

Property/Casualty
Insurers
US and Canada
Credit Analysis

ProAssurance Corp.

Ratings

Security Class	Rating
Long-Term IDR	BBB+
Insurer Financial Strength	A
Senior Debt	BBB

Outlook

Stable

Financial Data

ProAssurance Corp.

Financials	Date	\$ Mil.
Net Income	9/30/07	117
Equity	9/30/07	1,198
Debt and Hybrids	9/30/07	180
Prism Score	2007	AA

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Related Research

- [2006 Prism Results for US Life and Non-Life Insurers, Special Report, Nov. 6, 2007](#)
- [Initial Prism Scores of US Insurance Companies \(2005 Beta Testing Results\), Special Report, June 11, 2007](#)

Rating Rationale

- ProAssurance Corp. and its subsidiaries' (collectively referred to as PRA) have strong results under Fitch's economic capital model for insurers, Prism, with a score that is 102% in excess of the 'AA' capital requirement.
- Solid financial condition of its operating subsidiaries, including consistent profitability and financial flexibility.
- Highly experienced management team. PRA has an established reputation for providing quality service and expertise in risk management in the medical malpractice line as well as a strong track record of successfully defending nonmeritorious claims, which enhances customer loyalty and reduces fraud.
- Potential volatility of operating results to which the company is exposed as a monoline insurance writer that operates in one of the industry's most unpredictable lines of business.
- Competitive operating environment where rates in the medical malpractice market have peaked. Fitch favorably notes that PRA has maintained price discipline during past operating cycles.

Key Rating Drivers

- Fitch anticipates that the company will deploy the \$400 million from the sale of MEEMIC, which the company sold to GMAC Insurance Holdings, Inc. in 2006, via an acquisition in the medical malpractice space. Fitch notes the company's management is very prudent with its resources and will only deploy these proceeds for an acquisition that fits the company's profile.
- Fitch expects PRA to maintain reasonable financial leverage. As of Sept. 30, 2007, the company had approximately 13% leverage. Fitch notes that the company has room in its current rating to increase financial leverage. Fitch's long-term goal is for PRA's financial leverage not to exceed 30%.
- Fitch does not anticipate any meaningful, more than 5% of prior year's surplus, adverse reserve development.
- Fitch believes that PRA will maintain pricing discipline as the market starts to soften. Failure to do so would put negative pressure on the ratings.

Key Rating Issues

Strong Capital as Highlighted by 2006 Prism Results

Fitch views PRA's capital position as strong and was a key component to its recent upgrade. PRA's 2006 Prism score was 102% of the 'AA' capital requirement, up from 2005's 101% of 'A+' Prism score.

PRA's improved Prism score reflects a faster growth in available capital relative required capital. In particular, the approximately \$100 million increase in available capital was due to a decrease in the haircut of affiliated investments and a deferred acquisition cost (DAC) benefit. Fitch added a DAC benefit to available capital in the 2006 model for global consistency, a key strength of Prism. The other major model change for 2006 was the introduction of run-off expenses, which serve to increase required capital.

Required capital year-over-year increase was primarily attributable to a higher expected loss ratio and standard deviation on Fitch's estimation of one year's worth of new business and a higher Mack CV, a stochastic statistical measure of reserve volatility.

Fitch's in-depth capital analysis of PRA's capital via Prism quantitatively expresses and captures key risk drivers of the medical malpractice line of business—in particular, volatility of underwriting results and reserves. Due to higher-than-average volatility metrics, medical malpractice insurers have a higher sensitivity to operating leverage than companies with lower volatility metrics. This is modestly offset by a slightly higher-than-average liability duration for medical malpractice insurers, which allows the companies more time to earn investment income.

Fitch notes that consolidated policyholders surplus has grown significantly over the past five years. This growth is a function of acquisitions (National Capital Reciprocal Insurance Company [NCRIC] and Physician Insurance Companies of Wisconsin [PIC WI]), public stock offerings and growth of retained earnings from profitable operations.

