

REPORT ON EXAMINATION

OF THE

PREFERRED MUTUAL INSURANCE COMPANY

AS OF

DECEMBER 31, 2006

DATE OF REPORT

FEBRUARY 15, 2008

EXAMINER

FRANK P. SCHIRALDI

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STATE OF NEW YORK  
INSURANCE DEPARTMENT  
ONE COMMERCE PLAZA  
ALBANY, NEW YORK 12257

February 15, 2008

Mr. Eric R. 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 22636 dated May 1, 2007 attached hereto, I have made an examination into the condition and affairs of the Preferred Mutual Insurance Company as of December 31, 2006, and submit the following report thereon.

Wherever the designations "the Company" or "PMIC" appear herein without qualification, they should be understood to indicate the Preferred Mutual Insurance Company.

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 One Preferred Way, New Berlin, New York 13411.

## 1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 2001. This examination covered the five-year period from January 1, 2002 through December 31, 2006. 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, 2006. 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 organized in 1896 as The Preferred Mutual Fire Insurance Company of Chenango County, for the purpose of transacting business as a cooperative fire insurance corporation in Chenango County, New York. On December 27, 1910, a certificate was issued under the provisions of the New York Insurance Law, authorizing the Company to continue the transaction of business on the advance premium plan in ten counties of New York State.

On July 6, 1936 the Company was authorized to transact business within the entire state of New York.

On November 27, 1939, the Company was authorized to issue non-assessable policies.

The Company's charter was amended, in January 1952, to provide for the transaction of business, in addition to within the entire state of New York, wherever authorized by law, any other state, of the United States of America and the District of Columbia.

On February 19, 1957, a certificate was issued by this Department which authorized the Company to change its corporate title to the Preferred Mutual Insurance Company. A license dated March 7, 1957 reflected the new name.

On May 15, 2003 this Department approved the Company's request to issue a fixed/floating rate surplus note in the amount of \$10,000,000 to I-Preferred Term Securities IV, Ltd. and to enter into an indenture with U.S. Bank Association as trustee for I-Preferred Term Securities IV, Ltd. The interest rate from May 15, 2003 to May 15, 2008 shall be at a rate of 7.35%. Each succeeding interest payment is based on the 3 – month LIBOR plus 4.10%. The note was issued on May 15, 2003 and has a thirty year duration.

### 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 nine nor more than twenty-five members. The board meets four times during each calendar year. At December 31, 2006, the board of directors was comprised of the following twelve members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Matthew Thomas Cooney Jr. Ithaca, NY	Retired
William Clark Craine Sherburne, NY	Chairman Partners Trust Financial Group, Inc.
Martin Alan Dietrich Norwich, NY	President and Chief Executive Officer NBT Bank, N.A.
David Bruce Emerson Oxford, NY	Chairman of the Board Blueox Corporation
Patrick James Flanagan Norwich, NY	Attorney at Law Nelson and Flanagan
Irada Steadman Ingraham New Berlin, NY	Retired
John Charles Mitchell Hamilton, NY	President I.L. Richer Company, Inc.
Geoffrey Adam Smith West Oneonta, NY	President Medical Coaches, Inc.
Paul Oster Stillman Hilton Head Island, SC	Vice-Chairman of the Board Preferred Mutual Insurance Company
Christopher Paul Taft Clinton, NY	President and Chief Operating Officer Preferred Mutual Insurance Company
Robert Arthur Wadsworth New Berlin, NY	Chairman of the Board and Chief Executive Officer Preferred Mutual Insurance Company
William Clifton Westbrook Charlotte, NC	Retired

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.

Upon examination it was noted that the Board of Directors elected a Vice-Chairman at its meeting of February 28, 2006. The approved by-laws in effect on February 28, 2006 did not provide for the position of Vice-Chairman.

The Department approved a request submitted by the Company on August 14, 2006 in which the Company asked for approval to change its by-laws to add the position of Vice-Chairman. This approval was effective as of September 12, 2006.

It is recommended that the Company comply with its approved by-laws and not implement changes to the by-laws until approved by the Department.

