

REPORT ON EXAMINATION

OF THE

TOWER INSURANCE COMPANY OF NEW YORK

AS OF

DECEMBER 31, 2004

DATE OF REPORT

AUGUST 15, 2005

EXAMINER

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

August 15, 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 22274 dated January 4, 2005 attached hereto, I have made an examination into the condition and affairs of the Tower Insurance Company of New York as of December 31, 2004, and submit the following report thereon.

Wherever the designations "the Company" or "TICNY" appear herein without qualification, they should be understood to indicate the Tower Insurance Company of New York.

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 home office located at 120 Broadway, New York, NY 10271.

## 1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 2001. This examination covered the three-year period from January 1, 2002 through December 31, 2004. 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, 2004. The examination included a review of income, disbursements and company records deemed necessary to accomplish such analysis or verification and utilized, to the extent considered appropriate, work performed by the Company's independent 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 ("NAIC"):

- History of Company
- Management and control
- Corporate records
- Fidelity bond 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

The Company was incorporated under the laws of the State of New York on June 20, 1989. It was licensed and commenced business on December 5, 1990. On April 18, 1994, the Department approved the change of name from Tower Insurance Company to its current name, Tower Insurance Company of New York.

In addition, a holding company structure, LMC Holding Corp., was introduced, whereby the holding company owned 100% of the Company's stock. In 1996, the Company was reorganized under its new parent, Tower Group, Inc. ("TGI") and a managing general agency affiliate, Tower Risk Management Corp. ("TRM") was formed. Under this structure, TGI, an insurance services holding company, owns 100% of both the Company and TRM.

Effective September 18, 1997, the Company amended its charter to increase its capital stock from 400 shares to 1600 shares authorized having a par value of \$2,500 per share. The capital increase was filed with and approved by the Department.

Capital stock is \$3,705,000 consisting of 1,482 shares of common stock at \$2,500 par value per share. Gross paid in and contributed surplus is \$121,325,938. Gross paid in and contributed surplus increased by \$111,200,938, during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
2002	Beginning gross paid in and contributed surplus	\$10,125,000
	Capital contribution	\$1,800,000
2003	Capital contribution	15,305,000
2004	Return of capital in first quarter 2004	(4,000,000)
	Adjustment to return of capital in third quarter 2004	10,200
	Capital contribution	<u>98,085,738</u>
	Total capital contributions	<u>111,200,938</u>
2004	Ending gross paid in and contributed surplus	<u>\$121,325,938</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 nor more than twenty-one members. The board met four times during each calendar year. At December 31, 2004, the board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Charles A. Bryan Columbus, OH	Principal, CAB Consulting, Ltd.
Francis Colalucci New York, NY	Treasurer and Chief Financial Officer, Tower Insurance Company of New York
Gregory T. Doyle Sandy Hook, CT	Executive Chairman, BMS Vision Re
Ian Drachman East Rockaway, NY	Senior Vice President, Information Technology, Tower Insurance Company of New York
Steven G. Fauth, Esq. New York, NY	Senior Vice President, Secretary and General Counsel, Tower Insurance Company of New York
Chung Han Lee Tenafly, NJ	President, Pegasus International Group
Michael H. Lee New York, NY	President and Chief Executive Office, Tower Insurance Company of New York
Christian K. Pechmann Mendham, NJ	Senior Vice President, Underwriting, Tower Insurance Company of New York
Alexander H. Petro Duxbury, MA	Managing Partner, Fort Hill Capital Management
Andrew P. Saulitis, Esq. Darien, CT	Counsel, Law Office of APS
Steven W. Schuster, Esq. New York, NY	Partner, McLaughlin & Stern, LLP
Joel S. Weiner New York	Senior Vice President, Strategic Planning, Tower Insurance Company of New York
Austin P. Young III Houston, TX	Retired

Messrs. Chung Han Lee, Steven W. Schuster, Esq. and Alexander H. Petro were replaced by the following individuals as the board of directors effective April 28, 2005:

James Dulligan Massapequa, NY	Vice President, Finance, Tower Insurance Company of New York
Laurie Ranegar New Hope, PA	Vice President, Operations, Tower Insurance Company of New York
Josephine Saenz DeViteri Dobbs Ferry, NY	Vice President, Underwriting, Tower Insurance Company of New York

A review of the minutes of the board of directors' meetings held during the examination period indicated that the meetings were generally well attended and each board member has an acceptable record of attendance.

As of December 31, 2004, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Michael H. Lee	President and Chief Executive Officer
Steven G. Fauth, Esq.	Senior Vice President, Secretary and General Counsel
Frank Colalucci	Treasurer and Chief Financial Officer
Ian Drachman	Senior Vice President, Information Technology
Christian K. Pechmann	Senior Vice President, Underwriting
Joel S. Weiner	Senior Vice President, Strategic Planning

B. Territory and Plan of Operation

As of December 31, 2004, the Company was licensed to write business in New York and licensed as an accredited reinsurer in Texas.

