

REPORT ON EXAMINATION

OF THE

NATIONAL CONTINENTAL INSURANCE COMPANY

AS OF

DECEMBER 31, 2002

DATE OF REPORT

DECEMBER 5, 2003

EXAMINER

DENNIS J MCGOVERN

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Governor

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NEW YORK, NEW YORK 10004

GREGORY V. SERIO  
Superintendent of Insurance

December 5, 2003

Honorable Gregory V. Serio  
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 22040 dated April 2, 2003 attached hereto, I have made an examination into the condition and affairs of the National Continental Insurance Company as of December 31, 2002, and submit the following report thereon.

The examination was conducted at the Company's administrative offices located at 6300 Wilson Mills Road, Mayfield Village, Ohio.

Wherever the designations "the Company" or "NCIC" appear herein without qualification, they should be understood to indicate the National Continental Insurance Company.

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

## 1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 1998. This examination covers the four-year period from January 1, 1999 through December 31, 2002. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

The examination comprised a complete verification of assets and liabilities as of December 31, 2002. The examination included a review of income, disbursements and company records deemed necessary to accomplish such analysis or verification and utilized, to the extent considered appropriate, work performed by the Company's independent public accountants. A review or audit was also made of the following items as called for in the Examiners Handbook of the National Association of Insurance Commissioners:

- History of Company
- Management and control
- Corporate records
- Fidelity bond and other insurance
- Territory and plan of operation
- Growth of Company
- Business in force by states
- Loss experience
- Reinsurance
- Accounts and records
- Financial statements

A review was also made to ascertain what action was taken by the Company with regard to comments and recommendations contained in the prior report on examination.

This report on examination is confined to financial statements and comments on those matters, which involve departures from laws, regulations or rules, or which are deemed to require explanation or description.

## 2. DESCRIPTION OF COMPANY

The Company was incorporated as a stock fire insurer on December 24, 1897, under the name Caledonian-American Insurance Company, and commenced business on March 24, 1898 under the laws of the State of New York. Rathbone, King and Seeley, Inc. acquired control of the Company in 1958. At that time the Company's name was changed to American Star Insurance Company and its administrative office was moved to San Francisco, California. The Seibels Bruce Group, Inc. acquired 100% of the stock of Rathbone, King and Seeley, Inc. in 1981.

In November 1985, financial control of the Company was acquired by The Progressive Corporation (TPC) which contributed the stock of American Star Insurance Company to its subsidiary, Progressive Casualty Insurance Company ("PCIC"). The Company's name was changed to the National Continental Insurance Company and its administrative offices were moved to Cleveland, Ohio. In 1988, the Company's administrative offices were moved to Mayfield Heights, Ohio. Progressive Casualty Insurance Company transferred the Company's stock by means of a dividend to the Progressive Corporation on December 29, 1989. The Company's administrative offices were moved to Mayfield Village, Ohio in 1994. The relocations were approved pursuant to Section 325(b) of the New York Insurance Law. The Company's statutory home office is in Hauppauge, New York.

The Company received a surplus contribution of \$20,077,005 from the Progressive Corporation in 1995. This surplus contribution was the return of cash forwarded to the Progressive Corporation pursuant to stock redemption and retirement of common shares on March 22, 1994. This transaction was a condition of the de-pooling agreement approved by the Department on December 20, 1995.

Pursuant to the de-pooling process from the Progressive Pool, beginning in January 1996, the Company primarily acts as a servicing carrier for the Commercial Auto Insurance Plans (“CAIP”) and Special Risk Distribution Plans (“SRDP”) for selected states.

As of December 31, 1998, paid in capital was \$7,912,500, which consisted of 316,500 shares at \$25 par value per share and gross paid in and contributed surplus was \$35,250,753.

During the period under review the Company paid total dividends of \$43,700,000 as follows:

<u>Year</u>	<u>Ordinary Dividend</u>	<u>Extraordinary Dividend</u>	<u>Total Dividend</u>
1999	\$10,200,000	\$0	\$10,200,000
2000	\$10,000,000	\$0	\$10,000,000
2001	\$8,000,000	\$6,000,000	\$14,000,000
2002	<u>\$6,500,000</u>	<u>\$3,000,000</u>	<u>\$9,500,000</u>
<u>Total</u>	<u>\$34,700,000</u>	<u>\$9,000,000</u>	<u>\$43,700,000</u>

The dividends in 1999 (\$10,200,000) and 2000 (\$10,000,000) were comprised solely of ordinary dividends distributed from earnings. In 2001 and 2002 the dividends included both ordinary and extraordinary dividends. The extraordinary dividends were allocated among the common capital, gross paid in and contributed surplus and Unassigned funds pursuant to Department instructions as follows:

a) In 2001, the \$6,000,000 extraordinary dividend was allocated between Common

Capital stock, Gross paid and contributed surplus and Unassigned funds as follows:

