REPORT ON EXAMINATION

OF

PREFERRED MUTUAL INSURANCE COMPANY

AS OF

DECEMBER 31, 2016

DATE OF REPORT	OCTOBER 20, 2017
EXAMINER	JOSEPH REVERS

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NEW YORK STATE
DEPARTMENT of
FINANCIAL SERVICES

Andrew M. Cuomo
Governor

Maria T. Vullo
Superintendent

October 20, 2017

Honorable Maria T. Vullo
Superintendent
New York State Department of Financial Services
Albany, New York 12257

Madam:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 31563 dated January 6, 2017, attached hereto, I have made an examination into the condition and affairs of Preferred Mutual Insurance Company as of December 31, 2016, and submit the following report thereon.

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

Wherever the term "Department" appears herein without qualification, it should be understood to mean the New York State Department of Financial Services.

The examination was conducted at the Company's administrative office located at One Preferred Way, New Berlin, NY 13411.

1. SCOPE OF EXAMINATION

The Department has performed an examination of the Company, a multi-state insurer. The previous examination was conducted as of December 31, 2011. This examination covered the five-year period from January 1, 2012 through December 31, 2016. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

This examination was conducted in accordance with the National Association of Insurance Commissioners ("NAIC") Financial Condition Examiners Handbook ("Handbook"), which requires that we plan and perform the examination to evaluate the financial condition and identify current and prospective risks of the Company by obtaining information about the Company including corporate governance, identifying and assessing inherent risks within the Company and evaluating system controls and procedures used to mitigate those risks. This examination also includes assessing the principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation, management's compliance with New York Laws, Statutory Accounting Principles, and annual statement instructions.

This examination report includes, but is not limited to, the following:

Company history
Management and control
Territory and plan of operation
Holding company description
Reinsurance
Loss review and analysis
Financial statement presentation
Significant subsequent events
Summary of recommendations

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 that involve departures from laws, regulations or rules, or that are deemed to require explanation or description.

2. DESCRIPTION OF COMPANY

Preferred Mutual Insurance 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 November 27, 1939, the Company was authorized to issue non-assessable policies. Since January 1952, its charter has allowed for the transaction of business in all counties in New York and any other state and the District of Columbia. The Company adopted its current title on March 7, 1957.

On May 15, 2003, the Department approved the Company's request to issue a fixed/floating rate surplus note in the amount of $10,000,000 to I-Preferred Team Securities IV, Lt. 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, was 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. Corporate Governance

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 fifteen members. The board meets four times during each calendar year. At December 31, 2016, the board of directors was comprised of the following eleven members:

Name and Residence	Principal Business Affiliation
Matthew T. Cooney, Jr. Solomons, MD	Retired
William C. Craine Sherburne, NY	Treasurer, County of Chenango, NY
Martin A. Dietrich Norwich, NY	Chairman, NBT Bancorp
David E. Emerson Oxford, NY	Chairman of the Board, Blueox Corporation

Name and Residence	Principal Business Affiliation
Patrick J. Flanagan Norwich, NY	Attorney at Law, Nelson and Flanagan
Mary Ellen Luker New Hartford, NY	Attorney at Law, Petrone and Petrone, PC
John C. Mitchell Ithaca, NY	President, I.L. Richer Company, Inc.
Geoffrey A. Smith West Oneonta, NY	President, Medical Coaches, Inc.
Christopher P. Taft Clinton, NY	President and Chief Executive Officer, Preferred Mutual Insurance Company
Robert A. Wadsworth Fishers Landing, NY	Chairman of the Board of Directors, (Retired), Preferred Mutual Insurance Company
Rip L. Reeves New Foundland, NJ	Chief Investment Officer and Treasurer, Aegis Insurance Services, Inc.

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 had an acceptable record of attendance.

As of December 31, 2016, the principal officers of the Company were as follows:

Name	Title
Christopher P. Taft	President and Chief Executive Officer
Aaron J. Valentine	Sr. Vice-President, Treasurer and CFO
Robert A. Wadsworth	Board Chairman and Secretary

B. Territory and Plan of Operation

As of December 31, 2016, the Company was licensed to write business in New York and nine other states. The Company's licenses in certain states are subject to limitations or restrictions, but no business was written in these states during the examination period.

