SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended	**Commission file number**
December 31, 2003	**1-12338**

VESTA INSURANCE GROUP, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

Delaware **(STATE OR OTHER JURISDICTION OF** **INCORPORATION OR ORGANIZATION)**	**63-1097283** **(I.R.S. EMPLOYER** **IDENTIFICATION NO.)**
3760 River Run Drive, Birmingham, AL **(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)**	**35243** **(ZIP CODE)**

Registrant s telephone number, including area code:

(205) 970-7000

Securities registered pursuant to Section 12(b) of the Act:

TITLE OF EACH CLASS	**CUSIP NUMBER:**	**NAME OF EACH EXCHANGE ON WHICH REGISTERED**
Common Stock, $.01 Par Value	**925391104**	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act:

None

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) AND (2) HAS BEEN SUBJECT TO SUCH FILING REQUIREMENTS FOR THE PAST 90 DAYS. YES x NO ¨

INDICATE BY CHECK MARK IF DISCLOSURE OF DELINQUENT FILERS PURSUANT TO ITEM 405 OF REGULATION S-K (§229.405 OF THIS CHAPTER) IS NOT CONTAINED HEREIN, AND WILL NOT BE CONTAINED, TO THE BEST OF REGISTRANT S KNOWLEDGE, IN DEFINITIVE PROXY OR INFORMATION STATEMENTS INCORPORATED BY REFERENCE IN PART III OF THIS FORM 10-K OR ANY AMENDMENT TO THIS FORM 10-K. x

INDICATE BY CHECK MARK WHETHER THE REGISTRANT IS AN ACCELERATED FILER (AS DEFINED BY EXCHANGE ACT RULE 12B-2). YES x NO ¨

THE AGGREGATE MARKET VALUE OF THE VOTING STOCK HELD BY NON-AFFILIATES OF THE REGISTRANT AS OF JUNE 30, 2003: $ 82,059,538

THE NUMBER OF SHARES OUTSTANDING OF THE REGISTRANT S COMMON STOCK, AS OF March 12, 2004, 2004 is 36,065,811.

DOCUMENTS INCORPORATED BY REFERENCE

PORTIONS OF THE VESTA INSURANCE GROUP, INC. PROXY STATEMENT FOR ITS 2004 ANNUAL MEETING OF STOCKHOLDERS

ARE INCORPORATED BY REFERENCE INTO PART III HEREOF.

Table of Contents

Table of Contents

Table of Contents

Special Note Regarding Forward-Looking Statements

Any statement contained in this report which is not a historical fact, or which might otherwise be considered an opinion or projection concerning Vesta or its business, whether expressed or implied, is meant as and should be considered a forward-looking statement as that term is defined in the Private Securities Litigation Reform Act of 1996. Forward-looking statements are based on assumptions and opinions concerning a variety of known and unknown risks, including but not necessarily limited to reinsurance recoverables, financial strength ratings, natural disasters and other catastrophic events, increased competition, changes in availability and cost of reinsurance, changes in governmental regulations, and general economic conditions, as well as other risks more completely described in Vesta s filings with the Securities and Exchange Commission, including exhibit 99.1 to this Report on Form 10-K. If any of these assumptions or opinions proves incorrect, any forward-looking statements made on the basis of such assumptions or opinions may also prove materially incorrect in one or more respects.

Table of Contents

PART I

Item 1. Business

Business Overview

As used in this Annual Report, unless the context otherwise requires, the terms Vesta, we, and our refer to Vesta Insurance Group, Inc., a Delaware corporation, and its subsidiaries, collectively.

Vesta is a holding company whose principal assets are investments in the capital stock of a group of insurance companies that constitute the Vesta Insurance Group. Vesta was incorporated in Delaware on July 9, 1993 as the holding company for the property and casualty insurance subsidiaries of Torchmark Corporation. In November 1993, we completed an initial public offering of our common stock, with Torchmark retaining 25% of our shares. Torchmark divested its holdings of our shares in June 2000. Vesta s common shares are traded on the New York Stock Exchange under the symbol VTA .

Today, we conduct business in three areas of the personal insurance industry: (1) standard property and casualty; (2) non-standard automobile; and (3) life. We report the financial information of these three areas of personal insurance according to five business segments: (1) standard property-casualty insurance; (2) non-standard agency; (3) non-standard underwriting; (4) life insurance; and (5) corporate and other. We conduct our principle operations through Vesta Fire Insurance Corporation, a wholly-owned subsidiary domesticated in Illinois. In 2003, Vesta s consolidated revenue was approximately $617.7 million.

We formerly participated in the commercial and assumed reinsurance markets, but exited these business lines in 1999 and 2000, respectively, to pursue our current strategy of doing business in the personal insurance markets. In 2002, we also exited from the health insurance and consulting markets. In our consolidated financial statements, we have segregated the reporting for these discontinued operations for all periods presented. For information concerning discontinued operations, please refer to Management s Discussion and Analysis of Financial Condition and Results of Operations of this report and Note R to our consolidated financial statements.

Our largest business segment in terms of revenues is the standard property-casualty segment, where we underwrite or sell personal automobile and residential property insurance through approximately 2,525 independent insurance sales agencies. In 2003, the standard property-casualty segment generated approximately $313.1 million of revenue, or approximately 50.7% of consolidated revenue.

In the non-standard auto business, we operate as both an agency and a non-standard underwriting insurer. Non-standard personal automobile insurance policies provide coverage to drivers who find it difficult to obtain insurance from standard insurance companies due to a number of factors, including lack of prior insurance, failure to maintain continuous coverage, age, driving record or because they have limited financial resources. We currently offer products and services in selected target markets within 11 states in the Midwest, Southwest and Southeast regions of the United States. In our non-standard agency segment, our revenue consists of commissions and fees related to the sale of insurance products. In the non-standard underwriting segment, our revenue consists of risk-bearing premiums and policy fees. Since entering the non-standard auto business late in 2000, we have completed several acquisitions that have contributed to significant revenue growth in each of these segments. In 2003, our agency segment generated approximately $145.9 million of commission and fee-based revenue, or approximately 20.4% of aggregate revenue, before eliminations. In 2003, our non-standard underwriting segment generated approximately $192.3 million of revenue, or approximately 31.1% of consolidated revenue.

With respect to both standard and non-standard property-casualty insurance underwriting, key measures of performance are the combined and surplus leverage ratios. The combined ratio reflects the total expenses associated with our underwriting operations (including loss costs, loss adjustment expenses and other unallocated operating expenses) as a percentage of total earned premium and policy fees during the same period. The following table sets forth, for the years indicated, the combined ratios for our property-casualty business lines:

Table of Contents

Selected Operational Ratios for Property-Casualty Business

	2003	2002	2001
Standard property-casualty combined ratio	101.2%	102.5%	99.7%
Non-standard underwriting combined ratio	96.6%	97.0%	102.9%

The surplus leverage ratio reflects the underwriting operations net written premiums relative to statutory surplus at the end of the period. Our net premiums written to statutory surplus ratios as of December 31 2003, 2002, and 2001 was 2.17, 2.73, and 1.21, respectively.

Our net premiums written to statutory surplus ratio as of December 31, 2003 does not reflect the impact on statutory surplus from the $55.8 million litigation and arbitration settlement charge related to the 1997 20 percent whole account quota share that, for statutory reporting purposes, will be recorded in 2004. See Business Strategy and Recent Developments for additional discussion of the impact of these charges to our statutory surplus.

In our life insurance segment, we acquire and administer traditional life insurance products, universal life products, fixed rate annuities, pension contracts and other products. In 2003, our life insurance segment generated revenue, excluding realized gains, of approximately $42.3 million, or approximately 6.9% of consolidated revenue, excluding realized gains.

Our corporate and other business segment is primarily comprised of (1) investment income related to our property-casualty underwriting operations; (2) corporate interest expense; (3) general corporate operating expenses; and (4) realized gains and losses from the sale of investment securities or the repurchases of our own debt securities at a discount.

A more detailed discussion of each of our business segments is included later in this report.

As a holding company for 12 insurance subsidiaries, we hold certificates of authority to write various types of personal insurance in all 50 states and the District of Columbia. All of our insurance companies are subject to regulation by governmental agencies in the states in which we conduct business. For more information, please refer to the Regulation section of this report.

Each of the insurers we manage has been assigned a rating of B by the A.M. Best Company. For more information, please refer to the A.M. Best section of this report.

Our Internet address is www.vesta.com and the investor relations section of our web site is located at www.vesta.com/vta/ir_vta.htm. We make available free of charge, on or through the investor relations section of our web site, annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and

Exchange Commission. The investor relations section of our web site also contains information concerning purchases and sales of our equity securities by our executive officers and directors.

The investor relations section of our web site also contains a corporate governance page where we have posted our charters for our Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee, our Corporate Governance Guidelines, a Code of Ethics for Senior Financial Officers and a Code of Business Conduct and Ethics governing our directors, officers and employees. These documents are available in print upon request of any shareholder to our Investor Relations Department. Within the time period required by the SEC and the New York Stock Exchange, we will post on our web site any amendment to our Code of Ethics for Senior Financial Officers or our Code of Business Conduct and Ethics, and any waiver granted under either of those codes applicable to our directors, executive officers or senior financial officers.

Table of Contents

Business Strategy and Recent Developments

In recent years, the domestic insurance industry has been impacted by economic distress in the U.S. economy, a general decline in interest rates, capital losses following the September 11, 2001 tragedy, the adverse impact of scandals involving major U.S. corporations and the financial collapse of numerous companies. Insurance companies have responded to these challenging issues in a number of ways, including raising premium rates, discontinuing coverage in certain lines of business and terminating business activities within various states. Although these factors have created voids in various sectors of the general insurance markets, the environment of rapid industry transformation has created opportunities for financially viable insurance companies to provide underwriting and other services in various niche markets.

Since 1998, Vesta has faced a number of challenges. In addition to the above-mentioned factors, we have been challenged by changes in key management, modifications to the financial strength ratings of various subsidiaries and extensive litigation and arbitrations primarily related to a restatement in 1998 of our financial results for 1997 and prior periods. During this same time, we have pursued a strategy (1) to grow our market share in certain capacity constrained niche markets in the standard property-casualty business, (2) to exit certain states in which current results and projected future results do not fit our overall growth strategy, and (3) to participate in profitable opportunities in other industry segments such as the non-standard automobile business and life insurance business. We have also endeavored to streamline operations and divest business lines that were less profitable or did not complement our strategy.

As noted above, we have been involved in litigation and arbitration with various parties related to a restatement of our financial results for 1997 and prior periods. The Company received an arbitration panel ruling on March 1, 2004 that resulted in the recording in the 2003 consolidated financial statements a charge of $65.9 million related to our 1997 20 percent quota share treaty (as discussed in the Reinsurance Arbitrations section on page 6) and other reinsurance balances. We believe that the conclusion of these matters brings closure to the significant uncertainties created in that era and ends a difficult period in Vesta s history and will enable management to focus on improving long-term profitability and capital.

While we experienced significant and profitable growth in various personal lines business during the years 2000 through 2002, we also experienced significant declines in our property and casualty subsidiaries statutory capital and surplus during the same period. These declines in capital and surplus during this period were primarily attributable to less favorable arbitration awards and changes in estimates of disputed reinsurance recoverable balances, reserve strengthening in our discontinued commercial and assumed reinsurance segments and increased policy acquisition costs associated with significant premium growth. This decline in statutory surplus coupled with our significant growth in premium written is the primary reason that A.M. Best Company adjusted the financial strength ratings of our property and casualty subsidiaries from B+ (Very Good) to B (Fair) in March of 2003. During 2003, we reversed these two trends by stabilizing our growth rate for premiums written relative to 2002 and growing our statutory surplus. However, the impact from the occurrence of an $18.3 million net catastrophe loss resulting from a series of hailstorms in Texas and the Southeastern United States during the second quarter of 2003 resulted in a dampening of our improvement in statutory capital. See the Regulatory Guidelines section on page 6 for factors that negatively impact our statutory surplus on an ongoing basis.

Since the March 2003 A.M. Best downgrade, we have not experienced a significant negative impact in our core insurance operations. However, the level of our statutory surplus as of December 31, 2003, as discussed below, could lead to further negative adjustments in our A.M. Best ratings. We currently intend to consummate two transactions in order to strengthen our capital, each of which are discussed below under the heading Anticipated Capital Transactions, but we are unable to predict whether A.M. Best will refrain from taking any negative rating actions pending the consummation of these transactions. If we are unable to retain or improve our A.M. Best rating, we may ultimately experience deterioration in selected portions of our property and casualty premium volume, which could adversely impact our financial results, the degree to which management is unable to quantify.

In an effort to strengthen our capital position, we began a capital evaluation in March of 2003. The capital evaluation included concluding initiatives determined in 2002 as well as an analysis of the possible divestiture of certain of our businesses, including our life and property-casualty operations. The capital evaluation was conducted throughout 2003 and resulted in certain initiatives. One such initiative was the conclusion of our marketing of our health operations, which resulted in the divestiture of these operations. We completed the divestiture of our health insurance operations in the third quarter of 2003 with the sale of Aegis Financial Corporation (Aegis), the holding company for our health insurance line of business. Additionally, we began the process of combining our non-standard auto operations with our non-standard agency operations in the third quarter of 2003. Effective December 31, 2003, we completed the combination of our non-standard auto underwriting operations with our non-standard agency operations under a distinct holding company, Affirmative Insurance Holdings, Inc. Prior to December 31, 2003, all of our non-standard personal automobile insurance policies were issued by various insurance company subsidiaries and reinsured by Vesta Fire pursuant to an

Table of Contents

internal 100% quota share reinsurance contract. Effective December 31, 2003, we transferred to Affirmative Insurance Holdings, Inc. 100% of the stock of two insurance company subsidiaries Affirmative Insurance Company and its wholly owned subsidiary Insura Property and Casualty Insurance Company in exchange for additional shares of Affirmative s common stock. Also effective December 31, 2003, we restructured our internal reinsurance to effectively transfer to Affirmative Insurance Company and Insura all of our non-standard personal automobile insurance policies in force as of December 31, 2003 as well as any new and renewal non-standard personal automobile insurance policies issued by our insurance company subsidiaries and produced by Affirmative s underwriting agencies on or subsequent to December 31, 2003. We believe that combining these operations under a distinct holding company will enable us to (i) seek separate financial strength ratings for our non-standard auto underwriting operations and (ii) to raise capital independently from Vesta. We expect to file a registration statement relating to a proposed initial public offering of securities of Affirmative Insurance Holdings, Inc. in March 2004.

Reinsurance

In order to improve our statutory surplus during 2003 and into 2004, we increased our utilization of quota share reinsurance. Specifically, we entered into a 50% quota share agreement (2003 50% Quota Share Agreement), effective September 30, 2003, on our residential property book of business in the states of Alabama, Alaska, Arizona, California, Connecticut, Florida, Hawaii, Massachusetts, New Jersey, New York, Pennsylvania, Rhode Island, South Carolina, Tennessee, and West Virginia (Continuing States), representing the states in which we intend to continue to write new property and casualty business. Effective December 1, 2003, we added our residential property book of business in Texas to the 2003 50% Quota Share Agreement, which had been previously reinsured under a separate treaty covering only residential property business in Texas (2002 50% Quota Share Agreements).

We also increased the use of reinsurance for our non-standard auto book of business in order to strengthen our statutory surplus. Effective January 1, 2004, we entered into two quota share reinsurance agreements with unaffiliated reinsurers with various cession percentages, which provide us with an option to cede less of the business produced by our affiliated underwriting agencies to these reinsurers in the last two quarters of 2004. For a more detailed discussion of the standard property-casualty and non-standard auto quota share agreements, see our discussion captioned Reinsurance on page 21.

