerships and other invested assets are relatively illiquid and represent 24% and 20% of total investments as of December 31, 2018 and 2017, respectively. Investments in separately managed accounts and limited partnerships are generally comprised of loans with relatively short duration but subject to contractual withdrawal conditions. Other invested assets are generally investments in privately held companies that could be sold but timing is uncertain.

Concentration Risk

Financial instruments that potentially subject us to concentrations of credit risk are primarily cash and cash equivalents, restricted cash, investments, premiums receivable and reinsurance recoverable balances.

Cash equivalents and short-term investments include investments in money market funds and securities backed by the U.S. government. Investments are diversified throughout many industries and geographic regions. We limit the amount of credit exposure with any one financial institution or issuer and believe that no significant concentration of credit risk exists with respect to cash and investments. At December 31, 2018 and 2017, the outstanding premiums receivable are generally diversified due to the large number of entities comprising our customer base and their dispersion across many different lines of business and geographic regions. Failure by general agents to remit premiums could result in premium write-offs and a corresponding loss of income.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2. Summary of Significant Accounting Policies, continued

Risk and Uncertainties, continued

We also have recoverables from our reinsurers. One reinsurer comprises approximately 37% of the reinsurance recoverables balance and is rated A+ by A.M. Best, a widely recognized rating agency with an exclusive insurance industry focus. We evaluate the financial condition of our reinsurers and may obtain collateral to minimize our exposure to significant losses from reinsurer insolvencies.

Reclassifications

Certain 2017 amounts have been reclassified to conform to the 2018 presentation. Such reclassifications had no effect on our financial position, net income (loss) or cash flows.

3. Recent Accounting Pronouncements

In February 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, that allows a reclassification from accumulated other comprehensive income ("AOCI") to retained earnings of the stranded tax effects in AOCI resulting from the Tax Cuts and Jobs Act of 2017 ("TCJA"). Current guidance required the effect of a change in tax laws or rates on deferred tax balances to be reported in income from continuing operations in the accounting period that includes the period of enactment, even if the related income tax effects were originally charged or credited directly to AOCI. The amount of the reclassification would include the effect of the change in the U.S. federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances, if any, at the date of the enactment of TCJA related to items in AOCI. The updated guidance is effective for reporting periods beginning after December 15, 2018 and is to be applied retrospectively to each period in which the effect of the TCJA related to items remaining in AOCI are recognized or at the beginning of the period of adoption. Early adoption is permitted. We have adopted this ASU effective January 1, 2018. The adoption of this ASU did not have a material impact to our stockholders' equity.

In May 2017, the FASB issued ASU No. 2017-09, *Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting*, which clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. The guidance requires entities to apply the modification accounting guidance if the value, vesting conditions or classification of the award changes. In addition to all the disclosures about modifications that are currently required, the entities are now also required to affirmatively disclose when compensation expense has not changed. The ASU will be applied prospectively and is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. We have adopted this ASU effective January 1, 2018. The adoption of this ASU did not have a material impact on our consolidated financial statements.

In March 2017, the FASB issued ASU No. 2017-08, *Premium Amortization on Purchased Callable Debt Securities*, which provides guidance that shortens the amortization period for certain callable debt securities held at a premium by requiring the premium to be amortized to the earliest call date. The standard does not require an accounting change for securities held at a discount, which continue to be amortized to maturity. This ASU is effective for nonpublic entities with fiscal years beginning after December 15, 2019 and interim periods within fiscal years beginning after December 15, 2020. We have not yet completed our analysis of the effect that adopting this ASU will have on our consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles – Goodwill and Other (Topic 350)*. ASU 2017-04 eliminates the requirement to calculate the implied fair value of goodwill that is done in step two of the current goodwill impairment test to measure a goodwill impairment loss. Instead, entities will record an impairment loss based on the excess of a reporting unit's carrying amount over its fair value. The guidance will be applied prospectively and is effective for annual and interim impairment tests performed in periods beginning after December 15, 2021. We do not anticipate that this ASU will have a material impact on our consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-01, *Business Combinations (Topic 805)*. ASU 2017-01 clarifies the definition of a business to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The guidance specifies the minimum inputs and processes required to meet the definition of a business. The guidance is effective for annual periods beginning after December 15, 2018, and interim periods within the year of adoption. The adoption of this ASU will not have a material impact on our consolidated financial statements.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Recent Accounting Pronouncements, continued

In March 2016, the FASB issued ASU No. 2016-09, *Share-Based Payments*, to simplify the stock-based compensation guidance. It is meant to simplify and improve the accounting and statement of cash flows presentation for income taxes at settlement, forfeitures and net settlements for withholding tax for all entities. This ASU is effective for public entities for annual periods beginning after December 15, 2016. For private entities, this ASU is effective for annual periods beginning after December 15, 2017. Early adoption is permitted.

Under the new guidance ASU No. 2016-09, entities will be permitted to make an accounting policy election related to either estimating forfeitures each period as currently required, or accounting for forfeitures as they occur. All of the tax effects related to share-based payments at settlement (or expiration) will be recognized in the statement of operations. Entities will be permitted to report all tax-related cash flows resulting from share-based payments as operating activities in the statements of cash flows. Entities will also be permitted to withhold an amount up to the employees' maximum individual tax rate in the relevant jurisdiction, without resulting in liability classification of the award. We have adopted ASU No. 2016-09 and, accordingly, we have accounted for forfeitures as they occur, recognized the tax effects related to share-based payments at settlement (or expiration) in the statement of operations and reported all tax-related cash flows resulting from share-based payments as operating activities. There was no material effect on our consolidated financial statements due to the adoption of this ASU.

In February 2017, the FASB issued ASU No. 2016-02, *Leases*, to improve the financial reporting of leasing transactions. Under current guidance for lessees, leases are only included on the balance sheet if certain criteria, classifying the agreement as a capital lease, are met. This pronouncement will require the recognition of a right-of-use asset and a corresponding lease liability, discounted to the present value, for all leases that extend beyond 12 months. For operating leases, the asset and liability will be expensed over the lease term on a straight-line basis, with all cash flows included in the operating section of the statement of cash flows. For finance leases, interest on the lease liability will be recognized separately from the amortization of the right-of-use asset in the income statement and the repayment of the principal portion of the lease liability will be classified as a financing activity in the statements of cash flows while the interest component will be included in the operating activities in the statements of cash flows. This ASU is effective for reporting periods beginning after December 15, 2018 for public entities and reporting periods beginning after December 15, 2019 for private entities. Early adoption is permitted. We have not yet completed our analysis of the effect that adopting this ASU will have on our consolidated financial statements. See Note 17 for our total operating lease exposure as of December 31, 2018.

In August 2016, the FASB issued ASU 2016-15, *Classification of Certain Cash Receipts and Cash Payments (Topic 230)*. ASU 2016-15 will reduce diversity in practice on how eight specific cash receipts and payments are classified on the statement of cash flows. The ASU will be effective for fiscal years beginning after December 15, 2019. Early adoption is permitted. We are currently evaluating the impact that the adoption of the ASU will have on our financial results and disclosures but do not anticipate that any potential impact would be significant.

In June 2016, the FASB issued ASU 2016-13, *Measurement of Credit Losses on Financial Instruments (Topic 326)*. ASU 2016-13 requires organizations to estimate credit losses on certain types of financial instruments, including receivables and available-for-sale debt securities, by introducing an approach based on expected losses. The expected loss approach will require entities to incorporate considerations of historical information, current information and reasonable and supportable forecasts. The guidance is effective for fiscal years beginning after December 15, 2021. Early adoption is permitted. We are currently evaluating the impact that the adoption of the ASU will have on our consolidated financial statements.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments - Overall: Recognition and Measurement of Financial Assets and Financial Liabilities* to improve the recognition and measurement of financial instruments. The new guidance makes targeted improvements to GAAP as follows:

- a. Requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income;
- b. Simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment;
- c. Requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments;

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Recent Accounting Pronouncements, continued

- d. Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the consolidated financial statements; and
- e. Clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

This ASU is effective for reporting periods beginning after December 15, 2018 for public entities and December 15, 2019 for private entities. Early adoption is only permitted for provision (e) above. Upon adoption, a cumulative-effect adjustment to the balance sheet will be made as of the beginning of the fiscal year of adoption. We have adopted this ASU effective January 1, 2019. The adoption of this ASU will result in a reclassification of \$7.4 million, net of tax, from accumulated other comprehensive income to accumulated deficit in the statement of changes in stockholders' equity.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*. ASU No. 2014-09 was issued to specify the accounting for revenue from contracts with customers. The new ASU requires that an entity recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled. While insurance contracts are excluded from this ASU, fee income related to any brokerage operations will be subject to this updated guidance. ASU No. 2014-09 is effective for interim and annual periods beginning after December 15, 2017 for public entities and December 15, 2019 for private entities. We have adopted this ASU effective January 1, 2019. The adoption of this ASU will not have a material impact on our consolidated financial statements.

