

REPORT ON EXAMINATION
OF THE
TOWER INSURANCE COMPANY OF NEW YORK
AS OF
DECEMBER 31, 2001

DATE OF REPORT

JANUARY 31, 2003

EXAMINER

MOSES EGBON

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

January 31, 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 21924, dated August 13, 2002, attached hereto, I have made an examination into the condition and affairs of the Tower Insurance Company of New York as of December 31, 2001 and submit the following report thereon.

The examination was conducted at the Company's home office located at 120 Broadway, New York, New York 10271.

Wherever the designations " Tower" or "Company" appear herein without qualification, they should be understood to indicate the Tower Insurance Company of New York.

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

1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 1996. This examination covers the five year period from January 1, 1997 through December 31, 2001 and was limited in its scope to a review or audit of only those balance sheet items considered by this Department to require analysis, verification or description, including: invested assets, inter-company balances, loss and loss adjustment expense reserves.

The examination includes a review of income, disbursements and Company records to the extent deemed necessary to accomplish such verification and utilized, to the extent considered appropriate, work performed by the Company's independent certified 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
- Employees' welfare and pension plans
- Territory and plan of operation
- Market conduct activities
- Growth of the Company
- Business in force by states
- Loss experience
- Reinsurance
- Accounts and records

A review was also made to ascertain what action was taken by the Company with regard to comments and recommendations 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 on June 20, 1989, under the laws of the State of New York. It was licensed and commenced business on December 5, 1990.

The Company applied for and received approval to change its name from Tower Insurance Company to Tower Insurance Company of New York, ("TICNY") on April 18, 1994.

In addition, a holding company structure (LMC Holding Corp.) was introduced, whereby the holding company owned 100% of the Company stock. In 1996, the Company was reorganized under its new parent, Tower Group, Inc. ("TGI") and a managing general agency affiliate, Tower Risk Management Corp. ("TRM") was formed. Under this structure, TGI, an insurance services holding company, owns 100% of both the Company and TRM.

Effective September 18, 1997, the Company amended its Charter to increase its capital stock from 400 shares to 1600 shares authorized having a par value of \$2,500 per share. The capital increase was filed with and approved by this Department.

As of the examination date, the Company's paid up capital was \$3,705,000, consisting of 1,482 shares of common stock issued and outstanding with a par value of \$2,500 per share. Its gross paid in and contributed surplus was \$10,125,000.

A. Management

Pursuant to the Company's charter and by-laws, management of the Company is vested in the board of directors consisting of not less than thirteen nor more than twenty members. As of the examination date, the board of directors was comprised of thirteen members. The board met four times during each calendar year.

The following were the members of the board of directors and the principal officers of the Company as of December 31, 2001:

<u>Name and Residence</u>	<u>Principal Occupation</u>
Francis Colalucci New York, New York	Senior Vice President, Tower Insurance Company of New York
George J. Daddario, Jr. Armonk, NY	Senior Vice President, Tower Insurance Company of New York
James Dulligan Massapequa, NY	Assistant Vice President, Tower Insurance Company of New York
Steve G. Fauth New York, N.Y.	Attorney and General Counsel, Tower Insurance Company of New York
Darryl Keene New York, NY	Vice President- Underwriting, Tower Insurance Company of New York
Carl P. Lee Edison, NJ	Retired

<u>Name and Residence</u>	<u>Principal Occupation</u>
Chung Han Lee Montclair, NJ	President, Pegasus International Group
Helen H. Lee New York, N.Y.	Treasurer, Tower Insurance Company of New York
Michael H. Lee New York, N.Y.	President and Chief Executive Officer, Tower Insurance Company of New York
Dr. Terrence Han Lee Livingston, N. J.	Cardiologist
Alec H. Petro Duxbury, MA	Managing Partner, Fort Hill Capital Management
Richard Rafter Lyndhurst, NJ	Chief Financial Officer, Tower Insurance Company of New York
Andrew Saulitis, Esq. Darien, CT	Lawyer, Law Offices of Andrew Saulitis, P.C.

A review of the board meetings held during the examination revealed that the meetings were generally well attended. As of December 31, 2001, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Michael H. Lee	President
Steven G. Fauth	Secretary/General Counsel
George J. Daddario, Jr.	Senior Vice President
Francis Colalucci	Senior Vice President
Steven H. Nigro	Chief Financial Officer
James Dulligan	Assistant Vice President
Darryl Keene	Vice President Underwriting
Helen H. Lee	Treasurer

B. Territory and Plan of Operation

All of the Company's business is written through independent agents and brokers. It is licensed to write business in New York State only.