Reinsurance Arbitrations

As noted above, we have been involved in litigation and arbitration with various parties related to a restatement of our financial results for 1997 and prior periods. One such arbitration relates our 1997 20 percent whole account quota share treaty with NRMA Insurance Limited (NRMA), Alfa Mutual Insurance Company (Alfa) and Dorinco Reinsurance Company (Dorinco). As described further in Item 3 Legal Proceedings and Note G to our consolidated financial statements, the panel hearing our arbitration with NRMA regarding the 1997 20 percent whole account quota share issued a ruling on March 1, 2004 in favor of NRMA. As a result, we recorded a pre-tax charge of $33.5 million in the fourth quarter of 2003 related to this ruling. We considered the NRMA ruling in our evaluation of the recoverability of other amounts due us from the other participants on the same reinsurance treaty as well as another, unrelated treaty. Although there are distinct facts and circumstances underlying and affecting our disputes with those other participants, for financial reporting purposes, we concluded that those amounts may not ultimately be collected. Accordingly, we recorded an additional pre-tax charge of $32.4 million in the fourth quarter of 2003, $30.1 million of which was related to other balances recoverable from ALFA and Dorinco.

On March 4, 2004, we filed a motion to vacate the NRMA arbitration award in U.S. District Court. Additionally, the recording of the charge in our consolidated financial statements does not impact our intentions to continue to actively arbitrate the ALFA and Dorinco matters, the resolution to which we believe will not occur before 2005.

Regulatory Guidelines

Our insurance companies must file annual statutory based financial information by February 28th of each year. Our most recent filings were submitted prior to receipt of the above arbitration ruling and indicated statutory surplus of $203.8 million as of December 31, 2003. However, this level of surplus will be immediately impacted in the first quarter of 2004 by $55.8 million resulting from charges related to our 1997 20 percent whole account quota share and other disputed reinsurance treaties, which was recorded as a charge of $65.9 million in the fourth quarter of 2003 for GAAP financial reporting purposes. Although the statutory and GAAP charges related to the same reinsurance arbitrations and disputes, the statutory charges vary from the GAAP charges due to the recording of valuation allowances in prior periods in accordance with statutory reporting guidelines that are not required for GAAP financial reporting. With the recording of these charges, we will no longer have negative exposure related to the 1997 20 percent whole account quota share from a statutory surplus basis.

Table of Contents

We believe that this $55.8 million statutory charge could result in our statutory surplus falling below the company action level as defined by the NAIC. In the event an insurance company s statutory surplus falls below company action level, regulations require that the company submit a plan that details management s proposed actions to increase statutory surplus. Although we are not currently required to submit such a plan, we believe the actions contemplated below under the caption, Anticipated Transactions would adequately address our statutory surplus needs.

Based on our statutory surplus level at December 31, 2003, we had four NAIC Insurance Regulatory Information System (IRIS) ratios that unfavorably varied from the normal range. We submitted a plan to the Illinois Department of Insurance detailing our plan to resolve these variances, including requesting dividends from other insurance company subsidiaries as well as the liquidation of certain non-qualifying investments. The Illinois Department of Insurance is aware of these variances and, as of March 12, 2004, has not suggested any corrective action.

The charge we have incurred associated with the 1997 20 percent whole account quota share could result in additional unfavorable IRIS ratio variances. In the event that additional IRIS ratios fall outside of the favorable range, we will update and submit our year-end plan.

Anticipated Capital Transactions and Results of Continuing Operations

In addition to the sale of our health insurance operations, the increased use of reinsurance, and the segregation of our non-standard auto operations in anticipation of an initial public offering, we executed a definitive agreement on March 12, 2004 to sell American Founders Financial Corporation (AFFC), our life insurance subsidiary, for a total purchase price of approximately $63.5 million, consisting of $25 million in cash at closing and a promissory note in the amount of approximately $38.5 million. The note will bear a floating interest rate of LIBOR plus 200 basis points and will be repaid over a six-year term, with the interest payments only in the first year and the principal repayments in five equal annual payments thereafter. The note will be secured by a pledge of the stock of both AFFC and all capital stock and surplus debentures issued by AFFC s immediate subsidiary, Laurel Life Insurance Company, which owns 100% of the capital stock of American Founders Life Insurance Company. The divestiture of AFFC will not result in a significant impact to our GAAP equity, but will have a significant positive impact on our statutory surplus. We anticipate an increase in statutory surplus of approximately $19.5 million upon the closing of this transaction. Although we have executed a definitive agreement, the consummation of this transaction is subject to regulatory approval from various state departments of insurance. Such approval is beyond our control and no assurance can be given that this transaction will receive the required regulatory approval.

We believe that the divestiture of AFFC and a public offering of securities by Affirmative Insurance Holdings, Inc. will improve our statutory capital and surplus significantly and position us to realize the economic potential of our standard property-casualty business. However, as noted previously, the consummation of these transactions involves regulatory approval and other factors that are beyond our control. As such, we continue to evaluate our current capital position and methods by which we can improve our overall capital strength. The most significant factor that we look to in evaluating our future capital improvement opportunities, other than our sale of the non-standard auto and life business, is our core standard property-casualty results. We believe that our standard property-casualty operations over the past 12 months demonstrate the earnings potential of our strategy of focusing on capacity constrained states. Excluding the $18.3 million catastrophe loss in the second quarter, which represents the single largest catastrophe loss in our company s history, our standard property-casualty segment would have generated a pre-tax operating income of $15.4 million during 2003, equating to a combined ratio of 95.3%. Regardless of whether we are able to consummate the sale of American Founders or the initial public offering of our non-standard auto operations, we believe that these results, coupled with the consistent earnings of our life and non-standard auto and agency segments, will provide us with future earnings at levels that will enable us to improve our overall capital position.

Elsewhere in this document, we discuss the business and results of operations of our non-standard auto agency, non-standard auto underwriting and life insurance segments. Readers should be aware that our anticipated capital transactions discussed previously would involve the discontinuation of our life insurance segment and a change in the significance of the results of our non-standard agency and non-standard underwriting segments and the manner in which we account for those results.

Table of Contents

Business Segments

We report financial and other information according to five business segments: (1) standard property-casualty; (2) non-standard agency; (3) non-standard underwriting; (4) life insurance; and (5) corporate and other. All information included in this section should be read in conjunction with Management s Discussion and Analysis Financial Condition and Results of Operations and related notes to the consolidated financial statements as presented elsewhere in our Annual Report on Form 10-K for the year ended December 31, 2003.

Standard Property-Casualty Insurance Segment

Based upon revenue generated in 2003, our largest segment is the standard property-casualty segment. In this segment, we underwrite or sell standard residential property, automobile and miscellaneous insurance products to targeted markets. Our standard property-casualty products are offered through a network of 2,525 independent insurance agencies located in 16 states in the U.S.

The following table presents the source of gross premium written in our standard property-casualty segment (in thousands, except percentages):

Standard Property - Casualty Segment

Gross Written Premium

Year Ended December 31

	2003		2002		2001	
Residential Property	$ 412,513	86%	$ 372,518	83%	$ 181,859	63%
Personal Auto	64,946	14%	76,449	17%	104,667	37%
Total	$ 477,459	100%	$ 448,967	100%	$ 286,526	100%

Our standard property-casualty segment can be separated into two categories: (1) underwriting only residential property insurance in capacity constrained states; and (2) underwriting residential property and automobile insurance in states where we can profitably offer both products through independent agents.

Residential property

Through various subsidiaries, Vesta provides residential property insurance that we generally categorize into four geographic areas:

Florida and Texas

Hawaii

Northeast region of the U.S.

Midwest and Mid-Atlantic regions of the U.S.

In recent years, our growth in residential property underwriting has primarily occurred in catastrophe-exposed states with capacity constraints that offer high margin potential. As a result, we have focused on increasing our presence in Florida, Texas, Hawaii, South Carolina, New York, New Jersey and Massachusetts.

Our strategy in these catastrophe-exposed states is to optimize our portfolio of business through the integration of catastrophic risk management and underwriting. Our residential property management team utilizes a rigorous practice of continuously modeling our portfolio to maintain a geographically dispersed book of business. Using multiple catastrophe models, we strive to minimize our probable maximum loss from any single catastrophe event. When a geographic region gets out of balance from the production of new or renewal business, we seek to redistribute the risk by stopping production in over-concentrated zip codes.

In states that do not have capacity constraints Alabama, Connecticut, Pennsylvania, Rhode Island, Tennessee, West Virginia we strive to build effective relationships with our independent agencies.

Florida and Texas business In 2001, we acquired Florida Select, a historically profitable insurance provider located in Florida. Florida Select s customer base was comprised primarily of former customers of the Florida Residential Property and Casualty Joint Underwriting Association (JUA), a state-sponsored insurer created by the Florida Legislature following

8

Table of Contents

Hurricane Andrew in 1992. Florida Select was established in response to an incentive program designed to encourage private carriers to assume policies from the JUA. Florida Select was one of the first companies to assume policies from the JUA and has operated profitably since its inception. Florida Select generates new business through a wholly-owned subsidiary, Florida Select Insurance Agency, Inc.

Our residential property business in Texas is written by our subsidiary, Texas Select Lloyds Insurance Company. Since the second half of 2001, we have substantially increased our volume of insurance premiums written in Texas. The primary reason for the increase was the decision by several major insurance providers to discontinue providing new coverage in Texas because of potential exposure to claims associated with mold damage. Concurrent with Vesta s entry into the market, a dramatic decrease in the number of providers in Texas created opportunity for us to gain new homeowners customers. We believe that our lack of historical business is a competitive advantage in Texas, as we have avoided current exposure to mold problems resulting from old claims. Our policies contain a mold endorsement, which limits our mold exposure only to sudden and accidental water losses that occur during the term of our policy. In 2003, our net written premium in Florida and Texas declined to $131 million from $186 million in 2002 because of our increased usage of reinsurance, including our 2002 and 2003 50% quota share agreements.

In developing new homeowners business, we have taken measures to minimize exposure to mold claims. We implemented procedures which limit our exposure to mold claims on all new and renewal policies written in Texas unless policyholders purchase additional coverage.

Hawaii business We provide residential property-casualty insurance in Hawaii principally through The Hawaiian Insurance & Guaranty Company, Ltd., a wholly-owned subsidiary. In Hawaii, we target our products to owners of higher-value residential property. Until 2000, we primarily insured dwellings against fire and other catastrophic loss. However, in 2000, the state-sponsored insurance pool that had previously provided insurance coverage for wind and hurricane loss was disbanded and we subsequently increased the scope of our products and markets to include wind and hurricane loss. In 2003, our net written premium for Hawaiian property business declined to $9 from $15 million in 2002 because of our increased usage of reinsurance.

Northeast U.S. business In 1998, we acquired the Property Plus book of personal lines insurance from CIGNA, which primarily insures mid-to-high value residential property in the Northeast U.S. This book of business primarily insures older homes in densely populated areas. Our spread of geographic risk reflects the location of our agency force, and has resulted in a concentration of business on Long Island, New York and in the Nantuckett-Martha s Vineyard area of Massachusetts. In 2003, our net written premium in the Northeast declined to $27 million from $48 million in 2002 primarily because of our increased usage of reinsurance.

Our standard residential property lines in Florida, Texas, Hawaii and the Northeast U.S. are exposed in catastrophic-prone locales. We have mitigated our risk of exposure to wind and hurricane losses by purchasing reinsurance coverage from the traditional reinsurance markets. For more information, please refer to the below discussion of various reinsurance programs, Reinsurance of this report and Note I to our financial statements of this report.

Midwest and Mid-Atlantic business We provide homeowners insurance in the Midwest and Mid-Atlantic regions of the U.S. principally through Shelby Insurance Companies, a group of wholly owned subsidiaries we acquired in 1997. We primarily target homeowners of dwellings valued from $100,000 to $350,000. In this market we are minimally exposed to potential hurricane loss. In 2003, our net written premium in the Midwest and Mid-Atlantic regions declined to $14.7 million from $25 million in 2002 because of our increased usage of reinsurance.

Standard personal automobile

The majority of our standard auto business is underwritten by The Shelby Insurance Company and affiliates and is sold to individuals in Pennsylvania, West Virginia, Tennessee, Rhode Island, Connecticut and Alabama. We also provide standard auto insurance in Hawaii through our local subsidiary. The target market for our standard personal auto line insurance products are drivers who are older than thirty-five years of age with above-average driving records. We underwrite standard auto policies with liability limits up to $500,000.

We actively manage and re-underwrite our renewal book in a disciplined manner. Each existing policy with a loss in the past three years is reviewed for current acceptability and proper tier placement prior to future renewal offerings, dependent on individual state statute. Individual agency books of business are also reviewed separately if loss ratios exceed certain thresholds.

Table of Contents

Our independent agents enter the vast majority of our auto policies on our Internet platform, VIA (Vesta Internet Access). Standard underwriting tools such as motor vehicle reports, previous loss history and Additional Driver Discovery are ordered by agents to determine acceptability before submission. A series of underwriting edits and manual review ensure that all underwriting criteria are met prior to policy issuance. Our target market for the standard auto is the M and M account, mature drivers, multi-car risks, and multi-policy (auto and homeowners policies.) Our overall pricing strategy supports our target M and M account. Dependent on company or industry results, our pricing will be below a median price on target accounts and above median on non-target accounts. The primary ingredient in our pricing philosophy is that we will be disciplined to price our products to profitability even if that means sacrificing gross revenue.

Geographic Mix

The following table presents, for the year ending December 31, 2003, the principal geographic distribution of our gross premiums written in the standard property-casualty business for the ten states that generated the largest gross premiums (in thousands).

Residential Property Year Ended December 31, 2003 Gross Written Premium		**Standard Auto** Year Ended December 31, 2003 Gross Written Premium	
Texas	$ 216,693	Pennsylvania	$ 20,598
Florida	63,819	West Virginia	19,889
Hawaii	22,564	Hawaii	4,015
California	16,588	Rhode Island	3,918
Pennsylvania	14,697	Tennessee	3,882
New Jersey	12,176	Connecticut	3,320
New York	11,785	Alabama	2,844
South Carolina	10,859	Ohio	1,698
Massachusetts	6,722	Maryland	1,227
Arizona	6,384	North Carolina	1,040
Other	30,226	Other	2,515
Total	$ 412,513	Total	$ 64,946

As described previously, our gross written premium for residential property business is subject to the 2003 50% quota share agreement, effective September 30, 2003, for our Continuing States, excluding Texas. The residential property business in Texas has been subject to the 2002 50% Quota Share since December 1, 2002. Upon the expiration of the 2002 50% Quota Share on November 30, 2003, the residential property business in Texas was transferred to the 2003 50% Quota Share.

In 2003, we continued the process of ceasing to write standard property-casualty business in a number of states, including Arkansas, Georgia, Illinois, Indiana, Maryland, Nevada, New Mexico, North Carolina, Ohio and Virginia (our Discontinued States). Combined, our total loss ratio in these exiting states had a loss ratio of approximately 95% and a combined ratio of approximately 121% in 2003. However, our premium volume and policies-in-force have declined substantially during the year and we expect to be substantially out of these states by June 2004.

Underwriting. The target market for our underwriting activities in the standard property-casualty segment are families (1) with multiple insurance policies; (2) who own more than one automobile; and (3) who live in a home valued between $100,000 and $350,000. Our underwriters utilize standard industry computer and analytical software to assist in evaluating and selecting risks and to determine the appropriate levels of insurance to retain.

Our underwriting staff also provides support to our network of independent insurance agents. We require that independent insurance agents who sell our products and services adhere to our underwriting philosophy, discipline and objectives in developing and maintaining business.

Reinsurance exposure to catastrophic events. In the standard property-casualty segment, our greatest risk of loss is associated with property damage caused by catastrophic events such as hail storms in Texas, hurricanes and tropical storms affecting Florida, Texas, Hawaii and the Northeast U.S. These risks are seasonal, with the greatest risk existing generally between June and November of any given calendar year. Our exposure to loss from other catastrophic events, such as tornadoes and earthquakes is not as significant because we do not insure significant levels of property in areas traditionally affected by these types of events. Although we endeavor to reinsure a significant portion of our risk for potential catastrophic losses, there can be no assurances that losses will be maintained within the coverage limits of any reinsurance programs to which we are a party.