4. Goodwill and Intangible Assets

The changes in the carrying amount of goodwill by reporting unit and identifiable intangible assets for the years ended December 31, 2018 and 2017 are as follows (in thousands):

	2018	2017
Goodwill:		
Accident and Health	\$ 84,731	\$ 67,570
Hospitality	10,361	10,361
Mining	10,052	10,052
Exterminator Pro	11,809	11,809
Other	4,681	4,031
Total goodwill	121,634	103,823
Other intangibles assets:		
Indefinite lived intangible assets	16,141	15,141
Finite lived intangible assets	23,503	21,918
Total other intangibles	39,644	37,059
Less accumulated amortization	(16,641)	(15,229)
Total other intangible assets, net	23,003	21,830
Total goodwill and other intangibles	\$ 144,637	\$ 125,653

Our indefinite lived intangible assets relate to insurance licenses and trademarks. Our finite intangible assets, which relate to policy renewals, agency relationships and non-compete/exclusivity agreements, have a weighted average useful life of ten years.

We recognized amortization expense of approximately \$1.4 million for the years ended December 31, 2018 and 2017, respectively.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Goodwill and Intangible Assets, continued

Estimated future net amortization expense, including the amortization of the deferred financing cost, for the next five years is as follows (in thousands):

<u>Year Ending December 31,</u>	<u>Amount</u>
2019	\$ 1,730
2020	1,391
2021	1,023
2022	1,023
2023	1,023

5. Investments

The amortized cost and the fair value of our investments are summarized as follows (in thousands):

	<u>Gross Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
December 31, 2018				
Fixed maturity securities:				
U.S. government securities	\$ 59,390	\$ 226	\$ (308)	\$ 59,308
Corporate securities and miscellaneous	52,154	42	(1,161)	51,035
Municipal securities	49,021	324	(127)	49,218
Residential mortgage-backed securities	89,592	170	(1,551)	88,211
Commercial mortgage-backed securities	5,788	-	(84)	5,704
Asset-backed securities	<u>23,961</u>	<u>1</u>	<u>(168)</u>	<u>23,794</u>
Total fixed maturity securities	<u>\$ 279,906</u>	<u>\$ 763</u>	<u>\$ (3,399)</u>	<u>\$ 277,270</u>
Equity securities:				
Common stocks	\$ 58,696	\$ 997	\$ (10,291)	\$ 49,402
Mutual funds	<u>5,275</u>	<u>-</u>	<u>(37)</u>	<u>5,238</u>
Total equity securities	<u>\$ 63,971</u>	<u>\$ 997</u>	<u>\$ (10,328)</u>	<u>\$ 54,640</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Investments, continued

	<u>Gross Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
December 31, 2017				
Fixed maturity securities:				
U.S. government securities	\$ 29,478	\$ 3	\$ (257)	\$ 29,224
Corporate securities and miscellaneous	69,504	818	(110)	70,212
Municipal securities	51,131	1,684	(17)	52,798
Residential mortgage-backed securities	48,889	67	(559)	48,397
Commercial mortgage-backed securities	7,390	21	(72)	7,339
Asset-backed securities	<u>41,329</u>	<u>39</u>	<u>(52)</u>	<u>41,316</u>
Total fixed maturity securities	<u>\$ 247,721</u>	<u>\$ 2,632</u>	<u>\$ (1,067)</u>	<u>\$ 249,286</u>
Equity securities:				
Common stocks	\$ 54,368	\$ 3,224	\$ (2,164)	\$ 55,428
Mutual funds	<u>1,663</u>	<u>-</u>	<u>(10)</u>	<u>1,653</u>
Total equity securities	<u>\$ 56,031</u>	<u>\$ 3,224</u>	<u>\$ (2,174)</u>	<u>\$ 57,081</u>

The amortized cost and estimated fair value of fixed maturity securities at December 31, 2018 by contractual maturity are shown below (in thousands). Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Also, changing interest rates, tax considerations or other factors may result in portfolio sales prior to maturity.

	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in less than one year	\$ 11,286	\$ 11,246
Due after one year through five years	98,990	98,424
Due after five years through ten years	38,209	37,642
Due after ten years	17,868	17,953
Residential mortgage-backed securities	89,592	88,211
Asset-backed securities	<u>23,961</u>	<u>23,794</u>
Total	<u>\$ 279,906</u>	<u>\$ 277,270</u>

For fixed maturity securities, we are required to recognize an other-than-temporary impairment ("OTTI") loss when we intend to sell or it is more likely-than-not that we will be required to sell an impaired fixed maturity before the security recovers to its amortized cost value or it is likely that we will not recover the entire amortized cost value of an impaired fixed maturity security. If we have the intent to sell or it is more likely-than-not that we will be required to sell an impaired fixed maturity investment before the security recovers to its amortized cost value, we write the security down to fair value and the entire amount of the write-down is included in income as a realized investment loss. For all other impaired fixed maturities, the impairment loss is separated into the amount representing the credit loss and the amount representing the loss related to all other factors. The amount of the impairment loss that represents the credit loss is included in net income as a realized investment loss and the amount of the impairment loss that relates to all other factors is included in other comprehensive income (loss).

For fixed maturity securities, the split between the amount of OTTI losses that represents credit losses and the amount that relates to all other factors is principally based on assumptions regarding the amount and timing of projected cash flows. For fixed maturities other than mortgage-backed securities, cash flow estimates are based on assumptions regarding the probability of default and estimates regarding the timing and amount of recoveries associated with a default. For mortgage-backed securities, cash flow estimates are based on assumptions regarding future prepayment rates, default rates, loss severity and timing of recoveries. We have developed our estimates of projected cash flows using information based on historical market data, industry analyst reports and forecasts and other data relevant to the collectability of a security.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Investments, continued

For equity securities, we consider our intent and ability to hold a security for a period of time sufficient to allow for the recovery of cost. If we deem the decline in fair value of an equity security to be other-than-temporary, we write the security down to fair value and the amount of the write down is included in net income as an other-than-temporary impairment loss. We recognized no OTTI adjustments on fixed maturity or equity securities in an unrealized loss position for the years ended December 31, 2018 and 2017.

The following tables summarize gross unrealized losses and the corresponding fair values of investments, aggregated by length of time that individual securities have been in a continuous unrealized loss position (in thousands).

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2018						
U.S. government securities	\$ 4,981	\$ (12)	\$ 17,235	\$ (296)	\$ 22,216	\$ (308)
Corporate securities and Miscellaneous	33,355	(839)	13,603	(322)	46,958	(1,161)
Municipal securities	18,174	(94)	1,645	(33)	19,819	(127)
Residential mortgage-backed Securities	14,116	(393)	24,246	(1,158)	38,362	(1,551)
Commercial mortgage-backed Securities	1,255	(9)	3,508	(75)	4,763	(84)
Asset-backed securities	<u>12,502</u>	<u>(101)</u>	<u>8,576</u>	<u>(67)</u>	<u>21,078</u>	<u>(168)</u>
Total fixed maturity securities	84,383	(1,448)	68,813	(1,951)	153,196	(3,399)
Equity securities	<u>43,045</u>	<u>(9,307)</u>	<u>1,197</u>	<u>(1,021)</u>	<u>44,242</u>	<u>(10,328)</u>
Total	<u>\$ 127,428</u>	<u>\$ (10,755)</u>	<u>\$ 70,010</u>	<u>\$ (2,972)</u>	<u>\$ 197,438</u>	<u>\$ (13,727)</u>

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2017						
U.S. government securities	\$ 14,316	\$ (55)	\$ 11,434	\$ (202)	\$ 25,750	\$ (257)
Corporate securities and Miscellaneous	23,441	(100)	1,519	(10)	24,960	(110)
Municipal securities	3,171	(3)	1,818	(14)	4,989	(17)
Residential mortgage-backed Securities	10,493	(24)	25,866	(535)	36,359	(559)
Commercial mortgage-backed Securities	2,778	(37)	1,770	(35)	4,548	(72)
Asset-backed securities	<u>18,679</u>	<u>(23)</u>	<u>4,332</u>	<u>(29)</u>	<u>23,011</u>	<u>(52)</u>
Total fixed maturity securities	72,878	(242)	46,739	(825)	119,617	(1,067)
Equity securities	<u>24,856</u>	<u>(1,754)</u>	<u>838</u>	<u>(420)</u>	<u>25,694</u>	<u>(2,174)</u>
Total	<u>\$ 97,734</u>	<u>\$ (1,996)</u>	<u>\$ 47,577</u>	<u>\$ (1,245)</u>	<u>\$ 145,311</u>	<u>\$ (3,241)</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Investments, continued

At December 31, 2018, 200 individual fixed maturity and equity securities were in a gross unrealized loss position, of which 130 were fixed maturities. We do not have the intent to sell and it is not more likely-than-not that we will be required to sell these fixed maturities before the securities recover to their amortized cost value. In addition, we believe that none of the declines in the fair values of these fixed maturities relate to credit losses. We have the intent and ability to hold equity securities in an unrealized loss position for a period of time sufficient to allow for the recovery of cost. We believe that none of the declines in the fair value of these fixed maturity and equity securities were other-than-temporary at December 31, 2018.