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>
4	Fire
5	Miscellaneous property damage
6	Water damage
7	Burglary and theft
8	Glass
9	Boiler and machinery
12	Collision
13	Personal injury liability
14	Property damage liability
15	Workers' compensation and employers' liability
16	Fidelity and surety
19	Motor vehicle and aircraft physical damage
20	Marine and inland marine

The Company is also licensed to write special risks pursuant to Article 63 of the New York Insurance Law.

The Company is also licensed to transact such workers' compensation insurance as may be incident to coverages contemplated under paragraph 20 of Section 1113(a), including insurances described in the Longshoremen's and Harbor Workers' Compensation Act (Public Law 803, 69<sup>th</sup> Congress as amended)

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 and minimum capital in the amount of \$3,705,000.

The Company writes commercial property, package, auto, general liability and workers' compensation policies for retail, wholesale, service, real estate and construction industries. TICNY's market focus within these industries includes grocery stores, retail stores, wholesale trade, restaurants, hotels, motels, artisan contractors, apartments, co-ops, condos and shopping centers. The Company utilizes about 900 agents and brokers to generate the business.

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>Calendar Year</u>	<u>New York State</u>	<u>Total United States</u>	<u>Premiums Written in New York State as a percentage of United States Premium</u>
2002	\$105,266,410	\$105,266,410	100.00%
2003	\$133,263,449	\$133,263,449	100.00%
2004	\$176,166,064	\$176,166,064	100.00%

C. Reinsurance

Assumed reinsurance accounted for 1% of the Company's gross premium written at December 31, 2004. The Company's assumed reinsurance business has increased slightly since the last examination.

The Company's assumed business is primarily commercial multi-line business and is derived mainly from two unauthorized and unaffiliated insurers. The primary insurers are fronting this business for the Company and retain no risk; Tower Risk Management ("TRM"), an affiliate of the Company, administers the business. Article XVII of the reinsurance agreement between one of the reinsureds and TICNY states:

"The Company ("State National"), the Reinsurer ("TICNY") and the General Agent ("TRM") have entered into a General Agency Agreement effective January 1, 2004 ... the Reinsurer has selected the General Agent to administer the business reinsured hereunder. While for regulatory purposes, the General Agent will need to be appointed by the Company's agent, **it is recognized that the General Agent is acting on behalf of the Reinsurer.**" (emphasis added)

It is evident from this provision that the subject agency agreement and reinsurance agreements represent related party transactions between TRM and the Company and should have been filed with this Department at least 30 days prior to implementation for our non-disapproval pursuant to the provisions of Section 1505(d) of the New York Insurance Law.

It is recommended that the Company file the agency agreements with TRM and the related reinsurance agreements with this Department pursuant to the provisions of Section 1505(d) of the New York Insurance Law.

The Company has structured its ceded reinsurance program to limit its maximum exposure to any one risk as follows:

- The Company maintained a similar ceding reinsurance structure during the examination period with quota share, excess of loss and property catastrophe program. However, limits for each program were changed during the examination period. Premiums ceded are based on percentages of actual collected premiums.
- The Company currently ceded a 25% quota share, limit \$1,000,000 per risk, per occurrence for property, and per occurrence for casualty. The limits increased from \$500,000 as of the prior examination date and the quota share percentages have changed as follows: 85% through December 31, 2002; 70% from January 1, 2003 through September 30, 2003; 80% from October 1, 2003 through December 31, 2003; 60% from January 1, 2004 through September 30, 2004 and 25% thereafter. Losses on all contracts during the examination period were capped at 100% of ceded earned premiums. All of the quota share treaties during the examination period were ceded to unauthorized companies on a funds held basis. The quota share contract with PXRE was terminated effective September 30, 2003 on a cut-off basis and the succeeding quota share treaty effective October 1, 2003 covered in-force, new and renewal policies.
- For the excess of loss contracts, there are sub-limits per risks as the result of terrorist acts and annual aggregate limits.
- Limits for property per risk excess of loss reinsurance were changed from of \$4,662,500 excess of \$500,000 to \$9,000,000 excess of \$1,000,000. It was 100% ceded to authorized reinsurers.
- Limits for casualty excess of loss reinsurance were changed from \$1,500,000 excess of \$500,000 per occurrence to \$1,000,000 excess of \$1,000,000 per occurrence under the multi-line contracts. It was 100% ceded to authorized reinsurers.
- Limits for workers' compensation excess of loss reinsurance were changed from \$9,500,000 excess of \$500,000 each occurrence to \$9,000,000 excess of \$1,000,000 per occurrence. A majority of the business was ceded to authorized reinsurers.
- Limits for property catastrophe excess of loss reinsurance were changed from \$23,500,000 excess of \$2,500,000 to \$60,000,000 excess of \$15,000,000. It was 100% ceded to authorized reinsurers.

In August 2001, the Company added personal umbrella quota share reinsurance. For policies up to \$2,000,000, the reinsurer was liable for 95% of net losses exceeding the underlying primary policy limits. The contract was amended effective December 1, 2001, to add commercial

umbrella liability. For policies up to \$5,000,000, the reinsurer was liable for 95% of net losses exceeding the underlying primary policy limits. It was 100% ceded to an authorized reinsurer.

