

REPORT ON EXAMINATION

OF THE

USAGENCIES DIRECT INSURANCE COMPANY

AS OF

DECEMBER 31, 2007

DATE OF REPORT

AUGUST 31, 2008

EXAMINER

ROBERT A. VARGAS

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

August 31, 2008

Honorable Eric Dinallo
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 22688 dated November 7, 2007 attached hereto, I have made an examination into the condition and affairs of USAgencies Direct Insurance Company as of December 31, 2007, and submit the following report thereon.

The examination was conducted at the administrative offices of an affiliated company, USAgencies Management Services, Inc., located at 8550 United Plaza Blvd., Suite 805, Baton Rouge, Louisiana. USAgencies Direct Insurance Company has received permission to maintain its records outside the State of New York pursuant to Section 325(b) of the New York Insurance Law.

Wherever the designation "the Company" appears herein without qualification, it should be understood to indicate USAgencies Direct Insurance Company.

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

1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 2001. This examination covered the six-year period from January 1, 2002 through December 31, 2007. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

The examination comprised a verification of assets and liabilities as of December 31, 2007. 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 certified public accountants ("CPA"). 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 May 7, 1987, as a vehicle for the domestication of the United States (“U.S.”) Branch of Caledonian Insurance Company of London, England. On July 31, 1995, the Company became Caledonian Insurance Company of America, a domesticated (U.S.) Company. From 1996 to 1999, Atlas Assurance Company of America, a subsidiary of GRE-USA Corporation, held all of the outstanding capital stock of the Company. During 1999, the outstanding capital stock of the Company was acquired by USAgencies, L.L.C., an insurance holding company domiciled in Louisiana. The acquisition was approved by the Department on April 29, 1999. The Department approved the Company’s current name on August 9, 1999. On January 31, 2007, The Company was acquired by Affirmative Insurance Holdings, Inc. (“Affirmative”) an insurance holding company domiciled in the state of Delaware.

Capital paid in is \$2,500,000 consisting of 2,500,000 shares of common stock at \$1 par value per share. Gross paid in and contributed surplus is \$4,600,000 and it increased by \$4,100,000 during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
12/31/2001	Beginning gross paid in and contributed surplus	\$ 500,000
2004	Surplus contribution	<u>4,100,000</u>
12/31/2007	Ending gross paid in and contributed surplus	<u>\$4,600,000</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. At December 31, 2007, the board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Kevin R. Callahan Kenilworth, IL	Chief Executive Officer, Affirmative Insurance Holdings
W. Flora Chan Coppell, TX	Controller, Affirmative Insurance Holdings

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Joseph G. Fisher Chicago, IL	Senior Vice President & General Counsel, Affirmative Insurance Holdings
Teresa K. Hitchcock Southlake, TX	Assistant Vice President, Affirmative Insurance Company
William H. Huff Dallas, TX	Vice President, Regulatory Affairs, Affirmative Insurance Holdings
Avshalom Y. Kalichstein New York, NY	Managing Director, J.C. Flowers Co. LLC.
Michael J. McClure Western Springs, IL	Chief Financial Officer, Affirmative Insurance Holdings
M. Sean McPadden Western Springs, IL	President UW Division, Affirmative Insurance Holdings
Graham P. Monroe Coppell, TX	Vice President, Strategic Planning & International, Affirmative Insurance Holdings
Amy L. Nay Denton, TX	Assistant Vice President and Assistant Treasurer, Affirmative Insurance Holdings
David I. Schamis Sand point, NY	Managing Director, J.C. Flowers Co. LLC.
V. Van Vaughan Parker, TX	Senior Vice President and Treasurer, Affirmative Insurance Holdings
Wilson A. Wheeler Grapevine, TX	Senior Vice President Chief Claim Officer, Affirmative Insurance Holdings

A review of the minutes of the board of directors' meetings held during the examination period indicated that the meetings were generally well attended.

As of December 31, 2007, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
M. Sean McPadden	President
Joseph G. Fisher	Senior Vice President , General Counsel and Secretary
V. Van Vaughan	Senior Vice President, Chief Accounting Officer and Treasurer
Kenneth F. Champagne	Executive Vice President
Randy Smith	Senior Vice President and Chief Human Resources Officer
Jerome Zingg	Senior Vice President and Chief Information Officer
Terry C. Doming	Senior Vice President Finance, Asst. Secretary and Asst. Treasurer
William H. Huff	Vice President and Assistant Secretary
Amy L. Nay	Assistant Vice President and Assistant Treasurer
Teresa K. Hitchcock	Assistant Vice President

