PENN TREATY AMERICAN CORP
Form 10-Q
May 15, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

[X] Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2002

or

[ ] Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from ______________ to _____________

Commission file number 0-13972

PENN TREATY AMERICAN CORPORATION
3440 Lehigh Street, Allentown, PA 18103
(610) 965-2222

Incorporated in Pennsylvania I.R.S. Employer ID No. 023-1664166

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

The number of shares outstanding of the Registrant's common stock, par value $.10 per share, as of May 8, 2002 was 19,367,737.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Penn Treaty American Corporation is one of the leading providers of long-term nursing home and home health care insurance. Our Unaudited Consolidated Balance Sheets, Statements of Operations and Comprehensive Income and Statements of Cash Flows and Notes thereto required under this item are contained on pages 3 through 10 of this report, respectively. Our financial statements represent the consolidation of our operations and those of our subsidiaries: Penn Treaty Network America Insurance Company ("PTNA"), American Network Insurance Company ("American Network"), American Independent Network Insurance Company of New York ("American Independent") and Penn Treaty (Bermuda) Ltd. ("Penn Treaty (Bermuda)") (collectively, the "Insurers") and United Insurance Group Agency, Inc. ("UIG"), Network Insurance Senior Health Division ("NISHD") and Senior Financial Consultants (collectively, the "Agencies"), which are underwriters and marketers of long-term care insurance, disability and other senior-market products. PTNA is also an underwriter of life insurance products.

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PENN TREATY AMERICAN CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets
(amounts in thousands)

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ASSETS

Investments:
Bonds, available for sale at market (cost of $21,004 and $463,618, respectively)
Equity securities at market value (cost of $0 and $8,760, respectively)
Policy loans

Total investments
Cash and cash equivalents
Property and equipment, at cost, less accumulated depreciation of $6,992 and $6,594, respectively
Unamortized deferred policy acquisition costs
Receivables from agents, less allowance for uncollectable amounts of $199
Accrued investment income
Federal income tax recoverable
Goodwill
Present value of future profits acquired
Receivable from reinsurers
Corporate owned life insurance
Experience account due from reinsurer
Other assets

Total assets

LIABILITIES

Policy reserves:
Accident and health
Life
Policy and contract claims
Accounts payable and other liabilities
Long-term debt
Deferred income taxes

Total liabilities

Commitments and contingencies

SHAREHOLDERS' EQUITY

Preferred stock, par value $1.00; 5,000 shares authorized, none outstanding
Common stock, par value $.10; 40,000 shares authorized, 20,261 and 19,749 shares issued
Additional paid-in capital
Accumulated other comprehensive income
Retained earnings

Less 915 common shares held in treasury, at cost

Total liabilities and shareholders' equity

See accompanying notes to consolidated financial statements

PENN TREATY AMERICAN CORPORATION AND SUBSIDIARIES
Consolidated Statements of Operations and Comprehensive Income
(unaudited)
(amounts in thousands, except per share data)

	Three Months Ended
	2002
Revenues:	
Premium revenue	$ 84,236
Net investment income	692
Net realized capital gains (losses)	14,523
Trading account loss	--
Investment credit on experience account	(17,110)
Other income	2,770
	85,111
Benefits and expenses:	
Benefits to policyholders	80,187
Commissions	12,830
Net policy acquisition costs deferred	(3,326)
General and administrative expense	10,712
Expense and risk charges on reinsurance	3,577
Reserve for claim litigation	--
Excise tax expense	581
Interest expense	1,196
	105,757
Loss before federal income taxes	(20,646)
Benefit for federal income taxes	(7,020)
Net loss	(13,626)
Other comprehensive income:	
Unrealized holding (loss) gain arising during period	(634)
Income tax benefit (provision) from unrealized holdings	216
Reclassification of (gain) loss included in net loss	(14,523)
Income tax benefit (provision) from reclassification adjustment	4,938
Comprehensive (loss) income	$ (23,629)

Basic earnings per share	$ (0.72)	$
Diluted earnings per share	$ (0.72)	$
Weighted average number of shares outstanding	18,853	
Weighted average number of shares outstanding (diluted)	18,853	

See accompanying notes to consolidated financial statements

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PENN TREATY AMERICAN CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows for the Three Months Ended March 31,
(unaudited)
(amounts in thousands)

	2002	
Cash flow from operating activities:		
Net loss	$ (13,626)	$
Adjustments to reconcile net income (loss) to cash provided by operations:		
Amortization of intangible assets	194	
Amortization of deferred reinsurance premium	660	
Policy acquisition costs, net	(3,326)	
Deferred income taxes	(6,605)	
Depreciation expense	398	
Net realized capital (losses) gains	(14,523)	
Trading account loss	-	
Net proceeds from purchase and sales of trading securities	-	
Increase (decrease) due to change in:		
Receivables from agents	633	
Receivable from reinsurers	(3,003)	
Experience account due from reinsurer	10,562	
Policy and contract claims	14,669	
Policy reserves	24,589	
Accounts payable and other liabilities	(3,593)	
Federal income taxes recoverable	-	
Accrued investment income	7,521	
Other, net	(753)	
Cash provided by operations	13,797	
Cash flow from investing activities:		
Proceeds from sales of bonds	466,677	
Proceeds from sales of equity securities	9,547	
Proceeds from maturities of bonds	2,571	
Purchase of bonds	(12,888)	(
Purchase of equity securities	(20)	
Increase in corporate owned life insurance	(862)	
Initial premium for experience account	(563,529)	
Acquisition of property and equipment	(330)	
Cash used in investing	(98,834)	(
Cash flow from financing activities:		

Net cash from stock offering	228	
Proceeds from exercise of stock options	-	
Repayments of long-term debt	(2,880)	
Cash used in financing	(2,652)	
Decrease in cash and cash equivalents	(87,689)	(
Cash balances:		
Beginning of period	114,600	1
End of period	$ 26,911	$

See accompanying notes to consolidated financial statements.

PENN TREATY AMERICAN CORPORATION NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2002
(unaudited)
(amounts in thousands, except per share data)

The Consolidated Financial Statements should be read in conjunction with these notes and with the Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2001 of Penn Treaty American Corporation (the "Company").

In the opinion of management, the summarized financial information reflects all adjustments (consisting only of normal recurring adjustments) that are necessary for a fair presentation of the financial position and results of operations, comprehensive income and cash flows for the interim periods. Certain prior period amounts have been reclassified to conform to the current period presentation.

1. Recent Developments:

The Company's subsidiaries are required to hold statutory surplus that is, at a minimum, above a calculated authorized control level at which the Pennsylvania Insurance Department (the "Department") may place its subsidiary under regulatory control, leading to rehabilitation or liquidation. Insurers are obligated to hold additional statutory surplus above the authorized control level. At December 31, 2000, the Company's primary insurance subsidiary, representing 94% of our direct premium, had Total Adjusted Capital at the Regulatory Action level. As a result, it was required to file a Corrective Action Plan (the "Plan") with the insurance commissioner.

