

PROASSURANCE CORP  
Form 10-Q  
August 06, 2015  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2015 or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-16533

ProAssurance Corporation  
(Exact Name of Registrant as Specified in Its Charter)

Delaware 63-1261433  
(State or Other Jurisdiction of  
Incorporation or Organization) (IRS Employer Identification No.)

100 Brookwood Place, Birmingham, AL 35209  
(Address of Principal Executive Offices) (Zip Code)

(205) 877-4400  
(Registrant's Telephone Number, Including Area Code) (Former Name, Former Address, and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter), during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of July 31, 2015, there were 53,667,668 shares of the registrant's common stock outstanding.

Table of Contents

## Glossary of Terms and Acronyms

When the following terms and acronyms appear in the text of this report, they have the meanings indicated below.

Term	Meaning
AOCI	Accumulated other comprehensive income (loss)
BOLI	Business owned life insurance
DPAC	Deferred policy acquisition costs
Eastern Re	Eastern Re, LTD, S.P.C.
EBUB	Earned, but unbilled premium
FAL	Funds at Lloyd's
FASB	Financial Accounting Standards Board
FHLB	Federal Home Loan Bank
GAAP	Generally accepted accounting principles in the United States of America
HCPL	Healthcare professional liability
IRS	Internal Revenue Service
LLC	Limited liability company
Lloyd's	Lloyd's of London market
LP	Limited partnership
Medical Technology Liability	Medical technology and life sciences products liability
NAV	Net asset value
NYSE	New York Stock Exchange
NRSRO	Nationally recognized statistical rating organization
OCI	Other comprehensive income (loss)
OTTI	Other-than-temporary impairment
PCAOB	Public Company Accounting Oversight Board
Revolving Credit Agreement	ProAssurance's \$250 million revolving credit agreement
ROE	Return on equity
SEC	Securities and Exchange Commission
SPC	Segregated portfolio cell
Specialty P&C	Specialty Property and Casualty
Syndicate 1729	Lloyd's of London Syndicate 1729
Syndicate Credit Agreement	Unconditional revolving credit agreement with the Premium Trust Fund of Syndicate 1729
TIPS	Treasury Inflation Protected Securities
U.K.	United Kingdom of Great Britain and Northern Ireland
ULAE	Unallocated loss adjustment expense
VIE	Variable interest entity

Table of Contents

Forward-Looking Statements

Any statements in this Form 10-Q that are not historical facts are specifically identified as forward-looking statements. These statements are based upon our estimates and anticipation of future events and are subject to certain risks and uncertainties that could cause actual results to vary materially from the expected results described in the forward-looking statements. Forward-looking statements are identified by words such as, but not limited to, "anticipate," "believe," "estimate," "expect," "hope," "hopeful," "intend," "likely," "may," "optimistic," "possible," "potential," "preliminary," "project," "should," "will" and other analogous expressions. There are numerous factors that could cause our actual results to differ materially from those in the forward-looking statements. Thus, sentences and phrases that we use to convey our view of future events and trends are expressly designated as forward-looking statements as are sections of this Form 10-Q that are identified as giving our outlook on future business.

Forward-looking statements relating to our business include among other things: statements concerning future liquidity and capital requirements, investment valuation and performance, return on equity, financial ratios, net income, premiums, losses and loss reserve, premium rates and retention of current business, competition and market conditions, the expansion of product lines, the development or acquisition of business in new geographical areas, the availability of acceptable reinsurance, actions by regulators and rating agencies, court actions, legislative actions, payment or performance of obligations under indebtedness, payment of dividends, and other matters.

These forward-looking statements are subject to significant risks, assumptions and uncertainties, including, among other things, the following factors that could affect the actual outcome of future events:

- changes in general economic conditions, including the impact of inflation or deflation and unemployment;
- our ability to maintain our dividend payments;
- regulatory, legislative and judicial actions or decisions that could affect our business plans or operations;
- the enactment or repeal of tort reforms;
- formation or dissolution of state-sponsored insurance entities providing coverages now offered by ProAssurance which could remove or add sizable numbers of insureds from or to the private insurance market;
- changes in the interest rate environment;
- changes in U.S. laws or government regulations regarding financial markets or market activity that may affect the U.S. economy and our business;
- changes in the ability of the U.S. government to meet its obligations that may affect the U.S. economy and our business;
- performance of financial markets affecting the fair value of our investments or making it difficult to determine the value of our investments;
- changes in requirements or accounting policies and practices that may be adopted by our regulatory agencies, the FASB, the SEC, the PCAOB, or the NYSE and that may affect our business;
- changes in laws or government regulations affecting the financial services industry, the property and casualty insurance industry or particular insurance lines underwritten by our subsidiaries;
- the effect on our insureds, particularly the insurance needs of our insureds, and our loss costs, of changes in the healthcare delivery system, including changes attributable to the Patient Protection and Affordable Care Act;
- consolidation of our insureds into or under larger entities which may be insured by competitors, or may not have a risk profile that meets our underwriting criteria or which may not use external providers for insuring or otherwise managing substantial portions of their liability risk;
- uncertainties inherent in the estimate of our loss and loss adjustment expense reserve and reinsurance recoverable;
- changes in the availability, cost, quality, or collectability of insurance/reinsurance;
- the results of litigation, including pre- or post-trial motions, trials and/or appeals we undertake;
- effects on our claims costs from mass tort litigation that are different from that anticipated by us;
- allegations of bad faith which may arise from our handling of any particular claim, including failure to settle;