Our current catastrophe excess of loss reinsurance program, which covers the period July 1, 2003 to June 30, 2004, provides a maximum of $200 million of reinsurance for Hawaii risks, $110 million in Texas, and $160 million for other nationwide risks in excess of our retention of $15 million. These retention levels do not include the expenses that we would incur in the event we exceed our retention, most notably reinstatement premiums. In Florida, our current program provides $238 million of reinsurance in excess of our retention of $15 million of risk. Included in the reinsurance protection for Florida is an estimated $87.5 million of coverage in excess of $31.1 million of losses, with a 10% co-insurance requirement, from The Florida Hurricane Catastrophe Fund (FHCF). This catastrophe excess of loss reinsurance program, combined with other inuring reinsurance contracts, provides reinsurance coverage sufficient to cover the probable maximum loss, or PML, from a 1-in-100 year weather event based on estimates of probable losses provided by Risk Management Solutions, Inc. s RiskLink v4.2 sp1 run with demand surge, excluding storm surge.

Reinsurance quota share contracts. From time to time, our property-casualty companies may obtain quota share reinsurance. A quota share reinsurance treaty is a reinsurance contract that provides protection on a proportional basis. Unlike a conventional excess of loss reinsurance contract, where reinsurers provide coverage for certain losses in excess of specified limits, under a quota share arrangement a reinsurer shares losses and certain allocated expenses in the same percentage as it shares in premiums.

Reinsurance per risk coverage. We also maintain property per risk reinsurance coverage through excess of loss of reinsurance agreements, which provide coverage above a stated amount of loss on individual risks. We utilize excess loss arrangements primarily to provide reinsurance in Florida, Texas, Hawaii and the Northeast U.S. In our property reinsurance program, our retention is $1,000,000 per loss. In our casualty excess of loss reinsurance program, our retention is $500,000 per loss occurrence.

Marketing. Our standard property-casualty products are distributed through a network of 2,525 independent insurance agencies located in 16 states across the U.S. Key elements of our marketing strategy are developing and maintaining relationships with select independent agents located in rural or suburban areas. We believe the products we offer in the standard property-casualty lines meet the needs of a wide range of customers who are served by local independent agents. These independent agents typically maintain close relationships with their customers and usually experience a high rate of retention, which reduces our overall policy acquisition costs.

We have established compensation programs to enable independent agents to earn competitive industry pay when new policies are written through our companies, and we support the agency force through advertising and promotions designed to create a high level of awareness of the local agent and our companies. We also provide the independent agents with business-to-business technology support in order to increase productivity and reduce operating expenses.

Independent insurance agents are required to comply with strict guidelines established by Vesta and have predetermined and limited authority to bind insurance coverage on our affiliated companies. Our underwriting staff reviews all coverage implemented by the independent agents and has discretion to modify or override decisions by the agency force. Because of (1) the broad base of our independent agency force; (2) the contractual limitations on the agents authority to bind coverage; and (3) our disciplined underwriting review process, we believe the activities and strategy with respect to our independent agency force does not present any material risks to our overall operations.

Claims. Claims costs represent actual payments made and changes in estimated future payments to be made to or on behalf of our policyholders. Claims costs include expenses required to settle all claims and losses and loss estimates for future assignments and assessments.

Claims on policies written in the Northeast, Midwest and Mid-Atlantic regions are managed by our centralized claims department. When a notice of loss is received, our claims department personnel open a claim file and establish a corresponding reserve based upon standard industry specified criteria. Claims are reviewed and payments generated by employees of Vesta, with the exception of claims related to specific products adjusted by a managing general agency (MGA). With respect to MGA claims, our employees periodically conduct audits to insure compliance with Vesta s policies and procedures.

Table of Contents

We employ a centralized litigation staff to monitor all claims-related litigation. Our philosophy and practices are designed to emphasize prompt, fair and equitable settlement of meritorious claims. Our litigation staff also is responsible for insuring the adequacy of claim reserves and controlling claim adjustments and legal expenses.

Claims administration for polices written in Florida and Texas are outsourced to a third party administrator. The claims administration contract was in effect at the time of our acquisition of Florida Select, and we amended the contract in 2001 to include claims made on our policies written in Texas. We believe the third party providing these claims administration services is well-staffed and equipped with current technology to provide cost efficient and reliable claims administration for our Florida and Texas policies.

Systems. With the exception of policies written in Texas and Florida, policy issuance, billing, customer service and other facets of administration, are provided through a centralized policy management information system. In recent years, we have upgraded the core infrastructure and expanded the scope of this policy management information system. Administration for policies written in Florida and Texas is outsourced to a third party administrator.

We place a priority on e-commerce and have intensified resources in recent years to exploit internet-based technology. To assist the marketing and servicing capabilities of our independent agency force, we maintain internet-based programs to provide agents with the ability to quote, enter new business, perform endorsements and perform inquiries on policies, billing and claims. We have also established a network for exchange of intra-company information that provides independent agents with ready and convenient access to product, policy and claims information. We endeavor to utilize state-of-the-art electronic technology to allow the agency force to securely conduct transactions, access information and communicate with our insurance subsidiaries.

Non-Standard Underwriting

Our Products

Our non-standard insurance policies, which generally are issued for the minimum limits of liability coverage mandated by state laws, provide coverage to drivers who find it difficult to obtain insurance from standard insurance companies due to a number of factors, including lack of prior coverage, failure to maintain continuous coverage, age, prior accidents, driving violations, type of vehicle or limited financial resources. We believe that the majority of customers who purchase our non-standard personal automobile insurance policies do not qualify for standard policies because of financial reasons, such as the failure to maintain continuous coverage or the lack of flexible payment options in the standard market. Approximately 70% of the drivers who purchased our policies in 2003 had no at-fault accidents and no moving violations or tickets in the 36 months preceding the date of the quote. In general, customers in the non-standard market have higher average premiums for a comparable amount of coverage than customers who qualify for the standard market, resulting from increased loss costs and transaction expenses, partially offset by the lower severity of losses resulting from lower limits of coverage.

We offer a wide range of coverage options to meet our policyholders and agents needs. We offer both liability-only policies, as well as full coverage policies, which include first-party coverage for the insured s vehicle. Our liability-only policies generally include:

- *Bodily injury liability coverage*, which protects insureds if they are involved in accidents that cause bodily injury to others, and also provides them with a defense if others sue for covered damages; and

Property damage liability coverage, which protects insureds if they are involved in accidents that cause damage to another s property.

The liability-only policies may also include personal injury protection coverage and/or medical payment coverage, depending on state statutes. These policies provide coverage for injuries without regard to fault, as well as uninsured/underinsured motorist coverage. In addition to bodily injury liability and property damage liability coverage, the full coverage policies we sell include:

Collision coverage, which pays for damage to the insured vehicle as a result of a collision with another vehicle or object, regardless of fault; and

Comprehensive coverage, which pays for damages to the insured vehicle as a result of causes other than collision, such as theft, hail and vandalism.

Full coverage policies may also include optional coverages such as towing, rental reimbursement and special equipment.

The policies we offer are predominantly tailored to the typical non-standard customer, whose selection of policy, in our experience, is generally determined by a combination of payment terms and price. We offer a variety of policy terms ranging from one month to one year. Our policies are designed to be priced to allow us to achieve our target underwriting margin while at the same time meeting our customers needs for low down payments and flexible payment plans. Our policy processing systems and payment plans enable us to offer a variety of attractive payment plans while minimizing the potential credit risk of uncollectible premium. We offer discounts for proof of having purchased automobile insurance within a prescribed prior time period, maintaining homeowners insurance, vehicle safety and anti-theft equipment, while surcharging the insured for traffic violations and accidents.

Distribution

Most of the non-standard auto policies issued by our insurance companies use the services of our affiliated underwriting agencies which perform or supervise all of the administrative functions associated with the design, sale and subsequent servicing of a non-standard personal automobile insurance policy. We discuss our underwriting agencies operations below under the heading Non-Standard Agency Segment.

Our insurance companies also issue insurance policies that are designed, distributed and serviced by unaffiliated underwriting agencies. We issue insurance policies sold through unaffiliated underwriting agencies with established customer bases in order to capture business in markets other than those targeted by our affiliated underwriting agencies. In these instances, we collect fees to compensate us both for the use of our certificates of authority to transact insurance business in selected markets as well as for assuming the risk that the unaffiliated underwriting agency will continuously and effectively administer these policies. We generally reinsure a higher percentage of this business relative to the business administered by our affiliated underwriting agencies. During 2003, we issued insurance policies through four unaffiliated underwriting agencies which in turn distributed our policies through an aggregate of approximately 3,900 independent agencies. In the year ended December 31, 2003, these four unaffiliated underwriting agencies accounted for 28.6 % of the non-standard gross premiums written by our insurance companies, and no one unaffiliated underwriting agency accounted for more than 12.6% of the gross premiums written by our insurance companies.

For the years ended December 31, 2003 and 2002 the following chart displays the premium written by our insurance companies through both affiliated and unaffiliated underwriting agencies on a gross (before reinsurance) and net (after reinsurance) basis:

	Year Ended December 31			
	2003		**2002**	
	Gross	**Net**	**Gross**	**Net**
	(in thousands, except percentages)			
Affiliated underwriting agencies	$ 214,254	$ 150,758	$ 202,151	$ 173,948
Unaffiliated underwriting agencies	110,546	28,775	141,564	27,557
Total	$ 324,800	$ 179,533	$ 343,715	$ 201,505

Reinsurance

We cede a significant portion of our non-standard auto premiums to reinsurers under quota share reinsurance contracts. All of the reinsurers to which we have ceded premiums written in this line of business were rated A- or better by A.M. Best, and as of December 31, 2003, we have no reason to believe that any of these reinsurers will be unable or unwilling to pay the amounts reported to them as due. For more information, please refer to the Reinsurance section of this report, the Critical accounting policies reinsurance recoverable on paid and accrued losses section of this report and Note I to our financial statements of this report.

Table of Contents

Non-Standard Agency Segment

Underwriting Agencies

As mentioned above, most of the policies issued by our insurance companies use the services of our affiliated underwriting agencies. Our underwriting agencies provide the following services in exchange for commissions and fees:

Product design and management services, including the development, pricing and market positioning of non-standard personal automobile insurance policies.

Distribution services, including marketing and distribution, independent agency development and support and policy issuance.

Policy administration services, including premium billing and collection, endorsement processing, accounting and financial reporting.

Claims handling services, including claims settlement, adjuster auditing and special investigations.

Supervision of unaffiliated underwriting agencies, including oversight of each unaffiliated underwriting agency s underwriting, policy administration, claims handling and related operations.

While our underwriting agencies predominately design, distribute and service policies issued by our insurance companies, during 2003, our underwriting agencies also administered the policies of one unaffiliated non-standard personal automobile insurance company. In the future, our underwriting agencies may provide services to additional unaffiliated insurance companies in order to ensure continuity and sufficient underwriting product and capacity for our distribution channels regardless of hard or soft markets.

Our underwriting agencies effectively act as wholesalers of insurance policies issued by our insurance companies as well as other unaffiliated insurance companies. Our underwriting agencies appoint our retail agencies and independent agencies to sell these policies to individual customers.

The following table displays the amount of gross written premiums produced by our underwriting agencies through our retail stores and independent agencies for the years ended December 31, 2003 and 2002.

	Year Ended December 31,	
	2003	2002
	(in thousands)	
Our retail stores	$ 117,851	$ 119,825
Independent Agencies	157,325	162,766

	$ 275,176	$ 282,591

Retail Stores

Our retail stores serve as direct sales and customer service outlets for insurance companies and other vendors. As of December 31, 2003, we employed approximately 370 licensed sales personnel who sell products and services directly to individual consumers through 140 of our branded retail stores.

We operate our retail stores under four brand names A-Affordable, InsureOne, Driver s Choice and Yellow Key. We extend brand awareness through yellow pages advertisements, television and radio advertising campaigns and print advertisements that emphasize our low down payments, flexible payment plans, convenient neighborhood locations and customer service, all of which is designed to generate walk-in traffic in, or telephone inquiries to, our retail stores. Since our retail business is highly dependent on advertising, segmenting our geographic markets allows us to more efficiently concentrate these advertising and brand support activities.

We lease retail stores located in strip malls or other visible locations on major thoroughfares where we believe our customers drive or live near. Our retail stores provide customer contact at the point of sale, and most policy applications are completed in the retail stores. After completion of the initial insurance transaction, our customers often revisit these stores to make premium payments. During 2003, customers made approximately 52% of their installment payments at our retail locations. This direct contact gives us an opportunity to establish a personal relationship with our customers, who in our experience generally prefer face-to-face interaction, and helps us provide quality and efficient service and identify opportunities to provide additional products and services.

Our retail stores predominately sell non-standard personal automobile insurance policies issued by our insurance companies and administered by our underwriting agencies through a vertically integrated operation. For the year ended December 31, 2003, approximately 83% of our retail stores commission and fee revenue was paid by us, and eliminated in consolidation, for sales of our non-standard personal automobile insurance policies. The remaining 17% of our retail stores commission and fee revenue was generated through the sales of non-standard personal automobile policies issued by unaffiliated insurance companies as well as through sales of certain other complementary insurance products and ancillary non-insurance products and services.

Independent Agencies

Our underwriting agencies also appoint independent agencies to sell insurance policies to individual customers. We believe that selling insurance policies through the independent agency distribution channel, in addition to our retail stores, helps us better leverage our resources to maximize sales of our insurance companies policies when underwriting conditions are favorable. In 2003, our underwriting agencies utilized approximately 1,800 independent agencies to sell the policies that they administer and these independent agencies were responsible for 57.2% of the gross written premiums produced by our underwriting agencies.

The ability of our underwriting agencies to develop strong and mutually beneficial relationships with independent agencies is important to the success of our multiple distribution strategy. We believe that strong product position and service standards are key to independent agency loyalty. We foster our independent agency relationships by providing them our agency interface software applications designed to strengthen and expand their sales and service capabilities for our products. These internet-based software applications provide our independent agencies with the ability to service their customers accounts and access their own commission information on a real-time basis. We maintain strict and high standards for call answering and abandonment rate service levels in our customer service call centers. We believe the level and array of services that we offer our independent agencies creates value in their businesses.

Our underwriting agencies centralized marketing department is responsible for managing our relationships with independent agencies. This department is split into two key areas, promotion and service. The promotion function includes prospecting and establishing independent agency relationships, initial contracting and appointment of independent agencies, establishing initial independent agency production goals and implementing market penetration strategies. The service function includes training independent agencies to sell our products and supporting their sales efforts, ongoing monitoring of independent agency performance to ensure compliance with our production and profitability standards and paying independent agency commissions.

Life Insurance Segment

We entered the life insurance business in 2000, in an effort to stabilize our financial results and reduce our dependence upon the standard property-casualty business lines. Generally, losses in the property-casualty business are more difficult to estimate due to the unpredictability of potential catastrophes such as hurricanes, tornadoes and other weather-related events. Also, because of litigation and other factors, it can take years to ultimately determine property-casualty losses. In contrast, financial results and cash flows associated with the life insurance business are typically less volatile, easier to predict and the ultimate results can be determined sooner.

Initially Vesta purchased a seventy two percent (72%) interest in American Founders Financial Corporation (American Founders), our parent company for two wholly owned subsidiaries. Our interest in American Founders was increased to one hundred percent (100%) in February 2003 with the acquisition of all minority-held stock.