The components of net realized gains for the years ended December 31, 2018 and 2017 are as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Gross realized gains		
Fixed maturity securities	\$ 35	\$ 62
Equity securities	<u>4,063</u>	<u>9,175</u>
Total	<u>4,098</u>	<u>9,237</u>
Gross realized losses		
Fixed maturity securities	(480)	(442)
Equity securities	(669)	(359)
Investment in separately managed accounts	<u>(144)</u>	<u>-</u>
Total	<u>(1,293)</u>	<u>(801)</u>
Net realized gains	<u>\$ 2,805</u>	<u>\$ 8,436</u>

Proceeds from sales and maturities, of fixed maturity securities and equity securities, for the year ended December 31, 2018 were approximately \$61.1 million and \$36.7 million, respectively. Proceeds from sales and maturities, of fixed maturity securities and equity securities, for the year ended December 31, 2017 were approximately \$80.9 million and \$51.0 million, respectively.

Our net investment income for the year ended December 31, 2018 and 2017 is summarized as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Income:		
Fixed maturity securities	\$ 9,535	\$ 8,214
Equity securities	1,222	697
Investment in affiliates	1,498	710
Investment in limited partnerships	3,780	6,043
Investment in separately managed accounts	6,069	4,248
Short term investments and cash	259	455
Other	<u>79</u>	<u>208</u>
Total investment income	22,442	20,575
Investment expenses	<u>(4,580)</u>	<u>(3,337)</u>
Net investment income	<u>\$ 17,862</u>	<u>\$ 17,238</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Investments, continued

The change in net unrealized gains (losses) on investments, net of deferred income taxes, for the years ended December 31, 2018 and 2017 is as follows (in thousands):

	2018	2017
Fixed maturity securities	\$ (4,201)	\$ 2,162
Equity securities	(11,033)	(1,861)
Investment in separately managed accounts	617	-
Short-term investments	50	-
Foreign currency translation	654	459
Reclassification of tax effects	(355)	-
Deferred income taxes	3,248	(266)
Total	\$ (11,020)	\$ 494

We are required by various state regulations to maintain cash, investment securities or letters of credit on deposit with the states in a depository account. At December 31, 2018 and 2017, cash and investment securities on deposit had fair values of approximately \$75.3 million and \$74.0 million, respectively.

6. Fair Value Measurements

Our financial instruments include assets and liabilities carried at fair value, as well as assets and liabilities carried at cost or amortized cost but disclosed at fair value in our financial statements. In determining fair value, we generally apply the market approach, which uses prices and other relevant data based on market transactions involving identical or comparable assets and liabilities. We classify our financial instruments into the following three-level hierarchy:

Level 1 - Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.

Level 2 - Inputs are other than quoted prices included in Level 1 that are observable for the asset or liability through corroboration with market data at the measurement date.

Level 3 - Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date.

We used the following methods and assumptions in estimating the fair value disclosures for financial instruments in the accompanying consolidated financial statements and in these notes:

Our Level 1 investments consist of U.S. Treasury and equity securities traded in an active exchange market. We use unadjusted quoted prices for identical instruments to measure fair value.

Our Level 2 investments include most of our fixed maturity securities, which consist of U.S. government agency securities, municipal bonds, certain corporate debt securities and certain mortgage-backed and asset-backed securities. We measure fair value for the majority of the Level 2 investments using quoted prices of securities with similar characteristics.

We use data provided by a third-party investment manager to value our investments and we perform periodic analyses on the prices received from third parties to determine whether the prices are reasonable estimates of fair value. Our analyses include a review of month-to-month price fluctuations and, as needed, a comparison of pricing services' valuations to other pricing services' valuations for the identical security.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

6. Fair Value Measurements, continued

The following table summarizes fair value measurements by level at December 31, 2018 and 2017 for assets and liabilities measured at fair value on a recurring basis (in thousands):

December 31, 2018	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
Fixed maturity securities:				
U.S. government securities	\$ 59,308	\$ -	\$ -	\$ 59,308
Corporate securities and miscellaneous	-	51,035	-	51,035
Municipal securities	-	49,218	-	49,218
Residential mortgage-backed securities	-	88,211	-	88,211
Commercial mortgage-backed securities	-	5,704	-	5,704
Asset-backed securities	-	23,794	-	23,794
Total fixed maturity securities	<u>59,308</u>	<u>217,962</u>	<u>-</u>	<u>277,270</u>
Mutual funds:				
Fixed income bond fund	<u>5,238</u>	<u>-</u>	<u>-</u>	<u>5,238</u>
Total mutual funds	<u>5,238</u>	<u>-</u>	<u>-</u>	<u>5,238</u>
Equity securities:				
Consumer discretionary	10,335	-	-	10,335
Consumer staples	1,705	-	-	1,705
Energy	3,277	-	-	3,277
Finance	23,366	-	-	23,366
Industrial	3,415	-	-	3,415
Information technology	3,376	-	-	3,376
Material	906	-	-	906
Other	<u>3,022</u>	<u>-</u>	<u>-</u>	<u>3,022</u>
Total equity securities	<u>49,402</u>	<u>-</u>	<u>-</u>	<u>49,402</u>
Short-term investments	<u>57,611</u>	<u>-</u>	<u>-</u>	<u>57,611</u>
Grand total	<u>\$ 171,559</u>	<u>\$ 217,962</u>	<u>\$ -</u>	<u>\$ 389,521</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

6. Fair Value Measurements, continued

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2017				
Fixed maturity securities:				
U.S. government securities	\$ 29,224	\$ -	\$ -	\$ 29,224
Corporate securities and miscellaneous	-	70,212	-	70,212
Municipal securities	-	52,798	-	52,798
Residential mortgage-backed securities	-	48,397	-	48,397
Commercial mortgage-backed securities	-	7,339	-	7,339
Asset-backed securities	-	41,316	-	41,316
	<u>29,224</u>	<u>220,062</u>	<u>-</u>	<u>249,286</u>
Total fixed maturity securities				
Mutual funds:				
Fixed income bond fund	<u>1,653</u>	<u>-</u>	<u>-</u>	<u>1,653</u>
	<u>1,653</u>	<u>-</u>	<u>-</u>	<u>1,653</u>
Total mutual funds				
Equity securities:				
Consumer discretionary	1,820	-	-	1,820
Consumer staples	10,343	-	-	10,343
Energy	4,068	-	-	4,068
Finance	27,684	-	-	27,684
Industrial	4,728	-	-	4,728
Information technology	6,120	-	-	6,120
Material	614	-	-	614
Other	<u>51</u>	<u>-</u>	<u>-</u>	<u>51</u>
	<u>55,428</u>	<u>-</u>	<u>-</u>	<u>55,428</u>
Total equity securities				
Short-term investments	<u>130,975</u>	<u>-</u>	<u>-</u>	<u>130,975</u>
Grand total	<u>\$ 217,280</u>	<u>\$ 220,062</u>	<u>\$ -</u>	<u>\$ 437,342</u>

We had no assets measured at fair value on a recurring basis using Level 3 inputs for the years ended December 31, 2018 and 2017.

We measure certain assets, including investments in affiliates, investments in limited partnerships and investments in SMAs, at fair value on a nonrecurring basis only when they are deemed to be other-than-temporarily-impaired. At December 31, 2018 and 2017, none of these assets were deemed to be other-than-temporarily-impaired.

In addition to the preceding disclosures on assets and liabilities recorded at fair value in the consolidated balance sheets, we are also required to disclose the fair values of certain other financial instruments for which it is practicable to estimate fair value. Estimated fair value amounts, defined as the quoted market price of a financial instrument, have been determined using available market information and other appropriate valuation methodologies. However, considerable judgments are required in developing the estimates of fair value where quoted market prices are not available. Accordingly, these estimates are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions or estimating methodologies may have an effect on the estimated fair value amounts.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

6. Fair Value Measurements, continued

We used the following methods and assumptions in estimating the fair value disclosures of trust debenture securities and the note payable:

Trust debenture securities: The carrying value approximates the estimated fair value for our trust debenture as the trust debenture accrues interest at current market rates.

Note payable: The carrying value approximates the estimated fair value for notes payable as the note payable accrues interest at current market rates.

Other financial instruments qualify as insurance-related products and are specifically exempted from fair value disclosure requirements.

