

REPORT ON EXAMINATION

OF THE

HUDSON SPECIALTY INSURANCE COMPANY

AS OF

DECEMBER 31, 2005

DATE OF REPORT

MAY 3, 2007

EXAMINER

QI LIN

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

May 3, 2007

Honorable 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 22501 dated May 12, 2006, attached hereto, I have made an examination into the condition and affairs of Hudson Specialty Insurance Company as of December 31, 2005, and submit the following report thereon.

Wherever the designation "the Company" appears herein without qualification, it should be understood to indicate Hudson Specialty 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 office located at 17 State Street, New York, New York.

1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 2001. This examination covered the four-year period from January 1, 2002 through December 31, 2005. 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, 2005. 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
- Territory and plan of operation
- Business in force by states
- Reinsurance
- Accounts and records
- Financial statements
- Loss experience

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 December 13, 1984 as the Southwest International Reinsurance Company of New York (“Southwest NY”) to serve as the vehicle for the re-domestication of the Southwest International Reinsurance Company (“Southwest TX”), a Texas insurer. Effective December 31, 1985, Southwest TX merged with and into Southwest NY and the surviving Company adopted the name of its predecessor. On August 30, 1993, the name of the Company was changed to General Security Indemnity Company.

On October 28, 2003, Odyssey America Reinsurance Corporation (“OARC”), a Connecticut domiciled reinsurance company, acquired control of the Company from Scor Reinsurance Company pursuant to a stock purchase agreement. As part of the acquisition, all of the Company’s liabilities for business written prior to the purchase date were transferred to General Security Indemnity Company of Arizona (“GSIC-AZ”) through an assumption reinsurance, indemnification and administration agreement approved by the Department. Effective December 29, 2003, the Company changed its name to Hudson Specialty Insurance Company. On December 30, 2003, OARC transferred ownership of the Company through capital contribution to Clearwater Insurance Company (“Clearwater”), a Delaware domiciled company which is wholly-owned by OARC.

During December 2003, Clearwater contributed an additional \$18,000,000 surplus to the Company. On May 20, 2004, the Company amended its charter to increase its authorized capital from \$2.5 million, consisting of 2,500 shares of \$1,000 par value per share common stock, to \$7.5 million, consisting of 25,000 shares of \$300 par value per share common stock. The Company’s common capital stock and gross paid in and contributed surplus has changed during the examination period as follows:

| <u>Year</u> | <u>Description</u> | <u>Gross paid in and contributed surplus</u> | <u>Common Capital Stock</u> |
|-------------|----------------------------------|--|---------------------------------|
| 12/31/2001 | Beginning balance | \$20,500,000 | \$2,500,000 |
| 2003 | Surplus contribution from parent | 18,000,000 | |
| 2004 | Change in common capital stock | <u>(5,000,000)</u> | <u>5,000,000</u> |
| 12/31/2005 | Ending balance | <u>\$33,500,000</u> | <u>\$7,500,000</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. As of the examination date, the board of directors was comprised of the following thirteen members:

| <u>Name and Residence</u> | <u>Principal Business Affiliation</u> |
|--|--|
| Andrew A. Barnard Dobbs Ferry, NY | Chairman & Chief Executive Officer, Hudson Specialty Insurance Company |
| Robert S. Bennett Stamford, CT | Executive Vice President and Chief Actuary, Hudson Specialty Insurance Company |
| Christopher L. Gallagher New York, NY | Executive Vice President, Hudson Specialty Insurance Company |
| Robert Giammarco New York, NY | Executive Vice President, Hudson Specialty Insurance Company |
| Mark W. Hinkley Redding CT | Executive Vice President, Odyssey America Reinsurance Company |
| Kimber J. Lantry Hercules, CA | Executive Vice President, Hudson Specialty Insurance Company |
| Peter H. Lovell Glastonbury, CT | Senior Vice President, General Counsel & Corp. Secretary, Hudson Specialty Insurance Company |
| James E. Migliorini Lebanon, NJ | President & Chief Operating Officer, Hudson Specialty Insurance Company |
| Anthony J. Narcis, Jr. Kings Park, NY | Senior Vice President, Hudson Specialty Insurance Company |
| James B. Salvesen Ridgefield, CT | Senior Vice President & Controller, Odyssey America Reinsurance Corp. |
| Donald L. Smith New Canaan, CT | Senior Vice President, General Counsel & Corp. Secretary, Odyssey America Reinsurance Corp. |
| Michael G. Wacek Greenwich, CT | President, Odyssey America Reinsurance Corp. |
| Brian D. Young London, England | Executive Vice President, Odyssey America Reinsurance Corp. |