American Founders growth is currently driven by the acquisition of closed blocks of life insurance products and by marketing and distributing a single premium deferred annuity product. Life insurance products are sold through third party marketing firms, financial institutions and 400 independent agents located throughout 41 states and the District of Columbia. Approximately 70% of American Founders premiums are associated with business activities in Texas, Arizona, Ohio, California and Indiana. At December 31, 2003, American Founders had in force approximately $2.0 billion in face value of life and annuity products. In 2003, the life insurance segment generated approximately $44.7 million of revenues, including $2.4 million of realized gains.

Table of Contents

American Founders acquisition growth strategy is impacted by its ability to obtain regulatory approval of proposed acquisitions and maintain a secure rating from A.M. Best. Although it has continued to generate overall profitable underwriting results, during 2002 American Founders had approximately $27 million of loans made to borrowers in Mexico which had been non-performing since late in 2001. In November 2002, A.M. Best reduced the financial strength rating for American Founders from B+ to B , based largely on concerns about these loans. While we do not believe this rating adjustment will materially impact the level of existing business in force at American Founders, it indicates a capital adequacy concern that could impact American Founders ability to obtain regulatory approval of future acquisitions.

In the period ending December 31, 2002, we determined that these loans were impaired and American Founders wrote off the value of the loans. The write-off of these loans reduced American Founders statutory surplus significantly. In an effort to restore American Founders surplus to an acceptable level, we increased a third party reinsurer s coinsurance participation in substantially all of American Founders business from 35% to 62.5%, effective October 1, 2002. At December 31, 2003, American Founders had grown statutory capital and surplus of its operating subsidiary to approximately $35.7 million from approximately $30.6 million at December 31, 2002. This level of capital and surplus is comparable to the level it had in 2001, prior to the write-off of the loans.

Marketing. Our life insurance products are marketed through third party marketing firms, financial institutions and 400 independent agents located in 41 states and the District of Columbia. Our growth in this segment has been facilitated by our use of an efficient operating and administrating system for servicing policies. We believe our flexible systems have demonstrated the ability to efficiently assimilate and promptly provide administration for newly acquired blocks of policies and results in lower administrative costs.

Claims. Our life insurance subsidiaries have a dedicated staff of claim examiners and customer service representatives to assist policyholders with questions and filing claims and to ensure that policyholders receive the benefits to which they are entitled. Life insurance claims are usually paid promptly, often within a few days. Among other responsibilities, claim examiners verify (1) beneficiaries; (2) that a policy is current and in force; and (3) that all conditions of the policy have been met. Our insurance companies may challenge or deny any claim if we believe policy provisions have been violated.

Reinsurance. In our life insurance business, we utilize reinsurance arrangements to not only acquire blocks of life business; but, also as a means of ceding risk to third party reinsurers. American Founders maintains reinsurance agreements for more than $50,000 on life policies issued prior to October 24, 1990, and for more than $250,000 on life policies issued subsequently. In addition, the Company will from time to time, cede the risks associated with certain blocks of its business to other reinsurers. There can be no assurance regarding the ability of any of our reinsurance providers to meet their future obligations. Also, there can be no assurance that we will collect 100% of the amounts we expect to receive as reimbursement by these providers, as some reinsurers may dispute our calculation of amounts recoverable.

Corporate and other segment

Our corporate and other segment consists primarily of (1) net income earned on investments related to our property-casualty operations; (2) interest expenses associated with all debt; and (3) overhead expenses not directly associated with any other business segment.

Reserves

In our financial statements, we record and maintain reserves in amounts sufficient to cover the estimated ultimate liability for incurred reported and unreported loss claims for each of our companies. Our reserves are estimates based upon actuarial and statistical projections at a given point in time of what we expect will be the ultimate settlement and administration of claims. The establishment of appropriate reserves is an inherently uncertain process, and there can be no assurance that ultimate losses will not materially exceed our estimates. We base our reserve calculations upon (1) facts and circumstances then known; (2) estimates of future trends in claims severity; and (3) other variable factors such as inflation. To the extent established reserves are later proven to be inadequate, we are required to incur a charge to earnings in order to increase such reserves. In such case, the charge to earnings is recognized in the period the reserves are increased. These adjustments could have a material adverse effect on our results of operations and financial condition. For more information, please refer to the Critical accounting policies loss and loss adjustment expenses section of this report and Note F to our financial statements of this report.

Table of Contents

Reserves are established to insure that adequate funds are available to pay all expected losses. In order to validate that an insurance company s investments are sufficiently liquid to pay expected losses, the Illinois Department of Insurance (the governing authority for Vesta Fire Insurance Corporation, our primary insurance subsidiary) imposes a reserve reconciliation test . Generally, the reserve reconciliation test requires an insurance company to maintain a specified amount of high quality liquid assets. At December 31, 2003, the minimum level required pursuant to this test exceeded the qualifying assets of Vesta Fire Insurance Corporation by approximately $14.1 million. This shortfall is the result of our fourth quarter funding requirements of approximately $35.5 million in written premiums under the 2003 50% Quota Share. While this transaction reduced the amount of qualifying assets, it did not reduce the required level to be maintained. As a result of this shortage, Vesta Fire has submitted a plan to the Illinois Department of Insurance detailing our plan to resolve this shortage, which includes requesting dividends from subsidiaries of qualifying assets not utilized by the subsidiaries and the plan to liquidate a portion of Vesta Fire s non-qualifying investments in Affirmative Insurance Holdings, Inc.

For more information, please refer to the Liquidity and Capital Resources section of this report and Note E to our financial statements of this report.

Reserves standard property-casualty segment

With respect to reported claims, we establish reserves in our standard property-casualty segment based upon a case-by-case analysis. Reserve amounts are determined by taking into account the circumstances surrounding each claim and policy provision relating to the type of loss. Reserves are reviewed on a regular basis, and as new data becomes available, the reserves are adjusted appropriately to reflect estimated ultimate losses.

The insurance industry has developed a variety of methods for determining reserves associated with losses that have been incurred but not yet reported (IBNR). One common method of actuarial evaluation is the loss development method. This method utilizes the pattern by which losses have been reported over time and assumes that each accident year s experience will develop in the same pattern as the historical loss development. We also rely upon industry data to provide the basis for reserve analysis on newer lines of business.

Reserves are computed using actuarial principles and procedures applicable to the various lines of business and include assumptions for estimated inflation rates. Reserves are carried in our financial statements at an estimate of the ultimate expected loss for each claim without any discount to reflect the time value of money. Reserve calculations are reviewed by management on a regular and ongoing basis and, as required by state law, we engage an independent actuary to render opinions as to the adequacy of statutory reserves we have established. The actuarial opinions are filed with the various jurisdictions in which we are licensed. Based upon the practices and procedures we employ, management believes that our reserves are adequate as of the valuation date.

Table of Contents

The following table provides a reconciliation of beginning and ending property-casualty liability balances (presented in conformity with GAAP) for the periods indicated:

	Year Ended December 31,		
	2003	2002	2001
		(in thousands)	
Gross losses and LAE reserves at beginning of year	$ 322,320	$ 280,997	$ 263,689
Reinsurance receivable	(126,139)	(167,281)	(170,050)
Net losses and LAE reserves at beginning of year	196,181	113,716	93,639
Acquisitions			22,019
Increases (decreases) in provisions for losses and LAE for Claims incurred:			
Current year	344,366	334,758	162,984
Prior years	68,278	35,486	34,355
Losses and LAE payments for claims incurred:			
Current year	(235,185)	(198,747)	(119,668)
Prior years	(181,213)	(89,032)	(79,613)
Net losses and LAE reserves at end of year	192,427	196,181	113,716
Reinsurance receivable	163,128	126,139	167,281
Gross losses and LAE reserves	$ 355,555	$ 322,320	$ 280,997

The following table presents the reconciliation between statutory basis and GAAP basis reserves for each of the three years ending December 31:

	Year Ended December 31,		
	2003	2002	2001
		(in thousands)	
Statutory reserves	$ 186,572	$ 194,828	$ 156,659
Retroactive reinsurance and other amounts	(7,798)	(6,648)	(42,943)
Loss adjustment reserves held by non-statutory subsidiaries	13,653	8,001	
Gross-up of amounts netted against reinsurance balances receivable	163,128	126,139	167,281
Reserves on a GAAP basis	$ 355,555	$ 322,320	$ 280,997

The following table presents, on a GAAP basis, the development of reserves for unpaid losses and loss adjustment expense from 1993 through 2003 for our insurance subsidiaries, net of reinsurance recoveries or recoverables. The first line of the table presents liabilities at December 31 for each indicated year. The table reflects the estimated amounts of losses and loss adjustment expense for claims arising in that year and all prior years that are unpaid at the balance sheet date, including losses incurred but not yet reported to us. The upper portion of the table presents the cumulative amounts subsequently paid as of successive years with respect to the liability. The lower portion of the table presents the re-estimated amount of the previously recorded liability based upon experience as of the end of each succeeding year. The estimates are revised as more information becomes known about the frequency and severity of claims for individual years. A redundancy (deficiency) exists when the re-estimated liability at each December 31 is less (greater) than the prior liability estimate. The cumulative redundancy (deficiency) depicted in the table, for any particular calendar year, represents the aggregate change in the initial estimates over all subsequent calendar years.

Table of Contents

	Year Ended December 31,										
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Liability for unpaid losses & LAE	29,688	66,648	118,733	112,932	392,461	298,772	168,150	93,639	113,716	196,181	192,427
Paid (cumulative) as of											
One year later	20,761	51,527	88,377	86,978	197,477	178,883	117,094	79,613	89,032	181,213	
Two years later	28,766	65,360	116,388	114,704	253,109	236,301	159,777	116,925	186,715		
Three years later	34,776	66,490	125,299	131,342	287,385	264,896	184,479	198,187			
Four years later	33,139	72,273	137,081	137,926	297,544	281,589	256,655				
Five years later	38,222	81,156	139,485	141,234	290,337	350,292					
Six years later	46,298	82,336	142,180	133,046	326,156						
Seven years later	47,185	84,953	144,829	137,326							
Eight years later	49,801	87,482	148,487								
Nine years later	52,239	90,983									
Ten years later	55,791										
Liability reestimated as of											
End of year	29,688	66,648	118,733	112,932	392,461	298,772	168,150	93,639	113,716	196,181	192,427
One year later	28,930	61,033	127,790	99,708	391,692	276,605	162,289	127,167	168,991	264,459	
Two years later	34,219	66,582	110,437	144,986	353,969	255,915	182,409	157,142	236,323		
Three years later	38,940	66,713	118,657	132,761	344,726	274,838	213,163	220,091			
Four years later	41,517	76,863	146,090	140,775	346,482	301,672	274,040				
Five years later	50,993	88,770	144,256	147,361	353,324	363,420					
Six years later	53,330	86,357	152,916	143,395	385,497						
Seven years later	51,482	95,265	154,528	145,611							
Eight years later	60,217	96,659	156,662								
Nine years later	61,281	99,558									
Ten years later	64,830										
Cumulative redundancy/(deficiency)	(35,142)	(32,910)	(37,929)	(32,679)	6,964	(64,648)	(105,890)	(126,452)	(122,607)	(68,278)	

In the early 1980 s, we reinsured a number of casualty risks that, to the extent such liabilities were not excluded from the underlying policies, could result in claims for coverage for asbestos related and other environmental impairment liabilities. Our exposure to a significant loss from an asbestos or environmental claim has been mitigated because our participation in the reinsurance treaties relating to these risks is only at the higher levels and our percentage participation in those layers is relatively low. In addition, we carry reinsurance that would mitigate the effect of any losses under these treaties. Although the possibility exists that we could suffer material loss in the event of a high number of large losses under these treaties, management believes the occurrence of such events is unlikely.

Two significant factors occurred in 2003 that impacted the cumulative deficiency related to 2002. The first such factor relates to an increase of paid losses and the liability for unpaid losses and loss adjustment expenses of $60.2 million related to reinsurance arbitrations with NRMA, Dorinco and Alfa. The $60.2 million noted previously represents the $65.9 million aggregate charge for the 1997 20 percent whole account quota share, net of interest charges. Secondly, in 2003, Vesta commuted various reinsurance assumed treaties, at an amount in excess of the booked reserves. The commutations along with additional adverse development on the discontinued lines was approximately $5 million dollars in 2003, all related to prior accident years. In addition, in 2003 Vesta had slight adverse development on the homeowners line of business for accident year 2002. As disclosed last year, in 2002, Vesta received arbitration rulings related to litigation with USF&G and NRMA. Both companies reinsured Vesta companies, and Vesta fully expected to recover all unpaid liabilities. However, as disclosed last year, the impact of these cases resulted in adverse development to Vesta of $37.2 million. The adjustments affect all prior accident years to some extent. In 2001, Vesta had a $30 million charge taken in the discontinued lines of business. The main contribution to the adverse development was liability exposures written in the 1980 s.

Vesta discontinued all commercial and assumed reinsurance lines of business in 1999 and 2000, respectively. The variability in reserves is largely due to the ultimate disposition of individual claims associated with these lines of business. The absence of other risk factors from this listing does not imply that additional factors will not be identified in the future that will have a significant influence on our reserves.

Reserves   life insurance segment

Reserves for traditional life insurance contracts are generally calculated using the net level premium method based upon assumptions as to the mortality, withdrawals, dividends and assuming investment yields of 2.5% to 6.5%. These assumptions are generally made at the time a contract is issued or at the purchase date. Our assumptions and projections are based on past experience, making allowance for possible unfavorable deviations.

Table of Contents

Reserves for investment-type contracts are based upon (1) the contract account balance (if future benefit payments in excess of the account balance are not guaranteed); or (2) on the present value of future benefit payments (if such payments are guaranteed).

Investments

Our consolidated investment portfolio consists primarily of investment grade fixed income securities. Using both internal and external investment managers, we manage our investment portfolio in accordance with polices and guidelines established by management and the Board of Directors. At December 31, 2003, our cash and investments totaled $1.1 billion as follows (in thousands):

Type of Investment	Amount at which shown on Balance Sheet	% of Portfolio
Cash and short-term investments	$ 98,522	9.1%
Fixed maturity portfolio	853,608	79.2%
Equity securities	29,937	2.8%
Mortgage and collateral loans	9,089	0.8%
Policy loans	57,209	5.3%
Other invested assets	30,083	2.8%
Total	$ 1,078,448	100.0%

As part of a modified coinsurance agreement with Employers Reinsurance Corporation, our life insurance subsidiary is holding $161.3 million of invested assets for the benefit of Employers Re. Additionally, we have pledged investments having a market value of $178.8 million to the Federal Home Loan Bank.

The following table presents the value of our fixed maturities portfolio available-for-sale at December 31, 2003, as classified by category (in thousands):

	Amortized Cost	Fair Value
United States Government	$ 78,544	$ 78,878
Asset-backed securities	351,587	358,851
Corporate	203,165	211,679
Municipals	41,327	42,852
Total	$ 674,623	$ 692,260

The following table presents the value of our fixed maturities portfolio - trading at December 31, 2003, as classified by category (in thousands):

	Fair Value
United States Governments	$ 8,305
Asset-backed securities	56,201
Corporate	76,499
Municipals and other	20,343
Total	$ 161,348

The National Association of Insurance Commissioners (NAIC) has established a bond rating system that assigns securities to classes referred to as NAIC designations that are used by insurers in preparing their annual statutory financial statements. The NAIC assigns designations to both publicly and privately traded securities. The NAIC designations range from class 1 (highest quality) to class 6. The guidelines established by our management and Board of Directors generally require that we invest in securities with a NAIC rating of class 1 or class 2. The maturity and duration of our investment portfolio are managed to match the maturity and duration of our underlying life insurance and property-casualty reserves.

