DELPHI FINANCIAL GROUP INC/DE
Form 10-Q
May 09, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended March 31, 2012

¨ **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 001-11462

DELPHI FINANCIAL GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	(302) 478-5142	13-3427277
(State or other jurisdiction of incorporation or organization)	(Registrant s telephone number, including area code)	(I.R.S. Employer Identification Number)

1105 North Market Street, Suite 1230, P.O. Box 8985, Wilmington, Delaware	19899
(Address of principal executive offices)	(Zip Code)

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 filing requirements for the past 90 days: Yes x 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 x No ¨

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

Large accelerated filer x	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 x

As of April 30, 2012, the Registrant had 50,529,529 shares of Class A Common Stock and 6,111,557 shares of Class B Common Stock outstanding.

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DELPHI FINANCIAL GROUP, INC.

FORM 10-Q

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

AND OTHER INFORMATION

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Dollars in Thousands, Except Per Share Data)

(Unaudited)

	Three Months Ended March 31, 2012	2011
Revenue:		
Premium and fee income	$ 418,385	$ 376,399
Net investment income	105,780	92,294
Net realized investment gains (losses):		
Total other than temporary impairment losses	(6,791)	(7,539)
Portion of other than temporary impairment losses recognized in (reclassified from) other comprehensive income	368	(1,479)
Net impairment losses recognized in earnings	(6,423)	(9,018)
Other net realized investment gains	7,454	7,046
Net realized investment gains (losses)	1,031	(1,972)
	525,196	466,721
Benefits and expenses:		
Benefits, claims and interest credited to policyholders	311,531	271,265
Commissions	22,696	22,568
Amortization of cost of business acquired	21,333	18,961
Other operating expenses	116,243	77,909
	471,803	390,703
Operating income	53,393	76,018
Interest expense:		
Corporate debt	6,130	6,010
Junior subordinated debentures	3,242	3,242
	9,372	9,252
Income before income tax expense	44,021	66,766
Income tax expense	10,923	16,395
Net income	33,098	50,371
Less: Net (loss) income attributable to noncontrolling interest	(1,842)	147

Net income attributable to shareholders	$ 34,940	$ 50,224
Basic results per share of common stock:		
Net income attributable to shareholders	$ 0.62	$ 0.90
Diluted results per share of common stock:		
Net income attributable to shareholders	$ 0.60	$ 0.89
Dividends paid per share of common stock	$ 0.12	$ 0.11

See notes to consolidated financial statements.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Net income	$ 33,098	$ 50,371
Other comprehensive income, net of tax:		
Increase in net unrealized appreciation on investments	83,618	5,804
Decrease in other than temporary impairment losses recognized in other comprehensive income	4,146	4,393
Change in net periodic pension cost	555	77
Change in other comprehensive income attributable to shareholders	88,319	10,274
Total comprehensive income	121,417	60,645
Less: Net (loss) income attributable to noncontrolling interest	(1,842)	147
Total comprehensive income attributable to shareholders	$ 123,259	$ 60,498

See notes to consolidated financial statements.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands, Except Per Share Data)

(Unaudited)

	March 31, 2012	December 31, 2011
Assets:		
Investments:		
Fixed maturity securities, available for sale	$ 6,827,169	$ 6,489,637
Short-term investments	141,521	277,552
Investment accounts receivable	77,189	24,406
Other investments	873,793	678,133
	7,919,672	7,469,728
Cash	109,180	93,898
Cost of business acquired	149,128	156,675
Reinsurance receivables	363,726	365,391
Premiums receivable	193,297	154,612
Accrued investment income	73,190	74,672
Goodwill	93,929	93,929
Other assets	113,950	108,138
Assets held in separate account	124,068	117,365
Total assets	$ 9,140,140	$ 8,634,408
Liabilities and Equity:		
Future policy benefits:		
Life	$ 334,764	$ 328,678
Disability and accident	858,442	845,750
Unpaid claims and claim expenses:		
Life	53,728	57,049
Disability and accident	489,129	481,826
Casualty	1,571,758	1,506,129
Policyholder account balances	2,171,804	2,100,675
Unearned premium reserve	253,495	192,261
Corporate debt	375,000	375,000
Junior subordinated debentures	175,000	175,000
Advances from Federal Home Loan Bank	55,342	55,342
Investment accounts payable	85,627	41,719
Net deferred tax liability	193,316	135,559
Other liabilities and policyholder funds	448,904	442,172
Liabilities related to separate account	124,068	117,365
Total liabilities	7,190,377	6,854,525
Equity:		
Preferred Stock, $.01 par; 50,000,000 shares authorized, none issued		
Class A Common Stock, $.01 par; 150,000,000 shares authorized; 58,398,268 and 56,798,526 shares issued and outstanding, respectively	584	568