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 member had an acceptable attendance record.

As of December 31, 2005, the principal officers of the Company were as follows:

| <u>Name</u> | <u>Title</u> |
|---------------------|---|
| Andrew A. Barnard | Chief Executive Officer |
| James E. Migliorini | President & Chief Operating Officer |
| Peter H. Lovell | Senior Vice President, General Counsel & Corporate Secretary |
| Anthony J. Slowski | Senior Vice President & Treasurer |

B. Territory and Plan of Operation

As of December 31, 2005, the Company was licensed to write business in New York only. It also operates as a surplus lines carrier on a non-admitted basis in the other forty-nine states and the District of Columbia.

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

| <u>Paragraph</u> | <u>Line of Business</u> |
|------------------|--|
| 3 | Accident & health |
| 4 | Fire |
| 5 | Miscellaneous property damage |
| 6 | Water damage |
| 7 | Burglary and theft |
| 8 | Glass |
| 9 | Boiler and machinery |
| 10 | Elevator |
| 11 | Animal |
| 12 | Collision |
| 13 | Personal injury liability |
| 14 | Property damage liability |
| 15 | Workers' compensation and employers' liability |
| 16 | Fidelity and surety |
| 17 | Credit |
| 19 | Motor vehicle and aircraft physical damage |
| 20 | Marine and inland marine |
| 21 | Marine protection and indemnity |

The Company is also empowered to transact such workers' compensation insurance as may be incidental to coverages contemplated under paragraphs 20 and 21 of Section 1113(a) of the New York Insurance Law, including insurance described in the Longshoremen's and Harbor Workers' Compensation Act (Public Law 803, 69th Congress, as amended; 33 USC Section 901 et seq. 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 in the amount of \$4,400,000.

The Company is a direct writer. More than half of its business consists of medical malpractice business written directly by the Company. The remaining business consists mainly of other liability and is produced by program administrators ("PA"). The medical malpractice claims are handled directly, but the majority of claims from business produced by PAs are handled by third party administrators ("TPA").

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 | \$1,384,471 | \$34,754,212 | 3.98% |
| 2003 | \$0 | (\$260,884) | 0.00% |
| 2004 | \$0 | \$168,799,621 | 0.00% |
| 2005 | \$1,477,774 | \$231,625,915 | 0.64% |

C. Reinsurance

The Company had not assumed any premiums as of December 31, 2005.

Prior to the acquisition of the Company by OARC, the Company entered into a 100% assumption reinsurance, indemnification and administration agreement with its then affiliate General Security Indemnity Company of Arizona ("GSIC-AZ"), pursuant to which all of the liabilities for business written prior to October 28, 2003 were transferred to GSIC-AZ. In conjunction with the

agreement, and as a condition precedent to the sale of the Company, GSIC-AZ established a trust for the benefit of the Company to secure the full amount of the gross liabilities of the Company assumed by GSIC-AZ. GSIC-AZ has endeavored to obtain novation agreements from all insureds with outstanding liabilities; however, any policies that are not novated are 100% reinsured by GSIC-AZ.

