

**"The following report on examination was conducted as of  
December 31, 2005, and therefore does not contain information  
regarding the financial crisis subsequently encountered by the  
American International Group."**

REPORT ON EXAMINATION

OF

AIU INSURANCE COMPANY

AS OF

DECEMBER 31, 2005

DATE OF REPORT

DECEMBER 10, 2007

EXAMINER

PATRICK R. WHITE, CFE

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

December 10, 2007

Honorable Eric R. Dinallo  
Superintendent of Insurance  
Albany, New York 12257

Sir:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 22491 dated April 13, 2006 attached hereto, I have made an examination into the condition and affairs of the AIU Insurance Company as of December 31, 2005, and submit the following report thereon.

Wherever the designations the "Company" and "AIU" appear herein without qualifications, they should be understood to indicate the AIU Insurance Company.

Wherever the designation "Japan Branch" appears herein without qualification, it should be understood to indicate the AIU Japan Branch

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

The examination was conducted both at the Company's home office located at 70 Pine Street, New York, New York 10270 and at its Japan Branch's administrative office located at AIG Tower, 17th floor, 2-4 Kinshi 1-chome, Sumida Ku, Tokyo 130-8561.

## 1. SCOPE OF EXAMINATION

The previous filed examination report for the Company was as of December 31, 1996. In 2002, the Department commenced a financial examination of the Company as of December 31, 2001. However, during the course of the examination and as a result of regulatory inquiries into certain transactions, American International Group, Inc. (“AIG”) conducted an internal review of information and certain transactions from January 2000 to May 2005. As part of the internal review, the Company reviewed the statutory accounting treatment for matters identified during the internal review and concluded that certain transactions were materially misstated. With the agreement of the Department, the Company amended and refiled its 2004 annual statement using the methodology described under Statement of Statutory Accounting Principles (SSAP) No. 3, “Accounting Changes and Corrections of Errors.” In applying this methodology, the Company reflected the impact to its 2003 and prior unassigned surplus as an adjustment to unassigned surplus as of January 1, 2004. Due to the financial reporting misstatements acknowledged by the Company as part of the restatement of its 2004 annual statement, the Department’s 2001 report was not filed.

This examination covered the one year period from January 1 through December 31, 2005 and also included a review of the 2005 adjustments to the Company’s 2004 statutory financial statements. For legal and statutory compliance purposes, this examination covers the period from January 1, 1997 through December 31, 2005.

The current examination was organized, planned, and conducted based upon the application of the risk surveillance approach in accordance with the guidelines and procedures established in the Financial Condition Examiners Handbook of the National Association of Insurance Commissioners (“NAIC”). To the extent considered appropriate, work performed by the Company’s independent public accountants and the Sarbanes Oxley documentation was considered. A review was also made of the following items as called for in the Financial Condition Examiners Handbook of the NAIC:

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

The examination of AIU Insurance Company was performed concurrently with the examinations of the following insurers: National Union Fire Insurance Company of Pittsburgh, Pa. (“National Union”) (PA), Birmingham Fire Insurance Company of Pennsylvania (n/k/a AIG Casualty Insurance) (PA), The Insurance Company of the State of Pennsylvania (PA), Granite State Insurance Company (PA), American International South Insurance Company (PA), New Hampshire Insurance Company (PA), American Home Assurance Company (“American Home”) (NY), Commerce and Industry Insurance Company (NY), Illinois National Insurance Co. (IL). These companies are members of and participate in an intercompany pooling arrangement hereinafter referred to as the “Commercial Pool” (see section 2C, Reinsurance).

The examination was conducted in conjunction with the State of Pennsylvania which was the lead state for the examination of the Commercial Pool. The Pennsylvania examination of the Commercial Pool was conducted utilizing a modified risk surveillance methodology.

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 in New York on April 24, 1851 as the Pacific Fire Insurance Company. In 1913, the Company merged with Greenwich Insurance Company. The name was changed to Pacific Fire Insurance Company of New York on May 20, 1957. It was changed to American International Insurance Company on July 23, 1969 and to its present corporate title on November 4, 1976. Since 1970, complete financial control has been held directly or indirectly by American International Group, Inc. (“AIG”). AIG directly owns a majority interest (52%) with the remaining minority interest, since December 29, 1981, being held by National Union Fire Insurance Company of Pittsburgh, Pa. (32%), Birmingham Fire Insurance Company of Pennsylvania (8%) and The Insurance Company of the State of Pennsylvania (8%).

At December 31, 2005, capital paid in was \$8,000,000 consisting of 200,000 shares of \$40 par value per share common stock. Gross paid in and contributed surplus was \$154,786,801.

A. Management

Pursuant to the Company's charter and by-laws, management of the Company is vested in a board of directors consisting of not less than thirteen or more than twenty-one members. At December 31, 2005, the board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Merton B. Aidinoff New York, NY	Retired Attorney, Sullivan & Cromwell
Steven J. Bensinger New York, NY	Executive Vice President & Chief Financial Officer, AIG Inc.
Charles H. Dangelo Manasquan, NJ	Vice President, AIG Inc.
Jeffrey L. Hayman Tokyo, Japan	Regional President & Chief Operating Officer, AIG Companies Japan & Korea
David L. Herzog St. Albans, Missouri	Senior Vice President & Comptroller, AIG Inc.
Robert E. Lewis New York, NY	Senior Vice President, Chief Risk Officer, AIG Inc.
Kristian P. Moor Fairfield, CT	Chairman and President, AIU Insurance Company.
Win J. Neuger New York, NY	Executive Vice President & Chief Investment Officer, AIG Inc.
Ernest T. Patrikis New York, NY	Senior Vice President & General Counsel, AIG Inc.
Robert M. Sandler Bridgewater, NJ	Executive Vice President & Senior Actuary, AIG Inc.
Robert S. H. Schimek Newtown, PA	Senior Vice President & Treasurer, AIU Insurance Company
Nicholas S. Tyler Montclair, NJ	Vice President, AIG Inc.
Nicholas C. Walsh New York, NY	President & Chief Executive Officer, American International Underwriters

A review of the minutes of the board of directors' meetings held during the examination period indicated that the meetings were generally well attended.

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

<u>Name</u>	<u>Title</u>
Kristian P. Moor	Chairman and President
Robert S. H. Schimek	Senior Vice President & Treasurer
Elizabeth M. Tuck	Secretary

B. Territory and Plan of Operation

As of December 31, 2005, the Company was licensed to write business in forty-eight states and the District of Columbia. For 2005, direct premiums written totaled \$2.7 billion of which \$292 million were U.S sourced and \$2.4 billion were foreign sourced. New York direct written premium accounted for 3.1% of the total direct written premium. Premiums written through the AIU Japan Branch accounted for 89.2% of the Company's total direct premiums written. Japan sourced business accounted for 99.9% of the total foreign premium.

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

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

<u>Paragraph</u>	<u>Line of Business</u>
22	Residual value
24	Credit unemployment
26	Gap
27	Prize indemnification
28	Service contract reimbursement
29	Legal services

The Company is also authorized to write workers' compensation insurance as may be incident to coverages contemplated under paragraphs 20 and 21 of Section 1113(a) of the New York Insurance Law including coverages described in the Longshoremen's and Harbor Workers' Compensation Act and the kinds of insurance and reinsurance of every kind or description, except with respect to life insurance, title insurance and contracts for the payment of annuities, as specified in Section 4102(c) of the New York Insurance Law. The Company is authorized to transact business of special risk insurance as defined in Article 63 of the New York Insurance Law.

Based on the lines of business for which the Company is licensed and the Company's current capital structure, and pursuant to the requirements of Articles 13 and 41 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of \$35 million.

Related companies of the Commercial Pool operate as specialty multiple line carriers with emphasis on business developed and serviced by brokers. Underwriting facilities are maintained for handling virtually all forms of property and casualty insurance and reinsurance. Marketing efforts are directed mainly towards commercial and industrial risks. Related companies of the Commercial Pool specialize in assumed reinsurance, surplus lines, and risk management programs for large national insureds.

All of the Company's Japanese sourced premiums are written through the AIU Japan Branch ("Japan Branch"). The Japan Branch originated 60 years ago to act as a managing general agent to underwrite business for insurance companies outside of Japan. The AIU Japan Branch and the American Home Assurance Company's ("American Home") Japan Branch were established in the mid- 1970's at which time the Japanese Government asked that AIU and American Home have a local presence in Japan. At that time the Ministry of Finance (the predecessor to the current Financial Services Agency ["FSA"]) advised that these entities be set up as branches of AIU Insurance Company and American Home Assurance Company.

The Japan Branch writes the following types of insurance: accident and health, personal lines including auto, home and liability, commercial casualty lines including general liability, worker's compensation, fidelity and surety, directors and officers liability and commercial property including fire and package. Approximately 40% of the business written by the Japan Branch is personal lines (auto and home), 40% is accident and health and 20% is commercial lines, including marine and energy. The Japan Branch acquires its business from various distribution channels including agents, soliciting employees, brokers, travel agents, real estate agents and cross marketing agreements with other local carriers.