Additionally, the Company assumes a small percentage of business from an authorized insurer for policies underwritten by Tower Risk Management, Inc., an affiliated agency.

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

<u>Paragraph</u>	<u>Line of Business</u>
4	Fire
5	Miscellaneous property damage
6	Water damage
7	Burglary and theft
8	Glass
12	Collision
13	Personal injury liability
14	Property damage liability
15	Workers' compensation and employers' liability
19	Motor vehicle and aircraft
20	Marine

On March 29, 2002, the Company was approved to write the insurance specified in paragraphs nine (boiler and machinery) and sixteen (fidelity and surety) of Section 1113(a) of the New York Insurance Law.

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,

the Company is required to maintain a minimum surplus to policyholders of \$2,100,000 and a minimum capital of \$3,705,000. The Company met this requirement as of December 31, 2001.

C. Reinsurance

The examiner reviewed the ceded reinsurance contracts effected during the examination period. These contracts contained the required standard clauses, including insolvency clauses meeting the requirements of Section 1308 of the New York Insurance Law.

The Schedule F data as contained in the Company's annual statements filed for the years covered by the examination was found to accurately reflect its reinsurance transactions.

The Company has the following ceded reinsurance program in effect as of December 31, 2001:

<u>Treaty</u>	<u>Limits</u>
Quota share	80% of the net retained insurance liability of the Company subject to a \$500,000, per risk limit on property and \$5,000,000, per occurrence limit on liability.
	95% of the net retained insurance liability of the Company of personal umbrella subject to a \$2,000,000 per occurrence limit.
Multiple Line Excess of Loss	
Two-layers	\$1,500,000 excess of \$500,000 of property and casualty lines covering business classified as fire, allied lines, commercial multiple peril and inland marine.
Workers' Compensation Employers' Liability coverage	\$3,000,000 excess of \$2,000,000, per occurrence.
Workers' Compensation Accident and Health	\$18,000,000 excess of \$2,000,000, per occurrence.

<u>Treaty</u>	<u>Limits</u>
Catastrophe Excess of Loss	
Three-layers	\$14,000,000 excess of \$1,000,000, each occurrence covering fire, allied lines, CMP, and inland marine.

The Company reinsures primarily with authorized reinsurers.

Examination review indicated that the Company's ceded reinsurance agreements afforded a significant amount of surplus aid. Surplus aid is defined as the amount of ceding commissions, already recognized by the insurer as income, on its unearned ceded reinsurance premium. The Company's result on the "Surplus Aid to Surplus" ratio, as established by the Insurance Regulatory Information System of the National Association of Insurance Commissioners, has significantly exceeded the established benchmark of 15% or less, as set forth below:

2001	69.0 %*
2000	48.0
1999	41.0
1998	55.0

*Calendar year 2001 results do not take into account any surplus adjustments reflected in this report.

According to the National Association of Insurance Commissioners, the use of surplus aid reinsurance treaties may be an indication that company management believes policyholders' surplus to be inadequate. In addition, the continued solvency of an insurer with a large portion of policyholders' surplus resulting from surplus aid may depend upon the continuing cooperation of the reinsurer. While the Department's actuaries have concluded that the Company's reinsurance agreement meets the risk transfer requirements set forth in Statement of Statutory Accounting Principles No. 62, users of the Company's

filed Annual Statements should nonetheless be aware of - the possible distorting effects caused by the exceptionally large amount of surplus aid afforded by its reinsurance.

D. Holding Company System

The Company is a member of the holding company as defined in Section 1501(a) of the New York Insurance Law. Tower Insurance Company of New York is a wholly-owned subsidiary of Tower Group, Inc. As of the examination date, Messrs. Michael H. Lee and Chung Han Lee, who own 57.5% and 11.72%, respectively, of the issued and outstanding stock of Tower Group, Inc., are considered the ultimate controlling persons of the Company.

As a member of a holding company system, the Company has made all appropriate filings pursuant to Article 15 of the New York Insurance Law and Department Regulation 52. Such files were reviewed, and, with the exception of the findings indicated below, no other problem areas were noted.

As of the examination date, the Company was a party to the following agreements with affiliated entities:

1. Service and Expense Agreement between the Company and Tower Risk Management("TRM")

The Company is a party to a service and an expense agreement with Tower Risk Management Inc. ("TRM"). Tower provides essentially all space, including certain services and personnel necessary for the conduct of TRM business. On May 14, 1996, the Department approved the service and expense agreement.