Class B Common Stock, $.01 par; 20,000,000 shares authorized; 6,338,773 shares issued and outstanding	63	63
Additional paid-in capital	759,980	705,036
Accumulated other comprehensive income	195,848	107,529
Retained earnings	1,193,968	1,165,756
Treasury stock, at cost; 8,182,716 shares of Class A Common Stock and 227,216 shares of Class B Common Stock	(206,931)	(206,931)
Total shareholders equity	1,943,512	1,772,021
Noncontrolling interest	6,251	7,862
Total equity	1,949,763	1,779,883
Total liabilities and equity	$ 9,140,140	$ 8,634,408

See notes to consolidated financial statements.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EQUITY

(Dollars in Thousands)

(Unaudited)

	Class A Common Stock	Class B Common Stock	Additional Paid in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Shareholders Equity	Non-controlling Interest	Total Equity
Balance, January 1, 2011	$ 565	$ 60	$ 682,816	$ 30,932	$ 1,013,369	$ (197,246)	$ 1,530,496	$ 4,634	$ 1,535,130
Net income					50,224		50,224	147	50,371
Change in other comprehensive income				10,274			10,274		10,274
Change in noncontrolling interest ownership								774	774
Issuance of deferred and restricted shares and exercise of stock options	1		4,343				4,344		4,344
Stock-based compensation			1,141				1,141		1,141
Cash dividends					(6,158)		(6,158)		(6,158)
Balance, March 31, 2011	$ 566	$ 60	$ 688,300	$ 41,206	$ 1,057,435	$ (197,246)	$ 1,590,321	$ 5,555	$ 1,595,876
Balance, January 1, 2012	$ 568	$ 63	$ 705,036	$ 107,529	$ 1,165,756	$ (206,931)	$ 1,772,021	$ 7,862	$ 1,779,883
Net income (loss)					34,940		34,940	(1,842)	33,098
Change in other comprehensive income				88,319			88,319		88,319
Change in noncontrolling interest ownership								231	231
Issuance of deferred and restricted shares and exercise of stock options	16		62,281				62,297		62,297
Stock-based compensation			(7,337)				(7,337)		(7,337)
Cash dividends					(6,728)		(6,728)		(6,728)
Balance, March 31, 2012	$ 584	$ 63	$ 759,980	$ 195,848	$ 1,193,968	$ (206,931)	$ 1,943,512	$ 6,251	$ 1,949,763

See notes to consolidated financial statements.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Three Months Ended March 31,	
	2012	2011
Operating activities:		
Net income attributable to shareholders	$ 34,940	$ 50,224
Adjustments to reconcile net income attributable to shareholders to net cash provided by operating activities:		
Change in policy liabilities and policyholder accounts	161,289	123,648
Net change in reinsurance receivables and payables	1,232	1,017
Net change in premiums receivable	(38,685)	(33,471)
Amortization, principally the cost of business acquired and investments	8,808	13,912
Deferred costs of business acquired	(29,364)	(26,032)
Net realized (gains) losses on investments	(1,031)	1,972
Net change in federal income taxes	(1,250)	23,875
Other operating activities	(41,909)	(37,706)
Net cash provided by operating activities	94,030	117,439
Investing activities:		
Purchases of investments and loans made	(1,482,137)	(826,996)
Sales of investments and receipts from repayment of loans	1,052,706	592,455
Maturities of investments	114,336	71,970
Net change in short-term investments	136,031	66,826
Net cash used by investing activities	(179,064)	(95,745)
Financing activities:		
Deposits to policyholder accounts	89,101	99,076
Withdrawals from policyholder accounts	(29,590)	(97,028)
Proceeds from the issuance of common stock under share-based compensation plans	43,301	3,907
Cash dividends paid on common stock	(6,728)	(6,158)
Other financing activities	4,232	(1,272)
Net cash provided (used) by financing activities	100,316	(1,475)
Increase in cash	15,282	20,219
Cash at beginning of year	93,898	72,806
Cash at end of period	$ 109,180	$ 93,025

See notes to consolidated financial statements.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note A Significant Accounting Policies

The financial statements of Delphi Financial Group, Inc. (the Company, which term includes the Company and its consolidated subsidiaries unless the context indicates otherwise) included herein were prepared in conformity with accounting principles generally accepted in the United States (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 footnotes required by GAAP for complete financial statements. The information furnished includes all adjustments and accruals of a normal recurring nature which, in the opinion of management, are necessary for a fair presentation of results for the interim periods. Certain reclassifications have been made in the March 31, 2011 consolidated financial statements to conform to the March 31, 2012 presentation. Operating results for the three months ended March 31, 2012 are not necessarily indicative of the results that may be expected for the year ended December 31, 2012. For further information refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2011, as amended by Amendment No. 1 on Form 10-K/A (the 2011 Form 10-K). Capitalized terms used herein without definition have the meanings ascribed to them in the 2011 Form 10-K.

