

REPORT ON EXAMINATION

OF THE

WESTCHESTER FIRE INSURANCE COMPANY

AS OF

DECEMBER 31, 2002

DATE OF REPORT

FEBRUARY 10, 2006

EXAMINER

ALFRED W. BLOOMER, JR.

## TABLE OF CONTENTS

<u>ITEM</u>	<u>PAGE NO.</u>
1. Scope of examination	2
2. Description of Company	3
A. Management	4
B. Territory and plan of operation	6
C. Reinsurance	16
D. Holding company system	29
E. Significant operating ratios	39
F. Accounts and records	39
G. Facilitation of the examination	51
H. Data integrity	53
I. Business contingency plan	56
J. Information system controls	56
3. Financial statements	59
A. Balance sheet	59
B. Underwriting and investment exhibit	61
C. Capital and surplus account	62
4. Cash and short- term investments	63
5. Other invested assets	63
6. Premiums and agents' balances in the course of collection	64
7. Electronic data processing equipment and software	66
8. Receivable from parent, subsidiaries and affiliates	66
9. Equities and deposits in pools and associations	68
10. Aggregate write-ins for other than invested assets	69
11. Losses and loss adjustment expenses	69
12. Unearned premiums	71
13. Remittances and items not allocated	73
14. Provision for reinsurance	73
15. Drafts outstanding	75
16. Stop loss reinsurance	76
17. All other miscellaneous liabilities	77
18. Market conduct activities	77
19. Compliance with prior report on examination	78
20. Summary of comments and recommendations	81
Appendix A	88



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

February 10, 2006

Honorable Howard Mills  
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 21978 dated December 9, 2002 attached hereto, I have made an examination into the condition and affairs of Westchester Fire Insurance Company as of December 31, 2002, and submit the following report thereon.

Wherever the designations “the Company” or “WFIC” appear herein without qualification, they should be understood to indicate Westchester Fire Insurance Company.

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

The examination was conducted at the Company’s administrative offices located at 1601 Chestnut Street, Philadelphia, PA 19103.

## 1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 1997. This examination covered the five-year period from January 1, 1998 through December 31, 2002. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

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

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

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

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

## **2. DESCRIPTION OF COMPANY**

The Company was incorporated under the laws of the State of New York as the Westchester County Mutual Insurance Company on March 14, 1837. It was reorganized as a joint stock company, under the name of Westchester Fire Insurance Company, effective January, 1870 and was reincorporated as a stock corporation on June 21, 1920. The Company absorbed by merger: the Delaware Insurance Company in 1928; United States Merchants & Shippers Insurance Company in 1932; the Richmond Insurance Company of New York on December 17, 1948; Allemania Fire Insurance Company of Pennsylvania in 1951; and the Southern Fire Insurance Company of North Carolina in 1956.

The Company's charter was originally filed in the office of the Superintendent of Insurance of the State of New York on October 16, 1953, as amended effective February 21, 1957, April 2, 1962, March 16, 1967, March 21, 1968, July 24, 1969, November 20, 1973, December 5, 1974, June 17, 1981, February 7, 1985, September 22, 1988, January 8, 1998, July 29, 1998, April 29, 1999 and April 3, 2002.

Capital paid in is \$4,503,671 consisting of 928,592 shares of common stock at \$4.85 par value per share. Gross paid in and contributed surplus is \$128,333,500. The following are the changes in capital and paid in and contributed surplus during the examination period.

<u>Year</u>	<u>Changes to Capital</u>
1998	\$ 792
1999	\$ 0
2001	\$ 0
2002	\$1,002,879

Gross paid in and contributed surplus decreased by \$79,890,448 during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
1997	Beginning gross paid in and contributed surplus	\$208,223,948
1998	Surplus reduction	\$ (129,979,069)
1999	Surplus contribution	1,091,500
2001	Surplus contribution	50,000,000
2002	Surplus reduction	<u>(1,002,879)</u>
	Total surplus contributions (reductions)	<u>(79,890,448)</u>
2002	Ending gross paid in and contributed surplus	<u>\$128,333,500</u>

#### A. Management

Pursuant to the Company's charter and by-laws, management of the Company is vested in a board of directors consisting of not less than thirteen nor more than twenty-five members. The Company's approved by-laws require one meeting per year but during the examination period the board met four times during each calendar year with the exception of 2002 when it held two meetings. At December 31, 2002, the board of directors was comprised of the following fifteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
David M. Brodsky Dix Hills, NY	Senior Vice President, ACE Risk Management Custom Casualty
William N. Curcio Garden City, NY	President, ACE Risk Management
Brian E. Dowd Duluth, GA	President, Westchester Specialty Group
Richard C. Franklin Glenmore, PA	Senior Vice President, Product Line & Regulatory Support, ACE INA
Robert J. Gaffney Blue Bell, PA	Executive Vice President, ACE Special Programs
William P. Garrigan Alpharetta, GA	Executive Vice President and Chief Operating Officer, Westchester Specialty Group

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Geoffrey G. Gregory West Windsor, NJ	President, ACE Casualty Risk
Jay A. Lefkowitz Wayne, NJ	Senior Vice President-Director of Field Operations, ACE Risk Management
John J. Lupica Newtown, PA	President, ACE Diversified Risk
Francis W. McDonnell Marlton, NJ	Chief Financial Officer, ACE USA
Paul G. O'Connell Milltown, NJ	Executive Vice President & Chief Actuary, ACE USA
Ed K. Ota, Jr. Berwyn, PA	General Counsel, ACE INA
Susan Rivera New Hope, PA	President, ACE INA Holdings
Charles E. Stauber Matawan, NJ	Executive Vice President & Chief Technical Claims Officer, ACE INA
Edward D. Zaccaria New Hope, PA	President, ACE Specialty P&C Group

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.

The Company could provide no evidence that the board of directors serving at the time of the issuance of the prior report on examination had received a copy and read that report. Section 312(b) of the New York Insurance Law requires that "a copy of the report shall be furnished by such insurer or other person to each member of its board of directors and each such member shall sign a statement, which shall be retained in the insurer's files, confirming that such member has received and read such report." At the request of the examiners, the Company had the current board of directors read and submit

acknowledgement that the prior report on examination had been received by the directors and read by them.

It is recommended that the Company comply with Section 312 of the New York Insurance Law and submit a copy of the reports on examination to each of the members of the board of directors in a timely manner so that the board of directors can take the appropriate action on the comments and recommendations contained therein.

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

<u>Name</u>	<u>Title</u>
Brian Edward Dowd	President
George Dennis Mulligan	Secretary
Francis William McDonnell	Treasurer

B. Territory and Plan of Operation

As of December 31, 2002, the Company was licensed to write business in all fifty states of the United States, the District of Columbia, Guam and Puerto Rico.

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 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
22	Residual value
26	Gap
28	Service Contract reimbursement

The Company is also authorized to write such 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 insurances described in the Longshoremen's and Harbor Workers' Compensation Act (Public Law No. 803, 69 Cong. as amended; 33 USC Section 901 et seq. as amended), and as authorized by Section 4102(c) of the New York Insurance Law, insurance of every kind or description outside of the United States, reinsurance of every kind or description.

Based on the lines of business for which the Company is licensed, and the Company's current 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 following schedule shows the direct premiums written by the Company both in total and in New York for the period under examination:

DIRECT PREMIUMS WRITTEN

<u>Calendar Year</u>	<u>New York State</u>	<u>Total United States</u>	<u>Premiums Written in New York State as a percentage of United States direct premiums written</u>
1998	\$4,667,269	\$152,484,132	3.06%
1999	\$7,872,190	\$217,882,795	3.61%
2000	\$14,690,847	\$323,400,582	4.54%
2001	\$154,572,298	\$598,210,870	25.84%
2002	\$83,753,282	\$539,036,935	15.54%

It should be noted that the amount of premium written in New York versus the total amount of written premium nationwide was skewed in 2001 because of one residual value policy written for \$121,000,000 in premium with a New York situs.

The largest product lines of the Company are property, casualty, warranty, and professional risk. The Company is primarily a commercial lines writer. During the examination period, the Company changed its underwriting strategy by emphasizing the writing of property business rather than casualty. Going forward, the Company will continue its core strategy of leveraging its catastrophe book of business to pursue a larger market share of non-catastrophe specialty property business. As of the examination date, the Company's business mix was 81% property and 19% casualty.

During the examination period, the Company requested and the Department approved the Company to write three additional lines of business; residual value, gap, and service contract reimbursement.

The Company transacts its business through a system of brokers who underwrite and place the business. The Company has not appointed any managing general agents. The bulk of its warranty business is automobile extended warranty and is produced by an affiliated third party administrator.

#### Service Contract Business

Subsequent to the date of approval to write this line of business, the Company aggressively underwrote service contract reimbursement insurance business and by 2002, this business approximated 20% of its direct written premiums. During the examination period, the Company wrote \$389 million in direct premiums for this line of business, of which the bulk represented vehicle extended warranties.

The Company used a series of third party administrators to underwrite, price and settle claims on this business. The largest producer of this business was Dimension Service Corporation, an affiliated company. The third party administrators appointed agents that consisted mostly of automobile dealerships. These automobile dealerships added on their own commissions to the premiums charged by the insurer. In reality, the premium charged by WFIC for its policies was a relatively small percentage of the amount ultimately charged by the automobile dealerships.

In one of the programs, unauthorized captives of the automobile dealers reinsured all but 10% of the WFIC premiums and furnished WFIC with non-complying collateral used by WFIC to offset its provision for reinsurance liability, unearned premiums and losses. In this report, an additional provision for reinsurance due to this non-complying collateral in the amount of \$42,633,594 was established. This amount was based on a schedule provided by the Company.

A review of the Schedule F, Part 3 in the Company's 2002 Annual Statement noted that the Company failed to report the cessions under the warranty program to the actual warranty reinsurers. Further, the Company was unable to provide a schedule identifying which reinsurers the cessions were reported in Schedule F, Part 3. In addition, it was noted that the Company reported no ceded reinsurance

under this program prior to 2002 despite the fact that there were contracts dated prior to 2002. Further, a schedule provided to the examiners by the Company showed a calculation of the ceded unearned premium reserve at the examination date that was greater than the ceded reinsurance premium, which would appear to indicate that premiums were ceded prior to 2002. It is recommended that the Company properly report cessions under the warranty program in all future annual statements.

It was noted that the contracts with the captive reinsurers included certain accommodations to the reinsurers not normally associated with “arms-length” reinsurance agreements, such as: the insurer paying the reinsurer’s charter renewal fees, maintaining the reinsurer’s accounting records, preparing tax returns and paying “appropriate federal and state income tax deposits or payments, excise taxes or other taxes imposed by regulatory bodies.”

As of the examination date, the Company’s annual statement reported net incurred but not reported losses on the warranty business in the amount of \$5,264,327. However, the Company was unable to provide the examiners with the underlying loss data on a transaction level. Therefore, the examiners were unable to determine the accuracy of the Company’s reported reserves. As of December 31, 2004, the Company reported additional reserve development on this business in the amount of \$19.4 million. It is noted that due to the long-tail nature of this line, additional development of losses may be recognized in future periods. It is recommended that the Company maintain its loss data at a transaction level.

As of the examination date, the Company’s annual statement reported a reserve for unearned premiums on its warranty business in the amount of \$99,175,000. The Company could not provide documentation showing how this reserve was calculated. However, it indicated that the reserve was calculated using a method termed the “Reverse Rule of 78”. Such method is not an approved method pursuant to Section 1305 of the New York Insurance Law. Additionally, the Company could not provide substantiation that this method yielded a result that was no less than the largest result of the three methods

described in paragraphs 27 to 29 of the NAIC Accounting Practices and Procedures Manual Statements of Statutory Accounting Principles (“SSAP”) No. 65. The Company was also unable to provide the underlying premium data at the transaction level. Therefore, the examiners were unable to verify the adequacy of the Company’s unearned premium reserve. At December 31, 2004, the Company re-evaluated its unearned premiums and determined that the December 31, 2002 reserve should have been \$148,422,000 rather than \$99,175,000, or \$49,247,000 greater. The examination reserve for unearned premiums reflects this deficiency. It is recommended that the Company maintain adequate documentation to support its calculation of the reserve for unearned premiums.

Due to the rapid growth in warranty writings, it appears that the Company did not have adequate control of this business. There was no audit program to ensure contract compliance, the settlement of premiums and losses lagged months behind, and the Company failed to reconcile premiums to cash. Eighteen months after the examination date, the Company could provide only a “substantial reconciliation” of its premium suspense accounts, which included only a “best estimate” of cash collections. The Company was never able to produce a listing of premiums and losses on a transaction level.

It is recommended that the Company establish adequate internal controls over the premiums and losses for warranty business.

It was noted that in response to the Department’s examination planning questionnaire the Company indicated that it reconciled its cash accounts on a monthly basis. An internal audit report of the Warranty Division dated June 2002, states, "Warranty does not reconcile the outstanding check list to the Drafts Outstanding account." The Company subsequently admitted that it was aware that these accounts were not reconciled as reported in the examination planning questionnaire and that it had not implemented the internal audit report recommendation.

The examination relies on the answers from the Company to determine the procedures necessary to determine the accuracy of the Company's filed statements. When the Company does not give forthright and complete answers to questions, the examiners cannot rely on the Company's responses to properly plan an examination.

It is recommended that the Company respond accurately to all future questions posed by this Department.

It is further recommended that the Company institute the recommendation contained in the internal audit report.

#### Residual Value Policy

On April 29, 1999, the Department approved the Company's request to write residual value insurance. During the examination period, the Company wrote one residual value policy insuring Chase Manhattan Automotive Finance Corporation ("Chase"). This policy was effective December 31, 2000 and covers 207,147 automobiles leased between 1995 and December 31, 2000. The policy insures Chase for the difference between the amount recovered at the end of the lease and the reserve value set at the inception of the lease. The losses will be settled at the conclusion of the final lease, which is expected to expire sixty-two months after the effective date of the policy.