loss or consolidation of independent agents, agencies, brokers, or brokerage firms;  
changes in our organization, compensation and benefit plans;  
changes in the business or competitive environment may limit the effectiveness of our business strategy and  
impact our revenues;  
our ability to retain and recruit senior management;

Table of Contents

the availability, integrity and security of our technology infrastructure or that of our third party providers of technology infrastructure, including any susceptibility to cyber-attacks which might result in a loss of information or operating capability;

the impact of a catastrophic event, as it relates to both our operations and our insured risks;

the impact of acts of terrorism and acts of war;

the effects of terrorism related insurance legislation and laws;

assessments from guaranty funds;

our ability to achieve continued growth through expansion into new markets or through acquisitions or business combinations;

changes to the ratings assigned by rating agencies to our insurance subsidiaries, individually or as a group;

provisions in our charter documents, Delaware law and state insurance laws may impede attempts to replace or remove management or may impede a takeover;

state insurance restrictions may prohibit assets held by our insurance subsidiaries, including cash and investment securities, from being used for general corporate purposes;

taxing authorities can take exception to our tax positions and cause us to incur significant amounts of legal and accounting costs and, if our defense is not successful, additional tax costs, including interest and penalties; and

expected benefits from completed and proposed acquisitions may not be achieved or may be delayed longer than expected due to business disruption; loss of customers, employees and key agents; increased operating costs or inability to achieve cost savings; and assumption of greater than expected liabilities, among other reasons.

Additional risks that could arise from our membership in the Lloyd's of London market and our participation in Syndicate 1729 include, but are not limited to, the following:

members of Lloyd's are subject to levies by the Council of Lloyd's based on a percentage of the member's underwriting capacity, currently a maximum of 3%, but can be increased by Lloyd's;

Syndicate operating results can be affected by decisions made by the Council of Lloyd's over which the management of Syndicate 1729 has little ability to control, such as a decision to not approve the business plan of the Syndicate, or a decision to increase the capital required to continue operations, and by our obligation to pay levies to Lloyd's;

Lloyd's insurance and reinsurance relationships and distribution channels could be disrupted or Lloyd's trading licenses could be revoked making it more difficult for Syndicate 1729 to distribute and market its products; and

rating agencies could downgrade their ratings of Lloyd's as a whole.

Our results may differ materially from those we expect and discuss in any forward-looking statements. The principal risk factors that may cause these differences are described in "Item 1A, Risk Factors" in our Form 10-K and other documents we file with the SEC, such as our current reports on Form 8-K, and our regular reports on Form 10-Q. We caution readers not to place undue reliance on any such forward-looking statements, which are based upon conditions existing only as of the date made, and advise readers that these factors could affect our financial performance and could cause actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements. Except as required by law or regulations, we do not undertake and specifically decline any obligation to publicly release the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

Table of Contents

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED) - JUNE 30, 2015  
AND DECEMBER 31, 2014 6

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN CAPITAL  
(UNAUDITED) - SIX MONTHS ENDED JUNE 30, 2015 AND 2014 7

CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE  
INCOME (UNAUDITED) - THREE AND SIX MONTHS ENDED JUNE 30, 2015 AND 2014 8

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) - SIX  
MONTHS ENDED JUNE 30, 2015 AND 2014 9

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) 11

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS 37

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK 82

ITEM 4. CONTROLS AND PROCEDURES 85

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS 85

ITEM 1A. RISK FACTORS 85

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS 85

ITEM 6. EXHIBITS 86

SIGNATURE 87

Table of Contents

ProAssurance Corporation and Subsidiaries  
Condensed Consolidated Balance Sheets (Unaudited)  
(In thousands, except share data)