- (1) The number of shares issued and outstanding was reduced by 39,344 shares which resulted in reduction of Common Capital of \$983,579 from \$7,912,500 to \$6,928,921.
- (2) Gross paid in and contributed surplus was reduced by \$4,381,915.
- (3) Unassigned Funds was reduced by \$634,506.

b) In 2002, the \$3,000,000 extraordinary dividend was allocated between Common Capital stock,

Gross paid and contributed surplus and Unassigned funds as follows:

- (1) The number of shares issued and outstanding was reduced by 19,993 shares which resulted in reduction of Common Capital of \$499,815 from \$6,928,921 to \$6,429,106.
- (2) Gross paid in and contributed surplus was reduced by \$2,226,713.
- (3) Unassigned Funds was reduced by \$273,472.

The following table shows the net decrease in the Company's Capital and Surplus account

between 1998 and 2002:

	<u>December 31, 1998</u>	<u>December 31, 2002</u>	<u>Net Decrease</u>
Common capital stock	\$ 7,912,500	\$ 6,429,106	\$ (1,483,394)
Gross paid in and contributed surplus	35,250,753	28,642,125	(6,608,628)
Unassigned funds (surplus)	<u>9,243,820</u>	<u>3,152,493</u>	<u>(6,091,327)</u>
Surplus as regards policyholders	<u>\$52,407,073</u>	<u>\$38,223,724</u>	<u>\$(14,183,349)</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 nine members who are elected annually by the Company's sole shareholder, the Progressive Corporation.

The members of the board are all employees of Progressive Casualty Insurance Company. As such they do not receive any compensation from the Company. There are no outside directors. Five of the Directors are residents of New York.

At December 31, 2002, the Company's board of directors consisted of the following nine members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Michael R. Beney Camillus, NY	Regional Manager III, Progressive Casualty Insurance Company
Charles C. Boucherle Chardon, OH	General Manager, Progressive Casualty Insurance Company
Timothy R. Case Clarence Center, NY	Claims Manager III, Progressive Casualty Insurance Company
Margaret M. Dowd Valley Stream, NY	Claims Manager II, Progressive Casualty Insurance Company
W. Thomas Forrester, II Moreland Hills, OH	Chief Financial Officer, The Progressive Corporation
Charles E. Jarrett Pepper Pike, OH	Chief Legal Officer, The Progressive Corporation
Thomas A. King South Russell, OH	Investment Strategist, Progressive Casualty Insurance Company
David A. Mareello Penfield, NY	Regional Manager II, Progressive Casualty Insurance Company
Victor Politzi Loudonville, NY	State Manager V, Progressive Casualty Insurance Company

The meetings and or actions of the board members during the examination period were executed by means of written action without meeting in lieu of board meeting. The actions of the board were ratified by the shareholders through shareholders' written action without meeting in lieu of annual meeting.

As of December 31, 2002, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Charles C. Boucherle	President
Stephen D. Peterson	Treasurer
Dane A. Shrallow	Vice President, Secretary
Jeffrey W. Basch	Vice President
William Thomas Forrester,II	Vice President
Charles E. Jarrett	Vice President
Thomas A. King	Vice President
James L. Kusmer	Vice President, Assistant Treasurer

B. Territory and Plan of Operation

As of December 31, 2002, the Company was licensed to transact business in the District of Columbia and in all states except Connecticut and Vermont. The Company's business consists primarily of acting as a servicing carrier for policies written under state mandated involuntary commercial automobile insurance plans ("CAIP") and the special risk distribution plan for the State of New York.

In 2002, 93.3% of the Company's business was commercial automobile liability. There is a small amount of private passenger automobile insurance.

CAIP's are a pooling mechanism established by the states to handle commercial risks. In a CAIP a limited number of insurers act as servicing carriers for eligible risks on behalf of all insurers writing commercial automobile risks in the voluntary market. These carriers record CAIP business experience as direct business and then cede 100% to the appropriate state plan. The CAIP subscribers' companies assume their proportionate share of the pool's operating results.

The Company services the CAIP's for the following nine states.

Arizona	New York
California	Oregon
Colorado	Utah
Montana	Washington
New Jersey	

Progressive Casualty Insurance Company, an affiliate, services fifteen state CAIP plans. States may have more than one carrier servicing the business.

In 1986, the State of New York established a special risk distribution program ("SRDP") for handling its taxis and limousines policyholders. It was later redefined as the public automobile pool ("PAP") to include all vehicles classified as a public automobile. Participation in the New York SRDP and PAP is voluntary; a company may elect to receive direct assignment of SRDP and PAP type risk, or share in the results of the programs. In 2002 the, Company wrote \$86,889,945 in CAIP business and \$8,940,148 in SRDP business.

