

ASSOCIATION REPORT ON EXAMINATION  
OF THE  
ZURICH AMERICAN INSURANCE COMPANY  
AS OF  
DECEMBER 31, 2003

ZONES  
REPRESENTED

I  
II  
IV

STATES  
PARTICIPATING

NEW YORK  
MISSISSIPPI  
CALIFORNIA

EXAMINERS

JAMES CALL  
JACQUELINE PARKER  
JOHN PLOZIZKA



STATE OF NEW YORK  
INSURANCE DEPARTMENT  
25 BEAVER STREET  
NEW YORK, NEW YORK 10004

Honorable Mike Pickens  
Chairman, Executive Committee  
Commissioner of Insurance  
State of Arkansas

June 1, 2005

Honorable Janie Miller  
Chairman, Southeastern Zone  
Commissioner of Insurance  
State of Kentucky

Honorable Howard Mills  
Superintendent of Insurance  
State of New York

Honorable Mike Kreidler  
Chairman, Western Zone  
State of Washington

Sirs:

Pursuant to your instructions the examination has been made into the condition and affairs of the Zurich American Insurance Company hereinafter referred to as "the Company", at its administrative office located at 1400 American Lane, Schaumburg, Illinois 60196-1056.

The examination was conducted by the New York State Insurance Department, hereinafter referred to as "the Department" with participation from the State of Mississippi representing the Southeastern Zone and .

The report on examination is respectfully submitted.

REPORT ON EXAMINATION

OF THE

ZURICH AMERICAN INSURANCE COMPANY

AS OF

DECEMBER 31, 2003

DATE OF REPORT

June 1, 2005

EXAMINER

JAMES CALL, CFE

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STATE OF NEW YORK  
INSURANCE DEPARTMENT  
25 BEAVER STREET  
NEW YORK, NEW YORK 10004

June 1, 2005

Honorable Howard Mills  
Superintendent of Insurance  
Albany, New York 12257

Sir:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 22363 dated April 20, 2005, attached hereto, I have made an examination into the condition and affairs of the Zurich American Insurance Company as of December 31, 2003, and submit the following report thereon.

Wherever the designation "the Company" appears herein without qualification, they should be understood to indicate Zurich American Insurance Company.

Whenever the designation "ZAIG" appears herein without qualification, it should be understood to indicate Zurich American Insurance Group.

Wherever the term "Department" appears herein without qualification, it should be understood to mean the New York Insurance Department.

The examination was conducted at the Company's administrative offices located at 1400 American Lane, Schaumburg, Illinois 60196-1056.

Total examination adjustments to the Company's reported assets and liabilities results in negative surplus as to policyholders as of December 31, 2003 of \$1,053,938,846. This reduction is due principally to an examination increase in liabilities for loss and loss adjustment expenses. During 2004, subsequent to the examination date, but while this examination was pending, the Company strengthened its reserves

for loss and loss adjustment expenses for accident years 2003 and prior in the amount of \$2.01 billion and received surplus contributions made by Zurich Holding Company of America (“ZHCA”) and proceeds from the issuance of a surplus note to Zurich Insurance Company (Switzerland) (“ZIC”) totaling \$2.26 billion, as follows (\$000’s omitted):

<u>Date</u>	<u>Type</u>	<u>Amount</u>
12/21/2004	Surplus note from ZIC <sup>1</sup>	\$1,000,000
2004	Repaid previously issued surplus note from ZHCA	(38,700)
02/22/2005	Surplus contribution from ZHCA <sup>2</sup>	<u>1,300,000</u>
	Total	<u>\$2,261,300</u>

<sup>1</sup>: \$800,000 received in 2004 and \$200,000 received on January 27, 2005.

<sup>2</sup>: Reported by the Company as a Type 1 subsequent event in its filed 2004 annual statement.

The Company indicated that the surplus note and contributions were made during 2004 in response to the Company strengthening its reserves for accident years 2003 and prior. The surplus note and contributions had the effect of eliminating the examination surplus deficiency.

It is noted that the examination surplus reflects an additional Schedule F Penalty in the amount of \$262,408,000 as a result of the examination determination of additional loss and loss adjustment expenses. Of this amount, \$208,144,000 would have been eliminated if additional collateral the Company has indicated it obtained in 2004 following its reserve strengthening were in place as of the examination date. It is also noted that the examination surplus includes a not admitted asset in the amount of \$1,369,063,501 for a portion of the Company’s investment in the common stock of its insurance company subsidiaries pursuant to Section 1408(b) of the New York Insurance Law, which limits an insurer’s investment in insurance company subsidiaries to the greater of fifty percent of its surplus to policyholders or sixty percent of its surplus over liabilities and capital. The surplus notes and surplus contributions referenced above would have the effect of eliminating the not admitted asset pursuant to Section 1408(b) of the New York Insurance Law.

## **1. SCOPE OF EXAMINATION**

The previous examination was conducted as of December 31, 1998. This examination covered the five-year period from January 1, 1999 through December 31, 2003. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

The examination comprised a complete verification of assets and liabilities as of December 31, 2003, a review of income and disbursements deemed necessary to accomplish such analysis or verification and utilized, to the extent considered appropriate, work performed by the Company's independent certified public accountants. A review or audit was also made of the following items as called for in the Examiners Handbook of the National Association of Insurance Commissioners:

- History of Company
- Management and control
- Corporate records
- Fidelity bonds and other insurance
- Territory and plan of operation
- Growth of Company
- Business in force by states
- Loss experience
- Reinsurance
- Accounts and records
- Financial statements

A review was also made to ascertain what action was taken by the Company with regard to comments and recommendations contained in the prior report on examination.

This report on examination is confined to financial statements and comments on those matters, which involve departures from laws, regulations or rules, or which are deemed to require explanation or description.

## 2. DESCRIPTION OF COMPANY

Zurich American Insurance Company was incorporated under the laws of the State of New York on June 3, 1998 and commenced business on December 31, 1998. The Company was organized to provide the vehicle for the domestication under Article 72 of the New York Insurance Law of the United States Branch of Zurich Insurance Company (“Branch”). On December 31, 1998, all of the assets and liabilities of the Branch were transferred to the Company and the Branch ceased to exist. The Company is a member of the Zurich American Insurance Group.

The Company is a wholly-owned subsidiary of Zurich Holding Company of America (“ZHCA”), a Delaware holding company, which in turn is 99.87% owned by Zurich Insurance Company (Switzerland). Zurich Insurance Company (Switzerland) is 100% owned by Zurich Group Holding (Switzerland) (“ZGH”). In turn Zurich Financial Services (“ZFS”) (Switzerland) owns 100% of ZGH; 57% directly and 43% indirectly by its 100% ownership of Allied Zurich plc (UK).

Capital paid in is \$5,000,000 consisting of 5,000 shares of common stock at \$1,000 par value per share. Gross paid in and contributed surplus is \$2,206,131,141. Gross paid in and contributed surplus increased by \$1,704,820,290 during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
1/1/99	Beginning gross paid in and contributed surplus	\$ 501,310,851
1999	Contribution of Maryland Casualty from ZHCA	1,265,088,290
1999	Cash contribution from ZHCA	185,462,000
1999	Other contribution by ZHCA	35,070,000
2000	Cash contribution by ZHCA	11,200,000
2001	Cash contribution by ZHCA	200,000,000
2002	Other contribution by ZHCA	8,000,000
	Net increase during exam period	<u>1,704,820,290</u>
12/31/03	Ending gross paid in and contributed surplus	<u>\$2,206,131,141</u>

A. Management

Pursuant to the Company's charter and by-laws, management of the Company is vested in a board of directors consisting of not less than thirteen or more than twenty-one members. At December 31, 2003, the board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
John J. Amore Staten Island, NY	Chairman, Zurich American Insurance Company
David A. Bowers Winnetka, IL	Executive Vice President and Corporate Secretary, Zurich American Insurance Company
James P. Connors Monmouth Beach, NJ	Executive Vice President, Zurich American Insurance Company
Barry J. Gilway Cockeysville, MD	Executive Vice President, Zurich American Insurance Company
Donald J. Hurzeler Lake in the Hills, IL	Executive Vice President, Zurich American Insurance Company
John A. Kelm Crystal Lake, IL	Executive Vice President, Zurich American Insurance Company
James W. March Forest Hills, NY	Director, Zurich American Insurance Company
Michael D. Markman Mendota Heights, MN	Executive Vice President, Zurich American Insurance Company
John J. McCartney Omaha, NE	President, Zurich American Insurance Company
Nancy D. Mueller Kildeer, IL	Executive Vice President, Zurich American Insurance Company
Juliet G. Nash Brooklyn, NY	Director, Zurich American Insurance Company
Frank A. Patalano Barrington, IL	Executive Vice President, Zurich American Insurance Company

Name and ResidencePrincipal Business Affiliation

Raymond C. Thomas III  
Baldwin, MD

Executive Vice President,  
Zurich American Insurance Company

The Company's by-laws provide that the board of directors shall meet four times each year with the first meeting on the day of the annual election of directors by the stockholders. A review of the minutes of the meetings held during the examination period indicated that the board of directors physically met only one time each year, on the day of the annual stockholders' meeting. All other corporate actions and resolutions were done by unanimous written consent of the board without a meeting. The Company's by-laws do not provide that action by unanimous written consent may be used in lieu of a regular meeting of the board of directors. It is recommended that the Company comply with the provisions of its by-laws with regard to board of directors' meetings.

Committees of the Board of Directors

The Company's by-laws provide that the board of directors may elect from its own members, an executive committee and audit committee consisting of not less than one-third of the members of the board of directors. Those serving on committees as of December 31, 2003, are as follows:

Executive Committee

John J. Amore  
Nancy Mueller  
John J. McCartney  
John A. Kelm

Audit Committee

John J. Amore  
Nancy Mueller  
John J. McCartney  
John A. Kelm

As there were thirteen members of the board of directors as of December 31, 2003, both committees should have consisted of at least five members. It is recommended that the Company comply with its by-laws with regard to the number of appointees to its executive and audit committees.

The review of the minutes of those meetings of the board of directors that were held during the examination period indicated that meetings held were generally well attended. The review of the minutes of those meetings of the committees held during the examination period indicated that, while the number

of members of the committees was less than the required by the by-laws, the meetings held were generally well attended.

The review of the board of directors and the appointed subcommittee minutes indicated that the board failed to approve certain investment transactions of the Company. Section 1411(a) of the New York Insurance Law states:

“No domestic insurer shall make any loan or investment, except as provided in subsection (h) hereof, unless authorized or approved by its Board of Directors or a committee thereof responsible for supervising or making such investment or loan. The committee’s minutes shall be recorded and a report submitted to the Board of Directors at its next meeting.”

It is recommended that the board of directors or a committee thereof approve all investment transactions made by the Company in accordance with Section 1411(a) of the New York Insurance Law.

As of December 31, 2003, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
John J. Amore	Chairman & Chief Executive Officer
John J. McCartney	President
David A. Bowers	Executive Vice President & Corporate Secretary
David A. Levinson	Executive Vice-President & Treasurer
Earl R. Clouser	Executive Vice-President
J. Peter Connors	Executive Vice-President
James D. Engel	Executive Vice-President
Robert M. Fishman	Executive Vice-President
Craig J. Fundum	Executive Vice-President
Barry J. Gilway	Executive Vice-President
Donald J. Hurzeler	Executive Vice-President
John A. Kelm	Executive Vice-President
Michael D. Markman	Executive Vice-President
Nancy D. Mueller	Executive Vice-President
Frank A. Patalano	Executive Vice President
Steven P. Rand	Executive Vice-President
David J. Saul	Executive Vice President
Raymond C. Thomas III	Executive Vice President
Richmond N. Waller	Executive Vice President
Diana J. Whidden	Executive Vice President

B. Territory and Plan of Operation

As of December 31, 2003, the Company was licensed to write business in all fifty states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

As of the examination date, the Company was authorized to transact the kinds of insurance as defined in the following numbered paragraphs of Section 1113(a) of the New York Insurance Law:

<u>Paragraph</u>	<u>Line of Business</u>
3	Accident & health
4	Fire
5	Miscellaneous property damage
6	Water damage
7	Burglary and theft
8	Glass
9	Boiler and machinery
10	Elevator
11	Animal
12	Collision
13	Personal injury liability
14	Property damage liability
15	Workers' compensation and employers' liability
16	Fidelity and surety
17	Credit
19	Motor vehicle and aircraft physical damage
20	Marine and inland marine
21	Marine protection and indemnity
22	Residual value
24	Credit unemployment
26	Gap
27	Prize indemnification
28	Service Contract reimbursement

In addition, the Company is licensed to transact such workers' compensation insurance as may be incident to coverages contemplated under Paragraphs 20 and 21 of Section 1113(a) of the New York Insurance Law, including insurances described in the Longshoremen's and Harbor Workers' Compensation Act (Public Law No. 803, 69 Cong. as amended; 33 USC Section 901 et seq. as amended), and as authorized by Section 4102(c) of the New York Insurance Law, insurance of every kind or description outside of the United States, reinsurance of every kind or description.

Based on the lines of business for which the Company is licensed and the Company's current capital structure, and pursuant to the requirements of Articles 13 and 41 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of \$35,000,000.

The following schedule shows the direct premiums written by the Company both in total and in New York for the period under examination:

DIRECT PREMIUMS WRITTEN

	<u>New York State</u>	<u>Total United States</u>	<u>Percentage of Premiums Written in New York State</u>
1999	\$181,882,782	\$1,156,453,475	15.73%
2000	\$240,515,019	\$2,034,579,345	11.82%
2001	\$242,179,218	\$2,692,152,274	9.00%
2002	\$411,606,219	\$3,833,774,237	10.74%
2003	\$470,495,967	\$4,757,472,221	9.89%

In 2003, direct written premiums for the Company as well as Zurich American Insurance Group, ("ZAIG") were produced by a combination of approximately 14,000 independent agents and 300 brokers. Agency produced business accounted for approximately 70% of direct written premiums with the remainder produced by brokers.