7. Other Invested Assets

Investment in Separately Managed Account

During 2016, we began investing in a Separately Managed Account ("SMA1"), managed by Arena Investors, LP ("Arena"), which is affiliated with The Westaim Corporation ("Westaim") who, through Westaim HIIG LP, is our controlling shareholder. We committed a total investment of \$44.0 million for SMA1 and had unfunded commitments as of December 31, 2018 and 2017 of \$1.5 million and \$4.0 million, respectively. As of December 31, 2018 and 2017, our carrying value in the SMA1 is \$50.3 million and \$43.9 million, respectively. As of December 31, 2018, we held direct and indirect investments in notes receivable from 29 different creditors through the SMA1. The interest rate we earned on the notes ranged from 10.0% to 24.0% and the remaining term of the individual notes as of December 31, 2018 ranged from one month to forty-five months. The SMA notes are subject to collateral requirements and certain notes also include owner guarantees. During the year ended December 31, 2018 and 2017, we recorded investment income, net of expenses of \$2.7 million and \$3.0 million, respectively, related to our investment in SMA1.

During 2017, we began investing in a second Separately Managed Account ("SMA2"), managed by Arena. We committed a total investment of \$50.0 million for SMA2 and had unfunded commitments as of December 31, 2018 and 2017 of \$33.0 million and \$40.2 million, respectively. As of December 31, 2018 and 2017, our carrying value in SMA2 is \$17.9 million and \$9.8 million, respectively. As of December 31, 2018, we held undivided interests in notes receivable from ten different creditors through the SMA2. The interest rate we earned on the notes ranged from 7.0% to 9.0% and the remaining term of the individual notes as of December 31, 2018 ranged from five months to twenty-eight months. All notes owned through the SMA2 are subject to collateral requirements and certain notes include owner guarantees. During the year ended December 31, 2018 and 2017, we recorded investment income, net of expenses of \$0.7 million and \$0.2 million, respectively, related to our investment in SMA2.

Investment in Limited Partnerships

During 2012, we made a commitment to invest \$10.0 million in Dowling Capital Partners ("DCP"), which represents approximately a 6% ownership interest in DCP. During the years ended December 31, 2018 and 2017, we recorded income of \$0.6 million and \$0.4 million, respectively. Our carrying value in DCP as of December 31, 2018 and 2017 is approximately \$3.9 million and \$3.7 million, respectively. For the years ended December 31, 2018 and 2017, we made capital contributions of \$0.0 million and \$0.3 million, respectively and received distributions of \$0.4 million and \$4.2 million, respectively.

During 2015, we invested \$25.0 million in Arena Special Opportunities Fund, LP. During the years ended December 31, 2018 and 2017, we recorded investment income, net of expenses of \$3.0 million and \$4.8 million, respectively, related to this investment. As of December 31, 2018 and 2017, our carrying value is approximately \$33.3 million and \$30.4 million, respectively.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

7. Other Invested Assets, continued

Investment in Affiliates

In December 2010, we invested in our former subsidiary, ClearView Risk Holdings, LLC ("CVR"). Since then we have participated in additional CVR capital raises including contributing an additional \$0.8 million in 2016. During 2017, we invested an additional \$2.0 million in CVR for the purchase of newly issued class D units increasing our overall ownership to 24.84%. During the years ended December 31, 2018 and 2017, we recorded equity in earnings of approximately \$1.1 million and \$0.5 million, respectively, from our investment in CVR, which represented our pro-rata share of CVR's net income. Our investment in CVR as of December 31, 2018 and 2017 is recorded at approximately \$10.8 million and \$9.7 million, respectively, in the consolidated balance sheet. In January 2019, we sold our investment in CVR. See Note 21 for further details.

In March 2015, we purchased a 20% ownership interest in Regional Insurance Services Company LLC and its affiliates ("RISCOM"). The initial purchase price was \$3.2 million in cash. The purchase agreement also included a contingency for future earn-out payments of up to \$1.0 million. As of December 31, 2017, no earnout payments were made and the liability was reduced to \$0. Concurrent with the close of the transaction, a principle of RISCOM purchased units of Westaim HIIG LP for \$1.0 million in cash. During the years ended December 31, 2018 and 2017, we recorded equity in earnings of approximately \$0.8 million and \$0.6 million, respectively, from our investment in RISCOM, which represented our pro rata share of RISCOM's net income. During the years ended December 31, 2018 and 2017, we received distributions of approximately \$0.9 million and \$0.3 million, respectively from our investment in RISCOM. Our investment in RISCOM as of December 31, 2018 and 2017 is recorded at approximately \$4.6 million and \$4.7 million, respectively in the consolidated balance sheet.

In December 2015, we acquired a 24.5% capital interest in PVI Agency, LLC by converting the previously issued \$1.5 million note receivable to equity and investing an additional \$1.0 million of cash. In December 2016, we loaned \$0.5 million to PVI. The note bears interest at 6% per annum. In addition, we received warrants to acquire 0.5% of any newly issued units of PVI for each \$0.1 million we lend to PVI. In August 2017, we exercised these warrants which increased our ownership percentage in PVI to 27%. Also in August 2017, we agreed to loan an additional \$1.0 million and as of December 31, 2018 and 2017, \$0.6 million was outstanding. As part of this transaction, we also received additional warrants that expire 90 days after the 2017 loan is paid off. During the years ended December 31, 2018 and 2017, we recorded equity in earnings (loss) of approximately \$(0.6) million and \$(0.5), respectively, from our investment in PVI, which represented our pro-rata share of PVI's net income (loss). Our equity investment in PVI as of December 31, 2018 and 2017 is recorded at approximately \$0.8 million and \$1.4 million, respectively, in the consolidated balance sheet.

In January 2016, we purchased a 35% interest in Creative Risk Underwriters, LLC ("Creative Risk"), an accident and health underwriting agency, for \$1.0 million in cash. In October 2016, we extended a revolving note to Creative Risk for up to \$0.8 million. The note bore interest at 8% per annum, with interest due each quarter beginning in December 2016. The rate on the note was decreased to 6% per annum during 2017. As of December 31, 2017, approximately \$0.4 million was outstanding on the note. In December 2017, our ownership increased to 44.6% due to Creative Risk buying a former owner's interest. Effective October 1, 2018, we purchased the remaining 55.4% ownership interest in Creative Risk so as to own 100% of the company. The implied purchase price was \$20.0 million for the entire entity which resulted in an initial purchase price of \$9.97 million in cash to the two members owning the remaining 55.4%. The purchase agreement includes a contingency for future earnout payments up to \$1.1 million. The earnout is calculated over two years based on achieving certain operating thresholds. Prior to the acquisition, the amount available (in total) under the note and the outstanding amount due under the note was increased to \$2.1 million. The note was paid in full concurrent with the close of the transaction. We have accrued \$1.0 million, which approximates fair value of the contingent consideration, as part of the purchase price at December 31, 2018. The business combination was recorded using the purchase method of accounting. Accordingly, the purchase price has been allocated based on the fair value of assets acquired, with \$17.2 million of the purchase price being allocated to goodwill and \$1.5 million allocated to other intangible assets. With the recording of this transaction as a step up in accounting basis, we also recorded acquisition adjustment income of \$8.8 million related to the purchase accounting that is reported in total revenue.

In June 2017, we purchased a 20% interest in KIS Surety Bonds, LLC ("KIS Surety"), a surety managing general agency for \$0.2 million in cash. During each of the years ended December 31, 2018 and 2017, we recorded equity in earnings of approximately \$0.1 million from our investment in KIS Surety, which represented our pro rata share of KIS Surety's net income. Our investment in KIS Surety as of December 31, 2018 and 2017 is recorded at approximately \$0.3 million in the consolidated balance sheet.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

8. Trust Debenture Securities

On August 2, 2006, Delos Capital Trust n/k/a HIIG Capital Trust I (the "Trust"), a Delaware statutory trust, issued \$58.0 million of fixed/floating rate capital securities guaranteed by us. The Trust also issued us \$1.8 million of common stock.

The sole asset of the Trust consists of Fixed/Floating Rate Junior Subordinated Deferrable Interest Debentures (the "Debentures") with a principal amount of \$59.8 million issued by us. The Debentures are an unsecured obligation, are redeemable on or after September 15, 2011, and have a maturity date of September 15, 2036. Interest on the Debentures is payable quarterly at an annual rate based on the three-month LIBOR plus 3.4%, which was 6.2% at December 31, 2018.

We have not consolidated the Trust that issued the capital securities, as it does not meet the criteria for consolidation under guidance issued by the FASB. We reflect the debt related to the Debentures in our December 31, 2018 and 2017 consolidated balance sheets, net of debt issuance costs of approximately \$0.8 million and \$0.9 million, respectively. These deferred financing costs are presented on the balance sheet as a direct deduction from the carrying amount of the trust debenture securities.

