

REPORT ON EXAMINATION

OF THE

COMMERCE AND INDUSTRY INSURANCE COMPANY

AS OF

DECEMBER 31, 2010

DATE OF REPORT

JUNE 14, 2012

EXAMINER

LAMIN JAMMEH

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NEW YORK STATE  
DEPARTMENT *of*  
FINANCIAL SERVICES

Andrew M. Cuomo  
Governor

Benjamin M. Lawskey  
Superintendent

June 14, 2012

Honorable Benjamin M. Lawskey  
Superintendent of Financial Services  
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 30584 dated August 24, 2010 attached hereto, I have made an examination into the condition and affairs of Commerce and Industry Insurance Company as of December 31, 2010, and submit the following report thereon.

Wherever the designation “the Company” appears herein without qualification, it should be understood to indicate Commerce and Industry 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 administrative office located at 180 Maiden Lane, New York, NY 10038

## **1. SCOPE OF EXAMINATION**

The Department has performed a coordinated group examination of the Company, a multi-state insurer. The previous examination was conducted as of December 31, 2005. This examination covered the five year period from January 1, 2006 through December 31, 2010. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner. The examination was conducted in conjunction with the Pennsylvania Insurance Department, which was the coordinating state for the examination of the companies who are members of and participate in an intercompany pooling arrangement known as the “Chartis U.S. Admitted Pool” (Admitted Pool) as referenced in Item 2C of this report under the caption “Reinsurance.” The examination was performed concurrently with the examinations of the following insurers: National Union Fire Insurance Company of Pittsburgh, Pa. (PA), Insurance Company of the State of Pennsylvania (PA), Granite State Insurance Company (PA), Chartis Property Casualty Company (PA), New Hampshire Insurance Company (PA), American Home Assurance Insurance Company (NY), Illinois National Insurance Co. (IL), and Chartis Casualty Company (PA).

This examination was conducted in accordance with the National Association of Insurance Commissioners (“NAIC”) Financial Condition Examiners Handbook (“Handbook”), which requires that we plan and perform the examination to evaluate the financial condition and identify 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 Statutory Accounting Principles and annual statement instructions when applicable to domestic state regulations.

All financially significant accounts and activities of the Company were considered in accordance with the risk-focused examination process. This examination also included a review and evaluation of the Company’s own control environment assessment and an evaluation based upon the Company’s ultimate parent’s Sarbanes Oxley documentation and testing. The examiners also relied upon audit work performed by the Company’s independent public accountants when appropriate.

This examination report includes a summary of significant findings for the following items as called for in the Handbook:

- Significant subsequent events
- Company history
- Corporate records
- Management and control
- Fidelity bonds and other insurance
- Pensions, stock ownership and insurance plans
- Territory and plan of operation
- Growth of Company
- Loss experience
- Reinsurance
- Accounts and records
- Statutory deposits
- Financial statements
- Summary of recommendations

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 that involve departures from laws, regulations or rules, or that are deemed to require explanation or description.

## **2. DESCRIPTION OF COMPANY**

The Company was incorporated under the laws of the State of New York on December 11, 1957, as the American Reciprocal Insurers. On June 6, 1966, ownership shifted when the Company was absorbed by merger with its organizer, the American Reciprocal. The subscribers of the reciprocal exchanged their equity in surplus funds for stock of the Company. Ownership passed to the Combined Insurance Company of America of Chicago, Illinois on February 15, 1968 through an exchange of shares. On July 15, 1968, American International Group, Inc. ("AIG") acquired financial control of the Company. The Company is a wholly-owned subsidiary of Chartis U.S., Inc., which is in turn a wholly-owned subsidiary of Chartis Inc., itself a wholly-owned subsidiary of American International Group, Inc ("AIG").

Capital paid in is \$3,198,000 consisting of 2,050,000 shares of \$1.56 par value per share common stock. The Department approved the Company's return of capital totaling \$668 million to

its immediate parent as of December 31, 2010. The return of capital was accomplished by reducing the par value of the common stock from \$2.45 per share to \$1.56 per share with a proportional reduction to the Company's gross paid in and contributed surplus. Gross paid in and contributed surplus is \$1,169,391,251.

Gross paid in and contributed surplus increased by \$489,079,208 during the examination period. For the period under examination, transactions attributed to changes in gross paid in and contributed surplus are grouped into three main categories as follows:

1. Restructuring
2. Capital Contributions/Return of Capital
3. Tax adjustments ("FIN48") and Life Settlements

#### Restructuring

At December 31, 2007, AIG contributed its 39.3% interest in 21st Century Insurance Group to the Company and certain of its other affiliates. This was recorded as a capital contribution of \$166 million. In connection with the restructuring of AIG's domestic property and casualty operations and the transfer of AIU Insurance Company to Chartis International LLC, the Company recorded a capital contribution of \$293 million. Upon the sale of the Company's interest in AIG's Personal Auto Group, the company recorded \$378 million of capital contributions.

#### Return of Capital

On December 31, 2010, the Department approved the Company's return of capital totaling \$668 million to its immediate parent. The return of capital was accomplished by reducing the par value of the Company's common stock from \$2.45 per share to \$1.56 per share with a proportional reduction to the Company's gross paid in and contributed surplus.

#### Tax Adjustments

Pursuant to Tax Sharing Agreement described in Section 2D of this Report, Chartis, Inc. assumes FIN 48 Federal income tax related tax liabilities from the Subgroup, of which the Company is a member. Movements of the tax reserves are accounted for through as deemed capital contributions for the relief of liabilities or deemed dividends for the assumption of assets. Any

subsequent adjustments to the liabilities (including adjustments for annual interest or penalties) that Chartis, Inc. has assumed are also accounted for at Chartis, Inc. Tax reserves assumed by Chartis Inc. are considered a “forgiveness of debt” and are treated as capital contribution as set forth in SSAP No. 72. Tax related contributions to surplus totaled approximately \$328 million during the examination period.