C. Reinsurance

Assumed

Assumed reinsurance accounted for 13% of the Company's gross premium written at December 31, 2005. The Company receives 1% of the business subject to the AIG commercial lines pool pursuant to an intercompany pooling agreement. This agreement provides that the Company and ten affiliated entities are to share in premiums, losses, and expenses based on their respective pool participation percentages. Business written in Japan by the Company and American Home is not included in this pooling agreement. The Company's participation in the commercial lines pool accounted for 9% of its total gross premium for 2005.

As of December 31, 2005, the pooling participants and their participations were as follows:

<u>Company Name</u>	<u>State of Domicile</u>	<u>Pool %</u>
National Union Fire Insurance Company of Pittsburgh, Pa.	PA	38%
American Home Assurance Company	NY	36%
Commerce and Industry Insurance Company	NY	10%
The Insurance Company of the State of Pennsylvania	PA	5%
Birmingham Fire Insurance Company of Pennsylvania (n/k/a AIG Casualty Company)	PA	5%
New Hampshire Insurance Company	PA	5%
AIU Insurance Company	NY	1%
American International Pacific Insurance Company	CO	0%
American International South Insurance Company	PA	0%
Granite State Insurance Company	PA	0%
Illinois National Insurance Co.	IL	0%

Effective July 1, 2007, American International Pacific Insurance Company ("AIP") terminated its 0% participation in the Commercial Pooling Agreement. Commercial risks ceded to

the Commercial Pool by AIP prior to its exit will remain in the pool until their natural expiry. AIP's cessions of personal lines risks to the Commercial Pool were commuted and 100% ceded to AIG's Personal Lines Pool, which AIP joined effective July 1, 2007, also with a 0% participation.

Effective January 1, 2008, the Company terminated its 1% participation in the Commercial Pooling Agreement. Risks ceded to the Commercial Pool by the Company will be run off and its 1% participation will be reduced to zero.

The Company's assumed reinsurance program mostly consists of property, casualty and multi-line coverage assumed on a quota share and excess basis as follows:

<u>Category</u>	<u>Assumed Written Premium</u>
Intercompany Pooling Agreement	\$294,118,000
Affiliated non pool	4,412,000
Affiliated other non US	34,578,000
Other Unaffiliated US	1,126,000
Voluntary Pools	445,000
Other Non-US	<u>75,708,000</u>
Total	<u>\$410,387,000</u>

For the intercompany pool, all pool members are licensed in New York. The significant reinsureds reported under the caption "Affiliated Non Pooled Category" are AIG Global Trade and Political Risk Insurance Company, from which the Company assumed \$1,994,000 of political risk business (other liability) and American International Insurance Company ("AIIC"), from which the Company assumed personal lines premiums of \$2,415,000. For the "Affiliated other Non US" category, the significant reinsured is Fuji Fire & Marine Insurance Company Limited ("Fuji"), from which the Company assumed \$38,727,000 of property business: fire, auto and marine premiums. For the "Other Non-US" category the significant reinsured is TOA Reinsurance Company Ltd. ("TOA") Japan, from which the Company assumed \$46,073,000 of premium.

The Company assumes business from both authorized and unauthorized cedants. Additionally, the Company's participation in various mandated pools is reflected in its assumed reinsurance activity. The Company utilizes reinsurance accounting as defined in the NAIC Accounting Practices and Procedures Manual, Statements of Statutory Accounting Principles ("SSAP") No. 62 for all of its assumed reinsurance business.

AIU Japan Branch

The Japan Branch assumed approximately \$100,000,000 from local Japanese companies with eighty percent of the premiums emanating from two treaties: (1) an automatic facultative accident and health treaty which the Japan Branch has in place with Fuji, and (2) a facultative automobile agreement with TOA

Ceded

The Company reported the following ceded reinsurance by category in its 2005 Schedule F – Part 3 (in millions):

<u>Category</u>	<u>Ceded Premium</u>	<u>Percentage</u>
Authorized - Affiliates - U.S. Intercompany Pooling	\$ 994.7	41%
Unauthorized - Affiliates - Other (Non - U.S.)	621.3	26
Authorized - Affiliates - Other (Non - U.S.)	522.4	22
Unauthorized - Other Non – U.S Insurers	149.1	6
Unauthorized - Pools - Voluntary Pools	55.7	2
Authorized - Affiliates - U.S. Non-Pool	36.0	1
Authorized - Other Non - U.S. Insurers	18.3	1
Authorized - Other U.S. Unaffiliated Insurers	14.9	1
Authorized - Pools - Voluntary Pools	13.8	1
Unauthorized - Other U.S. Unaffiliated Insurers	1.9	0
Unauthorized - Affiliates - U.S. Non-Pool	.6	0
Authorized - Pools - Mandatory Pools	<u>.5</u>	<u>0</u>
Total	<u>\$2,429.3</u>	<u>100%</u>

Pooled Reinsurance

The affiliated member pooled companies with significant premium cessions as reported in the Company's 2005 Schedule F are reflected below (in millions):

<u>Affiliate</u>	<u>Reinsurance Premiums Ceded</u>	<u>Percentage of Ceded Premium to the Pool</u>
National Union Fire Insurance Company of Pittsburgh, Pa.	\$ 647.7	65%
New Hampshire Insurance Company	266.0	27
The Insurance Company of the State of Pennsylvania.	39.0	4
Commerce and Industry Insurance Company	30.3	3
American Home Assurance Company	7.3	1
Granite State Insurance Company	<u>4.4</u>	<u>0</u>
Total	<u>\$ 994.7</u>	<u>100%</u>

Included in the amounts reflected in the "Authorized-Affiliates-U.S. Intercompany Pooling" classification were cessions to the Domestic Commercial Lines Pool as well as amounts ceded from the Japan Branch through "exit treaties." An exit treaty is the reinsurance contract which enables the Japan Branch to cede its business into the American International Underwriters Overseas Association ("AIUOA") managed pool (see below), a portion of which is further retroceded to third parties through the world wide reinsurance facilities placed by AIUOA on behalf of the member companies. The third party reinsurance is on both a proportional and non-proportional basis, and affords capacity and capital/surplus protection. Of the \$994.7 million of pooled reinsurance premiums ceded at year end 2005, approximately \$623 million were ceded from AIU Japan Branch through various "exit treaties".

Japan Branch Ceded Reinsurance Program Overview

The Company manages the Japan Branch for an overall average retention of 30 percent of the direct premium business it writes in Japan. This retention percentage satisfies the Japanese capital requirements established by the FSA. To accomplish the retention requirements, the Japan Branch uses a combination of local facultative and treaty placements, as well as cessions to affiliates through exit treaties. Facultative certificates are placed at the local Japanese profit centers. Treaty reinsurance is purchased at the AIG home office in New York. In addition, the Japan Branch participates in two compulsory Japanese related programs for earthquake and automobile insurance.

Japan Branch Intercompany Exit Treaties

The following major “exit treaties” were reflected in the Japan Branch 2005 Schedule F Part 3:

<u>AIU Japan Branch Exit Treaties</u>		<u>Reinsurance Premiums Ceded</u>	
<u>Affiliated Reinsurer</u>	<u>State of domicile</u>	<u>Japanese Yen</u>	<u>\$US*</u>
National Union Fire Insurance Co. of Pittsburgh, Pa.	PA	30,809,981,103	\$ 283,274,669
New Hampshire Insurance Company	PA	28,759,542,129	264,422,420
The Insurance Company of the State of Pennsylvania	PA	4,242,042,281	39,002,397
Commerce and Industry Insurance Company	NY	3,285,594,892	30,208,581
American Home Assurance Company	NY	182,182,466	1,675,031
Granite State Insurance Company	PA	<u>482,809,142</u>	<u>4,439,068</u>
Subtotal AIG Domestic Exit Treaties		<u>67,762,152,013</u>	\$ <u>623,022,166</u>
<u>Affiliated Reinsurer</u>	<u>Country</u>	<u>Japanese Yen</u>	<u>\$US*</u>
American International Reinsurance Co. Ltd	BM	64,196,653,277	\$ 590,240,079
American Int'l Underwriters Overseas; Ltd	BM	<u>55,670,016,977</u>	<u>511,844,054</u>
Subtotal Bermuda Exit Treaties		<u>119,866,670,254</u>	\$ <u>1,102,084,133</u>
Total all Exit Treaties		<u>187,628,822,267</u>	\$ <u>1,725,106,299</u>

\* SSAP No. 23 requires foreign source premiums to be translated to U.S. dollars as follows: (i) for assets and liabilities, the exchange rate at the balance sheet date shall be used and (ii) for revenues, expenses, gains, losses and surplus adjustments, the exchange rate at the dates on which those elements are recognized shall be used. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, losses and surplus adjustments are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements. Gains or losses due to translating foreign operations to U.S. dollars shall be recorded as unrealized capital gains or losses.