9. Notes Payable

Term Loan Note and Revolving Line of Credit

On April 30, 2014, we executed a new five-year term loan note with a financial institution in the principal amount of \$40 million due May 1, 2019, and a new, related credit agreement. We executed an amendment to the credit agreement which extended the maturity date of our term loan to December 31, 2019. The interest rate on the note is the lesser of the one-month LIBOR (2.3% at December 31, 2018) plus the Eurodollar Rate, which is defined as 1.75%, or the Highest Lawful Rate. Interest-only payments are due and payable on a quarterly basis through December 31, 2019.

In addition, in 2015, we executed a new \$50 million revolving promissory note due May 1, 2018. We executed an amendment to the promissory note which extended the maturity date of our promissory note to December 31, 2019. The interest rate on the note is the lesser of the prime rate or the one-month LIBOR (2.3% at December 31, 2018) plus the Eurodollar Rate, which is defined as the lesser of 1.75%, or the Highest Lawful Rate. The revolving promissory note includes a fee of 0.20% on the unused portion. Interest-only payments are due and payable on a quarterly basis through December 31, 2019. The outstanding balance on the revolving promissory note was \$41.0 million and \$23.0 million as of December 31, 2018 and 2017, respectively. Management believes that it is probable that both the term and promissory notes will be refinanced or extended at maturity.

The indebtedness is collateralized by a perfected first priority security interest in all of the assets of HIIG and HIIGU and the outstanding capital stock of HSIC.

10. Income Taxes

Federal income tax (expense) benefit consists of the following for the years ended December 31, 2018 and 2017 (in thousands):

	2018	2017
Current income tax benefit (expense)	\$ 2	\$ (287)
Deferred tax (expense) benefit related to:		
Tax reform rate reduction	-	(22,120)
Future tax deductions	(4,835)	(5,076)
Total income tax (expense) benefit	\$ (4,833)	\$ (27,483)

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. Income Taxes, continued

The differences between income tax (expense) benefit expected at the federal statutory income tax rate of 21% and 35% and the reported income tax (expense) benefit for the years ended December 31, 2018 and 2017, respectively, are summarized as follows (in thousands):

	<u>2018</u>		<u>2017</u>	
	<u>Amount</u>	<u>Percentage</u>	<u>Amount</u>	<u>Percentage</u>
Income tax (expense) benefit at federal statutory rate	\$ (5,407)	(21.0)%	\$ (7,702)	(35.0)%
Tax reform rate reduction	-	-	(22,120)	(100.5)
Effect of earn-out revaluation	522	2.0	2,266	10.3
Effect of tax advantaged investments	180	0.7	335	1.5
Other	(128)	(0.5)	(262)	(1.2)
Total income tax (expense) benefit	<u>\$ (4,833)</u>	<u>(18.8)%</u>	<u>\$ (27,483)</u>	<u>(124.9)%</u>

On December 22, 2017, U.S. tax legislation referred to as the TCJA was enacted. The effects of changes in tax laws and tax rates are recognized in the period of enactment. Accordingly, we recorded the impact of the TCJA in our 2017 consolidated financial statements which, among other changes, primarily includes the remeasurement of our deferred tax assets and liabilities for the reduced US federal tax rate from 35% to 21% beginning on January 1, 2018. The remeasurement resulted in a reduction of net deferred tax assets of \$22.1 million, of which, \$0.4 million was due to the change in valuation allowance for the year ended December 31, 2017.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below (in thousands):

	<u>2018</u>	<u>2017</u>
Deferred tax assets:		
Net operating losses	\$ 29,502	\$ 30,544
Losses and loss adjustment expenses	4,510	4,008
Unearned premiums	5,253	4,239
Stock options/awards	970	893
AMT credits	1,059	1,112
Impairments	1,346	1,346
Indemnity settlement	210	1,563
Unrealized losses on investments	2,347	-
Other	1,413	1,894
Total deferred tax assets	46,610	45,599
Less valuation allowance	(586)	(586)
Total deferred tax assets after valuation allowance	<u>46,024</u>	<u>45,013</u>
Deferred tax liabilities:		
Deferred policy acquisition costs	1,909	1,786
Intangibles	5,724	4,537
Discount on fixed maturity securities	138	134
Depreciation	816	877
Unrealized gains on investments	-	534
Other	3,173	2,854
Total deferred tax liabilities	<u>11,760</u>	<u>10,722</u>
Net deferred tax assets	<u>\$ 34,264</u>	<u>\$ 34,291</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. Income Taxes, continued

As of December 31, 2018, there were no material uncertain tax positions for which our management believes it is more likely than not that the total amounts will significantly increase or decrease within 12 months of the reporting date. We classify all interest and penalties related to tax contingencies as income tax expense.

The change in our deferred tax valuation allowance for the years ended December 31, 2018 and 2017 is as follows (in thousands):

	2018	2017
Balance at beginning of year	\$ 586	\$ 976
Increase (decrease) related to:		
Net operating losses	-	(390)
Balance at end of year	\$ 586	\$ 586

Management has determined that a valuation allowance of \$0.6 million is required for a portion of the tax effected net operating loss carryforward. This valuation allowance has been established due to limitations imposed by Internal Revenue Code Section 382 on the utilization of net operating losses following a majority interest ownership change. The decrease in the valuation allowance in 2017 is attributable to the reduction in the federal statutory tax rate from 35% to 21% for future periods.

11. Losses and Loss Adjustment Expenses (LAE)

Loss reserves represent the accumulation of estimates of unpaid claims, including estimates for claims incurred but not reported ("IBNR"). We regularly review and update the methods used to determine loss reserve estimates. Any adjustments resulting from this review are reflected currently in loss and loss adjustment expense. Because these estimates are subject to the outcome of future events, changes in estimates are common given that loss trends vary and time is often required for changes in trends to be recognized and confirmed. Reserve changes that increase previous estimates of ultimate claim costs are referred to as unfavorable or adverse development or reserve strengthening. Reserve changes that decrease previous estimates of ultimate cost are referred to as favorable development.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. Losses and Loss Adjustment Expenses (LAE), continued

A reconciliation of unpaid losses and loss adjustment expenses as reported in the consolidated balance sheets as of December 31, 2018 and 2017 and the consolidated statements of operations for the years ended December 31, 2018 and 2017 are as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Reserve for losses and LAE:		
Balance at beginning of year	\$ 534,501	\$ 505,081
Less reinsurance recoverables	<u>(248,681)</u>	<u>(187,876)</u>
Net reserves for losses and LAE at beginning of year	<u>285,820</u>	<u>317,205</u>
Incurred losses, net of reinsurance, related to:		
Current year	190,679	176,548
Prior year	<u>5,805</u>	<u>8,811</u>
Total incurred losses, net of reinsurance	<u>196,484</u>	<u>185,359</u>
Paid losses, net of reinsurance, related to:		
Current year	68,863	80,217
Prior year	<u>120,170</u>	<u>136,527</u>
Total paid losses, net of reinsurance	<u>189,033</u>	<u>216,744</u>
Net reserves for losses and LAE at end of year	293,271	285,820
Plus reinsurance recoverables	<u>306,115</u>	<u>248,681</u>
Gross reserves for losses and LAE at end of year	<u>\$ 599,386</u>	<u>\$ 534,501</u>

Our estimate of incurred losses and LAE attributable to prior year insured events includes reserve increases of approximately \$5.8 million and \$8.8 million for the years ended December 31, 2018 and 2017, respectively. The 2018 and 2017 reserve increases were due primarily to greater than expected loss emergence in our commercial auto and other liability lines of business.

Short Duration Contract Disclosures

The following tables present incurred losses and LAE and cumulative paid losses and LAE by accident year, on a net basis after reinsurance for the years 2012 to 2018 for each of our operating segments (in thousands). During 2018 we changed our segment reporting to better describe our business. All periods presented have been conformed to the revised segmentation. During the third quarter of 2018, we made the decision to discontinue certain programs. Only the third and fourth quarters have been reflected with this change and prior periods have not been adjusted. Results are presented for accident years 2012 and after, as business written before 2012 is primarily related to discontinued business that is not related to ongoing operations. The information included in the following tables for each of the years 2012 through 2018 is unaudited.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. Losses and Loss Adjustment Expenses (LAE), continued

Short Duration Contract Disclosures, continued

Accident & Health - Group Medical insurance written on an excess basis known as Stop Loss business including both aggregate and specific coverage provided to small and medium size employee groups.