### Other

Life settlements contracts were taken out of the insurance companies’ books and placed under the “investment” activities to American International Reinsurance Company at fair value. The insurance companies recorded a gain, and the consequent tax impact from the gain was deferred. In 2008 AIG presented to the Internal Revenue Service an amended filing (2005 audit period), and part of the life settlement transaction was embedded in the filing. The ultimate resolution of the life settlement was recorded as a reduction in Gross paid in capital and contributed surplus in 2008 in the amount of \$16 million.

### A. Management

Pursuant to the Company’s charter and by-laws, management of the Company is vested in a board of directors consisting of not less than thirteen nor more than twenty-one members. As of December 31, 2010, there was one vacancy on the Board. The board meets at least once during each calendar year. At December 31, 2010, the board of directors was comprised of the following twelve members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
John Q. Doyle Rye, NY	Executive Vice President, Chartis Inc. President and Chief Executive Officer, Chartis U.S., Inc.
Peter J. Eastwood Norwell, MA	President and Chief Executive Officer, Lexington Insurance Company
David N. Fields New York, NY	Senior Vice President , Chief Reinsurance Officer, American International Group, Inc.
David L. Herzog St. Albans, MO	Executive Vice President & Chief Financial Officer, American International Group, Inc.
Louis P. Iglesias Huntington, NY	Chairman and Chief Executive Officer Commercial Casualty, Chartis U.S., Inc.

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Monika M. Machon New York, NY	Senior Vice President and Chief Investment Officer, American International Group, Inc.
Kristian P. Moor Fairfield, CT	President and Chief Executive Officer, Chartis Inc.
Ralph W. Mucerino Middletown, NJ	Senior Vice President, Chartis Inc. Chief Operating Officer, Chartis International, LLC Chairman, Chartis Global Marine and Energy
Siddhartha Sankaran New York, NY	Senior Vice President and Chief Risk Officer, American International Group, Inc.
Robert S. H. Schimek Newtown, PA	Executive Vice President and Chief Financial Officer, Chartis Inc.
Christopher L. Sparro Cortland Manor, NY	President, Specialty Markets, Chartis U.S., Inc.
Nicholas C. Walsh New York, NY	Vice Chairman, Chartis Inc. President and Chief Executive Officer, Chartis International, LLC
Mark T. Willis Naperville, IL	Executive Vice President, Chartis U.S., Inc.

A review of the minutes of the board of directors' meetings held during the examination period indicated that the meetings were generally well attended and each board member has an acceptable record of attendance.

As of December 31, 2010, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Kristian P. Moor	Chairman
John Q. Doyle	President, Chief Executive Officer
Sean T. Leonard	Senior Vice President, Chief Financial Officer
Denis M. Butkovic	Secretary

B. Territory and Plan of Operation

As of December 31, 2010, the Company was licensed to write business in all 50 states and the District of Columbia.

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

<u>Paragraph</u>	<u>Line of Business</u>
3	Accident & health
4	Fire
5	Miscellaneous property
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
24	Credit unemployment
26	Gap
27	Prize indemnification
28	Service contract reimbursement
29	Legal services
32	Substantially similar kind of insurance

Effective March 27, 2007, the Company's certificate of authority was amended to add the following lines of insurance: accident and health, credit, residual value, credit unemployment, prize indemnification, service contract reimbursement, and legal services insurance, as described in paragraphs 3, 17, 22, 24, 27, 28, and 29 Section 1113(a) of the New York Insurance Law

The Company is also authorized to write worker's compensation insurance as may be incident to coverages contemplated under paragraphs 20 and 21 of Section 1113, including coverages described in the Longshoremen's and Harbor Workers' Compensation Act and the kinds of insurance and reinsurance of every kind or description, including those located or resident outside of the United

States, its territories and possessions, 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 \$35,000,000.

The Admitted Pool companies accept business mainly from insurance brokers, enabling selection of specialized markets and retention of underwriting control. Any licensed insurance broker is able to submit business to the Admitted Pool companies, but such broker has no authority to commit the Admitted Pool companies to accept risk. In addition, the Admitted Pool companies utilize certain managing general agents and third party administrators for policy issuance and administration, underwriting, and claims adjustment services.

The Admitted Pool companies write substantially all lines of property and casualty insurance with an emphasis on U.S. commercial business including large commercial or industrial property insurance, excess liability, inland marine, environmental, workers' compensation and excess and umbrella coverages. Additionally, the Admitted Pool companies offer many specialized forms of insurance such as aviation, accident and health, warranty, equipment breakdown, directors' and officers' liability, difference in conditions, kidnap-ransom, export credit and political risk, and various types of errors and omissions coverages. Through the Private Client Group the Admitted Pool companies provide personal lines insurance to high net worth individuals.

The following schedule shows the direct premiums written by the Company both in total and in New York for the period under examination:

<u>Calendar Year</u>	<u>New York State</u>	<u>Total Premiums</u>	<u>Premiums Written in New York State as a percentage of Total Premium</u>
2006	\$133,496,933	\$1,761,473,456	7.58%
2007	\$109,420,025	\$1,254,087,801	8.73%
2008	\$104,282,276	\$ 969,288,698	10.76%
2009	\$103,986,270	\$ 940,795,605	11.05%
2010	\$ 73,325,597	\$ 920,000,698	7.97%

### C. Reinsurance

Assumed reinsurance accounted for 82% of the Company's gross premium written at December 31, 2010. The Company's assumed reinsurance business has decreased since the last examination. The Company's assumed reinsurance program consists primarily of its participation in the Inter-Company Reinsurance Pooling Agreement as described in the following section. The Company utilizes reinsurance accounting as defined in Statement of Statutory Accounting Principles No. 62 ("SSAP 62") for all of its assumed reinsurance business.