The contracts for SRDP and PAP are similar. Under the contracts with the governing committee of each state automobile insurance plan, the Company agrees to provide services to all eligible applicants which include but are not limited to policy services, underwriting, policy issuance, filing certificates, premium collection, statistical data processing, record keeping and claims services. The agreements for each state are basically the same.

Each states' governing committee will certify certain agents within the state to write this business. To be written in the programs a risk must be rejected three times. The application will be submitted by

the agent and billed through a separate software package that contains all of the CAIP/SRDP's rates and forms. The policy is a Company policy and is treated as direct business and ceded 100% to either programs. There is no separate reinsurance contract only the servicing contract.

Each servicing contract has an indemnification clause that protects the Company. Any insurer made or threatened to be made a party to any action for extra-contractual relief or reformation of the insurance policy because such insurer was or is a servicing carrier shall be indemnified against all judgments, fines, amounts paid in settlement, reasonable cost and expenses, including attorney's fees, and any other liabilities that may be incurred as a result of such actions, suit or proceeding, or threatened action, suit or proceeding, except in relation to matters as to which it is liable by reason of gross negligence or willful misconduct in the performance of its duties or obligations to the CAIP/SRDP, and, with respect to any criminal actions or proceedings, except when such insurer had reasonable cause to believe that its conduct was unlawful.

There is no risk under these contracts. The risks are ceded 100% to the CAIP/SRDP's. The Company receives a servicing fee. There is an administrative fee and a claims handling fee. The fee percentages will vary by state.

As of December 31, 2002, the Company was licensed to transact the kinds of business 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 and health
4	Fire
5	Miscellaneous property damage
6	Water damage
7	Burglary and theft
8	Glass
9	Boiler and machinery
12	Collision
13	Personal injury liability
14	Property damage liability
15	Workers' compensation and employers' liability
16	Fidelity and surety
19	Motor vehicle and aircraft physical damage
20	Marine
21	Marine protection and indemnity
26	Gap Insurance

The Company is also licensed to write workers' compensation insurance as may be incidental to the coverages contemplated under paragraphs 20 and 21 of Section 1113(a), including insurances described in the Longshoremen's and Harbor Workers' Compensation Act.

Based upon 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, National Continental Insurance Company is required to maintain a minimum surplus to policyholders in the amount of \$2,700,000.

The following is a schedule of direct written premiums countrywide and in New York State for the four-year period covered by this examination:

DIRECT PREMIUM WRITTEN

<u>Year</u>	<u>New York Direct Written Premiums</u>	<u>Countrywide Direct Written Premiums</u>	<u>Percentage of New York Direct Written Premiums to Countrywide Direct Written Premiums</u>
1999	\$3,052,688	\$43,755,528	6.97%
2000	\$2,324,393	\$41,277,698	5.63%
2001	\$7,367,883	\$59,562,089	12.37%
2002	\$9,793,345	\$96,715,669	10.13%

C. Reinsurance

There were no new contracts entered into during the period under review.

The following is a description of the Company's ceded reinsurance program in effect at December 31, 2002:

Commercial Automobile Insurance Plans ("CAIP")

These contracts cover commercial auto-related risks and call for 100% cession of all premiums and losses. Maximum gross exposures on casualty and property risks are \$10 million under combined single limits policies or \$5 million and \$1 million, respectively, under single limits policies. Physical damage limits on property-related claims are unlimited and vary according to the severity of the claim. There is no net exposure for these contracts. These agreements are continuous with no stated termination date.

In order to be a CAIP service carrier, certain jurisdictions require that the servicing insurer maintain an A.M. Best Rating of at least "A". In 1997, the Company lost its "A" rating from A.M. Best. To satisfy the rating requirement, effective December 12, 1997, the Company entered into a 100% contingent quota share agreement with United Financial Casualty Company ("UFCC", an "A" rated insurer), which provided that in the event that NCIC became insolvent, UFCC would cover 100% of the

Company's net retained liabilities to the extent that the Company was unable to pay. Payments by the reinsurer would be made directly to the Company or its conservator, liquidator or statutory successor, except where the contract of insurance or reinsurance or any applicable cut-through endorsement specifically provides another payee of such reinsurance in the event of insolvency of the ceding reinsurer. The agreement covered only certain jurisdictions and was limited to 500 policies.

In 2003, the Company Best Rating was upgraded to "A", therefore, the 100% contingent quota share agreement was no longer needed. The agreement was terminated effective June 1, 2003.

Effective July 1, 1995, as a condition of the de-pooling agreement approved by the Department, the Company and its affiliate, Progressive Casualty Insurance Company ("PCIC"), entered into an aggregate excess of loss agreement, as follows:

<u>Subject Business</u>	<u>Coverage</u>
All insurance and reinsurance policies, contracts and binders and all other evidence of insurance or reinsurance liability issued or renewed by the Company on or before November 25, 1985	\$45,000,000 excess of \$28,478,300

There are no ceded reserves on this treaty.