	June 30, 2015	December 31, 2014
Assets		
Investments		
Fixed maturities, available for sale, at fair value; amortized cost, \$2,903,152 and \$3,055,477, respectively	\$2,967,353	\$3,145,027
Equity securities, trading, at fair value; cost, \$290,811 and \$283,107 respectively	307,326	314,482
Short-term investments	144,351	131,259
Business owned life insurance	56,090	56,381
Investment in unconsolidated subsidiaries	291,661	276,501
Other investments, \$31,600 and \$28,958 at fair value, respectively, otherwise at cost or amortized cost	91,110	86,057
Total Investments	3,857,891	4,009,707
Cash and cash equivalents	151,366	197,040
Premiums receivable	219,993	202,528
Receivable from reinsurers on paid losses and loss adjustment expenses	9,024	6,494
Receivable from reinsurers on unpaid losses and loss adjustment expenses	237,801	237,966
Prepaid reinsurance premiums	35,673	32,115
Deferred policy acquisition costs	44,398	38,790
Real estate, net	39,374	39,799
Intangible assets	96,598	100,733
Goodwill	210,725	210,725
Other assets	98,648	93,263
Total Assets	\$5,001,491	\$5,169,160
Liabilities and Shareholders' Equity		
Liabilities		
Policy liabilities and accruals		
Reserve for losses and loss adjustment expenses	\$2,026,697	\$2,058,266
Unearned premiums	370,459	345,828
Reinsurance premiums payable	24,143	17,451
Total Policy Liabilities	2,421,299	2,421,545
Deferred tax liability	11,142	18,818
Other liabilities	161,866	320,853
Long-term debt	350,000	250,000
Total Liabilities	2,944,307	3,011,216
Shareholders' Equity		
Common shares, par value \$0.01 per share, 100,000,000 shares authorized, 62,496,623 and 62,297,214 shares issued, respectively	625	623
Additional paid-in capital	362,230	359,577
Accumulated other comprehensive income (loss), net of deferred tax expense (benefit) of \$21,784 and \$31,342, respectively	41,049	58,204
Retained earnings	2,028,745	1,991,704
Treasury shares, at cost, 8,481,567 shares and 5,763,388 shares, respectively	(375,465 )	(252,164 )
Total Shareholders' Equity	2,057,184	2,157,944
Total Liabilities and Shareholders' Equity	\$5,001,491	\$5,169,160
See accompanying notes.		





Table of Contents

ProAssurance Corporation and Subsidiaries  
Condensed Consolidated Statements of Changes in Capital (Unaudited)  
(In thousands)

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total
Balance at December 31, 2014	\$623	\$359,577	\$ 58,204	\$1,991,704	\$(252,164 )	\$2,157,944
Common shares reacquired	—	—	—	—	(123,301 )	(123,301 )
Common shares issued for compensation	—	2,082	—	—	—	2,082
Share-based compensation	—	4,966	—	—	—	4,966
Net effect of restricted and performance shares issued and stock options exercised	2	(4,395 )	—	—	—	(4,393 )
Dividends to shareholders	—	—	—	(33,931 )	—	(33,931 )
Other comprehensive income (loss)	—	—	(17,155 )	—	—	(17,155 )
Net income	—	—	—	70,972	—	70,972
Balance at June 30, 2015	\$625	\$362,230	\$ 41,049	\$2,028,745	\$(375,465 )	\$2,057,184

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total
Balance at December 31, 2013	\$621	\$349,894	\$ 59,661	\$2,015,603	\$(31,365 )	\$2,394,414
Common shares reacquired	—	—	—	—	(122,281 )	(122,281 )
Common shares issued for compensation	—	2,685	—	—	—	2,685
Share-based compensation	—	5,641	—	—	—	5,641
Net effect of restricted and performance shares issued and stock options exercised	2	(2,821 )	—	—	—	(2,819 )
Dividends to shareholders	—	—	—	(35,534 )	—	(35,534 )
Other comprehensive income (loss)	—	—	21,992	—	—	21,992
Net income	—	—	—	96,673	—	96,673
Balance at June 30, 2014	\$623	\$355,399	\$ 81,653	\$2,076,742	\$(153,646 )	\$2,360,771
See accompanying notes.						

Table of Contents

ProAssurance Corporation and Subsidiaries  
Condensed Consolidated Statements of Income and Comprehensive Income (Unaudited)  
(In thousands, except per share data)