Upon examination it was noted that Robert Arthur Wadsworth and Christopher Paul Taft were affiliated with Guilderland Reinsurance Company (“GRC”) during the examination period. Mr. Wadsworth has been the President of GRC since 2006 and a Director of GRC since 2004. Mr. Taft has been a Director since 2006.

A review of the conflict of interest forms completed revealed that Mr. Wadsworth did not disclose he was a Director of GRC on his 2004 form, and that he was the President of GRC on his 2006 form. Mr. Taft did not disclose that he was a Director of GRC on his 2006 form.

It is recommended that all Directors and Officers properly disclose all potential conflicts of interest when they complete their annual conflict of interest form.

As of December 31, 2006, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Robert A. Wadsworth	Chairman of the Board and CEO
Paul O. Stillman	Vice-Chairman of the Board
Christopher P. Taft	President and COO
Aaron J. Valentine	Vice President, CFO and Treasurer
Gary G. Strong	Vice President and Secretary
William F. Jardinella	Vice President
Martin M. Doto	Vice President

B. Territory and Plan of Operation

As of December 31, 2006, the Company was licensed to write business in the States of Massachusetts, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island and South Carolina. The Company has a “RESTRICTED, NO NEW BUSINESS” license for the state of North Carolina. In addition, the Company has a license for the state of Connecticut; however, it is only for servicing existing business.

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
6	Water damage
7	Burglary and theft
8	Glass
9	Boiler and machinery
10	Elevator
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 (inland marine only)

Approximately 98% of the Company's 2006 direct writings were concentrated in New York, Massachusetts and New Jersey.

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	\$90,457,169	\$142,246,937	63.59%
2003	\$100,239,897	\$158,226,746	63.35%
2004	\$110,861,298	\$176,268,079	62.89%
2005	\$119,258,126	\$197,182,766	60.48%
2006	\$121,387,426	\$202,424,515	59.97%

Based on the lines of business for which the Company is licensed and pursuant to the requirements of Articles 13, 41, and 66 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of \$1,450,000.

The review of all the Company's licenses as of December 31, 2006 revealed that the Company has been licensed in the State of New Hampshire for a line of business, ocean marine, for which it does not have authority in its New York license.

The Company's minimum financial requirements and authority to do business is predicated upon its New York licensed authority pursuant to the provisions of Section 1102 and Articles 41 and 66 of the New York Insurance Law.

Therefore, it is recommended that the Company complete the steps necessary to conform its New Hampshire license to its New York license.

At December 31, 2006, the Company wrote insurance through independent agents. The Company maintained a branch office in Norwich, New York.

The Company's predominate lines of business are homeowners multiple peril, commercial multiple peril, private passenger auto liability and auto physical damage, which accounted for 41.05%, 15.55%, 14.76% and 12.47%, respectively, of the Company's 2006 direct written business.

### C. Reinsurance

Assumed reinsurance accounted for less than 1% of the Company's gross premium written for each year covered by this examination. The Company's assumed reinsurance program consists mainly of its participation in various mandated pools.

As of December 31, 2006, the Company had the following excess of loss reinsurance program in place:

Casualty two layers	\$3,600,000 in excess of \$400,000 each loss occurrence.
Property Catastrophe six layers (excluding Auto Physical Damage)	95% of \$135,000,000 in excess of \$5,000,000 each loss occurrence; 100% of \$25,000,000 in excess of \$140,000,000 each loss occurrence.
Property Catastrophe Reinstatement	100% of any reinstatement premiums that the Company has paid, or becomes liable to pay under the Company's Property Catastrophe Excess of Loss Reinsurance (first 5 layers), subject to a maximum liability of \$5,000,000.
Auto Physical Damage Catastrophe	\$1,500,000 in excess of \$500,000 each loss occurrence, subject to a \$3,000,000 aggregate limit for all loss occurrences during the term of the contract.