Table of Contents

Reinsurance

We routinely purchase reinsurance in order to reduce the risk associated with all of our underwriting activities. Reinsurance is a contractual arrangement under which one insurer (the ceding company) transfers to another insurer (the reinsurer) all or a portion of a risk or group of risks that the ceding company has undertaken under the insurance policy or policies it has issued. We obtain reinsurance primarily to (1) provide protection for catastrophic losses; (2) support our statutory surplus and stabilize the results of our underwriting activities; and (3) reduce our net liability for individual risks. Changes or modifications to reinsurance contracts are typically negotiated annually. The renewal dates for our various reinsurance contracts are staggered; therefore, during the year, our retention, terms and coverage limits may change materially depending upon prevailing economic conditions in the reinsurance markets.

In certain reinsurance transactions, a portion of the premiums we receive are remitted to the respective reinsurer in exchange for reinsurance coverage. Initially, we pay all claims made pursuant to our policies and then seek to recover reinsured losses from the respective reinsurer. In accordance with GAAP, the amounts we expect to recover from reinsurers are reported as assets in our financial statements. In 2003, standard property-casualty gross written premiums ceded to third party reinsurers were $199.9 million, or approximately 43.3% of the gross premiums we wrote in the standard property-casualty segment.

Although a reinsurer is liable for losses to the extent of coverage to which it assumes, reinsurance arrangements do not legally discharge the principal insurer from primary liability for the full amount of a policy. Accordingly, we assess the credit quality of the third parties to which we cede business and seek to enter into arrangements with financially viable and reliable reinsurers. However, there can be no assurance regarding the ability of any of our reinsurance providers to meet their future obligations. Also, there can be no assurance that we will collect 100% of the amounts we expect to receive as reimbursement from these providers, as some reinsurers may dispute our calculation of amounts recoverable. In addition, there can be no assurance that our experienced losses will be within the coverage limits of our reinsurance arrangements. For more information, please refer to the Critical accounting policies reinsurance recoverable on paid and accrued losses section of this report and Note I to our financial statements of this report.

We entered into a 50% quota share agreement (2003 50% Quota Share Agreement), effective September 30, 2003, on our residential property book of business in the states of Alabama, Alaska, Arizona, California, Connecticut, Florida, Hawaii, Massachusetts, New Jersey, New York, Pennsylvania, Rhode Island, South Carolina, Tennessee, and West Virginia (Continuing States), representing the states in which we intend to continue to write new property and casualty business. Effective December 1, 2003, we added our residential property book of business in Texas to this 2003 50% Quota Share Agreement, which had been previously reinsured under a separate treaty covering only residential property business in Texas (2002 50% Quota Share Agreements). The 2003 50% Quota Share Agreement expires on September 30, 2004, but may be terminated on a cut-off basis on June 30, 2004 by either party. Depending on various factors such as our statutory surplus, loss experience on this book of business and the prevailing reinsurance market rates, we may elect to terminate or reduce the aggregate amounts ceded under this reinsurance contract in 2004.

The impact of the 2003 and 2002 50% quota share agreements on the standard property-casualty net premiums written was a reduction of $104.3 million. Additionally, the ceding commission received on the 2003 50% quota share agreement in 2003 increased statutory surplus by $21.4 million.

Our non-standard underwriting operations have historically utilized quota share reinsurance. For 2003, four quota share reinsurance agreements with unaffiliated reinsurers with variable cession percentages in were in place in the following states.

Illinois, Indiana and Missouri. This quota share reinsurance agreement covers all business written through our affiliated underwriting agencies in these states. We ceded 40% of the gross written premium in 2003 produced in these states to Hannover Re, which is currently rated A by A.M. Best.

Texas. This agreement covers business written on Old American County Mutual, which ceded 25% of the business to Vesta Fire and ceded 75% of the gross written premium in 2003 to three reinsurers AXA, Federal Insurance Company, and Folksamerica which are currently rated A-, A++, A, respectively, by A.M. Best.

New Mexico. This agreement covers business written through our affiliated underwriting agencies. We ceded 75% of the gross written premium in 2003 to three reinsurers AXA, Federal Insurance Company, and Folksamerica which are currently rated A-, A++, A, respectively, by A.M. Best.

Florida. This agreement covers all business written through our affiliated underwriting agencies in this state. This agreement commenced May 1, 2003 and expires April 30, 2004. During that twelve-month period, we ceded 40% of the gross written premium to Folksamerica, which is currently rated A by A.M. Best.

Effective January 1, 2004, we entered into three non-standard auto quota share reinsurance agreements with unaffiliated reinsurers with variable cession percentages, which provide us with an option to cede less of the business produced by our affiliated underwriting agencies to these reinsurers in the last two quarters of 2004.

Illinois, Indiana and Missouri. This agreement covers all business written through our affiliated underwriting agencies in these states. We will cede 60% of gross written premium in the first six months of 2004 and have the option to reduce the cession to 20% for the second six months of 2004. We must notify our quota share reinsurers 30 days prior to making the change in ceding percentage for the second six months of 2004. We can terminate this agreement on December 31, 2004 on a cut off basis, meaning the reinsurers retain the liability for all losses occurring prior to December 31, 2004 related to this agreement and the ceded unearned premium for unexpired policies in force is returned to us. The reinsurance under this agreement is provided by Hannover Re, which reinsures 50% of the premiums we cede, Swiss Re, which reinsures 20.83% of the premiums we cede, and AXA Re, which reinsures 29.17% of the premiums we cede. Hannover Re, Swiss Re and AXA Re are rated A, A+ and A-, respectively, by A.M. Best.

New Mexico and South Carolina. This agreement covers all business written through our affiliated underwriting agencies in these states. We will cede 75% of gross written premium in the first six months of 2004 and have the option to reduce the cession to 30% for the second six months of 2004. We must notify our quota share reinsurers 30 days prior to making the change in ceding percentage for the second six months of 2004. We can terminate this agreement on December 31, 2004 on a cut off basis. The reinsurance under this agreement is provided by Chubb Re, which reinsures 86.7% of the premiums we cede and AXA Re, which reinsures 13.3% of the premiums we cede. Chubb Re and AXA Re are rated A++ and A-, respectively, by A.M. Best.

Texas. We have entered into a quota share reinsurance agreement effective January 1, 2004 under which we will assume a portion of the business produced by our Texas-based A-Affordable underwriting agency and written by Old American Country Mutual Fire Insurance Company, an unaffiliated insurance company. We will assume 25% of the gross premium written in the first six months of 2004, with an option to increase our participation to 70% in the second six months of 2004.

In addition to the three quota share reinsurance agreements effective January 1, 2004, we currently cede 40% of the non standard auto business written through our affiliated underwriting agency in Florida to Folksamerica, which reinsures 100% of all premiums we cede. Folksamerica is rated A by A.M. Best. This reinsurance agreement expires May 1. 2004, and we expect to renew it on terms and conditions similar to the terms of the expiring contract.

Regulation

As a holding company for 12 insurance subsidiaries, Vesta holds certificates of authority to write various types of insurance in 50 states and in the District of Columbia. All of our insurance companies are subject to regulation by governmental agencies in the states in which we conduct business. The nature and extent of such regulation varies by jurisdiction, but typically involves (1) prior approval of the acquisition of control of an insurance company or any company controlling an insurance company; (2) regulation of certain transactions entered into by an insurance company with any of its affiliates; (3) approval of premium rates for many lines of insurance; (4) standards of solvency and minimum amounts of capital and surplus which must be maintained; (5) limitations on types and amounts of investments; (6) restrictions on the size of risks which may be insured by a single company; (7) licensing of insurers and agents; (8) deposits of securities for the benefit of policyholders; and (9) reports with respect to financial condition and other matters. In addition, state regulatory examiners perform periodic examinations of insurance companies. Generally, the purpose of such regulation is intended for the protection of policyholders.

In addition to the regulatory supervision of our insurance subsidiaries, we are also subject to regulation under the Illinois, Florida, Hawaii and Texas Insurance Holding Company System Regulatory Acts. These Holding Company Acts contain certain reporting requirements, including those requiring Vesta to file information relating to our capital structure, ownership and financial condition and general business operations of our insurance subsidiaries. These Holding Company Acts contain special reporting and prior approval requirements with respect to transactions among affiliates. The Illinois Holding Company Act is generally the more significant to us because Vesta Fire, our principal insurance subsidiary, is domiciled in Illinois.

[Table of Contents](#)

State insurance regulators and the NAIC periodically re-examine existing laws and regulations and their applicable insurance companies. In recent years, the NAIC has approved and recommended that states adopt and implement several regulatory initiatives designed to decrease the risk of insolvency of insurance companies. These initiatives include risk-based capital requirements for determining the levels of capital and surplus an insurer must maintain in relation to its insurance and investment risks. Other NAIC regulatory initiatives impose restrictions on an insurance company s ability to pay dividends to its stockholders. These initiatives may be adopted by the various states in which our subsidiaries are licensed, and the ultimate content and timing of any statutes and regulations adopted by the states is unknown. It is not possible to predict the future impact of changing state and federal regulation on our operations, and there can be no assurance that existing insurance related laws and regulations will not become more restrictive in the future or that laws and regulations enacted in the future will not be more restrictive.

The federal government does not directly regulate the insurance industry. However, federal legislation and administrative policies in specific areas, including pension regulation, privacy regulation, age and sex discrimination, financial services regulation and federal taxation, do affect the insurance industry. In recent years, legislation has been introduced which, if enacted, could result in the federal government assuming a more direct role in the regulation of the insurance industry.

Risk-based capital. The NAIC s risk-based capital requirements are intended to be used as an early warning tool to help insurance regulators identify deteriorating or weakly capitalized companies in order to initiate regulatory action. Risk-based capital is a method of establishing the minimum amount of capital appropriate for an insurance company to support its overall business operations in consideration of its size and risk profile. It provides an elastic means of setting the minimum capital requirement in which the degree of risk taken by the insurer is the primary determinant.

A Company s risk-based capital is calculated by applying factors to various asset, premium and reserve items. The factor is higher for those items with greater underlying risk and lower for less risky items. The adequacy of a company s actual capital may then be measured by a comparison to its risk-based capital as determined by this formula. Such requirements are not intended as a mechanism for ranking adequately capitalized companies. The formula defines a minimum capital standard that supplements the low, fixed minimum capital and surplus requirements previously implemented on a state-by-state basis.

The NAIC risk-based capital requirements mandate that insurance companies calculate and report information under a risk-based formula which attempts to measure statutory capital and surplus needs based on the risks in a company s mix of products and investment portfolio. The formula is designed to allow state insurance regulators to identify potential weakly capitalized companies. Under the formula, a company determines its risk-based capital by taking into account certain risks related to the insurer s assets (including risks related to its investment portfolio and ceded reinsurance) and the insurer s liabilities (including underwriting risks related to the nature and experience of its insurance business). Risk-based capital rules provide for different levels of regulatory attention depending upon the ratio of a company s total adjusted capital to its authorized control level of risk-based capital.

Pursuant to the formula described above, there are no issues with respect to a company s risk-based capital as long as risk-based capital as a percentage of authorized control level is in excess of 200%. At December 31, 2003, the total adjusted risk-based capital as a percentage of authorized control level for our principal insurance subsidiaries was 272% for the Vesta Fire Insurance Corporation and 720% for American Founders Life Insurance Company.

The risk-based capital percentage for Vesta Fire decreased from 285% at December 31, 2002 to a reported 272% at December 31, 2003 due to increased investments by Vesta Fire and its statutory subsidiaries in Affirmative Insurance Holdings, Inc. This increase is due to the fact that the common stock of Affirmative Insurance Holdings, Inc. was utilized in effecting certain inter-company transactions to legally segregate our non-standard automobile underwriting segment from our standard property and casualty segment with the intention of pursuing an initial public offering of Affirmative Insurance Holdings, Inc. in 2004.

The 272% reported adjusted risk-based capital as a percentage of authorized control level did not reflect the impact from the $55.8 million statutory surplus charge relating to the 1997 20 percent whole account quota share and other disputed reinsurance treaties which was recorded as a charge of $65.9 million in 2003 for GAAP financial reporting purposes. Although the statutory and GAAP charges related to the same reinsurance arbitrations and disputes, the statutory charges vary from the GAAP charges due to the recording of valuation allowances in prior periods in accordance with statutory reporting guidelines that are not required for GAAP financial reporting. With the recording of these charges, we will no longer have any exposure related to the 1997 20 percent whole account quota share from a statutory surplus basis.

Table of Contents

We believe that $55.8 million statutory charges in 2004 could result in our risk-based capital falling below the company action level as defined by the NAIC. In the event an insurance company s risk-based capital falls below company action level, regulations require that the company submit a plan that details management s proposed actions to increase statutory surplus. Although we are not currently required to submit such a plan, we have notified our primary regulator of this matter and we believe the actions contemplated below under the caption, Anticipated Transactions would adequately address our statutory surplus needs.

Restrictions on dividends to stockholders and transactions between affiliates. Transactions between Vesta and its insurance subsidiaries, including the payment of dividends and management fees to Vesta by such subsidiaries, are subject to certain limitations under the insurance laws of the governing states. The insurance laws of Illinois, where Vesta Fire is domiciled, permit the payment of dividends out of earned surplus in any year when, together with other dividends or distributions made within the preceding 12 months, such payments do not exceed the greater of 10% of statutory surplus as of the end of the preceding year or the net income of the preceding year. Furthermore, larger dividends are payable only after receipt of prior regulatory approval. The Illinois Insurance Department has taken the position that these limitations also apply if an insurer has negative or zero unassigned funds on its annual for statement. Because of these limitations, Vesta Fire may not be able to declare and pay a dividend for the foreseeable future without prior approval from the Illinois Department of Insurance. For further discussion, please refer to the Management s Discussion and Analysis of Results of Operations and Financial Condition Liquidity and Capital Resources section of this document.

IRIS Ratios. The NAIC has developed the Insurance Regulatory Information System (IRIS) to assist state insurance departments in identifying significant changes in the operations of an insurance company, such as changes in product mix, large reinsurance transactions, increases or decreases in premiums received and certain other changes in operations. Such changes may not be attributable to problems with an insurance company, but may indicate changes in certain ratios that are outside predetermined normal ranges as defined by the NAIC. When an insurance company has four or more ratios which fall outside normal ranges, state regulators may investigate to determine the reasons for the variance and whether corrective action is warranted.

Our year-end reported statutory levels resulted in Vesta Fire having four IRIS ratios unfavorably varying from the normal range. We submitted a plan to the Illinois Department of Insurance detailing our plan to resolve these variances, including requesting dividends from other insurance company subsidiaries as well as the liquidation of certain non-qualifying investments. As a result of the disputed reinsurance balances charge, we have three additional IRIS ratios that varied from the normal range. Our plan submission related to these additional IRIS ratio variance will remain with our initial submittal. The Illinois Department of Insurance is aware of the seven variances and, as of March 12, 2004, has not suggested any corrective action.

The $55.8 million statutory surplus charge related to the 1997 20 percent whole account quota share will negatively impact our statutory surplus in the first quarter of 2004 and could result in additional unfavorable IRIS ratio variances. In the event that additional IRIS ratios fall outside of the favorable range, we will update and submit our year-end plan.

Although we believe that our year-end plan addressing the IRIS ratio variances is prudent and feasible and would remain so in the event additional variances occur in the future, no assurance can be given that the Illinois Department of Insurance will not require additional actions to be taken that is beyond our current plans.

A.M. Best Rating

The A.M. Best Company rates insurance companies based upon factors of concern to policyholders, including a company s financial strength and ability to meet its obligations to policyholders. Under the A.M. Best rating system, a B+ is the minimum rating necessary to maintain classification as secure . Many financial institutions require insurance with companies rated at least B or B+ in connection with mortgage loans, and many independent insurance agents limit their field of carriers with which they will do business to B or B+ rated carriers. Because we have grown our presence in the homeowners markets significantly since 2001, these financial strength ratings have become increasingly important to our standard property casualty segment.