In October 2004, the Company added equipment breakdown quota share reinsurance for coverage up to \$35,000,000, per accident per policy with no retention. It was 100% ceded to an authorized reinsurer.

In addition to the working coverage previously described herein, the Company limited its aggregate exposure pursuant to the provisions of a stop loss reinsurance agreement with an unauthorized reinsurer. Pursuant to this agreement, the Company ceded a 52% quota share of its net retained liability for losses and loss adjustment expenses in excess of a 69.02% loss ratio, up to a loss ratio of 87.5%. The aggregate stop loss agreement was commuted effective October 1, 2003.

Effective January 1, 1994, the Company entered into an agreement to cede an 85% quota share of losses previously incurred, up to an 85% loss ratio. It is noted that until December 31, 2004, the Company had incorrectly accounted for this treaty as prospective reinsurance rather than as retroactive reinsurance pursuant to the requirements set forth in the Statements of Statutory Accounting Principles (“SSAP”) No. 62 of the NAIC Accounting Practices and Procedures Manual. The agreement was terminated on a cut-off basis effective December 31, 2000. Balances relating to this agreement were not material to the Company’s surplus to policyholders at December 31, 2004.

The Company cedes business pursuant to quota share reinsurance agreements, which provide that the ceded premiums less ceding commissions and other adjustments are deposited in funds held accounts for the benefit of the reinsurers. The ceding commission rate is adjustable based on the ratio of ceded losses to ceded premiums. The provisional ceding commission rate used to determine the funds held amount was 39.1%, which corresponds to an expected ultimate loss ratio of 57%. However, it is noted that the expected ultimate loss ratio on which the Company based its risk transfer analysis pursuant to SSAP 62 of the NAIC Accounting Practices and Procedures Manual was 77.6%, which corresponds to a ceding commission rate of 29.2%.

This Department reviewed the Company’s risk transfer analysis and determined that the Company’s estimated ultimate loss ratio of 77.6% was reasonable based on the historical data of Tower Insurance Group as provided by the Company and that the agreements comply with the risk transfer provisions of SSAP 62. The 29.2% ceding commission rate corresponds to the Company’s

expected ultimate loss ratio of 77.6%. Therefore, the provisional ceding commission rate of 39.1% was deemed to be excessive. A liability for returnable provisional ceding commission of \$4,600,000 would be the difference between the provisional ceding commission rate of 39.1% and the imputed rate of 29.2%. However, in light of the continuing claim emergence and development recorded on the Company's books, it appears that the loss ratio is close to that which was used in establishing the provisional ceding commission at inception of the contract. Accordingly, the Department has not established any adjustment to the provisional ceding commission in this Report.

All ceded reinsurance agreements in effect as of the examination date were reviewed and found to contain the required clauses, including an insolvency clause meeting the requirements of Section 1308 of the New York Insurance Law.

Examination review of the Schedule F data reported by the Company in its filed annual statement was found to accurately reflect its reinsurance transactions. Additionally, management has represented that all material ceded reinsurance agreements transfer both underwriting and timing risk as set forth in SSAP No. 62. Representations were supported by appropriate risk transfer analyses and an attestation from the Company's chief executive officer pursuant to Department Circular Letter No. 8 (2005). Additionally, examination review indicated that the Company was not a party to any finite reinsurance agreements. All ceded reinsurance agreements were accounted for utilizing reinsurance accounting as set forth in SSAP No. 62 of the NAIC Accounting Practices and Procedures Manual except the aforementioned retroactive reinsurance agreement.

Total gross reinsurance premiums ceded each year under examination were more than 50% of the unearned premiums on the net amount of the Company's insurance in-force at the beginning of each year under examination.

Section 1308(e)(1) of the New York Insurance Law requires that during any period of twelve consecutive months, the Company shall not cede an amount of its insurance on which the total gross reinsurance premiums are more than fifty percent of the unearned premiums on the net amount of its insurance in force at the beginning of such period without the superintendent's permission.

It is recommended that the Company obtain the Department's prior approval to cede more than 50% of its unearned premiums in accordance with Section 1308(e)(1) of the New York Insurance Law.

D. Holding Company System

The Company is a member of a holding company as defined in Section 1501(a) of the New York Insurance Law. The Company is a wholly-owned subsidiary of Tower Group, Inc., a Delaware corporation. Mr. Michael Lee is deemed to be the ultimate controlling person by virtue of his 14.41% ownership of Tower Group, Inc.

A review of the holding company registration statements filed with this Department indicated that the statements were submitted in a timely manner pursuant to Article 15 of the New York Insurance Law and Department Regulation 52; however, it was noted that the statements for each year during the examination period did not include certified financial statements for Mr. Michael Lee. Part 80-1.4(c) of Department Regulation 52 requires that within 120 days following the end of its ultimate holding company's fiscal year, every controlled insurer must furnish the superintendent with the following:

“A consolidated balance sheet of the ultimate holding company and each significant person within the holding company system, as of the end of the holding company's fiscal year, and related consolidated statements of income and surplus for the year then ended. Such financial statements shall be accompanied by the certificate of an independent public accountant to the effect that such financials present fairly the consolidated financial position of the ultimate holding company and such persons, and the results of their operations for the year then ended, in conformity with generally accepted accounting principles or with requirements of insurance or other accounting principles prescribed or permitted under law. In lieu of fully consolidated statements, registrant may furnish separate certified financial statements with respect to any person or persons, and certified consolidated or combined statements with respect to any group of persons, within the holding company system.”