As of December 31, 2006 the Company had the following pro rata reinsurance programs in place:

Property First Surplus (excluding Auto Physical Damage)	Personal lines - nine (9) times the Company's net retention on each risk, not more than \$4,500,000 on each risk and Commercial lines - nine (9) times the Company's net retention on each risk, not more than \$3,500,000 on each risk, subject to a per occurrence limit of 200% of the Company's ceded earned premium.
Property Quota Share (excluding Auto Physical Damage)	30% of the Company's ultimate net liability, subject to a maximum cession limit of \$150,000 each risk and \$47,000,000 as respects any one loss occurrence (\$23,500,000 as respects losses arising out of one or multiple acts of terrorism or counterterrorism during the contract year).
Casualty	Personal lines umbrella - 95% of Company's net loss up to \$1,000,000 resulting from each occurrence and 100% of Company's net loss in excess of \$1,000,000, but not exceeding \$5,000,000 resulting from each occurrence; Commercial lines umbrella 95% of the first \$1,000,000 each occurrence, \$1,000,000 aggregate; and 100% of the difference, if any, between the policy limit and the first \$1,000,000 each occurrence, \$1,000,000 aggregate limit of liability of the Company with respect to any one policy not to exceed \$5,000,000 each occurrence, \$5,000,000 aggregate.

It is noted that the Company's quota share percentage of 30% did not change during the examination period. However, the Company's retention on the casualty excess of loss reinsurance increased from \$250,000 at December 31, 2001 to \$400,000 at December 31, 2006.

As of December 31, 2006, the Company had the following facultative excess of loss reinsurance program in place:

Commercial	Three (3) times the Company's retention on each risk, each occurrence up to a maximum of \$12,000,000 each risk, each occurrence.
Homeowners	Maximum of \$1,000,000 each risk, each occurrence in excess of Company's net and treaty retention on each risk, each occurrence.
	Company's minimum and net treaty retention shall be \$4,000,000 each risk, each occurrence.

In addition to the reinsurance described above, the Company had a reinsurance program for equipment breakdown coverage in effect at December 31, 2006. Under the terms of this reinsurance program, the Company ceded 100% of its liability for Business owners' policies to which Equipment Breakdown Coverage Endorsement Form No. PMBP04700689 or Form PMB040700196 or subsequent editions are attached and Commercial Property Coverage Equipment Breakdown Coverage Endorsement where Form No. PMCP04700695 or Form No. PMRI00700899 or subsequent editions are attached. The reinsurers liability shall not exceed \$25 million for any one accident.

It is noted that 22.9% of the Company's reinsurance program was placed with unauthorized reinsurers. This is an increase from the prior examination where 9.6% was placed with unauthorized reinsurers. It is the Company's policy to obtain the appropriate collateral for its cessions to unauthorized reinsurers.

The examiner reviewed the Letters of Credit ("LOC") held by the Company at December 31, 2006. It was noted that the LOC issued by the Republic Bank & Trust in favor of the Company for the account of the Kentucky Farm Bureau Mutual Insurance Company, was found to be lacking several of the required conditions for an acceptable LOC, specifically those noted in Parts 79.2(d), 79.2(f) and 79.2(i) of Department Regulation 133.

Pursuant to Department Regulation 133, Part 79.6(a), “A letter of credit may not be used to reduce any liability for reinsurance ceded to an unauthorized reinsurer in financial statements required to be filed with this department unless: (1) a letter of credit, in compliance with the provisions of this Part with the filing ceding insurer as beneficiary, has been issued on or before the “as of” date of the financial statement of the ceding insurer;...”

As of the examination date, the Company utilized this LOC to reduce its reinsurance recoverable from Kentucky Farm Bureau Mutual Insurance Company.

Subsequent to the examination date but during the field portion of the examination, the Company amended the above mentioned LOC. The revised LOC was found to comply with Regulation 133. Due to the fact that the LOC was revised no examination financial change will be made.

Nevertheless, it is recommended that the Company ensure that all letters of credit used to reduce any liability for reinsurance ceded to an unauthorized reinsurer comply with Department Regulation 133.

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, per the NAIC Annual Statement Instructions, from the Company's Chief Executive and Chief Financial Officers. Additionally, examination review indicated that the Company was not a party to any finite reinsurance agreements.

#### D. Holding Company System

The Company had a wholly owned subsidiary Preferred Services Corporation as of December 31, 2006, which in turn had a wholly owned subsidiary Preferred Group, Inc. Preferred Group, Inc. is

a licensed agent of the Company. The Company had “Technical Services Agreements” with both Preferred Services Corporation and Preferred Group Inc.