Capitalization

(x)

	9/07	9/06	2006	2005	2004	2003	2002
Annualized Gross Premiums Written/Equity	0.49	0.56	0.52	0.75	1.29	1.35	1.26
Annualized Net Premiums Written/Equity	0.45	0.52	0.49	0.68	1.17	1.22	1.06
Total Assets/Total Equity	3.70	4.00	3.90	5.10	5.30	5.30	5.10

Source: SNL Financial, company SEC filings.

Prism Score

	IFS	Outlook	2006	%	2005	%	RBC % 2006
FPIC Group	A-	Stable	A-	106	BBB+	108	330
PRA	A	Stable	AA	102	A+	101	307
The Doctors Company	A	Stable	AAA	106	AA+	100	467

Source: Fitch.

Mergers and Acquisitions Likely

Fitch's current belief is that management will prudently sifting through possible acquisition candidates to deploy the \$400 million from the sale of MEEMIC. Fitch notes that PRA's management team is very judicious in reviewing possible acquisitions to make sure that the target company fits into the company's long-term strategic plan and that the purchase price is reflective of the company's true value.

Over the past several years many small insurers and risk retention groups have formed to help alleviate some pricing pressure for physicians. Unfortunately, many of these plans provided temporary rate relief but failed to charge a sufficient enough premium to sustain long-term performance. As these companies start to show signs of weakness or even insolvency, PRA may be able to pick up smaller books of business as opposed to a large transaction.

PRA's recent transactions of PIC WI in August 2006 for \$104 million and NCRIC in August 2005 for \$100 million were stock acquisitions.

Claims

Fitch views PRA's handling of nonmeritorious claims as a key component to building long-term loyal relationships with its policyholders in addition to lowering overall costs. Fitch believes that PRA tries more cases than any other medical malpractice insurer and has a favorable outcome approximately 80% of the time. ProAssurance is also committed to reaching a reasonable settlement in cases where there is merit and settles approximately 10% of the claims against its insureds

PRA operates 16 regional claims and offices. The company believes that local knowledge allows it to be more effective in evaluating claims.

Recent Events

Effective July 1, 2007, Stan Starnes, age 59, replaced Dr. Derrill Crowe, age 70, as CEO of the company. Dr. Crowe, a founding member of the company, will remain nonexecutive chairman of the board.

Mr. Starnes has a 29-year association with PRA. Prior to joining PRA he was senior and managing partner in Starnes and Atchison, a leading medical liability defense law practice based in Birmingham, Ala. Mr. Starnes is also a co-architect of PRA defense strategy.

Fitch believes that little will change with the company given Dr. Crowe's departure as CEO. However, Fitch does note that Stan Starnes extensive legal background will likely put more emphasis on claims. As noted above, claims management is a strength of the company.

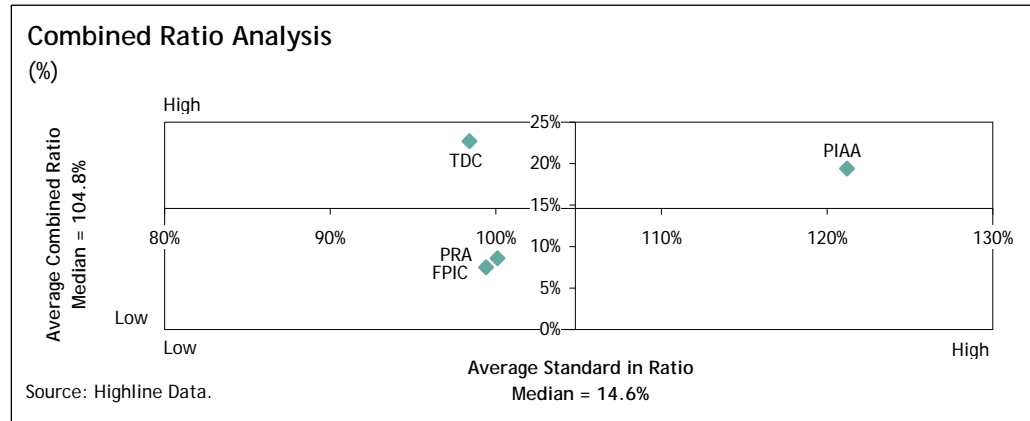
Peer Analysis

PRA's closest peers in Fitch's rated universe are The Doctors Company (TDC) and FPIC Group, Inc. (FPIC), both medical malpractice carriers. Additionally, there is a trade association of approximately 50 medical malpractice insurance companies carriers called the Physician Insurers Association of America (PIAA), whose aggregated results, less PRA, TDC, and FPIC, will appear in the peer analysis charts below.