At December 31, 2002, the Schedule F Part 3 ceded reserves to PCIC are for the run-off of the pooled business. These reserves are as follows:

Known case reserves	\$702,000
Known case loss adjustment expenses	105,000
Incurred but not reported loss reserves	42,000
Incurred but not reported loss adjustment expenses	<u>2,000</u>
Total	<u>\$851,000</u>

Environment, Asbestos, Products Liability

Prior to the acquisition by the Progressive Corporation in 1985, the Company ceded 100% of its business to an authorized insurer and other third party insurers. During 1994, the Progressive Corporation settled a dispute over the seller's refusal to pay certain pre-sale business written by American Star Insurance Company. The agreement provided for a commutation by the South Carolina Insurance Company (reinsurer) of the first \$20 million of losses for a consideration of \$10.1 million. The rights to the third party reinsurance recoverables were assigned to the Company. The reinsurer was also obligated to fund out 50% of its surplus in excess of \$20 million, 50% of the future loss payments in excess of \$20 million gross losses. In 1995, the Company purchased an excess of loss contract from an affiliate PCIC.

In August 2001, the Company agreed to commute all reinsurance agreements with American Mutual Reinsurance Company ("AMRECO"). AMRECO reinsured the Company under various reinsurance contracts prior to 1985. The claims that are open are primarily environmental and product liability claims arising from general liability coverage in the 1960's and 1970's. AMRECO has been in rehabilitation and is now liquidating and commuting all reinsurance agreements. The Company received cash and invested assets valued at \$1,541,800 for the return of loss and loss adjustment expenses reserves of \$3,551,687.

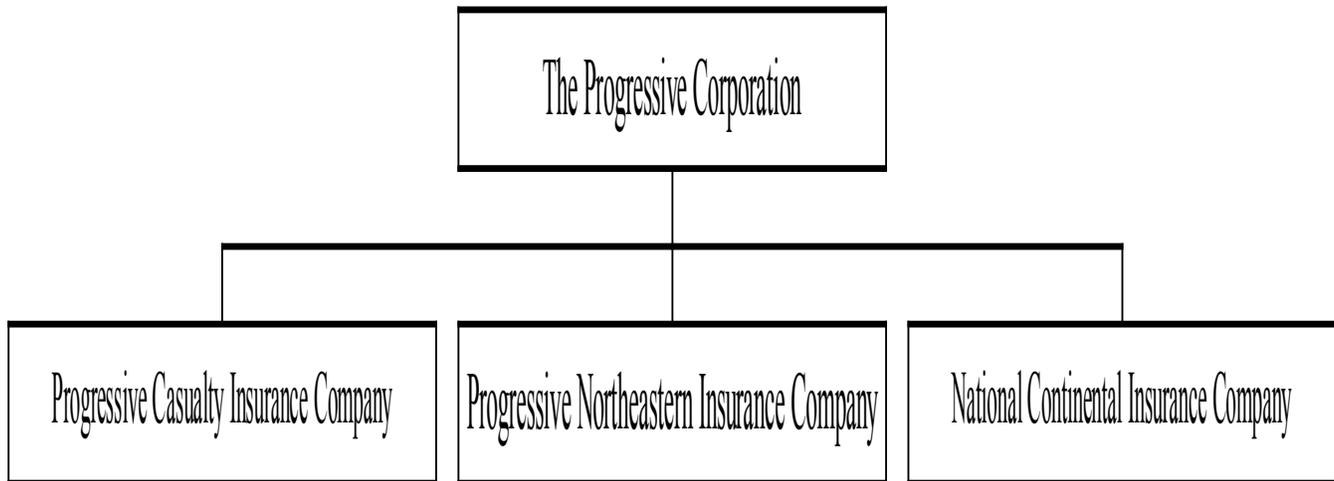
The examiner reviewed the pertinent ceded reinsurance contracts during the examination period to verify that the contracts contain standard clauses, including the insolvency clauses as per Section 1308 of the New York Insurance Law.

The Schedule F data as contained in the Company's filed annual statements appear to accurately reflect its reinsurance transactions.

D. Holding Company System

The Company is a wholly-owned subsidiary of The Progressive Corporation, an Ohio insurance holding company.