The Company used the foreign exchange rates based upon the quarterly daily weighted average rate of \$0.009194 for all Nominal Accounts (SSAP No. 23 Item ii) and \$0.008494 for all balance sheet accounts (SSAP No. 23 Item i).

Based on the AIU Japan Branch Schedule F, 36% percent of premiums ceded by the Japan Branch through “Exit Treaties” were ceded to domestic (US) affiliated insurers and 64% percent to Non-US affiliates (primarily Bermuda).

At December 31, 2005 the Japan Branch had the following reinsurance program which was placed with affiliated companies through “exit treaties”:

<u>Treaty</u>	<u>Cession</u>
<u>Property</u>	
Fire quota share treaty	93.5% quota share of \$10,000,000 any one risk
<u>Casualty</u>	
Automobile quota share treaty	70% quota share of \$2,000,000 any one risk
Casualty quota share	80% quota share of \$5,000,000 any one accident
Directors and officers liability quota share	50% quota share of \$15,000,000
<u>Fidelity and Surety</u>	
Fidelity quota share treaty	91% quota share of \$5,000,000
Surety quota share	90% quota share of \$16,000,000 100% surplus of \$24,000,000
<u>Accident and Health</u>	
Personal accident quota share	83.5% quota share of 35,000,000 JPY
Personal accident first surplus treaty	65,000,000 JPY any one person
Personal accident – act of God (Earthquake)	100,000,000 JPY any one life Ceded 100% to AIRCO
<u>All Lines</u>	
Working excess of loss	\$440,000 ultimate net loss excess of \$660,000 \$1,320,000 any one event
Catastrophe excess of loss reinsurance Contract	\$10,650,000 ultimate net loss excess of \$1,100,000 on any one event

#### American International Underwriters Overseas Association

On December 15, 1975, AIG formed the American International Underwriters Overseas Association (“AIUOA”) as the pooling mechanism for AIG’s international general insurance operations. AIUOA is not an insurance company but rather a Bermuda unincorporated association, operating pursuant to its Articles of Association. Since 1976, much of AIG’s foreign property/casualty insurance business has been written through AIUOA. AIUOA is comprised of four companies: three domestic property/casualty insurers (American Home Assurance Company, New Hampshire Insurance Company, and National Union Fire Insurance Company of Pittsburgh, Pa.) and American International Underwriters Overseas, Ltd., a Bermuda corporation which is an accredited reinsurer in New York. The AIUOA members participate in an inter-reinsurance agreement under which they pool their foreign business.

The Japan Branch cedes approximately 40% of its business to AIUOA members, either directly or through nominee companies (affiliated companies who are not members of the AIUOA) pursuant to intercompany reinsurance agreements referred to as “exit treaties.” Each reinsurer on the Japan cessions records the assumed reinsurance in its respective yellow book with an equal cession to the AIUOA remaining pool members. The Company reported the AIUOA pool business in its 2005 Schedule F Part 3 under the caption “Authorized Pools – Voluntary Pools.”

On December 1, 1980, the Articles of Association were modified such that the profits and losses on the Japanese business ceded through AIUOA are shared by three of the Member Companies as follows:

<u>Member Company</u>	<u>Participation%</u>
AIUO Ltd.	85%
New Hampshire Insurance Company (“NHIC”)	10
National Union Fire Insurance Company of Pittsburgh, Pa. (“NUFIC”)	5

American International Underwriters Overseas, Ltd (“AIUO, Ltd)

In 1976, AIUO, Ltd. (Bermuda) was granted an accredited reinsurer status by the Department. As a condition of granting accredited reinsurer status to AIUO Ltd., the Department required AIUO, Ltd. to sign a stipulation (i) agreeing to comply with pertinent New York Insurance Laws, rules and regulations, including filing of financial statements, and (ii) agreeing to establish a trust fund for the protection of U.S. cedents. The trust fund was required to hold, at all times, assets totaling \$10 million in excess of its liabilities. Other provisions also apply.

The Company reported the AIUO, Ltd Treaty under the caption “Authorized-Affiliates-Other (Non - U.S.)” in Schedule F Part 3 for 2005.

American International Reinsurance Company (“AIRCO”) (Bermuda)

AIRCO is a Bermuda domiciled affiliate that assumes approximately 30% of the Japan Branch’s business through various “exit treaties.” AIRCO is not a member of the AIUOA Pool. All Japan Branch cessions made to AIRCO are direct. AIRCO is an unauthorized reinsurer and has provided the Company with letters of credit as collateral for its outstanding recoverables.

The Company reported the reinsurance activity with AIRCO under the caption “Unauthorized-Affiliates-Other (Non - U.S.)” in Schedule F Part 3 for 2005.

A review of the AIRCO reinsurance agreement revealed that the agreement did not contain the security clause required pursuant to Part 79.5 (a)(1)and (2)of Department Regulation No. 133 which states that:

“Reinsurance agreements-required and permitted conditions. (a) When a letter of credit is obtained in conjunction with a reinsurance agreement, then such reinsurance agreement must contain provisions which: (1) require the reinsurer to be the applicant for and to provide letters of credit to the ceding insurer and specify what recoverables and/or reserves are covered;

(2) stipulate that the reinsurer and ceding insurer agree that the letters of credit provided by the reinsurer pursuant to the provisions of the reinsurance agreement may be drawn upon at any time, notwithstanding any other provisions in the reinsurance agreement, and be utilized by the ceding insurer or any successor by operation of law of the ceding insurer including, without limitation, any liquidator, rehabilitator, receiver or conservator of such insurer for the following purposes:

(i) to reimburse the ceding insurer for the reinsurer's share of premiums returned to the owners of policies reinsured under the reinsurance agreement on account of cancellations of such policies;

(ii) to reimburse the ceding insurer for the reinsurer's share of surrenders and benefits or losses paid by the ceding insurer under the terms and provisions of the policies reinsured under the reinsurance agreement;

(iii) to fund an account with the ceding insurer in an amount at least equal to the deduction, for reinsurance ceded, from the ceding insurer's liabilities for policies ceded under the agreement. Such amount shall include, but not be limited to, amounts for policy reserves, reserves for claims and losses incurred (including losses incurred but not reported), loss adjustment expenses, and unearned premiums; and

(iv) to pay any other amounts the ceding insurer claims are due under the reinsurance agreement:

All of the foregoing should be applied without diminution because of insolvency on the part of the ceding insurer or the reinsurer.”

At the examiner’s request, the Company amended all of the treaties between the Japan Branch and AIRCO to include a security clause as required by Part 79.5 of Department Regulation No. 133. The Company also amended several other clauses to the AIRCO exit treaties. These amendments

were filed with the Department by letter dated November 2, 2007 and have been non-disapproved by the Department.

It is recommended that the Company ensure that all AIRCO “exit treaties” with the American Home and AIU Japan Branches contain all the required security clauses pursuant to Part 79.5 of Department Regulation No. 133.

#### Failure to File Japan Branch Exit Treaties

By letter dated September 23, 2005 from Steven Bensinger, executive vice president and chief financial officer of AIG, Inc. to the Pennsylvania, New York, California and Delaware Insurance Departments, the Company stated the following related to the filing of its “exit treaties.”

#### “Intercompany Reinsurance Related to AIUOA Business Exit Treaties”

AIUOA's Articles of Association provides that the business written on behalf of AIUOA may be reinsured by non-AIUOA members as "nominees" of the AIUOA members, and that such business shall be deemed to be written for the account of the AIUOA members in proportion to their participatory share of the reinsurance pooling arrangement. Under this arrangement, certain of AIG's domestic property/casualty companies (that are not AIUOA members) are used as nominees under reinsurance treaties known as "exit treaties" to cede premiums and insurance liabilities to AIUOA. Because the liabilities emanating from the exit treaties remain liabilities of AIUOA and are proportionally allocated to its members under the reinsurance pool, they have not historically been reported as intercompany reinsurance agreements under the insurance holding company act or recorded on the statutory financial statements of the nominee companies.

#### Other Intercompany Reinsurance Treaties

Certain other intercompany reinsurance agreements to which foreign branches of the AIUOA members are party were not filed under the insurance holding company acts because they were historically viewed as reinsurance agreements ceding business from the AIUOA pool, rather than ceding business from the foreign branches themselves.”

Since the Company admitted that affiliated reinsurance agreements termed “exit treaties” were not filed with the Department on a consistent basis pursuant to the provisions of Section 1505(d) (2) of the New York Insurance Law, a recommendation regarding the Company’s failure to file these agreements with the Department is included in Item 2D of this report.