Accident and Health Incurred Losses and LAE, Net of Reinsurance Years Ended December 31,								As of December 31, 2018		
Accident Year	2012	2013	2014	2015	2016	2017	2018	2018 Prior Year Development	Total IBNR Plus Expected Development on Reported Losses	Cumulative Number of Reported Claims
2012	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	-
2013										-
2014										-
2015				25,063	27,500	28,210	28,113	(97)		101
2016					38,435	40,518	40,411	(107)		641
2017						23,807	24,011	204		879
2018							21,579		(1,796)	643
Total							\$114,114	\$ -	\$ (1,796)	2,264
Cumulative net paid loss and LAE							(108,160)			
Net reserves for loss and LAE and prior year development before 2012							-			
Total net reserves for loss and LAE and prior year development							\$ 5,954	\$ -		

Accident and Health Cumulative Paid Losses and LAE, Net of Reinsurance Years Ended December 31,							
Accident Year	2012	2013	2014	2015	2016	2017	2018
2012	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
2013							
2014							
2015				12,010	25,328	27,913	28,113
2016					26,609	36,693	39,843
2017						17,892	23,932
2018							16,272
Total							\$ 108,160

Commercial – Standard lines of business generally written on an admitted basis by most markets known as “Main Street” or “Middle Market” business.

Commercial Incurred Losses and LAE, Net of Reinsurance Years Ended December 31,								As of December 31, 2018		
Accident Year	2012	2013	2014	2015	2016	2017	2018	2018 Prior Year Development	Total IBNR Plus Expected Development on Reported Losses	Cumulative Number of Reported Claims
2012	\$ 28,660	\$ 19,121	\$ 18,622	\$ 29,983	\$ 33,871	\$ 30,596	\$ 30,596	\$ -	\$ 424	1,769
2013		68,684	67,033	68,856	78,747	80,311	80,311		311	2,952
2014			94,028	87,481	97,260	99,482	99,482		974	4,296
2015				77,084	97,683	93,169	92,275	(894)	1,983	4,482
2016					53,408	56,041	56,041		7,848	4,030
2017						55,505	56,098	593	4,756	4,417
2018							66,361		20,044	4,262
Total							\$481,164	\$ (301)	\$ 36,340	26,208
Cumulative net paid loss and LAE							(381,842)			
Net reserves for loss and LAE and prior year development before 2012							1,847			
Total net reserves for loss and LAE and prior year development							\$101,169	\$ (301)		

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. Losses and Loss Adjustment Expenses (LAE), continued

Short Duration Contract Disclosures, continued

Specialty – Niche business of generally unusual or difficult risks and business specific to certain industries or professions requiring underwriters with more specific knowledge and expertise.

Specialty Incurred Losses and LAE, Net of Reinsurance								As of December 31, 2018		
Years Ended December 31,										
Accident Year	2012	2013	2014	2015	2016	2017	2018	2018 Prior Year Development	Total IBNR Plus Expected Development on Reported Losses	Cumulative Number of Reported Claims
							\$			
2012	\$ 11,855	\$ 9,586	\$ 7,382	\$ 10,353	\$ 10,285	\$ 9,907	9,907	\$ -	\$ 195	600
2013		26,286	26,016	26,832	26,301	24,979	24,979	-	266	1,643
2014			56,640	47,397	60,067	58,035	59,035	1,000	417	3,531
2015				75,725	74,590	82,531	83,720	1,189	728	4,195
2016					84,025	83,607	84,735	1,128	1,023	3,996
2017						74,804	74,804	-	1,990	3,004
2018							70,204	-	37,215	3,664
Total							\$ 407,384	\$ 3,317	\$ 41,834	20,633
Reclass of net reserves to discontinued segment							(8,798)	-		
Cumulative net paid loss and LAE							(316,530)	-		
Net reserves for loss and LAE and prior year development before 2012							335	-		
Total net reserves for loss and LAE and prior year development							\$ 82,391	\$ 3,317		

Specialty Cumulative Paid Losses and LAE, Net of Reinsurance							
Years Ended December 31,							
Accident Year	2012	2013	2014	2015	2016	2017	2018
2012	\$ 584	\$ 6,494	\$ 6,796	\$ 6,970	\$ 7,086	\$ 7,132	\$ 9,250
2013		8,370	20,662	24,872	24,611	24,903	23,929
2014			12,910	35,136	43,911	43,026	52,232
2015				20,334	56,418	72,437	76,812
2016					45,013	69,074	74,261
2017						38,218	57,748
2018							22,298
Total							\$ 316,530

Discontinued and Other – Includes business no longer being actively written plus entries not included in the operating segments shown above.

Discontinued and Other Incurred Losses and LAE, Net of Reinsurance								As of December 31, 2018		
Years Ended December 31,										
Accident Year	2012	2013	2014	2015	2016	2017	2018	2018 Prior Year Development	Total IBNR Plus Expected Development on Reported Losses	Cumulative Number of Reported Claims
2012	\$ 13,982	\$ 23,866	\$ 36,502	\$ 31,717	\$ 29,070	\$ 29,312	\$ 29,312	\$ -	\$ -	702
2013		8,710	11,391	11,777	12,554	12,581	12,581	-	-	569
2014			1,686	1,408	2,163	3,258	3,337	79	464	215
2015				801	1,089	1,019	1,662	643	634	6
2016					3,100	3,100	3,207	107	1,054	-
2017						1,601	1,600	-	1,287	1
2018							6,608	-	-	28
Total							\$ 58,307	\$ 829	\$ 3,439	1,521
Reclass of net reserves from E&S and specialty segments							16,010	-		
Cumulative net paid loss and LAE							(52,424)	-		
Net reserves for loss and LAE and prior year development before 2012							29,389	421		
Total net reserves for loss and LAE and prior year development							\$ 51,282	\$ 1,250		

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. Losses and Loss Adjustment Expenses (LAE), continued

Short Duration Contract Disclosures, continued

Discontinued and Other, continued

Discontinued and Other Cumulative Paid Losses and LAE, Net of Reinsurance
Years Ended December 31,

Accident Year	2012	2013	2014	2015	2016	2017	2018
2012	\$ 8,913	\$ 19,977	\$ 24,806	\$ 26,589	\$ 28,086	\$ 29,312	\$ 29,312
2013		5,638	8,898	10,863	12,367	12,581	12,581
2014			1,406	2,395	3,130	3,257	3,610
2015				317	453	469	1,469
2016					343	2,338	4,490
2017						250	429
2018							533
Total							<u>\$ 52,424</u>

The table below presents the reconciliation of the net incurred and paid claims development to loss reserves in the consolidated balance sheets for the year ended December 31, 2018 for our operating segments (in thousands):

	2018
Net reserves for losses and LAE:	
Accident & health	\$ 5,954
Commercial	101,169
Excess & Surplus	52,475
Specialty	82,391
Discontinued & other	<u>51,282</u>
Reserves for losses and LAE, net of reinsurance	<u>293,271</u>
Reinsurance recoverable on unpaid claims:	
Accident & health	20,149
Commercial	91,218
Excess & Surplus	34,165
Specialty	133,555
Discontinued & other	<u>27,028</u>
Total reinsurance recoverable on unpaid claims	<u>306,115</u>
Gross reserves for losses and LAE at end of year	<u>\$ 599,386</u>

The following table presents supplementary information about average historical claims duration as of December 31, 2018, by operating segment:

Average Annual Percentage Payout of Incurred Claims by Age, Net of Reinsurance										
Years	1	2	3	4	5	6	7	8	9	10
Accident and Health	92.5%	4.3%	2.3%	0.7%	0.1%	0.1%	0.0%	0.0%	0.0%	0.0%
Commercial	40.5%	24.9%	14.0%	7.4%	3.8%	2.1%	1.3%	0.9%	0.7%	4.4%
Excess & Surplus	32.8%	21.9%	14.6%	9.8%	6.5%	4.2%	2.6%	1.7%	0.9%	5.0%
Specialty	38.0%	21.5%	13.3%	8.5%	5.3%	3.4%	2.1%	1.4%	1.3%	5.0%
Discontinued & Other	25.4%	19.4%	14.5%	10.5%	7.8%	5.5%	4.0%	3.7%	3.5%	5.8%

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

12. Premiums

Direct premiums written by line of business for the years ended December 31, 2018 and 2017 are as follows:

	<u>2018</u>	<u>2017</u>
Other liability	29.1%	33.5%
Property	26.3	21.0
Commercial auto liability	17.2	16.4
Accident and health	13.2	15.0
Workers compensation	8.9	8.8
Auto physical damage	4.1	4.2
Other	1.2	1.1
	<u>100.0%</u>	<u>100.0%</u>
Total	<u>100.0%</u>	<u>100.0%</u>

For the years ended December 31, 2018 and 2017, our direct premiums written were produced from the following states:

	<u>2018</u>	<u>2017</u>
Texas	16.0%	15.4%
Louisiana	11.2	11.4
Florida	8.3	8.1
California	7.1	6.9
New York	5.3	5.6
Oklahoma	3.9	4.6
Pennsylvania	3.9	4.1
Georgia	3.6	3.3
Illinois	2.7	3.3
New Jersey	2.5	3.4
All other states	35.5	33.9
	<u>100.0%</u>	<u>100.0%</u>
Total	<u>100.0%</u>	<u>100.0%</u>