Upon examination it was noted that the Company filed its federal taxes on a consolidated basis with Preferred Services Corporation and Preferred Group, Inc. It was also noted that there was no tax allocation agreement between the companies.

In accordance with Circular Letter No. 33 (1979), “Every domestic insurer which is a party to a consolidated federal income tax filing must have a definitive written agreement, approved by its Board of Directors, governing its participation therein...”

It is recommended that the Company comply with the requirements of Circular Letter No. 33 (1979) and enter into a written tax allocation agreement and file a copy of such tax allocation agreement with the Department forthwith.

Subsequent to the examination date, but prior to the date of filing of this report, the Company entered into a Tax Allocation Agreement (“Agreement”) with its subsidiaries and submitted the Agreement to the Department. The Agreement was non-objected to by the Department on June 19, 2008.

E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2006, based upon the results of this examination:

Net premiums written to surplus as regards policyholders	120%
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	65%
Premiums in course of collection to surplus as regards policyholders	1%

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	\$417,545,273	66.73%
Other underwriting expenses incurred	204,937,133	32.75%
Aggregate write-ins for underwriting deductions	21,583,918	3.45%
Net underwriting loss	<u>(18,348,656)</u>	<u>(2.93)%</u>
Premiums earned	<u>\$625,717,668</u>	<u>100.00%</u>

F. Accounts and Records

i. Custodial Agreement Provisions

The Company maintained custodial agreements as of December 31, 2006, with NBT Bank.

A review of the Company's custodial agreements indicated that several provisions and safeguards as set forth in the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook were not included in the agreements. Subsequent to the examination date but during the field portion of the examination, the Company amended its custodial agreements to include the recommended provisions and safeguards.

Nevertheless, it is recommended that the Company ensure that any custodial agreement it enters into in the future includes the provisions and safeguards as per the NAIC Financial Condition Examiners Handbook.

It was also noted that management answered affirmatively to the following General Interrogatory in its December 31, 2006 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 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?

As noted above, the Company's custodial agreements entered into with NBT Bank did not contain all of the provisions and safeguards.

Therefore, it is recommended that the Company respond appropriately to the General Interrogatory regarding custodial or safekeeping agreements in all future statements filed with this Department.

ii. Compliance with Department Regulation 118

A review of the written contract between the Company and its CPA for the audit years 2002 through 2005, revealed that the contracts were not in compliance with Part 89.2(c) of Department Regulation 118, which states, in part, that "...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 2006 audit year, the Company entered into a contract with a new CPA firm to provide the audited financial statements and opinion. The contract used the following wording, "We shall provide you by May 15, 2007 (circumstances permitting) an audited financial statement and opinion for the year ended December 31, 2006 and an evaluation of the Company's accounting procedures and internal control systems as are necessary to the furnishing of the opinion". Adding the wording "circumstances permitting" to the contract is not in accordance with the requirements of Part 89.2(a) of Department Regulation 118.

Therefore, it is recommended that the Company ensure that the contract with the CPA for all future audits contain the wording required by Department Regulation 118.

iii. Remittances and Items Not Allocated

The NAIC Annual Statement Instructions state the following regarding Remittances and items not allocated:

"Report a liability for cash receipts that the insurer cannot identify for a specific purpose or, for other reasons, the insurer cannot apply to a specific account when received. Refer to SSAP No. 67, Other Liabilities, for accounting guidelines."

SSAP No. 67, paragraph 9, states that the following shall be included in Remittances and items not allocated:

1. Premium payments received with the application for policies which have not yet been issued;
2. Premium payments in an amount different than the amount billed by the reporting entity; and
3. Unidentified cash receipts.

On examination, it was noted that the Company reported these items as advance premiums.

It is recommended that the Company comply with the NAIC Annual Statement Instructions and SSAP No. 67, paragraph 9 and report any premium payments received with the application for policies which have not been issued, premium payments received in an amount different than the amount billed by the reporting entity, and unidentified cash receipts as "Remittances and items not allocated."