	Three Months Ended June 30		Six Months Ended June 30	
	2015	2014	2015	2014
Revenues				
Net premiums earned	\$ 175,293	\$ 176,303	\$ 347,192	\$ 348,032
Net investment income	27,955	30,225	55,258	59,957
Equity in earnings (loss) of unconsolidated subsidiaries	2,420	719	4,041	2,470
Net realized investment gains (losses):				
Other-than-temporary impairment (OTTI) losses	(1,209)	) —	(4,480)	) (50)
Portion of OTTI losses recognized in (reclassified from) other comprehensive income before taxes	348	—	1,789	—
Net impairment losses recognized in earnings	(861)	) —	(2,691)	) (50)
Other net realized investment gains (losses)	(2,967)	) 13,046	3,702	15,840
Total net realized investment gains (losses)	(3,828)	) 13,046	1,011	15,790
Other income	1,576	2,154	3,745	4,249
Total revenues	203,416	222,447	411,247	430,498
Expenses				
Losses and loss adjustment expenses	112,747	104,052	230,915	200,104
Reinsurance recoveries	(8,808)	) (5,139)	) (21,837)	) (11,683)
Net losses and loss adjustment expenses	103,939	98,913	209,078	188,421
Underwriting, policy acquisition and operating expenses	53,525	52,157	104,881	104,672
Segregated portfolio cells dividend expense	1,230	1,789	3,414	2,838
Interest expense	3,710	3,521	7,341	7,091
Total expenses	162,404	156,380	324,714	303,022
Income before income taxes	41,012	66,067	86,533	127,476
Provision for income taxes				
Current expense (benefit)	13,776	14,389	14,128	22,294
Deferred expense (benefit)	(5,922)	) 1,736	1,433	8,509
Total income tax expense (benefit)	7,854	16,125	15,561	30,803
Net income	33,158	49,942	70,972	96,673
Other comprehensive income (loss), after tax, net of reclassification adjustments	(24,828)	) 11,247	(17,155)	) 21,992
Comprehensive income	\$ 8,330	\$ 61,189	\$ 53,817	\$ 118,665
Earnings per share:				
Basic	\$ 0.60	\$ 0.84	\$ 1.27	\$ 1.60
Diluted	\$ 0.60	\$ 0.84	\$ 1.26	\$ 1.59
Weighted average number of common shares outstanding:				
Basic	55,445	59,524	56,016	60,383
Diluted	55,645	59,742	56,226	60,615
Cash dividends declared per common share	\$ 0.31	\$ 0.30	\$ 0.62	\$ 0.60
See accompanying notes.				

Table of Contents

ProAssurance Corporation and Subsidiaries  
Condensed Consolidated Statements of Cash Flows (Unaudited)  
(In thousands)

	Six Months Ended June 30	
	2015	2014
Operating Activities		
Net income	\$70,972	\$96,673
Adjustments to reconcile income to net cash provided by operating activities:		
Depreciation and amortization, net of accretion	23,668	23,974
Net realized investment gains	(1,011	) (15,790
Share-based compensation	4,966	5,641
Deferred income taxes	1,433	8,509
Policy acquisition costs, net amortization (net deferral)	(5,608	) (4,535
Equity in earnings of unconsolidated subsidiaries, excluding distributions received and tax credit partnership amortization	(7,973	) (5,941
Other	(674	) (439
Other changes in assets and liabilities, excluding effect of business combinations:		
Premiums receivable	(17,465	) (27,786
Reinsurance related assets and liabilities	769	(17,128
Other assets	(5,909	) (6,017
Reserve for losses and loss adjustment expenses	(31,569	) (50,284
Unearned premiums	24,631	27,441
Other liabilities	(2,478	) (5,184
Net cash provided (used) by operating activities	\$53,752	\$29,134
Investing Activities		
Purchases of:		
Fixed maturities, available for sale	\$(375,552	) \$(365,421
Equity securities, trading	(153,610	) (56,006
Other investments	(15,786	) (19,535
Funding of tax credit limited partnerships	(659	) (5,348
Investment in unconsolidated subsidiaries	(26,275	) (16,603
Proceeds from sales or maturities of:		
Fixed maturities, available for sale	520,169	342,347
Equity securities, trading	157,005	85,477
Other investments	11,918	10,288
Distributions from unconsolidated subsidiaries	13,619	—
Net sales or maturities (purchases) of short-term investments	(13,130	) 99,244
Cash received in acquisitions	—	35,013
Unsettled security transactions, net change	1,229	19,866
(Increase) decrease in restricted cash	—	78,000
Other	(5,266	) 6,065
Net cash provided (used) by investing activities	\$113,662	\$213,387

Continued on following page.

Table of Contents

	Six Months Ended June 30	
	2015	2014
Financing Activities		
Borrowing under revolving credit agreement	\$100,000	\$—
Repurchase of common stock	(123,301	) (119,593
Dividends to shareholders	(184,411	) (36,223
Other	(5,376	) (5,429
Net cash provided (used) by financing activities	(213,088	) (161,245
Increase (decrease) in cash and cash equivalents	(45,674	) 81,276
Cash and cash equivalents at beginning of period	197,040	129,383
Cash and cash equivalents at end of period	\$151,366	\$210,659
Significant non-cash transactions		
Deposit transferred as consideration for acquisition	\$—	\$205,244
Dividends declared and not yet paid	\$16,728	\$17,607
See accompanying notes.		

Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

## 1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of ProAssurance Corporation and its consolidated subsidiaries (ProAssurance, PRA or the Company). The financial statements have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation, consisting of normal recurring adjustments, have been included. ProAssurance's results for the six months ended June 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. The accompanying Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes contained in ProAssurance's December 31, 2014 report on Form 10-K. In connection with its preparation of the Condensed Consolidated Financial Statements, ProAssurance evaluated events that occurred subsequent to June 30, 2015 for recognition or disclosure in its financial statements and notes to financial statements.

ProAssurance operates in four reportable segments as follows: Specialty P&C, Workers' Compensation, Lloyd's Syndicate, and Corporate. For more information on the nature of products and services provided and for financial information by segment, refer to Note 12 of the Notes to Condensed Consolidated Financial Statements.