13. Reinsurance

Certain premiums and benefits are assumed from and ceded to other insurance companies under various reinsurance agreements. The ceded reinsurance agreements provide us with increased capacity to write larger risks and maintain our exposure to loss within our capital resources. We remain obligated for amounts ceded in the event that the reinsurers do not meet their obligations. The effects of reinsurance on premiums written and earned for the years ended December 31, 2018 and 2017 are as follows (in thousands):

	<u>2018</u>		<u>2017</u>	
	<u>Written</u>	<u>Earned</u>	<u>Written</u>	<u>Earned</u>
Direct premiums	\$ 626,232	\$ 578,574	\$ 515,609	\$ 493,773
Assumed premiums	70,663	67,755	59,735	56,923
Ceded premiums	<u>(396,373)</u>	<u>(368,722)</u>	<u>(317,696)</u>	<u>(285,051)</u>
Net premiums	<u>\$ 300,522</u>	<u>\$ 277,607</u>	<u>\$ 257,648</u>	<u>\$ 265,645</u>
Ceded losses and LAE incurred		<u>\$ 321,527</u>		<u>\$ 224,687</u>

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

13. Reinsurance, continued

Reinsurance recoverables on unpaid losses and loss adjustment expense reserves ceded at December 31, 2018 and 2017 were approximately \$306.1 million and \$248.7 million, respectively. Reinsurance recoverables on paid losses and loss adjustment expense ceded at December 31, 2018 and 2017 were approximately \$72.8 million and \$49.4 million, respectively. Ceded unearned premiums at December 31, 2018 and 2017 were approximately \$158.4 million and \$130.8 million, respectively.

We entered into agreements with one of our reinsurers, whereby the reinsurer voluntarily established funded trust accounts with us as the sole beneficiary. These trust accounts provide us additional security to collect claim recoverables under reinsurance contracts. At December 31, 2018, the market value of these accounts was approximately \$9.2 million, representing case and incurred but not recorded loss reserves. The agreements provide that, as was customary in the past, the reinsurer will continue claim payment reimbursements without disturbing the trust balances. The trust amount will be adjusted periodically, by mutual agreement, based on the current activities of loss reserve recoverables.

Effective October 2017, we entered into a retroactive reinsurance agreement with Everest Re for \$20.0 million which is accounted for as a deposit of \$18.0 million and \$2.0 million as deferred expense which will be amortized over the expected payout of the agreement. The deposit and deferred expense are included in other assets as of December 31, 2018 and 2017. During the year ended December 31, 2018, we recorded amortization of \$0.2 million related to the deferred expense which resulted in a balance of \$1.8 million as of December 31, 2018. The retroactive reinsurance agreement provides us with coverage of up to \$20.0 million of loss development primarily related to continuing business with policies effective 2015 and prior. As of December 31, 2018, we have ceded approximately \$20.0 million of reinsurance under this contract. In accordance with the contract, we incur an annual maintenance fee at a minimum rate of 6.5% and a maximum rate of 8.5% based on the ceded amount under the contract. We incurred a maintenance fee of \$1.3 million for the year ended December 31, 2018.

14. Stock Based Compensation

We have two active plans, the Employee Share Program (the "2011 Program") and the Equity Incentive Program (the "2016 Program"), to incentivize our employees. The 2011 and 2016 Programs are administered by the Compensation Committee of our Board of Directors.

The 2011 Program and 2016 Program allow key employees to purchase our common stock at a price based on fair value of the Company at the end of the quarter in which the employee commits to the purchase. We then match all purchases with stock grants. The programs require an initial cash payment of at least 30% of the committed fair value of the purchase with any remaining commitment recorded as a note receivable to the Company which is included in Stockholders' Equity. Grants awarded prior to 2016, vest as the employee makes cash payments for the purchase of our common stock over a period of up to nine years. Commencing in 2016, grants awarded vest after two conditions are met (i) the employee has worked for us for three years and (ii) cash payments are made for stock purchases. All grants awarded under the 2011 plan are fully vested and have been expensed. Grants awarded under the 2016 plan vest annually over a three-year service period and are expensed on a pro rata basis over the service period.

For the years ended December 31, 2018 and 2017, stock based compensation was \$0.4 million and \$(0.1) million, respectively. Key employees purchased 74,039 shares and 40,130 shares of our common stock during the years ended December 31, 2018 and 2017, respectively. In accordance with the plan, we granted a match of 74,039 shares and 40,130 shares of our common stock during December 31, 2018 and 2017, respectively. The weighted-average grant-date fair value of shares granted during the years ending December 31, 2018 and 2017 was \$5.40 and \$4.98, respectively.

Under both the 2011 and 2016 plans, the Company will finance up to 70% of the purchased shares with a stock note receivable. These stock notes receivable are recorded as a reduction to Stockholders' Equity. At December 31, 2018 and 2017 stock notes receivable totaled \$3.8 million and \$4.7 million, respectively. The stock notes receivable bear interest at a rate ranging from 0.95% to 2.8%, based on the Internal Revenue Service applicable federal rates.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

14. Stock Based Compensation, continued

A summary of the status of our non-vested restricted common stock awards as of December 31, 2018, and changes during the year, is presented below:

	Weighted-average Grant-date Fair Value	Number of Shares
	<hr/>	<hr/>
Non-vested at January 1, 2018	\$ 4.96	761,606
Granted	5.40	74,039
Vested	4.77	(186,438)
Forfeited	5.33	<hr/> (39,678) <hr/>
Non-vested at December 31, 2018	\$ 5.01	<hr/> <hr/> 609,529

As of December 31, 2018, the total unrecognized compensation cost (net of forfeitures) related to non-vested, share-based compensation awards was \$0.1 million and the weighted average period over which that cost is expected to be recognized is 1.4 years.

15. Employee Benefit Plans

We sponsor the HIIG 401(k) Plan (the "Plan"). The Plan, available to substantially all of our employees, is subject to provisions of the Employee Retirement Income Security Act of 1974. We match employee contributions on a discretionary basis. We expensed \$1.3 million and \$0.9 million of matching contributions as of December 31, 2018 and 2017, respectively.

16. Change in Control and Related Party Transactions

Westaim

In 2014, we executed a subscription agreement with Westaim HIIG LP (a limited partnership controlled by Westaim, a Canadian public company) as part of a two-step transaction whereby Westaim HIIG LP acquired an approximate 54% controlling interest in HIIG that was previously owned by Lightyear Fund II, L.P. ("Lightyear") and a group of other investors.

In accordance with the terms of the subscription agreement, we also received a \$60.0 million cash investment from Westaim HIIG LP in exchange for newly issued shares of our common stock based on the December 31, 2013 book value of our shares, which approximated fair value at the date of the agreement. The transaction closed on July 31, 2014 and Westaim HIIG LP purchased 13,139,453 shares of our common stock for \$60 million on that date. We ultimately received net cash proceeds of approximately \$56.0 million after transaction expenses.

Immediately after the close of this transaction, Westaim HIIG LP purchased an additional \$25.0 million of our common stock at book value per share as of December 31, 2013 which approximated fair value. We issued 5,563,220 shares of common stock in connection with this transaction. The net cash proceeds we received from this transaction were approximately \$24.0 million. After these transactions, Westaim HIIG LP's ownership increased to 71%.

In connection with the above transactions, we experienced a change in control as contemplated by Section 382 of the Internal Revenue Code and, as a result, the utilization of our tax net operating loss in any one year will be limited. Accordingly, we established a valuation allowance for a portion of the deferred tax asset we had recognized related to the tax net operating loss carryforward we had generated prior to the transactions. The valuation allowance related to our net operating loss carryforward is approximately \$0.6 million at December 31, 2018 and 2017, respectively.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

16. Change in Control and Related Party Transactions, continued

Westaim, continued

In January 2015, we executed a subscription agreement with Westaim HIIG LP whereby Westaim HIIG LP purchased 14,213,487 shares of our common stock for \$70.0 million in cash, which was based on our December 31, 2014 book value per share which approximated fair value, bringing its total ownership to 76%. As of December 31, 2018, Westaim HIIG LP owns 75% of our common stock due to additional shares issued related to our stock-based compensation programs.

In 2015, we purchased 3,076,924 shares of Westaim common stock for \$8.3 million. Our investment in Westaim is included in equity securities in the consolidated balance sheet as of December 31, 2018 and 2017. The unrealized loss on this investment is \$(2.4) million and \$(0.8) million respectively, as of December 31, 2018 and 2017.