On February 12, 2002, the Department approved the Plan. It requires the Company's subsidiary to comply with certain agreements at the direction of the Department, including, but not limited to:

- The entrance into the reinsurance agreement for substantially all of its existing business at December 31, 2001. (See Note 2)

- New investments are limited to those rated by the National Association of Insurance Commissioners ("NAIC") as 1 or 2.

- Affiliated transactions are limited and require Department approval.

- An agreement to increase statutory reserves; the reinsurance agreement has provided the capacity to accommodate this increase and will provide an additional $80,000 throughout 2002-2004, such that the Insurers' policy reserves will be based on new, current claims assumptions and will not include any rate increases. These claim assumptions are applied to all policies, regardless of issue year and are assumed to have been present since the policy was first issued.

2. Reinsurance Agreement:

As a primary component of the Plan, effective December 31, 2001, the Company entered a reinsurance transaction to reinsure, on a quota share basis, substantially all of its respective long-term care insurance policies then in-force. The agreement was entered with Centre Solutions (Bermuda) Limited, which is rated A- by A.M. Best. The agreement is subject to certain coverage limitations, including an aggregate limit of liability that is a function of certain factors and that may be reduced in the event that rate increases are not obtained. The agreement meets the requirements to qualify as reinsurance for statutory accounting, but not for generally accepted accounting principles.

The initial premium of the reinsurance treaty resulted in the transfer of approximately $563,000 in cash and marketable securities during February 2002, and $56,000 as funds held due to the reinsurer. The initial premium and future cash flows of the reinsured policies, less claims payments, ceding commissions and risk charges, is credited to a notional experience account, which is held for the Company's benefit in the event of commutation and recapture following December 31, 2007. The notional experience account balance receives an investment credit based upon the total return of a series of benchmark indices and derivative hedges, which are designed to closely match the duration of reserve liabilities. Periodic changes in the market values of the benchmark indices and derivative hedges are recorded in the Company's financial statements as investment gains or losses in the period in which they occur. As a result, the Company's financial statements are subject to significant volatility. During the period ending March 31, 2002, the Company recorded a net loss of $17,110 resulting from the total return of the benchmark portfolio during the period.

The reinsurance agreement contains commutation provisions and allows the Company to recapture the reserve liabilities and the current experience account balance as of December 31, 2007, or on December 31 of any year thereafter. The Company intends to commute the treaty on December 31, 2007; therefore, it is accounting for the reinsurance agreements in anticipation of this commutation. In the event the Company does not commute the agreements on December 31, 2007, it will be subject to escalating expenses. Additionally, the reinsurance provisions contain covenants and conditions that, if breached, may result in the immediate commutation of the agreement and the payment of $2,500 per quarter from the period of the breach through December 31, 2007. These covenants include, but are not limited to, no material breach and insolvency.

As part of the agreement, the reinsurer was granted four tranches of warrants to purchase non-voting shares of convertible preferred stock. The first three tranches of convertible preferred stock are exercisable through December 31, 2007 at common stock equivalent prices ranging from $4.00 to $12.00 per share, if converted. The reinsurer, at its sole discretion, may execute a cash exercise or a cashless exercise. If exercised for cash, at the reinsurer's option, the warrants could yield additional capital and liquidity of approximately $20,000 and, if converted, would represent ownership of approximately 15% of the outstanding shares of our common stock. If the agreement is not commuted following December 31, 2007, the reinsurer may exercise the fourth tranche of warrants for common stock equivalent prices of $2.00 per share, if converted, potentially generating additional capital of

$12,000 and representing an additional 20% of the then outstanding common stock. The reinsurer is under no obligation to exercise any of the warrants.

The warrants are part of the consideration for the reinsurance contract and are recognized as premium expense over the anticipated life of the contract. The warrants were valued at the issuance date using a Black-Scholes model with the following assumptions: 6.0 years expected life, volatility of 70.9% and a risk free rate of 4.74%. The $15,855 value of the warrants was recorded as a deferred premium as of December 31, 2001. $660 of the deferred premium was amortized to expense during the three months ended March 31, 2002.

3. Contingencies:

The Company and certain of its key executive officers are defendants in consolidated actions that were instituted on April 17, 2001 in the United States District Court for the Eastern District of Pennsylvania by shareholders of the Company, on their own behalf and on behalf of a putative class of similarly situated shareholders who purchased shares of the Company's common stock between July 23, 2000 through and including March 29, 2001. The consolidated amended class action complaint seeks damages in an unspecified amount for losses allegedly incurred as a result of misstatements and omissions allegedly contained in the Company's periodic reports filed with the SEC, certain press releases issued by the Company, and in other statements made by its officials. The alleged misstatements and omissions relate, among other matters, to the statutory capital and surplus position of the Company's largest subsidiary, PTNA. On December 7, 2001, the defendants filed a motion to dismiss the complaint, which is currently pending. The Company believes that the complaint is without merit, and it and its executives will continue to vigorously defend the matter.

4. Investments:

Management has categorized all of its investment securities as available for sale since they may be sold in response to changes in interest rates, prepayments and similar factors. Investments in this category are reported at their current market value with net unrealized gains and losses, net of the applicable deferred income tax effect, being added to or deducted from the Company's total shareholders' equity on the balance sheet. As of March 31, 2002, shareholders' equity was increased by $578 due to unrealized gains of $875 in the investment portfolio. As of December 31, 2001, shareholders' equity was increased by $10,581 due to unrealized gains of $16,032 in the investment portfolio.

The amortized cost and estimated market value of the Company's available for sale investment portfolio as of March 31, 2002 and December 31, 2001 are as follows:

	March 31, 2002		December 31,
	Amortized Cost	Estimated Market Value	Amortized Cost

U.S. Treasury securities and obligations of U.S. Government authorities and agencies	$ 12,284	$ 13,006	$ 164,712
Obligations of states and political sub-divisions	-	-	572
Mortgage backed securities	2,025	2,029	42,587
Debt securities issued by foreign governments	206	207	11,954
Corporate securities	6,489	6,637	243,793
Equities	-	-	8,760
Policy Loans	196	196	181
Total Investments	$ 21,200	$ 22,075	$ 472,559
Net unrealized gain	875		16,032
	$ 22,075		$ 488,591

The majority of the Company's investment portfolio was transferred to the reinsurer as part of the initial premium paid for the Company's December 31, 2001 reinsurance transaction.

Pursuant to certain statutory licensing requirements, as of March 31, 2002, the Company had on deposit bonds aggregating $8,447 in Insurance Department special deposit accounts. The Company is not permitted to remove the bonds from these accounts without approval of the regulatory authority.