It was noted that this policy covers leases that incepted prior to the effective date of the policy; therefore, this policy represents retroactive insurance, which is not permitted pursuant to Section 1101(a) of the New York Insurance. Despite the fact that retrospective insurance is not permitted, no change has been made to the financial statements in this report based on the fact that there is a valid contract between the Company and Chase.

It is recommended that the Company comply with Section 1101(a) of the New York Insurance Law and refrain from writing retrospective insurance policies.

The policy provides that WFIC will pay losses up to \$220 million in excess of Chase's retention of \$280 million, with additional coverage of \$200 million above the \$500 million loss cap, which would be provided through reinsurance placed by WFIC. If losses are below \$405 million, the Company pays a profit commission to Chase. If losses are between \$435 million and \$465 million, Chase pays dollar-for-dollar additional premiums to the Company for the amount above \$435 million.

The premium for this policy was \$121 million; however, there was a provision that Chase would receive a return premium of \$6 million plus interest at 5.5% if the Company failed to place the \$200 million reinsurance above the \$500 million loss cap by April 1, 2001. The Company was given two extensions, with the second one expiring on June 29, 2001; however, the additional reinsurance was not placed. Therefore, Chase is entitled to the return premium of \$6 million plus interest.

A review of the Company's 2001 Annual Statement indicated that the Company reported the direct written premium of \$121 million with no provision for the \$6 million return premium due Chase. Additionally, the Company reported no provision for the return premium due Chase in subsequent annual statements. Therefore, WFIC overstated its 2001 direct premiums written and premiums earned by \$6 million.

It was also noted that the Company reported the premium as fully earned in 2001, despite the fact that the policy period continues for sixty-two months after December 31, 2000, the effective date of the policy.

Effective January 1, 2001, the Company entered into a 75% quota share facultative reinsurance agreement with an unauthorized affiliated reinsurer covering the Company's exposure on the Chase policy. It was noted that the Company's 2001 Annual Statement reported premium ceded of \$91,280,000

under this agreement, which amount represented 75% of \$121,706,667. As noted above, the Company's subject written premiums should have been \$115 million (\$121 million less return premium of \$6 million); therefore, the premium ceded on this agreement should have been \$86,250,000.

The reinsurer provided collateral for the above reinsurance agreement in the amount of \$97,944,061 in a trust account established pursuant to Department Regulation 114. Upon review of this account, it was noted that it included non-complying assets as more fully discussed in Item 2D of this report.

Pursuant to Section 1115(c)(2) of the New York Insurance Law, the Company is required to limit its exposure on any one residual value risk to 10% of its surplus to policyholders. Section 1115(c)(2) of the New York Insurance Law states:

“An insurer, selling residual value insurance in this state shall limit its exposure on any one risk, net of collateral and reinsurance to an amount not to exceed ten percent of the aggregate of the insurer's surplus to policyholders. *For the purposes of this section reinsurance must be placed with an authorized or accredited reinsurer in New York state.* The credit for collateral shall not exceed fifty percent of the appraised value of the underlying asset at the date in the future that the value of the property is guaranteed” (emphasis added.)

The Company's exposure on the Chase residual value policy is \$220 million; the Company can not take credit against its exposure for the 75% quota share reinsurance agreement since it is with an unauthorized reinsurer. As the Company's reported surplus to policyholders at September 30, 2001 was \$247,558,951, the single risk limitation was \$24,755,895 as of the effective date of the policy. Therefore, the policy exceeded the Company's single risk limitation by the amount of \$195.2 million.

It is recommended that the Company comply with the limit of exposure set forth in Section 1115(c)(2) of the New York Insurance Law.

In April 2004, the Company commuted the 75% facultative quota share reinsurance agreement pertaining to the residual value policy. At the time of the commutation, the Company estimated the loss

reserves to be \$155 million; therefore, the reinsurer's 75% share was \$116,250,000. Under the terms of the commutation agreement, the reinsurer paid \$109,524,000 to be released from its obligations under the reinsurance agreement. In its 2004 Annual Statement, the Company reported outstanding reserves on the residual value policy in the amount of \$170 million; therefore, if the agreement had not been commuted the reinsurer's 75% share would have been \$127,500,000.

During the period covered by this examination, the Company wrote extensive business through Marsh & McLennan and its affiliated companies. During 2002, this represented approximately \$30,000,000 in direct writings.

As part of an investigation conducted by the Attorney General of the State of New York, the Company's parent, ACE INA ("ACE"), was identified as paying commissions exceeding the contracted brokerage fees to Marsh & McLennan Companies Inc. for the placement of specific business.

The Company provided the following disclosure note to the examiners:

"On October 14, 2004, the New York Attorney General (NYAG) filed a civil suit against Marsh & McLennan Companies Inc. (Marsh), alleging that the certain Marsh business practices were fraudulent and violated antitrust and securities laws. ACE was not named as a defendant in the suit, although ACE was named as one of four insurance companies whose employees participated in the practices in question. There can be no assurance that ACE will not be named in future actions brought by the NYAG or any other state attorneys general. In addition, an underwriter who is no longer employed by ACE has pleaded guilty to a misdemeanor based on these practices. ACE is cooperating and will continue to cooperate with the attorneys general.

ACE, its subsidiaries and affiliates have received numerous subpoenas, interrogatories, and civil investigative demands in connection with the pending investigations of insurance industry practices. These inquiries have been issued by a number of attorneys general, state departments of insurance, and state and federal regulatory authorities, including the NYAG, the Pennsylvania Department of Insurance, and the Securities and Exchange Commission (SEC). These inquiries seek information concerning underwriting practices and non-traditional or loss mitigation insurance products. ACE is cooperating and will continue to cooperate with such inquiries.

ACE has been conducting its own investigation that encompassed the subjects raised by the NYAG, the other state attorneys general and the SEC. The investigation has been conducted by a team from the firm of Debevoise & Plimpton LLP. The team is headed by former United States Attorney Mary Jo White and has operated under the direction of the

Audit Committee of the Board of Directors. The Audit Committee of the Board of Directors has retained Cleary Gottlieb Steen & Hamilton, special outside counsel, to advise it in connection with these matters. ACE has terminated three employees, one of whom has pleaded guilty to a misdemeanor, and has suspended two other employees as a result of the internal investigation. ACE's internal investigations pertaining to underwriting practices and non-traditional or loss mitigation insurance products are essentially complete."

In reaction to this investigation, ACE paid a substantial fine, fired three officers and accepted the resignation of Susan Rivera, the president of ACE INA Holdings and a member of WFIC's board of directors at the examination date. On examination, the Company could not produce the brokerage agreements between WFIC and Marsh & McLennan and its affiliated companies. (See Section 2G.v in this report for comments and recommendations regarding record retention).

### C. Reinsurance

#### Assumed Reinsurance

In 2002, the Company's assumed premiums represented approximately 33% of its total gross written premiums for the year. During the period covered by this examination, the Company's assumed reinsurance business has increased dramatically. The Company's assumed reinsurance program consisted mainly of reinsurance business assumed under a 90% quota share agreement from an affiliate, Westchester Surplus Lines Insurance Company ("WSLIC"), a surplus lines writer domiciled in Georgia. On January 1, 1995, the Company entered into the inter-company reinsurance agreement with WSLIC, whereby WFIC assumes 90% of the business produced by WSLIC excluding business written in the State of New York. The contract was non-disapproved by this Department on March 7, 1995.

When the Company accounted for the 90% quota share agreement with WSLIC in Schedule F, Part 1, of its filed 2002 Annual Statement, it reported a balance for assumed premiums of \$275,537,000. Upon examination it was determined that the actual balance assumed from WSLIC was \$260,343,000 and that WFIC had included assumptions from four other entities, totaling \$15,194,000, in the WSLIC

Schedule F amount. Of the four entities making up the \$15,194,000 amount, WFIC could not provide supporting documentation confirming that one of these entities was an insurer.

It was also noted that Schedule F, Part 1 included incorrect balances from WSLIC for items entitled “Known case loss and LAE”, “Assumed premiums receivable”, and “Unearned premiums.”

It is recommended that the Company comply with the National Association of Insurance Commissioners’ annual statement instructions and report the balances assumed from each insurer separately as defined by those instructions.

It is recommended that the Company maintain adequate supporting documentation for all assumed reinsurance transactions reported in its filed annual statements.

It is recommended that the Company implement internal controls to assure that the reinsurance assumptions are properly recorded in its filed annual statements.

Ceded Reinsurance

The Company has structured its ceded reinsurance program to limit its maximum exposure on any one risk as follows:

<u>Type of treaty</u>	<u>Cession</u>
<u>Property / Casualty:</u>	
Westchester Specialty Group Property Per Risk * (3 layers, EOL) 1 <sup>st</sup> layer 91.7% Authorized 2 <sup>nd</sup> layer 95.6% Authorized 3 <sup>rd</sup> layer 62.2% Authorized	90% of \$4 million in excess of \$1 million ultimate net loss and loss adjustment expense each risk, with an occurrence limit of \$100 million. 90% of \$5 million in excess of \$5 million ultimate net loss and loss adjustment expense each risk, with an occurrence limit of \$20 million. 90% of \$15 million in excess of \$10 million ultimate net loss and loss adjustment expense each risk, with an occurrence limit of \$30 million
Westchester Specialty Group Property Catastrophe * (4 layers, EOL) 1 <sup>st</sup> layer 50.5% Authorized 2 <sup>nd</sup> layer 46.8% Authorized 3 <sup>rd</sup> layer 54.7% Authorized 4 <sup>th</sup> layer 53.2% Authorized	95 % of \$10 million in excess of \$20 million ultimate net loss each loss occurrence. 95 % of \$20 million in excess of \$30 million ultimate net loss each loss occurrence. 95 % of \$35 million in excess of \$50 million ultimate net loss each loss occurrence. 95 % of \$60 million in excess of \$85 million ultimate net loss each loss occurrence.
Group Property Catastrophe (2 layers, EOL) 1 <sup>st</sup> layer 68.5% Authorized 2 <sup>nd</sup> layer 75% Authorized	100% of ultimate net loss in excess of \$145 million each loss occurrence. 100% of \$60 million ultimate net loss in excess of \$245 million each loss occurrence.
High Value Homeowners' Property (2 layers, EOL) 1 <sup>st</sup> layer 95% Authorized 2 <sup>nd</sup> layer 95% Authorized	\$4 million in excess of \$1 million per loss, each risk, plus proportionate share of loss expense. \$10 million in excess of \$5 million per loss, each risk, plus proportionate share of loss expense.
High Value Homeowners Property Catastrophe (2 layers, EOL) 1 <sup>st</sup> layer 62.5% Authorized 2 <sup>nd</sup> layer 57.5% Authorized	\$3 million in excess of \$2 million ultimate net loss any one loss occurrence. \$5 million in excess of \$5 million ultimate net loss any one loss occurrence.
Primary Quota share 100% Authorized 36% Placed	100% of the first \$1 million for primary casualty premiums and losses per occurrence up to a general aggregate of \$2 million.

<u>Type of treaty</u>	<u>Cession</u>
Lead Umbrella Quota share 100% Authorized 60% Placed	100% of the first \$1 million for umbrella premiums and losses per occurrence.
Umbrella (2 layers, EOL) 1 <sup>st</sup> layer 100% Authorized 2 <sup>nd</sup> layer 100% Authorized	60% of the first \$1 million. 75% of \$4 million in excess of \$1 million ultimate net loss each insured each occurrence. 95% of \$20 million in excess of \$5 million ultimate net loss each insured each occurrence.
Hi Excess Quota share 100% Authorized 86% Placed	100% of the first \$25 million lead and high excess umbrella premiums and losses per occurrence.
Casualty Clash (2 layers, EOL) 1 <sup>st</sup> layer 47.5% Authorized 2 <sup>nd</sup> layer 78.33% Authorized	66.67% of \$15 million in excess of \$10 million ultimate net loss each and every loss occurrence. \$60 million in excess of \$25 million ultimate net loss each and every loss occurrence.
 <u>Professional Risk</u>	
Quota share 100% Authorized 90% Placed	50% quota share for directors & officers and financial institutions premiums and losses per occurrence up to a limit of \$15 million. 40% quota share for errors & omissions and other professional liability premiums and losses per occurrence up to a limit of \$15 million.
 <u>Other</u>	
Diversified Products Special Programs (3 layers, EOL) 1 <sup>st</sup> layer 100% Authorized 2 <sup>nd</sup> layer 97.5% Authorized 3 <sup>rd</sup> layer 85% Authorized	\$4 million in excess of \$1 million per loss, each risk, plus proportionate share of loss expense. \$5 million in excess of \$5 million per loss, each risk, plus proportionate share of loss expense. \$10 million in excess of \$10 million per loss, each risk, plus proportionate share of loss expense.
Stop Loss 100% Authorized	75% of ultimate net loss greater than \$721 million; limit \$750 million in the aggregate.
Stop Loss 100% Unauthorized	25% of ultimate net loss greater than \$721 million, limit \$50 million in the aggregate

\* - The annotation of "Westchester Specialty Group" in the reinsurance agreements, is not a legal entity It is an internal designation indicating the Westchester Fire Insurance Company, Westchester Surplus Lines Insurance Company and Industrial Underwriters Insurance Company.

The Company's retention generally remained the same compared with the prior examination period. The percentage of cessions to authorized reinsurers has decreased compared with the prior examination period.

In addition to its treaty reinsurance program, the Company also obtained facultative reinsurance coverage. In August 2001, the Company entered into an inter-company facultative reinsurance agreement with ACE Capital Re Overseas Ltd., an unauthorized affiliated reinsurer, to cover a retrospective residual value insurance policy effective December 31, 2000 covering 207,147 automobiles leased between 1995 and December 31, 2000. The losses ceded under this placement were \$93.75 million as of the examination date. Facultative cessions represented 6.7% of the Company's total premiums ceded in 2002 (see Section 2B, "Residual Value Policy" in this report).

#### Loss Portfolio Transfer

Effective December 31, 1992, the Company, along with two affiliates, entered into a loss portfolio transfer agreement transferring all losses occurring for all accident years incurred prior to January 1, 1993 in excess of \$755,073,000 retention to Ridge Re Limited with an aggregate limit on the loss payments of 85% of \$127,500,000. The Company paid consideration of \$51,000,000. The Company has accounted for this transaction properly pursuant to the provisions of Department Regulation 108.