Pursuant to paragraph 33 of SSAP 62, the novated liabilities “shall be written off through the accounts, exhibits, and schedules in which they were originally recorded.” The non-novated policies, which are 100% reinsured by GSIC-AZ, qualify for prospective accounting treatment pursuant to the provisions of paragraph 30(d) of SSAP 62, which provides that pursuant to paragraph 26 of SSAP 62, the Company report the gross loss and loss adjustment expense reserves, less the ceded reserves in the appropriate exhibits and schedules in its annual statement. A review of the Company’s financial statements indicated that the Company correctly accounted for the novated policies; however, it incorrectly accounted for the non-novated liabilities by writing off the unpaid balances, rather than showing the gross amount less the ceded amount in the appropriate exhibits and schedules.

There is no surplus impact of the incorrect accounting for the non-novated liabilities because the net reserves are \$0; however, it is recommended that the Company correctly report the non-novated liabilities ceded to GSIC-AZ, pursuant to the provisions of paragraphs 30(d) and 26 of SSAP 62.

As of the examination date, the Company had the following ceded reinsurance agreements in place (both agreements are with Odyssey America Reinsurance Corporation, an affiliate):

| Type of treaty | Cession |
|---|--|
| Variable Quota Share – Program Business 100% Authorized | Not less than 90% quota share of the Company’s gross liability. (Company cedes 100% of the excess auto program and 90% of all other programs). |
| Variable Quota Share – Healthcare Business 100% Authorized | 91% of the Company’s gross liability up to \$1,000,000; 100% of the Company’s gross liability in excess of \$1,000,000. |

Upon review of the cessions to the Variable Quota Share treaty for healthcare business, it was noted that the Company ceded 100% of its unallocated loss adjustment expenses (“ULAE”). It is noted that the agreement excludes ULAE from the ceded gross liability.

It is recommended that the Company cede its business to the reinsurer in accordance with the terms in the filed reinsurance agreement.

Reinsurance agreements with affiliates were reviewed for compliance with Article 15 of the New York Insurance Law. It was noted that all affiliated reinsurance agreements were filed with the Department pursuant to the provisions of Sections 1308(e)(1) and 1505(d)(2) of the New York Insurance Law.

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.

A 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 Statements of Statutory Accounting Principles (“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, the 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.

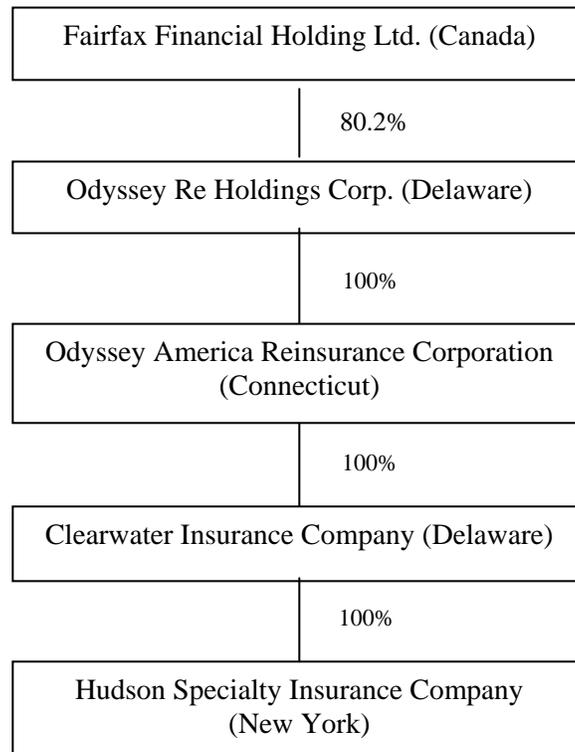
During the period covered by this examination, the company did not commute any reinsurance agreements.

D. Holding Company System

The Company is a member of the Odyssey Reinsurance Group. It is 100% owned by Clearwater Insurance Company, a Delaware domiciled company, which is ultimately controlled by Fairfax Financial Holding Ltd., a Canadian financial service holding company.