Subsequent to the examination date but during the field portion of the examination, when this matter was brought to the attention of Management, the Company made changes in its procedures, to properly record such items as "Remittances and items not allocated."

iv. Advance Premiums / Credits due to Insureds

During the review of the liability for advance premiums, it was noted that the Company included credits for amounts due to insureds for cancellations, overpayments and/or endorsements as part of this liability. In accordance with the NAIC Annual Statement Instructions, the liability for advance premiums includes premiums received prior to the effective date of the contract. Thus, the liability for credit amounts due to insureds should not have been included. Such credits would more appropriately be reported as a write-in liability.

Thus, it is recommended that the Company only report as "Advance premiums" those premiums received prior to the effective date of the contract as required by the NAIC Annual Statement Instructions.

A review of the Company's credit reports dated December 31, 2006 revealed that, in some instances, refunds for overpayments, endorsements and cancellations due to insureds were not



refunded timely. Although the time frame to refund overpayments/endorsements is not explicitly stated in the New York Insurance Laws or Regulations, there is guidance relative to cancellations.

OGC Opinion 07-09-09 states, in part, that "...since Insurance Law 3428(a) permits only earned premium to be retained by an insurer, such insurer would have to refund the unearned premium within a reasonable time."

Relative to policies where the premiums are financed pursuant to a premium finance agreement, New York Insurance Law, Section 3428(d) states, in part, that "... the insurer ... within a reasonable time not to exceed sixty days after the effective date of cancellation shall return whatever gross unearned premiums are due under the insurance contract or contracts..."

Upon review of the Company's homeowners policy form, it was noted that the cancellation policy states, in part, that "Your return premium, if any, will be refunded at the time of cancellation or as soon as practical."

Thus, refunds to insureds as a result of cancellations, overpayments and/or endorsements should be made within a reasonable time. In the absence of a specific Law or Regulation governing what is a reasonable time frame, sixty days as permitted by Section 3428(d) for refunds of unearned premiums due under insurance contracts where the premiums are financed pursuant to a premium finance agreement should be considered as a guideline.

It is recommended that the Company ensure that refunds to insureds as a result overpayments, endorsements and cancellations be made in a timely manner.

Subsequent to the examination date but during the field portion of the examination, the Company indicated that it changed the reporting mechanism and process by which it issues and tracks refunds due so that they are more timely.

#### v. Classification of Expenses

SSAP No. 55, paragraph 5c.ii.(c), states that, "Attorney fees incurred in the determination of coverage, including litigation between the reporting entity and the policyholder," should be classified as Adjusting and Other expenses. The Company noted that it categorized these expenses as Defense and Cost Containment expenses.

It is recommended that the Company comply with SSAP No. 55, paragraph 5c.ii.(c) and correctly categorize its loss adjustment expenses as Defense and Cost Containment or Adjusting and Other.

vi. Premium Deficiency Reserve

The Company reported a premium deficiency reserve of \$0 as of December 31, 2006.

SSAP No 53, paragraph 15 states the following:

“When the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, and any future installment premiums on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings.”

Although the Company indicated that it had reviewed each grouping and determined that no reserve was required, it did not maintain appropriate documentation that supports this position.

Therefore, it is recommended that the Company prepare and maintain appropriate documentation supporting the Company’s position regarding the establishment of a premium deficiency reserve, even for a zero balance, in all future years.

3. FINANCIAL STATEMENTSA. Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2006 as determined by this examination and as reported by the Company. The figures included in these financial statements have been rounded.

<u>Assets</u>	<u>Assets</u>	Nonadmitted <u>Assets</u>	Net Admitted <u>Assets</u>
Bonds	\$226,991,980	\$ 0	\$226,991,980
Preferred stocks	2,149,960	0	2,149,960
Common stocks	44,087,928	0	44,087,928
Real Estate: Properties occupied by the company	4,453,123	0	4,453,123
Real Estate: Properties held for the production of income	18,654	0	18,654
Cash, cash equivalents and short-term investments	10,660,398	0	10,660,398
Investment income due and accrued	2,596,131	0	2,596,131
Uncollected premiums and agents' balances in the course of collection	1,138,850	59,010	1,079,840
Deferred premiums, agents' balances and installments booked but deferred and not yet due	37,319,747	21,500	37,298,247
Amounts recoverable from reinsurers	4,343,602	0	4,343,602
Funds held by or deposited with reinsured companies	52,025	0	52,025
Net deferred tax asset	3,190,979	0	3,190,979
Electronic data processing equipment and software	72,013	72,013	0
Furniture and equipment, including health care delivery assets	365,852	365,852	0
Aggregate write-ins for other than invested assets	<u>17,426,434</u>	<u>7,344,121</u>	<u>10,082,313</u>
Total assets	<u>\$354,867,676</u>	<u>\$7,862,496</u>	<u>\$347,005,180</u>