Effective January 1, 1999, this loss portfolio was novated to National Indemnity Company ("NICO") in an agreement between Xerox Financial Services, Westchester Fire Insurance Company and its affiliates, Ridge Re Limited and NICO for \$95,025,000.

#### Stop Loss Quota Share Reinsurance

As part of the 1998 sale of WFIC to ACE, Limited, the Company entered into a retrospective 75% quota share agreement with National Indemnity Company protecting itself from adverse loss development

for accident years prior to 1997 to reinsure the losses from all policies entered into on or before December 31, 1996. The premium for this agreement was \$284,000,000; of which, WFIC paid \$150,000,000 and Talegen Holdings, Inc., the former owner of WFIC paid \$134,000,000. The aggregate limit on this policy is 75% of \$1 billion in excess of \$721,000,000 in ultimate net loss actually paid by WFIC.

This contract was non-disapproved by this Department on March 29, 1999 contingent upon the contract being accounted for as a deposit premium in accordance with Chapter 22 of the NAIC Accounting Practices and Procedures Manual for Property/Casualty Insurers.

A second “stop-loss” treaty pertaining to the same losses noted above was entered into with ACE Bermuda Insurance, Ltd. (“ACE Bermuda”) an affiliated insurer. Under the terms of this treaty, the Company cedes to ACE Bermuda 25% of the first \$200,000,000 of the paid ultimate net losses in excess of the retention of \$721,000,000. No reinsurance recoveries will be made under this treaty until WFIC has paid the losses retained by it. The premium for this treaty was \$43,000,000. There is an optional cover under this treaty which allows WFIC to purchase the remaining coverage for the layer \$200,000,000 to \$1,000,000,000; however, this is contingent upon two factors, neither of which was reached. These factors were set at such a high level that the possibility of reaching these levels was extremely remote.

The essence of this contract is that WFIC was to pay a \$43,000,000 premium for \$50,000,000 aggregate coverage that would not be paid until the first \$721 million in losses covered by this treaty were paid. At the examination date, the Company had paid \$575,169,000 of the losses retained under this coverage. Based on the premium to be paid plus the future value of this premium, ACE Bermuda appears to be guaranteed a profit on this contract. During the course of the examination, despite repeated requests, no cash flow analyses’ or other documentation substantiating the transfer of risk was provided by WFIC to the examiners.

The examiner reviewed all ceded reinsurance contracts with ceded written premium greater than \$6 million in effect at the examination date. The contracts all contained standard insolvency clauses meeting the requirements of Section 1308 of the New York Insurance Law.

This review showed that five contracts were not finalized and reduced to writing within the nine-month period required by the NAIC's Accounting Practices and Procedures Manual, SSAP No. 62, paragraph 23. A review of forty-six warranty contracts provided on examination led to the conclusion that twenty of these contracts were reported as prospective reinsurance despite the fact that four of the contracts exceeded the nine month period for finalization and signature and sixteen of the contracts were undated. In total, the examination determined that twenty-five of the reinsurance contracts reviewed were incorrectly recorded in the Company's 2002 Annual Statement as prospective reinsurance rather than as retroactive reinsurance.

SSAP No. 62, paragraph 23 states in part:

"However, except as respects business assumed by a U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the agreement is domiciled outside the U.S. and is not affiliated with such reinsurer, if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement. "

It is recommended that the Company report and account for all reinsurance agreements not reduced to writing and signed by the parties within nine months of inception as retroactive reinsurance using "deposit accounting" in all future filed statements.

Several of the Company's ceded reinsurance contracts state that arbitration shall take place in Philadelphia, PA or Atlanta, GA and shall be governed by the laws of Pennsylvania or Georgia.

This Department requires that in the event of a dispute between an insurer and its reinsurer, arbitration must take place in the domiciliary state of the ceding company.

It is recommended that the Company assure that all ceded reinsurance contracts entered into specify that arbitration shall be governed by the laws of New York State.

The Schedule F data as contained in the Company's filed annual statement was not found to accurately reflect its reinsurance transactions. The following deficiencies were noted:

i. Intercompany Reinsurance

Review of the accounting for intercompany reinsurance transactions indicates that these were recorded and carried in the Company's intercompany account "Receivable from or Payable to parent, subsidiaries or affiliates". SSAP No. 62, Paragraph 17 states in part that:

"Reinsurance recoverables shall be recognized in a manner consistent with the liabilities . . . relating to the underlying reinsured contracts."

There is no exception in SSAP No. 62 for inter-company reinsurance. As such, these transactions should have been recorded as "Reinsurance recoverables on loss and loss adjustment expenses" or "Reinsurance payable on paid loss and loss adjustment expenses" as appropriate.

It is recommended that the Company comply with the requirements of SSAP No. 62 and report all reinsurance transactions in the appropriate balance sheet accounts.

ii. Unauthorized Reinsurance

During the review of the Company's filed annual statement, the examiners tested the accuracy of the reporting for authorized/unauthorized reinsurers. The result of this testing indicates that the Company failed to follow the NAIC's Annual Statement Instructions by not properly segregating the authorized from the unauthorized reinsurers. It was found that the Company had reported a number of reinsurers as authorized, when in fact, they were not. The total amount of these discrepancies was not material to the

examination and, therefore, the report shows no change to the “Provision for reinsurance” for this discrepancy.

It is recommended that the Company report reinsurance transactions in its filed annual statement properly and in accordance with the NAIC’s Annual Statement Instructions.

Trust agreements and letters of credit obtained by the Company in order to take credit for cessions made to unauthorized reinsurers were reviewed for compliance with Department Regulations 114 and 133, respectively. The review revealed that one trust agreement was not in compliance with Part 126.5 of Department Regulation 114 and that one of the letters of credit was not in compliance with Department Regulation 133.

The Company reported in Schedule F, Part 5, of its filed 2002 annual statement reinsurance recoverable from an unauthorized affiliate in the amount of \$93,750,000 for the cession of a residual value policy. The Company reported an offset to this reinsurance recoverable for assets held in a trust. Department Regulation 114, Part 126.5 requires the market value of investments held in a trust account to be no less than 102% of the required amount of reinsurance recoverable. In addition, the investments are required to be in the form of cash, certificates of deposit, and investments of the types specified in paragraphs (1), (2), (3), (8), and (10) of subsection (a) of Section 1404 of the New York Insurance Law, which requires that such investments consist of obligations of American institutions.

Three of the investments held in this trust were obligations of foreign institutions that are not permitted by Department Regulation 114. Based on the subsequent commutation of the reinsurance treaty and the fact that the trust assets were returned to the reinsurer, no adjustment will be made to the provision for reinsurance related to these three investments.

It is recommended that the Company only take credit for assets held in trust accounts that comply with Department Regulation 114, Part 126.5(a)(2).

The Company reported a \$5 million letter of credit for which it was not the beneficiary. As such, the letter of credit is not in compliance with the requirements of Department Regulation 133. Regulation 133, Section 79.1(b) defines a beneficiary as follows:

“Beneficiary means the insurer in favor of which the letter of credit or its confirmation is established and shall include any successor by operation of law of any named beneficiary including, without limitation, any liquidator, rehabilitator, receiver or conservator.”

Department Regulation 133, Section 79.2(d) states that for a letter of credit to be acceptable it must:

“contain a statement that identifies the beneficiary and includes the definition set forth in section 79.1(b) of this Part.”

Therefore, a provision for reinsurance in the amount of \$5,000,000 has been established by this examination (see section 14, entitled “Provision for Reinsurance” for details of the financial change).

Selected other letters of credit were confirmed by the examination as being at lesser amounts than reported in Schedule F, Part 5 of WFIC’s filed annual statement. The financial statements presented in this report reflect the amounts of these letters of credit confirmed on examination. (See Section 14 of this report for details).

It is recommended that the Company comply with Department Regulation 133 and report letters of credit as reinsurance recoverable collateral only when the Company is the named beneficiary on the letter of credit and only at the available amount of the letters of credit at the date of the annual statement.

The Company reported the collateral for a transaction with an affiliated, non-admitted reinsurer as a letter of credit in Schedule F, Part 5 of its filed annual statement when in fact the collateral was held in a trust account. The letter of credit had been drawn down in early January 2002 and a trust had been established to replace the letter of credit.

iii. Unsupported Liabilities

The Company was unable to support the following reinsurance related liabilities reported in its filed annual statement:

- "Loss portfolio commutations" with a liability balance of \$13,198,338 - line 2303.
- Assumed reinsurance "Paid loss and loss adjustment expenses"- Schedule F, Part 1, Column 6, with a liability balance of \$20,467,046

In addition, the Company was unable to supply a complete aging report on the reinsurance recoverable on loss and loss adjustment expenses paid. The Company responded that the electronic workpapers supporting the aging of the reinsurance recoverable had been inadvertently overwritten. Later, the Company provided an aging report that contained no dates and did not tie in total to the amounts reported in the annual statement. The Company stated that this recreation of the aging only contained the data from one reinsurance system. Therefore, the examination was unable to verify the accuracy of aging and the completeness of the provision for reinsurance. Comments regarding record retention and maintenance of supporting detailed records for balances reported in the financial statements can be found in sections 2F.v and 2F.iv of this report, respectively.

iv. Schedule F Reporting Issues

Approximately sixty Federal Employer Identification Numbers (FEIN's) and fifteen NAIC Company Codes for insurers located within United States domiciliary jurisdiction were not entered in WFIC's filed Schedule F.

The Company reported \$274,210 as an asset "Funds held by reinsured companies" on the balance sheet of its filed annual statement, while Schedule F, Part 1 indicated an amount of \$590,000. The

Company reported \$1,337,083 for "Funds held by or deposited with reinsured companies" on its liabilities page while Schedule F - Part 3 reported an amount of \$1,327,000.

v. Internal Controls

The Company instituted specific internal controls set forth in a manual prepared by the ACE Limited Reinsurance Financial Security Committee ("the Committee"), a committee formed by the Company's parent, to set the standards regarding which insurers it would be permitted to place reinsurance business with. These controls include the size of the insurer, Standard & Poor's rating of the insurer, and "a rigorous financial review including areas such as financial and operational leverage, commitment to the reinsurance industry, stability, etc."

The Company entered into sixty reinsurance contracts to cede its warranty business to offshore reinsurers. These reinsurers do not meet the published standards set by the Committee's counterparty risk assessment framework nor did the Company supply any supporting documentation that these reinsurers were reviewed by the Committee for special placement.

These controls have been established to protect the Company's assets from default by unauthorized reinsurers. By-passing these controls place the Company's assets at risk.

It is recommended that the Company adhere to its established guidelines by placing its reinsurance business only with reinsurers approved by ACE Limited's Reinsurance Financial Security Committee and that all of their reinsurers meet the minimum guidelines established by the Committee or that the Company applies to the Committee for an exception.

Further, these reinsurers were not found in the Company's Annual Statement Schedule F, Part 3. The Company indicated that the premiums and losses associated with the warranty program are included with the "property contract" cessions. The Company failed to identify which specific reinsurers

constituted the “property contract” that the ceded premiums and losses on the warranty program were included with; however, the examiners were able to tie the total ceded reinsurance premiums written from the Underwriting and Investment Exhibit, Part 1B, to the Schedule F, Part 3, “Reinsurance premiums ceded.”

The reason why these reinsurance transactions were “rolled” into the balances of other reinsurers was not explained to the examiners, despite repeated requests.

In 2002, the Company ceded \$12,650,022 of warranty premiums to Whitestone Reinsurance Ltd., SPC (“Whitestone”), a Cayman Islands insurer. Under the terms of the agreement Whitestone would reinsure 90% of the contracts entered into by the automobile dealers listed in the addendums to the agreement. Whitestone allows the automobile dealerships to buy “cells” which it reinsures. There is no definition of a cell in the contract. WFIC management stated that it commuted the agreement with Whitestone in the first quarter of 2004 but was unable to furnish documents to support the commutation on examination.

It is recommended that the Company institute internal controls over the preparation of Schedule F that ensure the integrity and reliability of its filed annual statements.

#### Reinsurance Intermediaries

Review of four letters authorizing reinsurance intermediaries to place reinsurance for the Company indicates that these letters were not in compliance with Department Regulation 98. Although the Company authorized the placements, the authorization letters failed to include the following provisions required by the Regulation:

- the names of the insurers;
- limits of coverage; and
- expiration date.

It is recommended that the Company enter into authorization letters with appointed intermediaries that comply with Department Regulation 98.

D. Holding Company System

The Company is a member of the ACE Limited Group. The Company is a wholly-owned subsidiary of ACE USA, Inc., a Delaware corporation, which is ultimately controlled by ACE, Ltd, a Bermuda holding company.

A review of the holding company registration statements filed with this Department indicated that such filings were filed in a timely manner pursuant to Article 15 of the New York Insurance Law and Department Regulation 52; however, the 2002 filed statement was not complete as required by the Regulation.