When comparing metrics amongst peers, PRA stands out in three main areas:

1. Prism scores.
2. Five-year average combined ratios and its volatility.
3. Market share.

Fitch's Prism capital model generates the capital required for an individual insurer's stochastically generated default probability to equate to corporate bond default rates at various rating levels. These stochastically generated required capital levels are then compared to the company's available capital to determine the highest rating level at which available capital exceeds required capital. PRA's available capital exceeds stochastically generated required capital at the 'AA' level, while its peers' available capital generally exceeds stochastically generated required capital at higher thresholds.



PRA's five-year average combined ratio and standard deviation show that its underwriting results and volatility are better than industry and PIAA averages. Also, this chart shows that PRA's five-year averages are comparable to rated peers.

The market-share data shows that PRA is one of the largest stand-alone medical malpractice insurance carriers in the country. Fitch believes that PRA will maintain their dominant market share in the medical malpractice insurance industry but notes that no specific market-share target is associated with its ratings.

Market Share

(%)

Rank	Company	2006 Market Share	Direct Combined Ratio
1	Medical Liability Mutual Group	7.7	135.3
2	American International Group	6.7	62.2
3	National Indemnity Company Group	5.9	74.5
4	Continental Casualty Group	4.6	76.1
5	The Doctors Company Group	4.3	54.1
6	ProAssurance Corp. Group & Affiliates	4.0	71.3
7	ISMIE Insurance Group	3.2	71.9
8	MAG Mutual Group	2.8	57.9
9	ProMutual Group	2.7	86.9
10	Physicians Reciprocal Insurers	2.7	115.6
11	Health Care Indemnity Inc.	2.5	53.6
12	Medical Group Holdings and Affiliates	2.5	68.9
13	State Volunteer Mutual Insurance Co.	2.2	80.4
14	MCIC Vermont Inc. RRG	2.1	109.4
15	FPIC Insurance Group Inc.	2.0	67.2

Source: Highline Data.

Company Profile

Alabama-based PRA is a publicly traded holding company with operating subsidiaries engaged in providing medical malpractice insurance and, to a small degree, professional liability coverage to lawyers.