5. New Accounting Principles:

In June 2001, the Financial Accounting Standards Board ("FASB") issued two Statements of Financial Accounting Standards ("SFAS"). SFAS No. 141, "Business Combinations," requires usage of the purchase method for all business combinations initiated after June 30, 2001, and prohibits the usage of the pooling of interests method of accounting for business combinations. The provisions of SFAS No. 141 relating to the application of the purchase method are generally effective for business combinations completed after July 1, 2001. Such provisions include guidance on the identification of the acquiring entity, the recognition of intangible assets other than goodwill acquired in a business combination and the accounting for negative goodwill. The transition provisions of SFAS No. 141 require an analysis of goodwill acquired in purchase business combinations prior to July 1, 2001 to identify and reclassify separately identifiable intangible assets currently recorded as goodwill.

SFAS No. 142, "Goodwill and Other Intangible Assets," primarily addresses the accounting for goodwill and intangible assets subsequent to their acquisition. The Company adopted SFAS No. 142 on January 1, 2002 and ceased amortizing goodwill at that time. All goodwill recognized in the Company's consolidated balance sheet at January 1, 2002 has been assigned to one or more reporting units. Goodwill in each reporting unit will be tested for impairment by June 30, 2002. An impairment loss recognized as a result of a transitional impairment test of goodwill, if necessary, will be reported as the cumulative effect of a change in accounting principle. Management has completed an assessment of other intangible assets and as determined to continue to amortize these assets so as to closely match the future profit emergence from these assets.

The Company's book value is currently in excess of its market value, which will require an analysis of the goodwill at the reporting unit level. Management has not yet completed this analysis to determine the extent of impairment, if any. No goodwill was amortized for the three months ended March 31, 2002. For the three months ended March 31, 2001, the Company amortized $323 of goodwill.

6. Reconciliation of Earnings Per Share:

A reconciliation of the numerator and denominator of the basic earnings per share computation to the numerator and denominator of the diluted earnings per share computation follows. Basic earnings per share excludes dilution and is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Anti-dilutive effects are not included.

	Three Months Ended March 31,	
	2002	2001
Net income	$ (13,626)	$ (2,336)
Weighted average common shares outstanding	18,853	7,288
Basic earnings per share	$ (0.72)	$ (0.32)
Net income	$ (13,626)	$ (2,336)
Adjustments net of tax:		
Interest expense on convertible debt	-	-
Amortization of debt offering costs	-	-
Diluted net income	$ (13,626)	$ (2,336)
Weighted average common shares outstanding	18,853	7,288
Common stock equivalents due to dilutive effect of stock options	-	-
Shares converted from convertible debt	-	-
Total outstanding shares for diluted earnings per share computation	18,853	7,288
Diluted earnings per share	$ (0.72)	$ (0.32)

7. Equity Placement:

In March 2002, the Company completed a private placement of 510 shares of common stock for net proceeds of approximately $2,372. The common stock was sold to several current and new institutional investors, at $4.65 per share. The offering price was a 10 percent discount to the 30-day average price of our common stock prior to the issuance of the new shares. Our common stock is listed on the New York Stock Exchange. The Company intends to file a registration statement with the Securities and Exchange Commission on or before June 5, 2002.

The proceeds of the private placement provided additional liquidity to the parent company to meet its current year debt service obligations. The proceeds, together with currently available cash sources, are not sufficient to meet the December 2003 final interest requirement of the debt or to retire the debt upon maturity.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Overview

Our principal products are individual, defined benefit accident and health insurance policies that consist of nursing home care, home health care, Medicare supplement and long-term disability insurance. We experienced significant reductions in new premium sales during 2001 due to the cessation of new business generation in all states and as a result of market concerns regarding our insurance subsidiaries' statutory surplus. Under our Corrective Action Plan, which was approved by the Pennsylvania Insurance Department (the "Department") in February 2002, we recommenced sales in certain states, but intend to limit new business growth to levels that will allow us to maintain sufficient statutory surplus. Our underwriting practices rely upon the base of experience that we have developed in over 29 years of providing nursing home care insurance, as well as upon available industry and actuarial information. As the home health care market has developed, we have encouraged our customers to purchase both nursing home and home health care coverage, thus providing our policyholders with enhanced protection and broadening our policy base.

Our insurance subsidiaries are subject to the insurance laws and regulations of the states in which they are licensed to write insurance. These laws and regulations govern matters such as payment of dividends, settlement of claims and loss ratios. State regulatory authorities must approve premiums charged for insurance products. In addition, our insurance subsidiaries are required to establish and maintain reserves with respect to reported and incurred but not reported losses, as well as estimated future benefits payable under our insurance policies. These reserves must, at a minimum, comply with mandated standards. For a description of current regulatory matters affecting our insurance subsidiaries, see "Liquidity and Capital Resources" and "Subsidiary Operations."

Our results of operations are affected significantly by the following other factors:

Level of required reserves for policies in-force. The amount of reserves relating to reported and unreported claims incurred is determined by periodically evaluating historical claims experience and statistical information with respect to the probable number and nature of such claims. Claim reserves reflect actual experience through the most recent time period. We compare actual experience with estimates and adjust our reserves on the basis of such comparisons. Revisions to reserves are reflected in our current results of operations through benefits to policyholders.

We also maintain reserves for policies that are not currently on claim based upon actuarial expectations that a policy may go on claim in the future. These reserves are calculated based on factors that include estimates for mortality, morbidity, interest rates, premium rate increases and persistency. Factor components generally include assumptions that are consistent with both our experience and industry practices.

Policy premium levels. We attempt to set premium levels to maximize profitability. Premium levels on new products, as well as rate increases on existing products, are subject to government review and regulation.

Deferred policy acquisition costs. In connection with the sale of our insurance policies, we defer and amortize a portion of the policy acquisition costs over the related premium paying periods of the life of the policy. These costs include all expenses that are directly related to, and vary with, the acquisition of the policy, including commissions, underwriting and other policy issue expenses. The amortization of deferred policy acquisition costs ("DAC") is determined using the same projected actuarial assumptions used in computing policy reserves. DAC can be affected by unanticipated terminations of policies because, upon such terminations, we are required to expense fully the DAC associated with the terminated policies.

The number of years a policy has been in in-force. Claims costs tend to be higher on policies that have been in-force for a longer period of time. As the insured ages, it is more likely that the insured will need services covered by the policy. However, the longer the policy is in effect, the more premium we receive.

Investment income. Our investment portfolio consists primarily of investment grade fixed income securities. Income generated from this portfolio is largely dependent upon prevailing levels of interest rates. Due to the duration of our investments (approximately 5.0 years), investment income does not immediately reflect changes in market interest rates.

Experience account. In February, 2002, and in connection with our December 31, 2001 reinsurance agreement, we transferred substantially all of our investment portfolio to our reinsurer. The reinsurer will maintain a notional experience account for our benefit that includes the initial premium paid, all future cash flows from the reinsured business and accumulated investment earnings. The notional experience account balance will receive an investment credit based upon the total return of a series of benchmark indices and derivative hedges, which are designed to closely match the duration of our reserve liabilities. Periodic changes in the market values of the benchmark indices and derivative hedges are recorded in our financial statements as investment gains or losses in the period in which they occur. As a result, our future financial statements are subject to significant volatility.