2. Tax Allocation Agreement between the Company and its Holding Company

Effective December 31, 2001, the Company participates in a tax allocation agreement with its holding company. The agreement allows federal income taxes to be computed as if the Company were filing a separate income tax return, except that income tax benefits are recognized to the extent utilized in the consolidated federal income tax return. The tax allocation agreement provides for the establishment of an escrow account by the holding company for the benefit of the Company in order to maintain the Company's right to recoup federal income taxes paid to the holding company in the event of future losses.

This agreement was not submitted to this Department prior to implementation.

It is recommended that the Company file its tax allocation agreement with the Department in compliance with the provisions of Section 1505 of the New York Insurance Law, and Circular Letter No. 33 (1979). It is also recommended that the Company require its holding company to set up an escrow account, in compliance with the tax allocation agreement.

E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2001 based upon the results of this examination:

Net premiums written in 2001 to surplus as regards policyholders	.1:1
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	105%
Premiums in course of collection to surplus as regards policyholders	8%

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

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

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss adjustment expenses incurred	\$24,200,402	88.00%
Other underwriting expenses incurred	9,815,679	35.69
Net underwriting gain (Loss)	<u>(6,515,919)</u>	<u>(23.69)</u>
Premiums earned	<u>\$27,500,162</u>	<u>100.00%</u>

F. Accounts and Records

i. Internal Control

A review of the Company's internal control revealed that its system required only one signature on all checks issued regardless of the amount. It is recommended that the Company establish a procedure whereby all checks above a certain threshold must be signed by at least two officers.

ii. Underwriting and Investment Exhibit – Part 4 – Expenses

During the examination period, the Company received service fees from its affiliate TRM. The Company did not allocate the fees to the appropriate expense classification lines of the annual statement. The fees were reported as a one-line item and were not allocated as required by the annual statement instructions. It is recommended that the Company complete such exhibit in accordance with the Department's Regulation 30 and annual statement instructions.

iii. Electronic Data Processing Equipment

The Company capitalized certain electronic data processing equipment, which should have been expensed pursuant to Section 1301(a)(18) of Insurance Law. The examination adjustment is reflected in Section 4 of this report. The previous report on examination also contained a similar recommendation. Therefore, it is again recommended that the Company report this asset in accordance with Section 1301(a)(18) of the New York Insurance Law.

G. Abandoned Property Law

Section 1316 of the New York Abandoned Property Law requires the Company to file a report with the Office of the State Comptroller for any amounts payable to residents of New York, unclaimed for more than three years. The law requires all companies to file whether or not abandoned property exists. During this examination period, the Company did not file abandoned property reports.

It is recommended that the Company comply with Section 1316 of the Abandoned Property Law and file the necessary reports.

3. FINANCIAL STATEMENTS

A. Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as determined by this examination as of December 31, 2001.

	<u>EXAMINATION</u>		<u>COMPANY</u>		
<u>Assets</u>	<u>Ledger Assets</u>	<u>Assets Not Admitted</u>	<u>Admitted Assets</u>	<u>Admitted Assets</u>	<u>Surplus Increase (Decrease)</u>
Bonds	\$16,334,026	\$	\$16,334,026	\$16,334,026	
Preferred stocks	188,025		188,025	188,025	
Common stocks	982,703		982,703	982,703	
Short-term investment	36,654		36,654	36,654	
Cash on hand and on deposit	12,172,246		12,172,246	12,172,246	
Premiums and agents' balances in course of collection	746,318	105,041	641,277	641,277	
Premiums and agents balances Installments booked and deferred dut not yet due	6,077,770		6,077,770	6,077,770	
Reinsurance recoverable on loss and loss adjustment expense payments	4,068,625		4,068,625	4,068,625	
Federal income tax recoverable	14,631		14,631	14,631	
Electronic data processing equipment	541,969		541,969	629,525	(87,556)
Interest, dividends and real estate income due and accrued	277,203		277,203	277,203	
Receivable from parent subsidiaries and affiliates	3,278,081		3,278,081	3,408,739	(130,658)
Other assets non-admitted	175,907	175,907			
Balance due on reins. contracts	<u>1,271,652</u>		<u>1,271,652</u>	<u>1,271,652</u>	
Total assets	<u>\$46,165,810</u>	<u>\$280,948</u>	<u>\$45,884,862</u>	<u>\$46,103,076</u>	<u>\$(218,214)</u>