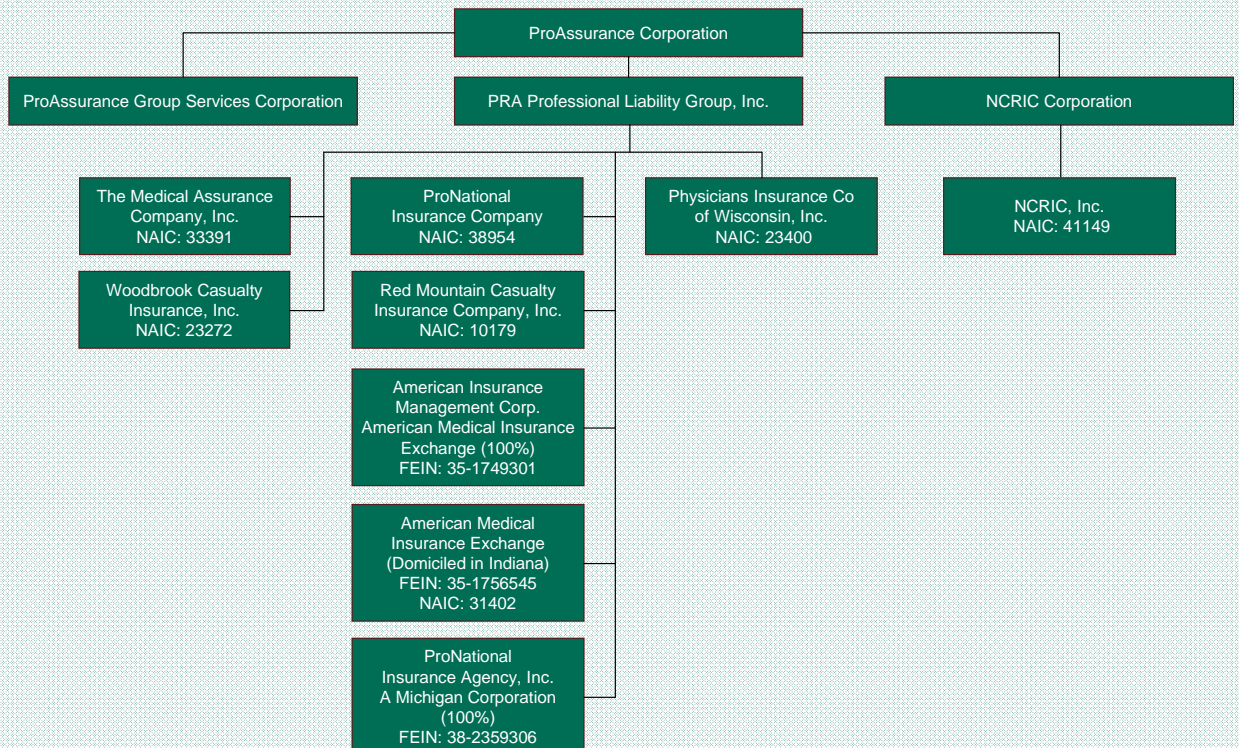
PRA's predecessor company, Medical Assurance, Inc., was founded as a mutual company by physicians in Alabama during 1976 and is currently the leading writer of medical malpractice insurance in that state. Following a demutualization, the company became public in 1991.

PRA was established in June 2001 as a result of Medical Assurance's combination with Professionals Group Inc., whose lead insurance company—ProNational Insurance Company (ProNational)—was formed in 1980 to write medical malpractice insurance in Michigan, and is currently one of the leading writers in the state.

Medical malpractice products are largely marketed to sole practitioners, small physician groups, dentists and small to medium-sized hospitals and facilities, which value PRA's quality service and risk management expertise.

PRA employs an underwriting strategy that is generally geared towards serving local markets where the company's reputation for providing value-added services and strong customer support has been established. Large physician groups and facilities generally utilize larger brokers, with the result being that decisions are made more on price than service; thus, they are not a target for PRA, although the company does insure several large groups and hospitals.

Organizational Chart
(As of May 16, 2007)



Source: Highline Data.

In the latter part of 2002, PRA established an excess and surplus lines insurer, Red Mountain Casualty Insurance Company (Red Mountain), in an effort to benefit from the limited capacity and improving pricing environment in medical malpractice insurance, potentially retain customers that no longer qualified for its standard/preferred rates and to better enable the company to still write groups of doctors if any of the members fell outside of PRA's standard/preferred underwriting guidelines. Risks are generally referred to Red Mountain from other PRA companies or specialized agents. Fitch views Red Mountain as a key to PRA's operating flexibility given its excess and surplus status.

In March 2004, PRA purchased the rights to offer renewal professional liability policies to OHIC Insurance Company's non-Ohio and Wyoming physician, hospital and health care facility clients. This transaction allowed PRA the opportunity to expand its professional liability business among its existing footprint as well as expand into the contiguous state of Wisconsin.

In August 2005, PRA closed the NCRIC transaction that was initiated in February 2005 for \$69.6 million in stock. NCRIC increases PRA's presence in the Mid-Atlantic region, particularly in the District of Columbia, Delaware, Virginia and, to a lesser extent, Maryland.

In January 2006, MEEMIC Holdings, PRA's Michigan-based auto insurance subsidiary, was sold to GMAC for \$325 million. Prior to the sale, PRA was allowed to pull out \$75 million in capital, raising the total compensation received from the sale of MEEMIC to \$400 million.

In July 2006, PRA acquired PIC WI in a stock-for-stock transaction valued at \$100 million. This transaction noticeably improved PRA's footprint into Wisconsin, a target growth state of management, allowed PRA to increase existing market share in existing Midwestern states, and expanded ProAssurance footprint into the upper Midwest and Nevada.