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

The following is an abridged organization chart of the holding company system at December 31, 2005:



At December 31, 2005, the Company was party to the following agreements with other members of its holding company system:

Investment Agreement

Effective October 28, 2003, the Company entered an investment agreement with its affiliates, Hamblin Wasta Investment Counsel Ltd (“HW”) and Fairfax Financial Holdings Limited (“FEH”). The agreement authorizes HW and FEH jointly manage and administer the Company’s investment accounts. This agreement has been filed with the Department pursuant to Section 1505 of the New York Insurance Law.

Inter-Company Tax Allocation Agreement

Pursuant to a tax allocation agreement, the Company has been filing consolidated federal income tax returns with its parent, Odyssey Re Holdings Corp., and its affiliates since October 28, 2003. This agreement has been filed with the Department pursuant to Section 1505 of the New York Insurance Law.

A review of the 2004 and 2005 consolidated tax worksheets revealed that the Company had made tax payments to the parent in excess of the actual payments made by the parent to the Internal Revenue Service on behalf of the Company. However, an escrow account has not been established for the excess amount paid pursuant to Department Circular letter No. 33 (1979).

It is recommended that the Company ensure that its parent establish an escrow account for the excess tax amount paid by the Company in accordance with Department Circular Letter No. 33 (1979).

Tax Service Agreement

Effective October 28, 2003, the Company entered a tax service agreement with Fairfax Inc. wherein Fairfax Inc. agreed to provide tax consulting and tax return preparation service to the Company. This agreement has been filed with the Department pursuant to Section 1505 of the New York Insurance Law.

Expense Sharing Agreement

Effective October 28, 2003, the Company entered an expense sharing agreement with its parent, OARC. Under the agreement, OARC provides the Company office space and management services, including, but not limited to, underwriting, actuarial, claims, accounting, financial, legal, personnel, data processing service and treasury. The expense sharing agreement requires that expenses should be allocated in a fair, reasonable and consistent manner according to Department Regulation 30. This agreement has been filed with the Department pursuant to Section 1505 of the New York Insurance Law.

A review of the expense sharing accounts revealed that the Company has been paying management fees at fixed amounts per year to OARC instead of allocating any expenses pursuant to Department Regulation 30.

It is recommended that the Company allocate its inter-company expenses per the filed expense sharing agreement and in accordance with Department Regulation 30.

E. Abandoned Property Law

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

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

F. Significant Operating Ratios

The following ratios have been computed as of December 31, 2005, based upon the results of this examination:

| | |
|--|-----|
| Net premiums written to surplus as regards policyholders | 30% |
| Liabilities to liquid assets (cash and invested assets less investments in affiliates) | 32% |
| Premiums in course of collection to surplus as regards policyholders | 8% |

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 four-year period covered by this examination:

| | <u>Amounts</u> | <u>Ratios</u> |
|--|---------------------|----------------|
| Losses and loss adjustment expenses incurred | \$16,396,999 | 62.96% |
| Other underwriting expenses incurred | (8,103,415) | (31.11) |
| Net underwriting loss | <u>17,750,296</u> | <u>68.16</u> |
| Premiums earned | <u>\$26,043,880</u> | <u>100.00%</u> |

G. Accounts and Records

(i) Investment

A review of the Company's investments as of December 31, 2005, revealed that it had invested \$23,308,996 in the Blackrock Treasury Trust Fund, which represents 16.2% of the Company's reported admitted assets of \$144,313,305 as of September 30, 2005. Section 1409(a) of New York Insurance Law states in part:

“that no domestic insurer shall have more than ten percent of its admitted assets as shown by its last statement on file with superintendent invested, or loaned up, the securities (including for this purpose certificate of deposit, partnership interests and other equity interests) of any one institution.”

It is recommended that the Company limit its investment in any one institution to no more than ten percent of its admitted assets pursuant to the provisions of Section 1409 of New York Insurance Law.