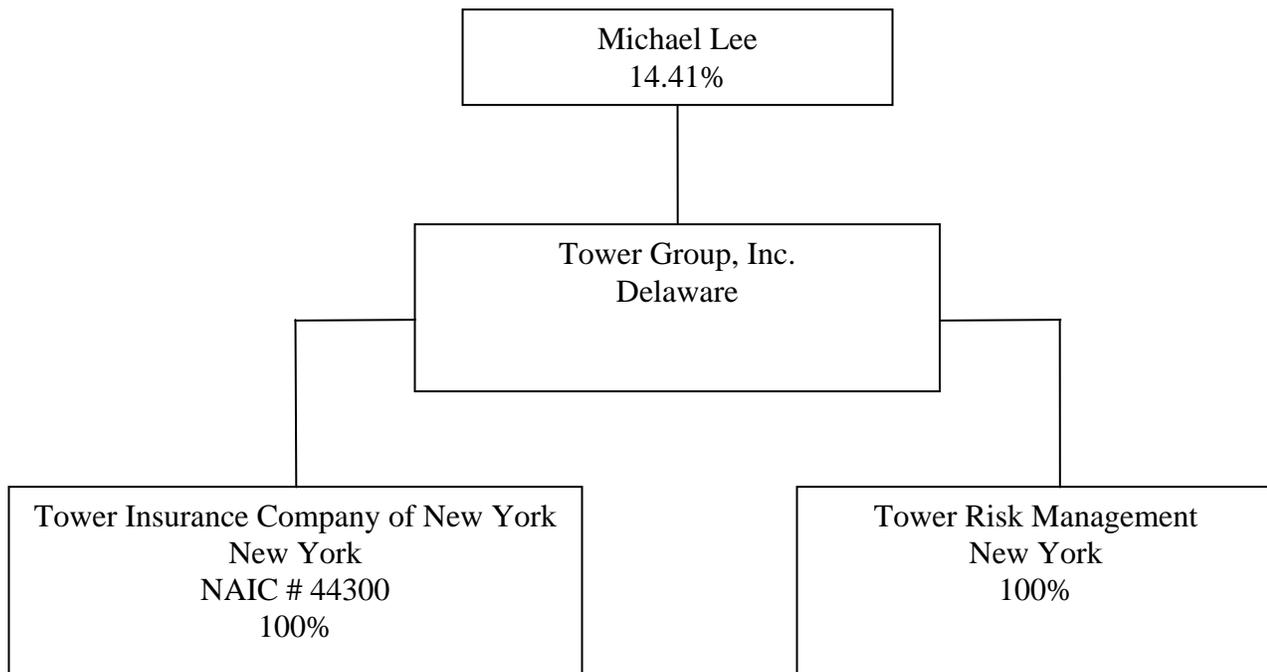
On February 1, 2005, this Department sent a letter to the Company requesting certified financial statements for Mr. Lee; however, as of the date of this report, the Company has not complied.

It is recommended that the Company provide certified financial statements for Mr. Michael Lee and each significant person within its holding company system in its annual holding company registration statements pursuant to the provisions of Part 80-1.4(c) of Department Regulation 52.

Upon review of the Company's holding company registration statement and Schedule Y of the Company's filed annual statement, it was noted that Mr. Michael Lee is not included in the organization chart. The Annual Statement Instructions for Schedule Y Part 1 specify that any person deemed to be an ultimate controlling person must be included in the organization chart.

It is recommended that the Company modify the organization chart in the registration statements ("Form HC-1") and Schedule Y Part 1 of all future quarterly and annual statements to reflect the ultimate controlling person or entity in accordance with Department Regulation 52 and the Annual Statement Instructions.

The following is a chart of the holding company system at December 31, 2004:



Tower Group, Inc. entered into a stock purchase agreement on January 18, 2005 to acquire North American Lumber Insurance Company ("NALIC"), a shell Massachusetts property and casualty domestic insurer licensed in seventeen states. NALIC is currently writing business in nine of the following states: New Jersey, Connecticut, Massachusetts, Rhode Island, Vermont, Maryland, Delaware, South Carolina and Wisconsin. Tower Group, Inc. completed the acquisition of NALIC on March 28, 2005 and paid \$1.05 million in cash at closing. NALIC was initially capitalized with part of the \$26 million raised by Tower Group, Inc. through two trust preferred offerings in

December 2004. An additional \$75,000, will be paid within one year of the closing date contingent upon license reactivation in each of Pennsylvania and Maine. NALIC was renamed Tower National Insurance Company (“Tower National”). In addition, all liabilities and assets of Tower National were transferred to a liquidating trust prior to closing with the exception of its charter and insurance licenses.