### Japan Branch Earthquake Insurance Pool

Under Japanese Law number 73 (1966), all homeowner earthquake policies written are required to be ceded to the Japanese Earthquake Reinsurance Company, Ltd. (“JERCO”). JERCO works as the pool agent and retains certain layered portions of the pooled risks. The risks in excess of the JERCO retention are retroceded to the Japanese Government and the pool members. Premium ceded from the Japan Branch totaled 4,080 million JPY for 2005. Retrocession premiums received by the Japan Branch from the pool was 178 million JPY for 2005

The Company reported the Japan Earthquake Reinsurance Company Ltd. treaty under the caption “Unauthorized-Other Non - U.S. Insurers” in Schedule F Part 3 for 2005.

### Compulsory Automobile Liability Insurance (“CALI”) Pool

Under Japanese Law number 97 (1955), all third party bodily injury (“TPBI”) Liability policies written are ceded to the Compulsory Automobile Liability Insurance Pool (“CALI”). The pool agent is TOA Reinsurance Company Ltd. The CALI Pool is mandatory reinsurance for the CALI product. Risks ceded to the pool are then retroceded to the pool members on a proportional basis. The Japanese Government has no involvement in this pool. The Japan Branch ceded 4,539 million JPY premium to (net of acquisition cost) and received 5,012 million JPY retrocession premium from the pool in 2005.

### Japan Auto BI EIC Pool

The Japan Auto BI EIC Pool is for voluntary auto policies with unlimited BI coverage. The attachment point is 800 million JPY (approximately \$7.5 million). The Company reported the Japan Auto BI EIC Pool Treaty under the caption “Unauthorized - Pools - Voluntary Pools” in Schedule F Part 3 for 2005.

Japan Branch Local Facultative Certificates:

The local Japan Branch profit center underwriters purchase facultative reinsurance as deemed necessary.

The Japan Branch has purchased facultative reinsurance for the following lines of business:

Commercial Property & Energy  
 Personal Lines  
 Commercial Liability  
 Marine and Accident and Health

All of the Japan Branch's local facultative reinsurance is placed with unauthorized reinsurers.

Management has indicated that the vast majority of the Japan Branch's facultative certificates in force at December 31, 2005 did not contain insolvency clauses as required by Section 1308 of the New York State Insurance Law. It is recommended that the Japan Branch include insolvency clauses in its facultative certificates in compliance with Section 1308 of the New York State Insurance Law.

It was noted that subsequent to the examination date the Japan Branch has made an effort to achieve better control over recording the issuance of its facultative certificates, as well as, attempting to secure proper insolvency clauses from reinsurers.

Japan Branch Local Treaty Reinsurance Programs

As of December 31, 2005 the Japan Branch had the following significant local treaties placed with alien reinsurers:

<u>Treaty</u>	<u>Cession</u>
<u>Property</u>	
First Surplus Property Treaty	8 billion JPY or 8 lines
<u>Casualty</u>	
Automobile Facultative Obligatory	200 million JPY (any one risk)
General liability Facultative Obligatory	up to 95% but not exceeding 1 billion JPY anyone risk
<u>Surety</u>	
Surety bond quota share	30% quota share max. Limit 240 Million JPY
<u>Accident and Health</u>	
Personal Accident Second Surplus	50 million JPY any one life per any one policy
Personal Accident Third Surplus	200 million JPY any one life per any one policy

All of the Japan Branch's local treaty reinsurance is placed with unauthorized reinsurers. Japan Branch local treaty reinsurance wording is approved by the AIG home office.

It was noted that several of the Japan Branch's locally placed treaties did not contain insolvency clauses as required by Section 1308 of the New York State Insurance Law. It is recommended that the Company obtain insolvency clauses in all of its locally placed treaties in compliance with Section 1308 of the New York Insurance Law.

#### Reinsurance Accounting in Compliance with Section 1308(a)(2) of the New York Insurance Law

Upon review of the reinsurance activity of the Japan Branch, it was noted that the facultative certificates lacked a proper insolvency clause pursuant to the provisions of Section 1308 of the New York Insurance Law. The Company accounted for these facultative certificates as valid reinsurance in its filed annual statements. This accounting treatment does not appear to comply with the provisions of Section 1308(a)(2)(A) of the New York Insurance Law, which states:

“No credit shall be allowed, as an admitted asset or deduction from liability, to any ceding insurer for reinsurance ceded, renewed, or otherwise becoming effective after January first, nineteen hundred forty, unless:

(i) the reinsurance shall be payable by the assuming insurer on the basis of the liability of the ceding insurer under the contracts reinsured without diminution because of the insolvency of the ceding insurer, and

(ii) under the reinsurance agreement the liability for such reinsurance is assumed by the assuming insurer as of the same effective date.

(B) Except as provided by subsection (a) of section four thousand one hundred eighteen of this chapter, no such credit shall be allowed any ceding insurer for reinsurance ceded, renewed, or otherwise becoming effective after September first, nineteen hundred fifty-two, unless the reinsurance agreement provides that payments by the assuming insurer shall be made directly to the ceding insurer or its liquidator, receiver or statutory successor, except where:

(i) the agreement specifies another payee of such reinsurance in the event of the insolvency of the ceding insurer, or

(ii) the assuming insurer with the consent of the direct insureds has assumed such policy obligations of the ceding insurer as its direct obligations to the payees under such policies, in substitution for the obligations of the ceding insurer to such payees.

(3) Such reinsurance agreement may provide that the liquidator, receiver or statutory successor of an insolvent ceding insurer shall give written notice of the pendency of a claim against such insurer on the contract reinsured within a reasonable time after such

claim is filed in the insolvency proceeding and that during the pendency of such claim any assuming insurer may investigate such claim and interpose, at its own expense, in the proceeding where such claim is to be adjudicated any defenses which it deems available to the ceding company, its liquidator, receiver or statutory successor. Such expense shall be chargeable subject to court approval against the insolvent ceding insurer as part of the expense of liquidation to the extent of a proportionate share of the benefit which may accrue to the ceding insurer solely as a result of the defense undertaken by the assuming insurer. Where two or more assuming insurers are involved in the same claim and a majority in interest elect to interpose defense to such claim, the expense shall be apportioned in accordance with the terms of the reinsurance agreement as though such expense had been incurred by the ceding company”.

\*underscoring added

It is noted that the Company’s financial statements included a provision for reinsurance for these certificates, which offset a majority of the reinsurance credits taken by the Company; therefore, the Company’s surplus as of December 31, 2005 was not materially affected by this accounting treatment. However, it is recommended that the Company account for reinsurance contracts that lack a proper insolvency clause by disallowing all reserve credits and reinsurance recoverables under these agreements in accordance with the provisions of Section 1308(a)(2)(A) of the New York Insurance Law.

Additionally, management has represented that all material ceded reinsurance agreements transfer both underwriting and timing risk as set forth in NAIC Accounting Practices and Procedures Manual Statements of Statutory Accounting Principles (“SSAP”) No. 62. Representations were supported by appropriate risk transfer analyses and an attestation from the Company's chief executive officer pursuant to Department Circular Letter No. 8 (2005). Additionally, 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 paragraph 23 of SSAP No. 62. Management has stated that the Branch has not been a party to any of the following transactions

Stop loss agreements  
Retro active reinsurance agreements  
Material Commutations

#### D. Holding Company System

The Company is wholly-owned subsidiary of American International Group, Inc. (“AIG”), a Delaware holding company organized in 1967, which includes insurance companies, management companies, agencies and other enterprises doing business in all states of the United States and around the world. AIG, is a publicly traded company, with approximately 11.89% of the shares owned by C.V. Starr & Co., Inc., Starr International Company, Inc., and the Starr Foundation as of December 31, 2005. AIG directly or indirectly owns all of the capital stock of several insurance companies including the American Home/National Union Group.

The following is an organizational chart of the U.S. domiciled insurance companies within the AIG insurance holding company system as of December 31, 2005:

#### Organizational Chart

American International Group, Inc. (Parent)

- **AIU Insurance Company** (AIG 52%-Ownership and Group A (see below) -48%)
- American Home Assurance Company
  - 21st Century Insurance Group (16.3%- Ownership Group I-83.7%)
    - 21st Century Insurance Company
    - 21st Century Casualty Company
    - 21st Century Insurance Company of Arizona (100%)
  - AIG Hawaii Insurance Company, Inc.
  - Transatlantic Holdings, Inc. (33.86%-Ownership Group B-17.84%)
    - Transatlantic Reinsurance Company
      - Putnam Reinsurance Company
- AIG Life Insurance Company (78.9%-Ownership Group C-21.1%)
- AIG Global Trade and Political Risk Insurance Company
- American International Insurance Company of Delaware, Inc.
- American International Life Assurance Company of N.Y. (77.5%-Ownership Group D-22.5%)
- American Life Insurance Company
- Birmingham Fire Insurance Company of Pennsylvania (n/k/a AIG Casualty Company)
- Commerce and Industry Insurance Company
  - American International Insurance Company (50%-Ownership Group E 50%)
    - Minnesota Insurance Company (n/k/a AIG Advantage Insurance Company)
    - American International Insurance Company of CA., Inc.
    - American International Insurance Company of New Jersey
- Delaware American Life Insurance Company
- The Insurance Company of the State of Pennsylvania
- Landmark Insurance Company
- National Union Fire Insurance Company of Pittsburgh, Pa.
  - American International Specialty Lines Insurance Company (70%-Ownership Group F-30%)
  - Lexington Insurance Company (70%-Ownership Group F-30%)
    - JI Accident & Fire Insurance Company Ltd. (50%)
  - National Union Fire Insurance Company of Louisiana
- NHIG Holding Corporation
  - Audubon Insurance Company
    - Audubon Indemnity Company
  - New Hampshire Insurance Company
    - American International Pacific Insurance Company (Formerly, American Fidelity Insurance Company)