Central to the Company and ZAIG's business strategy are its Customer-Focused business units ("CFBU") and a dedicated service business unit ("BU"), which provides various services to each of the CFBU's including claims management, risk engineering, information technology and marketing. The CFBU's are based on the type of customer they service and operate through independent agents and brokers and have access to ZAIG's products and services through a nation-wide network of seven regional offices and 63 branch offices. The CFBU's are categorized and focus as follows:

- The Global Corporate North America BU (n/k/a Corporate Customer) serves large corporate and commercial businesses globally and domestically in three major areas: property, casualty, and group captives. Coverages offered by this BU are workers' compensation, general

liability, commercial auto, property, and captive structures and services. On December 31, 2003 the group captives moved to Middle Markets.

- The Small Business BU provides a comprehensive, customized coverage portfolio of property, liability, commercial auto, umbrella, and in some locations, workers compensation. It provides coverages for small businesses in the retail, wholesale, service, office, institutional, builders risk and small trade fields.
- The Specialties BU offers coverages for emerging, potentially volatile and unique third-party liability exposures. These include the professional liability risks of group services providers such as architects and engineers, healthcare organizations, financial institutions, environmental contractors, and information technology firms, along with a wide range of specialty liability coverages, such as management, environmental, excess and umbrella products, volatile general and political risk insurance and accident and health, specialty health and disability programs. Liability coverages are also provided for the healthcare, environmental, financial and rail industries.
- The Zurich Programs BU (n/k/a Empire Fire and Marine Insurance Company (“Empire”)) provides specialized insurance and financial coverages to small and mid-sized commercial markets. Empire’s direct sales force distributes products to auto rental, independent auto dealer, recreational vehicle and contractors’ equipment business. Its nationwide network of managing general agents target markets such as long-haul trucking, ambulance and tow truck companies as well as general liability classes including tanning salons and security guard companies.
- The UUG BU (n/k/a Universal Underwriters Group) also includes the operations of Universal Underwriters Insurance Group (“Universal”). Universal became a member of the ZAIG pool as of January 1, 2002. Universal specializes in providing insurance and financial services to franchised auto, truck, equipment and motorcycle dealerships and automotive-related businesses. Universal offers a wide range of commercial insurance-related products and services including property-casualty insurance, workers compensation, risk management services, business life insurance, vehicle service contracts, credit life and disability insurance, GAP insurance, sub-prime financing services and income development programs.
- The Customer Services BU is a dedicated service BU, which unifies the Company’s approach to managing claims, managed care, risk engineering, information technology and marketing and provides support to all its commercial business units.
- The Commercial Business Group (“CBG”) consists of these four business units:
  - The Middle Markets CBG offers package and program coverages to meet the needs of the medium-sized commercial enterprise. Target segments include manufacturing services (including hospitality) and public entities. Middle Markets also offers programs for groups and associations and provides a full array of financial institution bonds, professional liability and property-casualty insurance.
  - The Construction CBG specializes in providing product, service and risk financing coverages for project owners, construction managers, contractors and subcontractors. In addition to all standard property-casualty coverages, this industry-focused business unit also provides a number of specialized products, including surety business. Surety serves

the needs of construction project owners, construction contractors and subcontractors and governmental entities, non-profit organizations and commercial enterprises in most industries with a wide array of contract, commercial and environmental surety bond products.

- The Global Energy CBG specializes in providing comprehensive risk management, risk engineering services and claims support tailored to the individual needs of oil and gas, petrochemical, natural resources, mining and power generation customers worldwide. The unit also provides a full range of marine products and services in the United States and London, including ocean cargo protection, hull, liabilities and other marine-related coverages.
- The Surety & Financial Enterprises CBG specializes in contracts, bonds and other liability coverages for the construction industry and financial enterprises.

### C. Reinsurance

#### Inter-company Pooling Agreement

Effective January 1, 1999, the Company entered into an amended ZAIG intercompany pooling agreement which includes the Company and seventeen affiliated insurers. Pursuant to the terms of the agreement, the participants cede 100% of all underwriting assets, liabilities and expenses, as well as underwriting income and losses (net of applicable reinsurance) to the Company. There is no retrocession from the Company to any of the pool participants. Subsequent to the date of the original agreement, six amendments have been made to the agreement, each adding or deleting participants in the pool.

At December 31, 2003, the following eighteen insurers participated in the pool:

- American Guarantee and Liability Insurance Company (NY)
- American Zurich Insurance Company (IL)
- Assurance Company of America (NY)
- Colonial American Casualty and Surety Company (MD)
- Empire Fire & Marine Insurance Company (NE)
- Empire Indemnity Insurance Company (OK)
- Fidelity and Deposit Insurance Company of Maryland (MD)
- Maine Bonding and Casualty Company (ME)
- Maryland Casualty Company (MD)
- Maryland Insurance Company (TX)
- National Standard Insurance Company (TX)
- Northern Insurance Company of New York (NY)
- Steadfast Insurance Company (DE)
- Universal Underwriters Insurance Company (KS)

Universal Underwriters of Texas Insurance Company (TX)  
Valiant Insurance Company (IA)  
Zurich American Insurance Company (NY)  
Zurich American Insurance Company of Illinois (IL)

Prior to cessions to the intercompany pooling agreement described above, the companies reduce their exposure to losses through facultative and treaty reinsurance. Further, Article V of the agreement provides that ZAIC agrees to be liable, for annual statement and other financial statement purposes, for any amount disallowed any of the companies on account of reinsurance with unauthorized companies and any amount disallowed the companies for non-admitted assets. Accordingly, only ZAIC reports a provision for reinsurance as the liability at December 31, 2003.

After cessions to the pool, the companies are party to the same pool ceded reinsurance program as that of ZAIC.

#### Assumed Reinsurance

During 2003, the volume of the premium assumed by the Company from non-affiliates was 1.7% of total gross written premium. These non-affiliate assumptions primarily emanated from facultative arrangements and mandatory pools.

Total premiums assumed by the companies participating in the ZAIG pooling arrangement represented 6.8% and 7.3% of the direct premiums written by the companies in 2003 and 1998, respectively. The total premiums assumed from non-pool affiliates represented 0.8% and 3.5% of the direct premiums written by the companies in 2003 and 1998, respectively. These comparisons are based on data from the 1998 through 2003 combined annual statements of the affiliated property and casualty companies.

ZAIG provides insurance to companies that operate internationally through two units, the Global Unit and the Reverse Flow Unit. The "Global Unit", is a part of ZAIG's All Lines Open Reinsurance Agreement ("ALORA") program, which is further discussed in the Ceded Reinsurance section of this report.

Business produced by the Global Unit, except for the property and some casualty business related to the captive insurance program reinsured by Zurich Global, Ltd., is assumed by American Guarantee and Liability Insurance Company (“AGL”) on a facultative basis, either proportionally or non-proportionally (generally, a 90% quota share of the primary layer). As a pool member, AGL’s net retention of this business is then ceded to the Company.

The Reverse Flow Unit provides insurance to foreign companies with U.S. subsidiaries through any of the participants in the intercompany pooling agreement. Business produced by the reverse flow unit is ceded to an affiliate, Zurich Insurance Bermuda Branch (“ZIBB”), on a facultative basis, either proportionally or non-proportionally (although generally a 90% quota share of the primary layer), through the reverse ALORA treaty.

A quota share agreement with The Healthcare Company (“HCA”), pursuant to which the Company accepted certain workers’ compensation and employers’ liability reserves, was commuted effective February 1, 2003. Although the commutation was effective February 1, 2003, the subject commutation agreement was not submitted to this Department until May 8, 2003. By a letter dated September 23, 2004 the Company was denied approval to enter into this agreement. No adjustments have been made to the financial statements presented in this report to reverse this commutation due to the fact that the Company failed to provide adequate documentation showing the entries made relative to the commutation.

#### Ceded Reinsurance

In 2003, the Company ceded 39% of its direct and assumed premiums (including amounts assumed from the pool participants in 2003).

The Company cedes a portion of risks on treaties that are believed to offer a higher than average return on earnings. No automatic, mandatory cessions of reinsurance risks to ZIC occur.

Reinsurance treaty placements are based on the needs of the business units as well as the overall reinsurance strategy of ZAIG. Retentions have been increased vertically as well as horizontally (through increased proportional reinsurance) to limit the number of treaties with retention below \$5 million.

During the examination, significant ceded reinsurance contracts were reviewed. All contracts contained the required standard clauses including insolvency clauses meeting the requirements of Section 1308 of the New York Insurance Law.

ZAIG provides insurance to companies that operate internationally through two units, the global unit and the reverse flow unit.

The global unit provides insurance through international affiliates of branches of Zurich Insurance Company to United States companies with worldwide exposures. Business produced by the global unit is assumed by American Guarantee and Liability Insurance Company on a facultative basis, either proportionally or non-proportionally (generally, a 90% quota share of the primary layer), through the all lines open reinsurance agreement (“ALORA Treaty”).

The reverse flow unit provides insurance to foreign companies with U.S. subsidiaries through any of the participants in the intercompany pooling agreement, which is in turn ceded by the Company to an affiliate, Zurich Insurance Bermuda Branch (“ZIBB”), on a facultative basis, either proportionally or non-proportionally (although generally a 90% quota share of the primary layer), through the reverse ALORA treaty.

The treaties in place at December 31, 2003 are summarized below:

Capital Treaties (Net line after Corporate Covers)

In effect for 2003 were three capital treaties for the benefit of all business units on a loss occurring basis and attaching to the net line after the corporate program addressed in the following paragraph. Two of

the capital treaties are multi-line quota share treaties, one ceding 15% to ZIBB and one ceding 10% to a non-affiliate.

Additionally, stop loss treaties between the Company and Hannover Reinsurance (Ireland) Limited (“Hannover Re”) cover the entire book for accident years 1999 through 2003. Based on the information provided by the Company, related stop loss data for each of the periods under review is as follows:

	1999	2000	2001	2002	2003
Subject Net Earned Premiums	\$ 2,472,615,973	\$ 3,057,624,520	\$ 4,916,553,433	\$ 7,788,599,732	\$ 6,897,670,885
Attachment Point	68.0%	65.0%	65.0%	74.0%	72.0%
Top of Cover	85.0%	82.0%	82.0%	80.0%	78.0%
Points of Cover	17	17	17	6	6
Available Coverage (\$)(Exposure Year Net Earned Premium)	\$ 420,344,715	\$ 519,796,168	\$ 835,814,083	\$ 467,315,983	\$ 413,860,253
Ceded Premium Rate	5.5275%	7.5375%	8.0402%	2.1266%	2.5650%
Ceded Premiums *	\$ 136,673,848	\$ 230,468,448	\$ 395,300,729	\$ 165,632,362	\$ 189,810,000
Incurred Losses **	\$ 2,569,043,034	\$ 2,903,521,035	\$ 3,886,871,131	\$ 5,226,092,628	\$ 4,371,288,000
Booked Loss Cession to Stop Loss ***	(\$ 420.4)	(\$ 519.8)	(\$ 691.1)	\$ 0	\$ 0
Paid Loss Recoveries	\$ 420,000,000	\$ 361,000,000	\$ 0	\$ 0	\$ 0
Maximum Cession to Stop Loss	(\$ 420.4)	(\$ 519.8)	(\$ 835.8)	(\$ 467.3)	(\$ 413.9)
Remaining Coverage	\$ 0	\$ 0	(\$144.7)	(\$ 467.3)	(\$ 413.9)

\* Based on minimum premium of \$7,400,000,000 per treaty in 2003

\*\* Annualized number in 2003

\*\*\* As reported

In relation to the Hannover Re stop loss treaties, effective October 1, 2003, ZIC entered into an adverse development reinsurance agreement with Hannover Re. Pursuant to this agreement, ZIC agrees to indemnify Hannover Re for 100% of the ultimate losses under the whole account aggregate stop loss treaties between the Company and Hannover Re for accident years 2001, 2002, and 2003 (for accident year 2001, only losses in excess of the accident year treaty attachment point plus 13.5% count as ultimate loss) in excess of a \$35 million retention.

In addition, ZIC agreed to provide a letter of credit to the Company where a claim notification by the Company under the 1999, 2000, 2001, 2002 or 2003 stop loss treaties combined creates a letter of credit requirement for Hannover Re in excess of \$490 million. As of December 31, 2003, ZIC had

provided a parental letter of credit in the amount of \$75 million in place for the benefit of the Company securing reinsurance recoverables from Hannover Re pursuant to the stop loss treaties.

It is the position of the Department that the 2003 agreement between Hanover Re and ZIC constitutes an attempt by the Company to circumvent the requirement for prior notice to the Superintendent before entering into a reinsurance agreement with any person in its holding company system as set forth in Section 1505(d)(2) of the New York Insurance Law.

It is recommended that the Company ensure that all future direct or indirect intercompany reinsurance agreements are submitted to the Department pursuant to Section 1505(d)(2) of the New York Insurance Law.

Further, the \$75 million parental letter of credit for the above agreement was not approved as of December 31, 2003 pursuant to the requirements of Department Regulation 20 Part 125.4(g)(1). Therefore, credit for it has been disallowed in this report.

### Corporate Covers

For property catastrophe losses, two internal treaties are placed with ZIC to address the difference between the business unit's retention and the attachment of the corporate property catastrophe cover. The first, the property "Gap" excess of loss treaty ("GAP"), addresses losses in excess of the business unit's individual retention (deemed a fixed amount under the contract). Individual business units' retentions range from \$5 million to \$25 million; therefore, the GAP contract provides from \$70 to \$50 million of coverage. The second treaty, the property "step-up" excess of loss ("Step Up"), provides an additional \$25 million layer above the \$75 million sum of the business unit retention and the portion reinsured under the GAP coverage.

The six layer "Group Property Catastrophe Excess of Loss Contract", which reinsures the eighteen members of the ZAIG pool, plus Maryland Lloyds (collectively referred to as "Zurich North America")

provides up to \$675 million of coverage for occurrences in excess of \$100 million. The agreement provides for a 5% retention of each layer. The annual limit is two times the cover. Coverage up to \$50 million in excess of \$725 million is provided under a third event excess of loss contract that has a \$100 million aggregate deductible and a \$50 million annual limit.