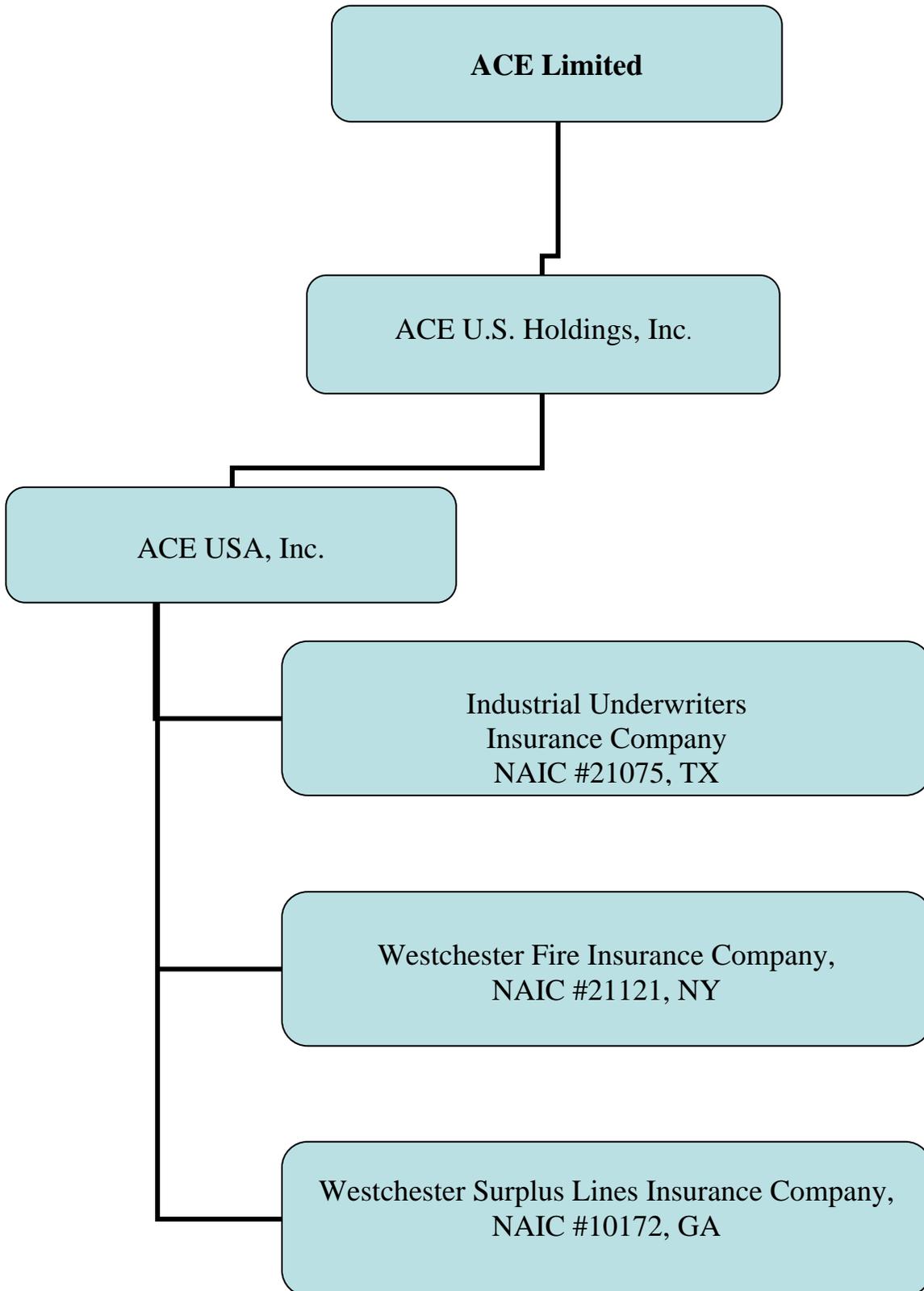
Dimension Service Corporation (“Dimension”), an affiliated company, produced in excess of \$100,000,000 in warranty business for WFIC in 2002. These transactions were not included in WFIC’s 2002 holding company registration statement nor were the transactions reported in Schedule Y, Part 2 of WFIC’s filed 2002 annual statement.

Review of Schedule Y also revealed that the Company had reported Industrial Excess & Surplus Insurance Brokers (“IESIB”) as an affiliated company despite the fact that the IESIB had been dissolved on May 10, 2001.

It is recommended that the Company comply with Department Regulation 52 and disclose all material transactions in the holding company registration statement.

It is further recommended that the Company prepare Schedule Y in accordance with the NAIC Annual Statement Instructions.

The following is an abbreviated chart of the holding company system at December 31, 2002:



At December 31, 2002, the Company was party to fifty-two agreements, comprised of 43 reinsurance agreements, 8 service agreements, and one tax allocation agreement (See Appendix A) with other members of its holding company system.

Of these, twenty-five agreements were submitted to the Department for either prior approval pursuant to Section 1505(c) or non-disapproval pursuant to Section 1505(d) of the New York Insurance Law. The remaining twenty-seven were not submitted. Of those twenty-seven agreements the Company claims that eleven reinsurance agreements were not required to be submitted pursuant to Section 1505(d) of the New York Insurance Law. The Company admits that it was required to file sixteen of these agreements (13 reinsurance agreements and 3 service agreements) that had not been filed. The listing can be found in Appendix A of this report.

It is recommended that the Company file all inter-company agreements pursuant to the requirements of Section 1505(c) and (d) of the New York Insurance Law.

Subsequent to the examination date, and at the direction of the examination, the Company submitted the documents entitled "Agreements which appear not to have been filed" (see Appendix A of this report) to the Department as required with the exception of the agreement with Dimension which has not been reduced to writing. This third-party administrator generated over \$100 million in warranty insurance premiums in 2002 for WFIC.

It is recommended that the Company reduce all inter-company agreements to writing and submit those agreements to this Department pursuant to Section 1505 of the New York Insurance Law.

A listing of the significant non-reinsurance inter-company agreements in effect as of the examination date is as follows:

- Correspondent agreement between WFIC and Westchester Specialty Insurance Services, Inc. to provide underwriting, management and agent services for WFIC.

- Tax allocation agreement by and among ACE US Holdings, Inc, ACE USA, Inc., Westchester Fire Insurance Company, Westchester Surplus Lines Insurance Company, Industrial Underwriters Insurance Company, Industrial Excess & Surplus Lines Insurance Brokers and Westchester Specialty Insurance Services, Inc.
- Service agreement with Century Indemnity Company where Century Indemnity will provide claims adjusting services arising from asbestos exposure and environmental liabilities.
- Administrative services agreement for ACE American Insurance Company to provide accounting, data processing, tax and auditing, functional support, policyholder services, collection, payroll, commission payment, underwriting, claims arbitration, reinsurance recovery, public relations and promotional services.
- Investment advisory service agreement with ACE Asset Management.
- Administrative agreement whereby Westchester Specialty Insurance Services will develop, market and administer vehicle service contract programs for WFIC.
- Administration agreement whereby Dimension Service Corporation is to provide underwriting and claims services for the Company's warranty program. This agreement has not been reduced to writing.

#### Tax Allocation Agreement

Effective January 2, 1998, this Department non-disapproved a tax allocation agreement between ACE US Holdings, Inc. and its subsidiaries, including Westchester Fire Insurance Company, as required by Section 1505(d) of the New York Insurance Law. The following affiliated companies were parties to the approved agreement:

ACE US Holdings, Inc.  
ACE USA, Inc.  
Westchester Fire Insurance Company  
Westchester Surplus Lines Insurance Company  
Industrial Underwriters Insurance Company  
Industrial Excess & Surplus Insurance Brokers  
Westchester Specialty Insurance Services, Inc.

Review of the Company's filed tax returns and the Notes to its filed annual statements during the period covered by this examination show that the entities identified in the tax allocation agreement are different than the entities identified in the Company's filed annual statements and consolidated federal income tax returns. The companies listed in the filed annual statements correspond with the federal income tax

filings for those years. It is noted that the companies that were parties to the consolidated federal income tax filings changed each year and that no amendments to the tax allocation agreement were submitted to this Department as required by Section 1505(d) of the New York Insurance Law.

In addition, Circular Letter No. 33 (1979) requires that an insurer notify the Department within 30 days of any amendment to or termination of a tax allocation agreement.

It is recommended that the Company comply with Section 1505(d) of the New York Insurance Law and Department Circular Letter No. 33 (1979) by submitting any amendments to its non-disapproved tax allocation agreement 30 days prior to affecting changes to the agreement.

It is further recommended that the Company amend its approved tax allocation agreement to reflect the current parties to the agreement.

Subsequent to the examination date, the Company submitted a revised tax allocation agreement to the Department for non-disapproval pursuant to Section 1505(d) of the New York Insurance Law. The revised agreement was submitted to the Company's board of directors for their approval pursuant to Circular Letter No. 33 (1979).

A provision in the approved tax allocation agreement, Section 4(b), requires that the Company establish either an escrow account or obtain a letter of credit for the amount WFIC's payments to the parent exceeds the actual income tax payment made by the group. This provision complies with Circular Letter No. 33 (1979), which states in part:

“To help assure the domestic insurer's enforceable right to recoup federal income taxes in the event of the future net losses an escrow account consisting of assets eligible as an asset for the domestic insurer shall be established and maintained by the parent in an amount equal to the excess of the amount paid by the domestic insurer to the parent for federal income taxes over the actual payment made by the parent to the Internal Revenue Service.”

The examination has determined that although WFIC was required to have either a letter of credit or an escrow account in the amount of \$23,988,015 at the examination date (which increased to \$75,689,015 as of December 31, 2003) it had not.

It is recommended that the Company comply with the terms of Section 4(b) of its inter-company tax allocation agreement and Circular Letter No. 33 (1979) and establish an escrow account or obtain a letter of credit in an amount equal to the amount of payments exceeding the actual income tax payments made by the group.

The non-disapproved tax allocation agreement includes language that it was subject to the approval of the board of directors. Circular Letter No. 33 (1979) requires that:

"Every domestic insurer which is a party to a consolidated federal income tax filing must have a definitive written agreement, *approved by its Board of Directors*, governing its participation therein" (emphasis added).

A review of the minutes of the meetings of the board of directors did not indicate that they approved the tax allocation agreement.

It is recommended that the Company take steps to ensure that any board of directors approval of agreements be reflected in the minutes of the board meetings.

ACE Limited acquired WFIC from Talegen Holdings, Inc. ("Talegen") (seller), a subsidiary of Xerox Financial Services, Inc. on January 2, 1998. Concurrent with this acquisition, a retrospective reinsurance policy from National Indemnity Company ("NICO") was purchased to protect WFIC from adverse loss development for accident years prior to 1997. Talegen paid NICO \$134 million for the coverage and WFIC recorded a corresponding tax deduction in its return filed for the tax period January 3, 1998 through December 31, 1998. This reinsurance premium deduction ultimately resulted in a federal income tax benefit ("tax benefit") to WFIC of approximately \$47 million.

Simultaneous with the acquisition, a tax allocation and indemnification agreement entered into by and among Xerox Financial Services, Inc., Talegen Holdings, Inc., Westchester Specialty Group, Inc., and ACE Limited (“the buyer”) placed an obligation on the buyer to pay to the seller an amount not to exceed \$10,200,000 in excess of \$22,500,000 based on the tax benefit that would accrue to the buyer for the aforementioned reinsurance.

In 2002, WFIC began to benefit from the purchase of the reinsurance agreement. Based on the tax benefit accruing to WFIC under this agreement it was determined that the seller was entitled to an additional payment pursuant to the contract of \$8,800,000.

The contract calls for the additional payment to be made by ACE Limited to Talegen Holdings, Inc. However, on examination, it was determined that WFIC paid Talegen Holdings, Inc. \$2,300,000 in 2002 and \$6,500,000 in 2003. The essence of the transaction was that WFIC assumed the obligations of ACE Limited and paid part of its own acquisition cost. This transaction was not submitted to this Department for non-disapproval pursuant to Section 1505(d) of the New York Insurance Law.

It is recommended that the ACE Limited reimburse WFIC in the amount of \$8,800,000 that was paid pursuant to ACE Limited’s legal obligations.

#### Service Agreements

The review of the inter-company service agreements and the accounting for these agreements indicates that the Company is not settling the agreements within the time frames specified in its non-disapproved agreements.

#### ACE American Insurance Company (“Ace American”) Service Agreement

The Company entered into an inter-company service agreement with ACE American which requires ACE American to collect premiums and other remittances for WFIC and sweep these collections

"into a lock-box bank arrangement, in the name of Westchester Fire" at least daily. On examination it was determined that the collections were not being swept into WFIC's account; rather, they were being held by ACE American and settled quarterly by offsetting the balances against other balances due.

This agreement also calls for ACE American to provide an invoice setting forth the costs and expenses it has incurred during the previous month. WFIC is to settle the net amount within 15 days of invoicing. In reality, these accounts are being offset with premiums and balances from other affiliated companies. These are being settled quarterly not within 45 days as required by the agreement.

It is recommended that the Company comply with the terms of its service agreement with ACE American and settle the transactions in the time and manner specified therein.

#### Westchester Surplus Lines Insurance Company ("WSLIC") Service Agreement

WFIC entered into an administrative service agreement with WSLIC effective January 1, 1993. This agreement calls for WFIC to provide certain services for WSLIC including underwriting, claims administration, and other services to WSLIC. The balances are to be settled net within 30 days of each month. In reality, balances are settled through ACE American within 90 days of the end of each quarter. The examination determined that balances are not being timely settled and that balances are not being settled between WFIC and WSLIC as required by the agreement, but rather, are being settled through ACE American.

It is recommended that the Company comply with the terms of its service agreement with WSLIC and settle the transactions in the time and manner specified therein.

#### Quota Share Reinsurance Agreement between WFIC and WSLIC

The non-disapproved inter-company quota share reinsurance agreement between WFIC and WSLIC calls for the settlement of all balances within 60 days of the end of each quarter, in cash. Rather

than settling the balances in cash, the Company prepared journal entries to eliminate the receivable due from WSLIC with an offsetting increase to a receivable from ACE American.

The reinsurance agreement between WFIC and WSLIC contains no clause authorizing either Company to settle these balances through an inter-company third party, ACE American. By offsetting these balances Westchester Specialty has abrogated its liability with WFIC.

In the fourth quarter of 2002, WSLIC settled balances owed to WFIC for transactions taking place in the third quarter of 2002 through a journal entry crediting WSLIC's balance with WFIC and debiting the balance between ACE American and WFIC. However, WFIC and ACE American did not settle this balance in cash until February 2003. This creates a balance on the underlying transaction that has now been "re-aged" so that it is current rather than more than 90-days past due.

It is recommended that the Company comply with the terms of its non-disapproved inter-company quota share reinsurance agreement with Westchester Surplus Lines Insurance Company and settle all balances due within sixty days of the close of the calendar quarter in cash.

#### Reinsurance Agreement with Industrial Underwriters Insurance Company ("IUICO")

An inter-company reinsurance agreement with IUICO calls for the reinsurance transactions to be settled within 45 days of the end of each month directly with each other. In reality, these balances are being settled within 90 days of the end of each quarter and these transactions are being settled through ACE American, not directly between the parties as called for in the contract.

