REPORT ON EXAMINATION

OF

MERCHANTS MUTUAL INSURANCE COMPANY

AS OF

DECEMBER 31, 2018

| | |
|---|---|
| DATE OF REPORT | AUGUST 29, 2019 |
| EXAMINER | WAYNE LONGMORE |

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NEW YORK STATE OF OPPORTUNITY. | Department of Financial Services

**ANDREW M. CUOMO**
Governor

**LINDA A. LACEWELL**
Superintendent

August 29, 2019

Honorable Linda A. Lacewell
Superintendent
New York State Department of Financial Services
Albany, New York 12257

Madam:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 31855 dated January 8, 2019, attached hereto, I have made an examination into the condition and affairs of Merchants Mutual Insurance Company as of December 31, 2018, and submit the following report thereon.

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

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

The examination was conducted at the Company's home office located at 250 Main Street, Buffalo, New York 14202.

## 1. SCOPE OF EXAMINATION

The Department has performed an examination of the Company, a multi-state insurer. The previous examination was conducted as of December 31, 2013. This examination covered the five-year period from January 1, 2014, through December 31, 2018. Transactions occurring subsequent to this period were reviewed when deemed appropriate by the examiner.

New York was the lead state of the Merchants Mutual Group. The examination was performed concurrently with the examinations of the following insurers: Merchants Preferred Insurance Company ("MPIC"), and Merchants National Insurance Company ("MNIC"). New Hampshire participated in this examination.

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

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

Company history
Management and control
Territory and plan of operation
Reinsurance
Affiliated group description
Financial statement presentation
Loss review and analysis
Summary of recommendations

A review was also made to ascertain what action was taken by the Company regarding the recommendation contained in the prior report on examination.

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

## 2. DESCRIPTION OF COMPANY

Merchants Mutual Insurance Company, formerly Merchants Mutual Automobile Liability Insurance Company, was incorporated under the laws of the State of New York on April 10, 1917. It became licensed on March 5, 1918 and commenced business on the same date.

On January 12, 1923, the corporate name was changed to Merchants Mutual Casualty Company and the current name was adopted on March 1, 1957.

In 2006, the Company established two insurance subsidiaries, MNIC and MPIC.

### A. Corporate Governance

Pursuant to the Company's charter and by-laws, management of the Company is vested in a board of directors consisting of not less than seven nor more than thirty-six persons. The board meets at least four times during each calendar year. At December 31, 2018, the board of directors was comprised of the following eleven members:

| Name and Residence | Principal Business Affiliation |
|---|---|
| Gary Martin Brost<br>Chautauqua, New York | Chairman and Chief Executive Officer,<br>Strategic Investments & Holdings, Inc. |
| Randall Livingston Clark<br>Vero Beach, Florida | Chairman,<br>Dunn Tire Corporation, LLC |
| Linda Petri Duch<br>Naples, Florida | President,<br>Partners for Business |
| John Melville Foehl, Jr.<br>Cheshire, Connecticut | Retired |
| Muriel Atkinson Howard, PhD<br>Upper Marlboro, Maryland | President,<br>American Association of State Colleges & Universities |
| Brian Jeffrey Lipke<br>Derby, New York | Retired |

| Name and Residence | Principal Business Affiliation |
|---|---|
| Nora Kathleen McGuire<br>Tonawanda, New York | Senior Vice President and Chief Marketing Officer,<br>Independent Health Association |
| Michael Joseph Murray<br>Hamburg, New York | Retired |
| Edward Galbraith Wright<br>Hamburg, New York | President and Chief Executive Officer,<br>W.J. Cox Associates, Inc. |
| Robert Michael Zak<br>Buffalo, New York | President and Chief Executive Officer,<br>Merchants Mutual Insurance Company |
| Ronald Keith Zoeller<br>Orchard Park, New York | Chief Executive Officer,<br>Azeros Healthcare, LLC |

As of December 31, 2018, the principal officers of the Company were as follows:

| Name | Title |
|---|---|
| Robert Michael Zak | President and Chief Executive Officer |
| Charles Edward Makey III | Senior Vice President, Insurance Operations |
| Shaddon Cale McKnight* | Senior Vice President, Underwriting, Product Development |
| Thomas Alan Meyers** | Senior Vice President, Chief Financial Officer and Treasurer |
| Daniel John Bierbrauer, Jr | Vice President, Sales and Marketing |
| Kenneth Patrick Carter | Vice President, Claims Operations |
| Kelly Julius | Vice President, Human Resources |
| Salvatore LaDuca III* | Vice President, Product Management and Actuarial |

* Shaddon McKnight resigned from the position of Senior Vice President, Underwriting, Product Development effective July 12, 2019 and was replaced by Salvatore LaDuca III as Senior Vice President, Underwriting, Product Development and Actuarial that same date.