Lapsation and persistency. Factors that affect our results of operations include lapsation and persistency, both of which relate to the renewal of insurance policies. Lapsation is the termination of a policy by non-renewal. Lapsation is automatic if and when premiums become more than 31 days overdue although, in some cases, a lapsed policy may be reinstated within six months. Persistency represents the percentage of premiums renewed, which we calculate by dividing the total annual premiums at the end of each year (less first year premiums for that year) by the total annual premiums in-force for the prior year. For purposes of this calculation, a decrease in total annual premiums in-force at the end of any year would be the result of non-renewal of policies, including policies that have terminated by reason of death, lapsed due to nonpayment of premiums and/or been converted to other policies we offered. First year premiums are premiums covering the first twelve months a policy is in-force. Renewal premiums are premiums covering all subsequent periods.

Policies renew or lapse for a variety of reasons, both internal and external. We believe that our efforts to address policyholder concerns or questions help to ensure policy renewals. We also believe that we enjoy a favorable reputation among policyholders for providing desirable policy benefits and efficient claims processing. We work closely with our licensed agents, who play an integral role in policy conservation and policyholder communication.

External factors also contribute to policy renewal or lapsation. Economic cycles can influence a policyholder's ability to continue the payment of insurance premiums when due. We believe that tax relief for certain long-term care insurance premiums and other governmental initiatives, which have raised public awareness of the escalating costs of long-term care, increase new sales and renewal payments. The ratings assigned to our insurance subsidiaries by independent rating agencies also influence consumer decisions.

Lapsation and persistency can both positively and adversely impact future earnings. Reduced lapses and higher persistency generally result in higher renewal premiums and lower amortization of deferred acquisition costs, but may lead to increased claims in future periods. Higher lapsation can result in reduced premium collection, a greater percentage of higher-risk policyholders, and accelerated expensing of deferred acquisition costs. However, higher lapsation may lead to decreased claims in future periods.

Results of Operations

Three Months Ended March 31, 2002 and 2001
(amounts in thousands, except per share data)

Premiums. Total premium revenue earned in the three month period ended March 31, 2002 (the "2002 quarter"), including long-term care, disability, life and Medicare supplement, decreased 12.3% to $84,236, compared to $96,019 in the same period in 2001 (the "2001 quarter").

Total first year premium earned in the 2002 quarter decreased 88.6% to $2,275, compared to $19,910 in the 2001 quarter. First year long-term care premiums earned in the 2002 quarter decreased 89.4% to $2,037, compared to $19,225 in the 2001 quarter. We experienced significant reductions in new premium sales due to the cessation of new business generation in all states and as a result of market concerns regarding our insurance subsidiaries' statutory surplus. As a result, expect to experience similar declines in future quarters compared to comparable prior periods. Under our Corrective Action Plan (the "Plan"), which was approved by the Pennsylvania Insurance Department (the "Department") in the 2002 quarter, we recommenced sales in certain states, but intend to limit new business growth to levels that will allow us to maintain sufficient statutory surplus. See "Liquidity and Capital Resources."

Effective September 10, 2001, we determined to discontinue the sale nationally of all new long-term care insurance policies until the Plan was completed and approved by the Department. This decision resulted from our concern about further depletion of statutory surplus from new sales prior to the completion and approval of the Plan and from increasing concern with respect to the status of the Plan expressed by many states in which the Company is licensed to conduct business. Upon the approval by the Department of the Plan in February 2002, we recommenced new sales in 23 states. We have since recommenced sales in 3 additional states. We are actively working with all states in order to recommence sales in all remaining jurisdictions.

Total renewal premiums earned in the 2002 quarter increased 7.7% to $81,961, compared to $76,108 in the 2001 quarter. Renewal long-term care premiums earned in the 2002 quarter increased 9.8% to $79,276, compared to $72,176 in the 2001 quarter. This increase reflects renewals of a larger base of in-force policies. We may experience reduced renewal premiums in the future if policies lapse, especially given our recent premium rate increases that are anticipated to cause additional policy lapses. Current declines in first year premiums, as discussed above, will negatively impact future renewal premium growth.

Net Investment Income. Net investment income earned for the 2002 quarter decreased 89.7% to $692, from $6,725 for the 2001 quarter. This decline resulted from the transfer of substantially all of our invested assets to our reinsurer as initial premium ceded for our reinsurance agreement, which was effective December 31, 2001. See "Liquidity and Capital Resources." Our average yield on invested assets at cost, including cash and cash equivalents, was 6.51% and 5.40%, respectively, in the 2002 and 2001 quarters. The higher yield in the 2002 period resulted from having investments only in higher yielding bonds, rather than in common stocks as were present in the 2001 quarter.

Net Realized Capital Gains and Trading Account Activity. During the 2002 quarter, we recognized capital gains of $14,523, compared to capital losses of $1,566 in the 2001 quarter. The gains recognized in the 2002 quarter resulted from the transfer of substantially all of our invested assets to our reinsurer. The results in the 2001 quarter were recorded as a result of our normal investment management operations.

During the 2001 quarter, we classified our convertible bond portfolio as trading account investments. Changes in trading account investment market values were recorded in our statement of operations during the period in which the change occurred, rather than as an unrealized gain or loss recorded directly through equity. As a result, we recorded a trading account loss in the 2001 quarter of $1,723, which reflected the unrealized and realized loss of our convertible portfolio that arose during that quarter. No investments were classified as trading during the 2002 quarter.

Investment credit on experience account. In connection with our December 31, 2001 reinsurance agreement, we recorded an investment loss of $17,110 on the experience account maintained by the reinsurer. The notional experience account balance will receive an investment credit based upon the total return of a series of benchmark indices and derivative hedges, which are designed to closely match the duration of our reserve liabilities. Periodic changes in the market values of the benchmark indices and derivative hedges are recorded in our financial statements as investment gains or losses in the period in which they occur. As a result, our future financial statements are subject to significant volatility.

Other Income. We recorded $2,770 in other income during the 2002 quarter, up from $2,400 in the 2001 quarter. The increase is attributable primarily to an increase in commissions earned by United Insurance Group on sales of insurance products underwritten by unaffiliated insurers and to income generated from our ownership of corporate owned life insurance policies.

Benefits to policyholders. Total benefits to policyholders in the 2002 quarter increased 11.2% to $80,187, compared to $72,137 in the 2001 quarter. Our loss ratio, or policyholder benefits to premiums, was 95.2% in the 2002 quarter, compared to 75.1% in the 2001 quarter.