Accounting Changes

On January 1, 2012, the Company adopted new guidance issued by the FASB regarding fair value measurements in order to have a common fair value measurement and disclosure requirement for purposes of both GAAP and International Financial Reporting Standards. This guidance further elaborates upon techniques used in measuring fair value. It does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The adoption of this guidance did not have any effect on the Company s consolidated financial position or results of operations.

On January 1, 2012, the Company adopted new guidance issued by the FASB regarding the presentation of comprehensive income. This guidance eliminates the option to present components of other comprehensive income as part of the statement of changes in stockholders equity and requires that all changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance does not change the items that must be reported in other comprehensive income or the calculation or presentation of earnings per share. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The adoption of this guidance did not have any effect on the Company s consolidated financial position or results of operations.

On January 1, 2012, the Company adopted new guidance issued by the FASB addressing the valuation process for goodwill. This guidance provides the ability to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Under this guidance, an entity will no longer be required to calculate the fair value of a reporting unit unless it determines, based on a qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. This guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of this guidance did not have any impact on the Company s consolidated financial position or results of operations.

Note B Investments

At March 31, 2012, the Company had fixed maturity securities available for sale with a carrying value and a fair value of $6,827.2 million and an amortized cost of $6,468.1 million. At December 31, 2011, the Company had fixed maturity securities available for sale with a carrying value and a fair value of $6,489.6 million and an amortized cost of $6,274.6 million. Declines in market value relative to such securities amortized cost which are determined to be other than temporary pursuant to the Company s methodology for such determinations and to represent credit losses are reflected as reductions in the amortized cost of such securities, as further discussed below.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note B Investments (Continued)

The amortized cost and fair value of investments in fixed maturity securities available for sale are as follows:

	$6,274,590	$6,274,590	$6,274,590	$6,274,590	$6,274,590
			March 31, 2012 Gross Unrealized		
	Amortized Cost	Gains	Losses	Other Than Temporary Impairments	Fair Value
			(dollars in thousands)		
Agency residential mortgage-backed securities	$ 520,634	$ 54,259	$ (68)	$	$ 574,825
Non-agency residential mortgage-backed securities	957,752	66,292	(14,435)	(17,439)	992,170
Commercial mortgage-backed securities	190,530	11,172	(3,466)	(39)	198,197
Corporate securities	1,738,458	102,003	(14,889)	(378)	1,825,194
Collateralized debt obligations	289,437	12,744	(19,088)	(22)	283,071
Foreign government securities	137,802	11,083	(2,861)		146,024
U.S. Treasury and other U.S. Government guaranteed securities	119,478	5,586	(606)		124,458
U.S. Government-sponsored enterprise securities	38,089	106	(249)		37,946
Obligations of U.S. states, municipalities and political subdivisions	2,475,876	174,828	(5,420)		2,645,284
Total fixed maturity securities	$ 6,468,056	$ 438,073	$ (61,082)	$ (17,878)	$ 6,827,169

	$6,274,590	$6,274,590	$6,274,590	$6,274,590	$6,274,590
			December 31, 2011 Gross Unrealized		
	Amortized Cost	Gains	Losses	Other Than Temporary Impairments	Fair Value
			(dollars in thousands)		
Agency residential mortgage-backed securities	$ 606,678	$ 61,928	$ (22)	$	$ 668,584
Non-agency residential mortgage-backed securities	819,027	50,256	(27,009)	(21,637)	820,637
Commercial mortgage-backed securities	96,251	2,135	(1,665)	(38)	96,683
Corporate securities	1,668,160	82,377	(42,269)	(771)	1,707,497
Collateralized debt obligations	284,667	6,582	(31,368)	(1,810)	258,071
Foreign government securities	258,578	12,557	(13,854)		257,281
	96,281	8,043	(487)		103,837

U.S. Treasury and other U.S. Government guaranteed securities					
U.S. Government-sponsored enterprise securities	42,229	156	(6)		42,379
Obligations of U.S. states, municipalities and political subdivisions	2,402,719	140,851	(8,902)		2,534,668
Total fixed maturity securities	$ 6,274,590	$ 364,885	$ (125,582)	$ (24,256)	$ 6,489,637

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note B Investments (Continued)

The amortized cost and fair value of fixed maturity securities available for sale at March 31, 2012, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations, with or without prepayment penalties.