** Thomas Meyers retired from the positions of Senior Vice President, Chief Financial Officer and Treasurer effective March 29, 2019 and Christine Schmitt was appointed to replace Mr. Meyers as Senior Vice President, Chief Financial Officer, effective April 1, 2019.

B. Territory and Plan of Operation

As of December 31, 2018, the Company was licensed to write business in 13 states.

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

| Paragraph | Line of Business |
|---|---|
| 3 | Accident & health |
| 4 | Fire |
| 5 | Miscellaneous property |
| 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 |
| 19 | Motor vehicle and aircraft physical damage |
| 20 | Marine and inland marine |
| 21 | Marine protection and indemnity |
| 26 (A)(B)(C)(D) | Gap |

The Company is also authorized to write 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. The Company is also licensed to write special risks pursuant to Article 63 of the New York Insurance Law.

Based upon the lines of business for which the Company is licensed, 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 $4,000,000. However, pursuant to Section 6302(c)(1) of the New York Insurance Law, to be licensed to write special risks, the Company is required to maintain surplus as regards policyholders of at least 200% of its authorized control level risk-based capital; therefore, the Company was required to maintain a minimum surplus to policyholders in the amount of $73,626,156, as of December 31, 2018.

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

| Calendar Year | Direct Premiums | Assumed Premiums | Total Gross Premiums |
|---|---|---|---|
| 2014 | $192,899,661 | $73,019,628 | $265,919,289 |
| 2015 | $192,496,968 | $67,581,885 | $260,078,853 |
| 2016 | $196,543,048 | $65,911,019 | $262,454,067 |
| 2017 | $206,417,993 | $73,723,055 | $280,141,048 |
| 2018 | $230,150,712 | $81,844,009 | $311,994,721 |

The Company's predominant lines of business are commercial multiple peril, other liability – occurrence, and commercial auto liability, which accounted for 42%, 26% and 18%, respectively, of the 2018 direct written premiums. Other liability – occurrence is made up of general liability, commercial and personal umbrella policies. Most of the Company's direct written premiums (approximately 88%) is written in New York (68%), New Jersey (13%) and Massachusetts (7%).

Approximately 97% of the Company's assumed premiums written was derived from its participation in an intercompany pooling agreement between the Company and its affiliates, MNIC and MPIC. The remaining 3% of assumed premiums reflects the Company's participation in various state-mandated risk pools.

The Company's products are sold through more than 750 independent insurance agents operating out of 1,100 locations.

Due to the pooling and reinsurance agreements (described in section 2C of this report), the net exposure of the Company is significantly different than its direct and assumed exposure.

C. Reinsurance Ceded

Intercompany Pooling Agreement

Effective July 1, 2007, the Company entered into an Amended and Restated Pooling Agreement with MNIC and MPIC ("Merchants Pooling Agreement"), whereby the Company assumes from MNIC and MPIC all the premiums, losses and underwriting expenses on their business and then cedes to MNIC an MPIC a percentage of the pooled business. The pooling percentages for the Company, MNIC and MPIC are 70%, 20% and 10%, respectively.

Ceded Reinsurance Program

The Company has structured its reinsurance program as follows:

| Type of Treaty | Cession |
|---|---|
| Property Per Risk Excess of Loss (2 layers) | $6,500,000 in excess of $500,000. |
| Property Catastrophe Excess of Loss (1st layer) | $5,000,000 in excess of $5,000,000 ultimate net loss, any one occurrence. |
| Layers 2 through 4 | $85,000,000 in excess of $10,000,000 ultimate net loss, any one occurrence. |
| Casualty Excess of Loss (3 layers) | $9,250,000 in excess of $750,000. |
| Section B – Combined Property and Casualty | $500,000 in excess of $750,000 ultimate net loss in any one combined occurrence. |
| Workers' Compensation Catastrophe Excess of Loss | $15,000,000 in excess of $10,000,000 ultimate net loss, any one loss occurrence. |
| Personal Umbrella Quota Share and Excess of Loss | 75% quota share of the first $1,000,000 each occurrence, and 100% of the difference, if any, between the policy limit and the first $1,000,000 each occurrence. |
| Commercial Umbrella Quota share and Excess of Loss | 75% quota share of the first $1,000,000 each occurrence, and 100% of the difference, if any, between the policy limit and the first $1,000,000 each occurrence. |
| Umbrella Excess Liability-Greene (2 layers)<br>Layer 1: 85% placed | 100% of $1,000,000 in net liability, each policy, each occurrence. |
| Layer 2 | $9,000,000 excess of $1,000,000 of the net liability, each policy, each occurrence. |
| Casualty Quota share<br>75% placed | 100% of the net liability, limited to $2,000,000 or $4,000,000 each policy, each occurrence or claim made as respects General Liability business or Products and Completed operations business, respectively. $4,000,000 aggregate limit each policy. |

In addition to its treaty reinsurance program, the Company also obtained facultative reinsurance coverage, in addition to its basic coverage for property losses. The facultative treaty will provide property coverage of $8 million excess of the Company's $7 million retention each risk.

Most of the Company's business was ceded to authorized reinsurers, and the amount in cessions to authorized companies has increased since the last exam.

It is the Company's policy to obtain the appropriate collateral for its cessions to unauthorized and certified reinsurers. Trust accounts obtained by the Company to take credit for cessions to unauthorized reinsurers were reviewed for compliance with Department Regulation 114.

All significant ceded reinsurance agreements in effect as of the examination date were reviewed and found to contain the required clauses, including an insolvency clause meeting the requirements of Section 1308 of the New York Insurance Law.

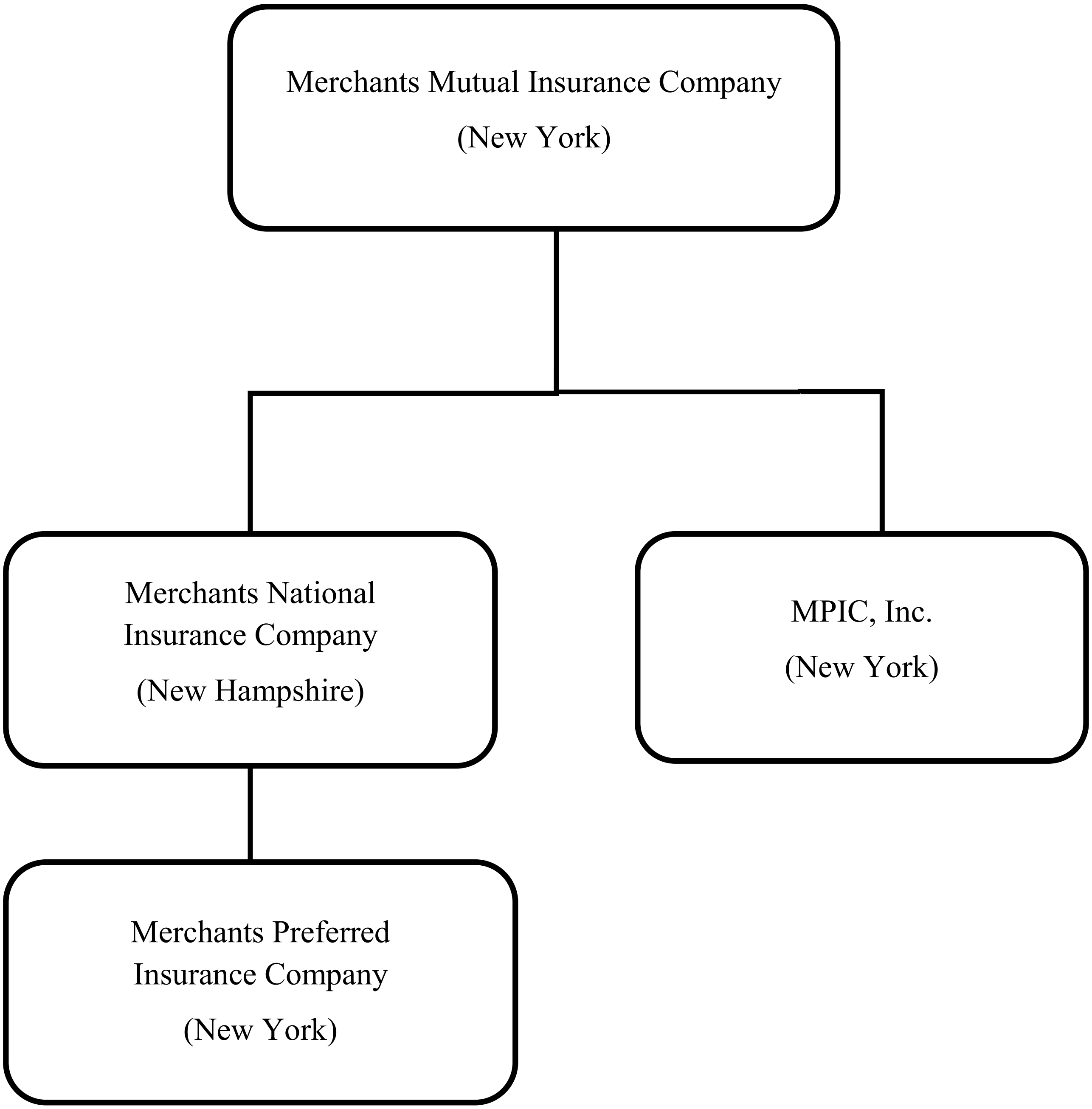
Examination review of the Schedule F data, reported by the Company in its filed annual statement, was found to accurately reflect its material reinsurance transactions. Additionally, management has represented that all material ceded reinsurance agreements transfer both underwriting and timing risk as set forth in the NAIC Accounting Practices and Procedures Manual, Statement of Statutory Accounting Principles ("SSAP") No. 62R. Representations were supported by an attestation from the Company's President and Chief Financial Officer. Additionally, examination review indicated that the Company was not a party to any finite reinsurance agreements. All ceded reinsurance agreements were accounted for utilizing reinsurance accounting as set forth in SSAP No. 62R.