PRA has a history of growing through acquisitions, and Fitch anticipates further acquisitions going forward. Fitch will evaluate any proposed acquisition to determine what, if any, impact it may have on current ratings.

Products

Fitch believes that PRA's long-duration commercial lines products exhibit a high degree of risk from a reserving perspective and pricing perspective but also exhibit a high degree of pricing flexibility. While most of PRA's business is written in the standard market, Red Mountain does provide the company with pricing flexibility.

Target Markets

Fitch believes that PRA's target markets are highly competitive but well diversified from a customer and geographic basis. The company's target markets include physicians and small physician practices. PRA writes some large physician groups and facilities where risk managers and insurance buyers make purchase decisions on factors other than price.

Distribution Channels

Fitch believes that PRA uses a tailored distribution strategy that balances independent agents and direct marketing depending on geography; however, the majority of business is placed through independent agents.

Fitch believes that PRA has long-term relationships with independent distribution sources that are effective in sourcing and retaining business. While this is a positive, independent agents by definition lack loyalty to any single insurance carrier and thus also pose a risk to the company. As of year-end 2006, approximately 65% of gross written premium was generated by three independent agencies.

Investments and Liquidity

(\$ Mil.)

	9/07	9/06	2006	2005	2004	2003	2002
Cash and Invested Assets	3,639	3,486	3,521	2,649	2,485	2,103	1,823
% Fixed Income	88	89	89	91	91	85	73
% Equities	1	0	0	1	2	2	3
% Mortgages and Real Estate	—	—	—	—	1	1	1
% Cash and Short-Term	8	8	6	5	3	7	22
% Other	4	3	4	4	4	4	1
Investment Yield	4.8	4.7	4.9	3.9	3.8	3.8	4.5

Source: SNL Financial, company SEC filings.

Profitability

(\$ Mil.)

	3Q07	Q306	2006	2005	2004	2003	2002
Revenue, Excluding Realized Gains (Losses)	539	542	739	647	787	704	561
Premiums Earned	405	429	583	543	696	624	477
Pretax Realized Gains (Losses)	(2)	(1)	(1)	1	8	6	(5)
Pretax Net Investment Income	129	109	150	99	87	74	77
Pretax Operating Income	164	128	178	108	90	44	19
Net Income	117	201	236	113	73	39	12
% Return on Common Equity	13.4	28.9	25.1	16.5	12.6	7.4	2.7
Combined Ratio (%)	90.3	94.7	94.2	97.6	99.2	105.1	112.9
Points from Prior-Year Reserve Development	(14.9)	(5.4)	(6.2)	(4.2)	(2.4)	(1.7)	1.8

Source: SNL Financial, company SEC filings.

Financial Analysis

Profitability

Fitch views PRA's profitability favorably and in line with current rating expectations. Underwriting performance, as measured by the combined ratio, has improved in recent years. The improvement is due mainly to a nationwide drop in frequency, a restoration of industry-wide underwriting discipline and, to a certain extent in some geographies, tort reform. Medical malpractice was one of the worst-performing lines in the property/casualty insurance industry over the last five years.

Although it appears that pricing in the medical malpractice market has peaked, Fitch notes that PRA has shown pricing discipline during past operating cycles. PRA's favorable comparison is reflective of its focused and disciplined underwriting approach that emphasizes long-term profitability as opposed to top-line growth.

While ProAssurance does write a number of large hospitals and physician groups, management has generally avoided an over-reliance on these type insureds as they have experienced the greatest price competition and do not play into the company's strengths. Furthermore, the company's good geographic mix and lack of dependence on specific markets allows for the withdrawal or pull back from overly competitive or difficult local markets.

Investments and Liquidity

PRA employs a conservative investment philosophy that is focused on generating current investment income through the purchase of medium-term bonds. Common stock investments are minimal, though may take on a bigger but still relatively manageable role in the future as the company's capital base grows.

PRA maintains a good liquidity position, evidenced by strong operating cash flows and a modest liquid-assets-to-liabilities ratio. Fitch believes short-term liquidity is adequate for the current rating.