During the 2002 quarter, we increased our policy reserves by approximately $16,500 above the levels that we would have normally anticipated. This increase in reserves resulted from the following:

(1) We establish reserves utilizing expectations for future events, including anticipated lapses. We generally assume that those policies expected to lapse are representative of the total in-force policy base and that we will thereby maintain a similar composition of in-force policies in future periods. During the 2002 quarter, we experienced shifts in the general composition of our policyholder base that caused us to hold an additional $11,000 in policy reserves at March 31, 2002, compared to our expectations. We have determined that the composition of policyholders at March 31, 2002 differed from the mix at December 31, 2001. This shift resulted in a higher than expected number of policies with features that require additional reserves to be held for future benefits, including more policies with inflation protection, more skilled facility care policies and reduced elimination periods. This change in the composition of our policies occurred as a result of higher lapses of policies without these features rather than as a result of new sales.

(2) Also, policy persistency, or the retention of renewing policies, also increased by 0.3% during the 2002 quarter, which generated additional policy reserves of approximately $5,500. This increase was only partially offset by higher premium revenue and lower amortization of deferred policy acquisition costs.

Historically, more new claims are reported during the first quarter than in later quarters. We refer to this as seasonality. As a result, this seasonality generates higher incurred claim ratios in the first quarter than in subsequent quarters. In the 2002 quarter, management estimates that approximately $5,000 in higher incurred claims resulted from this seasonality of reported claims. While the number of newly reported claims exceeded our "non-seasonally" adjusted expectations in the 2002 quarter, our paid loss ratio of 48% was as we expected.

Claims experience can differ from our expectations due to numerous factors, including mortality rates, duration of care and type of care utilized. When we experience deviation from our estimates, we typically seek premium rate increases that are sufficient to offset future deviation. During the third quarter 2001, we filed for premium rate increases on the majority of our policy forms. These rate increases were sought as a result of higher claims expectations and policyholder persistency than existed at the time of the original form filings. The assumptions used in requesting and supporting the premium rate increase filings are consistent with those incorporated in our newest policy form offerings. We have currently received approval for approximately 85% of the rate increases requested. We have been generally successful in the past in obtaining state insurance department approvals for increases. If we are unsuccessful in obtaining rate increases when deemed necessary, or if we do not pursue rate increases when actual claims experience exceeds our expectations, we would suffer a financial loss.

Commissions. Commissions to agents decreased 48.7% to $12,830 in the 2002 quarter, compared to $24,988 in the 2001 quarter.

First year commissions on accident and health business in the 2002 quarter decreased 88.7% to $1,456, compared to $12,889 in the 2001 quarter, due to the decrease in first year accident and health premiums. The ratio of first year accident and health commissions to first year accident and health premiums was 64.0% in the 2002 quarter and 65.6% in the 2001 quarter. We believe that the decrease in the first year commission ratio is primarily attributable to the increased sale of our Secured Risk policy, which pays a lower, limited commission. Our Secured Risk policy provides limited benefits to higher risk policyholders at a substantially increased premium rate. We believe that we are likely to experience an increase in the sale of these policies while we reenter sales in many states as a result of our lower financial ratings.

Renewal commissions on accident and health business in the 2002 quarter decreased 2.1% to $12,248, compared to $12,515 in the 2001 quarter, due to the decrease in renewal premiums discussed above. The ratio of renewal accident and health commissions to renewal accident and health premiums was 15.1% in the 2002 quarter and 16.9% in the 2001 quarter. This ratio reflects the sale of more Secured Risk and Medicare Supplement policies in the 2001 quarter, which pay no or reduced renewal commissions.

During the 2002 quarter, we reduced commission expense by netting $780 from override commissions affiliated insurers paid to our agency subsidiaries. During the 2001 quarter, we reduced commissions by $992.

Net policy acquisition costs deferred. The net deferred policy acquisition costs in the 2002 quarter decreased to $3,326, compared to $5,397 in the 2001 quarter.

Deferred costs are typically all costs that are directly related to, and vary with, the acquisition of new premiums. These costs include the variable portion of commissions, which are defined as the first year commission rate less ultimate renewal commission rates, and variable general and administrative expenses related to policy underwriting. Deferred costs are amortized over the life of the policy based upon actuarial assumptions, including persistency of policies in-force. In the event a policy lapses prematurely due to death or termination of coverage, the remaining unamortized portion of the deferred amount is immediately recognized as expense in the current period.

The net amortization of deferred policy acquisition costs is effected by new business generation, imputed interest on prior reserves and policy persistency. During the 2002 quarter, higher policy persistency (as noted under "Premiums") than was anticipated at December 31, 2001, resulted in reduced amortization of deferred policy acquisition costs. The deferral of costs and the imputed interest exceeded the amortization of deferred policy acquisition costs for the period, resulting in a net increase in deferred policy acquisition costs, and a related income statement benefit of approximately $3,000.

The amortization of deferred costs is generally offset largely by the deferral of costs associated with new premium generation. Lower new premium sales during the 2001 quarter produced significantly less expense deferral to offset amortized costs.

General and administrative expenses. General and administrative expenses in the 2002 quarter decreased 15.2% to $10,712, compared to $12,634 in the 2001 quarter. The 2002 and 2001 quarters include $1,657 and $1,626, respectively of general and administrative expenses related to United Insurance Group expense. The ratio of total general and administrative expenses to premium revenues, excluding United Insurance Group, was 11.0% in the 2002 quarter, compared to 11.5% in the 2001 quarter.

Expenses have declined as a result of reduced new premium sales and management initiatives to reduce operating expenses. However, we believe that if we remain unable to write new business in certain states where we have ceased new production, or if we are unable to utilize our existing staff and infrastructure capacity to generate additional premiums, we will need to decrease production expenses further.

Expense and risk charges on reinsurance and excise tax expense. Our reinsurance agreement provides the reinsurer with annual expense and risk charges, which are charged against our experience account in the event of future commutation of the agreement. The annual charge consists of a fixed cost and a variable component based upon reserve and capital levels needed to support the reinsured business. In the 2002 quarter, we accrued $3,577 for this charge. In addition, we are subject to an excise tax for premium payments made to a foreign reinsurer. We recorded $581 for excise tax expenses in the 2002 quarter.

Provision for federal income taxes. Our benefit for federal income taxes for the 2002 quarter increased 683.5% to $7,020, compared to an income tax benefit of $1,203 for the 2001 quarter. The effective tax rate of 34% in the 2002 and 2001 quarters is below the normal federal corporate rate as a result of anticipated credits from our investments in corporate owned life insurance that are partially offset by non-deductible goodwill amortization and other non-deductible expenses.

Comprehensive income. During the 2002 quarter, our investment portfolio generated pre-tax unrealized losses of $634, compared to unrealized gains of $5,139 in the 2001 quarter. After accounting for deferred taxes from these losses and gains, shareholders' equity decreased by $23,629 from comprehensive losses during the 2002 quarter, compared to comprehensive income of $3,227 in the 2001 quarter.