- American International South Insurance Company (Formerly, American Global Insurance Company)
- Granite State Insurance Company
- Illinois National Insurance Co.
- New Hampshire Indemnity Company, Inc.
  - AIG National Insurance Company, Inc.
- New Hampshire Life Insurance Company
- United Guaranty Corporation (6.95%-Ownership Group G-93.05%)
  - United Guaranty Insurance Company
  - United Guaranty Mortgage Insurance Company
  - United Guaranty Mortgage Insurance Company of North Carolina
  - United Guaranty Residential Insurance Company (75%-Ownership Group H-25%)
    - United Guaranty Commercial Insurance Company (n/k/a United Guaranty Mortgage Indemnity Company)
    - United Guaranty Commercial Insurance Company of North Carolina
    - United Guaranty Credit Insurance Company
- The Philippine American Life & General Insurance Company (99.78%)
  - Pacific Union Assurance Company

Referenced Groups:

- A - The Insurance Company of the State of Pennsylvania (8%)  
 Birmingham Fire Insurance Company of Pennsylvania (n/k/a AIG Casualty Company) (8%)  
 National Union Fire Insurance Company of Pittsburgh, Pa. (32%)
- B - American International Group, Inc. (17.84%)
- C - Commerce and Industry Insurance Company (21.1%)
- D - American Home Assurance Company (22.5%)
- E - American Home Assurance Company (25%)  
 AIU Insurance Company (25%)
- F - The Insurance Company of The State of Pennsylvania (20%)  
 Birmingham Fire Insurance Company of Pennsylvania (n/k/a AIG Casualty Company)(10%)
- G - National Union Fire Insurance Company of Pittsburgh, Pa. (45.9%)  
 American International Group (36.3%)  
 The Insurance Company of the State of Pennsylvania (0.9%)
- H - United Guaranty Residential Insurance Company of North Carolina (25%)
- I - Commerce and Industry Insurance Company (31.1%)  
 New Hampshire Insurance Company (20.6%)  
 National Union Fire Insurance Company of Pittsburgh, Pa. (32%)

The Company owns part of the companies listed below:

<u>Company</u>	<u>Percentage of ownership</u>
American International Insurance Company	25%
ALICO Properties, Inc.	49%
American International Realty Corp.	6%
Eastgreen, Inc.	3%
Pine Street Real Estate Holdings	6%

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

#### Service and Expense Agreement

The Company is party to a service and expense sharing agreement with AIG. Pursuant to this agreement, AIG and its affiliates are to share/supply certain operating expenses, equipment, office space, overhead expenses, services (including, but not limited to, data center systems, salvage, subrogation and recovery and claims management) and personnel. Settlement shall be quarterly, as per the agreement.

#### Intercompany Pooling Agreements

The Commercial Pool (also known as the American Home/National Union Pool or the Domestic Brokerage Group (“DBG”) Pool) was formed by the execution of an inter-company pooling agreement ("pooling agreement"), as more fully discussed in Item 2C. of this report.

#### Tax Allocation Agreement

The Company files a consolidated federal income tax return AIG pursuant to the terms of a filed tax allocation agreement.

#### Capital Maintenance Agreements

These agreements provide that in the event that the respective Company's Total Adjusted Capital falls below 200% of the Company's Authorized Control Level Risk Based Capital (“RBC”), AIG shall provide a capital contribution to the Company in the amount that equals the difference between the Company's Total Adjusted Capital and 200% of the Company's Authorized Control Level RBC.

#### Investment Advisory Agreement

The Company is a party to an agreement with AIG Global Investment, Corp. (“AIGGIC”) whereby AIGGIC provides investment advisory services to the Company. The agreement authorizes the manager to supervise and direct all investments and to exercise whatever powers the Company may possess with respect to its invested assets. Investment transactions are to be in accordance with

investment objectives of the Company and subject to restrictions established by the Company, as communicated to the manager in writing from time to time. With regard to these limitations, the manager may buy, sell, exchange, convert and otherwise trade in and engage in investment transactions of any nature whatsoever involving any stocks, bonds, commercial paper, money market instruments and other securities and assets when it deems appropriate and without prior consultation with the Company.

#### Filing of Affiliated Agreements with the Department

The prior report on examination recommended that the Company submit all intercompany agreements to the Department prior to their implementation and to establish an effective method of tracking its holding company filings. Upon review, it was noted that the Company could not provide adequate documentation to evidence that all of its affiliated agreements entered into during the examination period had been filed with the Department. As previously mentioned in Item 2C of this report, seventy-four affiliated reinsurance agreements entered into during the examination period were not filed with the Department pursuant to the provisions of Section 1505(d)(2) of the New York Insurance Law. The following chart shows the number of intercompany agreements filed and non-disapproved for the years 2002-2005:

<u>Year</u>	<u>Filed and non-disapproved</u>	<u>Notes:</u>
2002	7	An additional 12 agreements were submitted late. Department indicated that these agreements would be placed on file.
2003	6	An additional 17 agreements were submitted late. Department indicated that these agreements would be placed on file.
2004	37	
2005	45	The 2005 number reflects total filings with NY parties. The Department and AIG Global Reinsurance had extensive discussions concerning wording issues and pool sessions after the 2005 filings. After an agreement was reached on standard template language and pool sessions, the Department agreed that any remaining outstanding agreements filed prior to 12/1/2005 would be “grandfathered.”

While it is evident that the number of intercompany filings has increased from prior years, the Company could not demonstrate that it had fully complied with the recommendations in the prior report regarding filing of intercompany agreements. It is recommended, as in the prior report on examination, that the Company file all of its inter-company agreements pursuant to Section 1505 of the New York Insurance Law and maintain complete documentation to evidence such filings. It is

noted that in September 2005, the Company instituted procedures to address the lack of controls over the filing of affiliated reinsurance agreements.

American International Group Kabushiki Kaisha

The Japan Branch maintains a service agreement with the American International Group KK ("AIG KK") which provides the following services: facilities, general affairs including: housing for ex-patriots, motor vehicle leases, etc, human resources; investment accounting, training, language schools, operations (i.e., call center management), systems (infrastructure, network service, e-mail, internet, etc). AIG KK is a shared services company which provides services for all of the AIG Japan Branch operations. AIG KK is reimbursed for these services on a cost plus basis. By letter dated September 15, 2004, the supplement of the agreement on entrustment of information process business between the Company and AIG KK was filed and non-disapproved by the Department. By letter dated February 17, 2005, the amended and restated agreement on services between the Company and AIG KK was filed and non-disapproved by the Department.

AIG East Asia Holdings Management, Inc.

AIG, Inc. maintains a Support Services Agreement with the AIG East Asia Holdings Management, Inc. ("EAHM") to provide support service for all of the AIG Japan Branches including the American Home and AIU Japan Branches. The services provided pursuant to this agreement include: management, technical and operational "support services" which include: supervising the branches, formulating a market strategy for Japan, conducting government relationships and reporting to AIG. Also, according to the agreement, officers and executives of AIG are seconded to EAHM. Their time is not allocated back to any of the branches for these seconded services. The agreement provides that the cost for these services is billed directly to AIG, Inc.

It is recommended that the Company file the service agreement between AIG, Inc. and EAMH with the Department pursuant to Section 1505(d)(3) of the New York Insurance Law as EAHM performs services for AIG, Inc. that directly relate to Japan Branch operations and would, customarily, be billed to the insurance entities.

### Indirect Agreements

Members of the AIG Pool entered into various reinsurance and service agreements with other members of the AIG holding company system. Although the Company was not a direct party to these agreements it was often indirectly affected by these agreements by virtue of the pooling agreement. The prior report on examination recommended that the Company disclose such indirect agreements with the Department.

The Company did not submit any indirect agreements for the years 2001 through 2004. In 2005, the Company agreed to file indirect agreements with the Department if filing of such agreements was required by the Pennsylvania Department of Insurance under the Pennsylvania Holding Company Act. It is recommended that the Company continue to file such indirect agreements with New York whenever filing is required by the Pennsylvania Insurance Department under the Pennsylvania Holding Company Act's materiality threshold.

### E. Accounts and Records

#### i. EDP Equipment

The Company reported electronic data processing ("EDP") equipment totaling \$2,606,157 as an admitted asset in its 2005 Annual Statement. Upon examination, it was noted that this asset was consisted of company-developed software.