	Amortized Cost	Fair Value
	(dollars in thousands)	
Agency residential mortgage-backed securities	$ 520,634	$ 574,825
Non-agency residential mortgage-backed securities	957,752	992,170
Commercial mortgage-backed securities	190,530	198,197
Other fixed maturity securities:		
One year or less	79,904	77,358
Greater than 1, up to 5 years	684,167	707,749
Greater than 5, up to 10 years	1,210,076	1,251,704
Greater than 10 years	2,824,993	3,025,166
Total	$ 6,468,056	$ 6,827,169

Net investment income was attributable to the following:

	Three Months Ended March 31, 2012	2011
	(dollars in thousands)	
Gross investment income:		
Fixed maturity securities, available for sale	$ 96,264	$ 86,112
Mortgage loans	1,031	233
Other	18,903	14,210
	116,198	100,555
Less: Investment expenses	(10,418)	(8,261)
	$ 105,780	$ 92,294

Net realized investment gains (losses) arose from the following:

	Three Months Ended March 31, 2012	2011
	(dollars in thousands)	
Credit related other than temporary impairment losses:		
Fixed maturity securities, available for sale	$ (6,423)	$ (9,018)
Other net realized investment gains:		
Fixed maturity securities, available for sale	$ 6,814	$ 6,799
Other investments	640	247
	7,454	7,046
Total	$ 1,031	$ (1,972)

Proceeds from sales of fixed maturity securities during the first three months of 2012 and 2011 were $806.1 million and $520.0 million, respectively. Gross gains of $25.7 million and gross losses of $18.9 million were realized on the 2012 sales and gross gains of $10.6 million and gross losses of $3.8 million were realized on the 2011 sales. Net realized investment gains and losses on investment sales are determined under the specific identification method and are included in income. The change in unrealized appreciation and depreciation on investments, primarily relating to fixed maturity securities, is included as a component of accumulated other comprehensive income or loss.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note B Investments (Continued)

The gross unrealized losses and fair value of fixed maturity securities available for sale, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

	$1,067,809	$1,067,809	$1,067,809	$1,067,809	$1,067,809	$1,067,809
	March 31, 2012					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(dollars in thousands)					
Agency residential mortgage-backed securities	$ 7,489	$ (41)	$ 194	$ (27)	$ 7,683	$ (68)
Non-agency residential mortgage-backed securities	141,479	(5,295)	167,360	(26,579)	308,839	(31,874)
Commercial mortgage-backed securities	45,937	(3,466)	5	(39)	45,942	(3,505)
Corporate securities	298,662	(8,855)	40,417	(6,412)	339,079	(15,267)
Collateralized debt obligations	82,953	(3,115)	76,582	(15,995)	159,535	(19,110)
Foreign government securities	60,391	(2,861)			60,391	(2,861)
U.S. Treasury and other U.S. Government guaranteed securities	30,384	(206)	7,281	(400)	37,665	(606)
U.S. Government-sponsored enterprise securities	28,199	(249)			28,199	(249)
Obligations of U.S. states, municipalities and political subdivisions	88,668	(1,578)	24,259	(3,842)	112,927	(5,420)
Total fixed maturity securities	$ 784,162	$ (25,666)	$ 316,098	$ (53,294)	$ 1,100,260	$ (78,960)

	$1,067,809	$1,067,809	$1,067,809	$1,067,809	$1,067,809	$1,067,809
	December 31, 2011					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(dollars in thousands)					
Agency residential mortgage-backed securities	$ 2,489	$ (7)	$ 217	$ (15)	$ 2,706	$ (22)
Non-agency residential mortgage-backed securities	236,953	(10,510)	165,137	(38,136)	402,090	(48,646)

Commercial mortgage-backed securities	23,116	(1,480)	4,829	(223)	27,945	(1,703)
Corporate securities	440,672	(23,617)	69,933	(19,423)	510,605	(43,040)
Collateralized debt obligations	132,496	(9,397)	64,410	(23,781)	196,906	(33,178)
Foreign government securities	160,615	(13,854)			160,615	(13,854)
U.S. Treasury and other U.S. Government guaranteed securities	15,178	(487)			15,178	(487)
U.S. Government-sponsored enterprise securities	8,232	(6)			8,232	(6)
Obligations of U.S. states, municipalities and political subdivisions	48,058	(2,766)	82,220	(6,136)	130,278	(8,902)
Total fixed maturity securities	$ 1,067,809	$ (62,124)	$ 386,746	$ (87,714)	$ 1,454,555	$ (149,838)

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note B Investments (Continued)

The following table contains information, as of March 31, 2012, regarding the portions of the Company s investments in non-agency residential mortgage-backed securities (RMBS) represented by securities whose underlying mortgage loans are categorized as prime, Alt-A and sub-prime, respectively, and the distributions of the securities within these categories by the years in which they were issued (vintages) and the highest of their ratings from Standard & Poor s, Moody s and Fitch. All dollar amounts in this table are based upon the fair values of these securities as of March 31, 2012. As of this date, based upon the most recently available data regarding the concentrations by state of the mortgage loans underlying these securities, the states having loan concentrations in excess of 5% were as follows: California (38.8%), New York (8.0%) and Florida (6.7%).