Liabilities, surplus and other funds

Losses and loss adjustment expenses		\$118,205,534
Reinsurance payable on paid losses and loss adjustment expenses		2,104
Commissions payable, contingent commissions and other similar charges		6,077,031
Other expenses (excluding taxes, licenses and fees)		2,287,288
Taxes, licenses and fees (excluding federal and foreign income taxes)		339,627
Current federal and foreign income taxes		305,375
Unearned premiums		78,478,859
Advance premium		2,295,161
Ceded reinsurance premiums payable (net of ceding commissions)		5,951,549
Amounts withheld or retained by company for account of others		8,491,043
Provision for reinsurance		1,218
Drafts outstanding		211,428
Payable to parent, subsidiaries and affiliates		206,232
Payable for securities		<u>1,847,912</u>
Total liabilities		\$224,700,361
Aggregate write-ins for special surplus funds	\$ 1,450,000	
Surplus notes	10,000,000	
Unassigned funds (surplus)	<u>110,854,819</u>	
Surplus as regards policyholders		<u>122,304,819</u>
Total liabilities, surplus and other funds		<u>\$347,005,180</u>

Note 1: The Internal Revenue Service has completed its audit of the Company's consolidated Federal Income Tax return for tax year 2004. All material adjustments, if any, made subsequent to the date of examination and arising from said audit, are reflected in the financial statements included in this report. The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2002, 2003, 2005 and 2006. 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.

Note 2: No liability appears in the balance sheet for a surplus note in the amount of \$10,000,000 and accrued interest thereon in the amount of \$91,875 (as of December 31, 2006). This loan was granted pursuant to Section 1307 of the New York Insurance Law. As provided in Section 1307, repayment of principal and interest shall only be made out of the free and divisible surplus, subject to the prior approval of the Superintendent of the State of New York.

B. Underwriting and Investment Exhibit

Surplus as regards policyholders increased \$38,962,984 during the five-year examination period January 1, 2002 through December 31, 2006, detailed as follows:

Underwriting Income

Premiums earned		\$625,717,668
Deductions:		
Losses and loss adjustment expenses incurred	\$417,545,273	
Other underwriting expenses incurred	204,937,133	
Aggregate write-ins for underwriting deductions	<u>21,583,918</u>	
Total underwriting deductions		<u>644,066,324</u>
Net underwriting gain or (loss)		\$(18,348,656)

Investment Income

Net investment income earned	\$41,372,775	
Net realized capital gain	<u>6,233,519</u>	
Net investment gain or (loss)		47,606,294

Other Income

Net gain or (loss) from agents' or premium balances charged off	\$(3,139,908)	
Finance and service charges not included in premiums	16,207,836	
Aggregate write-ins for miscellaneous income	<u>288,192</u>	
Total other income		<u>13,356,120</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$42,613,758
Federal and foreign income taxes incurred		<u>13,155,345</u>
Net Income		<u>\$29,458,413</u>

Capital and Surplus

Surplus as regards policyholders per report on examination as of December 31, 2001				\$ 83,341,835
		<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income	\$29,458,413		\$ 0	
Net unrealized capital gains or losses	1,616,636		0	
Change in net deferred income tax	3,214,390		0	
Change in nonadmitted assets	0		5,592,343	
Change in provision for reinsurance	0		218	
Change in surplus notes	10,000,000		0	
Cumulative effect of changes in accounting principles	0		2,268,506	
Aggregate write-ins for gains and losses in surplus	<u>2,534,612</u>		<u>0</u>	
Net increase in surplus	<u>\$46,824,051</u>		<u>\$7,861,067</u>	<u>38,962,984</u>
Surplus as regards policyholders per report on examination as of December 31, 2006				<u>\$122,304,819</u>

4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for the captioned items of \$118,205,534 is the same as reported by the Company as of December 31, 2006. The examination analysis of the loss and loss adjustment expense reserves was conducted in accordance with generally accepted actuarial principles and practices and was based on statistical information contained in the Company's internal records and in its filed annual statements. Based upon the Department's actuarial review, the examination loss and loss adjustment expense reserves were found to be slightly higher than the Company's carried reserves, however, the difference noted is not considered material and therefore no examination change was made to the financial statements presented in this report.