(ii) Unearned Premium Reserves

A review of the Company's unearned premium reserves revealed that it calculated the unearned premium reserves for policies having terms greater than thirteen months as if they were earned within one year. In addition, the Company calculated unearned premium reserves for endorsements with a fixed extended reporting period as if they were earned within one year. SSAP No. 53, paragraphs 5 through 8 require that unearned premium reserve be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Further, SSAP No. 65, paragraph 7 requires that premiums for extended reporting endorsements with a fixed period be earned over the term of the fixed period. The examiners' recalculation of unearned premium reserves for these policies resulted in no material differences. Therefore, no change is being made to the annual statement.

It is recommended that the Company calculate unearned premium reserves in accordance with the practices and procedures prescribed in of SSAP No. 53 and SSAP No. 65.

(iii) Agents' Balances

A review of the agents' balances revealed the Company had reduced the non-admitted portion of such balances over ninety days due by the related unearned premium amount. SSAP No. 6

provides that “the uncollected agent’s receivable on a policy-by-policy basis, which is over ninety days due shall be non-admitted regardless of any unearned premium.” In addition, the Company was unable to provide aging of its agents' balance on a policy-by-policy basis for its program business. The examiners’ recalculation of the uncollected agents’ receivables resulted in no material differences. Therefore, no change is being made to the annual statement.

It is recommended that the Company adhere to SSAP No. 6 in determining its non-admitted agents' balance.

It is also recommended that the Company establish a system to enable it to maintain the agents' balances detail on a policy-by-policy basis and establish an aging policy for program administrators to use policy effective date as due date to determine the non-admitted balance.

(iv) Ceding Commissions

A review of the ceding commissions revealed that Company received ceding commissions in excess of its acquisition cost of the underlying business in 2004 and 2005. SSAP No 62, paragraph 51 states as follows:

“If the ceding commission paid under a reinsurance agreement exceeds the anticipated acquisition cost of the business ceded, the ceding entity shall establish a liability, equal to the difference between the anticipated acquisition cost and the reinsurance commissions received, to be amortized prior rata over the life of the reinsurance agreement.”

It is noted that the Company did not establish a liability for the excess of the ceding commissions received over its acquisition costs. The examiner’s recalculation of the liability for the excess of the ceding commissions received resulted in no material differences. Therefore, no change is being made to the annual statement.

It is recommended that the Company establish a liability for the difference between the anticipated acquisition cost and the reinsurance commissions received in accordance with SSAP No. 62.

3. FINANCIAL STATEMENTS

A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2005, 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> | <u>Net Admitted Assets</u> |
|--|----------------------|--------------------------------|--------------------------------|--------------------------------|
| Bonds | \$44,324,900 | \$0 | \$44,324,900 | \$44,324,900 |
| Common stocks | 1,201,940 | 0 | 1,201,940 | 1,201,940 |
| Cash, cash equivalents and short-term investments | 39,851,696 | 0 | 39,851,696 | 39,851,696 |
| Receivable for securities | 6,735 | 0 | 6,735 | 6,735 |
| Investment income due and accrued | 679,447 | 0 | 679,447 | 679,447 |
| Uncollected premiums and agents' balances in the course of collection | 6,177,267 | 604,642 | 5,572,625 | 5,572,625 |
| Deferred premiums, agents' balances and installments booked but deferred and not yet due | 19,999,704 | 0 | 19,999,704 | 19,999,704 |
| Amounts recoverable from reinsurers | 1,486,019 | 0 | 1,486,019 | 1,486,019 |
| Net deferred tax asset | 880,077 | 0 | 880,077 | 880,077 |
| Receivables from parent, subsidiaries and affiliates | <u>626,794</u> | <u>0</u> | <u>626,794</u> | <u>626,794</u> |
| Total assets | <u>\$115,234,579</u> | <u>\$604,642</u> | <u>\$114,629,937</u> | <u>\$114,629,937</u> |