B. Territory and Plan of Operation

As of December 31, 2007, the Company was licensed to write business in the following fifteen states:

Alabama	Iowa	Nevada	Washington
Arizona	Kentucky	Ohio	Wisconsin
Illinois	Louisiana	Oregon	Massachusetts
Indiana	Montana	Texas	

The Company is 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
6	Water damage
7	Burglary and theft
8	Glass
9	Boiler and machinery
12	Collision
13	Personal injury liability
14	Property damage liability
19	Motor vehicle and aircraft physical damage
20	Marine and inland marine
21	Marine protection and indemnity

After being inactive for several years, the Company began to underwrite automobile liability and physical damage insurance policies in Illinois in 2001 and Alabama in 2005. The business is

conducted by USAgencies Management Services, Inc., an affiliate, pursuant to a managing general agency arrangement. In June 2007, the Company discontinued writing business. The Company's business is being renewed and/or written by Affirmative Insurance Company, an affiliated insurance company. The Company plans on running off its existing business to facilitate the sale of the Company and its licenses.

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

<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	\$0	\$ 867,199	0.00%
2003	\$0	\$ 4,152,165	0.00%
2004	\$0	\$ 7,539,552	0.00%
2005	\$0	\$12,104,940	0.00%
2006	\$0	\$26,469,492	0.00%
2007	\$0	\$15,991,505	0.00%

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 \$1,100,000.

C. Reinsurance

Assumed

The Company does not assume any reinsurance business.

Ceded

The examiner reviewed all ceded reinsurance contracts in effect at December 31, 2007. The contracts all contained the required standard clauses meeting the requirements of Section 1308 of the New York Insurance Law.

Effective December 31, 2007, the Company entered into a 100% quota share and loss portfolio transfer agreement with Affirmative Insurance Company, which was approved by the Department. The 100% quota share agreement cedes 100% of the Company's liability on insurance

policies in force as of year-end 2007 or subsequently written. Pursuant to the loss portfolio transfer agreement, the Company cedes 100% of its outstanding losses and loss adjustment expenses, net of salvage and reinsurance recoverable, and will pay a reinsurance premium equal to the amount of the loss reserves, including ceding commissions, related to such ceded liabilities. The loss portfolio transfer agreement is not treated as retroactive reinsurance pursuant to paragraph 31(d) of SSAP 62, which exempts “intercompany reinsurance agreements, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction.”

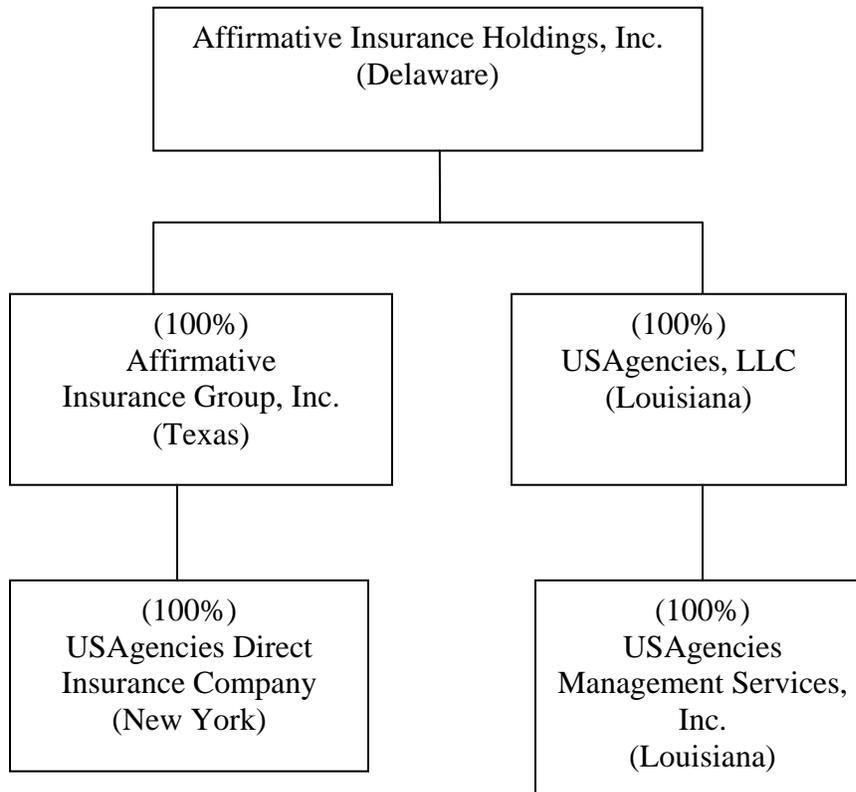
Examination review of the Schedule F data reported by the Company in its filed annual statement was found to accurately reflect its reinsurance transactions. Additionally, management has represented that all material ceded reinsurance agreements transfer both underwriting and timing risk as set forth in NAIC Accounting Practices and Procedures Manual, Statements of Statutory Accounting Principles (“SSAP”) No. 62. Such representations were supported by appropriate risk transfer analyses and an attestation from the Company's chief executive officer pursuant to the NAIC Annual Statement Instructions. Additionally, the examiners determined that the Company was not a party to any finite reinsurance agreements. All ceded reinsurance agreements were accounted for in accordance with reinsurance accounting set forth in paragraph 5 of SSAP No. 62.