#### Pooling Agreement

The majority of the Company's assumed reinsurance emanated from its participation in an Inter-Company Reinsurance Pooling Agreement with eight affiliates. Pursuant to the terms of this agreement, the Company and the affiliated entities share in premiums, losses, and expenses based on their respective pool participation among the nine pool participants.

Business written by American Home Assurance Company's Japan Branch is excluded from this pooling agreement.

At December 31, 2010, the pool included the following wholly-owned subsidiaries of AIG:

<u>Pool Company</u>	<u>State of Domicile</u>	<u>Pool %</u>
National Union Fire Insurance Co. of Pittsburgh, Pa.	Pennsylvania	38%
American Home Assurance Company	New York	36%
Commerce and Industry Insurance Company	New York	11%
Chartis Property and Casualty Company	Pennsylvania	5%
New Hampshire Insurance Company	Pennsylvania	5%
The Insurance Company of the State of Pennsylvania	Pennsylvania	5%
Chartis Casualty Insurance Company	Pennsylvania	0%
Granite State Insurance Company	Pennsylvania	0%
Illinois National Insurance Co.	Illinois	0%

#### Compulsory Cessions Auxiliary Accounts

The Company is a member of an AIG internal facility known as the Compulsory Cessions Auxiliary Account ("CCAA"). The CCAA account allows AIG to retain business by ceding selected business to affiliated companies. The facility retains additional amounts over the retentions

determined by the profit center managers. The CCAA business is largely retained via management accounting rather than through reinsurance transactions.

The Company has structured its ceded reinsurance program as follows:

External treaty reinsurance is placed by AIG's Global Reinsurance Division ("GRD"). Reinsurance officers within GRD are aligned with specific AIG Profit Centers and are responsible for determining structures, negotiating, and placing individual treaty reinsurance programs. GRD's Catastrophe ("CAT") Unit reviews, analyzes, and assists in placing AIG's overall CAT reinsurance. GRD places reinsurance for various legal entities within AIG. AIG maintains extensive reinsurance, with programs placed with U.S. domestic, international and offshore reinsurance facilities. Management's goal is to fully place its traditional excess of loss catastrophe reinsurance cover in order to limit the effect of a severe catastrophic event. AIG's reinsurance strategy is to retain a higher amount of low layer exposures, which could be absorbed through its earnings stream.

It is the Company's policy to obtain the appropriate collateral for its cessions to unauthorized reinsurers. A sample of letters of credit and trust accounts obtained by the Company to take credit for cessions to unauthorized reinsurers were reviewed for compliance with Department Regulations 133 and 114, respectively; no exceptions were noted. The Company also reduces its provision for reinsurance pursuant to the provisions of Parts 125.4(e) and (f) of Department Regulation 20. Examination review indicated that the Company maintained the documentation required by the Regulation.

As a party to various treaty and facultative agreements, the Company reinsures the business it writes in order to maximize protection, provide capacity, reduce volatility, and make the best use of market capacity. The Treaty business is further broken down into pro-rata and excess of loss agreements. Facultative reinsurance is purchased to provide added capacity or coverages that are not included in specific treaty agreements. Catastrophe agreements are bought to protect the net of the AIG companies for both property and workers' compensation exposures. Lines of business covered under various reinsurance protections include commercial and personal property, primary and excess casualty, environmental, marine, aviation, directors and officers, errors and omissions, medical and professional liability, and fidelity business.

Major excess of loss, catastrophe, and quota share treaties are summarized below:

## Property Catastrophe

AIG purchases catastrophe protection for its commercial and personal lines business. The domestic property catastrophe reinsurance program as of December 31, 2010 is set forth in the following table:

Cover		All Peril	Wind only	Cat Coverage Earthquake Only	Total Wind	Total Earthquake	
\$ 500,000,000	X	\$1,000,000,000	-	-	\$ 50,000,000	-	\$ 50,000,000
500,000,000	X	1,500,000,000	-	-	-	-	
500,000,000	X	2,000,000,000	102,250,000	-	-	102,250,000	102,250,000
500,000,000	X	2,500,000,000	275,000,000	-	-	275,000,000	275,000,000
500,000,000	X	3,000,000,000	225,000,000	50,000,000	120,000,000	275,000,000	345,000,000
500,000,000	X	3,500,000,000	-	400,000,000	460,000,000	400,000,000	460,000,000
500,000,000	X	4,000,000,000	304,700,000	-	145,000,000	304,700,000	449,700,000
500,000,000	X	4,500,000,000	475,000,000	-	-	475,000,000	475,000,000
500,000,000	X	5,000,000,000	-	-	-	-	
500,000,000	X	5,500,000,000	-	-	-	-	
500,000,000	X	6,000,000,000	471,100,000	-	-	471,100,000	471,100,000
500,000,000	X	6,500,000,000	262,100,000	-	-	262,100,000	262,100,000
729,068,000	X	5,144,603,000	475,000,000	-	-	475,000,000	475,000,000
1,000,000,000	X	5,000,000,000	250,000,000	-	-	250,000,000	250,000,000
1,000,000,000	X	6,500,000,000	175,000,000	-	-	175,000,000	175,000,000
Wind	X	2,500,000,000	-	50,000,000	-	50,000,000	-
Total		\$ 3,015,150,000	\$ 500,000,000	\$ 775,000,000	\$ 3,515,150,000	\$ 3,790,150,000	

\* Cat Bonds

The \$1 billion excess of \$5 billion layer is covered by means of a Lodestone CAT Bond. The Company placed \$250 million of that layer in the CAT Bond Market, covering Hurricane and Earthquake. The \$1 billion excess of \$6.5 billion layer is also covered by means of a Lodestone CAT Bond. The Company placed \$175 million of this layer in the CAT Bond Market, covering Hurricane and Earthquake.