We received notification from A.M. Best in March of 2003 that it had decided to adjust the financial strength ratings of our property and casualty insurance subsidiaries from B+ (Very Good) to B (Fair). Since the A.M. Best downgrade, we have not experienced a significant negative impact in our operations. However, if we are unable to retain or improve our A.M. Best rating, we may ultimately experience deterioration in selected portions of our property and casualty premium volume, which could adversely impact our financial results, the degree to which management is unable to quantify.

Table of Contents

In an effort to strengthen our capital position, we began a capital evaluation in March of 2003. The capital evaluation included an analysis of the possible divestiture of our life operations and elements of our property-casualty operations. The capital evaluation resulted in the following significant events affecting our results of operation and financial condition during 2003:

- The increased utilization of quota share reinsurance for our standard property-casualty operations during 2003;
- The combination of our non-standard auto insurance operations with our non-standard agency operations in an effort to (i) seek separate financial strength ratings for our non-standard auto underwriting operations and our standard property-casualty operations and (ii) facilitate an initial public offering of our combined non-standard auto underwriting and agency operations;
- The sale of our health insurance operations;
- The sale of our life insurance operations.

Although we believe the above mentioned measures enacted in 2003 coupled with our improved continuing operating results and the anticipated divestiture of our life and non-standard auto businesses provide us with a strong basis to expect an improved financial strength rating for our standard property and casualty business, uncertainty exists as to the consummation of these transactions. Uncertainties exist due to the fact that the sale of our life insurance and non-standard auto operations are subject to regulatory approval and other factors beyond our control. These uncertainties, coupled with the negative impact to our statutory surplus from the statutory charge associated with our 1997 20 percent whole account quota share, results in our inability to provide assurance that we will be able to retain and improve our current financial strength rating. Management is unable to quantify the impact to our future business in the event we are unable to retain and improve our current financial strength rating; however, the retention or downgrade of our rating could lead to significant deterioration in selected portions of our standard property and casualty premium volume and adversely impact the financial results of this segment going forward.

In November 2002, A.M. Best reduced the financial strength rating for American Founders, our life insurance subsidiary, from B+ to B , based largely on concerns about the collectability of approximately $27 million of loans held as assets by American Founders. While we do not believe that this rating adjustment will impact the level of existing business in force at American Founders, it indicates a capital adequacy concern that could impact American Founders ability to obtain regulatory approval of future acquisitions. Accordingly, we increased a third party reinsurer s coinsurance participation in American Founders business from 35% to 62.5%, effective October 1, 2002. Effective March 12, 2004, we executed a definitive agreement on March 12, 2004 to sell American Founders Financial Corporation (AFFC), our life insurance subsidiary, for a total purchase price of approximately $63.5 million, consisting of $25 million in cash at closing and a promissory note in the amount of approximately $38.5 million. The note will bear a floating interest rate of LIBOR plus 200 basis points and will be repaid over a six-year term, with the interest payments only in the first year and the principal repayments in five equal annual payments thereafter. The note will be secured by a pledge of the stock of both AFFC and all capital stock and surplus debentures issued by AFFC s immediate subsidiary, Laurel Life Insurance Company, which owns 100% of the capital stock of American Founders Life Insurance Company.

Competition

The property and casualty insurance market is highly competitive with respect to both price and service. We compete for direct business with other public companies, specialty insurance organizations, mutual insurance companies and other underwriting organizations, some of which are substantially larger and have greater financial resources. In recent years, the trend in property and casualty insurance has been toward consolidation, which could result in more competitive pricing. We also believe that, in general, the insurance industry may encounter increasing competition from banks and other financial institutions.

In recent years, large insurance companies with captive insurance agencies have made a strong push into the personal insurance lines business. These companies have competed almost exclusively by implementing aggressive pricing. While there is a segment of the population that is influenced solely by price, we believe many consumers desire the advice, counsel and relationship of a professional agent. We have pursued a business strategy that focuses on this segment of the market. Accordingly, maintaining relationships with our independent agents is critical to our ability to compete. In our day-to-day operations, we have implemented measures to develop and retain the loyalty and support of the independent agents. Such measures include providing assistance and innovative solutions to operational issues facing the independent agents, as well as responding promptly to their requests and needs.

Employees

As of February 2004, we employed 1,457 persons. Approximately 1,039 of our employees are involved in our agency and non-standard underwriting segments. None of our employees are represented by labor unions or subject to any collective bargaining agreements.

Table of Contents

Item 2. Properties

Properties

We lease approximately 115,000 square feet for our home office at 3760 River Run Drive, Birmingham, Alabama under a long-term operating lease. For our life insurance businesses, we lease approximately 25,000 square feet in Phoenix, Arizona. In our non standard auto insurance operations, we lease approximately 400,000 square feet of office space for our agencies, insurance companies and retail stores in various locations throughout the United States.

We believe our office facilities are suitable and adequate for our current and anticipated level of operations.

Item 3. Legal Proceedings

Life insurance related lawsuits

Our subsidiary, American Founders, is a defendant in a lawsuit brought by a judgment creditor of IFS Holdings, Inc. the former holder of American Founders series A and C preferred stock alleging that American Founders redeemed its Series A and Series C preferred stock from IFS Holdings, Inc. for less than reasonably equivalent value, and, therefore, engaged in a voidable fraudulent transfer. American Founders believes (i) that the redemption transaction was for reasonably equivalent value; and (ii) that the allegations brought against it in this lawsuit are without merit. Due to IFS s bankruptcy in 2001, the real party in interest to pursue this claim is the bankruptcy trustee administering IFS estate in bankruptcy. Since assuming this position, the trustee has not pursued any discovery or otherwise attempted to resolve this case. In the opinion of management, resolution of the lawsuit is not expected to have a material adverse effect on our financial position. However, depending upon the amount and timing, an unfavorable resolution of this matter could materially affect American Founders future operations or cash flows in a particular period.

Health insurance related lawsuits

Vesta and two former officers of Vesta are defendants in a lawsuit styled *James H. Cashion, Jr. d/b/a American Health Underwriters v. Vesta Insurance Group, Inc., et al.* Plaintiff, a former general agent of our subsidiary States General Life Insurance Company, which we purchased in 2001 and disposed of in 2003, alleges that the defendants engaged in an actionable civil conspiracy to tortiously interfere with his agency contracts. The civil conspiracy claim is premised, in part, on certain payments made to these two former officers of Vesta by another agent who replaced Mr. Cashion. The plaintiff is seeking actual and punitive damages. Vesta denies tortiously interfering with plaintiff s agency contract, believes the claims asserted against it have no merit, and is vigorously defending this lawsuit. The trial court recently denied defendant s motion to compel arbitration, which decision is currently on appeal to the Texas Supreme Court. Discovery has been stayed pending resolution of this appeal. In the opinion of management, resolution of this lawsuit is not expected to have a material adverse effect on our financial position.

Indemnification Agreements and Liability Insurance

Pursuant to Delaware law and our by-laws, we are obligated to indemnify our current and former officers and directors for certain liabilities arising from their employment with or services to Vesta, provided that their conduct complied with certain requirements. Pursuant to these obligations, we have been advancing costs of defense and other expenses on behalf of certain current and former officers and directors, subject to an undertaking from such individuals to repay any amounts advanced in the event a court determines that they are not entitled to indemnification.

Reinsurance Arbitration/Litigation

As discussed in previous SEC filings, in 1998 we corrected our accounting for assumed reinsurance business through restatement of our previously issued financial statements. Similar corrections were made on a statutory accounting basis through recording cumulative adjustments in Vesta Fire s 1997 statutory financial statements. The impact of this correction has been reflected in amounts ceded under our 20 percent whole account quota share treaty, which was terminated on June

Table of Contents

30, 1998 on a run-off basis. We believed such treatment was appropriate under the terms of this treaty and calculated the quarterly reinsurance billings presented to the three treaty participants accordingly. The aggregate amount included as recoverable from such reinsurers totaled $33.4 million at September 30, 2003. Additionally, we previously collected approximately $48.5 million from the drawdown of collateral on hand. Such amount net of related expenses had been reflected in the Company s financial statement.

NRMA Insurance Limited (NRMA), one of the participants in the 20 percent whole account quota share treaty, filed a lawsuit in the United States District Court for the Northern District of Alabama contesting our billings. NRMA sought rescission of the treaty and a temporary restraining order preventing us from drawing down approximately $34.5 million of collateral. We filed a demand for arbitration as provided for in the treaty and also filed a motion to compel arbitration which was granted in the United States District Court action. Vesta reached an agreement with NRMA to collect the $34.5 million of collateral in exchange for posting a $25 million letter of credit in favor of NRMA to provide collateral for any amounts NRMA may recover as a result of the arbitration. Pursuant to an order of the NRMA arbitration panel Vesta posted an additional $4.8 million letter of credit in October, 2003 in favor of NRMA. We also filed for arbitration against Alfa Mutual Insurance Company (Alfa) and Dorinco Reinsurance Company (Dorinco), the other two participants on the treaty.

On June 19, 2002, the panel in the NRMA arbitration issued an order to bifurcate the arbitration and scheduled a hearing for the week of October 28, 2002 to decide the issue of coverage for developmental losses under the treaty. On September 6, 2002, the panel notified the parties that it would make such determination on this specific issue on the papers and filings submitted by the parties without the necessity of a live hearing. On November 6, 2002 the panel notified the Company that it ruled that the treaty does not apply to loss occurrences prior to July 1, 1997. Primarily, as a result, Vesta recorded a $23.6 million pre-tax charge as a revision of our estimated reinsurance recoverable in the third quarter of 2002. Since this ruling did not set a binding precedent regarding Vesta s other arbitrations, we did not record any change in our estimate of our recoverable from the other treaty participants as a result from this ruling. In February, 2003, Vesta filed a petition to vacate the NRMA panel ruling in the U.S. District court for the Northern District of Alabama. On April 8, 2003 the court ruled that since the arbitration proceedings have not been fully exhausted, it was dismissing Vesta s petition without prejudice of the parties to seek the court s review of any final arbitration award.

The hearing in the NRMA arbitration began on October 20, 2003 and was adjourned on October 31, 2003. In January, 2004, the NRMA hearing concluded and on March 1, 2004 the NRMA panel ruled in favor of NRMA. As a result, the Company incurred a charge of $33.5 million to its 2003 fourth quarter earnings. While the NRMA ruling does not set a binding precedent regarding Vesta s other arbitrations, and while there are distinct facts and circumstances underlying and affecting our disputes with other participants, for financial reporting purposes, the Company will record a charge to its recoverable from the other treaty participants of $30.1 million for the fourth quarter of 2003. On March 4, 2004, Vesta filed a motion to vacate this arbitration award in the United States District Court for the Northern District of Alabama, Southern Division. The grounds for this motion are the evident partiality of the neutral umpire. Additionally, the recording of this charge does not impact our intention to actively arbitrate the Alfa and Dorinco matters.

On March 14, 2002, Alfa filed a motion for declaratory judgment asking the arbitration panel to order that there is no enforceable agreement between Alfa and Vesta or alternatively that there is no coverage for developmental losses under the treaty. After a hearing in June, 2002, the arbitration panel denied Alfa s motion. The hearing on the merits of the arbitration with Alfa was scheduled for May, 2003, however on April 21, 2003, Alfa filed a lawsuit against Vesta Fire in the state court in Montgomery, Alabama seeking a declaration from the court on certain procedural and organizational matters and requesting that the court stay the arbitration proceedings during the pendency of the litigation in state court in Alabama. On April 24, 2003, the court issued a temporary restraining order staying the proceedings in the on-going arbitration in order to maintain the status quo until the merits of Alfa s petition could be heard and determined. After the hearing in the Circuit Court of Montgomery County on December 8 and 9, 2003, the court decided the procedural and organizational matters partially in favor of the Company and partially for Alfa. While the arbitration hearing has not yet been rescheduled it is likely to be scheduled for early 2005.

On December 16, 2002, Dorinco filed a motion seeking an order that the treaty does not cover developmental losses related to loss occurrences prior to July 1, 1997. On May 1, 2003, the panel in the arbitration ruled that Dorinco was not responsible for losses on any policy or other insurance or reinsurance contract terminated prior to July 1, 1997 and that the arbitration will continue with respect to losses whenever occurring, on policies or other insurance or reinsurance contract in force at July 1, 1997. On January 27, 2004, the panel ruled that its May 1, 2003 ruling also extended to premium transactions under policies that had expired as of July 1, 1997. The hearing in the Dorinco arbitration was previously scheduled for the two weeks of March 8 through March 12, and April 26 thru April 30, 2004. Recently, those hearing dates were adjourned and the new hearing dates are presently being rescheduled, most likely for 2005.

We are in arbitration with CIGNA Property and Casualty Insurance Company (now ACE USA) under a personal lines insurance quota share reinsurance agreement, whereby we assumed certain risks from CIGNA. During September 2000, CIGNA filed for arbitration under the reinsurance agreement, seeking payment of the balances that CIGNA claimed were due under the terms of the treaty. At that time, the treaty was terminated on a cut-off basis. In the pending arbitration Vesta is seeking, among other things, recoupment of all believed improper excessive expense allocations and charges from CIGNA. The arbitration was bifurcated into two phases with Phase I concentrating on the interpretation of the intent of the parties related to the expense reimbursement provisions of the treaty at the time it was entered. Phase II, which has now been completed, related to any remaining issues between the parties, including those that exist with regard to an audit of expenses ceded to the treaty. The Phase I hearing was held in February 2002 and the panel ruled that (i) the Company is responsible for the payment of ceding commissions provided for in the treaty and should pay any outstanding billings for commissions and paid claims, plus interest; (ii) the Company may proceed with an audit of expenses ceded to the treaty; and (iii) the parties should identify any further issues to be brought before the arbitration panel for phase two of the hearing. During the course of preparing for and conducting the expense audit, the Company determined that it should revise its estimated reinsurance receivable and recorded during the second quarter of 2003 a pre-tax valuation allowance of $9.4 million as a component of discontinued operations. As a result of the expense audit conducted during Phase II, the Company has now recovered from ACE $462,000 in overcharged expense items. The only remaining issue in the arbitration is ACE s motion for attorney fees incurred in Phase I of the arbitration and Vesta s request for interest on the overcharged expense items recovered in Phase II.

Muhl vs. Vesta is a case pending in the supreme Court of the State of New York, County of New York, brought by the Liquidator of Midland Insurance Company (Midland), claiming recoveries under two alleged retrocession agreements (Pool I and Pool III) between Midland and Interstate Fire Insurance Company, Vesta s predecessor in interest. The Liquidator s claims against Vesta under Pool I and Pool III have been severed.

Third party auditors hired by Vesta have identified coverage issues that cast doubt on the validity of a number of claims. In addition, there is no actual retrocessional agreement that evidences the terms and conditions of Pool III which involves 60% or more of the incurred losses at issue. Although there are other tangential documents that the Liquidator may attempt to rely on to prove liability under Pool III, we believe that the Liquidator will not be able to establish liability for any portion of the Pool III claims. We also believe that a number of the losses allegedly incurred in connection with Pool I may be avoided on specific coverage grounds. We are defending this matter vigorously and are reasonably optimistic regarding the ultimate outcome, although an adverse ruling in this case could have a material effect on our financial condition. The first mediation session in this case was held on January 8, 2004 and a continued mediation is scheduled for March 31, 2004.

Vesta vs. New Cap Re is an arbitration against an Australian reinsurer, to collect reinsurance recoverables pursuant to two accident year excess of loss ratio reinsurance agreements. In the arbitration, New Cap Re challenged Vesta s earlier draw on a Letter of Credit for $7.5 million which was held in connection with one of the two contracts. Shortly after the arbitration commenced, New Cap Re became the subject of insolvency proceedings in Australia and an ancillary proceeding in the U.S. Bankruptcy Court in New York. The Bankruptcy Court stayed all pending litigation and arbitration against New Cap Re, and we appealed that ruling to the Southern District of New York, and ultimately to the U.S. Court of Appeals for the Second Circuit, which recently affirmed the Bankruptcy Court s stay of the arbitration against New Cap Re. Hence, our efforts to recover losses as well as New Cap Re s efforts to challenge the earlier draw on the $7.5 million Letter of Credit by us are stayed and the Company s options may be limited to seeking adjudication of the dispute in Australia.