	Non-Agency Prime RMBS Fair Value					
Vintage	AAA	AA	A	BBB	BB and Below [(1)]	Total
			(dollars in thousands)			
2001 and prior	$	$ 1,121	$	$	$ 207	$ 1,328
2002	5,579		2,269		1,375	9,223
2003	69,764	1,235		2,084	10,739	83,822
2004	19,876	8,354	17,184	9,103	6,312	60,829
2005	5,327	85	6,387		117,464	129,263
2006	13,737				59,169	72,906
2007	4,106				118,476	122,582
2008		687			366	1,053
Total	$ 118,389	$ 11,482	$ 25,840	$ 11,187	$ 314,108	$ 481,006

(1) The securities enumerated in this column include securities having a total of $277.6 million in fair value that have received the equivalent of an investment grade rating from the National Association of Insurance Commissioners (the NAIC) under its process which takes into account, among other things, the discounts at which the Company originally purchased the securities and modeling of the potential losses with respect to the securities underlying loans.

	Non-Agency Alt-A RMBS Fair Value					
Vintage	AAA	AA	A	BBB	BB and Below [(1)]	Total
			(dollars in thousands)			
2001 and prior	$	$	$	$ 1,525	$	$ 1,525
2002	184		1,249			1,433
2003	39,060				747	39,807

2004	13,514	3,473	665	1,149	5,323	24,124
2005	1,934		4,412		85,346	91,692
2006	7,430		38		83,540	91,008
2007	224				138,663	138,887
2010			3,960			3,960
Total	$ 62,346	$ 3,473	$ 10,324	$ 2,674	$ 313,619	$ 392,436

(1) The securities enumerated in this column include securities having a total of $279.5 million in fair value that have received the equivalent of an investment grade rating from the NAIC under its process which takes into account, among other things, the discounts at which the Company originally purchased the securities and modeling of the potential losses with respect to the securities underlying loans.

DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note B Investments (Continued)

	Non-Agency Subprime RMBS Fair Value					
Vintage	AAA	AA	A	BBB	BB and Below [1]	Total
			(dollars in thousands)			
2003	$ 9,235	$	$ 885	$	$	$ 10,120
2004	8,768				2,665	11,433
2005	10,771	1,143	6,276		25,677	43,867
2006			456	1,171	45,301	46,928
2007					6,380	6,380
Total	$ 28,774	$ 1,143	$ 7,617	$ 1,171	$ 80,023	$ 118,728

(1) The securities enumerated in this column include securities having a total of $77.3 million in fair value that have received the equivalent of an investment grade rating from the NAIC under its process which takes into account, among other things, the discounts at which the Company originally purchased the securities and modeling of the potential losses with respect to the securities underlying loans.

The Company regularly evaluates its investment portfolio utilizing its established methodology to determine whether declines in the fair values of its investments below the Company s amortized cost are other than temporary. Under this methodology, management evaluates whether and when the Company will recover an investment s amortized cost, taking into account, among other things, the financial position and prospects of the issuer, conditions in the issuer s industry and geographic area, liquidity of the investment, the expected amount and timing of future cash flows from the investment, recent changes in credit ratings of the issuer by nationally recognized rating agencies and the length of time and extent to which the fair value of the investment has been lower than its amortized cost to determine if and when a decline in the fair value of an investment below amortized cost is other than temporary. In the case of structured securities such as RMBS, commercial mortgage-backed securities and collateralized debt obligations, the most significant factor in these evaluations is the expected amount and timing of the future cash flows from the investment. In the case of fixed maturity securities, in instances where management determines that a security s amortized cost will be recovered during its remaining term to maturity, an additional component of this methodology is the Company s evaluation of whether it intends to, or will more likely than not be required to, sell the security before such anticipated recovery.

If the fair value of a fixed maturity security declines in value below the Company s amortized cost and the Company intends to sell, or determines that it will more likely than not be required to sell, the security before recovery of its amortized cost basis, management considers the security to be other than temporarily impaired and reports its decline in fair value as a realized investment loss in the income statement. If, however, the Company does not intend to sell the security and determines that it is not more likely than not that it will be required to do so, a decline in its fair value that is considered in the judgment of management to be other than temporary is separated into the amount representing credit loss and the amount related to other factors. Amounts representing credit losses are reported as realized investment losses in the income statement and amounts related to other factors are included as a component of accumulated other comprehensive income or loss, net of the related income tax benefit and the related adjustment to cost of business acquired. Declines in the fair value of all other investments below the Company s amortized cost that are considered in the judgment of management to be other than temporary are reported as realized investment losses in the income statement.