Pursuant to Section 1301(a)(18) of the New York Insurance Law, an insurer may only report an admitted asset for "electronic data processing apparatus and related equipment constituting a data processing, record keeping, or accounting system if the cost of each such system is fifty thousand dollars or more." Further, Part 83.4(c)(3)(i) of Department Regulation 172 provides that "non-operating system software shall be nonadmitted."

Beginning with its 2006 annual statement, the Company has reported all amounts reported under this caption as nonadmitted.

ii. Custodian Agreements

The Company's custodial agreements for securities held outside the U.S, do not contain the controls and safeguards recommended by Section J of the NAIC Financial Examiners Handbook as follows:

Japan: Citibank, NA through office in New York

This agreement does not include all of the recommended safeguards and does not show the proper name of Company.

China: Citibank, NA through its office in Hong Kong (2 agreements)

These Agreements do not include all of the recommended safeguards and do not show the proper name of Company.

Taiwan

This agreement does not include all of the recommended safeguards and does not show the proper name of Company.

It is recommended that the Company amend its foreign custodian agreements to conform to Section J of the NAIC Financial Condition Examiners' Handbook. Any specific local governmental requirements for descriptions of the branch and / or descriptions of the securities held under custody can be included in these agreements provided that these inclusions do not conflict with the requirements of Section J of the NAIC Financial Condition Examiners' Handbook.

iv. Proper Aging of Reinsurance Premium Receivable Balances

The Company did not age its premium receivable for assumed reinsurance as of the examination date as required by Section 1301(a)(11) of the New York Insurance Law.

Section 1301(a)(11) of the New York Insurance Law states that:

“Premiums in course of collection, other than life insurance premiums, not more than ninety days past due, less commissions payable thereon. The foregoing limitation of ninety days shall not apply to: reinsurance premiums payable by ceding insurers authorized to transact such business in this state, or reinsurance premiums payable which may be offset by amounts carried by the assuming insurer as liabilities for amounts due to the ceding insurer for unpaid losses or other mutual debts. However reinsurance premiums more than ninety days past due shall not be

allowed in excess of ten per centum of the reinsurer`s total admitted assets as shown on its most recent annual statement on file in the office of the superintendent pursuant to section three hundred seven of this chapter.”

It is recommended that the Company include assumed premium receivable balances in its calculation of statutory overdue balance calculations for ceding companies not authorized in New York in compliance with the provisions of Section 1301(a)(11) of the New York Insurance Law.

v. Unearned Premium Offset - Over 90 day Balances

Paragraph 9 of SSAP No. 6 provides that unearned premiums may be used to offset the not admitted asset for overdue premiums on direct billed business, but not for overdue premiums due from agents. Upon review, it was noted that the Company used unearned premiums to offset all overdue deferred premiums regardless of whether the premium was direct billed or due from agents.

It is recommended that the Company segregate its direct bill receivable balances from those due from agents and only use unearned premiums to offset the not admitted asset for overdue premiums on the direct billed balances in accordance with the provisions of Paragraph 9 of SSAP No. 6.

F. Internal Controls

As mentioned elsewhere in this report, under the caption “Scope of Examination”, the Company acknowledged that certain transactions were materially misstated in its Statutory Annual Statements for the years 2004 and prior. The examiners also noted that the December 31, 2005 Annual Statement was amended and re-filed during the course of this examination.

Examination review of the 2005 “Report on Significant Deficiencies in Internal Controls” issued by the Company’s external auditor indicated the following reportable conditions:

(i) Controls Over Income Tax Accounting

As noted in the AIU Insurance Company 2005 Material Weakness Letter dated May 31, 2006, the Company did not maintain effective controls over the determination and reporting of certain components of the provision for income taxes and related income tax balances. Specifically, the Company did not maintain effective controls to review and monitor the accuracy of the components

of the income tax provision calculations and related income tax balances and to monitor the differences between the income tax basis and the financial reporting basis of assets and liabilities to effectively reconcile the differences to the deferred income tax balances.

As of the date of this report, remediation efforts have included hiring additional resources to assist with reviewing and monitoring of the accuracy of the components of the income tax provision calculations and related income tax balances and the differences between the income tax basis and the financial reporting basis of assets and liabilities to reconcile the differences to the deferred income tax balances effectively.

It is recommended that the Company continue its efforts to remediate the material weakness related to controls over federal income tax.

(ii) Controls Over The Accounting For Certain Derivative Transactions

The AIU Insurance Company 2005 Material Weakness Letter dated May 31, 2006; stated that the Company did not maintain controls to ensure the completeness and accuracy of the recording of derivative transactions needed to be improved. Specifically, the Company lacks a centralized inventory system for the recording of derivatives and needs greater operational involvement in the booking and reconciling of interest rate swaps, over-the-counter and exchange traded options.

The Company is actively reviewing potential software solutions which will be implemented to enhance the control and monitoring of all derivative investments. In the interim, management has strengthened operational controls to include secondary reviews by Investment operations and accounting

It is recommended that the Company continue its efforts to strengthen its internal controls over accounting for certain derivative transactions.

(iii) Controls Over Certain Balance Sheet Reconciliations

The Company did not maintain effective controls to ensure the accuracy of certain balance sheet accounts in certain key segments of the Company's operations. Specifically, accounting personnel did not perform timely reconciliations and did not properly resolve reconciling items for premium receivables, reinsurance recoverables and intercompany accounts.

The Company has undertaken a significant effort to remediate this material weakness in internal control which includes hiring additional resources, reorganizing responsibilities within the DBG Comptroller's department and formalizing the reconciliation policies, procedures and approach to evaluating financial statement exposure.

It is recommended that the Company continue its efforts to strengthen internal controls over its balance sheet reconciliations.

(iv) Premium Key Functional Activity (Machine only)

Premium transactions enter the reporting system as either "Machine" or "Non-Machine" entries. Machine transactions are generated by the underwriting systems, which in turn interface with the billings and collections ("B&C") system and ultimately post to the general ledger. "Non-Machine" entries are manual journal entries initiated by various profit centers or the Domestic Brokerage Group ("DBG") Comptrollers department. Examples of non-machine entries would be accrual of business booked in the last 7-10 days of each calendar quarter where direct posting to the general ledger is halted for quarter-end closing (pipeline), recording of the business written overseas, and other "Topside" adjusting entries.

In testing of controls over the premium process, the Company's independent auditors identified three main control deficiencies:

- In testing of premium transactions processed through various underwriting systems, the Company's auditors noted several coding exceptions existed within several of the underwriting systems.
- Test of controls included review of letters of authority to ensure the validity of the premium entered into the underwriting system. Approximately 5 percent of the sampled transactions failed this test and were not supported by any referral or approval.
- The Underwriting Resources Division ("URD") is one of the key controls identified by the Company. The review of the URD reports indicated URD had also identified issues related to coding, pricing, and insufficient or missing documentation. However, this control was not operating properly since the same types of errors were still present at the time of the independent audit, indicating no effective action was taken to address errors reported by URD.

Management concluded, and the auditors concurred, that significant effort was required to ensure that controls over the premium process would be robust and could be sustained going forward.

It is recommended that the Company continue its efforts to strengthen internal controls over its premium processing.

(v) Additional Allowance Provision (FAS-5 Reserve)

During the examination period, the Company continued its remediation efforts in order to address the material weaknesses and significant deficiencies identified in the evaluation of internal controls and the effectiveness of those controls.

As a result of this undertaking in the billings & collection key activity area, approximately \$174 million of provision (FAS-5 Reserve) was set aside as of the examination date.

(vi) Non-Machine Key Functional Activity (all underwriting areas)

Financial data flows into the general ledger through journal entries classified by the Company as either machine or non-machine. Machine entries are those transactions which are system generated and require no manual intervention. These entries are automated transactions between various systems that are interfaced with each other as well as the general ledger. Non-machine entries are those transactions that are manually posted into the various systems due to lack of system interface or as an adjustment which cannot be generated through the machine process. There are also certain entries classified as non-machine that are actually entered through a semi-automated process which requires only minimal manual intervention such as pooling and apportionment transactions. Machine and non-machine entries are categorized as self-reversing or permanent transactions. Permanent entries are actual values (not estimates) or other entries that would have a permanent impact on the accounts. Self-reversing entries are used to record transactions such as accruals, estimates and transactions that would otherwise be machine entries, made necessary after the general ledger cut-off. Non-machine transactions are entered through specific journal codes assigned to the various departments throughout the Company and are supported by batch numbers that are used to identify the actual entry into the general ledger. The use of non-machine entries is prevalent throughout all companies and processes, and has a significant impact on financial reporting.

The AIU Insurance Company 2005 Material Weakness Letter dated May 31, 2006; stated that Company controls to ensure the validity of journal entries into certain financially significant systems needed to be improved. Specifically, the Company needs to enhance its review of journal entries, ensuring that each entry is fully supported by robust and appropriate documentation.