ZIC provides up to \$20 million of coverage on workers' compensation and employers' liability losses in excess of \$5 million under a two layer excess of loss contract. The annual limit on the \$10 million in excess of \$5 million layer is \$10 million. The top layer of \$10 million in excess of \$15 million has a \$30 million annual limit.

The "Group Casualty Catastrophe Excess of Loss Contract" reinsures Zurich North America and provides \$50 million in excess of \$25 million with an annual limit of \$100 million. The coverage is written on an earned premium basis.

The first three layers of a five layer "Group Workers' Compensation Catastrophe Contract" reinsures Zurich North America and provides up to \$85 million in excess of \$15 million of losses. Terrorism is excluded on these layers. A fourth layer provides up to \$100 million in excess of \$100 million and provides coverage for terrorism, including nuclear, chemical and biological events. A fifth layer provides up to \$50 million in excess of \$100 million and provides coverage for terrorism, excluding nuclear, chemical and biological events. The annual limit is \$200 million on the fourth layer and \$100 million on the fifth layer.

The "Group Multi-Line Terrorism Excess of Loss Contract" reinsures Zurich North America and provides \$200 million of coverage in excess of \$100 million and has an annual limit of \$200 million.

### Business Units

ZAIG writes business through 10 strategic business units: Canadian Unit ("CU"), Construction ("CON"), Corporate Customer ("CC") Corporate Solutions ("ZCS"), Empire Fire and Marine Insurance

Company (“Empire”), Global Energy (“ZGE”), Small Business (“ZSB”), Middle Market (“MM”), Specialties (“ZAS”) and Universal Underwriters (“UUIC”). Reinsurance covers benefiting each business unit are as follows:

#### Multiunit Coverage

A general property per risk contract provides up to \$50 million of coverages on losses in excess of \$25 million that are incurred on policies written by CON, CC, MM and ZSB. ZIC has a 10% participation across all units.

For property risks not in the United States, Canada or Europe but written by CC, CON and the Global Express and Financial Enterprises divisions of MM, catastrophe coverage is provided through an international excess of loss treaty that provides \$30 million of coverage in excess of \$25 million per occurrence. There is a 5% retention of losses falling in the \$30 million layer. ZIC’s participation as a reinsurer is 45%.

A commercial property per risk treaty provides two layers of protection for MM and SB. The first layer is \$5 million in excess of \$5 million. The second layer is \$15 million in excess of \$10 million. ZIC’s participation as a reinsurer is 7.5% in the second layer only. Separate treaty codes for each unit reinsured under the treaty facilitate application of different reinsurance premium rates.

#### Canadian Unit (“CU”)

The primary coverages on property business insured through CU are a seven line, first surplus share treaty providing proportional coverage above a \$5 million probable maximum loss (“PML”) retained line up to \$35 million PML any one risk and a six line, second surplus share treaty providing proportional coverage on both large industrial and global risks above a \$5 million retained line up to \$30 million any one risk. Both surplus share treaties provide for a provisional ceding commission, which is subsequently adjusted on a sliding scale basis. ZIB, an insurer owned jointly by ZIC and two

subsidiaries, has a 2.5% participation in the first surplus treaty and 95% in the second surplus treaty. The Canadian Branch of Zurich Insurance Company has a 5% participation in the second surplus treaty.

A five layer property catastrophe excess of loss agreement provides \$330 million of coverage above an occurrence of \$20 million. Catastrophe covers on Canadian produced, United States located risks are covered under the corporate catastrophe program.

A net account PML error excess of loss property treaty provides coverage of \$19.5 million in excess of \$6.5 million ultimate net loss any one location, any one event. ZIB's participation as a reinsurer is 24.5%.

On boiler and machinery risks, CU has in place a \$4.75 million line surplus share treaty with a \$5 million PML retention per risk.

A PML error excess of loss contract covering boiler and machinery provides up to \$15 million of coverage in excess of \$5 million ultimate net loss on any one risk. ZIB's participation as a reinsurer is 60%.

Further, a three layer automobile and casualty excess of loss agreement covers liability losses up to \$25 million in excess of \$5 million ultimate net loss each and every accident or occurrence.

#### Construction Unit ("CON")

Property risks written through CON are reinsured under two excess of loss contracts below and above the corporate general property per risk contract. The lower layer is \$15 million excess of \$10 million of which the ceding company retains 25%. The upper layer is \$25 million excess of \$75 million.

Surety bonds written through CON are reinsured under a four layer surety excess of loss contract attaching on a loss discovered basis and providing \$85 million of coverage on losses in excess of \$15 million. CON retains 5% on each layer.

Construction professional liability is covered under a 40% quota share contract.

CON has multi-section casualty blanket excess of loss treaties providing the following protection:

Workers' compensation losses are covered up to \$10 million in excess of \$5 million with CON retaining 85%. Homebuilders' protective policies are covered under a 57% quota share treaty having a \$15 million risk limit. General liability and umbrella policies are covered by an excess of loss contract that provides up to \$25 million in excess of \$1 million, with CON retaining 44%. Policies written under CON's subguard program are covered under an excess of loss contract providing up to \$18 million in excess of \$2 million with CON retaining 32.55%. A second excess of loss treaty on the subguard program provides \$20 million of coverage in excess of \$30 million with CON retaining 22.5%.

CON benefits from all the previously listed corporate covers, including the general property per risk, as well as the international property catastrophe coverages.

#### Corporate Customer Unit ("CC")

CC has an underlying property per risk excess of loss treaty providing \$15 million coverage in excess of a \$10 million loss. It is subject to an annual aggregate deductible of \$15 million with an occurrence limit of \$45 million and an annual limit of \$90 million. ZIC, as a reinsurer, has a 10% participation in this layer.

The two layered, global property excess facultative facility provides \$50 million in excess of \$7.5 million of coverage per risk.

CC benefits from all corporate covers including the general property per risk, the step up coverage, and the international property catastrophe coverage.

#### Corporate Solutions Unit ("ZCS")

"ZCS" is covered by the multi-line 60% ZCS integrated quota share. All corporate covers apply.

Empire Fire and Marine Insurance Company Unit (“Empire”)

Empire has a 3 layer property per risk program with the first and second layers providing \$13.5 million in excess of \$1.5 million. There is a \$7 million occurrence limit for the \$3.5 million first layer and a \$10 million occurrence limit for the second layer. These layers cover business written through Empire’s special operations (“SPOPS”) division as well as risks produced through Hull & Co. The third layer of \$5 million in excess of \$15 million has an occurrence limit of \$5 million and provides additional coverage only for the Hull & Company produced business.

Various property catastrophe treaties exist. An underlying catastrophe treaty of \$3 million in excess of \$2 million supports the SPOPS division. There is five layer catastrophe excess of loss covering wind and earthquake which provides \$155 million in excess of \$15 million per occurrence. This coverage is supplemented with a top layer cover of \$40 million in excess of \$170 million. In addition, as Empire has significant California exposure, a California catastrophe cover provides an additional five layer coverage of \$100 million excess of \$15 million for earthquake only. Primary, difference in condition (“DIC”) exposure is reinsured for up to \$40 million in excess of \$15 million through the three layer catastrophe reinsurance program.

Empire’s casualty exposures are reinsured through a three layer per occurrence program providing \$3.5 million in excess of \$1.5 million with a \$14 million annual limit, \$5 million in excess of \$5 million with a \$10 million annual limit, and \$10 million in excess of \$10 million with a \$20 million annual limit. In addition, a major medical 90% quota share treaty with a \$5 million lifetime maximum is in place. Umbrella business is written with policy limits up to \$10 million. The first \$5 million of non contractor risks is covered under a 75% quota share. The second \$5 million of non contractor risks as well as the full amount of contractor umbrella coverages are ceded under a 100% quota share.

Primary crop hail under the Rural Community Insurance program is reinsured through a 95% multi-peril stop loss attaching at 101%, and providing layered coverage up to a 140% loss ratio. A second

crop hail and named peril 95% stop loss attaches at a 90% loss ratio and provides layered coverage up to a 130% loss ratio. Assumed crop hail business is retroceded to a two layer 95% stop loss attaching at a 101% loss ratio and applying up to a 109% loss ratio.

Empire writes forced-placed mortgage insurance through ZC Sterling, an MGA, which was ceded 100% to its affiliate, Centre Reinsurance Company. Subsequent to the examination date, effective January 1, 2005, Empire retained this business. Empire also writes policies protecting businesses from income loss due to computer hacking (“E-Risk” business), which is ceded 100% to its affiliate, Fidelity and Deposit Company of Maryland.

Empire is covered under all corporate covers, except for the GAP and step-up treaties.

Global Energy Unit (“ZGE”)

Three reinsurance contracts cover risks identified as onshore property. A 40% quota share covers losses up to \$20 million with the cedent retaining \$12 million. This contract provides for a provisional commission with subsequent adjustments made on a sliding scale basis. A two layer excess of loss contract covers \$55 million of losses (except for a 10% retention) in excess of \$20 million. A 10% quota share covers losses above \$75 million.

Five reinsurance contracts cover risks associated with onshore and offshore oil, gas or other extractive businesses. The cedents retain \$7 million per risk, per occurrence after application of a four layer excess of loss contract and a 70% quota share contract. Up to \$65 million in excess a \$10 million of coverage is provided under the excess of loss contract with the cedents’ retention being 14% on each of the first two layers, 7% on the third and 10% on the highest layer. The excess of loss cover is a common account cover and is applied on a pre quota share basis.

A catastrophe excess of loss treaty provides up to \$50 million in excess of \$75 million on any one loss or any one series of losses and requires maximum acceptance on any one rig or platform to \$75 million. A facultative facility makes available \$25 million of coverage on risks in excess of \$75 million. A two layer net retained run-off cover provides up to \$30 million in excess of \$10 million per risk. The cedent retains 15% participation in the first layer and 20% in the second layer.

ZGE’s ocean marine business is protected by a five layer excess of loss treaty that provides up to \$49 million in excess of \$1 million each loss, casualty or disaster. Marine cargo is covered by a three layer excess of loss facility that provides up to \$9 million of coverage in excess of \$1 million.

Middle Market Unit (“MM”)

MM’s benchmark program is reinsured under an excess of loss agreement on a per risk basis on property losses and a per occurrence basis on general liability up to \$500,000 excess of \$500,000. A retention of 25% applies to the general liability portion.

An 82% quota share contract applies to losses up to \$25 million incurred under umbrella policies issued by MM.

Losses related to Riverboat Casino coverages are covered under a two layer excess of loss contract that provides up to \$40 million in excess of \$10 million per loss. ZIC’s participation as a reinsurer is 8% in the second layer, which is \$25 million in excess of \$25 million.

Auto and garage liability exposures arising from the unit’s Falcon Trust program are covered under an excess of loss contract which provides up to \$650,000 above a \$350,000 retention.

Fidelity bond exposures are covered under a four layer excess of loss contract with provides up to \$23 million in excess of \$2 million; however, a retention of 10% of each layer applies.

Certain business classified as E-Risk and Net Secure and including fidelity, professional liability and property risks is covered under a 66.6666% quota share for risks up to \$15 million.

Two reinsurance contracts covering professional liability exposure benefit MM. Primary policies are covered by an excess of loss contract of \$24 million in excess of \$1 million per policy, per loss subject to a 25% retention of the covered layer. The second contract, a 75% quota share, provides coverage for MM’s excess policies up to a limit of \$25 million per risk.

MM benefits from all corporate covers and the multi-unit commercial property contract previously described. Also, the global express and financial enterprise units of MM are provided coverage under the international property excess of loss contract described in the multi-unit section.

### Small Business Unit (“ZSB”)

ZSB writes commercial lines property and workers’ compensation business with limits up to \$25 million, which it reinsures under two excess per risk contracts, each of which provides \$3 million of coverage in excess of \$2 million per loss. However, the insurer retains 24% and 25% of each cover, respectively.

An umbrella excess of loss contract covers up to \$9 million in excess of a \$1 million loss. The insuring entity has a retention of 5% on this coverage. ZSB benefits from all corporate covers.

### Specialties Unit (“ZAS”)

ZAS benefits from two 17.5 % quota share contracts that cover A & H medical expenses. One is specific to business underwritten by a particular underwriter and one applies to business written on a direct basis. The reinsurer pays its share of the contingency fee and profit commission. ZAS business is also covered under an excess contract that provides up to \$4 million in excess of \$1 million per person, per policy year.

An A & H Critical Care 45% quota share contract covers business classified by the Company as Managed Transplant.

Monthly benefits payable under A & H long term disability policies are covered under a two part reinsurance contract. The first part provides 70% quota share up to a monthly maximum of \$15,000. The second part provides for a 100% facultative cession for monthly benefits between \$15,000 and \$30,000.

Two treaties provide catastrophe excess of loss coverage on group accident business. Up to \$55 million in excess of \$5 million is provided by the first contract in three layers. The second contract provides up to \$40 million in excess of the \$60 million of losses under the first contract.

The healthcare excess cover provides up to \$25 million in excess of \$5 million; however there is a retention of 62.5% on the first \$5 million layer and a 20% retention on the second layer.

Political and trade credit risks are covered under a 78.29% quota share treaty and a 75% quota share treaty, respectively. ZIC, as a reinsurer, has a 14.29% share (based on the full loss) of the political risk cession and a 13.69% share of the trade credit risk cession.

Business classified by ZAS as railroad business is covered under a 20% net quota share contract placed with a licensed insurer. The maximum risk ceded is \$10 million.

General liability coverage provided to California residential subcontractors is reinsured under a 38.10% quota share contract for losses up to \$525,000.

Professional liability coverage up to \$2 million for small law and accountant entities is reinsured under a 20% quota share contract.

Two portfolios of non medical professional liability, diversified financial institutions and large professional liability policies, are each covered by a variable quota share contract. Losses on underlying policies with limits less than \$2 million are retained; limits from \$2 million to \$10 million are ceded on a 50% basis; and limits from \$10 million to \$25 million are ceded on a 60% basis.

The ZAS top risk excess cover provides up to \$20 million in excess of \$30 million of losses on specialty products with the exception of accident and health, political risks, and financial liability lines.