<u>Liabilities</u>	<u>Examination</u>	<u>Company</u>	<u>Surplus Increase (Decrease)</u>
Losses and loss adjustment expenses	\$12,768,997	\$8,619,997	(\$4,149,000)
Reinsurance payable on paid loss and loss adjustment expenses	1,338,233	1,338,233	
Other expenses	527,384	527,384	
Taxes, Licenses and fees	765,018	765,018	
Federal income and foreign income taxes	759,357	759,357	
Commission income receivable in advance	5,000,000		\$(5,000,000)
Unearned premiums	7,272,614	7,272,614	
Ceded reinsurance premiums payable	8,858,342	8,858,342	
Workers compensation assessment payable	129,233	129,233	
Other liabilities	260,871	260,871	
Funds held under self-insured program	<u>87,883</u>	<u>87,883</u>	
Total liabilities	<u>\$37,767,932</u>	<u>\$28,618,932</u>	<u>\$(9,149,000)</u>
<u>Capital and Equity</u>			
Common capital stock	\$3,705,000	\$3,705,000	
Gross paid in and contributed surplus	10,125,000	10,125,000	
Unassigned funds	<u>(5,713,070)</u>	<u>3,654,144</u>	<u>(9,367,214)</u>
Surplus as regards policyholders	<u>\$8,116,930</u>	<u>\$17,484,144</u>	<u>\$(9,367,214)</u>
Total liabilities and surplus	<u>\$45,884,862</u>	<u>\$46,103,076</u>	

Note: The Internal Revenue Service has not conducted any audit of the Company's federal income tax returns through 2001. The effect of examination adjustments on tax liability resulting from the examination has not been calculated herein.

B. Underwriting and Investment Exhibit

Surplus as regards policyholders increased \$2,099,853 during the five-year examination period January 1, 1997 through December 31, 2001, detailed as follows:

Statement of Income

Underwriting Income

Premiums earned		\$27,500,162
Deductions:		
Losses incurred and loss adjustment expenses incurred	\$24,200,402	
Other underwriting expenses incurred	<u>9,815,679</u>	
Total underwriting deductions		<u>34,016,081</u>
Net underwriting gain(loss)		\$(6,515,919)

Investment Income

Net investment income earned	\$2,503,456	
Net realized capital gain	<u>242,903</u>	
Net investment gain		2,746,359

Other Income

Net gain from premium balances charge off	144,906	
Miscellaneous income	<u>500,000</u>	
Total other income		<u>644,906</u>

Net income before dividends to policyholders and federal and foreign federal income taxes	\$(3,124,654)
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Dividends to policyholders	<u>5,173</u>
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Net income after dividends to policyholders and before federal and foreign income taxes	\$(3,129,827)
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Federal and foreign income taxes incurred	<u>2,512,115</u>
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Net Gain or (Loss)	<u>\$(5,641,942)</u>
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Capital and Surplus Account

Surplus as regards policyholders, December 31, 1996 per report on examination			\$6,017,077
	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income	\$	\$5,641,942	
Net unrealized capital gain		139,241	
Change in not admitted asset		418,964	
Surplus adjustments-Paid in Dividends to stockholders	8,500,000		
	<u> </u>	<u>200,000</u>	
Total gains and losses	<u>\$8,500,000</u>	<u>\$6,400,147</u>	
Net increase in surplus as regards policyholders			<u>2,099,853</u>
Surplus as regards policyholders, December 31, 2001 per report on examination			<u>\$8,116,930</u>

4. ELECTRONIC DATA PROCESSING EQUIPMENT

The examination admitted asset of \$541,969 is \$87,556 less than the \$629,525 reported by the Company as of the examination.

The Company had capitalized certain equipment, which did not meet the requirements for treatment as an admitted asset pursuant to Section 1301(a)(18) of New York Insurance Law.

5. **RECEIVABLE FROM PARENTS, SUBSIDIARIES AND AFFILIATES**

The examination admitted asset of \$3,278,081 is \$130,658 less than the \$3,408,739 reported by the Company as of the examination date.

The Company had erroneously classified the amount of \$130,658 as an admitted asset; therefore, the amount was disallowed and treated as a not admitted asset.

6. **COMMISSION INCOME RECEIVED IN ADVANCE**

The Company reported no liability under the caption as of the examination date. The examination has established the caption liability in the amount of \$5,000,000.

The amount represented a non-refundable special commission that the Company had received from one of its reinsurers, in accordance with the quota share reinsurance agreement that was effective January 1, 2002. The Company had received the amount on December 28, 2001 and recorded it as an increase to cash as well as a decrease to commissions expense during the same period. However, despite the fact that the commission was received prior to year-end 2001, it was a provision of a reinsurance contract that was not effective until subsequent to the examination period. Thus, it would appear that the recognition of this revenue should have been consistent with the effective date of the reinsurance agreement. Therefore, this report reflects this amount as a commission received in advance.