During 2005, Company management began remediation efforts to address the control weakness. As part of the remediation effort, on December 1, 2005, a non-machine journal entry procedure went into effect throughout DBG that is required to be followed by all departments. The procedure requires that each non-machine entry have a cover page, a detailed journal entry, auditable support and a transaction posting report. The procedure also requires the preparer and approver to initial the auditable support attached to the journal entry for completeness and accuracy and that the journal entries be part of the monthly reconciliation process to ensure that each entry is accounted for and accompanied by adequate documentation.

To ensure compliance with the procedure, the Company established a Quality Control Department (“QCD”) to conduct periodic examinations of sample journal entries to ensure that the procedure is being followed and that the recorded transactions are accurate and complete. Non-machine transactions were sampled and reviewed by the QCD for compliance in 2006 on a quarterly basis. Initial QCD reviews in 2006 indicated that a primary concern was the lack of adequate auditable documentation supporting the journal entries reviewed which is consistent with examination findings relative to 2005 sampled transactions. By the fourth quarter of 2006, the Company received a high internal rating from the QCD for compliance with the procedure indicating that the entries posted to the general ledger have been reviewed and were posted completely and accurately. Before the control deficiencies noted in this process can be considered remediated, the Company will need to demonstrate that the improvements derived by the control enhancements are sustainable over several periods and that the results are independently verified. While enhancements to the control environment will continue to be developed and implemented, management expects the remediation of the control weaknesses in this process to be completed by the fourth quarter of 2007.

It is recommended that the Company continue its efforts to strengthen internal controls over its “non-machine key functional activity”.

(vii) DBG – Fusion

Fusion is an accounting and service unit responsible for post-bind service functions such as billing of premium and losses to the insured, program adjustments, and ensuring income statement and balance sheet integrity and customer service for complex accounts written by AIG for all Risk Management Group divisions, World Source and Global Energy. The annual gross written premium of these businesses is approximately \$5 billion of the \$32.7 billion written by AIG DBG.

The Company did not maintain effective controls to ensure the accuracy of certain balance sheet accounts in certain key segments of the Company's operations, including Fusion. Specifically, accounting personnel did not perform timely reconciliations and did not properly resolve reconciling items for premium and insurance balances receivable, reinsurance recoverable and other assets were misstated. This material weakness resulted in management concluding and the Company's independent auditor concurring that in the establishment of a FAS 5 reserve was required as of December 31, 2005.

Management undertook a 2005 reserve reassessment of all Fusion clients in a legal status (i.e., in bankruptcy, legal collection or a buyout situation) and established a FAS 5 provision in the amount of \$5.6 million as of December 31, 2005, with respect to this default exposure. In addition, a \$151.3 million provision for other contingent liabilities had been established for the Commercial Pool companies relating to potential premium tax underpayment for deductible policies and related settlements with regulatory authorities.

It is recommended that the Company continue its efforts to strengthen internal controls over its "Fusion" accounts.

(viii) Outstanding Loss Drafts

Outstanding loss drafts ("OLD") at December 31, 2005 on a pooled basis totaled \$1,415,474,005. The Company uses the term "OLD" for paid loss clearing. The OLD account is not related to outstanding loss drafts. This balance is net of approximately \$12 billion in unmatched debit amounts and \$10.5 billion in unmatched credits. The amount allocated to the Company based on its 1% pooling percentage is \$14,154,740 (1% of \$1,415,474,005). During the years 2004 and 2005 the Company was in the process of remediating this account. As of December 31, 2005, \$70 million in unsupported pooled debit amounts were reserved for future write off.

The remediation process has continued into years 2006 and 2007. In the third quarter of 2006, an additional unsupported \$225 million was reserved for future write-off. In the fourth quarter another \$111.5 million was reserved for future write-off. Unsupported December 31, 2005 balances of \$406.5 million have thus far been reserved for future write-off as of December 31, 2006. The Company's share of this reserve is \$4,065,000.

As of December 31, 2005, the Company continues to require significant outside resources to assist them in this remediation process. This is due to the fact that many of the numerous accounts, whose activity has flowed through the outstanding loss drafts account, have not been reconciled for many years. The Company continues to monitor activity in the OLD account. The examiners are uncertain whether additional reserves / write-offs of OLD amounts will be necessary.

It is recommended that the Company continue its efforts to reconcile and strengthen internal controls over the "OLD" accounts.

### 3. FINANCIAL STATEMENTS

#### A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2005 as determined by this examination and as reported by the Company:

<u>Assets</u>	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>
Bonds	\$1,716,134,909	\$ 0	\$1,716,134,909
Common stocks	576,000,344	0	576,000,344
Cash, cash equivalents and short-term investments	139,524,097	0	139,524,097
Other invested assets	27,640,382	0	27,640,382
Receivable for securities	1,145,460	0	1,145,460
Policy Loans	1,817,520	0	1,817,520
Investment income due and accrued	16,600,620	0	16,600,620
Uncollected premiums and agents' balances in the course of collection	441,923,115	11,997,479	429,925,636
Deferred premiums, agents' balances and installments booked but deferred and not yet due	38,745,458	311,470	38,433,988
Accrued retrospective premiums	856,737	85,674	771,063
Amounts recoverable from reinsurers	34,472,246	0	34,472,246
Funds held by or deposited with reinsured companies	17,437,125	0	17,437,125
Current federal and foreign income tax recoverable and interest thereon	113,383,765	0	113,383,765
Net deferred tax asset	57,149,300	50,856,000	6,293,300
Guaranty funds receivable or on deposit	558,304	0	558,304
Electronic data processing equipment and software	26,396,608	23,790,451	2,606,157
Furniture and equipment, including health care delivery assets	9,815,846	9,815,846	0
Receivables from parent, subsidiaries and affiliates	21,292,673	0	21,292,673
Health care and other amounts receivable	0	0	0
Deposit Accounting Asset	39,349,716	2,229,088	37,120,628
Loss Funds on Deposit	18,503,907	0	18,503,907
Accounts Receivable	17,658,248	0	17,658,248
Equities and Deposits in Pools and Associations	17,031,014	984,386	16,046,628
Outstanding Loss Drafts	14,154,740	0	14,154,740
Deposit Accounting Asset F/H	12,027,426	0	12,027,426
Amounts Receivable Under High Deductible Policies	9,233,698	462,240	8,771,458
Other Assets	39,398,171	39,098,805	299,366
Accrued Recoverables	188,330	0	188,330
Other Assets Non Admitted	72,520	72,520	0
Deposits	9,189,349	9,189,349	0
Memberships	537,734	537,734	0
Advances to Employees	41,498	41,498	0
Prepaid Expenses	7,606,945	7,606,945	0
Retroactive Reinsurance Recoverable	(236,944)	0	(236,944)
Allowance Provision	<u>(12,409,613)</u>	<u>0</u>	<u>(12,409,613)</u>
Totals	<u>\$3,413,241,248</u>	<u>\$157,079,485</u>	<u>\$3,256,161,763</u>

Liabilities, surplus and other funds

Losses	\$ 453,744,802
Reinsurance payable on paid losses and loss adjustment expenses	16,551,446
Loss adjustment expenses	75,761,787
Commissions payable, contingent commissions and other similar charges	73,098
Other expenses (excluding taxes, licenses and fees)	25,974,799
Taxes, licenses and fees (excluding federal and foreign income taxes)	3,058,440
Unearned premiums	421,694,150
Ceded reinsurance premiums payable (net of ceding commissions)	323,894,721
Funds held by company under reinsurance treaties	38,287,180
Amounts withheld or retained by company for account of others	870,316
Provision for reinsurance	136,611,041
Payable to parent, subsidiaries and affiliates	171,095,793
Policyholder Funds On Deposits	250,224,246
Other Liabilities	108,080,914
Liability for Pensions and Severance Pay	105,979,000
Accounts Payable Other	28,822,560
Deposit Accounting Liability F/H	27,956,273
Collateral Deposit Liability	14,048,741
Deposit Accounting Liability	13,525,287
Accrued Retrospective Premiums	1,406,220
Deferred Commission Earnings	1,049,650
Loss Clearing	378,068
Servicing Carrier Liability	164,394
Retroactive Reinsurance Payable	(338,108)
Retroactive Reinsurance - Ceded	<u>(893,080)</u>
Total liabilities	<u>\$2,218,021,738</u>
Special Surplus Fund	\$ 1,891,851
Common capital stock	8,000,000
Gross paid in and contributed surplus	154,786,801
Unassigned funds (surplus)	<u>873,461,373</u>
Surplus as regards policyholders	<u>\$1,038,140,025</u>
Totals	<u>\$3,256,161,763</u>

NOTE: The Internal Revenue Service has completed its audits of the Company's consolidated Federal Income Tax returns through tax year 1996. AIG has filed letters of protest for the 1997, 1998 and 1999 tax years. All material adjustments, if any, made subsequent to the date of examination and arising from said audits, are reflected in the financial statements included in this report. Audits covering tax years 2000 through 2002 are currently under examination. The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2003 through 2005. 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.