On September 5, 2002, New Cap Re served us with an Application pursuant to Section 588FF of the Australian Corporations Act seeking an order directing us to pay New Cap Re and its liquidator $1.0 million that Vesta allegedly received as an unfair preference and/or arising out of an uncommercial transaction, as those terms are defined by the Corporations Act. We filed a Notice of Appearance on October 31, 2002. The liquidator filed a Statement of Claim on August 13, 2003, and the Company filed its defense on December 18, 2003. Discovery has not commenced. While management intends to vigorously defend this matter, given the preliminary nature of these proceedings, it is too early to evaluate the likelihood of success.

Other

Vesta, through its subsidiaries, is routinely a party to pending or threatened legal proceedings and arbitration relating to the regular conduct of its insurance business. These proceedings involve alleged breaches of contract, torts, including bad faith and fraud claims and miscellaneous other specified relief. Based upon information presently available, and in light of legal and other defenses available to Vesta and its subsidiaries, management does not consider liability from any threatened or pending litigation regarding routine matters to be material.

Table of Contents

Item 4. Submission of Matters to a Vote of Security Holders

None.

29

Table of Contents

PART II

Item 5. Market for Registrant s Common Equity and Related Stockholder Matters

Price Range of Common Stock and Dividend Policy

Market Prices. Our common stock trades on the New York Stock Exchange under the symbol VTA.

Quarterly high and low market prices of our common stock in 2003 and 2002 were as follows:

Quarter Ended	High	Low
2003		
March 31	$ 3.20	$ 2.22
June 30	3.00	2.01
September 30	2.80	2.25
December 31	4.55	2.25
2002		
March 31	$ 8.40	$ 4.85
June 30	6.00	3.85
September 30	4.53	2.30
December 31	3.84	1.95

Dividend Policy and History. The declaration and payment of dividends will be at the discretion of our Board of Directors and will depend upon many factors, including our financial condition and earnings, the capital requirements of our operating subsidiaries, legal requirements and regulatory constraints.

The dividends we paid on our common stock for the past three years were as follows (in thousands):

Quarter Ended	2003	2002	2001
March 31	$ 892	$ 925	$ 239
June 30	892	912	617
September 30	892	911	872
December 31	892	910	879

Illinois, Hawaii and Texas impose restrictions on the payment of dividends to us by our insurance subsidiaries under their regulatory authority in excess of certain amounts without prior regulatory approval. For more discussion, please refer to the Business Regulation Restrictions on Dividends to Stockholders section of this report.

In the fourth quarter of 2003, we exchanged 402,751 shares of our common stock for $2.193 million principal amount of our 8.525% Deferrable Capital Securities. The transactions were not registered under the Securities Act of 1933 in reliance on the exemption afforded by Section 3(a)(9) thereof.

Table of Contents

Item 6. Selected Financial Data

The following information should be read in conjunction with Vesta s Consolidated Financial Statements and related notes reported elsewhere in this Form 10-K:

	Year Ended December 31,				
	2003	2002	2001	2000	1999
	(in thousands, except share amounts)				
Statement of Operations Data *					
Net premiums written	$ 448,768	$ 546,473	$ 285,520	$ 210,742	$ 227,807
Net premiums earned	477,078	492,250	266,001	216,999	248,076
Net Investment Income	40,691	53,400	63,411	45,903	25,949
Policy fees	35,779	19,827	7,674	4,386	
Realized gains (losses)	7,776	(28,582)	(1,113)	(2,061)	12,756
Agents fees and commissions	49,110	55,146	5,892		
Other	7,311	8,382	7,803	903	4,527
Total revenues	617,745	600,423	349,668	266,130	291,308
Policyholder benefits, losses and LAE incurred	343,306	345,110	193,688	135,042	165,014
Policy acquisition and other operating expenses	235,027	258,469	127,017	98,389	89,569
Litigation settlement charge	65,920	9,029	25,000		
Gain on debt extinguishment	(602)	(9,477)	(1,400)	(8,077)	
Interest on debt and deferrable capital security distributions	13,710	14,922	17,565	15,105	13,215
Total expenses	657,361	618,053	361,870	240,459	267,798
Income (loss) from continuing operations before taxes, minority interest, and deferrable capital securities distributions	(39,616)	(17,630)	(12,202)	25,671	23,510
Income taxes (benefit)	62,050	(6,013)	(4,455)	8,491	7,129
Minority interest, net of tax	605	(2,479)	1,076	1,595	
Deferrable capital securities distributions, net of tax	622	1,081	1,394	1,986	5,632
Income (loss) from continuing operations	(102,893)	(10,219)	(10,217)	13,599	10,749
Loss from discontinued operations, net of tax	(15,925)	(21,992)	(19,113)	(2,397)	12,706
Preferred stock dividend			(163)	(3,670)	(563)
Gain on redemption of preferred securities, net of tax		560	7,068	9,190	9,548
Cummulative effect of change in accounting principle, net of tax	(1,167)				
Net income (loss) available to common stockholders	$ (119,985)	$ (31,651)	$ (22,425)	$ 16,722	$ 32,440
Diluted net income (loss) from continuing operations per share	$ (2.95)	$ (0.30)	$ (0.38)	$ 0.34	$ 0.53
Diluted net income (loss) from discontinued operations per share	$ (0.46)	$ (0.65)	$ (0.72)	$ (0.10)	$ 0.63
Diluted net income (loss) available to common shareholders per share	$ (3.44)	$ (0.94)	$ (0.84)	$ 0.78	$ 1.63

Shares used in per share calculation	34,917	33,793	26,652	24,255	20,202
Cash dividends per share	$ 0.10	$ 0.11	$ 0.09	$ 0.05	$ 0.04
Balance Sheet Data (at end of period)					
Total investments and cash	$ 1,078,448	$ 1,153,686	$ 1,059,328	$ 1,019,266	$ 483,997
Total assets	1,912,414	2,042,858	1,830,882	1,621,999	915,809
Reserves for losses, LAE & future policy benefits	1,023,853	1,000,739	976,167	923,973	354,709
Total indebtedness	85,680	85,795	109,396	91,419	146,876
Federal Home Loan Bank advances	158,811	176,793	168,614	150,691	
Total liabilities	1,800,816	1,784,552	1,548,325	1,373,663	674,519
Deferrable capital securities	20,252	22,445	23,250	33,225	41,225
Stockholders equity	111,598	235,861	259,307	215,111	200,065

* As a result of Vesta s decision to discontinue its health insurance and consulting business in 2002, its reinsurance assumed business in 2000 and its commercial business in 1999, all periods presented have been reclassified to present operations on a continuing and discontinued basis.

Table of Contents

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview

Vesta conducts business in three areas of the personal insurance industry: (1) standard property and casualty insurance; (2) non-standard automobile insurance; and (3) life insurance. Our consolidated revenue is derived principally from risk-bearing premiums, policy fees, commissions and fees, investment income and investment gains and losses. Our consolidated expenses consist primarily of payments for claims and expenses associated with underwriting activities, agents commissions and operations.

We report financial information according to five business segments: (1) standard property-casualty insurance; (2) non-standard agency; (3) non-standard underwriting; (4) life insurance; and (5) corporate and other. Since 1999, we have discontinued a number of business lines. We have segregated the reporting for these discontinued operations in our consolidated financial statements.

Since 2000, we have pursued a strategy (1) to grow our market share in certain capacity restrained niche markets in the standard property-casualty business, (2) to exit certain states in which current results and projected future results do not fit our overall profitability strategy and (3) to participate in profitable opportunities in other industry segments such as the non-standard automobile business and the life insurance business. While we have experienced significant and profitable growth in various personal lines business since 2000, we have also experienced significant declines in our property and casualty subsidiaries statutory capital and surplus during the same period. These declines in capital and surplus are primarily attributable to lower than expected arbitration awards and changes in estimates of disputed reinsurance recoverable balances, reserve strengthening in our discontinued commercial and assumed reinsurance segments and increased policy acquisitions costs associated with significant premium growth. This decline in statutory surplus coupled with significant growth in premium written is the primary reason that A.M. Best Company adjusted the financial strength ratings of our property and casualty insurance subsidiaries from B+ (Very Good) to B (Fair) in March of 2003. Since the A.M. Best rating action, we have not experienced a significant negative impact from our operations. However, the adjustment could lead to significant deterioration in selected portions of our standard property and casualty premium volume and adversely impact the financial results of this segment going forward, the degree to which management is unable to quantify.

In an effort to strengthen our capital position, we began a capital evaluation in March of 2003. The capital evaluation included an analysis of the possible divestiture of certain of our businesses, including our life and health operations and elements of our property-casualty operations. The capital evaluation resulted in the following significant events affecting our results of operation and financial condition during 2003:

- The increased utilization of quota share reinsurance for our standard property-casualty operations during 2003;
- The combination of our non-standard auto insurance operations with our non-standard agency operations in an effort to (i) seek separate financial strength ratings for our non-standard auto underwriting operations and our standard property-casualty operations and (ii) facilitate an initial public offering of our combined non-standard auto underwriting and agency operations;
- The sale of our health insurance operations;
- The anticipated sale of our life insurance operations in March 2004.

Standard property-casualty and non-standard underwriting

The financial results of our property-casualty underwriting activities (including our standard property-casualty segment and the non-standard underwriting segment) primarily depend upon three variables: (1) the amount of premiums and policy fees we collect, which is dependent upon rates and volume; (2) the costs we incur to adjust and pay claims submitted by individuals we have insured; and (3) the expenses we incur for policy acquisition and to operate our insurance companies.

Subject to competitive and market trends and regulatory approval, premium rates are generally within our control, and we continuously monitor and seek to adjust rates as appropriate. During 2003, we implemented six rate increases in our standard automobile business line in the states of North Carolina, Ohio, West Virginia and Pennsylvania, which represented a weighted average premium increase of approximately 5.5% on actual gross written premiums during 2003 of $45.4 million. During 2003, we also implemented 17 rate increases in our standard residential property line in the states of West Virginia, Ohio, Pennsylvania,

Table of Contents

Tennessee, South Carolina, Arizona, Florida and New York which represented a weighted average premium increase of approximately 18.6% on actual gross written premiums during 2003 of $126.7 million. In regard to our non-standard underwriting segment, our 2003 rate adjustments will result in a weighted-average overall maintenance of rate adequacy, which is reflective of our favorable loss ratio experience.

The degree to which the Company is able to realize the positive impact from these rate increases is contingent upon the degree to which we can sustain current net written premium levels. Decreased written premium levels due to our surplus constraints, competition, or further increases in our utilization of reinsurance would reduce the impact of these rate increases. Furthermore, the impact of these rate increases may be reduced through future rate reductions enacted by state regulatory agencies.

The costs we incur to adjust and pay claims, known as loss and loss adjustment expenses, are largely beyond our control and depend primarily upon the frequency and/or severity of claims made by our policyholders. One measure of performance in the insurance industry is the loss ratio, which is the ratio of (i) the sum of loss and loss adjustment expenses; to (ii) the sum of earned premiums and policy fees. Our loss ratio will generally increase or decrease according to the frequency and/or severity of claims made by our policyholders.

Another key performance measure for insurance companies is the combined ratio. The combined ratio compares (i) the sum of loss, loss adjustment expenses, operating expenses and policy acquisition expenses; to (ii) total earned premiums and policy fees. A combined ratio of less than 100% indicates underwriting profitability, without regard to investment income earned from investing the premium received.

Our property and casualty insurance companies also earn investment income by collecting and investing premiums in advance of paying claims. In addition to investing operating cash flow, these insurance companies invest funds and earn investment income related to the required statutory surplus that we maintain in our insurance companies to support the premium that we underwrite. We report the investment income and realized investment security gains or losses generated from these activities of our property and casualty insurance companies in our corporate and other segment.

Non-standard agency

The financial results of our agency activities primarily depend upon the amount of fees and commissions we can collect from the sale of insurance products and the expenses we incur to conduct our day-to-day operations. Although we expect the minimum commissions and policy fees that we earn under a typical agency contract to be relatively stable, we expect to earn a substantial amount of additional profit sharing commissions in excess of the contractual minimums.

Our underwriting agencies predominantly design, distribute and service policies issued by our insurance companies. During 2003, our underwriting agencies also administered the policies of one unaffiliated non-standard personal automobile insurance company. In the future, these underwriting agencies may provide services to additional unaffiliated insurance companies in order to ensure continuity and sufficient underwriting product and capacity for our distribution channels regardless of hard or soft cycles.

Our underwriting agencies appoint our retail agencies and independent agencies to distribute insurance policies to individual customers. In the year ended December 31, 2003, our retail stores were responsible for 42.8% of the gross written premiums produced by our underwriting agencies. In the year ended December 31, 2003, our underwriting agencies utilized approximately 1,900 independent agencies to sell the policies that they administer and these independent agencies were responsible for 57.2% of the gross written premiums produced by our underwriting agencies.

Our retail stores predominately sell non-standard personal automobile insurance policies issued by our insurance companies and administered by our underwriting agencies. Approximately 83% of our retail stores commission and fee revenue is paid by us for sales of our non-standard personal automobile insurance policies and is therefore eliminated in the consolidated financial statements. The remaining 17% of our retail stores commission and fee revenue is generated through sales of non-standard personal automobile policies issued by unaffiliated insurance companies as well as through sales of certain other complementary insurance products and ancillary non-insurance products and services.

Table of Contents

Life insurance

The financial results of our life insurance operations primarily depend upon (1) the amount we collect as premium; (2) the amount of investment income earned on invested premium; and (3) the benefits we pay to insureds upon their death. Unlike the standard property-casualty segment, we typically hold the premium collected on our life products for many years and invest such premium over a long period of time, making investment income a significant component of revenue that we report in the life segment. The greatest variable in our revenue in the life segment is the amount of income we can earn on invested assets, which is dependent upon general interest rates and market conditions. The greatest variable in our expense from period to period is the mortality rate of our insureds, as mortality rates in excess of our actuarially predicted levels will adversely impact financial results in any given period.

Corporate and other

The financial results of our corporate and other segment reflect other revenue and expenses that are not allocated to any particular segment, including (i) investment income related to our property-casualty underwriting operations; (ii) corporate interest expense; (iii) general corporate operating expenses; and (iv) realized gains and losses from the sale of investment securities or the repurchases of our own debt securities at a discount.

In addition to the above-mentioned factors, our financial results may also be impacted by weather-related events such as hurricanes and tornadoes. Also, our ability to effectively compete in the insurance markets we serve is influenced by the financial strength ratings assigned to our companies by A.M. Best.

Critical accounting policies and estimates

Our consolidated financial statements are based upon the selection and application of accounting policies that require management to make significant estimates and assumptions. Our financial results would be directly impacted by changes in assumptions and judgments used to apply our accounting policies, particularly in certain critical areas. We believe the following are some of the more critical judgment areas in the application of our accounting policies that affect our financial condition and results of operations.

- Recoverability of assets, including reinsurance receivables, deferred policy acquisition costs, deferred tax assets and other intangible assets;
- Valuation of goodwill and other intangibles with indefinite lives;
- Valuation of investments;
- Reserves for losses and loss adjustment expenses;

Recognition of revenue;

Allocation of purchase price for acquisitions; and

Evaluation of litigation.

We have discussed the application of these critical accounting policies with our Board of Directors and audit committee. In 2003, we initially adopted the following accounting standards:

FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees ;

FASB Interpretation No. 46, Consolidation of Variable Interest Entities (VIEs) ;

Derivatives Implementation Group Issue No. B36 Bifurcation of Embedded Credit Derivatives ;

SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure ; and

SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity .

Emerging Issues Task Force Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments

For a discussion of the accounting pronouncements that we have recently adopted, please refer to Note A to our consolidated financial statements.

Recoverability of assets

Our financial statements include as assets amounts we either (i) expect to collect from third parties, particularly reinsurance recoverables, or (ii) expect to benefit from in future periods, particularly deferred acquisition costs and deferred tax assets. In establishing these amounts, we have made significant judgments and estimates regarding the ultimate realization of each asset. Specifically, we have made critical assumptions and judgments in establishing assets for reinsurance recoverables on

Table of Contents

paid losses, deferred policy acquisition costs and deferred income taxes. Changes in the assumptions, judgments or estimates we have made with respect to each of these assets would directly impact our financial results and financial condition.

Reinsurance recoverable on paid and incurred losses

As a matter of practice, we routinely cede risks associated with insurance policies we underwrite to reinsurers pursuant to contractual arrangements. We obtain reinsurance to provide protection for individual loss occurrences, including catastrophic losses, to stabilize the results of our underwriting activities and to reduce our net liability for individual risks. We report as assets the estimated reinsurance recoverable on paid losses, including an estimate for losses incurred but not reported, and amounts paid to reinsurers applicable to unexpired terms of policies in force.

In exchange for reinsurance coverage, we pay a portion of the policy premiums we receive to reinsurers who have assumed a specified level of risk pursuant to a reinsurance contract. Although a reinsurer is liable for losses to the extent of coverage to which it assumes, reinsurance arrangements do not legally discharge the principal insurer from primary liability for the full amount of a policy.

When we determine that a claim for loss made under one of our policies is owed, we initially pay the full amount owed to the insured or the claimant. Subsequently, we seek to recover any amounts due from reinsurers in accordance with the terms of the applicable reinsurance contract. We record the amounts we expect to receive from reinsurers pursuant to these contracts as assets in our financial statements.

At December 31, 2003, we have recorded $46.5 million, captioned as Reinsurance recoverable on paid losses on our consolidated balance sheet, for our estimate of amounts due Vesta from reinsurers for the payment of valid claims. Additionally, at December 31, 2003, we have recorded $423.7 million, captioned as Reinsurance balances receivable on our consolidated balance sheet, for our estimate of amounts due Vesta from reinsurers for unpaid losses, and amounts paid to these reinsurers applicable to terms of policies in force. These amounts reflect the impact of our current reinsurance agreements including the impact from the 2003 50% Quota Share.

The amounts recorded have been estimated based upon management s interpretation of each reinsurer s obligations pursuant to individual reinsurance contracts between Vesta and each reinsurer. In establishing the balances for reinsurance recoverables and reinsurance receivables, we have made judgments in assessing the financial viability and credit quality of each reinsurer as well as the ability of each reinsurer to pay amounts owed to us. In evaluating the credit and financial quality of each reinsurer, we rely upon financial statements, credit reports and other publicly available information applicable to each reinsurer as well as management s experience and industry knowledge.

The Company has ceded reserves of $26.5 million to Lumbermens Mutual Casualty Company, a member of the Kemper Insurance Companies, primarily related to long-term care obligations under personal injury protection auto policies of the Shelby insurance companies originating prior to their acquisition in 1997. Lumbermens and other members of the Kemper Insurance Companies, which operate under a business pooling arrangement, were assigned an A. M. Best s rating of D (Poor) on June 30, 2003. The Company is closely monitoring the financial condition of Lumbermens, which has entered into a voluntary run-off plan with the Illinois Department of Insurance. As of December 31, 2003, no valuation allowance has been recorded related to the ceded reserve receivables from Lumbermens.

It is possible that the amounts we recover under reinsurance contracts could be materially less than the amounts we have recorded, which may result in a material adverse impact on our financial condition and results of operations. Some reinsurers may dispute our claims under reinsurance contracts, including our calculation of amounts recoverable and may pursue arbitration or litigation over these matters. During the years 2002 and 2003, we have recorded changes in our estimated reinsurance recoverables of approximately $106.3 million primarily related to several reinsurance arbitrations including NRMA Insurance Ltd., Alfa Mutual Insurance Company and Dorinco Reinsurance Company related to our 1997 20% whole account quota share, F&G Re (on behalf of USF&G), CIGNA Property and Casualty Insurance Company, Hartford Reinsurance, and Delta Re.

Changes in our assumptions, estimates and judgments with respect to establishing assets for reinsurance recoverables on paid losses and reinsurance balances receivable would materially impact our financial results and financial condition. For more discussion of reinsurance recoverables and other amounts subject to estimation due to arbitrations with our reinsurers, please refer to Notes G and I to our consolidated financial statements.

Deferred policy acquisition costs

Deferred policy acquisition costs represent costs we incur in connection with acquiring new business or renewing existing business. Deferred policy acquisition costs are primarily comprised of commissions and other costs related to issuing insurance policies, net of amounts received from reinsurers as reimbursements of such costs. In accordance with GAAP, these costs are not expensed in their entirety upon their incurrence (as is the case for statutory accounting purposes); rather, they are initially recorded as assets in our financial statements and are subsequently amortized over the life of the insurance policies to which they relate or at a constant rate based upon the present

Table of Contents

value of the estimated gross profits to be earned from the underlying policies. This treatment is intended to match the expenses associated with issuing an insurance policy with estimated profits to be earned on the policy over the life of the policy. At December 31, 2003, we had established $51.5 million as assets for deferred acquisition costs in our financial statements.

A reduction in recorded deferred policy acquisition costs shall be recognized if the sum of the expected loss and loss adjustment expenses, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums and anticipated investment income. On an ongoing basis, management reviews the components of deferred acquisition costs we have established and assesses their recoverability. At December 31, 2003, we determined that there was no premium deficiency. Changes in our assumptions, estimates and judgments with respect to establishing deferred acquisition costs could materially impact our financial statements and financial condition. Such changes assessed by management that could negatively impact the recoverability of deferred acquisition costs on an ongoing basis include changes in estimated future loss ratios, changes in projected investment income, reduction of premium rates due to competitive factors or regulatory actions, or changes in our overall expense levels.

Deferred income taxes

Deferred income taxes are provided for temporary differences between amounts of assets and liabilities for financial reporting purposes and the basis of such assets and liabilities as measured by tax laws and regulations, as well as net operating loss, tax credit and other carryforwards. SFAS 109, Accounting for Income Taxes, requires that deferred tax assets be reduced by a valuation allowance if, based on available evidence, it is more likely than not that all of the recorded deferred tax assets will not be realized in future periods. This assessment requires significant judgment, and an evaluation of both objective and subjective positive and negative factors.

We evaluate the recoverability of our deferred tax assets on an ongoing basis. In making this evaluation during 2003, we considered all available positive and negative evidence, including our past results, the existence of significant cumulative losses in recent years, and our estimate of future taxable income.

While we anticipate being profitable in future periods, the combination of significant cumulative losses in recent years and uncertainty with respect to our ability to achieve sufficient taxable income to fully realize our year-end deferred tax asset balances within a reasonable time frame, warrants the recording of a valuation allowance under SFAS No. 109. Accordingly, we recorded an additional valuation allowance of $75.4 million for the year ended December 31, 2003, which represents our net deferred tax asset balance for which corresponding deferred tax liabilities did not offset. This increase in our valuation allowance, coupled with the $7.3 million valuation allowance that existed at December 31, 2002 that related to an acquisition made in 2000, resulted in an aggregate deferred tax asset valuation allowance of $82.7 million as of December 31, 2003.

We will continue to review our estimated taxable income in relation to our actual results on an ongoing basis. In the event that certain planned transactions are consummated or management believes that existing uncertainties regarding our forecasted taxable income are minimized, the existing valuation allowance may be reversed.

Goodwill and Other Intangible Assets with Indefinite Lives

In our financial statements, we have recorded $143.8 million of goodwill and other intangible assets with indefinite lives, which represents the amount by which the price we paid to acquire net assets exceeds the fair value of tangible assets and identified intangibles with definite lives acquired less the fair value of the liabilities assumed. The determination of whether these assets are impaired involves significant judgments based upon management s short and long-term projections of future performance for each of our business lines. Certain of these forecasts reflect assumptions regarding our ability to sustain or increase activities in our various business lines. Changes in strategy and/or market conditions may result in changes to recorded asset balances.

Table of Contents

Effective January 1, 2002, in accordance with the provisions of SFAS No. 142, Goodwill and Other Intangibles , we no longer amortize goodwill on a periodic basis in our consolidated financial statements. Rather, on at least an annual basis, we conduct an evaluation to assess whether the fair value of our reporting units exceeds each reporting units carrying value. Our annual evaluation is performed as of September 30[th]. Upon the occurrence of significant events, which could impact the assumptions we use to project future profitability, we update our evaluation of our reporting units. We evaluate impairment of three reporting units: homeowners insurance operations; life insurance companies; and non-standard agency operations. For purposes of applying the provisions of SFAS No. 142, we compare the aggregate fair value and carrying value of each reporting unit to determine if there is any impairment. As long as the aggregate fair value exceeds the aggregate carrying value for each reporting unit, no impairment is recognized in our financial statements, even if an individual component of a reporting unit would be impaired on a stand-alone basis.

For the year ended December 31, 2003, we have recorded goodwill and other intangible assets with indefinite lives for each reporting unit as follows: homeowners insurance operations -$57.7 million; life insurance companies - $10.8 million; and non-standard auto insurance operations - $75.3 million. We assess the valuation of goodwill and other indefinite intangibles based upon (a) the historical financial performance of each unit; (b) the most recent financial performance of each unit; (c) management s financial forecast for each reporting unit; (d) information regarding publicly available financial terms of recent transactions in the insurance industry; and (e) other publicly available information.

As noted above, our required annual evaluation was performed as of September 30, 2003. Based on this evaluation, we concluded that there is no goodwill impairment. Based on the significance of the events that occurred during and subsequent to the fourth quarter, we updated our goodwill evaluation and again we have concluded that there is no goodwill impairment as of December 31, 2003. With respect to all of our reporting units, our ability to achieve forecasts and projected undiscounted cash flows are based upon various assumptions made by management. There can be no assurance that our actual financial results in the future will not vary materially from the estimates we have used in our assessment of goodwill and intangible assets with indefinite lives. The reader should refer to Exhibit 99.1 of this filing for a summary of the factors we believe present a potential risk to Vesta s ability to achieve anticipated future performance. Also, because of uncertain market conditions and potential changes in our strategy and business lines, it is possible that forecasts used to support goodwill may change in the future, which could result in additional non-cash charges that would adversely affect our results of operations and financial condition.

Valuation of investments

In accordance with guidelines established by our Board of Directors, our investment portfolio consists primarily of investment grade, fixed income securities. At December 31, 2003, our cash and investment portfolio was approximately $1.1 billion, with 2.8% consisting of investments in equity securities. Because of the nature of our investments, the fair value of our portfolio is not typically volatile, and the market values of our investments have generally been greater than or equal to their costs.

Our investments are recorded at fair value based upon quoted prices, if available. If quoted prices are not available, fair value is primarily determined based upon management s assessment of the market value of comparable investments. Our determination of fair value also considers various factors including time value and volatility issues, credit quality of the counterparty and existing conditions in the overall financial markets. From time-to-time, the carrying values of our investments may be temporarily impaired because of such factors. We do not adjust the carrying value of any investment unless management determines that its value is other than temporarily impaired. Management evaluates securities for other-than-temporary impairment on at least a quarterly basis, and more frequently when economic concerns warrant such an evaluation. Factors considered by management in determining whether an impairment of an investment security is other than temporary includes the credit quality of the security, the severity of the decrease between the security s cost and market value, the length of time of the security s impairment and the likelihood that the impairment will reverse in the future. In the event that management determined that a reduction in an investment security s fair value below its costs basis is other than temporary, the security s cost basis is reduced to its fair value and a corresponding realized loss is recorded in our consolidated income statement. For the years ended December 31, 2003 and 2002, we recorded $3.1 million and $8.0 million, respectively, of realized losses for other than temporary impairments of investment securities.

The determination of whether other than temporary impairment has occurred involves significant assumptions, estimates and judgments by management. Changing economic conditions global, regional or related to industries of specific issuers could adversely affect these values.

Table of Contents

At December 31, 2003, included in securities available-for-sale are the following investments with unrealized losses classified according to the term of the unrealized loss of less than twelve months or twelve months or longer:

	Less Than 12 Months			12 Months or Longer			Total		
Description of Securities	**# of Positions**	**Fair Value**	**Unrealized Loss**	**# of Positions**	**Fair Value**	**Unrealized Loss**	**# of Positions**	**Fair Value**	**Unrealized Loss**
U.S. Treasury obligations	40	$ 47,379	$ (659)		$	$	40	$ 47,379	$ (659)
Federal agency obligations	60	71,394	(767)	30	31,193	(261)	90	102,587	(1,028)
Corporate Bonds	75	65,697	(1,631)	10	6,290	(265)	85	71,987	(1,896)
Debt securities		184,470	(3,057)		37,483	(526)		221,953	(3,583)
Common Stock		406	(36)		187	(2)		593	(38)
Total temporarily impaired securities		$ 184,876	$ (3,093)		$ 37,670	$ (528)		$ 222,546	$ (3,621)

The unrealized loss approximates 1.6% of the fair value of the temporarily impaired securities at December 31, 2003. For those securities identified as having temporary impairments for less than twelve months, management noted that the temporary losses are due to recent increases in U.S. Treasury yields and are not due to deterioration in credit quality or impairment issues. During the second half of 2003, 5-10 year U.S. Treasury yields increased .73% to .83% resulting in a lowering of the market values of these securities. Bonds purchased in the lower interest rate environment of early 2003 showed year-end unrealized losses that are attributable to changes in overall yields and, in management s opinion, do not represent a permanent impairment issues.

For those securities identified as having temporary impairments of twelve months or more, approximately 48% of these unrealized losses occurred in federal agency mortgage-backed securities. Management does not view these losses as being related to credit quality as these bonds are guaranteed by the issuing agency and, with respect to certain securities, by the U.S. Government. It is not expected that the securities would be settled at a price less than the amortized cost of the investment.

The remaining potential losses over one year are split between investment and non-investment grade securities. A majority of these losses represent securities that are secured by collateral mitigating any impairment risk. It is not expected that the securities will be settled at a price less than the amortized cost of the investment.

Loss and loss adjustment expenses

We maintain property-casualty loss reserves to cover the estimated ultimate unpaid liability for losses and loss adjustment expenses with respect to reported and unreported claims incurred. Reserves do not represent an exact calculation of the ultimate liability, but rather utilize actuarial projection techniques commonly used in the insurance industry to develop estimates. Reserve estimates represent managements expectations of what the ultimate settlement and administration of claims will cost based upon, among other factors, (1) an assessment of facts and circumstances then known; (2) a review of historical settlement patterns; (3) estimates of trends in claims severity and frequency; and (4) estimates of salvage and subrogation.

For purposes of establishing reserves on risks insured during the most recent year, including interim periods for which there is minimum experience to date, we have used forecasted loss ratios that have been applied to earned premiums during the interim periods. The determination of such forecasted loss ratios involved significant judgments by management, taking into account the results of the most recent actuarial studies performed, current pricing and underwriting, expected loss and loss adjustment expense trends and other pertinent considerations. In addition, we monitored and analyzed key loss and loss adjustment expense indicators and trends throughout the year. These included, but were not limited to, paid losses, newly reported claims and incidents, closed claim activity and other metrics.

At December 31, 2003, we had recorded liabilities for loss and loss adjustment expenses of $355.6 million. Our loss and loss adjustment expense reserves comprise the largest liability and most significant estimate or compilation of estimates in our consolidated financial statements. Furthermore, our loss and loss adjustment expense reserves are subject to significant inherent uncertainties and so there can be no assurance as to whether the actual results will be higher or lower than