The following is an abbreviated holding company chart showing the Company, its parent and those affiliates which are relevant to this examination:



The Company has entered into the following agreements with members of its holding company system, all of which have been found to be non-objectionable by the Department pursuant to the provisions of Section 1505(d)(3) of the New York Insurance Law:

1. Cash Management Agreement between Progressive Casualty Insurance Company and National Continental Insurance Company

This agreement, effective January 1, 1998, provides for the Company's participation in the Progressive Casualty Insurance Company's central cash management system (cashier account) in which all the cash of the Progressive Holding Company system's companies are deposited. Pursuant to the agreement, Progressive Casualty Insurance Company is responsible in a fiduciary capacity for the Company's cash, and performs all the Company's duties and operations as they pertain to cash, including the recording and payment of the Company's obligations. The balances in the cashier account are to be settled on a quarterly basis, with payment commencing within thirty (30) days of the end of each quarter. The companies will use their best efforts to complete settlement within sixty (60) days after the end of the quarter.

2. Interest Agreement between Progressive Casualty Insurance Company and National Continental Insurance Company and Other Affiliates

The Company became a participant, effective November 25, 1985, to the existing interest agreement among Progressive Casualty Insurance Company and members of the holding company system. Pursuant to the agreement, the Company agrees to pay Progressive Casualty Insurance Company or to receive credit from Progressive Casualty Insurance Company for any balances owed to Progressive Casualty Insurance Company or owed by Progressive Casualty Insurance Company as a result of the activity in the cashier account per the Cash Management Agreement.

3. Investment Services Agreement between Progressive Capital Management Corporation. and National Continental Insurance Company and Other Affiliates

Pursuant to this agreement, effective July 16, 1992, Progressive Partners, Inc. provide investment management services to the Company as well as other affiliated members. Costs of the investment services are shared among the members of the holding company system.

4. Service Agreement between Progressive Casualty Insurance Company (“PCIC”) and National Continental Insurance Company

Effective January 1, 1996, the Company entered into a service agreement with Progressive Casualty Insurance Company. Pursuant to the Agreement, the Company utilizes the personnel, property and facilities of Progressive Casualty Insurance Company. PCIC also provides all services relating to the insurance operations, including administrative and record keeping functions for the Company. The Company reimburses PCIC for all its identifiable expenses. The expenses that are not identifiable are allocated based on formulas and factors consistent with the provisions of Department Regulation 30.

5. Allocation of Federal Income Taxes between the Progressive Corporation and National Continental Insurance Company and Certain Affiliates

Effective April 2, 1990, the Company has entered into an income tax sharing agreement with The Progressive Corporation, as well as other members of its holding company system, whereby the companies file a consolidated federal income tax return. A review of the agreement revealed that it did not contain all the provisions required by the Department Circular Letter No. 33 (1979), including an escrow provision, a provision that any taxes payable by the Company shall not exceed any amounts that would have been payable if the Company filed a separate income tax return, and a provision that any balances owing are to be settled within thirty (30) days.

6. General Agency Agreement between ProgNY Agency, Inc. and National Continental Insurance Company

Effective August 14, 1996, this agreement authorized ProgNY agency to sell insurance products for the Company.

7. Producer's Agreement between United Financial Insurance Agency, Inc. and United Financial Insurance Agency of Washington, Inc. and National Continental Insurance Company

Pursuant to the agreement, effective May 15, 1996, United Financial Insurance Agency, Inc. and United Financial Insurance Agency of Washington, Inc. are authorized to sell selected insurance business for the Company in New York State.

8. Escrow Agreement by and among NCIC, TPC and Progressive Investment Company, Inc. (effective January 1, 1998)

PICI has agreed to place and hold certain of its assets in escrow, when necessary to satisfy certain tax escrow obligations imposed upon NCIC pursuant to New York Insurance Laws.

9. Reinsurance Agreement between National Continental Insurance Company and United Financial Casualty Company

Effective December 31, 1997, this 100% quota share agreement with United Financial Casualty Company provides protection for the Company's CAIP business. The agreement is continuous with no termination date and only attach as if both the Company and the state were to become insolvent.

10. Aggregate Excess of Loss Reinsurance Agreement between National Continental Insurance Company and Progressive Casualty Insurance Company

11. Assumption and Administrative Agreement between the Company and PCIC effective April 6, 1990

Pursuant to this agreement certain property and casualty business (non-auto) is reinsured and assumed by NCIC from PCIC. In 2002 there was no business ceded or paid under this agreement.

In 2001 the services agreement was amended to add a nondisclosure of nonpublic personal information clause and to revise payment of expenses-reimbursement clause to comply with SSAP No. 70.

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, 2002, based upon the results of this examination:

Net premiums written to surplus as regards policyholders	2%
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	114%*
Premiums in course of collection to surplus as regards policyholders	68%*

The above ratios denoted with an asterisk fall outside the benchmark ranges set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners.

The Company's ratio of liabilities to liquid assets of 114% exceeded the benchmark ratio of 105%. It is noted that a large percentage of the company's admitted assets are non-liquid assets.