During 2010 the Company also obtained a Workers' Compensation CAT program (\$320,000,000 p/o \$500,000,000 excess of \$500,000,000). In addition, the Company purchased quota share protection for Aviation Hull exposures, Fidelity, eCommerce and Environmental Liability.

National Union Fire Insurance Company of Pittsburgh, Pa. ("NUFIC"), on behalf of itself and its affiliates, entered into two reinsurance agreements with Lodestone Re Ltd. ("Lodestone"), a special-purpose insurer ("SPI"), whose financing is primarily derived through a debt offering of two series of risk-linked securities ("CAT bonds"). Via the reinsurance agreements, Lodestone assumes cat excess of loss exposure from NUFIC, and issues CAT bonds to investors that transfer the risk assumed by Lodestone to the bondholders. The CAT bonds are structured as floating rate bonds

whose principal is lost if specified trigger conditions are met. If a natural catastrophe triggers the excess of loss layers, the principal is paid to NUFIC. By establishing this structure, NUFIC has accessed capital markets rather than entering into a traditional excess of loss reinsurance contract, and has set rates for multiple years. If no loss triggers the contracts, NUFIC will have paid approximately \$100 million in premium for this coverage over three years. Based upon the Companies representations to the examiners regarding the non-ownership of any of the CAT bonds (same representations were made to the external CPA firm), there are no SSAP 62 issues with the CAT bonds.

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

A sample of 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 reinsurance transactions. Additionally, management has represented that all material ceded reinsurance agreements transfer both underwriting and timing risk as set forth in SSAP 62R with the exception of those agreements that were accounted for as Deposit Accounting in accordance with SSAP No. 75. Representations were supported by appropriate risk transfer analyses and an attestation from the Company's Chief Executive Officer pursuant to the NAIC Annual Statement Instructions. Additionally, examination review indicated that the Company was not a party to any finite reinsurance agreements. With the exception of matters noted in the Reinsurance Attestation Supplement filed with the Company's Annual Statement, all ceded reinsurance agreements were accounted for utilizing reinsurance accounting as set forth in SSAP 62.

During the period covered by this examination, the company commuted various reinsurance agreements where it is was a ceding/assuming reinsurer. These commutations resulted in a net loss to the Company's surplus position in the amount of \$154.6 million.

D. Holding Company System

The Company is a direct wholly owned subsidiary of Chartis U.S., Inc., a Delaware Corporation, which in turn is owned by Chartis Inc., a Delaware Corporation. The Company's ultimate parent is American International Group, Inc. ("AIG"), a publicly traded company.

AIG reports the results of its operations through the following three reportable segments:

- **Chartis** — AIG's property and casualty operations are conducted through multiple line companies writing substantially all commercial and consumer lines both domestically and abroad.
- **SunAmerica Financial Group (SunAmerica)** — SunAmerica offers a comprehensive suite of products and services to individuals and groups, including term life, universal life, accident and health (A&H), fixed and variable deferred annuities, fixed payout annuities, mutual funds and financial planning.
- **Financial Services** — AIG's financial services businesses engage in commercial aircraft leasing through International Lease Finance Corporation (ILFC) and the remaining Capital Markets portfolios through AIG Financial Products Corp. and AIG Trading Group Inc. and their respective subsidiaries (collectively, AIGFP).

The Company is part of the AIG holding company structure, which includes insurance companies, management companies, agencies and other enterprises doing business in all states of the United States and around the world. The parent company, AIG, is a publicly traded company.

In September, 2008, AIG experienced a severe strain on its liquidity that resulted in AIG entering into an \$85 billion revolving credit facility and a guarantee and pledge agreement with the Federal Reserve Bank of New York ("FRBNY"). Pursuant to the credit facility agreement, on March 4, 2009, AIG Issued 100,000 shares of Series C Perpetual, Convertible, Participating Preferred Stock (the "Series C Preferred Stock") to the AIG Credit Facility Trust, a trust established for the sole benefit of the United States Treasury. The Credit Facility obligations were guaranteed by certain subsidiaries of AIG and the obligations were secured by a pledge of certain assets of AIG and its subsidiaries. The Series C Preferred Stock is entitled to:

- (i) Participate in any dividends paid on the common stock, with the payments attributable to the Series C Preferred Stock being approximately 79.9 percent of the aggregate dividends paid on AIG's common stock, treating the Series C Preferred Stock as converted, and
- (ii) To the extent permitted by law, vote with AIG's common stock on all matters submitted to AIG shareholders and hold approximately 79.9 percent of the aggregate voting power of the common stock, treating the Series C Preferred Stock as converted. The Series C

preferred Stock will remain outstanding even if the credit facility is repaid in full or otherwise terminates.

In November 2008 and April 2009, AIG also issued preferred securities to the United States Department of the Treasury under the Troubled Asset Relief Program (“TARP”). At December 31, 2010, ownership of AIG was split between the AIG Credit Facility Trust, which held approximately 79% of the voting power, and public shareholders, who held approximately 21% of the voting power.

Pursuant to Part 80-1.4 of New York Regulation 52, all controlled insurers are required to file an annual holding company registration statement (Form HC1) within 120 days following the end of its ultimate holding company’s fiscal year. A review of the Holding Company Registration Statements filed with this Department indicated that such filings were complete and were filed in a timely manner.