The combined excess of loss contract provides separate coverages for casualty, railroad, and fidelity exposures. Each provides up to \$20 million in excess of \$10 million with a retention of 10%.

Directors' and officers' liability and employers' practices liability policies are reinsured under a 57.5% quota share treaty. ZIC assumes 5%.

Universal Underwriters (“UUIC”)

In addition to reinsurance provided under the group covers, UUIC has four treaties in place.

Property and automobile inventory risks are covered under a three layer excess of loss contract which covers up to \$12 million in excess of \$2 million. Umbrella policies are subject to a semi automatic facultative treaty providing up to \$25 million of coverage for losses in excess of \$12 million. A property catastrophe contract provides up to \$100 million of coverage in excess of \$15 million per occurrence with 5% of the layer being retained.

Casualty and group workers’ compensation exposures are covered under a two layer excess of loss contract with coverage up to \$10 million on casualty losses in excess of \$2 million. UUIC retains a 27.5% participation on the first layer’s \$3 million coverage. A casualty catastrophe treaty provides \$13 million in excess of \$12 million per occurrence.

Except as noted below, Schedule F data as contained in the Company’s annual statements filed for the years within the examination period was found to accurately reflect its reinsurance transactions.

Reinsurance Intermediary Licensing

It was noted that one reinsurance intermediary included on the Company’s approved list of reinsurance intermediaries was not licensed in New York. However, no transactions were initiated with the intermediary.

Nevertheless, it is recommended the Company ensure that all intermediaries included on the Company’s approved list are licensed in New York in order to maintain compliance with Section 2102(a)(1) of the New York Insurance Law.

### Reinsurance with Affiliates

The report on examination as of December 31, 1998, recommended that the Company file with the Department the applicable cover notes for any reinsurance agreement where a related party's participation is 10% or more. Such filing was to be made within thirty days after the agreement's effective date. A copy of the complete related party contract should have been forwarded to the Department within thirty days of ratification. The 1998 examination report was accepted by the Company and filed by the Department.

During the period cover by this examination, instances were noted where neither the affiliated reinsurance agreement nor its cover notes was submitted to the Department in accordance with the requirements of Section 1505(d)(2) of the New York Insurance Law, which states:

“(d) The following transactions between a domestic controlled insurer and any person in its holding company system may not be entered into unless the insurer has notified the superintendent in writing of its intention to enter into any such transaction at least thirty days prior thereto or such shorter period as he may permit and he has not disapproved it within such period.

(2) reinsurance treaties or agreements;”

It is again recommended that the Company ensure that in the future, all affiliated Company reinsurance transactions are submitted to the Department in compliance with Section 1505(d)(2) of the New York Insurance Law.

### Multiple Applicant Letters of Credit

It was noted in the report on examination dated December 31, 1998 that the Department would allow letters of credit with multiple applicants as long as the applicants were affiliates of the Company. It was recommended that the Company prepare schedules showing the allocation of the amount of the letters

of credit to each of the applicants, which should be updated quarterly. The schedules should be available for review by the Department's examiners.

Per the current examination review, it was noted that the Company continues to have multiple applicant letters of credit and that the multiple applicants are not affiliates of the Zurich American Insurance Company. It is again recommended that the Company ensure that it only utilize letters of credit with multiple applicants where the applicants are affiliates of the Company.

#### Department Regulation 114 Trust Account Agreement Requirements

Department Regulation 114 governs the construction and language of trust agreements for credit for reinsurance. Part 126.2(a) of that regulation reads in part:

“Beneficiary means the entity for whose sole benefit the trust has been established. The trust agreement shall contain a provision that includes within the term beneficiary any successor of the beneficiary by operation of law, including, without limitation, any liquidator, rehabilitator, receiver or conservator. . .”

Additional requirements of Regulation 114 include Part 126.3(f)(4) which requires that the trust agreement provide for the trustee to:

“...notify the grantor and the beneficiary, within 10 days, of any deposits to or withdrawals from the trust account. . .”

Also, Part 126(f)(3) which requires the that the trust agreement provide for the trustee to:

“...furnish to the grantor and the beneficiary a statement of all assets in the trust account upon its inception and at intervals no less frequent than the end of each calendar quarter. . .”

A review of the trust agreements utilized by the Company to secure credit for reinsurance from unauthorized reinsurers revealed that certain trust agreements were not in compliance with Department Regulation 114. The following exceptions were noted:

- Instances where the beneficiary was not properly defined pursuant to Department Regulation 114, Part 126.2(a).

- Instances where the trust agreement did not require statements of account to be provided at least quarterly pursuant to Department Regulation 114, Part 126.3(f)(3).
- Instances where trust account agreement did not require notification to the grantor and the beneficiary of any deposits to or withdrawals from the trust within 10 days pursuant to Department Regulation 114, Part 126.3(f)(4).

In addition it was noted that the Company maintains several reinsurance trust accounts, which contain multiple beneficiaries. Department Regulation 114, Part 126.2(a) and Part 126.3(e) indicate the use of the singular word “beneficiary” and “entity.” Further, Opinion No. 99-104 of the Office of the General Counsel indicates that it is not permissible to have multiple beneficiaries on trust accounts utilized to secure reinsurance balances pursuant to Department Regulation 114. Opinion No. 99-104 specifically cites Section 126.2(a) in its argument for sole beneficiaries to trust accounts.

It is recommended the Company comply with the requirements of Department Regulation 114, Parts 126.2(a) and 126.3(e) and create trust account arrangements that involve only one beneficiary. It is further recommended that the Company ensure that all trust agreements to which it is a party meet the required conditions of Department Regulation 114.

#### Reinsurance settled through inter-company accounts

Upon examination, it was noted that many of the Company's transactions with affiliates are related to reinsurance agreements. It is the Company's policy to settle reinsurance transactions with affiliates through the inter-company accounts. There are reinsurance-related receivables and payables reported as receivable or payable to parent, subsidiaries and affiliates. Statement of Statutory Accounting Principles (“SSAP”) No. 62, Paragraph 26 of the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions for Property-Casualty Insurance Companies instructs companies to report reinsurance related receivables/payables on annual statement line items specifically for reinsurance. New York Insurance Law requires companies to prepare their annual statements in accordance with NAIC Annual Statement Instructions.

It is recommended that the Company record its reinsurance related receivables and payables in accordance with Annual Statement Instructions and SSAP No. 62, Paragraph 26 of the NAIC Accounting Practices and Procedures Manual.

Errors in Schedule F regarding Letters of Credit

During the examination of the collateral securing reinsurance recoverables, it was noted that a bank issuing a letter of credit in the amount of \$675,000 was not included on the NAIC listing of acceptable banks.

It is recommended the Company comply with Department Regulation 133, Part 79.2(c) and ensure that letters of credit obtained are issued by a qualified bank or trust company.

It was also noted that an increase in one letter of credit for which credit was claimed in Schedule F was not in effect as of December 31, 2003. The amount of the increase, which became effective on February 5, 2004, was \$11,195,121.

It is recommended that the Company comply with Department Regulation 133, Part 79.6(a)(1) and the NAIC Annual Statement Instructions and only reduce its liability for reinsurance ceded to an unauthorized reinsurer in financial statements required to be filed with this Department where the letter of credit is issued on or before the “as of” date of the Company’s financial statement.

Letters of Credit Missing Definition of Beneficiary, Department Regulation 133, Part 79.2(d)

In accordance with Department Regulation 133, Part 79.2(d) for a letter of credit to be acceptable, it “contain a statement that identifies the beneficiary and includes the definition set forth in Section 79.1(b) of this Part.” On examination it was noted that several letters of credit did not contain the required definition of beneficiary pursuant to Department Regulation 133, Part 79.2(d) and 79.1(b).

It is recommended that the Company ensure the letters of credit accepted by the Company include the proper definition of beneficiary pursuant to Department Regulation 133, Part 79.2(d) and 79.1(b).

Authorized/Unauthorized Reinsurers

The analysis of the 2003 Schedule F penalty ("Provision for reinsurance") found several insurers included as authorized in the Company's 2003 Schedule F, which should have been designated as unauthorized because they were not authorized in the State of New York. Included among the unauthorized insurers included by the Company as authorized were several affiliates of the Company.

The Company indicated in its written responses to the examiners that the affiliates should be considered authorized because they are part of the pooling arrangement. However, the Company could not cite anything in the New York Insurance Law or Regulations of the Department indicating that affiliates in a pooling arrangement are considered authorized.

The examiners' recalculation of the Provision for reinsurance for these improperly reported unauthorized reinsurers resulted in an increase to the 2003 Schedule F penalty of \$7,605,306. This calculation included the Company's unauthorized affiliates. See Item 11 for further details.

It is recommended the Company ensure that no credit is taken against the Schedule F penalty for insurers that are unauthorized in New York.

D. Holding Company System

The Company is a wholly-owned subsidiary of Zurich Holding Company of America, a Delaware holding company, which in turn is 99.87% owned by Zurich Insurance Company (Switzerland). Zurich Insurance Company (Switzerland) is wholly-owned by Zurich Group Holding (Switzerland) which in turn is ultimately controlled by Zurich Financial Services (Switzerland).

Effective January 1, 1999, the Company became the owner of 100% of the outstanding shares of Maryland Casualty Company when Zurich Insurance Company contributed its 15.8% ownership and Zurich Holding Company of America contributed its 84.2% ownership. The transfer of ownership was made concurrent with the adoption of the amended inter-company pooling agreement, which is detailed in Section 2C of this report.

A review of the holding company registration statements filed with this Department indicated that such filings were complete and were filed in a timely manner pursuant to Article 15 of the New York Insurance Law and Department Regulation 52 with the following exceptions.

Affiliated Agreements not Provided

The intercompany receivable and payable amounts reported by the Company on its 2003 annual statement included various balances for claims or services provided to or received from various non-pooled affiliated companies for which the Company could not provide written agreements.

In accordance with Section 1505(b) of the New York Insurance Law:

“the books, accounts and records of each party to all such transactions shall be so maintained as to clearly and accurately disclose the nature and details of the transactions  
... “

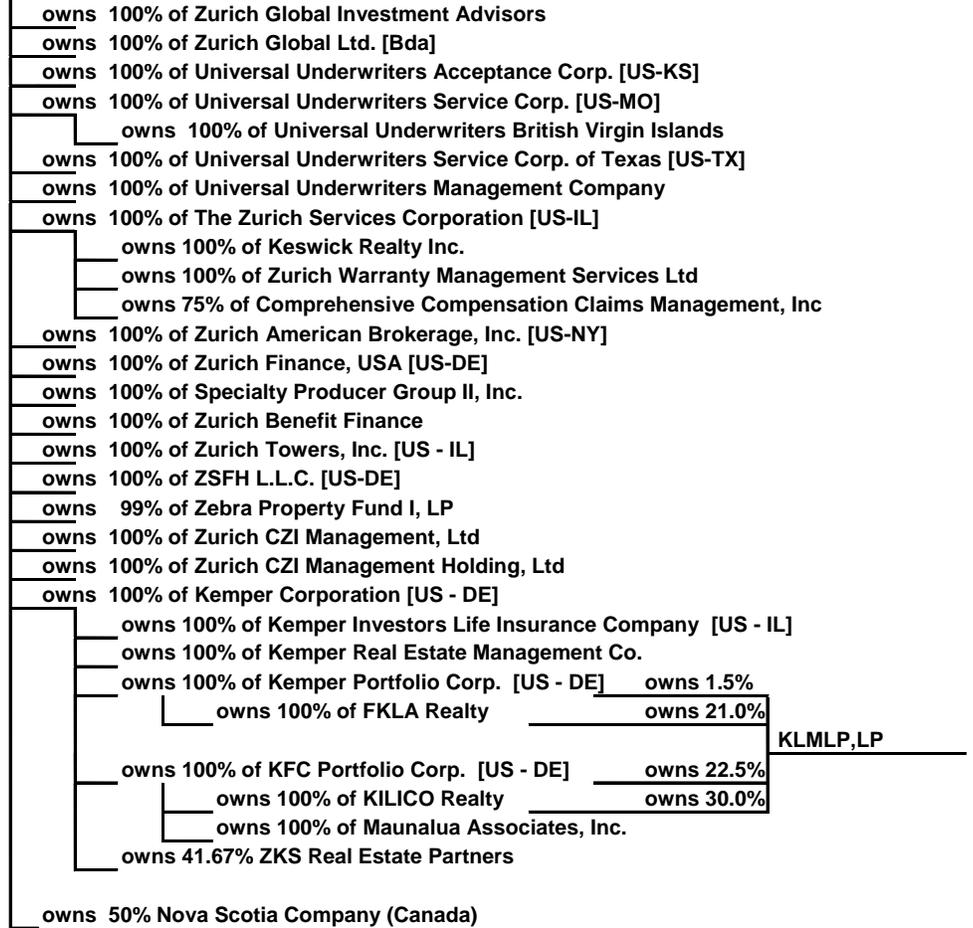
The amounts were not material as of the examination date; however, it is recommended that the Company comply with the requirements of Section 1505(b) of the New York Insurance Law, by maintaining adequate records to include written agreements for all transactions with affiliates.

The following is an abbreviated chart of the holding company system at December 31, 2003:



Zurich Group -US

See preceding page



In addition to the intercompany pooling arrangement previously discussed in the Reinsurance section of this report, the Company was a party to the following agreements with other members of its holding company system at December 31, 2003:

Amended and Restated Tax Allocation Agreement

Since 1998, the Company has been a party to a tax sharing agreement between ZHCA and its subsidiaries. The participants of the agreement record their apportioned tax liabilities and estimated tax payments according to terms of the agreement. Those terms provide for allocation of the consolidated Federal income tax in an amount equal to the consolidated tax liability multiplied by a fraction, the numerator of which is the separate taxable income of the member and the denominator of which is the sum of the taxable income of all the members of the consolidated group having taxable income. If a member has no taxable income, its share shall be zero. The allocation method is consistent with Financial Accounting Standards (“FAS”) No. 109 as modified by SSAP No. 10.