Liquidity and Capital Resources

Our consolidated liquidity requirements have historically been created and met from the operations of our insurance subsidiaries, from our agency subsidiaries and from funds raised in the capital markets. Our primary sources of cash are premiums, investment income and maturities of investments. We have obtained, and may in the future obtain, cash through public and private offerings of our common stock, the exercise of stock options and warrants, other capital markets activities or debt instruments. Our primary uses of cash are policy acquisition costs (principally commissions), payments to policyholders, investment purchases and general and administrative expenses.

In the 2002 period, our cash flows were attributable to cash provided by operations, cash used in investing and cash provided by financing. Our cash decreased $87,689 in the 2002 period primarily due to payments made to our reinsurer and from the purchase of $12,908 in bonds and equity securities. Cash was provided primarily from the maturity and sale of $478,795 in bonds and equity securities. These sources of funds were supplemented by $13,797 from operations. The major provider of cash from operations was premium and investment income received.

Our cash decreased $35,855 in the 2001 period primarily due to the purchase of $94,766 in bonds and equity securities. Cash was provided primarily from the maturity and sale of $29,778 in bonds and equity securities. These sources of funds were supplemented by $32,256 from operations. The major provider of cash from operations was premium revenue used to fund reserve additions of $36,215.

We invest in securities and other investments authorized by applicable state laws and regulations and follow an investment policy designed to maximize yield to the extent consistent with liquidity requirements and preservation of assets. As of March 31, 2002, shareholders' equity was increased by $578 due to unrealized gains of $875 in the investment portfolio. As of December 31, 2001, shareholders' equity was increased by $10,581 due to unrealized gains of $16,032 in the investment portfolio.

Subsidiary Operations

Our insurance subsidiaries are regulated by various state insurance departments. In its ongoing effort to improve solvency regulation, the National

Association of Insurance Commissioners ("NAIC") has adopted Risk-Based Capital ("RBC") requirements for insurance companies to evaluate the adequacy of statutory capital and surplus in relation to investment and insurance risks, such as asset quality, mortality and morbidity, asset and liability matching, benefit and loss reserve adequacy, and other business factors. The RBC formula is used by state insurance regulators as an early warning tool to identify, for the purpose of initiating regulatory action, insurance companies that potentially are inadequately capitalized. In addition, the formula defines minimum capital standards that an insurer must maintain. Regulatory compliance is determined by a ratio of the enterprise's regulatory Total Adjusted Capital, to its Authorized Control Level RBC, as defined by the NAIC. Companies below specific trigger points or ratios are classified within certain levels, each of which may require specific corrective action depending upon the insurer's state of domicile.

Our subsidiaries are required to hold statutory surplus that is, at a minimum, above a calculated mandatory control level at which the Pennsylvania Insurance Department (the "Department") would be required to place our subsidiaries under regulatory control, leading to rehabilitation or liquidation. Insurers are obligated to hold additional statutory surplus above the mandatory control level. At December 31, 2000, our primary insurance subsidiary, representing 94% of our direct premium, had Total Adjusted Capital at the Regulatory Action level. As a result, it was required to file a Corrective Action Plan (the "Plan") with the insurance commissioner.

On February 12, 2002, the Department approved the Plan. As a primary component of the Plan, effective December 31, 2001, we entered a reinsurance transaction to reinsure, on a quota share basis, substantially all of our respective long-term care insurance policies then in-force. The agreement is subject to certain coverage limitations, including an aggregate limit of liability that is a function of certain factors and that may be reduced in the event that the rate increases that the reinsurance agreement may require are not obtained. The agreement meets the requirements to qualify as reinsurance for statutory accounting, but not for generally accepted accounting principles.

The initial premium of the treaties was approximately $619,000, comprised of $563,000 of cash and qualified securities transferred in February 2002, and $56,000 as funds held due to the reinsurer. The initial premium and future cash flows from the reinsured policies, less claims payments, ceding commissions and risk charges, is credited to a notional experience account, which is held for our benefit in the event of commutation and recapture on or after December 31, 2007. The notional experience account balance receives an investment credit based upon the total return from a series of benchmark indices and derivative hedges that are intended to match the duration of our reserve liability.

The agreement contains commutation provisions and allows us to recapture the reserve liabilities and the current experience account balance as of December 31, 2007 or on December 31 of any year thereafter. If we choose not to or are unable to commute the agreement as planned, our financial results would likely suffer a materially adverse impact due to an escalation of the charges paid to the reinsurer. Additionally, our reinsurance provisions contain significant covenants and conditions that, if breached, could result in a significant loss, requiring a payment of $2.5 million per quarter from the period of the breach through December 31, 2007. Any breach of the reinsurance agreement may also result in the immediate recapture of the reinsured business, which would have a negative on our subsidiaries' statutory surplus. Management has completed an assessment of its ability to avoid any breach through 2002 and believes that the insurance subsidiaries will remain compliant. In addition, the reinsurer has been granted warrants to acquire convertible preferred stock in the event we do not commute the agreements that, if converted, would represent an additional 20 percent of the common stock then outstanding.

The Plan requires our subsidiary to comply with certain other agreements at the direction of the Department, including, but not limited to:

- New investments are limited to NAIC 1 or 2 rated securities.

- Affiliated transactions are limited and require Department approval.

- An agreement to increase statutory reserves; the reinsurance agreement has provided the capacity to accommodate this increase and will provide an additional $80,000 throughout 2002-2004, such that the our insurance subsidaries' policy reserves will be based on new, current claims assumptions and will not include any rate increases. These claim assumptions are applied to all policies, regardless of issue year and are assumed to have been present since the policy was first issued.

Effective September 10, 2001, we determined to discontinue the sale nationally of all new long-term care insurance policies until the Plan was approved by the Department. The decision resulted from our concern about further depletion of statutory surplus from new sales prior to the completion and approval of the Plan and from increasing concern regarding our status by many states in which we are licensed to conduct business. The form of our cessation varied by state, ranging from no action to certificate suspensions.

Upon the approval by the Department of the Plan in February 2002, we recommenced new sales in 23 states. We have since recommenced sales in 3 additional states. We are actively working with all states in order to recommence sales in all remaining jurisdictions.

The majority of our insurance subsidiaries' cash flow results from our existing long-term care policies, which will be ceded to the reinsurer under this agreement. Our subsidiaries' ability to meet additional liquidity needs and fixed expenses in the future is highly dependent upon our ability to issue new policies and to control expense growth.

Our future growth is dependent upon our ability to continue to expand our historical markets, retain and expand our network of agents and effectively market our products and our ability to fund our marketing and expansion while maintaining minimum statutory levels of capital and surplus required to support such growth.

We are unlikely in the foreseeable future to be able to make dividend payments from our two largest insurance subsidiaries. Additionally, the Plan requires the Department to approve all dividend requests, regardless of statutory allowances. However, our New York subsidiary is not subject to the Plan and was permitted by New York statute to make a dividend payment following December 31, 2001. During the 2002 quarter, we received a dividend from our New York subsidiary of $651.