At December 31, 2010, the Company was party to the following agreements with other members of its holding company system:

#### Service and Expense Agreement

The Company and other affiliates are party to a Service and Expense Sharing Agreement with AIG. Pursuant to the terms of this agreement, AIG and/or any of its affiliates may provide the services and facilities specified in the agreement, at cost, to any named party to the agreement. Services include: Law, Investment, EDP, Internal Audit, Actuarial, Claims, Underwriting, Accounting, Tax, and Employee Benefits. This Service and Expense Sharing Agreement has been amended multiple times to add additional affiliates.

#### Tax Sharing Agreement

The Company is party to a written tax sharing agreement with Chartis, Inc. (“Subgroup Parent”), which was amended, effective January 1, 2010, which provides that Subgroup Parent will not charge the Company a greater portion of the consolidated tax liability than would have been paid by the Company if it had filed a separate federal income tax return. Subgroup Parent also has a separate tax sharing agreement with AIG (“Parent”), which provides that AIG will not charge Subgroup Parent a greater portion of the consolidated tax liability than would have been paid by the Chartis Subgroup if it had filed a separate federal income tax return. Additionally, the Company’s amended tax sharing agreement contains the following significant requirements:

- A tax Subgroup was formed with Chartis, Inc. as the Subgroup Parent. The Company will settle inter-company income taxes with the Subgroup Parent as if the Company were filing its own separate federal income tax return. Any net liability will be settled with the Subgroup Parent in accordance with federal estimated tax payment requirements with final payments/refunds paid within 30 days after Subgroup Parent makes or receives a final payment to or receipt of refund from Parent.
- Any tax realized by the Company from triggering a deferred inter-company gain (as determined under Treasury regulation Section 1.1502-13) in which no consideration was received will be paid by the Subgroup Parent.
- Chartis, Inc. assumes the Company's Tax Reserves in a deemed capital contribution transaction. Tax Reserves mean any liability recorded in accordance with Financial Accounting Standards Board Interpretation No. 48 – Accounting for Uncertainty in Income Taxes (FIN 48) and any tax liability recorded as the result of an agreed upon adjustment with the tax authorities, except ones arising as a result of errors or omissions.

In accordance with N.Y. Department of Insurance Circular Letter 1979-33, Subgroup Parent shall establish and maintain an escrow account for amounts where the Company's separate return liability exceeds the consolidated tax liability of the Parent group

#### Capital Maintenance Agreement

This agreement provides that in the event that the Company's Total Adjusted Capital (TAC) falls below 200% of the Company's authorized control level (ACL) risk based capital (RBC), AIG will provide a capital contribution to the Company in an amount that equals the difference between the Company's TAC and 200% of the Company's ACL RBC. The Company was party to additional Capital Maintenance Agreements as described in the "Subsequent Events" section of this report.

#### Investment Advisory Agreements

The Company is party to an agreement with AIG Asset Management (U.S.), LLC ("Manager") to provide investment advisory services to include investment advisory account. 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 will 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. Within 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.

### Program Administration Agreement

The Company received Department approval to enter into several program administrator agreements with certain risk specialists (“program administrators”) companies whereby the program administrators will provide insurance placement and other program administration services to the commercial pool members. Services provided include assisting the Company in developing producer and underwriting guidelines and modifications thereto for the underwriting program, processing applications for insurance, and collecting and accounting for premiums and endorsing checks payable to the Company.

### Administrative Services Agreement

Effective May 7, 2007, the Company and certain affiliates entered into an administrative service agreement with Integra (f/k/a AIG Business Processing Services Inc) (“BPS”). Pursuant to the agreement BPS shall provide certain administrative and accounting services relating to the Company’s business operations including call center operations, data entry, indexing processes, basic policyholder service updates and, accounts payable processing. The Agreement was assigned effective November 1, 2010 to Chartis Technology and Operations Management Corporation (Philippines) (formerly AIU Technology and Operations Management Corporation).

### E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2010, based upon the results of this examination:

Net premiums written to surplus as regards policyholders	72%
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	103%
Premiums in course of collection to surplus as regards policyholders	7%

The ratio of adjusted liabilities to liquid assets of 103% is above the benchmark ratio of 100%. All of the other above ratios fall within the benchmark ranges set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners.

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

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss adjustment expenses incurred	\$7,784,041,013	82.61%
Other underwriting expenses incurred	2,211,455,965	23.47
Net underwriting loss	<u>(572,587,731)</u>	<u>(6.08)</u>
Premiums earned	<u>\$9,422,909,247</u>	<u>100.00%</u>

### 3. FINANCIAL STATEMENTS

#### A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2010 as determined by this examination and as reported by the Company:

<u>Assets</u>	<u>Assets</u>	<u>Examination</u> Assets Not <u>Admitted</u>	Net Admitted <u>Assets</u>
Bonds	\$5,416,905,724	\$ 0	\$5,416,905,724
Preferred stocks	23,202,349	0	23,202,349
Common stocks	557,035,615	37,557,859	519,477,756
Cash, cash equivalents and short-term investments	152,336,179	0	152,336,179
Other invested assets	664,835,481	0	664,835,481
Receivables for securities	232,125	0	232,125
Investment income due and accrued	66,548,966	0	66,548,966
Uncollected premiums and agents' balances in the course of collection	173,109,385	48,231,180	124,878,205
Deferred premiums, agents' balances and installments booked but deferred and not yet due	125,467,588	215,854	125,251,734
Accrued retrospective premiums	459,419,381	17,083,668	442,335,713
Amounts recoverable from reinsurers	120,481,073	0	120,481,073
Funds held by or deposited with reinsured companies	12,669,443	0	12,669,443
Current federal and foreign income tax recoverable and interest thereon	89,481,055	89,481,055	0
Net deferred tax asset	387,284,613	33,946,696	353,337,917
Guaranty funds receivable or on deposit	3,727,396	0	3,727,396
Electronic data processing equipment and software	12,705,869	12,705,869	0
Receivables from parent, subsidiaries and affiliates	58,738	0	58,738
Notes receivable commutation	11,308,406	0	11,308,406
Notes receivable commutation	(11,308,406)	0	(11,308,406)
Equities and deposits pools and association	180,191,919	14,724,816	165,467,103
Paid loss clearing	97,262,024	0	97,262,024
Other assets	40,620,086	1,281,802	39,338,284
Deposit accounting assets-funds held	27,046,324	0	27,046,324
Loss funds on deposits	9,199,519	0	9,199,519
Amounts receivable under high deductible policies	20,416,458	10,348,955	10,067,503
Retroactive reinsurance recoverable	389,354	0	389,354
Deposit accounting assets	209,544	0	209,544
Allowance for uncollectible accounts provision	(63,778,718)	0	(63,778,718)
Intangible asset-from sale of affiliate	<u>152,938,577</u>	<u>152,938,577</u>	<u>0</u>
Total assets	<u>\$8,729,996,067</u>	<u>\$418,516,331</u>	<u>\$8,311,479,736</u>