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:

Paragraph	Line of Business
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

Based upon 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 following schedule shows the direct and assumed premiums written by the Company for the period under examination:

Calendar Year	Direct Premiums	Assumed Premiums	Total Premiums Written
2012	$260,757,659	$119,393	$260,877,052
2013	$278,435,410	$300,014	$278,735,424
2014	$289,801,307	$353,433	$290,154,740
2015	$296,596,232	$323,291	$296,919,523
2016	$311,044,775	$336,318	$311,381,093

The Company’s predominant lines of business during 2016 include: homeowners multiple peril, commercial multiple peril, private passenger auto liability and auto physical damage which represented for 42.0%, 18.2%, 14.8%, and 13.4% of direct written premiums, respectively. During 2016, the business is largely produced through approximately 500 independent agents in the states of New York, Massachusetts and New Jersey.

Assumed Reinsurance

Assumed reinsurance accounted for .1% of the Company's gross premium written during 2016. The Company's assumed reinsurance program consists of the Company's participation in various mandated pools. The Company utilizes reinsurance accounting as defined in Statement of Statutory Accounting Principle ("SSAP") No. 62 for all of its assumed reinsurance business.

C. Reinsurance Ceded

The Company has structured its ceded reinsurance program as follows:

Type of Treaty	Cession
Property Quota Share (Auto excluded)	30% of $500,000 of each risk after any cession to the Surplus Treaty, subject to a maximum per risk cession of $150,000 and an occurrence limit of 150% of ceded gross net written premium for the term of the contract.
Property First Surplus Share (Auto excluded)	$4,500,000 excess of $500,000, not to exceed nine times the Company's retention or $4,500,000 per each risk, and subject to an occurrence limit of 150% of ceded gross net written premium for the term of the contract.
Casualty Excess of Loss 2 Layers	1st Layer $1,500,000 excess of $500,000. 2nd Layer $5,000,000 excess of $2,000,000.
Umbrella – Commercial lines 2 Layers	1st Layer 90% of $1,000,000. 2nd Layer $4,000,000 excess of $1,000,000.
Umbrella – Personal lines 2 Layers	1st Layer 90% of $1,000,000. 2nd Layer $4,000,000 excess of $1,000,000.
Property Catastrophe Excess of Loss – Loss Occurring Basis - 4 layers (Auto physical damage included; Collision excluded)	$150,000,000 excess of $10,000,000.

Type of Treaty	Cession
Regional Reciprocal Catastrophe Pool Catastrophe Excess of Loss – Loss Occurring Basis (Auto physical damage included; Collision excluded)	$45,000,000 excess of $160,000,000.
Equipment Breakdown	100% of $25,000,000 of equipment breakdown liability.
Facultative Property Per Risk Excess of Loss	$20,000,000 excess of $5,000,000.

The majority of cessions is to authorized reinsurers. It is the Company's policy to obtain the appropriate collateral for its cessions to unauthorized reinsurers. Letters of credit obtained by the Company to take credit for cessions to unauthorized reinsurers were reviewed, on a sample basis, for compliance with Department Regulation No. 133. One exception was noted. Subsequently, the Company made the proper changes to be in compliance with Department Regulation No. 133. As of December 31, 2016, the Company reported no significant reinsurance recoverables from one reinsurer that are material to surplus.

Section 1308(e)(1)(A) of the New York State Law states in pertinent part, "During any period of twelve consecutive months, without the superintendent's permission, no domestic insurer, except life, shall by any reinsurance agreement or agreements 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". It was noted that the Company's ceded premiums during 2016 totaled more than 50% of its unearned premiums as of prior year end, without obtaining the Superintendent's permission.

It is recommended that the Company comply with Section 1308(e)(1) of the New York Insurance Law, by submitting to the Department for prior approval, a summary of its ceded reinsurance program if total ceding premiums will exceed 50% of its prior year end unearned premiums.

All significant 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 found that the Schedule F data reported by the Company in its filed annual statement accurately reflected 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. 62R. Representations were supported by appropriate risk transfer analyses and an attestation from the Company's Chief Executive Officer and Chief Risk Officer pursuant to the NAIC Annual Statement Instructions. 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. 62R.

D. Affiliated Group

The Company had a wholly owned subsidiary, Preferred Services Corporation ("PSC") as of December 31, 2016, which in turn had a wholly owned subsidiary, Preferred Group, Inc. ("PGI"). PGI is a licensed agent of the Company. Both PSC and PGI were inactive during the examination period.

The Company had the following inter-company agreements in effect as of December 31, 2016:

Technical Service Agreement Between the Company and PSC and PGI

The Company entered into a technical service agreement with PSC and PGI (collectively the "Subsidiaries"), effective January 1, 2002, whereby the Company will provide all insurance and administrative duties for each of the two companies.