The Company has been settling all inter-company balances with other members of the holding company through another company, ACE American. The settlement is made by offsetting journal entries in which WFIC is either debited or credited as needed by ACE American. The total balances are not

settled in their entirety and they are not being settled timely nor are they being settled in the manner called for in their non-disapproved agreements.

It is recommended that the Company comply with the terms of its inter-company reinsurance agreement with IUIICO and settle the transactions associated in the time and manner specified therein.

#### Transactions Without Benefit of an Inter-Company Agreement

The Company's annual statement account, "Receivables from Parent, Subsidiaries and Affiliates" contained balances from four affiliated companies for which no inter-company agreement was presented on examination. Further, the balances were "stale" and the Company could not identify where the balances were from and in one case, when it was from. These balances have been non-admitted on examination, (See Section 8 of this report.).

The examination further revealed that thirty-four claims checks were issued on the check stock of affiliated companies without an inter-company service agreement authorizing these companies to pay claims on behalf of WFIC. It is recommended that transactions within the holding company system that occur on a "regular or systematic basis" be made part of an intercompany agreement and submitted to the Department pursuant to the requirements of Section 1505 of the New York Insurance Law.

It is further recommended that the Company expunge all balances from its books and records for which it cannot identify the transactions creating the balance.

E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2002, based upon the results of this examination:

Net premiums written in 2002 to surplus as regards policyholders	7.29:1
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	109%
Premiums in course of collection to surplus as regards policyholders	82%

All of the above ratios fall outside the benchmark ranges set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners. The cause of the ratio failures is the decrease in the “Surplus as regards policyholders” as determined by this examination.

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	\$971,432,984	94.95%
Other underwriting expenses incurred	306,346,566	29.94
Net underwriting loss	<u>(254,662,659)</u>	<u>(24.89)</u>
Premiums earned	<u>1,023,116,891</u>	<u>100.00%</u>

F. Accounts and Records

i. Custodian

a. Merrill Lynch Custodian

The Company held approximately \$177 million in securities in an account with Merrill Lynch as of December 31, 2002. Merrill Lynch is a brokerage and is not a member bank of the Federal Reserve System.

It is the Department's position that a security broker may not be a custodian of insurer owned securities, even if the custodian broker redeposits such securities. Pursuant to Circular Letters No. 1 (1975) and 2 (1977), the Department permits the participation of insurance companies in the "certificateless society" programs of the Federal Reserve System and of the Depository Trust Company. However, participation in the Federal Reserve book-entry program is only permitted through a member bank of the Federal Reserve System.

Further, pursuant to Circular Letter No. 2 (1977) the Department requires that certain custodian affidavits be executed on its examination of insurance companies in order for the affected securities to be recognized as admitted assets.

Since Merrill Lynch is not a member bank in the Federal Reserve System the Company's account with Merrill Lynch is not in accordance with Department Circular Letter Nos. 1 (1975) and 2 (1977).

The NAIC Examiners Handbook, Part 1, Section IV, J also requires that the securities of an insurer be held in a Federal bank or trust company to be considered an admitted asset. Merrill Lynch does not qualify as either of these.

Upon examination it was noted that the Company responded affirmatively to the following General Interrogatory in its December 31, 2002 filed Annual Statement:

"Excluding items in Schedule E, real estate, mortgage loans and investments held physically in the reporting entity's offices, vaults or safety deposit boxes, were all stocks, bonds and other securities, owned throughout the current year held pursuant to a custodial agreement with a qualified bank or trust company in accordance with Part 1-General, Section IV.H-Custodial or Safekeeping Agreements of the NAIC Financial Condition Examiners Handbook."

As previously noted, the securities held by Merrill Lynch were not held pursuant to a custodial agreement with a qualified bank or trust company.

The Company also failed to list Merrill Lynch as a broker/dealer in response to General Interrogatory number 22.05 of its 2002 filed annual statement.

It is recommended that the Company comply with Department Circular Letters No. 1 (1975) and 2 (1977) and ensure that all securities not physically held in its offices, vaults or safety deposit boxes are held by a proper custodian pursuant to a custodial agreement.

It is further recommended that the Company respond appropriately to the General Interrogatories in all future statements filed with this Department.

b. Confirmation of Assets by Custodian

State Street Bank, the custodian for certain of the Company's investments, signed the required New York State affidavit stating that the securities confirmed were in its custody for the account of Westchester Fire Insurance Company. Upon examination it was discovered that in addition to confirming the securities held by it, State Street Bank also confirmed the Company's statutory deposits, which were on deposit with the various states and were not in the custody of State Street Bank. When the examiners questioned the Company about why State Street Bank was confirming securities not in its custody, the Company responded that "State Street Bank keeps track of them for us as a courtesy." At the examiners request, State Street Bank provided a listing of securities it confirmed that were not in its custody.

c. Custodial Agreement

The examiner reviewed the custodian agreement entered into between WFIC and State Street Bank. This custodian agreement lacked the following safeguards and controls required by the Part 1, Section IV(H) of the NAIC Examiners Handbook.

1. "That in the event that the custodian gains entry in a clearing corporation through an agent, there should be (an) a written agreement between the custodian and the agent that the agent shall be subjected to the same liability for loss of securities as the custodian. If the agent is governed by laws that differ from the regulation of the custodian, the Commissioner of Insurance of the state of

domicile may accept a standard of liability applicable to the agent that is different from the standard liability."

2. "That if the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn, the custodian shall provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner."

It is recommended that the Company revise its custodial agreement to include the protective safeguards and controls in accordance with Part 1 General - Section IV (H) of the NAIC Financial Condition Examiner's Handbook.

ii. Investment Referral Fee

The Company entered into agreements with three financial advisors to administer its investment program. One of these advisors, Hyperion Capital Management, Inc. (Hyperion), entered into an agreement with ACE US Holdings, Inc. ("ACE US") to rebate to ACE US a "referral fee" for the placement of WFIC'S investment business. ACE US is an upstream parent of WFIC. The Company entered into two other agreements with investment advisors from which the Company reports that ACE US receives no referral fees.

The rebate is based on a specific percentage of the core fixed income portfolio assets under management by Hyperion. This fee is included in the amount charged to WFIC for the asset management performed by Hyperion.

On examination, it was determined that the only advisor rebating fees to ACE US was Hyperion Capital Management, Inc. The Company could provide no rationale for the fee and there was no apparent benefit to WFIC. In fact, Hyperion managed approximately 72% of WFIC invested assets yet was paid the highest fee per millions of dollars managed. It does not appear that this agreement was fair and equitable to WFIC nor is it an arms length transaction. Rather, it worked to the detriment of the Company.

Section 1505(a)(1) & (2) states:

"Transactions within a holding company system to which a controlled insurer is a party shall be subject to the following: (1) the term shall be fair and equitable; (2) charges or fees for services performed shall be reasonable."

Further, the existence of this referral fee was not revealed to the Department until discovered on examination. It is the Company's position that the Department did not need to be informed and the agreement need not be filed because WFIC was not a party to the agreement.

It is the position of this Department that this agreement should have been submitted to the Department for non-disapproval in accordance with Section 1505(d) of the New York Insurance Law and the Company was so directed on examination. The Company has refused to comply with the Department's directive.

Further, there remains a question of the role WFIC's board of directors and its investment committee in this "side agreement." Responses to the Department's examination planning questionnaires and review of the minutes of the board of directors meetings indicate that the investment committee reviewed all investment transactions.

It is the board of directors fiduciary responsibility to safeguard the Company's assets. There is no apparent benefit to WFIC for allowing ACE US Holdings, Inc. to receive \$3,022,493 in investment referral fees for referring WFIC to Hyperion. It appears that neither the board of directors nor the investment committee fulfilled its fiduciary responsibility to the Company's policyholders and claimants.

It is recommended that the Company submit the agreement entered into between ACE US Holdings, Inc and Hyperion Capital Management, Inc. to the Superintendent for non-disapproval in accordance with Section 1505(d) of the New York Insurance Law.

It is recommended that ACE US Holdings, Inc. cease collecting these fees until receiving non-disapproval from the Department.

It is recommended that the Company properly disclose the existence of this agreement in the Notes to the Financial Statements.

It is recommended that the WFIC board of directors and investment committee fulfill their fiduciary duty to the Company by protecting its assets.

iii. Allocation of Expenses

The examiners attempted to test the Company's compliance with Department Regulation No. 30, which dictates the methodology permissible for the allocation of expenses and the requisite documentation to be maintained by the Company to support its allocation. Despite repeated requests and two meetings with Company personnel, the Company failed to supply the documentation underlying its allocation procedures to support its compliance with Department Regulation No. 30.

Based on that failure to supply the requested documentation, the examination concludes the following:

- The Company could not provide evidence to support the compliance with the provisions of Department Regulation 30 for the allocation of expenses among companies.
- The Company could not substantiate that the "allocation of salaries" and the "recapitulation of salaries" is in compliance with Department Regulation No. 30.
- The Company could not provide sufficient detailed documentation to verify that the allocation process under the inter-company expense agreement was working in accordance with Department Regulation 30 and that WFIC was billed only for legitimate expenses. Thus, it could not be determined if the charges or fees to the Company were fair and reasonable.

It is recommended that the Company provide and maintain documentation of special studies to justify the basis of inter-company expense allocations as described in Section 105.25(a) of Department Regulation No. 30.

It is further recommended that the Company provide records of the effects of the application to each operating expense classification of all bases of allocation as described in Section 109.2 of Department Regulation No. 30.

It is recommended that the Company comply with Section 1505(b) of the New York Insurance Law and maintain the accounting information necessary to support the reasonableness of the charges or fees to the respective parties and produce such information upon examination.

A comment regarding the Company's failure to assist the examination appears in Section 2G, entitled "Facilitation of the Examination".

iv. Unsupported Liabilities

On examination, the Company could not support the following liabilities reported on its 2002 annual statement:

Commissions payable, contingent commissions and other similar charges	\$10,874,937
Taxes, licenses and fees	11,049,350
Reinsurance payable on paid loss and loss adjustment expenses	20,467,046
Loss portfolio commutation	13,198,338
Unearned Premium Reserve for Long Duration contracts	<u>99,175,000</u>
Total Unsupported Liabilities	<u>\$154,764,671</u>

The total of the unsupported liabilities noted above represents approximately 38.24% of the surplus as regards policyholders reported in the annual statement.

It is recommended that the Company maintain supporting records for all liabilities reported in its financial statements.

v. Compliance with Department Regulation 152

During the course of the examination, the Company reported that it was unable to produce documentation requested by the examiners. The documentation requested which the Company was unable to provide includes but is not limited to the following items:

- Brokerage agreements with Marsh & McLennan;
- Interest & Liability agreements for a substantial number of its reinsurance contracts;
- Support for several of its balance sheet accounts as well as support for the allocation of expenses;
- Certain claim files;
- Exhibit A, an attachment to its contract with its investment manager, Blackrock Financial Management, Inc.;
- The underlying data files supporting the calculation for the unearned premium reserve for long duration contracts.

The examiners selected the contracts of Marsh & McLennan and its affiliated companies for review. The Company failed to provide any producer (agency or brokerage) contracts with Marsh & McLennan (or any subsidiary of Marsh & McLennan) in effect for 2002 even though its records show payment of commissions to this producer. The Company did provide two agreements effective January 1, 2003 with Marsh Broking Group, Inc. (a subsidiary of Marsh & McLennan), which state:

"This agreement shall replace any currently existing contingent commission or profit-sharing agreements between MBG and Company relating to the lines or classes of insurance set forth in paragraph 1."

The Company stated that they could not locate any of the brokerage agreements with Marsh & McLennan and its subsidiaries in existence prior to the examination date.

Relative to the claim files selected for review on examination, it took the Company almost one year to produce 156 of the 159 claims files selected. During the examination period ACE, Ltd acquired the CIGNA Property and Casualty group, located in Philadelphia, PA. With this acquisition the books and records of Westchester Fire Insurance Company were moved from Atlanta, GA to Philadelphia, PA. During this move, some of the claim files were renumbered. These claims files were then subsequently stored in the Company's Philadelphia office or shipped off-site for storage. It does not appear that these claims files were accurately cross-referenced. In the end, three of the requested files could not be located.

In response to the examiners request, the Company produced documentation that it had internal controls to ensure that their policy and claim files were retained in accordance with statutory guidance. The document entitled, "The ACE USA – Claims Operating Procedure, effective July 1, 2003, includes a section entitled, "Storage and Retention." This section states:

"Once complete, the reserve change sheets and any supporting documentation must be filed in chronological order within a binder to be maintained by the Vice President or his/her designee. The retention period will be on a rolling 24 month cycle."

Department Regulation 152 provides:

"In addition to any other requirement contained in Insurance Law Section 325, any other section of the Insurance Law or other law, or any other provision of this Title, every insurer shall maintain its claims, rating, underwriting marketing, complaint, financial, and producer licensing records, and such other records subject to examination by the superintendent, in accordance with the provisions of this part."

In addition, Department Regulation 152 states a policy record shall include:

"A claim file for six calendar years after all elements of the claim are resolved and the file is closed or until after the filing of the report on examination in which the claim file was subject to review, which ever is longer."

As the Company's procedures in effect as of July 1, 2003 did not comply with Department Regulation 152, the Company revised its record retention policy to now equal or exceed the minimum requirements of Department Regulation 152.

vi. Contract with Certified Public Accountant/Report Filing

The Company entered into a written contract with its certified public accountant ("CPA") to provide an audit of the Westchester Fire Insurance Company's financial statements for 2002 as required by Department Regulation 118 which states, in part:

"Every insurer subject to this Part shall retain an independent Certified Public Accountant (CPA) who agrees by written contract with such insurer to comply with the provisions of section 307(b) of the Insurance Law, this Part and the Code of Professional Conduct adopted by the American institute of Certified Public Accountants (AICPA)...."

In accordance with the regulation, the contract between the insurer and the CPA's must specify certain items. The engagement letter between the Company and its CPA's provided on examination does not comply with the requirements of Department Regulation 118. It does not include requirements that the CPA's will provide an audited financial statement to the insurer by May 31st; that any material misstatement will be reported to the Superintendent of Insurance within 15 calendar days following such determination; and that the CPA will retain its workpaper records in accordance with Department Regulation 152.