The agreement provides that when a member exits, a settlement payment shall be made to ZHCA for any benefit realized by the exiting member due to lower tax payments as a result of being part of ZHCA (less than what would have been due on a separate return basis). Conversely, a settlement payment shall be made to the exiting member for any benefit realized by ZHCA resulting from utilization of losses or credits generated by the exiting member. As this provision had the potential for creating significant contingent liabilities for all members of ZHCA, beginning with the year ending December 31, 2000, companies with losses agreed by written declaration to forego tax benefits (rights to settlement payments) related to the use of their losses by ZHCA.

The agreement was submitted to the Department and non-disapproved on November 30, 1998.

### Investment Advisory Agreement

On January 1, 2003 the Company and its direct and indirect subsidiaries entered into an investment advisory agreement with Zurich Global Investment Advisors and Zurich Investment Services.

Under the terms of the agreement Zurich Global Investment Advisors provides investment advice and develops investment guidelines for the Company's investment committee.

Zurich Investment Services provides record keeping services for the companies. Services include investment accounting and reporting such as, monthly security acquisition and disposition information and investment income summaries.

This agreement was submitted to the Department and non-objected to January 6, 2003.

### Information Technology Services Agreement

The Company participates in an information technology services agreement, which was signed on July 24, 2003. The agreement consolidates and transfers the entire mainframe-based computer processing functions that had been performed by the Company in Schaumburg, Illinois to the Data Center of Farmers Group, Inc., an affiliate, in Los Angeles, California. This data center consolidation affects the data processing for all of the member companies of ZAIG operating within North America. The primary objective of this data center consolidation is to reduce mainframe hardware and software costs for Zurich Financial Services North American operations.

This agreement was submitted to the Department and non-disapproved on September 9, 2003.

### Lease Agreement with Zurich Towers, Inc.

Effective December 28, 1998, the Company entered into a master office lease agreement with Zurich Towers, Inc. Pursuant to the agreement the Company leases the land and buildings consisting of

Tower I and Tower II located in Schaumburg, Illinois. The premises serve as the Company's main administrative office. The lease has a ten year term expiring December 31, 2008. The lease arrangement was non-disapproved by the Department.

E. Abandoned Property Law

Section 1316 of the New York Abandoned Property Law provides that amounts payable to a resident of this state from a policy of insurance, if unclaimed for three years, shall be deemed to be abandoned property. Such abandoned property shall be reported to the comptroller on or before the first day of April each year. Such filing is required of all insurers regardless of whether or not they have any abandoned property to report.

The Company's abandoned property reports for the period of this examination were all filed on a timely basis pursuant to the provisions of Section 1316 of the New York State Abandoned Property Law.

F. Significant Operating Ratios

The following ratios have been computed as of December 31, 2003, based upon the results of this examination:

Net premiums written to Surplus as regards policyholders	Note (1)	
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	166.50%	*
Premiums in course of collection to Surplus as regards policyholders	Note(1)	

Note (1) This examination has determined that the Company's Surplus as regards policyholders is \$(1,053,938,846); therefore, the results of these ratios have not been calculated.

The above ratio denoted with an asterisk falls outside the benchmark ranges set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners. The ratio reflects the reserve deficiencies noted in the loss and loss adjustment expense reserve analysis by the Department's actuaries as well as the examination change to the provision for reinsurance based on the examination reserves.

The underwriting ratios presented below are on an earned/incurred basis and encompass the five-year period covered by this examination:

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss		
adjustment expenses incurred	\$21,428,563,615	95.22%
Other underwriting expenses incurred	6,021,323,988	26.76%
Net underwriting loss	<u>(4,945,647,275)</u>	<u>(21.98)</u>
Premiums earned	<u>\$22,504,240,328</u>	<u>100.00%</u>

#### G. Accounts and Records

The general books of the Company are maintained by the use of electronic data processing equipment and applicable pre-programmed insurance related software packages. Basic data consists of cash receipts documents, cash disbursements vouchers, working papers, reports of premium and losses and various other documents and memoranda of a journal nature. Standardized insurance accounting procedures are employed in transactions involving premiums, losses, expenses and valuation of assets and liabilities resulting from the operation of the company.

During the course of the review of the Company's accounts and records the operational and organizational controls in place were analyzed. In general, it appears the Company has a sufficient level of controls in place.

However, the following record keeping deficiencies were noted during the course of the current examination:

### Securities Lending Agreement

It was noted during the examination that various members of ZAIG, including the Company, have been participating in a securities lending program with the Bank of New York without an agreement. The Company indicated that Northern Insurance Company of New York entered into a securities lending agreement with the Bank of New York effective February 12, 1998 and it considers that agreement to be the master agreement for all entities, even though they are not named on the agreement.

Additionally, it was noted that the agreement does not provide for the lending of any foreign securities. Upon review of the securities actually loaned as of December 31, 2003, it was noted that there were several foreign securities then on loan. However, the securities were "loaned" in United States ("US") currency. The US currency was placed as collateral for the loaned securities.

It is recommended that the Company not participate in a securities lending program unless it is a named party on a securities lending agreement.

It is recommended that the agreement make provision for the loaning of foreign securities pursuant to SSAP No. 18.

### Custody Agreement

The Company was not able to provide evidence that the board of directors authorized entering into the insurance company custody agreement with the Bank of New York ("BONY"). The NAIC Financial Examiners' Handbook, Part 1, Section IV, J Paragraph 1, requires authorization by board resolution.

It is recommended that the Company's board of directors approve the insurance company custody agreement with the Bank of New York in accordance with the NAIC Financial Examiners' Handbook, Part 1, Section IV, J Paragraph 1.

It was noted that management answered affirmatively to the following General Interrogatory in its December 31, 2003 filed annual statement:

“Excluding items in Schedule E, real estate, mortgage loans and investments held physically in the reporting entity’s offices, vaults or safety deposit boxes, were all stocks, bonds and other securities, owned throughout the current year held pursuant to a custodial agreement with a qualified bank or trust company in accordance with Part 1-General, Section IV.H-Custodial or Safekeeping Agreements of the NAIC Financial Condition Examiners Handbook?”

Examination review indicated that the insurance company custody agreement entered into with BONY did not contain any provision for notification to the Superintendent if the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn. Part 1, Section IV, J, Paragraph 2(f) of the NAIC Financial Condition Examiners Handbook suggests that the custodian, BONY, shall provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner.

It is recommended that the Company revise its custody agreement with BONY to provide that the custodian provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner.

It is also recommended that the Company respond appropriately to the General Interrogatory regarding custodial or safekeeping agreements in future statements filed with this Department.

#### Structured Settlement Reporting in Annual Statement

In response to Note 27 (Structured Settlements) of the Notes to Financial Statements in the Company’s 2003 annual statement, the Company responded “None.” However, upon examination it was determined that the Company did in fact enter into structured settlements, for which it is contingently liable. In accordance with the Annual Statement Instructions, the Company is required to disclose the amount of reserves no longer carried by the insurer because it has purchased annuities with the claimant

as payee and the extent to which the insurer is contingently liable for such amount should the issuers of the annuities fail to perform under the terms of the annuities.

It is recommended the Company properly disclose its structured settlements in all future annual statements.

Failure to Comply with Department Regulation 118, Part 89.2

The engagement letter between the Company and its independent auditor was reviewed for compliance with Part 89.2 of Department Regulation No. 118. Pursuant to the Regulation, the contract must specify that:

“(a) on or before May 31st, the CPA shall provide an audited financial statement of such insurer and of any subsidiary required by section 307(b)(1) of the Insurance Law together with an opinion on the financial statements of such insurer and any such subsidiary for the prior calendar year and an evaluation of the insurer’s and any such subsidiary’s accounting procedures and internal control systems as are necessary to the furnishing of the opinion;

(b) any determination by the CPA that the insurer has materially misstated its financial condition as reported to the superintendent or that the insurer does not meet minimum capital or surplus to policyholder requirements set forth in the Insurance Law shall be given by the CPA, in writing, to the superintendent within 15 calendar days following such determination; and

(c) the workpapers and any communications between the CPA and the insurer relating to the audit of the insurer shall be made available for review by the superintendent at the offices of the insurer, at the Insurance Department or at any other reasonable place designated by the superintendent. The CPA must retain for review such workpapers and communications in accordance with the provisions of Part 243 of this Title (Regulation 152). More specifically, such workpapers and communications must be retained by the CPA for the period specified in sections 243.2(b)(7) and (c) of this Title. For the purposes of this subdivision, the workpapers and communications shall be deemed to have been created on the date the filing required by section 89.2(a) of this Part was submitted to the superintendent.”

Based upon the review, the letter for the 2003 engagement did not contain the above language.

It is recommended that the Company comply with Regulation 118, Part 89.2 and incorporate the appropriate language in all future engagement letters or similar contracts with its independent certified public accountants.

#### Note No. 31 in 2003 Annual Statement was in Error

In response to Note 31 (High Deductibles) of the Notes to Financial Statements in the Company's 2003 Annual Statement, the Company reported reserve credits for high deductibles on unpaid claims of \$1,634,583,987. Per discussions with management, it was determined that this amount was not accurate as it included all policies with deductibles and not just high deductibles. The Company indicated that they did not have detail by claim number for high deductible policies at December 31, 2003.

It is recommended the Company maintain appropriate data to accurately report reserve credits for high deductibles in future annual statement filings.

#### Accounts and Records-Reclasses

The following accounts should be reclassified in accordance with the NAIC Annual Statement Instructions. These reclasses have no surplus impact and therefore have not been reflected in the examination financial statements.

##### 1. Reclassification of Draft Outstanding

\$262,837,577 of the \$266,681,418 reported by the Company under the caption "Drafts outstanding" actually represents outstanding claims that will be settled in connection with certain reinsurance agreements executed by Empire Fire and Marine Insurance Company and should therefore be reclassified under the caption "Amounts withheld or retained by Company for account of others."

##### 2. Other Expenses misclassification Cash Collateral

\$21,035,509 reported by the Company under the caption "Other expenses" relates to captive policies billed to corporate customers and should be reclassified to "Amounts withheld or retained by company for account of others."

### 3. Reclass of Certain Credit Balances in Agents Balances

It was determined that the following accounts with credit balances within the “Uncollected premiums and agents’ balances in course of collection” should be reclassified to the following accounts:

#### (a) Remittances and Items not allocated:

<u>Acct #</u>	<u>Description</u>	<u>Amount</u>
140120	Direct Premium Rec. GAP Suspense	\$ 55,578
144200	Unapplied Cash Assm Rein	19,027,163
144408	Unapplied Cash Wire Clearing	38,303,938
144410	Unapplied Cash Items Returned	22,072
144416	Unapplied Cash Misc Lock	234

#### (b) Amounts Withheld by Company for Account of Others:

140132	Cash Collateral	\$71,219,456
140134	Loss Funds Retro Program	77,265,769

#### (c) Commissions Payable:

140182	EDW Dir Commissions Payable Coml	\$17,365,802
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The total amount reclassified from Agents’ balances is \$223,261,012.

### 4. Improperly Classified-Amounts Recoverable-High Deductible Plans

\$222,671,328 of amounts billed to insureds for recoverables under high deductible plans, less unapplied receipts of \$21,677,958, were reported by the Company under the caption “Aggregate write-in for liabilities.” NAIC Annual Statement Instructions provide that these amounts should be reported as “Aggregate write-ins for other than invested assets.”

### 5. Improper Classification of Loss Funds on Deposit with Third Party Administrators

The Company reported \$108,816,634 in funds on deposit with third party administrators as “Aggregate write-in for liabilities.” The Company determined as of December 31, 2004 that this debit balance account would be more appropriately reported as an “Aggregate write-in for other than invested assets.”

### 6. Uncollectible Premiums and Agents’ Balances in Course of Collection

An adjustment in the amount of \$452,515,974 for booked as billed premiums was incorrectly made to “Uncollectible premiums and agents’ balances in course of collection” in the 2003 Annual Statement. During 2004, the Company booked the adjustment correctly to “Deferred premiums, agents’ balance and installments booked but deferred and not yet due” on the Annual Statement. The Company has additionally

indicated that reinsurance premiums were improperly reported in the intercompany accounts, and this was also corrected in the 2004 annual statement.

It is recommended that the Company prepare its annual statement in accordance with NAIC Annual Statement Instructions.

#### Advance Premium

SSAP No. 53, Paragraph 13 states:

"Advance premiums result when policies have been processed, and the premium has been paid prior to the effective date. These advance premiums are reported as a liability in the statutory financial statement and not considered income until due. Such amounts are not included in written premium or the unearned premium reserve."

While the majority of the Company's business is commercial business where there would be a minimum amount of advance premium, it was noted that there was some advance premiums collected before December 31, 2003 with an effective date beginning in 2004. The Company did not report any "Advanced premiums" on the 2003 annual statement.

It is recommended the Company recognize and set up the liability for Advance premiums for those premiums received prior to the effective date of a policy in accordance with SSAP No. 53, Paragraph 13.

#### Annual Statement Disclosure of Adjustment Methodology

The Company did not indicate in its 2003 annual statement the methodology used for each type of loan-backed securities held. SSAP No. 43, Paragraph 27, requires that the Company make certain disclosures related to loan-backed securities. Subparagraph d, requires that the Company disclose the adjustment methodology used for each type of loan-backed security (either prospective or retrospective). The Company did not make the required disclosures.

It is recommended that the Company follow the Annual Statement Instructions, and also comply with SSAP No. 43, which requires disclosure in the Notes to Financial Statements of the methodology used for each type of loan-backed security (either prospective or retrospective).

#### Permitted Practice Non-allowance

The Company filed with the Department the details of the formation of Zurich SF Holdings LLC and received a non-objection letter to the formation on December 22, 1999. In the letter, the Department indicated that the investment in Sterling Forest, which had been appraised at approximately \$21,878,000, was permissible under Article 14 of the New York Insurance Law.

During the period covered by this examination, the Company, incorrectly believing that the Department's December 22, 1999 letter of non-objection to the investment also granted it a permitted practice relative to the valuation of this investment at cost, continued to reported the value of this investment as \$21,878,000. On August 13, 2004, the Company submitted a request to the Department to discontinue the use of this permitted practice and was advised that the Department had not granted a permitted practice.