Liabilities, surplus and other fundsLiabilities

| | |
|---|----------------|
| Losses | \$14,272,062 |
| Loss adjustment expenses | 921,669 |
| Commissions payable, contingent commissions and other similar charges | 633,913 |
| Other expenses (excluding taxes, licenses and fees) | 3,300 |
| Current federal and foreign income taxes | 640,484 |
| Unearned premiums | 7,806,890 |
| Ceded reinsurance premiums payable (net of ceding commissions) | 21,369,318 |
| Funds held by company under reinsurance treaties | 1,346,577 |
| Amounts withheld or retained by company for account of others | (171) |
| Drafts outstanding | 250,327 |
| Payable to parent, subsidiaries and affiliates | <u>431,704</u> |
| Total liabilities | \$47,676,073 |

Surplus and Other Funds

| | |
|--|----------------------|
| Common capital stock | \$ 7,500,000 |
| Gross paid in and contributed surplus | 33,500,000 |
| Unassigned funds (surplus) | <u>25,953,864</u> |
| Surplus as regards policyholders | <u>66,953,864</u> |
| Total liabilities, surplus and other funds | <u>\$114,629,937</u> |

NOTE: The Internal Revenue Service has completed its audits of the Company's consolidated Federal Income Tax returns through tax year 2002. All material adjustments, if any, made subsequent to the date of examination and arising from said audits, are reflected in the financial statements included in this report. Audits covering tax years 2003 through 2004 are currently under examination. 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 \$35,166,122 during the four-year examination period January 1, 2002 through December 31, 2005, detailed as follows:

Underwriting Income

| | | |
|--------------------------------------|--------------------|------------------|
| Premiums earned | | \$ 26,043,880 |
| Deductions: | | |
| Losses incurred | \$ 14,809,778 | |
| Loss adjustment expenses incurred | 1,587,221 | |
| Other underwriting expenses incurred | <u>(8,103,415)</u> | |
| Total underwriting deductions | | <u>8,293,584</u> |
| Net underwriting gain or (loss) | | \$ 17,750,296 |

Investment Income

| | | |
|-------------------------------|------------------|-----------|
| Net investment income earned | \$ 8,165,918 | |
| Net realized capital gain | <u>1,028,396</u> | |
| Net investment gain or (loss) | | 9,194,314 |

Other Income

| | | |
|---|-------------------|----------------------|
| Net gain or (loss) from agents' or premium balances charged off | \$ <u>303,045</u> | |
| Total other income | | <u>303,045</u> |
| Net income after dividends to policyholders but before federal and foreign income taxes | | \$ 27,247,655 |
| Federal and foreign income taxes incurred | | <u>9,889,607</u> |
| Net income | | <u>\$ 17,358,048</u> |

C. Capital and Surplus Account

| | | | |
|--|----------------------|---------------------|---------------------|
| Surplus as regards policyholders per report on examination as of December 31, 2001 | | | \$31,787,742 |
| | <u>Gains in</u> | <u>Losses in</u> | |
| | <u>Surplus</u> | <u>Surplus</u> | |
| Net income | \$ 17,358,048 | \$ 0 | |
| Net unrealized capital gains or (losses) | 0 | 1,298,060 | |
| Change in net deferred income tax | 880,077 | 0 | |
| Change in nonadmitted assets | 0 | 604,642 | |
| Change in provision for reinsurance | 55,774 | 0 | |
| Capital changes paid in | 5,000,000 | 0 | |
| Surplus adjustments paid in | 13,000,000 | 0 | |
| Aggregate write-ins for gains and losses in surplus | <u>774,925</u> | <u>0</u> | |
| Total gains and losses | <u>\$ 37,068,824</u> | <u>\$ 1,902,702</u> | |
| Net increase (decrease) in surplus | | | <u>35,166,122</u> |
| Surplus as regards policyholders per report on examination as of December 31, 2005 | | | <u>\$66,953,864</u> |

4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for the captioned items of \$15,193,731 is the same as reported by the Company as of December 31, 2005. The examination analysis 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.