Westaim performs consulting and certain other services for us pursuant to an agreement (the "Advisory Services Agreement"). Pursuant to the Advisory Services Agreement, we are required to pay Westaim \$1.0 million per year for the first three years, beginning in 2015 and \$0.5 million in years four and five, plus reasonable expenses incurred to provide the services. The Advisory Services Agreement was amended during 2017, and increases the fees paid to Westaim from \$0.5 million to \$1.0 million in years four and five. The Advisory Services Agreement will terminate on the earliest of (a) July 2019, (b) upon an Initial Public Offering or a change of control, or (c) when Westaim HIIG LP owns less than 8% of the Company. Pursuant to the Advisory Services Agreement, we incurred fees of approximately \$1.0 million and \$1.0 million, respectively, related to services provided by Westaim in each of the years ended December 31, 2018 and 2017.

Contingent Consideration Related to Acquisitions

We potentially owe earn-out liabilities to former owners of assets and business acquired. During the years ended December 31, 2018 and 2017, we reduced the earn-out liability by \$2.5 million and \$6.5 million, respectively, to approximate the fair value we expect to pay. This amount was recognized as acquisition adjustment income included in total revenue on the statement of operations. We paid earn-out liabilities of approximately \$0.0 million and \$1.8 million during the years ended December 31, 2018 and 2017, respectively. As discussed in Note 7, we purchased the remaining 55.4% ownership interest in Creative Risk so as to own 100% of the company. As part of this acquisition, we accrued an earn-out liability of approximately \$1.0 million during 2018. Included in accounts payable and accrued liabilities are \$1.0 million and \$2.5 million of earn-out liabilities as of December 31, 2018 and 2017, respectively.

RISCOM

During 2016, we entered into an intercompany agency agreement with RISCOM, in which we hold a 20% ownership interest, for wholesale brokerage services in addition to the already existing managing general agency agreement between the parties. We had \$37.9 million and \$29.0 million of net earned premium in 2018 and 2017, respectively, related to these agreements. Premium receivable from RISCOM was \$11.2 million and \$6.7 million, respectively, as of December 31, 2018 and 2017.

Creative Risk

During 2016, we entered into a managing general underwriters agreement with Creative Risk, in which we held an ownership interest, for medical stop loss business. We had \$3.5 million and \$2.4 million of net earned premium in 2018 and 2017, respectively, related to this agreement. This agreement was terminated effective October 1, 2018 as a result of acquiring the remaining 55.4% share of Creative Risk. See Note 7 for further details.

KIS Surety

During 2017, we entered into a managing general agency agreement with KIS Surety, in which we hold a 20% ownership interest, for a construction bond program. We had \$4.0 million and \$0.7 million of net earned premium in 2018 and 2017, respectively, related to this agreement.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

16. Change in Control and Related Party Transactions, continued

Reinsurance

We have a reinsurance agreement with XL Re, Ltd., which is affiliated with Catlin Re Switzerland Ltd, who is a limited partner of Westaim HIIG LP. We recorded \$0.1 million and \$0.3 million of reinsurance premiums ceded during the years ended December 31, 2018 and 2017, respectively, related to the agreement.

We have reinsurance agreements with Everest Re, an affiliate of Mt. Whitney Securities, LLC, a limited partner of Westaim HIIG LP. We recorded \$119.2 million and \$95.7 million of reinsurance premiums ceded during the years ended December 31, 2018 and 2017, respectively, related to the agreement. Reinsurance recoverable from Everest Re, net of premium payables, was \$178.6 million and \$110.2 million, respectively, as of December 31, 2018 and 2017.

Other

During 2018 and 2017, we paid approximately \$0.3 million and \$0.4 million, respectively, of advisory and professional services to various affiliated shareholders and directors.

During 2018 and 2017, we paid approximately \$1.0 million and \$0.3 million, respectively, of transportation costs to companies owned by an officer of the Company.

See Note 7 for loans to affiliated companies and additional related party transactions.

17. Commitments and Contingencies

Leases

We lease office space under various lease agreements expiring through 2025. The following is a schedule of future minimum annual lease payments (in thousands) on operating leases having initial or remaining non-cancelable lease terms in excess of one year:

<u>Year Ending December 31,</u>	<u>Lease Payment</u>
2019	\$ 2,819
2020	2,996
2021	2,708
2022	2,163
2023	1,820
2024	1,417
2025	1,270
	<u>\$ 15,193</u>

Rent expense incurred under operating leases was approximately \$2.7 million and \$2.7 million for the years ended December 31, 2018 and 2017, respectively.

Litigation

We are named as a defendant in various legal actions arising from claims made under insurance policies and contracts. Those actions are considered by us in estimating the losses and loss adjustment expense reserves. Also, from time to time, we are a defendant in various legal actions that relate to bad faith claims, disputes with third parties or that involve alleged errors and omissions. We record accruals for these items to the extent the losses are probable and reasonably estimable. Although the ultimate outcome of these matters cannot be determined at this time, based on present information, the availability of insurance coverage and advice received from outside legal counsel, our management believes the resolution of any such matters will not, individually or in the aggregate, have a material adverse effect on our consolidated financial position, results of operations or cash flows. During the years ended December 31, 2018 and 2017, we recorded a \$0.5 million and \$1.1 million for litigation expense, which was included in other operating expenses.

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

17. Commitments and Contingencies, continued

Indemnification

In conjunction with the sale of business assets and subsidiaries, we have provided indemnifications to certain of the buyers. Certain indemnifications cover typical representations and warranties related to the responsibilities to perform under the sales contracts. The amount of potential exposure covered by the indemnifications is difficult to determine because the indemnifications cover a variety of matters, operations and scenarios. Certain of these indemnifications have no time limit. However, at this time we do not have reason to believe any such significant claims exist.

18. Regulatory Matters

A significant amount of the consolidated assets represent assets of our insurance company subsidiaries, HSIC, IIC, GMIC, BIC and OSIC. IIC, BIC, OSIC and GMIC are all direct and indirect wholly-owned subsidiaries of HSIC. HSIC is restricted by Texas law as to the amount of dividends it may pay without the approval of regulatory authorities. The maximum amount of dividends which can be paid by HSIC without prior approval is subject to restrictions relating to policyholder surplus, net income, and dividends declared or distributed during the preceding 12 months. As of December 31, 2018, HSIC can pay \$8.0 million in ordinary dividends subject to notice to the Texas Department of Insurance. HSIC did not declare or pay any dividends during the years ended December 31, 2018 and 2017.

Property and casualty insurance companies are subject to certain Risk Based Capital (“RBC”) requirements as specified by the National Association of Insurance Commissioners (“NAIC”). Under those requirements, the amount of capital and surplus maintained by a property and casualty insurance company is to be determined based on the various risk factors related to it. At December 31, 2018 and 2017, our insurance company subsidiaries met the RBC requirements.

The capital and surplus and RBC level of HSIC on a consolidated statutory basis (including IIC, GMIC OSIC, and BIC) as of and for the years ended December 31, 2018 and 2017 were as follows (in thousands):

	2018	2017
Statutory capital and surplus	\$ 264,289	\$ 261,310
RBC authorized control level	56,862	51,744

19. Statutory Accounting Principles

The statutory capital and surplus for our principal operating subsidiaries at December 31, 2018 and 2017 were as follows (in thousands):

	2018	2017
HSIC	\$ 264,289	\$ 261,310
IIC	181,302	166,537
GMIC	129,189	106,970
BIC	25,646	-
OSIC	20,524	19,466

HOUSTON INTERNATIONAL INSURANCE GROUP, LTD. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

19. Statutory Accounting Principles, continued

These amounts include ownership interests in affiliated insurance subsidiaries. The statutory net income (loss) for our principal operating subsidiaries for the years ended December 31, 2018 and 2017 was as follows (in thousands and BIC 2018 net income represents three months only subsequent to purchase see Note 20 for further information):

	<u>2018</u>	<u>2017</u>
HSIC	\$ 4,860	\$ 19,629
IIC	(265)	(2,161)
GMIC	3,520	(1,046)
BIC	40	-
OSIC	1,140	518

20. Acquisitions

Effective October 1, 2018, GMIC acquired all assets of Boston Indemnity Company (“BIC”), an insurance company domiciled in South Dakota currently writing surety in 28 states. The purchase price was \$1.7 million in excess of BIC’s statutory surplus at the time of the transaction. Concurrent with this transaction, HIIGU acquired certain assets of East Coast Surety Agency, a related agency of BIC. The business combinations were recorded using the purchase method of accounting. Accordingly, the purchase price has been allocated based on the fair value of the assets acquired, with \$0.7 million of the purchase price being allocated to goodwill, which is deductible for income tax purposes, and \$1.1 million allocated to other intangible assets.

Effective October 1, 2018, we purchased the remaining 55.4% ownership interest in Creative Risk so as to own 100% of the company. See Note 7 for further details.

21. Subsequent Events

In January 2019, our investment in CVR was sold. We received \$19.6 million in cash related to the transaction and recorded a realized gain of \$9.3 million.

Our management has evaluated subsequent events through March 14, 2019, which is the date the consolidated financial statements were available to be issued and has concluded that there are no other significant events requiring additional disclosure in the consolidated financial statements.