Reserve Adequacy and Development

(\$ Mil.)

	3Q07	3Q06	2006	2005	2004	2003	2002
Beginning-of-Year Reserves	2,603	2,314	2,224	2,030	1,815	1,622	1,442
Beginning-of-Year Total Equity	1,119	910	765	611	546	505	413
Prior-Accident-Year (PAY) Reserve Development	(25)	(11)	(36)	(23)	(17)	(11)	8
PAY/Beginning-of-Year Reserves (%)	(1.0)	(0.5)	(1.6)	(1.1)	(0.9)	(0.7)	0.6
PAY/Beginning-of-Year Total Equity (%)	(2.2)	(1.2)	(4.7)	(3.8)	(3.0)	(2.2)	2.0

Source: SNL Financial, company SEC filings.

Reserve Adequacy and Development

Fitch views PRA's loss reserve position as adequate and views the reserving process as well managed and conservative based on historical results, discussions with management and results of Fitch's internal loss reserve model.

PRA's management has a policy to litigate nonmeritorious claims and policyholders have consent to settle rights where allowed by law. ProAssurance does attempt to reach reasonable settlements in cases where true negligence is evident. This approach serves to minimize frivolous or fraudulent lawsuits as well as increase customer loyalty. Premiums for all states are reviewed at least annually to ensure proper pricing; key states may be reviewed more often and loss reserves are reviewed twice yearly.

Fitch's current ratings reflect PRA's strong reserve adequacy. If reserves were to adversely develop in excess of 5% of prior year's surplus, Fitch would further scrutinize the current rating.

Financial Leverage and Balance Sheet Quality

PRA maintains good financial flexibility that reflects its moderate financial leverage, strong interest coverage ratios and, in recent periods, access to the capital markets.

Financial leverage, as measured by debt to total capital, was 13% as of Sept. 30, 2007. Giving 75% equity credit to the \$62 million of trust preferred debt would bring PRA's adjusted debt to total capital down to approximately 10% as of Sept. 30, 2007. Fitch anticipates that over the near to intermediate term, financial leverage will remain at or below 25%.

Financial Leverage and Balance Sheet Quality

(\$ Mil.)

	9/07	9/06	2006	2005	2004	2003	2002
Total Capital	1,378	1,261	1,298	932	762	651	604
% Total Debt	13	14	14	18	20	16	12
% Preferred Equity	—	—	—	—	—	—	—
% Minority Interest	—	—	—	—	—	—	4
% Common Equity	87	86	86	82	80	84	84
% Total Debt/Tangible Capital	13.8	15.0	14.6	18.5	20.5	16.8	12.5

Source: SNL Financial, Company SEC Filings.

Debt-Servicing Capabilities

PRA's principal source of funds to service its fixed income securities are dividends from its operating companies. The maximum allowable dividend PRA's subsidiaries could give in 2007 without regulatory approval is \$186 million, an amount well in excess of the company's \$12 million interest expense.

Additionally, management currently maintains a meaningful cash cushion at the holding company that will potentially allow for its operating subsidiaries to retain earnings to support organic growth over the near to intermediate term.

Debt-Servicing Capabilities

(\$ Mil.)

	3Q07	3Q06	2006	2005	2004	2003	2002
Interest Expense	9	8	11	9	7	3	3
Operating EBIT/Interest Expense (x)	19.4	16.8	17.1	13.1	14.8	14.0	7.6
Operating EBIT/Interest Expense and Preferred Div. (x)	19.4	16.8	17.1	13.1	14.8	14.0	7.6
Cash Flow from Operations	207	134	183	324	374	283	177

EBIT – Earnings before interest and taxes. Div. – Dividends.

Source: SNL Financial, company SEC filings.

Debt Structure

Security	Maturity	Coupon (%)	Amount (\$ Mil.)
Unsecured Convertible Debt	Due June 2023	3.90	107.6
Trust Preferred Security	Due Dec 2032	9.62	15.5
Trust Preferred Security	Due Apr 2034	9.41	13.4
Trust Preferred Security	Due May 2034	9.41	33
Unsecured Surplus Note	Due May 2009	7.70	12

Source: ProAssurance

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