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. Sales and advertising
- B. Underwriting
- C. Rating
- D. Claims and complaint handling

Upon review of cancellation notices and supporting documentation for policies that had been in effect for sixty days, or for cancellation of renewal policies issued, it was noted that the Company issued a limited number of personal line cancellation notices for other than statutory reasons in violation of Section 3425(c) of the New York Insurance Law and for reasons that were known to the Company at the time of the annual anniversary date of the policy. It was also noted that, in some instances the reason(s) for cancellation were not adequately documented.

It is recommended that the Company comply with Section 3425(c) of the New York Insurance Law and not issue personal line midterm cancellations for other than statutory reasons. It is further recommended that the Company ensure that the statutory reason for cancellation is properly documented. A similar recommendation was included in the prior report on examination.

No other problem areas were encountered.

6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

<u>ITEM</u>	<u>PAGE NO.</u>
<p>A. <u>Territory and Plan of Operation</u></p> <p>It was recommended that the Company complete the steps necessary to conform its licenses outside this state to its New York license.</p> <p>The Company has complied with this recommendation for the states specified in the previous report. In the current examination, it was noted that the New Hampshire license needs to be changed. A similar recommendation is contained in this report. See section 2(B).</p>	<p>6</p>
<p>B. <u>Abandoned Property</u></p> <p>It was recommended that the Company escheat all amounts to the State Comptroller's Office required by the New York Abandoned Property Law, henceforth.</p> <p>The Company has complied with this recommendation.</p>	<p>10</p>
<p>C. <u>Accounts and Records</u></p>	
<p>i. <u>Allocation of Expenses</u></p> <p>Management was directed to establish and maintain written documentation supporting the allocation of each expense category to the major expense groups as required by Department Regulation 30.</p> <p>The Company has complied with this recommendation.</p>	<p>11</p>
<p>ii. <u>Custodial agreement provisions</u></p> <p>It was recommended that should the Company enter into any new custodial agreements that it ensure such agreements contain all the provisions established by this Department to be included in custodial agreements.</p> <p>A recommendation regarding custodial agreements has been made in this report.</p>	<p>11</p>



<u>ITEM</u>	<u>PAGE NO.</u>
iii. <u>Call dates and prices on bonds</u>	12
<p>It was recommended that the Company comply with the annual statement instructions and report the call date and call price on which amortization is based for bonds purchased at a premium on Schedule D-Part 1 of future annual statements. A similar recommendation was included in the prior report.</p> <p>The Company has complied with this recommendation.</p>	
iv. <u>Approval of Investments</u>	12
<p>It was recommended that the Company comply with the requirements of Section 1411(a) of the New York Insurance Law.</p> <p>The Company has complied with this recommendation.</p>	
v. <u>Repurchase Agreements and SSAP No. 45</u>	13
<p>It was recommended that the Company adhere to the requirements of SSAP 45 section (8) (a) when entering into repurchase agreements in the future.</p> <p>The Company has complied with this recommendation.</p>	
vi. <u>Annual Statement Schedule P</u>	13
<p>a) It was recommended that the Company complete Schedule P Part 5 of all future annual statements in accordance with the annual statement instructions.</p> <p>The Company has complied with this recommendation.</p>	
<p>b) It was recommended that in future annual statements the Company ensure that the amounts reported in Schedule P agree with the applicable amounts reported in other parts of the annual statement.</p> <p>The Company has complied with this recommendation.</p>	
D. <u>Market Conduct Activities</u>	19
<p>i. It was recommended that the Company file the annual reports required by Department Regulation 58 Section 13.6 by the filing deadline of April 1<sup>st</sup>, henceforth.</p> <p>The Company has complied with this recommendation.</p>	

<u>ITEM</u>		<u>PAGE NO.</u>
ii.	It was recommended that the Company comply with the provisions of Section 3425(b) of the New York Insurance Law when issuing notices of cancellation on policies in effect sixty days or less by including the specific reason or reasons for cancellation in such notice.	19
	The Company has complied with this recommendation.	
iii.	It was recommended that the Company not issue personal line mid-term cancellation for other than statutory reasons as required by Section 3425(c) of the New York Insurance Law.	19
	The Company has not complied with this recommendation. A similar recommendation is included in this report. See section 5.	