Tower Group, Inc. (“TGI”) entered into a credit agreement with CIT Group/Equipment Financing, Inc. (“CIT”) on February 21, 2003, for loans up to \$6,000,000. Pursuant to the agreement, TGI borrowed \$3,000,000 on February 25, 2003 and another \$3,000,000 on December 31, 2003. TGI had pledged all outstanding common stock of TICNY and TRM as collateral for the loans pursuant to the agreement. In October 2004, the loans were paid off completely and the agreement was terminated.

At December 31, 2004, the Company was party to the following agreements with other members of its holding company system:

Service and Expense Service Agreement

Effective January 1, 2002, the Company is a party to a service and an expense agreement with Tower Risk Management, Inc. (“TRM”). In accordance with article 2 of the service and expense agreement, joint expenses between TICNY and TRM will be allocated in accordance with Regulation 30. In addition, TRM is required to pay 5% of TRM's gross premium written if the joint expenses allocated to TRM are less than 5% of TRM gross written premium. On June 22, 2004, the Department approved the service and expense service agreement between TICNY and TRM in accordance with Section 1505(d)(3) of the New York Insurance Law.

Tax Allocation Agreement

Effective December 31, 2001, the Company participates in a tax allocation agreement with its holding company. The agreement allows federal income taxes to be computed as if the Company were filing a separate income tax return, except that income tax benefits are recognized to the extent utilized in the consolidated federal income tax return. The tax allocation agreement provides for the establishment of an escrow account by the holding company for the benefit of the company in order to maintain the Company’s right to recoup federal income taxes paid to the holding company in the event of future losses.

This agreement was not submitted for Department for approval within 60 days of filing the consolidated tax return as required by Department Circular Letter No. 33 (1979). A recommendation was included in the prior report on examination. The Company subsequently submitted the tax allocation agreement to the Department and the Department approved the agreement on February 12, 2004.

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 neglected to file the abandoned property reports for 2002 and 2003 during this examination period. The Company eventually filed the abandoned property report for calendar year 2004.

It is recommended that the Company submit future abandoned property reports and any escheated funds in a timely manner pursuant to Section 1315 and 1316 of the New York Abandoned Property Law. The previous report on examination contained a similar recommendation.

F. Significant Operating Ratios

The following ratios have been computed as of December 31, 2004, based upon the results of this examination:

Net premiums written to surplus as regards policyholders	81%
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	59%
Premiums in course of collection to surplus as regards policyholders	3%

All of the above ratios fall within the benchmark ranges as set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners.

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

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss adjustment expenses incurred	\$54,333,666	57.19%
Other underwriting expenses incurred	35,823,334	37.70
Net underwriting loss	<u>4,854,322</u>	<u>5.11</u>
Premiums earned	<u>\$95,011,322</u>	<u>100.00%</u>

G. Accounts and Records

(i) Classification of Assumed Premium Receivable

The Company reported assumed premiums receivable in the amount of \$1,196,853 as "Balance due on reinsurance contracts" on Line 23 "Aggregate write-ins for other than invested assets" in its 2004 annual statement.

Statements of Statutory Accounting Principles ("SSAP") No. 62, Paragraph 35 of the NAIC Accounting Practices and Procedures Manual and the 2004 Annual Statement Instructions specifies that assumed premiums receivable shall be combined with direct business receivable and reported as agents' balances or uncollected premiums.

It is recommended that Company prepare its quarterly and annual statements and report its accounts to the proper lines in accordance with the NAIC Accounting Practices and Procedures Manual and the Annual Statement Instructions.

(ii) Certified Public Accountant ("CPA") Engagement Letter

The Company hired Johnson Lambert & Co. to render an opinion for the Company's 2002 to 2004 financial statements. It was noted that the engagement letters for the 2002 to 2004 audits do not contain the required wording set forth in the Department Regulation 118, Section 89.2. Even though Johnson Lambert provided the Company an awareness letter containing the required

wording, the engagement letter does not refer to the awareness letter. Regulation 118 specifies that the “written contract” between the Company and the independent auditors 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”.

It is recommended that the Company include the required wording set forth in the Department Regulation 118 in the engagement letters for all future audits of its financial statements.

(iii) Investments Interrogatories

The Company pledged about \$2 million of certificates of deposit for a standby letter of credit issued by Citibank. However, the Company did not properly disclose such pledge in the general interrogatories of the 2004 annual statement as required by the Annual Statement Instructions.

It is recommended that the Company properly disclose any pledged assets in the general interrogatories of all future quarterly and annual statements in accordance with the Annual Statement Instructions.

(iv) Custodial Agreement

A review of the State Street Bank custodial agreement noted that it is missing the following recommended clause in accordance with Part 1 Section IV Subsection J.2.f of the NAIC Financial Condition Examiners Handbook:

"That if the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn, the custodian shall provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner."

It is recommended that the Company amend the custodial agreement with State Street Bank to include all recommended clauses set forth in Part 1 Section IV Subsection J of the NAIC Financial Condition Examiners Handbook.

(v) Guaranty Funds

The Company did not set up an accrual for guaranty fund assessment for the quarter ending December 31, 2004 which was due on February 15, 2005.