A review of the Company's 2006 Schedule P revealed that it reported the earned premiums and losses incurred from extended reporting period (tail coverage) policies of medical malpractice and other liability lines of business in the "Claims-Made" sections of Schedule P. NAIC annual statement instructions require that earned premiums and losses incurred on tail policies be included in the "Occurrence" sections of the respective lines in Schedule P.

It is recommended that the Company adhere to NAIC annual statement instructions by reporting earned premiums and losses incurred from tail policies in the "Occurrence" sections of Schedule P for each respective line of business.

5. MARKET CONDUCT ACTIVITIES

A review was made as to the manner in which the Company conducts its business and fulfills its contractual obligations to policyholders and claimants. This 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 Underwriting and Claims and complaint handling.

No problem areas were encountered.

6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination did not contain any recommendations.

7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

| <u>ITEM</u> | <u>PAGE NO.</u> |
|---|-----------------|
| A. <u>Reinsurance</u> | |
| i. it is recommended that the Company correctly report the non-novated liabilities ceded to GSIC-AZ, pursuant to the provisions of paragraphs 30(d) and 26 of SSAP 62. | 7 |
| ii. It is recommended that the Company cede its business to the reinsurer in accordance with the terms in the filed reinsurance agreement. | 8 |
| B. <u>Holding Company System</u> | |
| i. It is recommended that the Company ensure that the parent company establishes an escrow account for the excess tax amount paid by the Company in accordance with Department Circular Letter No. 33 (1979). | 10 |
| ii. It is recommended that the Company allocate its inter-company expenses per the filed expense sharing agreement and in accordance with Department Regulation 30. | 10 |
| C. <u>Accounts and Records</u> | |
| i. <u>Investments</u> | |
| It is recommended that the Company limit its investment in any one institution to no more than ten percent of its admitted assets pursuant to the provisions of Section 1409 of New York Insurance Law. | 12 |
| ii. <u>Unearned Premium Reserves</u> | |
| It is recommended that the Company calculate unearned premium reserves in accordance with the practices and procedures prescribed in of SSAP No. 65. | 12 |
| <u>Agents' Balances</u> | |
| iii. It is recommended that the Company adhere to SSAP No. 6 in determining its non-admitted agents' balance. | 13 |
| iv. It is also recommended that the Company establish a system to enable it to maintain the agents' balance detail on policy by policy basis and establish an aging policy for program administrators to use policy effective date as due date to determine the non-admitted balance. | 13 |

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- v. Ceding Commissions
- It is recommended that the Company establish a liability for the difference between the anticipated acquisition cost and the reinsurance commissions received in accordance with SSAP No. 62. 13
- D. Losses and Loss Adjustment Expenses
- It is recommended that the Company adhere to NAIC annual statement instructions by reporting earned premiums and losses incurred from tail policies in the “Occurrence” sections of Schedule P for each respective line of business. 18

Respectfully submitted,

_____/s/_____
Qi Lin
Senior Insurance Examiner

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

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

_____/s/_____
Qi Lin

Subscribed and sworn to before me
this _____ day of _____, 2007.

Appointment No. 22501

**STATE OF NEW YORK
INSURANCE DEPARTMENT**

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

Qi Lin

as proper person to examine into the affairs of the

HUDSON SPECIALTY INSURANCE COMPANY

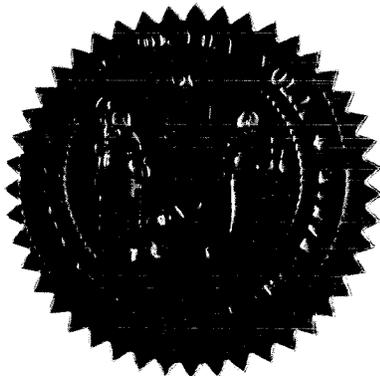
and to make a report to me in writing of the condition of the said

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 12th day of May, 2006



A handwritten signature in cursive script, appearing to read "Howard Mills".

HOWARD MILLS
Superintendent of Insurance