In the case of structured securities such as RMBS, commercial mortgage-backed securities and collateralized debt obligations as to which a decline in fair value is judged to be other than temporary, the amount of the credit loss arising from the impairment of the security is determined by discounting such security s expected cash flows at its effective interest rate, taking into account the security s purchase price. The key inputs relating to such expected cash flows consist of the future scheduled payments on the underlying loans and the estimated frequency and severity of future defaults on these loans. For those securities as to which the Company recognized credit losses in 2012 as a result of determinations that such securities were other than temporarily impaired, representative default frequency estimates ranged from 2.6% to 4.5% and representative default severity estimates ranged from 43.3% to 60.1%.

In the case of corporate securities as to which a decline in fair value is determined to be other than temporary, the key input utilized to establish the amount of credit loss arising from the impairment of the security is the market price for such security. For each such security, the Company obtains such market price from a single independent nationally recognized pricing

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note B Investments (Continued)

service. The Company has not in any instance adjusted the market price so obtained; however, management reviews these prices for reasonableness, taking into account both security-specific factors and its knowledge and understanding of the pricing methodologies used by the service. The credit loss for such security is determined to be equal to the excess of the Company s amortized cost over such market price, as measured at the time of the impairment; as such, the entirety of the depreciation in market value is deemed to be reflective of credit loss.

During the first three months of 2012, the Company recognized $4.4 million of after-tax other than temporary impairment losses, of which $4.2 million was recognized as after-tax realized investment losses in the income statement related to credit losses and $0.2 million was recognized, net of the related income tax benefit, as a component of accumulated other comprehensive income on the balance sheet related to noncredit losses.

The following table provides a reconciliation of the beginning and ending balances of other than temporary impairments on fixed maturity securities held by the Company for which a portion of the other than temporary impairment was recognized in accumulated other comprehensive income or loss (dollars in thousands):

	Three Months Ended March 31	
	2012	2011
Balance at the beginning of the period	$ 76,623	$ 79,602
Increases attributable to credit losses on securities for which an other than temporary impairment was not previously recognized	484	732
Increases attributable to credit losses on securities for which an other than temporary impairment was previously recognized	4,066	7,666
Reductions due to sales, maturities, pay downs or prepayments of securities for which an other than temporary impairment was previously recognized	(5,398)	(7,826)
Balance at the end of the period	$ 75,775	$ 80,174

The gross unrealized losses at March 31, 2012 are attributable to 604 fixed maturity security positions, with the largest unrealized loss associated with any one security equal to $4.1 million. At March 31, 2012, approximately 29.0% of these aggregate gross unrealized losses were attributable to fixed maturity security positions as to which the unrealized loss represented 10.0% or less of the amortized cost for such security. Unrealized losses attributable to fixed maturity securities having investment grade ratings by a nationally recognized statistical rating organization comprised 35.0% of the aggregate gross unrealized losses at March 31, 2012, with the remainder of such losses being attributable to non-investment grade fixed maturity securities.

At March 31, 2012, the Company held approximately $883.2 million of insured municipal fixed maturity securities, which represented approximately 11.2% of the Company s total invested assets. Based upon the highest of the ratings assigned to the respective securities by nationally recognized statistical rating organizations, these securities had a weighted average credit rating of A at March 31, 2012. Credit enhancements provided by the insurance did not impact the weighted average credit rating at such date by such organizations. Insurers of significant portions of the municipal fixed maturity securities held by the Company at March 31, 2012 included Assured Guaranty ($304.8

million), National Public Finance Guarantee Corp. ($298.6 million), Ambac Financial Group, Inc. ($153.4 million), Texas Permanent School Fund ($53.8 million) and Radian ($25.0 million). At March 31, 2012, the Company did not have significant holdings of credit enhanced asset-backed or mortgage-backed securities, nor did it have any significant direct investments in the guarantors of the municipal fixed maturity securities held by the Company.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note C Fair Value Measurements

The Company measures its assets and liabilities recorded at fair value in the consolidated balance sheet based on the framework set forth in the GAAP fair value accounting guidance. This framework establishes a fair value hierarchy of three levels based upon the transparency and availability of information used in measuring the fair value of assets or liabilities as of the measurement date. The levels are categorized as follows:

Level 1 Valuation is based upon quoted prices for identical assets or liabilities in active markets. Level 1 fair value is not subject to valuation adjustments or block discounts.

Level 2 Valuation is based upon quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar instruments in markets that are not active. In addition, a company may use various valuation techniques or pricing models that use observable inputs to measure fair value.