It is recommended that the Company set up the proper accruals for guaranty fund assessments in accordance with the Annual Statement Instructions and SSAP No. 35 of the NAIC Accounting Practices and Procedures Manual.

(vi) Surplus Notes

On December 19, 2002, the Company issued a surplus note in the amount of \$10 million to PXRE Reinsurance (Barbados) Company, Ltd. ("PXRE"), which was approved by this Department pursuant to the provisions of Section 1307 of the New York Insurance Law. The surplus note was part of a financing agreement in conjunction with the aggregate stop loss reinsurance agreement between the Company and PXRE. On December 26, 2003, this Department approved the Company to repay the principal of the surplus note plus \$125,000 in interest in conjunction with a surplus contribution in the amount of \$10,125,000 from the Company's parent, TGI.

### 3. FINANCIAL STATEMENTS

#### A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2004 as determined by this examination and as reported by the Company:

<u>Assets</u>	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>
Bonds	\$223,562,359	\$	\$223,562,359
Preferred stocks	117,390		117,390
Common stocks	2,367,553		2,367,553
Cash, cash equivalents and short-term investments	15,403,831		15,403,831
Investment income due and Accrued	1,961,850		1,961,850
Uncollected premiums and agents' balances in the course of collection	4,219,873	74,107	4,145,766
Deferred premiums, agents' balances and installments booked but deferred and not yet due	17,406,786		17,406,786
Amounts recoverable from reinsurers	9,399,748		9,399,748
Current federal and foreign income tax recoverable and interest thereon	1,453,673		1,453,673
Net deferred tax asset	5,360,408	3,300,725	2,059,683
Electronic data processing equipment and software	4,315,410	3,118,692	1,196,718
Furniture and equipment, including health care delivery assets	327,192	327,192	
Receivables from parent, subsidiaries and affiliates	2,803,353		2,803,353
Other assets nonadmitted	429,148	429,148	0
Balance due on reinsurance contracts	1,196,853		1,196,853
Retroactive reinsurance losses Recoverable	153,146		153,146
State income taxes recoverable	<u>338,867</u>	<u>          </u>	<u>338,867</u>
 Total assets	 <u>\$290,817,440</u>	 <u>\$7,249,864</u>	 <u>\$283,567,576</u>

Liabilities, Surplus and Other fundsLiabilities

Losses		\$ 30,212,754
Reinsurance payable on paid losses and loss adjustment expenses		1,145,180
Loss adjustment expenses		6,891,973
Commissions payable, contingent commissions and other similar charges		330,608
Other expenses (excluding taxes, licenses and fees)		2,274,937
Unearned premiums		67,114,491
Ceded reinsurance premiums payable (net of ceding commissions)		(6,739,660)
Funds held by company under reinsurance treaties		54,151,832
Amounts withheld or retained by company for account of others		22,192
Workers compensation assessment payable		1,839,475
Other liabilities		154,140
Funds held under self insured managed program		<u>87,883</u>
Total liabilities		\$157,485,805

Surplus and Other Funds

Common capital stock	\$ 3,705,000	
Gross paid in and contributed surplus	121,325,938	
Retroactive reinsurance	347,546	
Unassigned funds (surplus)	<u>703,287</u>	
Surplus as regards policyholders		<u>126,081,771</u>
Total liabilities, surplus and other funds		<u>\$283,567,576</u>

NOTE: The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2002 through 2004. The examiner is unaware of any potential exposure of the Company to any tax assessment and no liability has been established herein relative to such contingency.

B. Underwriting and Investment Exhibit

Surplus as regards policyholders increased \$113,378,310 during the three-year examination period January 1, 2002 through December 31, 2004, detailed as follows:

Statement of Income

Underwriting Income

Premiums earned		\$95,011,322
Deductions:		
Losses incurred	\$41,437,402	
Loss adjustment expenses incurred	12,896,264	
Other underwriting expenses incurred	<u>35,823,334</u>	
Total underwriting deductions		<u>90,157,000</u>
Net underwriting gain or (loss)		\$4,854,322

Investment Income

Net investment income earned	\$ 8,340,486	
Net realized capital gain	<u>600,559</u>	
Net investment gain or (loss)		8,941,045

Other Income

Finance and service charges not included in premiums	\$1,592,557	
Aggregate write-ins for miscellaneous income	<u>(1,074,129)</u>	
Total other income		<u>518,428</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$ 14,313,795
Federal and foreign income taxes incurred		<u>5,475,800</u>
Net Income		\$ <u>8,837,995</u>

Capital and Surplus Account

Surplus as regards policyholders per report on Examination as of December 31, 2001			\$ 8,116,930
	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income	\$ 8,837,995		
Net unrealized capital gains or (losses)	765,972		
Change in net deferred income tax	4,073,512		
Change in nonadmitted assets		\$6,376,333	
Change in provision for reinsurance	\$218,214		
Cumulative effect of changes in accounting principles	\$694,310		
Surplus adjustments paid in	111,200,938		
Dividends to stockholders		2,768,016	
Aggregate write-ins for gains and losses in surplus	<u>1,318,249</u>	_____	
Total gains and losses	<u>\$127,109,190</u>	<u>\$9,144,349</u>	
Net increase (decrease) in surplus			<u>117,964,841</u>
Surplus as regards policyholders per report on Examination as of December 31, 2004			<u>\$126,081,771</u>

**4. LOSSES AND LOSS ADJUSTMENT EXPENSES**

The examination liability for the captioned items of \$37,104,727 is the same as reported by the Company as of December 31, 2004. The examination analysis was conducted in accordance with generally accepted actuarial principles and practices and was based on statistical information contained in the Companies internal records and in its filed annual statements.