Liabilities, Surplus and Other FundsLiabilities

Losses and loss adjustment expenses	\$4,328,588,128
Reinsurance payable on paid losses and loss adjustment expenses	47,386,282
Commissions payable, contingent commissions and other similar charges	(268,981)
Other expenses (excluding taxes, licenses and fees)	5,802,947
Taxes, licenses and fees (excluding federal and foreign income taxes)	63,530,577
Net deferred tax liability	8,583,255
Unearned premiums	867,410,019
Ceded reinsurance premiums payable (net of ceding commissions)	110,949,993
Funds held by company under reinsurance treaties	40,313,191
Amounts withheld or retained by company for account of others	3,806,897
Remittances and items not allocated	8,685,855
Provision for reinsurance	29,337,859
Payable to parent, subsidiaries and affiliates	688,734,110
Derivatives	2,762,459
Payable for securities	19,517,711
Collateral deposit liability	103,973,403
Deposit accounting liabilities	58,022,253
Other liabilities	12,721,857
Accrued retrospective premium	19,754,350
Servicing carrier liabilities	1,710,339
Deferred commission earnings	1,331,345
Retroactive reinsurance reserves – ceded	640,616
Loss clearing	542,916
Retroactive reinsurance payable	384,534
Deposit accounting liability – funds held	<u>302,500</u>
Total liabilities	<u>\$6,424,524,415</u>

Surplus and Other Funds

Special surplus SSAP 10R	\$ 243,994,887
Special surplus from retroactive reinsurance	151,005
Common capital stock	3,198,000
Gross paid in and contributed surplus	1,169,391,251
Unassigned funds (surplus)	<u>470,220,179</u>
Surplus as regards policyholders	<u>1,886,955,322</u>
Total liabilities, surplus and other funds	<u>\$8,311,479,736</u>

NOTE: The Internal Revenue Service has completed its audits of the consolidated Federal Income Tax returns through tax year 1999. 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 2006 are currently under examination. The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2007 through 2010. 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

Surplus as regards policyholders increased \$602,861,943 during the five-year examination period January 1, 2006 through December 31, 2010, detailed as follows:

Underwriting Income

<u>Premiums earned</u>		\$9,422,909,247
<u>Deductions:</u>		
Losses and loss adjustment expenses incurred	\$7,784,041,013	
Other underwriting expenses incurred	2,222,103,965	
Other underwriting deductions	<u>(10,648,000)</u>	
Total underwriting deductions		<u>9,995,496,978</u>
Net underwriting gain or (loss)		\$ (572,587,731)

Investment Income

Net investment income earned	\$1,572,930,632	
Net realized capital gain	<u>179,106,441</u>	
Net investment gain or (loss)		1,752,037,073

Other Income

Net gain or (loss) from agents' or premium balances charged off	\$ (68,874,866)	
Finance and service charges not included in premiums	10,559,072	
Aggregate write-ins for miscellaneous income	<u>63,516,332</u>	
Total other income		<u>5,200,538</u>
Net income before dividends to policyholders and before federal and foreign income taxes		\$1,184,649,880
Dividends to policyholders		<u>511,575</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$1,184,138,305
Federal and foreign income taxes incurred		<u>159,774,048</u>
Net Income		<u>\$1,024,364,257</u>

Surplus as regards policyholders per report on examination as of December 31, 2005			\$1,284,093,379
	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income	\$1,024,364,257		
Net unrealized capital gains or (losses)		103,217,786	
Change in net unrealized foreign exchange capital gain or (loss)		3,612,033	
Change in net deferred income tax		29,749,362	
Change in nonadmitted assets		132,809,556	
Change in provision for reinsurance	51,054,153		
Cumulative effect of changes in accounting principles		3,207,420	
Capital changes paid in		1,824,500	
Surplus adjustments paid in	472,686,197		
Dividends to stockholders		750,220,345	
Aggregate write-ins for gains and losses in surplus	<u>79,398,338</u>	<u>0</u>	
Net increase (decrease) in surplus	<u>\$1,627,502,945</u>	<u>\$1,024,641,002</u>	<u>\$ 602,861,943</u>
Surplus as regards policyholders per report on examination as of December 31, 2010			<u>\$1,886,955,322</u>

#### **4. LOSSES AND LOSS ADJUSTMENT EXPENSES**

The examination liability for the captioned items of \$4,328,588,128 is the same as reported by the Company as of December 31, 2010. 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 SUBSEQUENT EVENTS**

On January 14, 2011, AIG completed a series of integrated transactions (the "Recapitalization") with FRBNY, the Department of Treasury and the Trust to recapitalize AIG. AIG repaid to the FRBNY approximately \$21 billion in cash, representing complete repayment of the credit facility, and the FRBNY credit facility was terminated. In addition, the following occurred:

- (i) The shares of the Series C Preferred Stock held by the Trust were exchanged for 562,868,096 shares of AIG common stock and were subsequently transferred by the Trust to the Department of Treasury,
- (ii) The shares of AIG's Series E Fixed Rate Non-Cumulative Preferred Stock, par value \$5.00 per share, held by the Department of Treasury were exchanged for 924,546,133 shares of AIG common stock; and

- (iii) The shares of AIG's Series F Fixed Rate Non-Cumulative Perpetual Preferred Stock, held by the Department of Treasury were exchanged for:
- (a) Preferred interest in two special purpose vehicles,
  - (b) 20,000 shares of AIG's Series G Cumulative Mandatory Convertible Preferred Stock, par value \$5.00 per share, a new series of TARP Preferred stock, and
  - (c) 167,623,733 shares of AIG common stock. As a result of these transactions, The Department of Treasury owned 1,655,037,962 shares of newly issued AIG Common Stock, representing ownership of approximately 92 percent of the outstanding AIG common stock at December 31, 2010. After the exchange and distribution were completed, the Trust terminated pursuant to the terms and conditions of the agreement that established the Trust.

On February 25, 2011, the Company entered into a Capital Maintenance Agreement (CMA) with AIG. The CMA provides that in the event that the Company's TAC falls below 425% of the ACL RBC, as estimated by the Company at the end of the first and third fiscal quarters, subject to any adjustments or modifications required by the Company's domiciliary regulator or its independent auditors, AIG will, within a specified time period prior to the close of the following fiscal quarter, contribute cash, cash equivalents, securities or other acceptable instruments that qualify as admitted assets to the Company so that the Company's TAC is projected to be equal to 425% of its ACL RBC as of the second and fourth fiscal quarters. The current CMA superseded and replaced the CMA described in Section 2D of this report.

Effective February 17, 2012, the Company, together with the members of the Admitted Pool, the Chartis U.S. Surplus Lines Pool and AIU Insurance Company (collectively, the "Fleet") entered into a Capital Maintenance Agreement with AIG and Chartis Inc. ("AIG CMA"). The AIG CMA provides that in the event that the Fleet's TAC falls below the specified minimum percentage of 350 percent of the Fleet's ACL RBC as estimated by Chartis Inc. on a semiannual basis subject to any adjustments or modifications required by the Company's domiciliary regulator or its independent auditors (the "SMP"), AIG will, within a specified time period prior to the close of the following fiscal quarter, contribute cash, cash equivalents, securities or other acceptable instruments that qualify as admitted assets to the Fleet so that the Fleet's TAC is projected to be equal to or greater than the SMP of the upcoming year-end. Additionally, each of Chartis and each Fleet member agreed, subject to approval by its board of directors and, if necessary, its domestic regulator, as applicable, to pay dividends that will be paid to AIG up to an amount equal to the lesser of (i) the amount necessary to

reduce the Fleets ACL RBC to an amount not materially greater than the SMP or (ii) the maximum ordinary dividends permitted by any applicable domiciliary regulator.

Effective February 17, 2012, the Fleet entered into a CMA (Chartis CMA) with Chartis Inc., Chartis U.S., Inc. and Chartis International, LLC (the Chartis entities). The Chartis CMA provides that in the event that the Fleet's TAC exceeds the SMP (as determined pursuant to the terms of the AIG CMA) while at the same time any Fleet member, as an individual legal entity, has a Total Adjusted Capital below 300 percent of such Company's ACL RBC (the "Individual Entity Minimum Percentage") (as determined by Chartis pursuant to the methodology set forth in the AIG CMA that is used to determine the SMP), the Chartis Entities and each Fleet member agree to make contributions, pay dividends or cause other transactions to occur that would result in each Fleet member's TAC being above the Individual Entity Minimum Percentage. No Fleet member is required to pay any dividend which would trigger the extraordinary dividend provisions of its domiciliary state or that is otherwise prohibited by such state.

The Capital Maintenance Agreements effected in 2012 superseded the CMA effective February 25, 2011.

On March 31, 2011, the member companies of the Admitted Pool, including the Company, and certain other Chartis affiliated insurers (collectively, the "Chartis Reinsureds") entered into a loss portfolio transfer reinsurance agreement ("Asbestos Reinsurance LPT"), with an inception date of January 1, 2011, with Eaglestone Reinsurance Company (Eaglestone), an affiliate. Under the Asbestos Reinsurance LPT, the Chartis Reinsureds transferred all of their net (net of discount and net of external reinsurance) U.S. asbestos liabilities to Eaglestone which is presented as a paid loss impacting prior accident years. The Chartis Reinsureds made an adjusted initial payment of \$2,790,351,000 to Eaglestone (representing the net carrying value of their asbestos reserves as of January 1, 2011) and Eaglestone agreed to provide coverage up to an aggregate limit of \$5,000,000,000 on the assumed asbestos portfolio. The Company's share of the net reserves (and payment) assumed by Eaglestone was \$239.5 million.

Eaglestone and the Chartis Reinsureds received the required regulatory approvals to enter into the Asbestos Reinsurance LPT. The transaction closed and settled on May 13, 2011. Eaglestone and the Chartis Reinsureds recorded the transaction as prospective reinsurance in accordance with SSAP 62R.