## D. Affiliated Group

The Company is a member of the Merchants Mutual Group ("Group"). The Company wholly-owns MNIC, a New Hampshire domiciled property and casualty insurance company, and MPIC, Inc, a general-purpose New York State business corporation whose primary asset is the office building that is leased to the Company. MNIC wholly-owns MPIC, a New York domiciled property and casualty insurance company. The Group offers property and casualty insurance to individuals and small to medium-sized businesses throughout the Northeast and North Central United States. During 2018, the Group completed the run-off of personal lines in all states except for New York, where it continues to write personal lines business.

Pursuant to Section 1502(a)(1) of the New York Insurance Law, the Company, as an authorized insurer, is exempt from the filing requirements of Article 15. However, pursuant to the provisions of Circular Letter No. 10 (2010), every domestic insurer that is exempt from the provisions of Article 15 is required to submit a copy of the NAIC insurance holding company system annual registration statement with this Department within 120 days following the close of the ultimate company's fiscal year. The Company made the required filings on a timely basis during the period covered by this examination.

The following is an unabridged chart of the Company and its affiliated entities at December 31, 2018:



At December 31, 2018, the Company was party to the following agreements with other affiliated entities:

Management Agreement

Effective October 1, 2011, the Company entered into a Second Amended and Restated Management Agreement with MPIC and MNIC. Pursuant to the terms of the agreement, the Company agreed to provide MPIC and MNIC with facilities, management, and personnel required to operate their business.

Lease Agreement

Effective October 31, 2002, the Company entered into a leasing agreement with its subsidiary MPIC, Inc. Under the terms of the agreement, MPIC, Inc. leases the main administrative office at 250 Main Street, Buffalo, NY to the Company. The office building is owned by MPIC, Inc. The terms of the lease are comparable to other leases in the Buffalo area

Tax Sharing Agreement

Effective January 1, 2007, the Company entered into an Amended and Restated Tax Sharing Agreement with its subsidiaries. Pursuant to the terms of the agreement, the parties file a consolidated federal income tax return. The agreement provides that the Company's tax liability on a consolidated basis will not exceed the liability had it filed its tax return on a stand-alone basis. This agreement was filed with the Department.