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Our subsidiaries' debt currently consists primarily of a mortgage note in the amount of approximately $1,560 that was issued by a former subsidiary and assumed by us when that subsidiary was sold. The mortgage note is currently amortized over 15 years, and has a balloon payment due on the remaining outstanding balance in December 2003. Although the note carries a variable interest rate, we have entered into an amortizing swap agreement with the same bank with a nominal amount equal to the outstanding debt, which has the effect of converting the note to a fixed rate of interest of 6.85%.

Parent Company Operations

Our parent company is a non-insurer that directly controls 100% of the voting stock of our insurance subsidiaries. If we are unable to meet our financial obligations, become insolvent or discontinue operations, the financial condition and results of operations of our insurance subsidiaries could be materially affected.

On April 27, 2001, we distributed rights to our shareholders and holders of our 6.25% convertible subordinated notes due 2003 ("Rights Offering") for the purpose of raising new equity capital. Pursuant to the Rights Offering, holders of our common stock and holders of our convertible subordinated notes received rights to purchase 11,547 newly issued shares of common stock at a set price of $2.40 per share. The Rights Offering was completed on May 25, 2001 and generated net proceeds of $25,726 in additional equity capital. We contributed $18,000 of the net proceeds to the statutory capital of our subsidiaries.

Parent company debt currently consists of $74,750 of 6.25% Convertible Subordinated Notes due 2003. The convertible subordinated notes, issued in November 1996, are convertible into common stock at $28.44 per share until maturity in December 2003. At maturity, to the extent that the convertible subordinated notes have not been converted into common stock, we will have to repay their entire principal amount in cash. The convertible subordinated notes carry a fixed interest coupon of 6.25%, payable semi-annually. Because we do not have sufficient cash flow to retire the debt upon maturity, and the conversion price of $28.44 per share is not likely to be met, we expect that we will need to refinance our 6.25% Convertible Subordinate Notes on or before maturity in 2003. The terms of any such refinancing are not yet known, or if refinancing is achievable. We cannot give assurance that these terms will not be materially adverse to our existing shareholders' interests.

On January 1, 1999, we purchased all of the common stock of United Insurance Group, a Michigan based consortium of long-term care insurance agencies, for $18,192. As part of the purchase, we issued a note payable for $8,078, which was in the form of a three-year zero-coupon installment note. The installment note, after discounting for imputed interest, was recorded as a note payable of $7,167, and had an outstanding balance of $2,858 at December 31, 2001. The remainder of the purchase was paid in cash. The total outstanding balance of the note was repaid in January 2002.

At March 31, 2002, our total debt and financing obligations through 2006 are as follows:

			Lease
	Debt	Commitments	Total
2002	$ -	$ 325	$ 325
2003	76,212	344	76,556
2004	-	252	252
2005	-	18	18
2006	-	18	18
Total	$ 76,212	$ 957	$ 77,169

Amounts subsequent to 2006 are immaterial.

In December 1999, we contributed $1,000 to initially capitalize another subsidiary, which concurrently lent us $750 in exchange for a demand note, which is still outstanding.

As part of our reinsurance agreement, effective December 31, 2001, the reinsurer was granted four tranches of warrants to purchase non-voting shares of convertible preferred stock. The first three tranches of convertible preferred stock are exercisable through December 31, 2007 at common stock equivalent prices ranging from $4.00 to $12.00 per share if converted. If exercised for cash, at the reinsurer's option, the warrants could yield additional capital and liquidity of approximately $20,000 and would represent, if converted, approximately 15% of the outstanding shares of our common stock. If the agreement is not commuted on or after December 31, 2007, the reinsurer may exercise the fourth tranche of warrants for common stock equivalent prices of $2.00 per share if converted, potentially generating additional capital of $12,000 and representing an additional 20% of the then outstanding common stock. No assurance can be given that the reinsurer will exercise any or all of the warrants granted or that it will pay cash in connection with their exercise.

Cash flow needs of the parent company primarily include interest payments on outstanding debt and limited operating expenses. The funding is primarily derived from the operating cash flow of our agency subsidiary operations and dividends from the insurance subsidiaries. However, as noted above, the dividend capabilities of the insurance subsidiaries are limited and the only insurance company that can pay dividends is American Independent Network Insurance Company of New York. While we intend to sell this insurance subsidiary in order to generate additional parent company liquidity, we cannot assure that this will be accomplished during 2002. In the event the sale is not completed, we may need to rely upon the dividend capabilities of our agency subsidiaries to meet current liquidity needs. These sources of funds, however, are expected to be insufficient to meet our future needs beyond June 30, 2003, including the repayment of $74,750 million of long-term debt in December 2003.

In March 2002, we completed a private placement of 510 shares of common stock for net proceeds of approximately $2,400. The common stock was sold to several current and new institutional investors, at $4.65 per share. The offering price was a 10 percent discount to the 30-day average price of our common stock prior to the issuance of the new shares. Our common stock is listed on the New York Stock Exchange. We have agreed to file a registration statement with the Securities and Exchange Commission on or before June 5, 2002 to register these shares for resale. The proceeds of the private placement provided sufficient additional liquidity to the parent company to meet our debt obligations prior to the maturity of the convertible debt in 2003. The proceeds, together with currently available cash sources, are not sufficient to meet the December 2003 final interest requirement of the debt or to retire the debt upon maturity.

Our liquidity projections, while based upon our best estimates and containing excess margin for our estimated needs, may not be sufficient to meet our obligations throughout 2003. We cannot assure that we will not need additional funding in the event that our liquidity projections are insufficient to meet our future cash needs.

New Accounting Principles

In June 2001, the Financial Accounting Standards Board ("FASB") issued two Statements of Financial Accounting Standards ("SFAS"). SFAS No. 141, "Business Combinations," requires usage of the purchase method for all business combinations initiated after June 30, 2001, and prohibits the usage of the pooling of interests method of accounting for business combinations. The provisions of SFAS No. 141 relating to the application of the purchase method are generally effective for business combinations completed after July 1, 2001. Such provisions include guidance on the identification of the acquiring entity, the recognition of intangible assets other than goodwill acquired in a business combination and the accounting for negative goodwill. The transition provisions of SFAS No. 141 require an analysis of goodwill acquired in purchase business combinations prior to July 1, 2001 to identify and reclassify separately identifiable intangible assets currently recorded as goodwill.

SFAS No. 142, "Goodwill and Other Intangible Assets," primarily addresses the accounting for goodwill and intangible assets subsequent to their acquisition. We adopted SFAS No. 142 on January 1, 2002 and ceased amortizing goodwill at that time. All goodwill recognized in our consolidated balance sheet at January 1, 2002 has been assigned to one or more reporting units. Goodwill in each reporting unit will be tested for impairment by June 30, 2002. An impairment loss recognized as a result of a transitional impairment test of goodwill, if necessary, will be reported as the cumulative effect of a change in accounting principle.

Management has completed an assessment of other intangible assets and as determined to continue to amortize these assets so as to closely match the future profit emergence from these assets.