7. **LOSSES AND LOSS ADJUSTMENT EXPENSES**

The examination liability of \$12,768,977 is \$4,149,000 more than the \$8,619,997 reported by the Company as of the examination date. 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.

8. **MARKET CONDUCT ACTIVITIES**

During the course of this examination, a review was made of the manner in which the Company conducts its business practices and fulfills its contractual obligations to policyholders and claimants. The review was general in nature and is not to be construed to encompass the generally more precise scope of a market conduct investigation, which is the responsibility of the Market Conduct Unit of the Property Bureau of this Department. This examination's general review was directed at the Company's practices in the treatment of policyholders and claimants. No problem areas were encountered.

9. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination contained the following comments and recommendations (numbers refer to the prior report):

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Management and Control</u>	
I It is recommended that board members who are unable or unwilling to attend meetings consistently should resign or be replaced immediately and especially those board members noted during the last examination of 1992. This recommendation was included in the prior report on examination.	6
The Company has complied with this recommendation.	
II It is recommended that the Company comply with Section 1411(a) of the New York Insurance Law by instituting procedures for the approval of all investments by the board of directors or a committee thereof responsible for supervising or making such investments.	6
The Company has complied with this recommendation.	
B. <u>Holding Company System</u>	
It is recommended that the Company comply with the provision of Section 1505 of the New York Insurance Law.	11
The Company has not complied with this recommendation. A similar recommendation is repeated in this report.	
C. <u>Abandoned Property Law</u>	
It is recommended that the Company file the necessary reports on a regular basis with the State Comptroller's Office in order to comply with the aforementioned statutory requirements.	13
The Company has not complied with this recommendation. A similar recommendation is repeated in this report.	

<u>ITEM</u>	<u>PAGE NO.</u>
D. <u>Premium and Agents' Balances In Course of Collection</u>	
It is recommended that the Company comply with the directive issued in November 1978, when determining the captioned asset.	17-18
The Company has complied with this recommendation.	
E. <u>Electronic Data Processing Equipment</u>	
It is again recommended that the Company comply with the directive of Section 1301 of the New York Insurance Law when determining the admissibility of its equipment.	18
The Company has not complied with this recommendation. A similar recommendation is repeated in this report.	
F. <u>Losses and Loss Adjustment Expenses</u>	
It is again recommended that the Company comply with the instructions of the annual statement relative to the reporting of unpaid losses and loss adjustment expense reserves in Schedule P of the annual statement	19
The Company has complied with this recommendation.	

10. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Reinsurance</u>	
The Company significantly exceeded the benchmark range for the IRIS ratio surplus aid to surplus for each of the years covered during the examination period. Users of the Company's annual statements should be aware the possible distorting effects caused by the exceptionally large amount of surplus aid afforded by its reinsurance.	8
B. <u>Holding Company System</u>	
i. It is recommended that the Company file its tax allocation agreement with the Insurance Department in compliance with the provisions of Section 1505 of the New York Insurance Law, and Circular Letter No. 33 (1979).	10

<u>ITEM</u>	<u>PAGE NO.</u>
ii. It is also recommended that the Company require its holding company set up an escrow account, in compliance with the tax allocation agreement.	10
C. <u>Accounts and Records</u>	
i. <u>Internal Control</u>	
It is recommended that the Company establish a procedure whereby all checks above a certain threshold be signed by at least two officers.	11
ii. <u>Underwriting and Investment Exhibit</u>	
It is recommended that the Company complete such exhibit in accordance with the Department's Regulation 30 and annual statement instructions.	11
iii. <u>Electronic Data Processing Equipment</u>	
It is again recommended that the Company report this asset in accordance with Section 1301(a)(18) of the New York Insurance Law.	12
D. <u>Abandoned Property Law</u>	
It is recommended that the Company comply with Section 1316 of the New York Abandoned Property Law.	12

Respectfully submitted,

_____/S/_____
Moses Egbon, C.F.E.
Senior Insurance Examiner

STATE OF NEW YORK)
)SS.
)
COUNTY OF NEW YORK)

MOSES EGBON, being duly sworn, deposes and says that the foregoing report submitted by him is true to the best of his knowledge and belief.

_____/S/_____
Moses Egbon

Subscribed and sworn to before me
this _____ day of _____ 2003.

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:

Moses Egbon

as proper person to examine into the affairs of the

TOWER INSURANCE COMPANY OF NEW YORK

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 13th day of August, 2002





GREGORY V. SERIO
Superintendent of Insurance