It is recommended that the Company cease carrying Zurich SF Holdings, LLC at its acquisition cost and value its investment in Zurich SF Holdings, LLC pursuant to SSAP No. 46. The Company should also cease indicating in its annual statement that it has received a permitted practice pertaining to this investment.

#### Direct Bill System

Upon examination the Company was unable to provide a direct bill uncollected premium file supporting the Company's premium receivable asset. The Company indicated that no detail year-end data files are maintained. This practice is not in compliance with Regulation 152, Part 243.2(b)(7) which

states that financial records required to verify an insurer's financial condition be maintained for six calendar years from their creation or until after the filing of the report on examination in which the record was subject to review, whichever is longer.

It is recommended that the Company comply with Department Regulation 152, Part 243.2(b)(7) and retain a copy of direct bill uncollected premium detailed data files at each year-end to support its premium receivable asset for financial examinations.

#### Deferred Tax Asset

SSAP 10, paragraph 6a provides that a reporting entity's deferred tax assets and liabilities are computed as follows:

"Temporary differences are identified and measured using a "balance sheet" approach whereby statutory and tax basis balance sheets are compared".

The Company supplied a Schedule of Deferred Taxes that uses an "income statement" approach. The schedule focuses on the differences in book and taxable incomes, rather than the book/tax differences of the underlying assets or liabilities. The advantage of the balance sheet approach is that the statutory and tax basis of all assets and liabilities are considered in the calculation of the deferred taxes. This helps to ensure that all book/tax differences are identified and considered in the measurement of the deferred taxes.

It is recommended that the Company identify and measure their deferred taxes using a balance sheet approach as prescribed by SSAP No 10, Paragraph 6a.

#### Failure to Comply with Circular Letter No. 10 (2001)

Department Circular Letter No. 10 (2001) provides for the proper method for collecting and paying premium tax on workers' compensation and employers' liability policies containing deductibles in New York State. The letter advises that the amount of deductible paid by the policyholder to the insurer should be treated as a premium paid to the insurer for the purpose of Section 1510 of the New York Tax

Law. Examination review revealed that the participants of the ZAIG Pool did not recognize the reimbursements as premiums.

It is recommended that the ZAIG Pool, and specifically the Company, comply with Department Circular Letter No. 10 (2001) and treat the amount of deductible paid by the policyholder to the insurer under high deductible policies as premium paid to the insurer for the purpose of Section 1510 of the New York Tax Law.

### 3. FINANCIAL STATEMENTS

#### A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as determined by this examination as of December 31, 2003 and as reported by the Company.

<u>Assets</u>	<u>Examination</u>		<u>Company</u>		<u>Surplus Increase (Decrease)</u>
	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Net Admitted Assets</u>	
Bonds	\$11,123,104,827	\$0	\$11,123,104,827	\$11,123,104,827	\$0
Common stocks	2,400,655,651	1,369,063,501	1,031,592,150	2,400,655,651	(1,369,063,501)
Cash, cash equivalents and short-term Investments	172,040,460	0	172,040,460	172,040,460	0
Other invested assets	40,680,125	0	40,680,125	40,680,125	0
Aggregate write-ins for invested assets	40,410,744	0	40,410,744	40,410,744	0
Investment income due and accrued	100,009,013	0	100,009,013	100,009,013	0
Uncollected premiums and agents' balances in the course of collection	980,083,519	303,427,059	676,656,460	855,036,309	(178,379,849)
Deferred premiums, agents' balances and installments booked but deferred and not yet due	1,857,206,629	22,099,348	1,835,107,281	1,835,107,281	0
Accrued retrospective premiums	574,874,759	8,708,871	566,165,887	566,165,887	0
Amounts recoverable from reinsurers	1,190,419,364		1,190,419,364	1,190,419,364	0
Funds held by or deposited with reinsured companies	12,148,601	0	12,148,601	12,148,601	0
Net deferred tax asset	983,344,356	683,657,605	299,686,751	299,686,751	0
Guaranty funds receivable or on deposit	42,186,028	0	42,186,028	42,186,028	0
Electronic data processing equipment and software	160,126,787	155,969,548	4,157,239	4,157,239	0
Furniture and equipment, including health care delivery assets	40,719,866	40,719,866	0	0	0
Receivables from parent, subsidiaries and affiliates	279,825,588	19,043,856	260,781,732	279,782,474	(19,000,742)
Other assets non-admitted	31,152,665	31,152,665	0	0	0
Aggregate write-ins for other than invested assets	<u>208,539,282</u>	<u>64,397,224</u>	<u>144,142,058</u>	<u>145,833,150</u>	<u>(1,691,092)</u>
Total assets	<u>\$20,237,528,264</u>	<u>\$2,698,239,543</u>	<u>\$17,539,288,721</u>	<u>19,107,423,904</u>	<u>(\$1,568,135,183)</u>

<u>Liabilities, Surplus and Other Funds</u>			Surplus
<u>Liabilities</u>	<u>Examination</u>	<u>Company</u>	<u>Increase</u> <u>(Decrease)</u>
Losses and loss adjustment expenses	\$11,369,566,717	\$8,766,566,717	\$(2,603,000,000)
Reinsurance payable on paid losses and loss adjustment Expenses	346,485,009	346,485,009	0
Commissions payable, contingent commissions and other similar charges	81,142,391	81,142,391	0
Other expenses (excluding taxes, licenses and fees)	274,541,220	274,541,220	0
Taxes, licenses and fees (excluding federal and foreign income taxes)	168,077,796	144,637,534	(23,440,262)
Current federal and foreign income taxes	68,896,616	68,896,616	0
Net deferred tax liability	0	0	0
Borrowed money and interest thereon	0	0	0
Unearned premiums	3,931,055,020	3,836,055,020	(95,000,000)
Advance premiums	0	0	0
Policyholders (dividends declared and unpaid)	5,723,168	5,723,168	0
Ceded reinsurance premiums payable (net of ceding commissions)	740,669,557	740,669,557	0
Funds held by company under reinsurance treaties	1,092,984,371	1,092,984,371	0
Amounts withheld or retained by company for account of Others	51,626,702	51,626,702	0
Remittances and items not allocated	0	0	0
Provision for reinsurance	455,484,180	15,530,271	(439,953,909)
Net adjustments in assets and liabilities due to foreign exchange rates	0	0	0
Drafts outstanding	266,681,418	266,681,418	0
Payable to parent, subsidiaries and affiliates	0	0	0
Payable for securities	11,192,230	11,192,230	0
Liability for amounts held under uninsured accident and health plans	0	0	0
Capital notes and interest thereon	0	0	0
Aggregate write-ins for liabilities	<u>(270,898,831)</u>	<u>(270,898,831)</u>	<u>0</u>
Total liabilities	<u>\$18,593,227,564</u>	<u>\$15,431,833,393</u>	<u>\$(3,161,394,171)</u>
 <u>Surplus and Other Funds</u>			
Aggregate write-ins for special surplus funds	\$199,427,929	\$199,427,929	\$ 0
Common capital stock	5,000,000	5,000,000	0
Preferred capital stock	0	0	0
Aggregate write-ins for other than special surplus funds	0	0	0
Surplus notes	1,053,000,000	1,053,000,000	0
Gross paid in and contributed surplus	2,206,131,141	2,206,131,141	0
Unassigned funds (surplus)	<u>(4,517,497,916)</u>	<u>212,031,440</u>	<u>(4,729,529,356)</u>
Surplus as regards policyholders	<u>\$(1,053,938,846)</u>	<u>\$3,675,590,510</u>	<u>\$(4,729,529,356)</u>
Total liabilities, surplus and other funds	<u>\$17,539,288,718</u>	<u>\$19,107,423,904</u>	

NOTES:

(1) The Internal Revenue Service has completed its audits of the Company's (consolidated) federal income tax returns through tax year 2002. All material adjustments, if any, made subsequent to the date

of examination and arising from said audits, are reflected in the financial statements included in this report. The Internal Revenue Service has not yet begun to audit tax returns covering tax year 2003. Potential exposures of the Company to tax assessments have been estimated by the Company and a liability of approximately \$70,000,000 has been established herein relative to such contingency.

(2) This examination has concluded that the Company's liabilities at December 31, 2003 as determined by the examination exceeded its assets at December 31, 2003 as determined by the examination in the amount of \$1,053,938,846. The Company is required to maintain a minimum surplus of \$35,000,000 and capital in the amount of \$5,000,000.

As noted on page 2 of this report, subsequent to the examination date, the Company received surplus contributions made by Zurich Holding Company of America ("ZHCA") and proceeds from the issuance of a surplus note to Zurich Insurance Company (Switzerland) ("ZIC"), totaling \$2.3 billion. During 2004, the Company repaid \$38,700,000 in principal relating to a previously issued surplus note from ZHCA. The surplus note and contributions had the effect of eliminating the examination surplus deficiency.

B. Underwriting and Investment Exhibit

Surplus as regards policyholders decreased \$2,813,748,086 during the five-year examination period January 1, 1999 through December 31, 2003, detailed as follows:

Underwriting Income

Premiums earned		\$22,504,240,328
Deductions:		
Losses and loss adjustment expenses incurred	\$21,428,563,615	
Other underwriting expenses incurred	6,021,323,988	
Aggregate write-ins for underwriting deductions	<u>0</u>	
Total underwriting deductions		<u>27,449,887,603</u>
Net underwriting gain or (loss)		\$(4,945,647,275)

Investment Income

Net investment income earned	\$4,453,428,851	
Net realized capital gain	<u>310,555,739</u>	
Net investment gain or (loss)		4,763,984,590

Other Income

Net gain or (loss) from agents' or premium balances charged off	\$(137,854,730)	
Finance and service charges not included in premiums	53,661,007	
Aggregate write-ins for miscellaneous income	<u>(231,432,781)</u>	
Total other income		<u>(315,626,504)</u>
Net income before dividends to policyholders and before federal and foreign income taxes		<u>\$(497,289,189)</u>
Dividends to policyholders		<u>35,557,961</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$(532,847,150)
Federal and foreign income taxes incurred		<u>43,134,626</u>
Net Income		<u>\$(575,981,776)</u>

Surplus as regards policyholders per report on examination as of December 31, 1998			\$1,647,309,240
	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income		\$575,981,777	
Net unrealized capital gains or (losses)		2,054,528,822	
Change in net unrealized foreign exchange capital gain (loss)	\$1,312,851		
Change in net deferred income tax	983,344,356		
Change in nonadmitted assets		2,495,428,723	
Change in provision for reinsurance		401,512,841	
Change in surplus notes	953,000,000		
Cumulative effect of changes in accounting principles		119,967,228	
Surplus adjustments paid in	1,704,820,290		
Dividends to stockholders		684,000,000	
Aggregate write-ins for gains and losses in surplus		<u>12,306,192</u>	
Total gains and losses	<u>\$ 3,642,477,497</u>	<u>\$ 6,343,725,583</u>	
Net increase (decrease) in surplus			<u>(2,701,248,086)</u>
Surplus as regards policyholders per report on examination as of December 31, 2003			<u>\$(1,053,938,846)</u>

#### 4. COMMON STOCKS

The examination admitted asset of \$1,031,592,150 is \$1,369,063,501 less than the \$2,400,655,651 reported by the Company as of December 31, 2003. The examination change represents the disallowance upon examination of a portion of the Company's investment in the common stocks of insurance company subsidiary stocks pursuant to the limitations set forth in Section 1408(b) of the New York Insurance Law.

Section 1408(b) of the New York Insurance Law limits an insurer's investment in insurance company stocks to the greater of fifty percent of the insurer's surplus to policyholders or sixty percent of its surplus.

This examination has determined the Company's surplus as regards policyholders to be \$315,124,655 before any Section 1408(b) penalty. Thus the Company's investment in insurance company stocks is limited to \$157,562,328. As of December 31, 2003 the Company reported \$1,526,625,828 book value investment in common stocks of subsidiaries and affiliates as follows:

American Guarantee and Liability Insurance Company	\$ 93,728,973
Empire Fire and Marine Insurance Company	123,644,958
Empire Indemnity Insurance Company	28,973,110
Fidelity and Deposit Insurance Company of Maryland	165,944,489
Maryland Casualty Company	345,072,937
Steadfast Insurance Company	309,423,916
Universal Underwriters Insurance Company	<u>459,837,445</u>
Total	<u>\$1,526,625,828</u>

The examination has non-admitted the \$1,369,063,501 excess investment in insurance company stocks.

#### 5. UNCOLLECTED PREMIUMS AND AGENTS' BALANCES IN THE COURSE OF COLLECTION

The examination admitted asset of \$676,656,460 is \$178,379,849 less than the \$855,036,309 reported by the Company in its December 31, 2003 filed annual statement.

The Company performs a manual review of a systems generated report that shows all premiums more than ninety days past due. Utilizing a Company developed series of rules based on management's interpretation of Statutory Accounting Principles, the Company then restores such overdue balances to its admitted assets pursuant to a process identified as "purification." Based on a review of the "Over 90's Codification Rules" and the Company's explanation of the rules, it has been determined that Company erroneously reported \$178,379,849 of premiums receivable over ninety days due as part of its admitted assets.

Examination review of the Company rules indicated that certain of these rules did not comply with Statement of Statutory Accounting Principles No. 6, as follows:

Rule No. 2: Credits (Cross Apply)	\$114,623,633
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The Company's policy is to net related and unrelated policies of an insured, while SSAP No. 6, Paragraph 9(c) states: "the balances must be on the same underlying policy." The Company's rule description permits credit balances with the same insured to be applied to other policies for that insured.

Since the rule is not in compliance with SSAP No. 6 the balance allowed by the Company under Rule 2 was disallowed on examination.

Rule No. 3: Letter of Credit	\$ 31,256,215
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The Company's position is that a clean and irrevocable letter of credit ("LOC") may be used to purify overdue items and treat them as admitted assets and that an LOC is an allowable substitution for unearned premium reserves ("UPR"). Of the \$330,921,532 in premiums purified by this rule, \$299,665,316 were deferred retro premiums which did not have an overdue premium due balance. The remaining \$31,256,215 were overdue installment premiums.