## E. Significant Ratios

The Company's operating ratios, computed as of December 31, 2018, fall within the benchmark ranges set forth in the Insurance Regulatory Information System of the NAIC.

| Operating Ratios | Result |
|---|---|
| Net premiums written to policyholders' surplus | 76% |
| Adjusted liabilities to liquid assets | 68% |
| Two-year overall operating | 86% |

Underwriting Ratios

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

| | Amounts | Ratios |
|---|---|---|
| Losses and loss adjustment expenses incurred | $461,854,137 | 61.02% |
| Other underwriting expenses incurred | 267,549,297 | 35.35 |
| Net underwriting gain | 27,500,838 | 3.63 |
| Premiums earned | $756,904,272 | 100.00% |

The Company's reported risk-based capital ("RBC") score was 617% as of December 31, 2018. The RBC is a measure of the minimum amount of capital appropriate for a reporting entity to support its overall business operations in consideration of its size and risk profile. An RBC of 200% or below can result in regulatory action. There were no financial adjustments in this report that impacted the Company's RBC score.

F. Accounts and Records

Non-compliance with Expense Limitation

Section 4110(a) of the New York Insurance Law states in part the following:

> "No domestic mutual property/casualty insurance company licensed to write a kind of insurance specified in paragraph seven, eight, nine, ten, eleven, thirteen, fourteen, fifteen, sixteen or seventeen of subsection (a) of section one thousand one hundred thirteen of this chapter shall expend in any one calendar year for management expenses a greater amount than thirty percent of the sum of its net premium income and seventy-five percent of its investment income for such year…"

MMIC exceeded the 30% expense threshold for the calendar years 2016 (30.6%), 2017 (32.3%) and 2018 (31.3%).

It is recommended that the Company at all times comply with the expense limitation set forth in Section 4110(a) of the New York Insurance Law.

## 3. FINANCIAL STATEMENTS

### A. Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2018, as reported by the Company.

Assets

| | Assets | Assets Not Admitted | Net Admitted Assets |
|---|---|---|---|
| Bonds | $365,569,047 | | $365,569,047 |
| Preferred stocks (stocks) | 8,320,065 | | 8,320,065 |
| Common stocks (stocks) | 85,424,471 | | 85,424,471 |
| Cash, cash equivalents and short-term investments | 31,017,523 | | 31,017,523 |
| Other invested assets | 172,481 | | 172,481 |
| Investment income due and accrued | 2,354,755 | | 2,354,755 |
| Uncollected premiums and agents' balances in the course of collection | 8,963,877 | $ 540,714 | 8,423,163 |
| Deferred premiums, agents' balances and installments booked but deferred and not yet due | 56,550,500 | | 56,550,500 |
| Amounts recoverable from reinsurers | 707,628 | | 707,628 |
| Funds held by or deposited with reinsured companies | 498,412 | | 498,412 |
| Current federal and foreign income tax recoverable and interest thereon | 1,014,436 | | 1,014,436 |
| Net deferred tax asset | 8,900,000 | 944,000 | 7,956,000 |
| Electronic data processing equipment and software | 731,804 | 508,039 | 223,765 |
| Furniture and equipment, including health care delivery assets | 418,052 | 418,052 | |
| Prepaid expenses | 443,805 | 443,805 | |
| Equities and deposits in pools and associations | 1,820,344 | 0 | 1,820,344 |
| Miscellaneous receivables | 34,634 | 34,634 | 0 |
| Total assets | $572,941,834 | $2,889,244 | $570,052,590 |

Liabilities, Surplus and Other Funds

Liabilities

| | | |
|---|---|---|
| Losses and loss adjustment expenses | | $210,579,351 |
| Commissions payable, contingent commissions and other similar charges | | 10,465,601 |
| Other expenses (excluding taxes, licenses and fees) | | 11,333,511 |
| Taxes, licenses and fees (excluding federal and foreign income taxes) | | 1,798,374 |
| Unearned premiums | | 89,023,210 |
| Advance premium | | 804,506 |
| Dividends declared and unpaid: Policyholders | | 194,950 |
| Ceded reinsurance premiums payable (net of ceding commissions) | | 15,442,109 |
| Funds held by company under reinsurance treaties | | 127,210 |
| Amounts withheld or retained by company for account of others | | 529,760 |
| Provision for reinsurance | | 104,000 |
| Payable to parent, subsidiaries and affiliates | | 3,022,587 |
| Reserve for uncashed checks | | 282,663 |
| Unearned ceded commission income | | 1,765,676 |
| Total liabilities | | $345,473,508 |
| Surplus and Other Funds | | |
| Voluntary reserve | $ 1,500,000 | |
| Special contingent reserve | 1,500,000 | |
| Surplus notes | 27,000,000 | |
| Unassigned funds (surplus) | 194,579,082 | |
| Surplus as regards policyholders | | 224,579,082 |
| Total liabilities, surplus and other funds | | $570,052,590 |