## Other Liabilities

Other liabilities consisted of the following:

(In millions)	June 30, 2015	December 31, 2014
SPC dividends payable	\$ 18.6	\$ 15.8
Unpaid dividends	16.7	167.7
All other	126.6	137.4
Total other liabilities	\$ 161.9	\$ 320.9

SPC dividends payable are the cumulative undistributed earnings contractually payable to the external preferred shareholders of SPCs operated by ProAssurance's Cayman Islands subsidiary, Eastern Re.

Unpaid dividends represents common stock dividends declared by ProAssurance's Board of Directors that have not yet been paid. Unpaid dividends at December 31, 2014 reflect a special dividend declared in late 2014 that was paid in January 2015.

## Accounting Changes Adopted

## Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity

Effective for fiscal years beginning after December 15, 2014, the FASB issued guidance regarding the requirements for reporting discontinued operations. Under the new guidance, reporting entities are required to report disposals of business components only if the disposal represents a strategic shift in the entity's operations that will have a major effect on the entity's operations and financial results. The new guidance expands disclosure requirements for reported discontinued operations and requires disclosure of pre-tax profit or loss attributable to significant disposals that are not reported as discontinued operations. ProAssurance adopted the guidance as of January 1, 2015. Adoption of the guidance had no effect on ProAssurance's results of operations or financial position.

## Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent)

Effective for fiscal years beginning after December 15, 2015, the FASB issued guidance which removed the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The guidance also revised other disclosure requirements for investments measured or eligible to be measured at fair value using the net asset value per share practical expedient. ProAssurance adopted the guidance as of June 30, 2015 as early adoption is permitted. Adoption of the guidance had no effect on ProAssurance's results of operations or financial position as it affected disclosures only.



Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

Accounting Changes Not Yet Adopted

Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period

Effective for fiscal years beginning after December 15, 2015, the FASB issued guidance for share-based payments in which the terms of the award provide that a performance target can be achieved after completion of the requisite service period. The new guidance provides that compensation cost for such awards should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. ProAssurance plans to adopt the guidance beginning January 1, 2016. Adoption of the guidance is expected to have no effect on ProAssurance's results of operations or financial position as ProAssurance has no awards with performance targets extending beyond the requisite service period.

Revenue from Contracts with Customers

Effective for fiscal years beginning after December 15, 2016, the FASB issued guidance related to revenue from contracts with customers. The core principle of the new guidance is that revenue should be recognized 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 in exchange for those goods or services. ProAssurance plans to adopt the guidance beginning January 1, 2017. As the majority of ProAssurance's revenues come from insurance contracts which fall under the scope of other FASB standards, adoption of the guidance is expected to have no material effect on ProAssurance's results of operations or financial position.

Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern

Effective for fiscal years ending after December 15, 2016 and interim periods beginning after December 15, 2016, the FASB issued guidance that establishes principles and definitions related to management's evaluation of whether there is substantial doubt about the organization's ability to continue as a going concern. For each interim and annual reporting period, the new guidance requires management to evaluate the organization's ability to meet its obligations as they are due within one year of the date the financial statements are issued and requires disclosure when there is substantial doubt regarding the organization's ability to continue as a going concern. ProAssurance plans to adopt the guidance on its effective date. Adoption is expected to have no effect on ProAssurance's results of operations or financial position.

Simplifying the Presentation of Debt Issuance Costs

Effective for fiscal years beginning after December 15, 2015, the FASB issued guidance related to the presentation of debt issuance costs. The new guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. ProAssurance plans to adopt the guidance beginning January 1, 2016. Adoption of the guidance is not expected to have a material effect on ProAssurance's results of operations or financial position.

Amendments to the Consolidation Analysis

Effective for fiscal years beginning after December 15, 2015, the FASB issued additional guidance regarding the consolidation of legal entities such as limited partnerships, limited liability corporations, and securitization structures (collateralized debt obligations, collateralized loan obligations, and mortgage-backed security transactions). The new standard modifies the evaluation of whether or not entities are VIEs and the consolidation analysis of entities involved with VIEs, particularly those having fee arrangements and related party relationships. ProAssurance is in the process of evaluating the effect, if any, of the new guidance on its results of operations and financial position and plans to adopt the guidance beginning January 1, 2016. The effect is not expected to be material.

Customer's Accounting for Fees Paid in a Cloud Computing Arrangement

Effective for fiscal years beginning after December 15, 2015, the FASB issued additional guidance regarding accounting for cloud computing arrangements. Under the new guidance, customers participating in cloud computing

arrangements that include a software license should account for the software license element of the arrangement consistent with the acquisition of other software licenses. Customers should account for cloud computing arrangements that do not include a software license as a service contract, following existing guidance for service contracts. ProAssurance is in the process of evaluating the effect that the use of the new method would have on its results of operations and financial position and plans to adopt the guidance beginning January 1, 2016. The effect is not expected to be material.



Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

Disclosures about Short-Duration Contracts

Effective for fiscal years beginning after December 15, 2015, the FASB issued guidance that requires insurance entities to provide detailed disclosures relative to the reserve for losses and loss adjustment expenses in annual reporting periods and a roll-forward of the reserve for losses and loss adjustment expenses in interim reporting periods. The guidance also requires disclosures regarding significant changes in the methodologies and assumptions used to calculate the reserve for losses and loss adjustment expenses, including reasons for and the effects of such changes. ProAssurance plans to adopt the guidance beginning January 1, 2016. Adoption of the guidance is not expected to have a material effect on ProAssurance's results of operations or financial position as it affects disclosures only.

Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

2. Fair Value Measurement

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A three level hierarchy has been established for valuing assets and liabilities based on how transparent (observable) the inputs are that are used to determine fair value, with the inputs considered most observable categorized as Level 1 and those that are the least observable categorized as Level 3. Hierarchy levels are defined as follows:

- Level 1: quoted (unadjusted) market prices in active markets for identical assets and liabilities. For ProAssurance, Level 1 inputs are generally quotes for debt or equity securities actively traded in exchange or over-the-counter markets.
- Level 2: market data obtained from sources independent of the reporting entity (observable inputs). For ProAssurance, Level 2 inputs generally include quoted prices in markets that are not active, quoted prices for similar assets or liabilities, and results from pricing models that use observable inputs such as interest rates and yield curves that are generally available at commonly quoted intervals.
- Level 3: the reporting entity's own assumptions about market participant assumptions based on the best information available in the circumstances (non-observable inputs). For ProAssurance, Level 3 inputs are used in situations where little or no Level 1 or 2 inputs are available or are inappropriate given the particular circumstances. Level 3 inputs include results from pricing models for which some or all of the inputs are not observable, discounted cash flow methodologies, single non-binding broker quotes and adjustments to externally quoted prices that are based on management judgment or estimation.

Fair values of assets measured at fair value on a recurring basis as of June 30, 2015 and December 31, 2014 are shown in the following tables. The tables also indicate the fair value hierarchy of the valuation techniques utilized to determine those fair values. For some assets, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. When this is the case, the asset is categorized based on the level of the most significant input to the fair value measurement. Assessments of the significance of a particular input to the fair value measurement require judgment and consideration of factors specific to the assets being valued.

Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

(In thousands)	June 30, 2015			Total Fair Value
	Fair Value Measurements Using Level 1	Level 2	Level 3	
Assets:				
Fixed maturities, available for sale				
U.S. Treasury obligations	\$—	\$99,506	\$—	\$99,506
U.S. Government-sponsored enterprise obligations	—	29,735	—	29,735
State and municipal bonds	—	1,003,611	—	1,003,611
Corporate debt, multiple observable inputs	2,262	1,396,416	—	1,398,678
Corporate debt, limited observable inputs:				
Other corporate debt, NRSRO ratings available	—	—	7,927	7,927
Other corporate debt, NRSRO ratings not available	—	—	541	541
Residential mortgage-backed securities	—	267,273	—	267,273
Agency commercial mortgage-backed securities	—	11,348	—	11,348
Other commercial mortgage-backed securities	—	45,617	—	45,617
Other asset-backed securities	—	98,340	4,777	103,117
Equity securities				
Financial	71,102	—	—	71,102
Utilities/Energy	38,219	—	—	38,219
Consumer oriented	48,270	—	76	48,346
Industrial	40,846	—	—	40,846
Bond funds	79,419	—	—	79,419
All other	16,391	13,003	—	29,394
Short-term investments	141,496	2,855	—	144,351
Other investments	3,346	27,294	960	31,600
Total assets categorized within the fair value hierarchy	\$441,351	\$2,994,998	\$14,281	\$3,450,630
LP/LLC interests carried at NAV which approximates fair value. These interests, reported as a part of Investment in unconsolidated subsidiaries, are not categorized within the fair value hierarchy.				149,083
Total assets at fair value				\$3,599,713

Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

(In thousands)	December 31, 2014			Total Fair Value
	Fair Value Measurements Using Level 1	Level 2	Level 3	
Assets:				
Fixed maturities, available for sale				
U.S. Treasury obligations	\$—	\$ 166,512	\$—	\$ 166,512
U.S. Government-sponsored enterprise obligations	—	39,563	—	39,563
State and municipal bonds	—	1,057,590	5,025	1,062,615
Corporate debt, multiple observable inputs	—	1,404,020	—	1,404,020
Corporate debt, limited observable inputs:				
Other corporate debt, NRSRO ratings available	—	—	10,474	10,474
Other corporate debt, NRSRO ratings not available	—	—	2,607	2,607
Residential mortgage-backed securities	—	276,056	—	276,056
Agency commercial mortgage-backed securities	—	15,493	—	15,493
Other commercial mortgage-backed securities	—	51,063	—	51,063
Other asset-backed securities	—	111,855	4,769	116,624
Equity securities				
Financial	79,341	—	—	79,341
Utilities/Energy	25,629	—	—	25,629
Consumer oriented	65,670	—	—	65,670
Industrial	55,460	—	—	55,460
Bond funds	55,196	—	—	55,196
All other	33,186	—	—	33,186
Short-term investments	131,199	60	—	131,259
Other investments	6,050	22,908	—	28,958
Total assets categorized within the fair value hierarchy	\$451,731	\$3,145,120	\$22,875	\$3,619,726
LP/LLC interests carried at NAV which approximates fair value. These interests, reported as a part of Investment in unconsolidated subsidiaries, are not categorized within the fair value hierarchy.				133,250
Total assets at fair value				\$3,752,976