**4. LOSSES AND LOSS ADJUSTMENT EXPENSES**

The examination liability for the captioned items of \$546,058,035 is the same as reported by the Company as of December 31, 2005. The examination analysis was conducted in accordance with generally accepted actuarial principles and practices and was based on statistical information contained in the Company's internal records and in its filed annual statements.

## 5. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

<u>ITEM</u>	<u>PAGE NO.</u>	
<b>A. <u>Management</u></b>		
i. It is recommended that board members who are unable or unwilling to attend meetings consistently should resign or be replaced.	7	
The Company has complied with this recommendation.		
ii. It is recommended that the company include mention of its Japanese segment in its board of directors' minutes.	7	
The Company has complied with this recommendation.		
<b>B. <u>Reinsurance</u></b>		
It is recommended that the Company continue in its effort to electronically scan treaty reinsurance contracts and facultative reinsurance certificates, and that such scanned documentation be maintained in a secure central repository.	25	
The Company has complied with this recommendation.		
<b>C. <u>Holding company system</u></b>		
i. It is recommended that the inter-company agreements be submitted to the Department prior to their implementation, in accordance with the provisions of Section 1505(d)(2) and (3) of the New York Insurance Law.	28	
The Company has not fully complied with this recommendation. A similar recommendation is contained in the current report on examination.		
ii. Since indirect transactions affect the Company by virtue of the pooling agreement, it is recommended that the Company disclose these arrangements with the Department.	28	
The Company did not submit any indirect agreements for the years 2001 through 2004. In 2005, the Company agreed to file indirect agreements with the Department if filing of such agreements was required by the Pennsylvania Department of Insurance under the Pennsylvania Holding Company Act.		25

<u>ITEM</u>	<u>PAGE NO.</u>
D. <u>Accounts and Records</u>	
i. <u>Section 325 Plan</u>	
It is recommended that the Company file a revised 325(b) plan with the Department setting forth where the Company maintains its records.	30
The Company has complied with this recommendation.	
ii. <u>High Deductible on Policies Written in New York State</u>	
(a) The Company did not include deductible reimbursements when computing its New York corporate franchise tax. It is recommended that these amounts be included when computing the tax imposed by Section 1510 of the New York Corporate Franchise Tax Law.	31
The Company has complied with this recommendation.	
(b) The Company responded “no” to Annual Statement General Interrogatory when it should have responded “yes”. It is recommended that the Company exercise greater care when responding to this General Interrogatory.	31
The Company has complied with this recommendation.	
iii. <u>Maturity Refund Reserve</u>	
It is recommended that the Company disclose in Schedule E – Part 2 assets that have been earmarked for the benefit of its Japanese maturity refund policyholders.	32
The company has complied with this recommendation.	
iv. <u>Record Retention</u>	
It is recommended that the Company update its record retention policy to maintain documents in accordance with the Department Regulation 152.	32
The Company has complied with this recommendation.	
E. <u>Federal Income Tax Recoverable</u>	
It is recommended that the Company’s parent company settle its federal income tax recoverable with its affiliate promptly.	38
The Company has complied with this recommendation.	

ITEMPAGE NO.F. Losses

- i. It is recommended that AIG strive to improve the clarity and consistency of its actuarial analyses. Each reserve review should contain a clear summary of the estimates, separately by business segment and in total for all business segments combined. 38

The Company has complied with this recommendation.

- ii. It was also noted that, for some divisions, it was difficult to determine exactly what the final estimates were, since the results were not clearly presented in a uniform manner. It is recommended that the findings resulting from each reserve review be clearly presented. 38

The Company has complied with this recommendation.

G. Provision for Reinsurance

It is recommended that the Company include the necessary language pursuant to Section 1308(a)(2)(B) of the New York State Insurance Law prior to taking credit for reinsurance. 39

The Company is not in compliance with this recommendation. A similar recommendation is made in the current report on examination.

## 6. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Reinsurance</u>	
i.     It is recommended that all AIRCO “exit treaties” with the American Home and AIU Japan Branches contain all the required security clauses pursuant to Part 79.5 of Department Regulation No. 133.	15
ii.    It is recommended that the Japan Branch include insolvency clauses in its facultative certificates in compliance with Section 1308 of the New York State Insurance Law.	17
iii.   It is recommended that the Company obtain insolvency clauses in all of its locally placed treaties in compliance with Section 1308 of the New York Insurance Law.	18
iv.    It is recommended that the Company account for reinsurance contracts that lack a proper insolvency clause by disallowing all reserve credits and reinsurance recoverables under these agreements in accordance with the provisions of Section 1308(a)(2)(A) of the New York Insurance Law.	19
B. <u>Holding Company System</u>	
i.     It is recommended, as in the prior report on examination, that the Company file all of its inter-company agreements pursuant to Section 1505 of the New York Insurance Law and maintain complete documentation to evidence such filing. It is noted that in September 2005, the Company instituted procedures to address the lack of controls over the filing of affiliated reinsurance agreements.	23
ii.    It is recommended that the Company file the service agreement between AIG, Inc. and the AIG East Asia Management Holdings, Inc. with the Department pursuant to Section 1505(d)(3) of the New York Insurance Law as AIG East Asia Management Holdings, Inc. performs services for AIG, Inc. that directly relate to Japan Branch operations and would, customarily, be billed to the insurance entities.	24
iii.   It is recommended that the Company continue to file all indirect agreements with New York whenever filing is required under the materiality thresholds set forth in the Pennsylvania Insurance Department’s Holding Company Act.	25

<u>ITEM</u>	<u>PAGE NO.</u>
C. <u>Accounts and Records</u>	
i. <u>Custodian Agreements</u>	
It is recommended that the Company amend its foreign custodian agreements to conform to Section J of the NAIC Financial Examiners Handbook. Any specific local governmental requirements for descriptions of the branch and/or descriptions of the securities held under custody can be included in these agreements provided that these inclusions do not conflict with the requirements of Section J of the NAIC Financial Examiners Handbook.	26
ii. <u>Proper Aging of Reinsurance Premium Receivable Balances</u>	
It is recommended that the Company include assumed premium receivable balances in its calculation of statutory overdue balance calculations for ceding companies not authorized in New York in compliance with the provisions of Section 1301(a)(11) of the New York Insurance Law.	27
iii. <u>Uncollected Premiums and Agents' Balances in Course of Collection</u>	
It is recommended that the Company segregate its direct bill receivable balances from those due from agents when applying the unearned premium offset for the determination of over 90 days past due balances in accordance with the provisions of SSAP No. 6.	25
D <u>Internal Control Review</u>	
i. <u>Controls over income tax accounting</u>	
It is recommended that the Company continue its efforts to remediate the material weakness related to controls over federal income tax.	28
ii. <u>Controls over the accounting for certain derivative transactions</u>	
It is recommended that the Company continue its efforts to strengthen its internal controls over accounting for certain derivative transactions.	28
iii. <u>Controls over certain balance sheet reconciliations</u>	
It is recommended that the Company continue its efforts to strengthen internal controls over its balance sheet reconciliations.	29

<u>ITEM</u>		<u>PAGE NO.</u>
iv.	<u>Premium Key Functional Activity</u>	
	It is recommended that the Company continue its efforts to strengthen internal controls over its premium processing.	30
v.	<u>Non-Machine Key Functional Activities</u>	
	It is recommended that the Company continue its efforts to strengthen internal controls over its “non-machine key functional activity”	31
vi.	<u>DBG -Fusion</u>	
	It is recommended that the Company continue its efforts to strengthen internal controls over its “Fusion” accounts.	32
vii.	<u>OLD Accounts</u>	
	It is recommended that the Company continue its efforts to reconcile and strengthen internal controls over the “OLD” accounts.	33

Respectfully submitted,

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Patrick R. White, CFE

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

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

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Patrick R. White

Subscribed and sworn to before me

this \_\_\_\_\_ day of \_\_\_\_\_, 2008.

Appointment No. 21491

STATE OF NEW YORK  
INSURANCE DEPARTMENT

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

**Patrick White**

as proper person to examine into the affairs of the

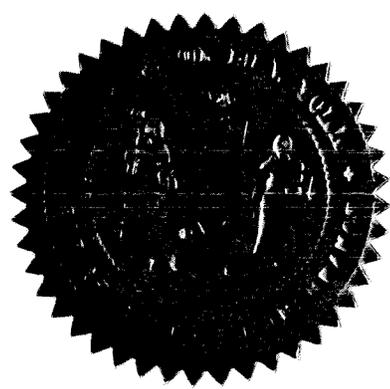
**AIU INSURANCE COMPANY**

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

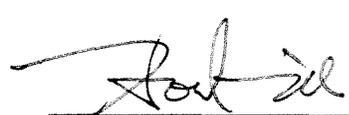
**Company**

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 13th day of April, 2006

  
\_\_\_\_\_  
HOWARD MILLS  
Superintendent of Insurance