Note: The Internal Revenue Service did not audit any of the Company's federal income tax returns during the period 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. Statement of Income

The net income for the examination period as reported by the Company was $59,134,560, as detailed below:

| | | |
|---|---|---|
| Underwriting Income | | |
| Premiums earned | | $756,904,272 |
| Deductions: | | |
| Losses and loss adjustment expenses incurred | $461,854,137 | |
| Other underwriting expenses incurred | 267,195,911 | |
| Assignment credit fee expense | 353,386 | |
| Total underwriting deductions | | 729,403,434 |
| Net underwriting gain or (loss) | | $ 27,500,838 |
| Investment Income | | |
| Net investment income earned | $ 48,902,520 | |
| Net realized capital gain | (1,118,727) | |
| Net investment gain or (loss) | | 47,783,793 |
| Other Income | | |
| Net gain or (loss) from agents' or premium balances charged off | $ (1,578,980) | |
| Finance and service charges not included in premiums | 6,537,505 | |
| Miscellaneous income | 571,028 | |
| Total other income | | 5,529,553 |
| Net income before dividends to policyholders and before federal income taxes | | $ 80,814,184 |
| Dividends to policyholders | | 357,937 |
| Net income after dividends to policyholders but before federal income taxes | | $ 80,456,247 |
| Federal income taxes incurred | | 21,321,687 |
| Net income | | $ 59,134,560 |

C. Capital and Surplus

Surplus as regards policyholders increased $74,308,242 during the examination period January 1, 2014 through December 31, 2018 as reported by the Company, detailed as follows:

| | | | |
|---|---|---|---|
| Surplus as regards policyholders as reported by the Company as of December 31, 2013 | | | $150,270,840 |
| | Gains in Surplus | Losses in Surplus | |
| Net income | $59,134,560 | | |
| Net unrealized capital gains or (losses) | 22,248,383 | | |
| Change in net deferred income tax | | $3,900,000 | |
| Change in nonadmitted assets | 1,626,538 | | |
| Change in provision for reinsurance | 198,761 | | |
| Change in surplus notes | 0 | 5,000,000 | |
| Total gains and losses | $83,208,242 | $8,900,000 | |
| Net increase (decrease) in surplus | | | 74,308,242 |
| Surplus as regards policyholders as reported by the Company as of December 31, 2018 | | | $224,579,082 |

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

## 4. LOSSES AND LOSS ADJUSTMENT EXPENSES

The examination liability for the captioned items of $210,579,351 is the same as that reported by the Company as of December 31, 2018. The examination analysis of the loss and loss adjustment expense reserves was conducted in accordance with generally accepted actuarial principles and statutory accounting principles, including SSAP No. 55. The reported reserves are concentrated in the commercial lines, which is consistent with the business written by the Company.

## 5. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination contained the following recommendation (page number refers to the prior report):

| ITEM | | PAGE NO. |
|---|---|---|
| A. | Loss and Loss Adjustment Expenses | |
| | It was recommended that the Company ensure that the Actuarial Report underlying its Statement of Actuarial Opinion complies with the NAIC Annual Statement Instructions. | 18 |
| | The Company has complied with this recommendation. | |

## 6. SUMMARY OF COMMENTS AND RECOMMENDATIONS

| ITEM | | PAGE NO. |
|---|---|---|
| A. | Account and Records | |
| | It is recommended that the Company at all times comply with the expense limitation set forth in Section 4110(a) of the New York Insurance Law. | 12 |

Respectfully submitted,

_____________/S/___________
Wayne Longmore
Associate Insurance Examiner

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

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

_____________/S/___________
Wayne Longmore

Subscribed and sworn to before me

this__________ day of ___________________, 2019.

*APPOINTMENT NO. 31855*

*NEW YORK STATE*

# *DEPARTMENT OF FINANCIAL SERVICES*

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

***Wayne Longmore***

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

***Merchants Mutual Insurance Company***

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

***COMPANY***

*with such other information as he shall deem requisite.*

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

*this 8th day of January 2019*

NEW YORK STATE ★ DEPARTMENT OF FINANCIAL SERVICES ★ EXCELSIOR

*MARIA T. VULLO*
*Superintendent of Financial Services*

*By:*

*Joan Riddell*
*Deputy Bureau Chief*