The Company's ratio of Premiums in course of collection to surplus as regards policyholders of 68% exceeded the benchmark ratio of 40%. It is noted that the majority of the Company's business is ceded 100%. The amount of Premiums in course of collection appears reasonable in relation to the gross premiums written by the Company. Additionally, it is noted that the premiums for the State CAIP plans are initially received by the States and then remitted to the Company for processing; there is no direct billing on the CAIP business.

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

Amounts

Ratios

Losses and loss		
adjustment expenses incurred	\$32,749,741	347.06%
Other underwriting expenses	25,693,612	272.29
incurred		
Net underwriting loss	<u>(49,007,079)</u>	<u>(519.35)</u>
Premiums earned	<u>\$ 9,436,274</u>	<u>100.00%</u>

The Company services CAIP business for various state CAIP facilities. It cedes the business 100% and collects a fee for processing the business. Rather than show the fees as an offset to Other Underwriting Expenses the fees are shown as an Aggregate Write-In item for other income.

G. Accounts and Records

(i) Certified Public Accountants

“The engagement letter from the Company’s independent certified public accountants does not contain the following required provisions pursuant to the Part 89.2 of the Department Regulation 118:

- (a) On or before May 31<sup>st</sup>, the CPA shall provide an audited financial statement of such insurer and of any subsidiary required by section 307(b)(1) of the Insurance Law together with an opinion on the financial statements of such insurer and any such subsidiary for the prior calendar year and an evaluation of the insurer’s and any such subsidiary’s accounting procedures and internal control systems as are necessary to the furnishing of the opinion;
- (b) Any determination by the CPA that the insurer has materially misstated its financial condition as reported to the superintendent or that the insurer does not meet minimum capital or surplus to policyholder requirements set forth in the Insurance Law shall be given by the CPA, in writing, to the superintendent within 15 calendar days following such determination; and
- (c) The workpapers and any communications between the CPA and the insurer relating to the audit of the insurer shall be made available for review by the superintendent at the offices of the insurer, at the Insurance Department or at any other reasonable place designated by the superintendent. The CPA must retain for review such workpapers and communications in accordance with the provisions of Part 243 of this Title (Regulation 152). More specifically, such workpapers and communications must be retained by the CPA for the period specified in sections 243.2(b)(7) and (c) of this Title. For the purposes of this subdivision, the workpapers and communications shall be deemed to have been created on the date the filing required by section 89.2(a) of this Part was submitted to the superintendent.

It is recommended that the Company amend the engagement letter with its independent certified public accountants to comply with the provisions of Department Regulation No. 118.

(ii) Residual Market Premiums

The Company reported its net participation in various state private passenger and commercial automobile residual market facilities under the caption "State plan liability". Allocations of experience from the facilities' manager indicated that such allocation should be recorded as reinsurance assumed.

Paragraph 8 of SSAP No. 63 Underwriting Pools and Associations Including Intercompany Pools states:

"Underwriting results shall be accounted for on a gross basis whereby the participant's portion of premiums, losses, expenses, and other operations of the pools are recorded separately in the financial statements rather than netted against each other. Premiums and losses shall be recorded as direct, assumed, and/or ceded as applicable. If the reporting entity is a direct writer of the business, premiums shall be recorded as directly written and accounted for in the same manner as other business which is directly written by the entity. To the extent that premium is ceded to a pool, premiums and losses shall be recorded in the same manner as any other reinsurance arrangement. A reporting entity who is a member of a pool shall record its participation in the pool as assumed business as in any other reinsurance arrangement."

IT IS RECOMMENDED THAT THE COMPANY PROPERLY REPORT RESIDUAL MARKET PREMIUMS UNDER THE APPROPRIATE CAPTION IN FUTURE ANNUAL STATEMENT FILINGS.

3. FINANCIAL STATEMENTSA Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as determined by this examination as of December 31, 2002 and as reported by the Company:

<u>Assets</u>	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>
Bonds	\$49,456,935	\$ 0	\$49,456,935
Cash and short-term investments	438,038	0	438,038
Premiums and agents' balances in course of collection	25,845,077	1,645	25,843,432
Premiums, agents' balances and installments booked but deferred and not yet due	242,192	0	242,192
Funds held by or deposited with reinsured companies	40,171	40,171	0
Reinsurance recoverables on loss and loss adjustment expense payments	14,970,622	0	14,970,622
Federal and foreign income taxes recoverable	3,448,617	1,568,982	1,879,635
Interest, dividends and real estate income due and accrued	613,807	0	613,807
Receivable from parent, subsidiaries and affiliates	2,512,175	0	2,512,175
Miscellaneous other assets and PLIGA receivable	<u>618,131</u>	<u>618,131</u>	<u>0</u>
Total Assets	<u>\$98,185,765</u>	<u>\$2,228,929</u>	<u>\$95,956,836</u>