Amounts due by the Subsidiaries shall be determined at the end of each month by the Company and paid by each subsidiary on a monthly basis.

Tax Allocation Agreement Between the Company and PSC and PGI

The Company entered into a tax allocation agreement, effective January 1, 2008, with PSC and PGI whereby the Company files a consolidated annual federal income tax return with the Subsidiaries. The agreement requires that each subsidiary prepare and furnish to the Company a computation of its federal tax liability as if each subsidiary had filed separate federal tax returns for the consolidated return year.

The Subsidiaries are then required to pay to PMIC an amount equal to the federal taxes shown as due on the separate returns within thirty days following the filing of the consolidated federal tax return of the Group.

Since the ultimate controlling party of the affiliated group is the Company, an authorized insurer, it is exempt from the requirements of Article 15 of the New York Insurance Law and Department Regulation 52. However, it is subject to the requirements of Article 16 of the New York Insurance and Department Regulation 53. A review of the annual filings made pursuant to Department Regulation 53 during the examination period indicated that such filings were complete and filed in a timely manner.

E. Significant Operating Ratios

The Company’s operating ratios, computed as of December 31, 2016, fall within the benchmark ranges set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners.

Operating Ratios	Result
Net premiums written to surplus as regards policyholders	91%
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	56%
Two-year overall operating	90%

Underwriting Ratios

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

	Amounts	Ratio
Losses and loss adjustment expenses incurred	$636,580,536	65.63%
Other underwriting expenses incurred	324,803,769	33.48%
Net underwriting gain (loss)	8,638,548	0.89%
Premiums earned	$970,022,853	100.00%

The Company’s risk based capital score (“RBC”) was 1,057.1% as of 12/31/16. The RBC is a measure of the minimum amount of capital appropriate for a reporting entity to support its overall business operations in consideration of its size and risk profile. An RBC of 200 or below can result in regulatory action.

3. FINANCIAL STATEMENTS

A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2016 as reported by the Company:

	Assets	Assets Not Admitted	Net Admitted Assets
Bonds	$349,229,343	$0	$349,229,343
Common stocks	57,648,163	0	57,648,163
Properties occupied by the company	4,642,720	0	4,642,720
Cash, cash equivalents and short-term investments	23,443,846	0	23,443,846
Receivables for securities	494,593	0	494,593
Annuities	93,308	0	93,308
Investment income due and accrued	2,787,773	0	2,787,773
Uncollected premiums and agents' balances in the course of collection	1,081,062	19,616	1,061,446
Deferred premiums, agents' balances and installments booked but deferred and not yet due	59,616,293	15,000	59,601,293
Amounts recoverable from reinsurers	6,081,952	0	6,081,952
Current federal and foreign income tax recoverable and interest thereon	875,873	0	875,873
Net deferred tax asset	8,626,598	0	8,626,598
Furniture and equipment, including health care delivery assets	1,532,253	1,532,253	0
Cash surrender value	13,688,008	0	13,688,008
Equity in fair plans	10,064,733	0	10,064,733
Prepaid expenses	16,507,821	16,507,821	0
NJ prop/liab guaranty recoup	595,456	0	595,456
Equities and deposits in pools and associations	120,000	0	120,000
Other receivables	5,831	6,707	(876)
Totals	$557,135,626	$18,081,397	$539,054,229

Liabilities, surplus and other funds

Liabilities		
Losses and loss adjustment expenses		$142,853,135
Reinsurance payable on paid losses and loss adjustment expenses		898
Commissions payable, contingent commissions and other similar charges		11,441,720
Other expenses (excluding taxes, licenses and fees)		4,798,606
Taxes, licenses and fees (excluding federal and foreign income taxes)		539,705
Unearned premiums		115,912,669
Advance premium		2,889,563
Ceded reinsurance premiums payable (net of ceding commissions)		10,007,828
Funds held by company under reinsurance treaties		253,419
Amounts withheld or retained by company for account of others		14,387,205
Provision for reinsurance		97,072
Payable to parent, subsidiaries and affiliates		182,033
Payable for securities		481,581
Credits due to policyholders		582,714
Total liabilities		304,428,148
Surplus and Other Funds		
Special contingent surplus	$ 1,450,000	
Surplus notes	10,000,000	
Unassigned funds (surplus)	223,176,081	
Surplus as regards policyholders		234,626,081
Total liabilities, surplus and other funds		$539,054,229

Note: The Internal Revenue Service has not audited tax returns covering tax years 2012 through 2016. 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. Statement of Income

The net income for the examination period as reported by the Company was $74,319,720 as detailed below:

Underwriting Income		
Premiums earned		$970,022,853
Deductions:		
Losses and loss adjustment expenses incurred	$636,580,536	
Other underwriting expenses incurred	318,914,079	
Aggregate write-ins for underwriting deductions	5,889,690	
Total underwriting deductions		961,384,305
Net underwriting gain or (loss)		$8,638,548
Investment Income		
Net investment income earned	$51,775,671	
Net realized capital gain	13,740,537	
Net investment gain or (loss)		$65,516,208
Other Income		
Net gain or (loss) from agents' or premium balances charged off	$(1,151,668)	
Finance and service charges not included in premiums	23,469,328	
Aggregate write-ins for miscellaneous income	1,809,409	
Total other income		$24,127,069
Net income before dividends to policyholders and before federal and foreign income taxes		$98,281,825
Dividends to policyholders		0
Net income after dividends to policyholders but before federal and foreign income taxes		$98,281,825
Federal and foreign income taxes incurred		23,962,105
Net Income		$74,319,720

C. Capital and Surplus Account

Surplus as regards policyholders increased $79,494,123 during the five-year examination period January 1, 2012 through December 31, 2016 as reported by the Company, detailed as follows:

Surplus as regards policyholders per report on examination as of December 31, 2011			$155,131,913
	Increases in Surplus	Decreases in Surplus	
Net income	$74,319,719		
Net transfers (to) from protected cell accounts			
Net unrealized capital gains or (losses)	8,231,556		
Change in net unrealized foreign exchange capital gain (loss)			
Change in net deferred income tax	1,131,173		
Change in nonadmitted assets		$4,169,353	
Change in provision for reinsurance		18,972	
Change in surplus notes			
Net increase (decrease) in surplus	$83,682,448	$4,188,325	$ 79,494,123
Surplus as regards policyholders per report on examination as of December 31, 2016			$234,626,036

No adjustments were made to surplus as a result of this examination.

4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for the captioned items of $142,853,135 is the same as reported by the Company as of December 31, 2016. The examination analysis of the Loss and loss adjustment expense reserves was conducted in accordance with generally accepted actuarial principles and statutory accounting principles, including the NAIC Accounting Practices & Procedures Manual, Statement of Statutory Accounting Principle No. 55 (“SSAP No. 55).

5. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

ITEM		PAGE NO.
A.	Accounts and Records	
	It is recommended that the Company maintain custodial agreements that contain all of the safeguards and controls required by this Department and the NAIC Financial Condition Examiners Handbook.	11
	The Company has complied with this recommendation.	
B.	Information Technology	
i	It is recommended that the Company store its backup tapes at a secondary site that is a sufficient distance from its primary facility such that it would not be impacted by the same conditions as its primary site.	12
	The Company has complied with this recommendation.	
ii.	It is recommended that the Company establish a formal assessment and mechanism to ensure that all data, programs, and systems can be restored in a timely manner.	12
	The Company has complied with this recommendation.	
iii.	It is recommended that the Company continue to formally update all parts of its Disaster Recovery / Business Continuity Plan into a centralized document. This Plan should be available offline at various locations and regularly updated.	12
	The Company has complied with this recommendation.	

6. SUMMARY OF COMMENTS AND RECOMMENDATIONS

ITEM			PAGE NO.
A		Ceded Reinsurance	
	i	It is recommended that the Company comply with Section 1308(e)(1) of the New York Insurance Law, by submitting to the Department for prior approval, a summary of its ceded reinsurance program if total ceding premiums will exceed 50% of its prior year end unearned premiums.	7

Respectfully submitted,

____
Joseph Revers, CFE
Associate Insurance Examiner

STATE OF NEW YORK)
)ss:
COUNTY OF NEW YORK)

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

____
Joseph Revers

Subscribed and sworn to before me

this__________ day of ____________________, 2017.

APPOINTMENT NO. 31563

NEW YORK STATE

DEPARTMENT OF FINANCIAL SERVICES

*I, **Maria T. Vullo**, Superintendent of Financial Services of the State of New York, pursuant to the provisions of the Financial Services Law and the Insurance Law, do hereby appoint:*

Joseph Revers

as a proper person to examine the affairs of the

Preferred Mutual Insurance Company

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

COMPANY

with such other information as he shall deem requisite.

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

this 6th day of January, 2017

MARIA T. VULLO
Superintendent of Financial Services

By: Joan P. Riddell

Joan Riddell
Deputy Bureau Chief

NEW YORK STATE ★ DEPARTMENT OF FINANCIAL SERVICES ★ EXCELSIOR