The fair values for securities included in the Level 2 category, with the few exceptions described below, were developed by one of several third party, nationally recognized pricing services, including services that price only certain types of securities. Each service uses complex methodologies to determine values for securities and subject the values they develop to quality control reviews. Management selected a primary source for each type of security in the portfolio and reviewed the values provided for reasonableness by comparing data to alternate pricing services and to available market and trade data. Values that appeared inconsistent were further reviewed for appropriateness. If a value did not appear reasonable, the valuation was discussed with the service that provided the value and would have been adjusted, if necessary. No such adjustments were necessary in 2015 or 2014.

## Level 2 Valuations

Below is a summary description of the valuation methodologies primarily used by the pricing services for securities in the Level 2 category, by security type:

U.S. Treasury obligations were valued based on quoted prices for identical assets, or, in markets that are not active, quotes for similar assets, taking into consideration adjustments for variations in contractual cash flows and yields to maturity.

U.S. Government-sponsored enterprise obligations were valued using pricing models that consider current and historical market data, normal trading conventions, credit ratings, and the particular structure and characteristics of the security being valued, such as yield to maturity, redemption options, and contractual cash flows. Adjustments to model inputs or model results were included in the valuation process when necessary to reflect recent regulatory, government or corporate actions or significant economic, industry or geographic events affecting the security's fair value.

Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

State and municipal bonds were valued using a series of matrices that considered credit ratings, the structure of the security, the sector in which the security falls, yields, and contractual cash flows. Valuations were further adjusted, when necessary, to reflect the expected effect on fair value of recent significant economic or geographic events or ratings changes.

Corporate debt with multiple observable inputs consisted primarily of corporate bonds, but also included a small number of bank loans. The methodology used to value Level 2 corporate bonds was the same as the methodology previously described for U.S. Government-sponsored enterprise obligations. Bank loans were valued based on an average of broker quotes for the loans in question, if available. If quotes were not available, the loans were valued based on quoted prices for comparable loans or, if the loan was newly issued, by comparison to similar seasoned issues. Broker quotes were compared to actual trade prices on a regular basis to permit assessment of the reliability of the quotes; unreliable quotes were not considered in quoted averages.

Residential and commercial mortgage backed securities. Agency pass-through securities were valued using a pricing matrix which considers the issuer type, coupon rate and longest cash flows outstanding. The matrix used was based on the most recently available market information. Agency and non-agency collateralized mortgage obligations were both valued using models that consider the structure of the security, current and historical information regarding prepayment speeds, ratings and ratings updates, and current and historical interest rate and interest rate spread data. Other asset-backed securities were valued using models that consider the structure of the security, monthly payment information, current and historical information regarding prepayment speeds, ratings and ratings updates, and current and historical interest rate and interest rate spread data. Spreads and prepayment speeds considered collateral type. Equity securities were securities not traded on an exchange on the valuation date. The securities were valued using the most recently available quotes for the securities.

Short-term investments are securities maturing within one year, carried at cost which approximated the fair value of the security due to the short term to maturity.

Other investments consisted of convertible bonds valued using a pricing model that incorporated selected dealer quotes as well as current market data regarding equity prices and risk free rates. If dealer quotes were unavailable for the security being valued, quotes for securities with similar terms and credit status were used in the pricing model. Dealer quotes selected for use were those considered most accurate based on parameters such as underwriter status and historical reliability.

Level 3 Valuations

Below is a summary description of the valuation processes and methodologies used as well as quantitative information regarding securities in the Level 3 category.

Level 3 Valuation Processes

Level 3 securities are priced by the Chief Investment Officer.

Level 3 valuations are computed quarterly. Prices are evaluated quarterly against prior period prices and the expected change in price.

The securities noted in the disclosure are primarily NRSRO rated debt instruments for which comparable market inputs are commonly available for evaluating the securities in question. Valuation of these debt instruments is not overly sensitive to changes in the unobservable inputs used.

Level 3 Valuation Methodologies

State and municipal bonds consisted of auction rate municipal bonds valued internally using either published quotes for similar securities or values produced by discounted cash flow models using yields currently available on fixed rate securities with a similar term and collateral, adjusted to consider the effect of a floating rate and a premium for illiquidity.