Liabilities, Surplus and Other FundsLiabilities

Losses		\$12,877,461
Loss adjustment expenses		10,974,170
Commissions payable, contingent commissions and other similar charges		9,932
Other expenses (excluding taxes, licenses and fees)		549,387
Taxes, licenses and fees (excluding federal and foreign income taxes)		742,339
Unearned premiums		439,397
Advance premiums		9,385
Ceded reinsurance premiums payable (net of ceding commissions)		15,416,099
Amounts withheld or retained by company for account of others		36,692
Provision for reinsurance		114,000
Drafts outstanding		5,894,862
Unearned fee reserve		7,582,030
State plan liability		2,900,714
Other liabilities		165,873
Escheatable property		<u>20,771</u>
Total liabilities		\$57,733,112

Surplus and Other Funds

Common capital stock	\$ 6,429,106	
Gross paid in and contributed surplus	28,642,125	
Unassigned funds (surplus)	<u>3,152,493</u>	
Surplus as regards to policyholders		<u>38,223,724</u>
Total liabilities, surplus and other funds		<u>\$95,956,836</u>

Note: The Internal Revenue Service has completed its audits of the Company's (consolidated) Federal Income Tax returns through tax year 2000. A claim for refund for tax years 1993-1998 was agreed upon and signed in July 2003. The refund of taxes and interest for the Progressive Group amounted to \$85 million. The audits covering tax years 1999 and 2000 are complete and the Company has the revenue agents report. The company expects a modest refund for these years. The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2001 and through 2002.

B. Underwriting and Investment Exhibit

Surplus as regards policyholders decreased \$14,183,349 during the four-year examination period January 1, 1999 through December 31, 2002, detailed as follows:

Underwriting Income

Premiums earned		\$ 9,436,274
Deductions:		
Losses incurred	\$ 6,429,233	
Loss adjustment expenses incurred	26,320,508	
Other underwriting expenses incurred	<u>25,693,612</u>	
Total underwriting deductions		<u>58,443,353</u>
Net underwriting gain or (loss)		\$(49,007,079)

Investment Income

Net investment income earned	\$16,386,732	
Net realized capital gain	<u>896,932</u>	
Net investment gain or (loss)		17,283,664

Other Income

Net gain or (loss) from agents' or premium balances charged off	\$ (69,824)	
Finance and service charges not included in premiums	199,409	
Service business revenue	60,606,442	
Miscellaneous other income	279,094	
Interest (income)expense on intercompany balances	<u>(5,728)</u>	
Total other income		<u>61,009,393</u>
Net income before federal and foreign income taxes		\$ 29,285,978
Federal and foreign income taxes incurred		<u>8,817,756</u>
Net Income		\$ <u>20,468,222</u>

C. Capital and Surplus Account

Surplus as regards policyholders per report on examination as of December 31, 1998			\$52,407,073
	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income	\$20,468,222		
Net unrealized capital gains or (losses)	348,650		
Change in net deferred income tax	446,419		
Change in nonadmitted assets	91,674		
Change in provision for reinsurance	7,199,848		
Cumulative effect of changes in accounting principles	961,838		
Capital changes paid in		\$ 1,483,394	
Surplus adjustments paid in		7,516,606	
Dividends to stockholders		<u>34,700,000</u>	
Total increases and decreases	<u>\$29,516,651</u>	<u>\$43,700,000</u>	
Net increase (decrease) in surplus			<u>(14,183,349)</u>
Surplus as regards policyholders per report on examination as of December 31, 2002			<u>\$ 38,223,724</u>

#### 4. LOSSES AND LOSS ADJUSTMENT EXPENSES

THE EXAMINATION LIABILITIES FOR THE ABOVE CAPTIONED ACCOUNTS TOTALING \$12,877,461 AND \$10,974,170 RESPECTIVELY, ARE THE SAME AS THE AMOUNTS REPORTED BY THE COMPANY IN ITS DECEMBER 31, 2002 FILED ANNUAL STATEMENT.

THE EXAMINATION RELIED ON THE REVIEW OF THE RESERVES BY MARY MILLER, FCAS, MAAA OF THE OHIO DEPARTMENT OF INSURANCE WHO CONDUCTED A REVIEW OF THE COORDINATED EXAMINATION OF THE PROGRESSIVE GROUP OF COMPANIES. OHIO WAS THE LEAD STATE IN THAT EXAMINATION.

#### 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

No problem areas were encountered.