Our book value is currently in excess of our market value, which will require an analysis of the goodwill at the reporting unit level. We have not yet completed this analysis to determine the extent of impairment, if any.

Forward Looking Statements

Certain statements made by the Company may be considered forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. Although the Company believes that its expectations are based upon reasonable assumptions within the bounds of its knowledge of its business and operations, there can be no assurance that actual results of the Company's operations will not differ materially from its expectations. Factors which could cause actual results to differ from expectations include, among others, the Company's new reinsurance agreement is subject to certain coverage limitations including an aggregate limit of liability, which is a function of certain factors and which may be reduced as a result of our inability to obtain certain rate increases, the ability to file and make effective a registration statement for its newly issued, privately placed shares, whether its Corrective Action Plan will be

accepted and approved by state insurance regulators in addition to the Pennsylvania Department of Insurance, the Company's ability to meet its future risk-based capital goals, the adverse financial impact of suspending new business sales, the Company's ability to raise adequate capital to meet the requirements of anticipated growth and the cost associated with recommencing new business sales, liquidity needs and debt obligations, the possible sale of certain product lines and its New York subsidiary, the adequacy of the Company's loss reserves and the recoverability of its unamortized deferred policy acquisition cost asset, the Company's ability to sell insurance products in certain states, to resume generating new business in all states and to succeed in obtaining necessary rate increases, the Company's ability to comply with government regulations and the requirements which may be imposed by state regulators as a result of the Company's capital and surplus levels, the ability of senior citizens to purchase the Company's products in light of the increasing costs of health care, the ability of the Company to retain its current policyholder base, the ability of the Company to defend itself against adverse litigation, and the Company's ability to recapture, expand and retain its network of productive independent agents, For additional information, please refer to the Company's reports filed with the Securities and Exchange Commission.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We invest in securities and other investments authorized by applicable state laws and regulations and follow an investment policy designed to maximize yield to the extent consistent with liquidity requirements and preservation of assets.

A significant portion of assets and liabilities are financial instruments, which are subject to the market risk of potential losses from adverse changes in market rates and prices. Our primary market risk exposures relate to interest rate risk on fixed rate domestic medium-term instruments and, to a lesser extent, domestic short-term and long-term instruments. We have established strategies, asset quality standards, asset allocations and other relevant criteria for our portfolio to manage our exposure to market risk.

As part of our reinsurance transaction, our reinsurer will maintain a notional experience account for our benefit that includes the initial premium paid, all future cash flows from the reinsured business and accumulated investment earnings. The notional experience account balance will receive an investment credit based upon the total return of a series of benchmark indices and derivative hedges, which are designed to closely match the duration of our reserve liabilities. Periodic changes in the market values of the benchmark indices and derivative hedges are recorded in our financial statements as investment gains or losses in the period in which they occur. As a result, our future financial statements are subject to significant volatility.

We currently have an interest rate swap on our mortgage, which is used as a hedge to convert the mortgage to a fixed interest rate. We believe that, since the notional amount of the swap is amortized at the same rate as the underlying mortgage and both financial instruments are with the same bank, no credit or financial risk is carried with the swap.

Our financial instruments are held for purposes other than trading. Our portfolio does not contain any significant concentrations in single issuers (other than U.S. treasury and agency obligations), industry segments or geographic regions.

We urge caution in evaluating overall market risk from the information below. Actual results could differ materially because the information was developed using estimates and assumptions as described below, and because insurance liabilities and reinsurance receivables are excluded in the hypothetical effects (insurance liabilities represent 84.5% of total liabilities and reinsurance receivables on unpaid losses represent 3.0% of total assets). Long-term debt, although not carried at fair value, is included in the hypothetical effect calculation.

The hypothetical effects of changes in market rates or prices on the fair values of financial instruments as of March 31, 2002, including the value of our experience account, but excluding insurance liabilities and other reinsurance receivables on unpaid losses because such insurance related assets and liabilities are not carried at fair value, would have been as follows:

If interest rates had increased by 100 basis points, there would have been an approximate $31,981,000 decrease in the net fair value of our financial instruments. The change in fair values was determined by estimating the present value of future cash flows using models that measure the change in net present values arising from selected hypothetical changes in market interest rate. A 200 basis point increase in market rates at March 31, 2002 would have resulted in an approximate $60,471,000 decrease in the net fair value. If interest rates had decreased by 100 and 200 basis points, there would have been an approximate $35,932,000 and $76,339,000 net increase, respectively, in the net fair value of our financial instruments.

We hold certain mortgage and asset backed securities as part of our investment portfolio. The fair value of these instruments may react in a convex or non-linear fashion when subjected to interest rate increases or decreases. The anticipated cash flows of these instruments may differ from expectations in changing interest rate environments, resulting in duration drift or a varying nature of predicted time-weighted present values of cash flows. The result of unpredicted cash flows from these investments could cause the above hypothetical estimates to change. However, we believe that the minimal amount we have invested in these instruments and their broadly defined payment parameters sufficiently outweigh the cost of computer models necessary to accurately predict their possible impact to our investment income from the hypothetical effects of changes in market rates or prices on the fair values of financial instruments as of March 31, 2002.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

Our subsidiaries are parties to various lawsuits generally arising in the normal course of their business. We do not believe that the eventual outcome of any of the suits to which we are party will have a material adverse effect on our financial condition or results of operations. However, the outcome of any single event could have a material impact upon the quarterly or annual financial results of the period in which it occurs.

The Company and certain of our key executive officers are defendants in consolidated actions that were instituted on April 17, 2001 in the United States District Court for the Eastern District of Pennsylvania by shareholders of the Company, on their own behalf and on behalf of a putative class of similarly situated shareholders who purchased shares of the Company's common stock between July 23, 2000 through and including March 29, 2001. The consolidated amended class action complaint seeks damages in an unspecified amount for losses allegedly incurred as a result of misstatements and omissions allegedly contained in our periodic reports filed with the SEC, certain press releases issued by us, and in other statements made by our officials. The alleged misstatements and omissions relate, among other matters, to the statutory capital and surplus position of our largest subsidiary, Penn Treaty Network America Insurance Company. On December 7, 2001, the defendants filed a motion to dismiss the complaint, which is currently pending. We believe that the complaint is without merit, and we will continue to vigorously defend the matter.

Item 2. Changes in Securities

Not Applicable

Item 3. Defaults Upon Senior Securities

Not Applicable

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

Not Applicable

Item 5. Other Information

Not Applicable

Item 6. Exhibits and Reports on Form 8-K

Reports on Form 8-K:

February 21, 2002 - Reinsurance Agreement with Centre Solutions (Bermuda) Limited.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant had duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PENN TREATY AMERICAN CORPORATION

Registrant

Date: May 15, 2002 /s/ Irving Levit

Irving Levit
Chairman of the Board, President
and Chief Executive Officer

Date: May 15, 2002 /s/ Cameron B. Waite

Cameron B. Waite
Chief Financial Officer