Level 3 Valuation is generated from techniques in which one or more of the significant inputs for valuing such assets or liabilities are not observable. These inputs may reflect the Company s best estimates of the various assumptions that market participants would use in valuing the financial assets and financial liabilities.

For these purposes, the Company determines the existence of an active market for an asset or liability based on its judgment as to whether transactions for the asset or liability occur in such market with sufficient frequency and volume to provide reliable pricing information. If the Company concludes that there has been a significant decrease in the volume and level of activity for an investment in relation to normal market activity for such investment, adjustments to transactions and quoted prices are made to estimate fair value.

The inputs used in the valuation techniques employed by the Company are provided by nationally recognized pricing services, external investment managers and internal resources. To assess these inputs, the Company s review process includes, but is not limited to, quantitative analysis including benchmarking, initial and ongoing evaluations of methodologies used by external parties to calculate fair value, and ongoing evaluations of fair value estimates based on the Company s knowledge and monitoring of market conditions.

The Company, from time-to-time, surveys its external pricing service providers to better understand the process performed in determining fair value. The Company administers meetings with these external parties, speaking directly with the individuals who are involved in the valuation process. Certain pricing service providers also have policies in place, along with committees, that evaluate the reasonability of its valuations given the information available. The Company requests to understand these policies and the involvement of the committees to determine the process in arriving at fair value.

The assumptions underlying the valuations from external service providers, including unobservable inputs, is generally not readily available as this information is often deemed proprietary. Accordingly, the Company is unable to obtain comprehensive results of these assumptions and methodologies.

The Company s investments in fixed maturity securities available for sale, equity securities available for sale, trading account securities, assets held in the separate account and its liabilities for securities sold, not yet purchased are carried at fair value. The methodologies and valuation techniques used by the Company to value its assets and liabilities measured at fair value are described below.

Instruments included in fixed maturity securities available for sale include mortgage-backed and corporate securities, U.S. Treasury and other U.S. government guaranteed securities, securities issued by U.S. government-sponsored enterprises, securities issued by foreign governments and obligations of U.S. states, municipalities and political subdivisions. The market liquidity of each security is taken into consideration in the valuation technique used to value such security. For securities where market transactions involving identical or comparable assets generate sufficient relevant information, the Company employs a market approach to valuation. If sufficient information is not generated from market transactions involving identical or comparable assets, the Company uses an income approach to valuation. If sufficient information is not generated from market transactions involving identical or comparable assets, the Company uses an income approach to valuation. The majority of the instruments included in fixed maturity securities available for sale are valued utilizing observable inputs; accordingly, they are categorized in either Level l or Level 2 of the fair value hierarchy described above. However, in instances where significant inputs utilized are unobservable, the securities are categorized in Level 3 of the fair value hierarchy.

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note C Fair Value Measurements (Continued)

The Company uses various valuation techniques and pricing models to measure the fair value of its investments in residential mortgage-backed securities and commercial mortgage-backed securities, including option-adjusted spread models, volatility-driven multi-dimensional single cash flow stream models and matrix correlation to comparable securities. Residential mortgage-backed securities include U.S. agency securities and collateralized mortgage obligations. Inputs utilized in connection with the valuation techniques relating to this class of securities include monthly payment and performance information with respect to the underlying loans, including prepayments, default severity, delinquencies, market indices and the amounts of the tranches in the particular structure which are senior or subordinate, as applicable, to the tranche represented by the Company s investment. A portion of the Company s investments in mortgage-backed securities are valued using observable inputs and therefore categorized in Level 2 of the fair value hierarchy. The remaining mortgage-backed securities are valued using non-binding broker quotes. These methodologies rely on unobservable inputs and thus these securities are categorized in Level 3 of the fair value hierarchy.

Corporate securities primarily include fixed rate corporate bonds, floating and variable rate notes and securities acquired through private placements. Inputs utilized in connection with the Company s valuation techniques relating to this class of securities include recently executed transactions, market price quotations, benchmark yields, issuer spreads and, in the case of private placement corporate securities, cash flow models. These cash flow models utilize yield curves, issuer-provided information and material events as key inputs. Corporate securities are categorized in Level 2 of the fair value hierarchy, other than securities acquired through private placements, which are categorized in Level 3 of the fair value hierarchy.

Collateralized debt obligations consist of collateralized loan obligations. The Company s valuation techniques relating to this class of securities utilize non-binding broker quotes as the key input. As this input is generally unobservable, collateralized debt obligations are categorized in Level 3 of the fair value hierarchy.

Foreign government securities consist of bonds that are issued by a foreign government. Inputs utilized in connection with the Company's valuation techniques relating to this class of securities include recently executed transactions, interest rate yield curves, maturity dates, foreign currency exchange rates, and market price quotations relating to similar instruments. These inputs are generally observable and accordingly, these securities are generally categorized in Level 2 of the fair value hierarchy.