It is recommended that the Company enter into a written contract with its appointed independent certified public accountant that complies with Department Regulation 118.

Subsequent to the examination date, the Company failed to file its 2003 audited financial statement and the requisite opinion of its certified public accountants by June 1, 2004 as required by Section 307(b)(1) of the New York Insurance Law.

Section 307(b)(1) of the New York Insurance Law requires every insurer doing business in this state to submit to the Department a filed, audited financial statement by June 1, of each year. The Law states, in part:

“Every licensed insurer, except an assessment co-operative property/casualty insurance company having direct premiums written in this state of less than two hundred fifty thousand dollars in any calendar year and having less than five hundred policyholders at the end of such calendar year, shall be required to file *within five months of the end of such calendar year*, an annual financial statement (including an annual financial statement of any subsidiary of the type described in paragraph nine of subsection (a) of section one thousand four hundred four or subparagraph (B) of paragraph four of subsection (a) of section one thousand four hundred seven of this chapter) together with an opinion thereon of an independent certified public accountant on the financial statement of such insurer . . .” (*emphasis added.*)

There is no exception to this requirement in the law.

On June 16, 2004, the Company notified this Department that it would not be filing its audited financial statements by June 1<sup>st</sup> and requested an extension to file the requisite documents. The reason given was that there was an inter-company reinsurance treaty that was improperly accounted for and that Westchester Fire Insurance Company had understated its surplus to policyholders by \$4.8 million at December 31, 2003.

Subsequently, the Company requested permission to file an amended statement to include the proper accounting for this treaty. This Department denied that request.

On July 9, 2004, the Company filed its audited financial statements along with the opinion of its certified public accountant that included an “Adverse Financial Condition Letter.”

It is recommended that the Company comply with Section 307(b)(1) and file its future audited financial statement and the opinion of its auditor by June 1.

vii. Preparation of Statement of Actuarial Opinion

At a meeting held with the examiners on December 8, 2004, the Company stated that it had incorrectly reported its unearned premium reserve for contracts with durations of greater than one year in its 2002 Statement of Actuarial opinion. The amount did not reconcile to the amount reported in the Underwriting and Investment Exhibit (“U&I”), Part 1A of its 2002 annual statement. While the

Company's actuary stated that both numbers were wrong, the opining actuary never provided an amended statement of actuarial opinion to this Department. It is recommended that management ensure that the reserves included in the scope of the actuarial opinion are accurate.

viii. Preparation of Annual Statement

The jurat page of the Company's filed annual statements is intended to represent a true and complete representation of the Company's management. The Examination determined that the Company failed to report Charles E. Stauber as a director of WFIC on the Jurat page of its 2002 annual statement.

Upon submission of a filed statement, the NAIC performs analytic procedures through the use of computer software. These procedures are used to determine if the balances crosscheck from one schedule to another. The Company's 2002 filed annual statement failed thirty-seven crosschecks for consistency and one crosscheck for completeness.

Further, the examination revealed the following errors in the Company's 2002 annual statement:

- Schedule E was incorrect. The Schedule listed banks as depositories in which the Company did not have accounts or had closed the account prior to the statement date. The Company restated Schedule E on examination.
- Schedule E-2 was incorrect. The Schedule listed a statutory deposit with the State of Iowa that was instead held by the Company's custodian.
- Numerous errors were noted in Schedule F (see Section 2C for details.)
- Part 3 of the Underwriting & Investment Expense Exhibit was misstated. The statement reported \$1,523,047 in investment expenses in the write in line with an equal off-setting expense. The total reported investment expense was \$0. On line 11 of the Exhibit of Net Investment Income the Company reported \$1,841,651 for investment expense. This amount was improperly netted against Investment income and reported on line 9 of the Underwriting and Investment Exhibit Statement of Income.
- Reconciliation of Schedule P to the Underwriting and Expense Exhibit in the annual statement indicated a variance in the amounts reported for the paid losses.
- The Company reported a negative premium of \$237,670 for personal auto liability on a direct basis in its 2003 annual statement, but a review indicates there were no direct written premiums for personal auto liability for 1998 through 2002.

- The Notes to the Financial Statements, Item 10 F, incorrectly identified ACE INA Holdings, Inc. (not ACE US Holdings, Inc.) as a party to the approved tax allocation agreement with the Company.
- Schedule Y was not prepared in accordance with the NAIC's Annual Statement Instructions. The Schedule listed Industrial Excess & Surplus Insurance Broker as a member of the holding Company when it had been dissolved the prior year. No transactions were listed for Dimension Services Corporation.
- The cumulative number of claims reported in Schedule P, Part 5, Column 10 did not reconcile to the sum of claims closed with payment, closed without payment and claims outstanding, by line of business.

It is recommended that the Company exhibit greater care in the preparation of its filed Annual Statement and complete said statement in compliance with the NAIC Annual Statement Instructions.

G. Facilitation of the Examination

Section 310(a)(2) of the New York Insurance Law states, in part:

“Any examiner authorized by the superintendent shall be given convenient access at all reasonable hours to the books, records, files, securities and other documents of such insurer or other person, including those of any affiliated or subsidiary companies thereof, which are relevant to the examination...”

Section 310(a)(3) of the New York Insurance Law states:

“The officers and agents of such insurer or other person shall facilitate such examination and aid such examiners in conducting the same so far as it is in their power to do so.”

Throughout the examination, the Company failed to respond in a timely manner to the examination requests and memorandum. The examiners sent requests and memorandum to the Company with time limits of 10 days to provide the requested documentation. At the conclusion of fieldwork, the Company took, on average, approximately 46 business days to respond to a request and approximately 87 business days to respond to a memorandum. Further, there were twelve unanswered requests and thirteen unanswered memoranda at the conclusion of fieldwork. The amount of time the Company took to

respond delayed the completion of fieldwork, increased the cost of the examination for the Company and taxed the resources of the Department.

The Company failed to respond to requests for documentation for the following material transactions:

- Data underlying the calculation of the unearned premium reserve for long duration contracts (auto warranty) (see Section 2(B) entitled “Warranty Business” and Section 12 of this report for details).
- Support for various liability accounts reported in its 2002 filed annual statement (see Section 2F. iv. of this report for details).
- Support for the allocation of expenses in accordance with Department Regulation 30. (see Section 2, F, iii., of this report for details).

In one instance the Company refused to submit a contract to the Department when requested by the examination team citing that WFIC was not a party to the contract in question despite the fact that the contract indirectly impacted WFIC.

On examination it was determined that the officers of the Company failed to comply with Section 310 of the New York Insurance Law. Throughout the examination numerous correspondence was sent to Company representatives inquiring as to the status of the examination requests for information. In addition, several meetings were held between Company representatives and the examiners to review outstanding examination requests and memoranda. Despite these efforts several examination requests went unanswered or were incomplete.

It is recommended that the Company comply with Section 310(a)(3) of the New York Insurance Law by facilitating the examination and aid the examiners in the performance of their duties in future examinations.

## H. Data Integrity

### School Property and Liability Policies

The Company appointed a third-party administrator to underwrite school property and liability policies in New England. This administrator also underwrites business for Illinois Union Insurance Company, an affiliated company. The third-party administrator enters the policies into a database that is transferred to the insurance companies.

During the examination period, the Company recorded direct written premiums on its books that were in fact direct premiums written on the school property and liability policies (“SP”) of Illinois Union Insurance Company. The examination was able to identify twenty such policies, which were incorrectly recorded in 2002. The examination identified these policies through a random sample of the Company’s premium database. Based on the sample, the examiners could not quantify the extent of the errors because the company field of the policy data contained the wrong company number and the fact that the Company was unwilling to audit its third-party administrator (“TPA”) in order to correct this field.

The examiners' request, that the Company meet with them in order to quantify the extent of the problem and agree upon steps to be undertaken to prevent errors such as these from happening in the future, was not responded to by the Company.

It should be noted that the examiners could not ascertain if this was the full extent of the direct written premium overstatement because the data selected was from the 2002 year only. Further, the examination could not determine if any WFIC policies were incorrectly entered on the books of Illinois Union Insurance Company.

### Duplicate Premium Data

The Company maintains two databases for its written premiums; the “PAR” file, which contains direct premiums written and non-intercompany assumptions, and the “UPR” file, which represents premiums assumed from WSLIC. Hence, there should not be any duplication of policy numbers when comparing the two databases. The examiners made a comparison of two of the premium data sources to test whether there were any policies recorded in both databases in 2002. This review revealed that there were sixty-nine policies with the same policy numbers in the “PAR” source data file and the “UPR” source data file.

Based on these findings, it appears that the Company booked the same premiums more than once. The net effect of the overstatement of direct written premiums does not appear to be material to the examination. However, as the data reviewed contained only 2002 data, the examination could not determine if this error had occurred in prior years.

It is recommended that the Company establish controls in its premium data systems to identify duplicate policy numbers coming from different sources.

### Premiums Written by Line-of-Business

The Company is required to report its written premiums by line-of-business in Part 1B of the Underwriting and Investment Exhibit in its annual statement. The examination used ACL audit software to test the accuracy of the reporting of premiums, by line of business, in the Underwriting and Expense Exhibit in the 2002 annual statement. The examination found the following discrepancies:

- Line 5, Commercial multiple peril was overstated by \$15,000; and Line 27, Boiler and machinery was understated by \$15,000.
- The Company did not segregate claims-made from occurrence for Line 17-Other liability; thus overstating the occurrence amount by the claims-made amount of \$25,329,972

The Company responded to this examination finding that there was data from several sources including amounts adjusted manually and that the system line-of-business field did not capture certain refined information requiring manual adjustments to correct.

It is recommended that the Company modify its premium system so that premium data is segregated by proper annual statement line of business.

### Claims Data

A number of problems were identified when the examiners tested the Company's claims data.

These include:

- One claim that was closed remained open in the OMNI and AIR systems.
- Two claims were miscoded by state.
- One claim file contained the wrong business code.

The Company's claim system is the OMNI system. This is the system in which the claims examiners enter their data. The review on examination indicated that some of the data entered into the claims system was not being properly captured in the accounting system (AIR.)

- Two insureds' names in the AIR system did not agree with the names in the OMNI system.
- Most of the report dates were different between the two systems.
- Twelve claims had no insured's names in the AIR data but the names were contained in the OMNI system.
- Most of the producer codes were missing from the OMNI system but when they did appear, those codes were different than in the AIR system.

Further, three of the claims from the sample were related to policies written by ACE Property and Casualty Insurance Company. Three additional files were actually closed in 2001 but continued to carry a reserve balance at December 31, 2002.

It is recommended that the Company institute data edit procedures to ensure that specific fields are captured in the accounting database, that the data from the claims system is in agreement with the data in the accounting database relative to claims, and that the data is accurate. It is further recommended that adequate controls be implemented to prevent claims against policies issued by one company from being coded to another company.

#### I. Business Contingency Plan

During the course of the examination, the examiners reviewed the Company's preparedness for a catastrophic loss of its business operation through a disaster. The Company did have a disaster recovery plan for its information technology systems but did not have a business contingency plan. The disaster recovery plan is designed to minimize the impact of the unexpected loss of vital business processes. Although the Company advised that a business contingency plan was being constructed, it did not have such plan in place at the examination date.

It is recommended that the Company complete its business contingency plan and test it prior to implementation.

#### J. Information System Controls

To determine the adequacy of the controls established by the Company to protect its information systems, the examination reviewed the response to the "information system questionnaire" and tested selected controls. This review has revealed certain deficiencies in the systems.

There should be a control that ensures that all necessary steps are appropriately included in the project plan. The procedures should provide a standardized step-by-step approach to project management, identifying specific activities, checklists and forms required for application development projects. Each procedure should be comprised of several key components: purpose description, inputs, deliverables, estimates, responsibilities, techniques and tools. The purpose of this procedure is to ensure that adequate plans are in place for the managing of a new software effort.

This plan, referred to as the system development life cycle methodology, had not been completed at the time of the examination. The Company indicated that it was in the process of implementing this control.

It is recommended that the Company institute the development of the life cycle procedures that ensures that all necessary steps are appropriately included in a project plan.

The examiner requested that the Company provide the index of the system design standard manual for review. The Company stated that WFIC relies on the support from the information technology (“IT”) vendors to adhere to the design standards as considered for the projects or to maintain the proper technical documents in support of its programming effort. While this may, in theory, seem acceptable, if the Company were to change vendors they would need to rely on the vendor they were replacing to forward complete documentation to the new vendor.

It is recommended that the Company maintain systems design, programming standards, and technical documentation manuals pursuant to Department Regulation 152.

One of the controls tested for the adequacy of the Company’s document retention is the review of the standards manual for system documentation. The Company responded that they did not have such documentation; they were in the process of developing it with the aid of their vendors.

It is recommended that the Company compile and employ a standards manual for system documentation.

The review and testing of procedures wide area network and internet controls provided reasonable assurance that adequate control procedures are in place. However, the control of scanning or filtering outgoing e-mail for offensive or damaging content was not in place.

It is recommended that the Company implement a system to scan or filter outgoing e-mail or files for either offensive or potentially damaging content.