Corporate debt with limited observable inputs consisted of corporate bonds valued using dealer quotes for similar securities or discounted cash flow models using yields currently available for similar securities. Similar securities are

defined as securities of comparable credit quality that have like terms and payment features. Assessments of credit quality were based on NRSRO ratings, if available, or were subjectively determined by management if not available. At June 30, 2015, 94% of the securities were rated; the average rating was A-.

Other asset-backed securities consisted of securitizations of receivables valued using dealer quotes for similar securities or discounted cash flow models using yields currently available for similar securities.

Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

Equity securities and Other investments consisted of common stock and convertible securities for which limited observable inputs were available at June 30, 2015. The securities were valued internally based on expected cash flows, including the expected final recovery, discounted at a yield that considered the lack of liquidity and the financial status of the issuer.

## Quantitative Information Regarding Level 3 Valuations

(In millions)	Fair Value at		Valuation Technique	Unobservable Input	Range (Weighted Average)
	June 30, 2015	December 31, 2014			
Assets:					
State and municipal bonds	\$—	\$5.0	Market Comparable Securities	Comparability Adjustment	0% - 10% (5%)
			Discounted Cash Flows	Comparability Adjustment	0% - 10% (5%)
Corporate debt with limited observable inputs	\$8.5	\$13.1	Market Comparable Securities	Comparability Adjustment	0% - 5% (2.5%)
			Discounted Cash Flows	Comparability Adjustment	0% - 5% (2.5%)
Other asset-backed securities	\$4.8	\$4.8	Market Comparable Securities	Comparability Adjustment	0% - 5% (2.5%)
			Discounted Cash Flows	Comparability Adjustment	0% - 5% (2.5%)
Equity securities and Other investments	\$1.1	\$—	Discounted Cash Flows	Comparability Adjustment	0% - 10% (5%)

The significant unobservable inputs used in the fair value measurement of the above listed securities were the valuations of comparable securities with similar issuers, credit quality and maturity. Changes in the availability of comparable securities could result in changes in the fair value measurements.



Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

## Fair Value Measurements - Level 3 Assets

The following tables (the Level 3 Tables) present summary information regarding changes in the fair value of assets measured at fair value using Level 3 inputs.

(In thousands)	June 30, 2015					Total
	Level 3 Fair Value Measurements – Assets					
	U.S. Government- Enterprise Obligations	State and sponsored Municipal Bonds	Corporate Debt	Asset-backed Securities	Equity Securities and Other Investments	
Balance March 30, 2015	\$—	\$5,025	\$9,977	\$ 4,788	\$—	\$19,790
Total gains (losses) realized and unrealized:						
Included in earnings, as a part of:						
Net investment income	—	—	—	—	—	—
Net realized investment gains (losses)	—	—	—	—	—	—
Included in other comprehensive income	—	(459 )	21	(11 )	(80 )	(529 )
Purchases	—	—	—	—	1,116	1,116
Sales	—	—	(536 )	—	—	(536 )
Transfers in	—	—	—	—	—	—
Transfers out	—	(4,566 )	(994 )	—	—	(5,560 )
Balance June 30, 2015	\$—	\$—	\$8,468	\$ 4,777	\$ 1,036	\$14,281
Change in unrealized gains (losses) included in earnings for the above period for Level 3 assets held at period-end	\$—	\$—	\$—	\$—	\$—	\$—

(In thousands)	June 30, 2015					Total
	Level 3 Fair Value Measurements – Assets					
	U.S. Government- Enterprise Obligations	State and sponsored Municipal Bonds	Corporate Debt	Asset-backed Securities	Equity Securities and Other Investments	
Balance December 31, 2014	\$—	\$5,025	\$13,081	\$ 4,769	\$—	\$22,875
Total gains (losses) realized and unrealized:						
Included in earnings, as a part of:						
Net investment income	—	—	17	—	—	17
Net realized investment gains (losses)	—	—	2	—	—	2
Included in other comprehensive income	—	(459 )	(262 )	8	(80 )	(793 )
Purchases	—	—	1,515	—	1,116	2,631
Sales	—	—	(836 )	—	—	(836 )
Transfers in	—	—	—	—	—	—
Transfers out	—	(4,566 )	(5,049 )	—	—	(9,615 )
Balance June 30, 2015	\$—	\$—	\$8,468	\$ 4,777	\$ 1,036	\$14,281

Change in unrealized gains (losses)  
included in earnings for the above  
period for Level 3 assets held at  
period-end

\$—      \$—      \$—      \$—      \$—      \$—

19

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Table of Contents

ProAssurance Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 30, 2015

(In thousands)	June 30, 2014					Total
	Level 3 Fair Value Measurements – Assets					
	U.S. Government- Enterprise Obligations	State and Municipal Bonds	Corporate Debt	Asset-backed Securities	Equity Securities and Other Investments	
Balance March 30, 2014	\$999	\$7,490	\$12,381	\$ 7,226	\$—	\$28,096
Total gains (losses) realized and unrealized:						