U.S. Treasury and other U.S. government guaranteed securities include U.S. Treasury bonds and notes, Treasury Inflation Protected Securities (TIPS) and other U.S. government guaranteed securities. The fair values of the U.S. Treasury securities and TIPS are based on quoted prices in active markets and are generally categorized in Level 1 of the fair value hierarchy.

Inputs utilized in connection with the Company s valuation techniques relating to its investments in other U.S. government guaranteed securities, as well as its investments in U.S. government-sponsored enterprise securities, which consist of medium term notes issued by these enterprises, include recently executed transactions, interest rate yield curves, maturity dates, market price quotations and credit spreads relating to similar instruments. These inputs are generally observable and accordingly, these securities are generally categorized in Level 2 of the fair value hierarchy.

Obligations of U.S. states, municipalities and political subdivisions primarily include bonds or notes issued by U.S municipalities. Inputs utilized in connection with the Company s valuation techniques relating to this class of securities include recently executed transactions and other market data, spreads, benchmark curves including treasury and other benchmarks, trustee reports, material event notices, new issue data, and issuer financial statements. These inputs are generally observable and these securities are generally categorized in Level 2 of the fair value hierarchy.

Other investments held at fair value primarily consist of equity securities available for sale and trading account securities are primarily valued at quoted active market prices and are therefore categorized in Level 1 of the fair value hierarchy. For private equity investments, since quoted market prices are not available, the transaction price is used as the best estimate of fair value at inception. When evidence is believed to support a change to the carrying value from the transaction price, adjustments are made to reflect expected exit values. Ongoing reviews by Company management are based on assessments of each underlying investment and the inputs utilized in these reviews include, among other things, the evaluation of financing and sale transactions with third parties, expected cash flows, material events and market-based information. These investments are included in Level 3 of the fair value hierarchy.

Assets held in the separate account represent funds invested in a separately administered variable life insurance product for which the policyholder, rather than the Company, bears the investment risk. These assets are invested in interests in a limited

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note C Fair Value Measurements (Continued)

liability company that invests in funds which trade in various financial instruments. This limited liability company, all of whose interests are owned by the Company s separate account, utilizes the financial statements furnished by the funds to determine the values of its investments in such funds and the carrying value of each such investment, which is based on its proportionate interest in the relevant fund as of the balance sheet date. As such, these funds financial statements constitute the key input in the Company s valuation of its investment in this limited liability company. The Company concluded that the value calculated using the equity method of accounting on its investment in this limited liability company was reflective of the fair market value of such investment. The investment portfolios of the funds in which the fund investments are maintained vary from fund to fund, but are generally comprised of liquid, publicly traded securities that have readily determinable market values and which are carried at fair value on the financial statements of such funds, substantially all of which are audited annually. The amount that an investor is entitled to receive upon the redemption of its investment from the applicable fund is determined by reference to such security values. These investments are included in Level 3 of the fair value hierarchy.

Other liabilities measured at fair value consist of securities sold, not yet purchased. These securities are valued using the quoted active market prices of the securities sold and are categorized in Level 1 of the fair value hierarchy.

Assets and liabilities measured at fair value in the consolidated balance sheet on a recurring basis are summarized below:

	March 31, 2012			
	Total	Level 1	Level 2	Level 3
	(dollars in thousands)			
Assets:				
Fixed maturity securities, available for sale:				
Agency residential mortgage-backed securities	$ 574,825	$	$ 557,509	$ 17,316
Non-agency residential mortgage-backed securities	992,170		968,336	23,834
Commercial mortgage-backed securities	198,197		190,849	7,348
Corporate securities	1,825,194		1,646,088	179,106
Collateralized debt obligations	283,071		126	282,945
Foreign government securities	146,024		144,813	1,211
U.S. Treasury and other U.S. Government guaranteed securities	124,458	93,222	18,624	12,612
U.S. Government-sponsored enterprise securities	37,946		37,946	
Obligations of U.S. states, municipalities and political subdivisions	2,645,284		2,637,957	7,327
Other investments	542,143	517,072	10,193	14,878
Assets held in separate account	124,068			124,068
Total	$ 7,493,380	$ 610,294	$ 6,212,441	$ 670,645
Liabilities:				
Other liabilities	$ 84,933	$ 84,933	$	$

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DELPHI FINANCIAL GROUP, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Note C Fair Value Measurements (Continued)

	December 31, 2011			
	Total	Level 1	Level 2	Level 3
	(dollars in thousands)			
Assets:				
Fixed maturity securities, available for sale:				
Agency residential mortgage-backed securities	$ 668,584	$	$ 660,632	$ 7,952