#### 6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

<u>ITEM</u>		<u>PAGE NO.</u>
A	<u>REINSURANCE</u>	
i.	IT IS RECOMMENDED THAT THE COMPANY AMEND ITS REINSURANCE CONTRACTS TO BE GOVERNED UNDER THE LAWS OF NEW YORK STATE, ITS STATE OF DOMICILE.	10
	THE COMPANY HAS COMPLIED WITH THIS RECOMMENDATION	10
ii.	IT IS RECOMMENDED THAT THE COMPANY AMEND THE ARBITRATION CLAUSES CONTAINED IN ITS REINSURANCE CONTRACTS TO REQUIRE THAT THE SEAT FOR ARBITRATION SHALL BE IN NEW YORK STATE, ITS STATE OF DOMICILE.	
	The Company has complied with this recommendation.	
B	<u>FEDERAL INCOME TAX ALLOCATION AGREEMENT</u>	
	IT IS AGAIN RECOMMENDED THAT THE COMPANY AMEND THIS AGREEMENT TO COMPLY WITH THE PROVISIONS SET FORTH IN DEPARTMENT CIRCULAR LETTER NO. 33 (1979) AND THAT SAID AMENDED AGREEMENT BE SUBMITTED TO THE DEPARTMENT FOR APPROVAL IN ACCORDANCE WITH SECTION 1505(D) OF THE NEW YORK INSURANCE LAW.	16
	The Company has complied with the recommendation.	
C	<u>ACCOUNTS AND RECORDS</u>	
i.	IT IS RECOMMENDED THAT THE COMPANY AMEND ITS CUSTODIAL AGREEMENT TO INCLUDE THE PROTECTIVE COVENANTS AND PROVISIONS WHICH MEET THE GUIDELINES ESTABLISHED BY THE DEPARTMENT FOR THE CONTENTS OF SUCH AGREEMENTS.	17
	IT IS RECOMMENDED THAT THE CUSTODIAL AGREEMENT BE AMENDED TO CONTAIN THE AFOREMENTIONED PROVISION.	
ii.	IT IS AGAIN RECOMMENDED THAT THE COMPANY'S BOARD OF DIRECTORS ESTABLISH LIMITATIONS AS TO THE AMOUNT OF FUNDS THAT CAN BE TRANSFERRED VIA THE METHODS DESCRIBED ABOVE, AS WELL AS SPECIFY THOSE ACCOUNTS TO WHICH FUNDS COULD BE TRANSFERRED.	17
iii.	The Company was in the process of changing its custodian at the time of these comments concerning custodian agreements and many of the issues were addressed in the new custodial agreement. The Company is again in the midst of changing custodians for its securities.	17
		<u>PAGE NO.</u>
<u>ITEM</u>	IT IS AGAIN RECOMMENDED THAT THE COMPANY PROPERLY REPORT RESIDUAL MARKET PREMIUMS UNDER THE APPROPRIATE CAPTION IN FUTURE ANNUAL STATEMENT FILINGS.	
iv.	The Company responded that they agree with the recommendation and are now in the process of implementing this accounting change. However, due to implementing Codification during 2001, the Company was not able to complete the change.	18
	IT IS AGAIN RECOMMENDED THAT THE COMPANY COMPLY WITH REGULATION 64, PART 216, 4(C) AND CIRCULAR LETTER NO. 11 (1978).	

IN A LETTER DATED NOVEMBER 5, 2002 THE COMPANY APPOINTED TIMOTHY CERCELLE, DIRECTOR OF COMPLIANCE, AS THE CORPORATE OFFICER RESPONSIBLE FOR CONSUMER SERVICES.

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v.

## 7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>		<u>PAGE NO.</u>
A	<u>Accounts and Records</u>	
i.	<u>Certified Public Accountants</u> It is recommended that the Company amend the engagement letter with its external auditors to comply with the provisions of Department Regulation No. 118.	21
ii.	<u>RESIDUAL MARKET PREMIUM</u> IT IS RECOMMENDED THAT THE COMPANY PROPERLY REPORT RESIDUAL MARKET PREMIUMS UNDER THE APPROPRIATE CAPTION IN FUTURE ANNUAL STATEMENT FILINGS.	21



Appointment No 22040

STATE OF NEW YORK  
INSURANCE DEPARTMENT

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

*Dennis Mc Govern*

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

**NATIONAL CONTINENTAL INSURANCE COMPANY**

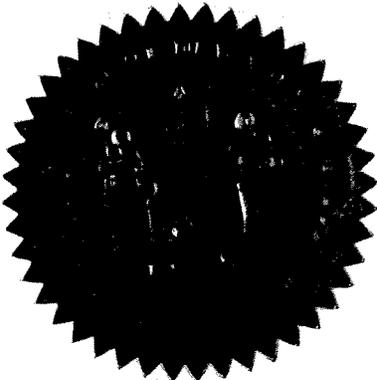
*and to make a report to me in writing of the condition of the said*

**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 2nd day of April, 2003*



  
\_\_\_\_\_  
GREGORY V. SERIO  
Superintendent of Insurance