SSAP No. 6 does not allow an over 90 day balance to be admitted because the Company has a right to draw on an LOC, nor does SSAP No. 6 provide that a LOC is an allowable substitution for UPR. Since Rule No. 3 is not in compliance with SSAP No. 6, the installment portion of the balance allowed by the Company under Rule 3 has been disallowed on examination.

Rule No. 35: Purification of Future Installments	\$32,500,000
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Rule No. 35 states that if a producer, policy symbol or policy has been 100% purified for all but the future installment amount, then, the future installments amount can be purified using this rule. The Company explains that Paragraph 9(b) of SSAP No. 6 states that if any installment is past due, the entire bills receivable balances from that policy is non-admitted. Conversely, if the over 90 day installment is purified, the future installments from that policy are admitted.

Since it has been determined that balances purified under Rules Nos. 2 and 3 should be reported as not admitted assets, any related future installments purified under Rule No. 35 should also be reported as not admitted.

Overall examination adjustment associated with non-allowance of the above listed rules result in an increase to non-admitted assets in the amount of \$178,379,849 with a corresponding decrease to surplus.

## **6. RECEIVABLES FROM PARENT, SUBSIDIARIES AND AFFILIATES**

The examination admitted asset of \$260,781,732 is \$19,000,742 less than the \$279,782,474 reported by the Company in its December 31, 2003 filed annual statement. Affiliated receivable balances in the amount of \$19,000,742 were reported by the Company as being disputed and/or unpaid at December 31, 2003. These amounts, most of which are not supported by agreements, have been included in the examination financial statement as a not admitted asset due to the fact that they were still

uncollected 90 days past year-end. The Company indicated that the balances over 90 days past due were secured by letters of credit. However, there is nothing in the New York Insurance Law, Rules, or Regulations that allows this practice.

It is recommended that the Company non-admit all affiliated balances over 90 days past due in compliance with Department Circular Letter No. 15 (1975).

## **7. AGGREGATE WRITE-INS FOR OTHER THAN INVESTED ASSETS**

The examination admitted asset of \$144,142,058 is \$1,691,092 less than the \$145,833,150 reported by the Company in its December 31, 2003 filed annual statement. Nine letters of credit (“LOCs”) used as collateral for amounts billed to six different insureds for recovery of deductibles were reviewed for compliance with Department Regulation 133, Part 79.

The following discrepancies were noted:

1. Three of the LOCs name multiple beneficiaries. Of these, two do not name the Company as a beneficiary.
2. One LOC names only Zurich Insurance Company (making three LOCs that do not name the Company as a beneficiary)
3. Two LOCs are issued by banks not on the SVO Approved Issuer List.
4. One LOC was not in effect as of December 31, 2003.

Most of the outstanding balances secured by the LOCs with compliance issues had other acceptable collateral. One account, however, had no other collateral. The Schindler LOC, which names only Zurich Insurance Company, had an account balance of \$16,910,916.46. SSAP 65 requires 10% of the account balance in excess of collateral to be non-admitted.

It is recommended that the Company negotiate LOCs in compliance with Department Regulation 133, Part 79.

**8. LOSSES AND LOSS ADJUSTMENT EXPENSES**

The examination liability of \$11,369,566,717 is \$2,603,000,000 more than the \$8,766,566,717 reported by the Company as of December 31, 2003. The examination analysis of the loss and loss adjustment expense reserves was conducted in accordance with generally accepted actuarial principles and was based on statistical information contained in the Company's internal records and in its filed annual statements. The deficiencies noted were primarily in general liability, workers' compensation and medical malpractice. Significant development during calendar year 2003 across all accident years was noted in medical malpractice.

The Company's own historical development through June 30, 2006 indicates that it has already recognized the recommended examination loss and loss adjustment expense reserve deficiency.

**9. TAXES, LICENSES AND FEES**

The examination liability of \$168,077,796 is \$23,440,262 more than the \$144,637,534 reported by the Company in its December 31, 2003 filed annual statement. A review of the 2003 year-end premium tax accruals and subsequent settlements indicated that the Company had underestimated the liability. Specifically, general ledger account No. 252417, Premium Based Other Accruals was underaccrued by \$8,640,262 and general ledger account No. 252419, Loss Based Assessment accrual appears to be underestimated by \$14,800,000, for a total of \$23,440,262.

**10. UNEARNED PREMIUM RESERVE**

The examination liability of \$3,931,055,020 is \$95,000,000 more than the \$3,836,055,020 reported by the Company in its December 31, 2003 filed annual statement. The examination change is

comprised of an additional retrospective premium reserve and was determined in accordance with generally accepted actuarial principles.

## **11. PROVISION FOR REINSURANCE**

The examination liability of \$455,484,180 is \$439,953,909 more than the \$15,530,271 reported by the Company in its December 31, 2003 filed annual statement. The examination change is due to the following:

- \$22,852,000 increase to the Provision for Reinsurance for the \$75 million parental LOC disallowed on examination;
- \$117,760,000 additional Schedule F Penalty (exclusive of the Hannover Re stop losses) as a result of the additional ceded IBNR pursuant to the Department's actuarial analysis as of December 31, 2003;
- \$144,648,000 additional losses ceded out under stop loss treaties covering accident years 1999 through 2003 with Hannover Re, an unauthorized insurer, pursuant to the Department's actuarial analysis which are not collateralized at December 31, 2003;
- \$147,088,603 credits taken for reinsurance ceded to unauthorized reinsurers collateralized with trust agreements involving multiple beneficiaries disallowed for examination purposes; and
- \$7,605,306 additional Schedule F, Penalty as a result of the recalculation for unauthorized insurers improperly reported as authorized.

It is noted that had the Department allowed additional collateral obtained in 2004 to secure the ceded IBNR reserve strengthening made in 2004 for accident years 2003 and prior, the \$117,760,000 additional Schedule F penalty (exclusive of the Hannover Re stop losses) would have been reduced to \$54,264,000. In addition, the additional losses ceded out to Hannover Re under the stop losses would have been fully collateralized by the parental letter of credit, subsequently approved by the Department and parental trust agreement.

## 12. MARKET CONDUCT ACTIVITIES

In the course of this examination, a review was made of the manner in which the Company conducts its business practices and fulfills its contractual obligations to policyholders and claimants. The review was general in nature and is not to be construed to encompass the more precise scope of a market conduct investigation, which is the responsibility of the Market Conduct Unit of the Property Bureau of this Department.

The general review was directed at practices of the Company in the following areas:

- A. Sales and advertising
- B. Underwriting
- C. Claims and complaint handling

The following exceptions were noted:

Testing performed relative to the licensing and appointment of agents for various ZAIG Pool participants revealed instances where the agent was not properly licensed and/or appointed.

It is recommended that the ZAIG Pool, and specifically the Company, initiate procedures to ensure that the agents utilized to market its products are properly licensed and appointed.

The Company's complaint log was not in compliance with the requirements of Circular Letter No. 11 (1978). The following columns were found to be missing:

1. The person in the Company with whom the complainant has been dealing.
2. The dates of correspondence to the Department's Consumer Services Bureau
3. Chronology of further contacts with the Department.
4. Remarks about internal remedial action taken as a result of the investigation.

In view of the above, it is recommended that the Company fully comply with the requirements of Circular Letter No. 11 (1978) and going forward maintain a complaint log that encompasses the eleven subject matters required in this circular letter.

### 13. LEGAL DISCLOSURE

Commencing in August 2004, subsequent to the examination date, the Company was served with four subpoenas by the Office of the New York Attorney General (“NYAG”) for documents/information concerning incentive compensation arrangements and various alleged anti-competitive behaviors involving brokered transactions. Subpoenas and information requests also were served by various other state governmental entities. In connection with these regulatory investigations, and as a result of its own internal review, ZAIC terminated six employees. Two of the terminated employees have pled guilty to a misdemeanor violation of New York law and one has pled guilty to the felony crime of fraud under New York law and another has been charged with two felony violations of New York law and has entered a plea of not guilty.

Beginning on or about November 15, 2004, Zurich Financial Services (“ZFS”) and several ZFS subsidiaries received two subpoenas from the United States Securities and Exchange Commission (“SEC”) and one subpoena from the NYAG concerning finite reinsurance and other nontraditional products. In April of 2005, the Georgia Insurance Commissioner also served a subpoena related to finite reinsurance and other non-traditional products on the Company and other of its subsidiaries. In May 2005, the Delaware Department of Insurance served a letter inquiry on Steadfast Insurance Company relating to finite insurance/reinsurance. On or about June 14, 2005, ZFS received a grand-jury subpoena issued by the United States Attorney for the Southern District of New York. The subpoena has not been officially served on ZFS or any of its subsidiaries or affiliates and ZFS has not otherwise accepted service of the subpoena. The subpoena purports to require ZFS and all affiliates and subsidiaries, to provide the grand jury with certain documents, largely relating to finite, stop-loss, funding and limit-of-liability cover agreements, and reinsurance agreements affected by side agreements.

On March 27, 2006, ZAIC and Zurich Holding Company of America, Inc. reached separate settlement agreements with the Offices of the Attorneys General of the States of New York, Connecticut,

and Illinois and the Department (the "Three-State Agreement") relating to their industry-wide investigations into broker compensation and insurance placement practices and non-traditional products and finite risk and insurance/reinsurance. The Three-State Agreement called for the payment of approximately \$88 million in restitution to excess casualty policyholders and \$65 million in fines and certain business reforms, including producer compensation disclosure requirements and certain limitations on the payment of contingent commissions. ZAIC did not admit to any violation of U.S. federal or state laws as part of the Three-State Agreement.

Also, beginning on March 20, 2006, ZAIC reached settlement agreements with ten additional state attorneys general, inclusive of the state attorneys general of Florida and Texas, and one insurance commissioner (the "Multi-State Agreement"), and separate agreements with three other state attorneys general and one insurance commissioner, relating to their industry-wide investigations into broker compensation and insurance placement practices and "non-traditional" products and finite insurance/reinsurance. Also beginning on March 20, 2006, ZAIC reached settlement agreements with fifteen insurance commissioners, inclusive of the insurance commissioners of California and Illinois (the "Regulatory Agreement"), relating to their industry-wide investigations into broker compensation and insurance placement practices. As part of these settlement agreements, ZAIC agreed to certain business reforms. As part of the implementation of the business reforms under the Multi-State Agreement, actions were instituted in state courts by certain settling state attorneys general for entry of an order and stipulated injunctions, and subsequently for entry of an amended order and stipulated injunctions.

Under the Multi-State Agreement, ZAIC agreed to a \$51,700,000 settlement fund that will be distributed through a separate settlement agreement entered into in the Consolidated Class Action described below. The Multi-State Agreement also required ZAIC to pay \$20 million for the states' fees and costs. The Regulatory Agreement did not require the payment of any money. ZAIC did not admit to any violation of U.S. federal or state laws as part of these settlement agreements with state attorneys general and insurance commissioners.

A number of lawsuits have been filed by private parties against the Company and its insurance subsidiaries arising out of the foregoing regulatory investigations. The complaints in these suits allege that the defendants unlawfully participated in bid-rigging and/or a contingent commission scheme in violation of state and/or federal laws and seek unspecified damages and injunctive relief. On July 28, 2006, and as amended on August 28, 2006, the Zurich defendants entered into a settlement agreement with plaintiffs in class actions which had been consolidated into one action before the United States District Court for the District of New Jersey under the caption, In re Insurance Brokerage Antitrust

Litigation, Civil No. 04-5184 (the “Consolidated Class Action”). Under the settlement agreement, Zurich defendants agreed to settle the claims made in the litigation (the "Class Action Settlement"). The Class Action Settlement, in conjunction with the Multi-State Agreement, provides for a settlement fund of \$121,800,000 to be distributed to settlement class members. On February 16, 2007, the Court approved as final the Class Action Settlement. An appeal is pending. The Company has been named as a defendant (among other insurers and brokers) in suits that have been brought by plaintiffs who have formally excluded themselves from the settlement class in the Class Action Settlement.

Through January 2008, the Company has paid and incurred over \$50 million in legal fees and expenses related to these investigations and lawsuits. The Company has advised that at this time, it believes the ultimate liability for the matters referred to above is not likely to have a material adverse effect on the Company's combined statutory financial position, however, it is possible the effect could be material to the Company's results of operations for any future reporting period.

#### 14. SUBSEQUENT EVENTS

Total examination adjustments to the Company’s reported assets and liabilities result in negative surplus as to policyholders as of December 31, 2003 of \$1,053,938,846. This reduction is due principally to an examination increase in liabilities for loss and loss adjustment expenses. During 2004, subsequent to the examination date, but while this examination was pending, the Company strengthened its reserves for loss and loss adjustment expenses for accident years 2003 and prior in the amount of \$2.01 billion and received surplus contributions made by Zurich Holding Company of America (“ZHCA”) and proceeds from the issuance of a surplus note to Zurich Insurance Company (Switzerland) (“ZIC”) totaling \$2.26 billion, as follows (\$000’s omitted):

<u>Date</u>	<u>Type</u>	<u>Amount</u>
12/21/2004	Surplus note from ZIC <sup>1</sup> .	\$1,000,000
2004	Repaid previously issued surplus note from ZHCA	(38,700)
02/22/2005	Surplus contribution from ZHCA <sup>2</sup> .	<u>1,300,000</u>
	Total	<u>\$2,261,300</u>

<sup>1</sup>. \$800,000 received in 2004 and \$200,000 received on January 27, 2005.

<sup>2</sup>. Reported by the Company as a Type 1 subsequent event in its filed 2004 annual statement.

The Company indicated that the surplus note and contributions were made during 2004 in response to the Company strengthening its reserves for accident years 2003 and prior. The surplus note and contributions had the effect of eliminating the examination surplus deficiency.

It is noted that the examination surplus reflects an additional Schedule F Penalty in the amount of \$262,408,000 as a result of the examination determination of additional loss and loss adjustment expenses. Of this amount, \$208,144,000 would have been eliminated if additional collateral the Company has indicated it obtained in 2004 following its reserve strengthening were in place as of the examination date. It is also noted that the examination surplus includes a not admitted asset in the amount of \$1,369,063,501 for a portion of the Company's investment in the common stock of its insurance company subsidiaries pursuant to Section 1408(b) of the New York Insurance Law, which limits an insurer's investment in insurance company subsidiaries to the greater of fifty percent of its surplus to policyholders or sixty percent of its surplus over liabilities and capital. The surplus notes and surplus contributions referenced above would have the effect of eliminating the not admitted asset pursuant to Section 1408(b) of the New York Insurance Law.