D. Holding Company System

The Company is a wholly owned subsidiary of Affirmative Insurance Group. Its ultimate parent is Affirmative Insurance Holdings, Inc.

A review was made of the filings submitted by the Company pursuant to the requirements and standards set forth for holding company organizations under Article 15 of the New York Insurance Law and Department Regulation No. 52.

The following abridged organization chart depicts the position of the Company in the holding company system as of December 31, 2007.



At December 31, 2007, the Company was party to the following agreements with other members of its holding company system.

Administrative Services Agreement

The Company submitted an administrative service agreement with USAgencies Management Services, Inc., (“USMS”), a Louisiana Corporation, as part of its acquisition of control of the Company pursuant to Section 1506 of the New York Insurance Law. Under the terms of this agreement, USMS provides the Company management, administrative, claims, policyholder, and information system services. The Department approved the acquisition in April 1999.

Inter-Company Tax Allocation Agreement

Effective October 17, 2006, the Company entered into an inter-company tax allocation agreement with its ultimate parent, Affirmative Insurance Holdings, Inc. The agreement specified that the Company and parent, along with the other members of the affiliated group, have elected to file a consolidated federal income tax return. The Company shall compute and pay to the ultimate parent its federal income tax liability as if it were computed on a separate return. The agreement was

filed with the Department as part of its acquisition of control of the Company pursuant to Section 1506 of the New York Insurance Law.

E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2007, based upon the results of this examination:

Net premiums written to surplus as regards policyholders	85%
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	47%
Premiums in course of collection to surplus as regards policyholders	0%

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

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	\$22,982,590	104.23%
Other underwriting expenses incurred	3,670,670	16.65
Net underwriting loss	<u>(4,603,753)</u>	<u>(20.88)</u>
Premiums earned	<u>\$22,049,507</u>	<u>100.00%</u>

3. FINANCIAL STATEMENTS

A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2007 as determined by this examination and as reported by the Company:

<u>Assets</u>	<u>Assets</u>	<u>Non-admitted Assets</u>	<u>Net Admitted Assets</u>
Bonds	\$15,412,164		\$15,412,164
Cash, cash equivalents and short-term investments	(281,499)		(281,499)
Investment income due and accrued	129,444		129,444
Reinsurance recoverable from reinsurers	842,627		842,627
Reinsurance receivable under reinsurance contracts	364,084		364,084
Current federal and foreign income tax recoverable	156,225		156,225
Net deferred tax asset	52,084	\$51,789	295
Guaranty funds receivable or on deposit	52,598		52,598
Prepaid expenses and miscellaneous	<u>913</u>	<u>844</u>	<u>69</u>
Total assets	<u>\$16,728,641</u>	<u>\$52,633</u>	<u>\$16,676,007</u>

Liabilities, Surplus and Other Funds

Liabilities

Other expenses (excluding taxes, licenses and fees)	\$ 1,443
Taxes, licenses and fees (excluding federal and foreign income taxes)	88,663
Ceded reinsurance premiums payable (net of ceding commissions)	6,798,274
Payable to parent, subsidiaries, and affiliates	<u>264,394</u>
Total liabilities	\$ 7,152,774

Surplus and other funds

Common capital stock	\$2,500,000
Gross paid in and contributed surplus	4,600,000
Unassigned funds - surplus	<u>2,423,233</u>
Surplus as regards policyholders	<u>9,523,233</u>
Total liabilities, surplus and other funds	<u>\$16,676,007</u>

NOTE: The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2002 through 2007. 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 \$2,496,407 during the six-year examination period January 1, 2002 through December 31, 2007.