On June 17, 2011, Eaglestone and the Chartis Reinsureds completed a transaction, effective as of January 1, 2011, with National Indemnity Company (NICO), a subsidiary of Berkshire Hathaway Inc., under which the bulk of the Chartis Reinsureds' U.S. asbestos liabilities that were assumed by Eaglestone under the Asbestos Reinsurance LPT were transferred through a reinsurance agreement by Eaglestone to NICO. The transaction with NICO covers potentially volatile U.S.-related asbestos exposures. The NICO transaction does not cover asbestos accounts that the Chartis Reinsureds believe have already been reserved to their limit of liability or certain other ancillary asbestos exposures of Chartis affiliates. In addition to its assumption of the subject asbestos liabilities and as included as part of its liability under the reinsurance agreement with Eaglestone, NICO assumed the collection risk on the Chartis Reinsureds' third party reinsurance recoverables with respect to the asbestos reserves NICO assumed.

#### Excess Workers' Compensation Loss Portfolio Transfer

On March 31, 2011, the member companies of the Admitted Pool, including the Company entered into a loss portfolio transfer agreement (Excess Workers' Compensation Reinsurance LPT), with an inception date of January 1, 2011, with Eaglestone to transfer \$2,720,102,000 of net excess workers' compensation liabilities to Eaglestone on a funds withheld basis. Eaglestone established an initial "funds withheld" asset in the aggregate of \$2,720,102,000 and agreed to provide coverage up to an aggregate limit of \$5,500,000 on the assumed exposures. The Company transferred \$299 million in reserves to Eaglestone in this transaction.

On March 13, 2012, the Department of the Treasury completed a registered public offering of AIG common stock, in which it sold 206,896,552 shares of AIG common stock. AIG purchased 103,448,276 shares in the offering for an aggregate purchase amount of approximately \$3 billion. As a result of the Department of the Treasury's sale of AIG common stock and AIG's purchase of shares in this offering, ownership by the Department of the Treasury was reduced to approximately 70% of the AIG common stock outstanding after the completion of the offering.

On May 10, 2012, the Department of the Treasury completed a registered public offering of AIG common stock, in which it sold 188,524,589 shares (including 24,590,163 shares sold pursuant to the exercise in full of the underwriters' over-allotment option) of AIG common stock. AIG purchased 65,573,770 shares in the offering for an aggregate purchase amount of approximately \$2 billion. As a result of the Department of the Treasury's sale of AIG common stock and AIG's

purchase of shares in this offering, ownership by the Department of the Treasury was reduced to approximately 61% of the AIG common stock outstanding after the completion of the offering.

## 6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination contained 14 recommendations as follows (page numbers refer to the prior report):

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Reinsurance</u> It is recommended that the Company comply with the provisions of Department Regulation 114 when utilizing trust agreements to calculate its provision for reinsurance.  The Company has complied with this recommendation	12
B. <u>Holding Company System</u>	
i. It is recommended that the Company file all 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.  The Company has complied with this recommendation	18
ii. It is recommended that the Company continue to file indirect agreements with the Department whenever filing is required under the materiality thresholds set forth in the Pennsylvania Insurance Department's Holding Company Act. The Company has complied with this recommendation	19
C. <u>Accounts and Records</u>	
i. <u>Agents balances in course of collection</u> It is recommended that the Company segregate its direct bill receivable balances from those due from agents in the calculation of its statutory penalty for over 90 days past due balances in accordance with the guidelines of SSAP No. 6.  The Company has complied with this recommendation	19
ii. <u>Schedule D Reporting</u> It is recommended that, for future annual statement filings, the Company comply with the NAIC Property and Casualty Annual Statement Instructions when reporting loaned securities on Schedule D- Part 1.  The Company has complied with this recommendation.	20

ITEMPAGE NO.D. Internal Controls

- i. Controls Over Income Tax Accounting  
It is recommended that the Company continue its efforts to remediate the material weakness related to controls over federal income tax. 21
- This item was not yet remediated. The Company continues to remediate the internal control deficiency for income tax accounting
- ii. Controls Over The Accounting For Certain Derivative Transactions  
It is recommended that the Company continue its efforts to strengthen its internal controls over accounting for certain derivative transactions. 21
- The Company has complied with this recommendation
- iii. Controls Over Certain Balance Sheet Reconciliations  
It is recommended that the Company continue its efforts to strengthen internal controls over its balance sheet reconciliations 21
- The Company has complied with this recommendation
- iv. Premium Key Functional Activity  
It is recommended that the Company continue its efforts to strengthen internal controls over its premium processing. 22
- The Company has complied with this recommendation
- v. Non-Machine Key Functional Activities  
It is recommended that the Company continue its efforts to strengthen internal controls over its “non-machine key functional activity”. 24
- The Company has complied with this recommendation
- vi. DBG –Fusion  
It is recommended that the Company continue its efforts to strengthen internal controls over its “Fusion” accounts. 25
- The Company has complied with this recommendation
- vii. OLD Accounts  
It is recommended that the Company continue its efforts to reconcile the “OLD” accounts and to strengthen internal controls over these accounts. 25
- The Company has complied with this recommendation

7. **SUMMARY OF COMMENTS AND RECOMMENDATIONS**

This report contains no comments or recommendations.

Respectfully submitted,

\_\_\_\_\_/s/\_\_\_\_\_  
Lamin Jammeh  
Senior Insurance Examiner

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

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

\_\_\_\_\_/s/\_\_\_\_\_  
Lamin Jammeh

Subscribed and sworn to before me  
this \_\_\_\_\_ day of \_\_\_\_\_, 2012.

*Appointment No. 30584*

*STATE OF NEW YORK  
INSURANCE DEPARTMENT*

*I, James J. Wrynn Superintendent of Insurance of the State of New York,  
pursuant to the provisions of the Insurance Law, do hereby appoint:*

**Lamin Jammeh**

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

**COMMERCE & INDUSTRY 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 24th day of August, 2010*



*James J. Wrynn*

JAMES J. WRINN

*Superintendent of Insurance*