## **15. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION**

The prior report on examination contained nine recommendations as follows (page numbers refer to the prior report):

<u>ITEM</u>	<u>PAGE NO.</u>
A	
<u>Management</u>	
i.	6
<u>Board of Directors' Meetings</u>	
It is recommended that the Company hold regular meetings of its board of directors and amend its by-laws to restrict the use of unanimous written consent in lieu of regular meetings to emergency situations only.	
The Company has complied with this recommendation.	
ii.	7
<u>Actions of the Executive Committee</u>	
It is recommended that the actions of the executive committee be reported to the board of directors at its next meeting, pursuant to Article III, Section 3 of the Company's by-laws.	
The Company has complied with this recommendation.	
iii.	7
<u>Approval of Investments</u>	
It is recommended that the board of directors approve all investment transactions made by the Company and that the minutes include a listing of the transactions so approved, pursuant to Section 1411(a) of the New York Insurance Law.	
The Company did not comply with this recommendation. A similar recommendation is made in this report.	
B	
<u>Reinsurance</u>	
i.	14
It is recommended that the Company maintain all reinsurance contracts and related underwriting files readily available for examination review.	
The Company has complied with this recommendation.	
ii.	35
It is recommended that the Company file with this Department the applicable cover notes for any reinsurance agreement where a related party's participation is 10% or more. Such filing is to be made within thirty days after the agreement's effective date. The complete related party reinsurance contract should be forwarded to this Department within thirty days of ratification; however, the filing should be no later than nine months after the effective date of the agreement.	

ITEMPAGE NO.

The Company did not comply with this recommendation. A similar recommendation is made in this report.

- iii. The Company is required to file the master facultative reinsurance agreement thirty days prior to entering into such an arrangement. Further, the Company should submit a list of all facultative reinsurance slips entered into with related parties pursuant to the master facultative reinsurance agreement with its annual holding company filing statement. 35

The Company did not comply with this recommendation. A similar recommendation is made in this report.

C Accounts and Records

- i. Record Retention 36

It is recommended that the Company maintain periodic back-ups at check level detail, in magnetic form, of all information contained in its database, in unadulterated form, to support the amounts reported in its annual quarterly statements, pursuant to Part 243 of New York Regulation 152.

The Company did not comply with this recommendation. A similar recommendation is made in this report.

- ii. Booked as Billed Premiums 38

It is recommended that the Company report only applicable workers' compensation premiums on a booked as billed basis, pursuant to SSAP No. 53 of the Accounting Practices and Procedures Manual of the National Association of Insurance Commissioners.

The Company has complied with this recommendation.

- iii. Letters of Credit with Multiple Applicants 39

It is recommended that the Company prepare schedules showing the allocation of the amount of the letters of credit of each applicant. The schedules should be updated quarterly and be available for examination review.

The Company did not comply with this recommendation. A similar recommendation is made in this report.

## **16. SUMMARY OF COMMENTS AND RECOMMENDATIONS**

<u>ITEM</u>	<u>PAGE NO.</u>
<p>A     <u>Policyholders' Surplus</u></p> <p>This examination has concluded that the Company's liabilities at December 31, 2003 as determined by the examination exceeded its assets at December 31, 2003 in the amount of \$1,053,938,846. The Company is required to maintain a minimum surplus of \$35,000,000 and capital in the amount of \$5,000,000.</p> <p>As noted on page 2 of this report, subsequent to the examination date, the Company received surplus contributions made by Zurich Holding Company of America ("ZHCA") and proceeds from the issuance of a surplus note to Zurich Insurance Company (Switzerland) ("ZIC"), totaling \$2.26 billion. During 2004, the Company repaid \$38,700,000 in principal relating to a previously issued surplus note from ZHCA. The surplus note and contributions had the effect of eliminating the examination surplus deficiency.</p>	<p>1, 52, 64</p>
<p>B     <u>Management</u></p> <p>i.     It is recommended that the Company comply with its by-laws with regard to the number of appointees to its executive and audit committees.</p> <p>ii.    It is recommended that the board of directors or a committee thereof approve all investment transactions made by the Company in accordance with Section 1411(a) of the New York Insurance Law.</p>	<p>6</p> <p>7</p>
<p>C     <u>Reinsurance</u></p> <p>i.     It is the position of the Department that the 2003 agreement between Hannover Re (Ireland) and ZIC constitutes an attempt to circumvent the approval of an inter-company reinsurance agreement by the Superintendent as required by Section 1505(d)(2) of the New York Insurance Law.</p> <p>ii.    It is recommended that the Company ensure that all future direct or indirect inter-company reinsurance agreements are submitted to the Department pursuant to Section 1505(d)(2) of the New York Insurance Law.</p> <p>iii.   The parental letter of credit provided by Zurich Insurance Company to secure Hannover Re's obligations to the Company under the stop losses was not approved as of December 31, 2003, pursuant to the requirements of Department Regulation 20, Part 125.4(g)(1). It is recommended that in the future, the Company seek timely approvals pursuant to the requirements of Department Regulation 20, Part</p>	<p>16</p> <p>16</p> <p>16</p>

<u>ITEM</u>	<u>PAGE NO.</u>
125.4(g)(1).	
iv. It is recommended that the Company ensure that all intermediaries included on the Company's approved list are licensed in New York in order to maintain compliance with Section 2102(a)(1) of the New York Insurance Law.	27
v. It is recommended the Company ensure that in the future, all affiliated Company reinsurance transactions are submitted to the New York Insurance Department involved in compliance with Section 1505(d)(2) of the New York Insurance Law.	28
vi. It was recommended that the Company prepare schedules showing the allocation of the amount of the letters of credit to each of the applicants, which should be updated quarterly. The schedules should be available for review by the Department's examiners.	29
vii. It is recommended that the Company ensure that it only utilize letters of credit with multi applicants where the applicants are affiliates of the Company.	29
viii. It is recommended that the Company comply with Department Regulation 114, Parts 126.2(a) and 126.3(e) and create trust account arrangements that involve only one beneficiary. It is further recommended that the Company ensure that all trust agreements to which is a party meet the required conditions of Department Regulation 114.	30
ix. It is recommended that the Company record its reinsurance related receivables and payables in accordance with Annual Statement Instructions and SSAP No. 62, Paragraph 26 of the NAIC Accounting Practices and Procedures Manual.	31
x. It is recommended that the Company comply with Department Regulation 133, Part 79.2(c) and ensure that letters of credit obtained are issued by a qualified bank or trust company.	31
xi. It is recommended that the Company comply with Department Regulation 133, Part 79.6(a)(1) and the NAIC Annual Statement Instructions and only reduce its liability for reinsurance ceded to an unauthorized reinsurer in financial statements required to be filed by this Department where the letter of credit is issued on or before the "as of" date of the Company's financial statement.	31
xii. It is recommended the Company ensure the letters of credit accepted by the Company include the proper definition of beneficiary pursuant to Regulation 133, Parts 79.2(d) and 79.1(b).	32

<u>ITEM</u>		<u>PAGE NO.</u>
xiii.	It is recommended the Company ensure that no credit is taken against the Schedule F penalty for insurers that are unauthorized in New York.	32
D	<u>Holding Company System</u>	
i.	It is recommended that the Company comply with New York Insurance Law Section 1505(b) by maintaining adequate records to include written agreements for all transactions with affiliates.	34
E.	<u>Accounts and Records</u>	
i.	It is recommended that the Company not participate in a securities lending program unless it is a named party on a securities lending agreement.	41
ii.	It is recommended that the various affiliates of the Company that loan securities pursuant to the securities lending agreement with the BONY and Northern Insurance Company of New York make provision for the loaning of foreign securities pursuant to SSAP No. 18.	41
iii.	It is recommended that the Company's board of directors approve the insurance company custody agreement with the Bank of New York in accordance with the NAIC Financial Examiners' Handbook, Part 1, Section IV, J Paragraph 1.	41
iv.	It is recommended that the Company revise its custody agreement with BONY to provide that the custodian provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner.	42
v.	It is also recommended that the Company respond appropriately to the General Interrogatory regarding custodial or safekeeping agreements in future statements filed with this Department.	42
vi.	It is recommended the Company properly disclose its structured settlements in all future annual statements.	43
vii.	It is recommended that the Company comply with Department Regulation 118, Part 89.2 and incorporate the appropriate language in all future engagement letters or similar contracts with its independent certified public accountants.	44
viii.	It is recommended the Company use appropriate data to prepare the note relative to high deductibles in future annual statement filings.	44
ix.	It is recommended that the Company prepare its annual statement in accordance with NAIC Annual Statement Instructions.	46

<u>ITEM</u>	<u>PAGE NO.</u>
x.	46
It is recommended the Company recognize and set up the liability for advance premiums for those premiums received prior to the effective date of a policy in accordance with SSAP No. 53, Paragraph 13.	
xi.	47
It is recommended that the Company follow the Annual Statement Instructions, and also comply with SSAP No. 43, which requires disclosure in the Notes to Financial Statements of the methodology used for each type of loan-backed security (either prospective or retrospective).	
xii.	47
It is recommended that the Company cease carrying Zurich SF Holdings, LLC at its acquisition cost and value its investment in Zurich SF Holdings, LLC pursuant to SSAP No. 46. The Company should also cease indicating in its annual statement that it has received a permitted practice pertaining to this investment.	
xiii.	48
It is recommended that the Company comply with Department Regulation 152, Part 243.2(b)(7) and retain a copy of direct bill uncollected premium detailed data files at each year end to support its premium receivable asset for financial examinations.	
xiv.	48
It is recommended that the Company identify and measure their deferred taxes using a balance sheet approach as prescribed by SSAP No. 10, Paragraph 6a.	
xv.	49
It is recommended that the Company comply with Department Circular Letter No. 10 (2001) and treat the amount of deductible paid by the policyholder to the insurer under high deductible policies as premium paid to the insurer for the purpose of Section 1510 of the New York Tax Law.	
F.	
<u>Receivables from Parent, Subsidiaries and Affiliates</u>	
	58
It is recommended that the Company non-admit all affiliated balances over 90 past due in compliance with Department Circular Letter No. 15 (1975).	
G.	
<u>Aggregate Write-ins for Other than Invested Assets</u>	
	58
It is recommended that the Company negotiate letters of credit in compliance with Department Regulation 133, Part 79.	
H.	
<u>Market Conduct</u>	
i.	61
It is recommended that the ZAIG Pool, and specifically the Company, initiate procedures to ensure that the agents utilized to market its products are properly licensed and appointed.	

ITEMPAGE NO.

- ii. It is recommended that the Company fully comply with the requirements of Circular Letter No. 11 (1978) and going forward maintain a complaint log that encompasses the eleven subject matters required in this circular letter.

61

Respectfully submitted,

\_\_\_\_\_/s/\_\_\_\_\_  
James Call, CFE

STATE OF NEW YORK     )  
                                  )SS:  
                                  )  
COUNTY OF NEW YORK    )

JAMES CALL, being duly sworn, deposes and says that the foregoing report, subscribed to by him, is true to the best of his knowledge and belief.

\_\_\_\_\_/s/\_\_\_\_\_  
James Call

Subscribed and sworn to before me

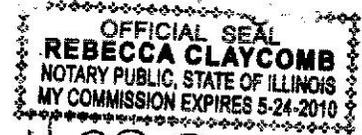
this \_\_\_\_\_ day of \_\_\_\_\_, 2007.

State of Illinois

County of Sangamon

Jacqueline Parker being duly sworn, deposes and says that the foregoing report, subscribed to and by her, is true to the best of her knowledge and belief.

*1/3/07*  
Jacqueline Parker, CFE



*4-23-2007*

Subscribed and sworn before me this  
twenty third (23rd) day of April 2007

State of New York  
County of Albany

EXAMINER'S AFFIDAVIT AS TO STANDARDS AND PROCEDURES  
USED IN AN EXAMINATION

John Plozicka, BEING DULY SWORN, STATES AS FOLLOWS:

1. I have authority to represent the State of California in the examination of Zurich American Insurance Company.
2. California is accredited under the National Association of Insurance Commissioners Financial Regulation Accreditation Standards.
3. I have reviewed the examination work papers and examination report and the examination of Zurich American Insurance Company, Inc. was performed in a manner consistent with the standards and procedures required by the State of California

The affiant says nothing further.

  
Examiner's Signature

Subscribed and sworn before me by John Plozicka on this 11<sup>th</sup> day of July 2007

  
Notary Public

My commission expires 4/1/10

JENNIFER TEDESCO  
Notary Public, State of New York  
Reg. No: 01TE6072360  
Qualified in Rensselaer County  
Commission Expires 5/1/10

Appointment No 22363

STATE OF NEW YORK  
INSURANCE DEPARTMENT

I, HOWARD MILLS, Acting Superintendent of Insurance of the State of New York,  
pursuant to the provisions of the Insurance Law, do hereby appoint:

**James Call**

*as proper person to examine into the affairs of the*

**ZURICH AMERICAN INSURANCE COMPANY**

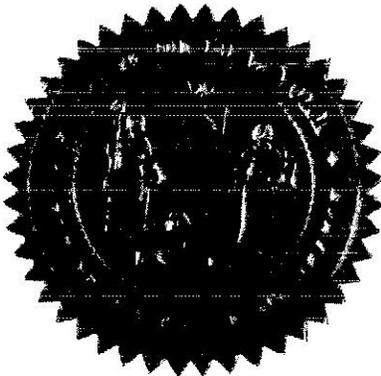
*and to make a report to me in writing of the condition of the said*

**Company**

*with such other information as he shall deem requisite.*

*In Witness Whereof, I have hereunto subscribed by the  
name and affixed the official Seal of this Department, at  
the City of New York,*

*this 20th day of April, 2005*



*Howard Mills*

HOWARD MILLS

Acting Superintendent of Insurance