Statement of Income

Underwriting Income

Premium earned \$22,125,983

Deductions:

Losses and loss adjustment expenses incurred	\$17,208,309	
Loss expenses incurred	6,006,079	
Other underwriting expenses incurred	3,921,053	
Aggregate write-ins for underwriting deductions	<u>(1)</u>	

Total underwriting deductions 27,135,440

Net underwriting gain (loss) \$(5,009,457)

Investment Income

Net investment income earned	\$2,420,936	
Net realized capital gains (losses)	<u>(165,644)</u>	
Net investment gain		<u>2,255,292</u>

Net income before federal and foreign income taxes \$ (2,754,165)

Federal and foreign income taxes incurred (1,151,121)

Net income \$(1,603,044)

12
Capital and Surplus Accounts

Surplus as regards policyholders per report on examination
as of December 31, 2001 \$ 7,026,826

	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income		\$1,603,044	
Change in net deferred tax	\$ 51,783		
Surplus adjustments paid in	4,100,000		
Change in nonadmitted assets		52,632	
Cumulative effect of changes in accounting principles	<u>300</u>	<u>0</u>	
Total gains and losses	<u>\$4,152,083</u>	<u>\$1,655,676</u>	
 Net increase in surplus			 <u>2,496,407</u>
 Surplus as regards policyholders per report on examination as of December 31, 2007			 <u>\$9,523,233</u>

4. LOSSES AND LOSS ADJUSTMENT EXPENSES

As previously mentioned in Item 2C of this report, the Company has a loss portfolio transfer agreement with an affiliate whereby it transferred 100% of its outstanding liability for loss and loss adjustment expenses as of December 31, 2007 and a quota share reinsurance agreement whereby it cedes 100% of its liability on insurance policies in force at year-end 2007 or subsequently written. Therefore, the Company reports no liability for the captioned items.

5. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

<u>ITEM</u>		<u>PAGE NO.</u>
A.	<u>Management</u>	
i.	It was recommended that board members who are unable or unwilling to attend meetings consistently should resign or be replaced.	5
	The Company has complied with this recommendation.	
ii.	It was recommended that the Company maintain conflict of interest statements for review during examinations.	5
	The Company has complied with this recommendation.	

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- iii. It was recommended that the members of the investment and audit committees be identified and named in the board minutes when elected to the committees. 5

The Company has complied with this recommendation.

- iv. It was recommended that the Company attach a listing of the investments approved by the board in either the minutes or as an attachment or exhibit. 5

The Company has complied with this recommendation.

B. Reinsurance

- It was recommended that the Company comply with the provisions of Section 1308(e)(1)(A) of the New York Insurance Law and file with the Department for each year that the Company cedes more than 50% of its beginning unearned premium reserves. 8

The Company has complied with this recommendation.

C. Holding Company System

- It was recommended that cost be allocated in accordance with the provisions of the filed service agreement and Department Regulation 30. 10

The Company has complied with this recommendation.

D. Custodian Service Agreements

- It was recommended that the Company change the name on its custodial agreement to reflect its current name. 12

The Company has complied with this recommendation.

- It was recommended that the custodial agreement be amended to comply with Part 1V H Paragraph 2f of the NAIC Examiners Handbook regarding the required custodian service agreement notification provision. 12

The Company has complied with this recommendation.

- It was recommended that the Company change the name of the Hibernia Commercial Checking account to reflect its current name. 13

The Company has complied with this recommendation.

6. SUMMARY OF COMMENTS AND RECOMMENDATIONS

This report contains no comments or recommendations.

Respectfully submitted,

_____/S/
Robert A. Vargas, CPA
Senior Insurance Examiner

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

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

_____/S/
Robert A. Vargas

Subscribed and sworn to before me
this _____ day of _____, 2009.

STATE OF NEW YORK
INSURANCE DEPARTMENT

I, Eric R. Dinallo, Superintendent of Insurance of the State of New York,
pursuant to the provisions of the Insurance Law, do hereby appoint:

Robert Vargas

as proper person to examine into the affairs of the

USAGENCIES DIRECT INSURANCE COMPANY

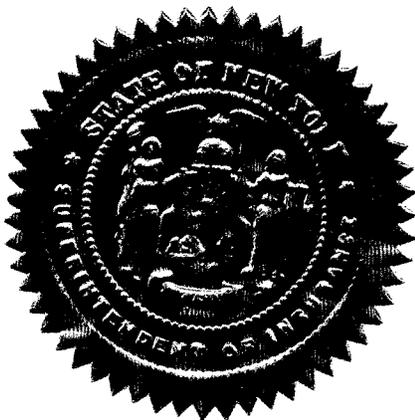
and to make a report to me in writing of the condition of the said

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 1st day of November, 2007



A handwritten signature in cursive script, appearing to read "Eric Dinallo".

ERIC R. DINALLO
Superintendent of Insurance