## 5. MARKET CONDUCT ACTIVITIES

In the course of this examination, a review was made of the manner in which the Company conducts its business 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. Producer Licensing
- B. Claims and complaints handling

The Company entered into the agency agreements with 256 agents effective September 29, 2004 in conjunction with the acquisition of OneBeacon renewal business. However, the Company neglected to appoint those agents with the Department in accordance with Section 2103(b) of the New York Insurance Law, until it was disclosed by this examination in July 2005.

Section 2103(b) of the New York Insurance Law states:

"(b) The superintendent may issue a license to any person, firm, association or corporation who or which has complied with the requirements of this chapter, authorizing the licensee to act as agent of any authorized insurer, other than an insurer specified in subsection (b) of section two thousand one hundred fifteen of this article, with respect to the lines of authority for accident and health or sickness, property, casualty, personal lines or any other line of authority granted other than life, and variable life and variable annuity products, which such insurer is authorized to do in this state. "

Since the Company compensated the agents for business produced for the Company without properly appointing them, the Company violated Section 2115(a)(1) of the New York Insurance Law which states:

"(a)(1) No insurer doing business in this state, and no agent or other representative thereof, except as provided in subsection (b) hereof, shall pay any commission or other compensation to any person, firm, association or corporation for acting as insurance agent in this state, except to a licensed insurance agent of such insurer or to a person described in paragraph two or four of subsection (a) of section two thousand one hundred one of this article or except as provided in subsection (c) of this section."

It is recommended that the Company properly appoint and compensate its agents in a timely manner in accordance with Section 2103(b) and Section 2115(a)(1) of the New York Insurance Law.

Subsequently, the Company filed the appointments of the agents with the Department.

## 6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

<u>ITEM</u>	<u>PAGE NO.</u>
A	
<u>Reinsurance</u>	
The Company significantly exceeded the benchmark range for IRIS ratio surplus aid to surplus for each of the years covered during the examination period. Users of the Company's annual statements should be aware of the possible distorting effects caused by the exceptionally large amount of surplus aid afforded by its reinsurance.	8
The Company improved the surplus aid to surplus ratio due to capital contribution from the parent using funds generated from the parent's initial public offering.	
B	
<u>Holding Company System</u>	
i. It is recommended that the Company file its tax allocation agreement with the Insurance Department in compliance with the provisions of Section 1505 of the New York Insurance Law and Circular Letter No. 33 (1979). The Company has complied with this recommendation.	10
ii. It is also recommended that the Company require its holding company set up an escrow account, in compliance with the tax allocation agreement.	10
The Company has complied with this recommendation.	
C.	
<u>Accounts and Records</u>	
i. <u>Internal Control</u>	
It is recommended that the Company establish a procedure whereby all checks above a certain threshold by signed by at least two officers.	11

<u>ITEM</u>	<u>PAGE NO.</u>
<p>The Company has not complied with this recommendation. However, the Company revised its check issuance policy which payments between \$100,000 and \$250,000 require approval from claims supervisor and vice president of claims and are signed by the senior vice president. Payments above \$250,000 require approval from claims supervisor and senior vice president and are signed by the president.</p>	
<p>ii. <u>Underwriting and Investment Exhibit</u></p> <p>It is recommended that the Company complete such exhibit in accordance with the Department's Regulation 30 and annual statement instructions.</p> <p>The Company has complied with this recommendation.</p>	11
<p>iii. <u>Electronic Data Processing Equipment</u></p> <p>It is again recommended that the Company report this asset in accordance with Section 1301(a)(18) of the New York Insurance Law.</p> <p>The Company has complied with this recommendation.</p>	12
<p>D. <u>Abandoned Property Law</u></p> <p>It is recommended that the Company comply with Section 1316 of the New York Abandoned Property Law.</p> <p>The Company has not complied with this recommendation. A similar comment is made in this report.</p>	12

## 7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

The following are comments and recommendations made in this report on examination:

<u>ITEM</u>		<u>PAGE NO.</u>
A	<u>Reinsurance</u>	
i.	It is recommended that the Company file the assumed reinsurance agreements, the agency agreements and all related agreements with the Department pursuant to Section 1505 of the New York Insurance Law.	7
ii.	Effective January 1, 1994, the Company entered into an agreement to cede an 85% quota share of losses previously incurred, up to an 85% loss ratio. It is noted that until December 31, 2004, the Company had incorrectly accounted for this treaty as prospective reinsurance rather than as retroactive reinsurance pursuant to the requirements set forth in the Statements of Statutory Accounting Principles (“SSAP”) No. 62 of the NAIC Accounting Practices and Procedures Manual. The agreement was terminated on a cut-off basis effective December 31, 2000. Balances relating to this agreement were not material to the Company’s surplus to policyholders at December 31, 2004.	9
iii.	It is recommended that the Company obtain the Department’s prior approval to cede more than 50% of its unearned premiums in accordance with Section 1308(e)(1) of the New York Insurance Law.	11
B	<u>Holding Company System</u>	
i.	It is recommended that the Company provide certified financial statements for Mr. Michael Lee and each significant person within its holding company system in its annual holding company registration statements pursuant to the provisions of Part 80-1.4(c) of Department Regulation 52.	11
ii.	It is recommended that the Company modify the organization chart in the registration statements (“Form HC-1”) and Schedule Y Part 1 of all future quarterly and annual statements to reflect the ultimate controlling person or entity in accordance with Department Regulation 52 and the Annual Statement Instructions.	12
C	<u>Abandoned Property Law</u>	
	It is recommended that the Company submit future abandoned property reports and any escheated funds in a timely manner pursuant to Section 1315 and 1316 of the New York Abandoned Property Law. The previous report on examination contained a similar recommendation.	14

<u>ITEM</u>		<u>PAGE NO.</u>
D	<u>Accounts and Records</u>	
	<u>Classification of Assumed Premium Receivable</u>	
	It is recommended that Company prepare its quarterly and annual statements and report its accounts to the proper lines in accordance with the NAIC Accounting Practices and Procedures Manual and the Annual Statement Instructions.	15
	<u>Certified Public Accountant (“CPA”) Engagement Letter</u>	
	It is recommended that the Company include the required wording set forth in the Department Regulation 118 in the engagement letter for all future audits of its financial statements.	16
	<u>Investment Interrogatories</u>	
	It is recommended that the Company properly disclose any pledged assets in the general interrogatories of all future quarterly and annual statements in accordance with the Annual Statement Instructions.	16
	<u>Custodial Agreements</u>	
	It is recommended that the Company amend the custodial agreement with State Street Bank to include all recommended clauses set forth in Part 1 Section IV Subsection J of the NAIC Financial Condition Examiners Handbook.	17
	<u>Guaranty Funds</u>	
	It is recommended that the Company set up the proper accruals for guaranty fund assessments in accordance with the Annual Statement Instructions and SSAP No. 35 of the NAIC Accounting Practices and Procedures Manual.	17
	<u>Surplus Notes</u>	
	On December 19, 2002, the Company issued a surplus note in the amount of \$10 million to PXRE Reinsurance (Barbados) Company, Ltd. (“PXRE”), which was approved by this Department pursuant to the provisions of Section 1307 of the New York Insurance Law. The surplus note was part of a financing agreement in conjunction with the aggregate stop loss reinsurance agreement between the Company and PXRE. On December 26, 2003, this Department approved the Company to repay the principal of the surplus note plus \$125,000 in interest in conjunction with a surplus contribution in the amount of \$10,125,000 from the Company’s parent, TGI.	17

ITEMPAGE NO.

E

Market Conduct Activities

It is recommended that the Company properly appoint and compensate its agents in a timely manner in accordance with Section 2103(b) and Section 2115(a)(1) of the New York Insurance Law.

23

Respectfully submitted,

\_\_\_\_\_/S/  
Annie Lau, CFE  
Associate Insurance Examiner

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

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

\_\_\_\_\_/S/  
Annie Lau

Subscribed and sworn to before me  
this \_\_\_\_\_ day of \_\_\_\_\_, 2006.

*Appointment No. 22274*

**STATE OF NEW YORK  
INSURANCE DEPARTMENT**

*I, GREGORY V. SERIO, Superintendent of Insurance of the State of New York,  
pursuant to the provisions of the Insurance Law, do hereby appoint:*

**Annie Lau**

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

**TOWER INSURANCE COMPANY OF NEW YORK**

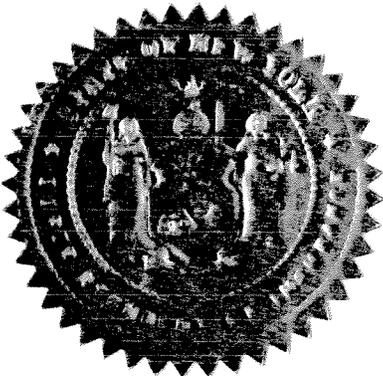
*and to make a report to me in writing of the condition of the said*

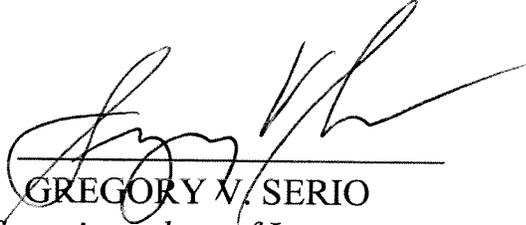
**Company**

*with such other information as she 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 4th day of January, 2005*



  
GREGORY V. SERIO  
Superintendent of Insurance