### 3. FINANCIAL STATEMENTS

#### A Balance Sheet

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

<u>Assets</u>	<u>Examination</u>		Net Admitted <u>Assets</u>	<u>Company</u>		Surplus Increase <u>(Decrease)</u>
	<u>Assets</u>	Assets Not <u>Admitted</u>		Net Admitted <u>Assets</u>	Net Admitted <u>Assets</u>	
Bonds	\$960,704,904	\$0	\$960,704,904	\$960,704,904	\$ 0	
Cash and short-term investments	80,939,619	1,020,922	79,918,697	80,939,619	(1,020,922)	
Other invested assets	18,823,272	3,307,195	15,516,077	18,823,272	(3,307,195)	
Receivable for securities	864,927	0	864,927	864,927	0	
Premiums and agents' balances in course of collection	77,233,453	22,877,191	54,356,262	72,574,004	(18,217,742)	
Premiums, agents' balances and installments booked but deferred and not yet due	1,134,557	0	1,134,557	1,134,557	0	
Funds held by or deposited with reinsured companies	274,210	0	274,210	274,210	0	
Reinsurance recoverables on loss and loss adjustment expense payments	48,401,107	0	48,401,107	48,401,107	0	
Federal and foreign income tax recoverable	60,800,969	30,695,039	30,105,930	30,105,930	0	
EDP equipment and software	5,228,780	5,228,780	0	5,228,780	(5,228,780)	
Interest, dividends and real estate income due and accrued	11,625,908	0	11,625,908	11,625,908	0	
Receivable from parent, subsidiaries and affiliates	29,545,337	5,735,864	23,809,473	29,545,337	(5,735,864)	
Equities and deposits in pools and associations	4,118,000	4,118,000	0	4,118,000	(4,118,000)	
Other assets non-admitted	446,052	446,052	0	0	0	
Aggregate write-ins for other than invested assets (loss pending allocation and other)	<u>5,909,511</u>	<u>5,213,655</u>	<u>\$695,856</u>	<u>3,278,555</u>	<u>(2,582,699)</u>	
Total assets	<u>\$1,306,050,606</u>	<u>\$78,642,698</u>	<u>\$1,227,407,908</u>	<u>\$1,267,619,110</u>	<u>\$(40,211,202)</u>	

<u>Liabilities, Surplus and Other Funds</u>	<u>Examination</u>	<u>Company</u>	Surplus Increase (Decrease)
Losses and Loss adjustment expenses	\$913,775,838	\$660,995,838	\$(252,780,000)
Reinsurance payable on paid losses and loss adjustment expenses	20,467,046	20,467,046	\$ 0
Commissions payable, contingent commissions and other similar charges	10,874,937	10,874,937	0
Other expenses (excluding taxes, licenses and fees)	3,064,115	3,064,115	0
Taxes, licenses and fees (excluding federal and foreign income taxes)	11,049,350	11,049,350	0
Federal and foreign income taxes	17,826,886	17,826,886	0
Unearned premiums	391,595,111	342,348,111	(49,247,000)
Ceded reinsurance premiums payable (net of ceding commissions)	60,727,852	60,727,852	\$ 0
Funds held by company under reinsurance treaties	1,337,083	1,337,083	0
Amounts withheld or retained by company for account of others	58,816	58,816	0
Remittances and items not allocated	3,031,337	(9,968,008)	(12,999,345)
Provision for reinsurance	80,468,713	28,142,119	(52,326,594)
Drafts outstanding	(6,674,495)	(15,533,486)	(8,858,991)
Aggregate write-ins for liabilities	<u>(346,172,174)</u>	<u>(268,452,129)</u>	<u>77,720,045</u>
Total liabilities	<u>\$1,161,430,415</u>	<u>\$862,938,530</u>	<u>\$(298,491,885)</u>
<u>Surplus and Other Funds</u>			
Aggregate write-ins for special surplus funds	\$117,300,000	\$117,300,000	\$ 0
Common capital stock	4,503,671	4,503,671	0
Gross paid in and contributed surplus	128,333,500	128,333,500	0
Unassigned funds (surplus)	<u>(184,159,673)</u>	<u>154,543,408</u>	<u>338,703,081</u>
Surplus as regards policyholders	<u>\$65,977,498</u>	<u>\$404,680,579</u>	<u>\$338,703,081</u>
 Total liabilities, surplus and other funds	 <u>\$1,227,407,913</u>	 <u>\$1,267,619,109</u>	

NOTES

1. The Internal Revenue Service has completed its audits of the Company's (consolidated) federal income tax returns through tax year 1998. 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 1999 through 2001 are currently under examination. The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2002. 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. Underwriting and Investment Exhibit

Surplus as regards policyholders decreased \$243,976,673 during the five-year examination period

January 1, 1998 through December 31, 2002, detailed as follows:

Premiums earned		\$1,023,116,891
Deductions:		
Losses incurred	\$ 853,949,510	
Loss adjustment expenses incurred	117,483,474	
Other underwriting expenses incurred	<u>306,346,566</u>	
Total underwriting deductions		<u>1,277,779,550</u>
Net underwriting gain or (loss)		\$ (254,662,659)
<u>Investment Income</u>		
Net investment income earned	\$226,010,053	
Net realized capital gains	<u>2,530,626</u>	
Net investment gain or (loss)		228,540,679
<u>Other Income</u>		
Net gain or (loss) from agents' or premium balances charged off	\$ (705,817)	
Aggregate write-ins for miscellaneous income	<u>(71,160,058)</u>	
Total other income		<u>(71,865,875)</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$ (97,987,855)
Federal and foreign income taxes incurred		<u>39,731,434</u>
Net income		<u>\$(137,719,289)</u>

C. Capital and Surplus Account

Surplus as regards policyholders per report on examination as of December 31, 1997			\$266,954,171
	<u>Gains in</u>	<u>Losses in</u>	
	<u>Surplus</u>	<u>Surplus</u>	
Net income		\$137,719,289	
Net unrealized capital gains or (losses)	\$962,009		
Change in net deferred income tax		10,512,971	
Change in nonadmitted assets		30,756,090	
Change in provision for reinsurance		73,030,006	
Cumulative effect of changes in accounting principles	24,756,345		
Capital changes paid in	1,002,879		
Capital changes transferred from surplus (stock dividend)	792		
Surplus adjustments paid in	116,179,329		
Dividends to stockholders		70,000,000	
Aggregate write-ins for gains and losses in surplus		<u>21,859,671</u>	
Total gains and losses	<u>\$142,901,354</u>	<u>\$343,878,027</u>	
Net increase (decrease) in surplus			<u>(200,976,673)</u>
Surplus as regards policyholders per report on examination as of December 31, 2002			<u>\$ 65,977,498</u>

#### 4. CASH AND SHORT- TERM INVESTMENTS

The examination net admitted asset of \$79,918,697 is \$1,020,922 less than the \$80,939,619 reported by the Company in its December 31, 2002 annual statement. The Company's reported balance is comprised of Cash in the amount of \$23,294,656 and Short-term investments in the amount of \$57,644,963. The examination adjustment is to the Cash portion of this account. As of the examination date, the examiners were able to confirm \$22,273,734 in cash with the banks in which the Company's deposits were held. The difference between the balance reported for Cash and the balance confirmed, \$1,020,922, has been non-admitted on examination. It should be noted that \$777,269 of the \$1,020,922 amount also appeared as an offsetting liability in All Other Miscellaneous Liabilities in Section 17 of this report.

#### 5. OTHER INVESTED ASSETS

The examination net admitted asset of \$15,516,077 is \$3,307,195 less than the \$18,823,272 reported by the Company in its 2002 annual statement.

In its annual statement, the Company overvalued the carrying amounts of two investments in limited partnerships. Upon examination it was determined that the Company reported values of Conning Insurance Capital Ltd. Partnership III and Capital Z Financial Services Fund II, L.P., \$1,345,699 and \$17,477,533, respectively, should have been \$1,034,365 and \$14,481,762, respectively, or a combined overstatement of \$3,307,195.

The valuation of these two limited partnerships was determined through review of the partnerships' audited financial statements. SSAP # 48 requires that limited partnerships be recorded based on the underlying Generally Accepted Accounting Principles ("GAAP") equity of the investment.

## 6. PREMIUMS AND AGENTS' BALANCES IN THE COURSE OF COLLECTION

The examination net admitted asset of \$54,356,262 is \$18,217,742 less than the \$72,574,004 reported by the Company in its December 31, 2002 filed annual statement. The examination change is due to balances more than 90 days past due and balances that were debited on the books of the Company but were actually the assets of Illinois Union Insurance Company ("Illinois Union"), an affiliated company.

Statutory accounting guidance for Agents' balances and premiums in the course of collection dictates that all agents' balances be non-admitted on examination if the balance remains uncollected for more than 90 days. Section 1301 of the New York Insurance Law sets forth the assets that allowed as admitted assets for an insurer. Pursuant to Section 1301(a)(11) of the New York Insurance Law the following are allowed as admitted assets:

*"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: (i) premiums payable directly or indirectly by the United States government or any of its instrumentalities, (ii) reinsurance premiums payable by ceding insurers authorized to transact such business in this state, or (iii) 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"* (emphasis added.)

SSAP No. 6 states in part:

- “9. c. Agents' Balances — the uncollected agent's receivable on a policy by policy basis which is over ninety days due shall be nonadmitted regardless of any unearned premium;
- i. If amounts are both payable to and receivable from an agent on the same underlying policy, and the contractual agreements between the agent and

the reporting entity permit offsetting, the nonadmitted portion of amounts due from that agent shall not be greater than the net balance due, by agent;

- ii. If reconciling items between a reporting entity's account and an agent's account are over ninety days due, the amounts shall be nonadmitted.”

The following is a chart of the changes made to this account:

<u>Item in the account reconciliation</u>	<u>Amount of Change</u>	<u>Cause of change</u>
Policies of another affiliated company	\$5,803,418	These were policies that were the asset of Illinois Union
Warranty receivables	\$8,448,618	Balances more than 90 days past due
Non-admitted balances	\$3,965,705	Recalculation of non-admitted balances

The examination identified premiums recorded on the books of WFIC that were actually due to policies of Illinois Union (see item 2H Data Integrity - the School Property and Liability Policies section in this report). The amount of agents' balances identified was \$5,803,418, which amount was extrapolated from the sample examined.

It should be noted that although the premiums were recorded on the books of WFIC no corresponding losses were recorded on its books for Illinois Union policies.

The Company carried an amount of \$8,865,893 in its agents' balances account for warranty business. On examination it was determined that \$417,275 of this amount represented assets less than 90 days past due. The remaining asset of \$8,448,618 was determined to be more than 90 days past due and was non-admitted on examination.

The Company's not admitted asset for overdue premiums was derived from three data sources; the PBRS, Genius and CBS databases. These databases included aged "buckets", from which the Company's not admitted asset was determined. The Company could not provide the premium billing dates; however, using these buckets, the examiner determined that the not admitted asset should have been \$8,625,154, which is \$3,965,705 more than the \$4,659,449 reported by the Company.

It is recommended that the Company only report as admitted assets premiums in course of collection not more than ninety days past due in accordance with Section 1301(a)(11) of the New York Insurance Law and SSAP No. 6.

**7. ELECTRONIC DATA PROCESSING EQUIPMENT AND SOFTWARE**

The Company reported an admitted asset under this caption in the amount of \$5,228,780 as of the examination date. Pursuant to this examination, the admitted asset has been eliminated.

On examination, it was found that the asset reported by the Company for EDP equipment and software should have a net book carrying value of zero. This asset is for operating systems developed internally by the Company and for which the Company was unable to provide documentation to support the basis cost of this asset, the depreciation of the asset, and any reason why it believes the asset qualifies for admission under statutory accounting.

The Company non-admitted this asset in its 2003 and 2004 filed annual statements.

**8. RECEIVABLE FROM PARENT, SUBSIDIARIES AND AFFILIATES**

The examination admitted asset of \$23,809,473 is \$5,735,864 less than the \$29,545,337 reported by the Company in its 2002 annual statement.

On examination it was found that certain receivables from affiliates were carried in the financial statements as admitted assets despite having been substantially overdue. The following chart depicts the dates of the last transactions relative to the receivable balances with affiliated companies and the amount not admitted on examination:

<u>Affiliated Company</u>	<u>Date of Last Transaction</u>	<u>Receivable Amount</u>
ACE Ins. Co of Canada	June 2001	\$2,871,000
ACE USA Inc.	September 2000	2,393,752
ACE INA Holdings, Inc.	September 2000	467,276
ACE Ltd.	Unknown	<u>3,836</u>
Total amount not admitted		<u>\$5,735,864</u>

In accordance with Department Circular Letter No. 15 (1975), intercompany receivable balances more than 90 days past due should be not admitted.

It is recommended that the Company comply with Circular Letter No. 15 (1975) and report all assets more than 90 days past due as non-admitted in future filed annual statements.

As noted in Section 2D of this report, the Company was not settling its inter-company balances in accordance with the timeframes noted in its filed agreements. Further, the Company was found to be settling its inter-company balances with various affiliates through its inter-company account with ACE American Insurance Company, a third party affiliate. It was noted on examination that on December 27, 2002 the balance due the Company from its affiliate Westchester Surplus Lines Insurance Company was settled by means of two fourth quarter journal entries totaling \$185,985,577, thereby netting the Company's receivable from Westchester Surplus Lines Insurance Company against the Company's payable to ACE American Insurance Company. The net receivable from ACE American Insurance Company, after the above noted journal entries were made, was settled in February 2003.

The practice of settling balances due to or from one affiliated entity via journal entries offsetting balances due to or from another affiliated entity is contrary to the settlement terms per the filed agreements and is contrary to SSAP No. 64 which states, in part:

“Assets and liabilities shall be offset and reported net only when a valid right of offset exists except as provided for in paragraphs 3 and 4.”

Since there is no valid right of offset contained in the approved agreements, the Company should not have offset balances due to or from one affiliate with balances due to or from another affiliate.

It is noted that the September 30, 2002, inter-company balance of \$111,727,421, due the Company from Westchester Surplus Lines Insurance Company was settled by means of the journal entries noted above. Thus the mere posting of journal entries on December 27, 2002, resulted in the balance due the Company from Westchester Surplus Lines Insurance Company being reported as a current receivable balance from ACE American Insurance Company on December 31, 2002. No adjustment has been made to the financial statements in this report to reverse the journal entries noted above based on the fact the net receivable balance due from ACE American Insurance Company after the two inter-company reclass journal entries were made was subsequently settled in February 2003. Had the examination reversed these journal entries and non-admitted the entire September 30, 2002 balance due from Westchester Surplus Lines Insurance Company, the Surplus as regards policyholders per this examination would have been reduced by an additional \$111,727,421.

It is recommended that the Company comply with SSAP No. 64 and only offset balances when a valid right of setoff exists. Recommendations relative to compliance with filed inter-company agreements was made in Section 2D of this report.