## 7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>		<u>PAGE NO.</u>
A.	<u>Management</u>	
i.	It is recommended that the Company comply with its approved by-laws and not implement changes to the by-laws until approved by this Department.	5
ii.	It is recommended that all Directors and Officers properly disclose all potential conflicts of interest when they complete their annual conflict of interest form.	5
B.	<u>Territory and Operations</u>	
	It is recommended that the Company complete the steps necessary to conform its New Hampshire license to its New York license.	7
C.	<u>Reinsurance</u>	
	It is recommended that the Company ensure that all letters of credit used to reduce any liability for reinsurance ceded to an unauthorized reinsurer comply with Department Regulation 133.	10

ITEMPAGE NO.D. Holding Company System

It is recommended that the Company comply with the requirements of Circular Letter No. 33 (1979) and enter into a written tax allocation agreement and file a copy of such tax allocation agreement with the Department forthwith. 11

Subsequent to the examination date, but prior to the date of filing of this report, the Company entered into a Tax Allocation Agreement (“Agreement”) with its subsidiaries and submitted the Agreement to the Department. The Agreement was non-objected to by the Department on June 19, 2008.

E. Accounts and Recordsi. Custodial Agreement Provisions

It is recommended that the Company ensure that any custodial agreement it enters into in the future includes the provisions and safeguards as per the NAIC Financial Condition Examiners Handbook. 12

It is recommended that the Company respond appropriately to the General Interrogatory regarding custodial or safekeeping agreements in all future statements filed with this Department. 13

ii. Compliance with Department Regulation 118

It is recommended that the Company ensure that the contract with the CPA for all future audits contain the wording required by Department Regulation 118. 13

iii. Remittances and Items Not Allocated

It is recommended that the Company comply with the NAIC Annual Statement Instructions and SSAP No. 67, paragraph 9 and report any premium payments received with the application for policies which have not been issued, premium payments received in an amount different than the amount billed by the reporting entity, and unidentified cash receipts as "Remittances and items not allocated." 14

<u>ITEM</u>	<u>PAGE NO.</u>
iv. <u>Advance Premiums / Credits due to Insureds</u>	
It is recommended that the Company only report as “Advance premiums” those premiums received prior to the effective date of the contract as required by the NAIC Annual Statement Instructions.	14
It is recommended that the Company ensure that refunds to insureds as a result of overpayments, endorsements and cancellations be made in a timely manner.	15
v. <u>Classification of Expenses</u>	
It is recommended that the Company comply with SSAP No. 55, paragraph 5c.ii.(c) and correctly categorize its loss adjustment expenses as Defense and Cost Containment or Adjusting and Other.	16
vi. <u>Premium Deficiency Reserve</u>	
It is recommended that the Company prepare and maintain appropriate documentation supporting the Company’s position regarding the establishment of a premium deficiency reserve, even for a zero balance, in all future years.	16
F. <u>Market Conduct Activities</u>	
It is recommended that the Company comply with Section 3425(c) of the New York Insurance Law and not issue personal line mid-term cancellations for other than statutory reasons.	21
It is further recommended that the Company ensure that the statutory reason for cancellation is properly documented.	
A similar recommendation was included in the prior report on examination.	



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:

Frank P. Schiraldi

as proper person to examine into the affairs of the

**Preferred Mutual Insurance Company**

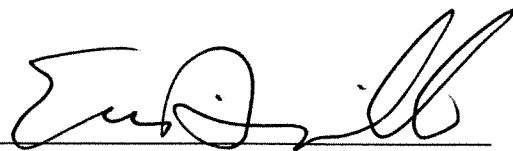
and to make a report to me in writing of the condition of the said

**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 May 2007



Eric R. Dinallo  
Superintendent of Insurance