## **9. EQUITIES AND DEPOSITS IN POOLS AND ASSOCIATIONS**

The Company reported an admitted asset in the amount of \$4,118,000 as of the examination date. Pursuant to this examination, the admitted asset has been eliminated. The Company could not provide the examiner with support to show that the amount reported in its annual statement was collectible and subsequently it wrote off this balance in 2003. Review of this account on examination, indicates that the

balances are not collectible and, therefore, do not meet the criteria set by Section 1301(a) of the New York Insurance Law to qualify as an admitted asset.

#### **10. AGGREGATE WRITE-INS FOR OTHER THAN INVESTED ASSETS**

The examination of admitted asset of \$665,481 is \$2,582,699 less than the \$3,248,180 reported by the Company in its 2002 annual statement. The Company reported a balance of \$3,248,180 under the caption "Losses pending allocation and other" on page 2, line 2501 of its 2002 annual statement. The Company was asked to provide a lead schedule, reconciliation and detail of this item. The documentation provided to the examination was able to support \$665,481 of this asset. The remainder of the asset has been non-admitted in this report.

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

The examination liability of \$913,775,838 is \$252,780,000 more than the \$660,995,838 reported by the Company in its 2002 annual statement. The examination change, gross of a stop loss treaty with National Indemnity Company, is due to the following:

- Two-year development of Losses and allocated loss adjustment expenses in the amount of \$206,820,000 as reported by the Company in its 2004 annual statement;
- Two year development of Adjusting and other expenses in the amount of \$23,660,000 as reported by the Company in its 2004 annual statement;
- The adoption of the high end of the Company's actuary's estimate of the reserves for the asbestos and environmental losses (including LTE) in the amount of \$8,200,000;
- Additional deficiency through December 31, 2004 for accident years 2002 and prior, exclusive of asbestos and environmental losses, noted in WFIC's internal actuarial evaluation in the amount of \$14,100,000;

The examination analysis of the loss and loss adjustment expense reserves was conducted in accordance with generally accepted actuarial principles and was based on statistical information contained in the Company's internal records and in its filed annual statements.

The examination analysis of the asbestos and environmental reserves was significantly limited due to the failure of the Company to provide detailed claim file information. In addition, there were repeated delays in responses to the Department's requests for information and explanations of submissions that greatly impeded the actuarial analysis.

Further, the Department's review of the actuarial workpapers underlying the 2002 statement of actuarial opinion finds that the Company is not in compliance with the NAIC Annual Statement Instructions which prescribe that exhibits in the actuarial report include a clear roadmap connecting the underlying raw data to the top-level summary exhibits.

It is recommended that the Company comply with the NAIC Annual Statement Instructions and ensure that the workpapers underlying the statement of actuarial opinion are clear and map the underlying raw data to the top-level summary exhibits.

In accordance with Section 1303 of the New York Insurance Law,

“Every insurer shall,...maintain reserves in an amount estimated in the aggregate to provide for the payment of all losses or claims incurred on or prior to the date of statement, whether reported or unreported, which are unpaid as of such date and for which such insurer may be liable, and also reserves in an amount estimated to provide for the expenses of adjustment or settlement of such losses or claims.”

It is recommended that the Company comply with Section 1303 of the New York Insurance Law.

In the prior report on examination it was noted that the Company was unable to provide the examiners with Schedule P loss run-off data in the form requested by this Department. The request was for information broken down into sixteen parts that isolate the various components of an insurer's

reserves. It was noted that this is information that the Company would normally capture in monitoring the adequacy of its loss reserves.

The prior report on examination recommended that the Company institute procedures that will enable the Company to provide Schedule P loss run-off data in the form requested by the Department.

During this examination, the Company again was unable to supply this information in the format requested. It is again recommended that the Company institute procedures that will enable it to provide Schedule P loss run-off data in the form requested by this Department.

SSAP No. 55 describes, in part, how loss adjustments are to be classified into two categories and provides a list of how expense items are allocated into these two categories. The review of the methodology employed by the Company indicates that the allocation is not in compliance with SSAP No. 55, paragraph 5, subparagraph c, which states, in part:

“Loss adjustment expenses can be classified into two broad categories: Defense and Cost Containment (“DCC”) and Adjusting and Other (“AO”)...”

It is recommended that the Company allocate its loss adjustment expenses in compliance with SSAP No. 55, paragraph 5, subparagraph c.

As part of the verification of losses, the examiners tested claims payments to ensure that the payments are made and reported during the same accounting period. A sample of 159 claims revealed that there were nine checks issued in 2001 that were not recorded on the Company's books until 2002. In addition, five claims from the sample were found to be under reserved by more than \$1,000,000.

It is recommended that the Company report its claims payments in the proper accounting period.

## **12. UNEARNED PREMIUMS**

The examination liability for “Unearned premiums” of \$391,595,111 is \$49,247,000 greater than the \$342,348,111 reported by the Company in its 2002 annual statement. This change is due to the establishment by the examination of a premium deficiency reserve in the amount of \$49,247,000.

As stated in section 2B of this report, the examination determined that the Company calculated the unearned premium reserve using methods that were not approved by this Department. The Company reported an unearned premium reserve for long duration contracts at December 31, 2002 in the amount of \$99,175,000. The Company’s re-evaluation at December 31, 2004 shows the required reserve for unearned premiums for long duration contracts at December 31, 2002 should have been \$148,422,000. Therefore, based on the Company’s revised estimate, the unearned premium reserve for long duration contracts was found to be deficient by \$49,247,000.

It is noted that despite the Department’s repeated requests to obtain complete documentation in support of the calculation of the unearned premium reserve for long duration contracts, the Company was never able to comply. Many of the requests were ignored and went unanswered. When the Company did respond to a request, it was extremely delayed or incomplete. Due to the Company’s inability to provide documentation to support the calculation of the unearned premium reserve for long duration contracts the examination report is using the Company’s own indicated deficiency in the unearned premium reserve for long duration contracts as of the examination date, re-evaluated at December 31, 2004.

**13. REMITTANCES AND ITEMS NOT ALLOCATED**

The examination liability for "Remittances and items not allocated" of \$3,031,337 is \$12,999,345 greater than the \$(9,968,008) reported by the Company in its 2002 annual statement. This increase is due to the following:

- A debit adjustment of \$16,033,645-- Merrill Lynch Clearing
- A credit adjustment of \$22,090,214-- Merrill Lynch Clearing
- A credit adjustment of \$6,942,776 to reduce "Other miscellaneous liabilities"

As noted earlier in this report, the Company maintained a brokerage account with Merrill Lynch. The examiners confirmed the account balance with Merrill Lynch directly. The confirmation contained no balances due to or due from WFIC. Apparently, the journal entries supporting these balances were not cleared from the general ledger when they were settled. However, the Company could not support these balances.

The credit adjustment of \$6,942,776 to this account is an off-setting entry which will reduce "Other miscellaneous liabilities" in the same amount. The entries were erroneously credited to the wrong account when they were entered into the Company's bookkeeping system.

**14. PROVISION FOR REINSURANCE**

The examination liability of \$80,468,713 is \$52,326,594 more than the \$28,142,119 reported by the Company in its 2002 annual statement. The changes to the amount reported in the Company's annual statement are included in the chart below:

<u>Cause of change</u>	<u>Amount</u>
Warranty business ceded to unauthorized reinsurers	\$ 42,633,594
Letters of credit	5,115,000
Unsupported aging in reinsurance recoverable	<u>4,578,000</u>
Total increase in Provision for Reinsurance	<u>\$52,326,594</u>

In its annual statement, the Company reported cessions totaling \$16,891,847 for its warranty business. The reinsurance contracts reviewed on examination indicated that none of the reinsurers were authorized in New York. Further, the annual statement Schedule F failed to indicate these reinsurers. WFIC advised that the cessions to these reinsurers had been reported under the “property treaty” (as further explained in item 2Cv. of this report). The examiners requested specific information regarding which reinsurers had received credit for this reinsurance. The Company failed to respond to this request.

Upon examination, the Company supplied a schedule of reinsurance ceded by WFIC to the aforementioned unauthorized reinsurers. This schedule indicated that the net amount recoverable from these reinsurers totaled \$42,633,594, comprised entirely of unearned premium reserves, and collateral in the form of custodial accounts totaling \$23,159,663.

Despite repeated requests, the Company failed to supply substantiation that this collateral complies with the requirements of Department Regulation 114 or Appendix A-785 of the NAIC’s Statements of Statutory Accounting Principles. Since the collateral does not meet these requirements, the examination established a provision for reinsurance for the entire amount reported as ceded recoverable.

The Company also reported as complying collateral, a \$5,000,000 letter of credit for which the Company is not the beneficiary. Since the Company is not the beneficiary, the letter of credit does not meet the requirements of Department Regulation 133. As such, a provision for reinsurance has been established in the amount of \$5,000,000.

Other letters of credit offsetting reinsurance recoverables from unauthorized reinsurers were confirmed at \$115,000 less than that reported by the Company. As a result, the examination has adjusted the calculation of the provision for reinsurance for these reinsurers by this amount.

In total, letters of credit offsetting reinsurance recoverables were overstated in the amount of \$5,115,000 for which a "Provision for reinsurance" has been established.

After repeated requests, the Company provided an aging schedule of the reinsurance recoverable that was necessary to calculate the overdue penalty on authorized reinsurance. The schedule contained no billing dates for these reinsurance recoverables on paid losses and paid loss adjustment expenses and did not tie to the Company's annual statement. Based on this, the examination has established a penalty provision for the entire amount recoverable.

The amount recoverable is \$28,716,000; of which the 20% penalty for overdue recoverables from authorized reinsurers is \$5,743,000. The Company established an overdue penalty of \$1,165,000. The additional penalty is \$4,578,000 (\$5,743,000 - \$1,165,000.)

## **15. DRAFTS OUTSTANDING**

The examination contra-liability of \$(6,674,495) is \$8,858,991 less than the \$(15,533,486) reported by the Company in its 2002 annual statement.

Upon examination, it was determined that the \$15,533,486 balance included:

- A duplicate amount also included in agents' balances
- a reconciliation of accounts also included in the reconciliation of cash
- mathematical errors
- a receivable for claims paid on behalf of an unrelated company
- adjustments based on incorrect estimates

This contra-liability represented funds being advanced to third-party administrators (“TPA”) to pay warranty claims. There is a two-month lag from the time that the funds are advanced until claims payments are recorded in the Company’s system. Also, some of these funds are retained by the TPA for future claims payments. Since the money has been advanced to these TPAs the funds have been credited from cash and debited to the Drafts outstanding that is used by the Company as a suspense account.

Repeated attempts by the Company to reconcile this account failed. The examination concluded that the account was misstated and cannot be accurately reconciled. There are a number of reasons why this account cannot be balanced. They are: the timing of the claims payments in relationship to when the TPA receives the cash, the insolvency of one producer, poor internal controls by the Company, and lax reporting by the TPA. On examination, the Company has been given credit for amounts that it can substantiate and have not been reported twice in the balance sheet. In total, the Company was able to substantiate \$6,674,495 debit balance to this account. The remaining balances totaling \$8,858,991 has been disallowed upon examination.

## **16. STOP LOSS REINSURANCE**

The examination contra-liability for “Stop loss reinsurance” of \$263,000,000 is \$70,000,000 greater than the \$193,000,000 reported by the Company in its 2002 annual statement. The contra-liability consists of two stop-loss agreements; a \$150,000,000 agreement with National Indemnity Company (“NICO”) and a \$43,000,000 agreement with ACE Bermuda Insurance Company (“ACE Bermuda”).

The actuarial review conducted by this Department increased the liability for loss and loss adjustment expense by \$252,780,000 (see section 11, “Loss and Loss Adjustment Expenses”). The NICO agreement reinsured \$70,000,000 of this increase.

**17. ALL OTHER MISCELLANEOUS LIABILITIES**

The examination liability for "All other miscellaneous liabilities" of \$6,091,822 is \$7,720,045 less than the \$13,811,867 reported by the Company in its 2002 annual statement. This change was caused by a balance carried in the asset account, "Cash," for \$777,269 that should have been carried as a deduction to this liability. Further, there was a re-classification of \$6,942,776 to the liability account "Remittances and items not allocated" which further reduced this liability. Offsetting adjustments have been made to the aforementioned accounts in this report.

**18. MARKET CONDUCT ACTIVITIES**

In the course of this examination, a review was made of the manner in which the Company conducts its business practices and fulfills its contractual obligations to policyholders and claimants. The review was general in nature and is not to be construed to encompass the more precise scope of a market conduct investigation, which is the responsibility of the Market Conduct Unit of the Property Bureau of this Department.

The general review was directed at practices of the Company in the following areas:

- A. Underwriting
- B. Claims and complaint handling

No exceptions were noted.

## 19. 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>
A. <u>Reinsurance</u>	
i. It is recommended that the Company amend its reinsurance agreement to include a mutual offset clause, whereby each party to this contract agrees to honor the terms set forth therein as if the contracts were separate agreement between the reinsurer and each individual named reinsured.	11
<p>The Company has complied with this recommendation.</p>	
ii. It is recommended that the Company maintain sufficient documentation to identify both the reinsurer's loss obligations due each reinsured and each reinsured's premium remittance to the reinsurer.	11-12
<p>The Company has not complied with this recommendation. A similar comment is made in this report.</p>	
iii. It is recommended that the Company maintain documentation of its evaluation of transfer of risk for significant ceded reinsurance contracts to support management's accounting position related to these contracts in accordance with Chapter 22 of the NAIC Accounting Practices and Procedures Manual.	14
<p>The Company has not complied with this recommendation. A similar comment is made in this report.</p>	
B. <u>Audited Financial Statements</u>	
It is recommended that the Company comply with the provisions of Section 307(b) of the New York Insurance Law and Department Regulation 118 with respect to its written engagement contracts with its CPA's.	21
<p>The Company has not complied with this recommendation. A similar comment is made in this report.</p>	
C. <u>Conflict of Interest</u>	

ITEMPAGE NO.

- i. It is recommended that the Company exercise due care in obtaining and maintaining signed conflict of interest statements from the board of directors, officers and responsible employees. 22

The Company has complied with this recommendation.

- ii. It is recommended that the Company establish a procedure for enforcing such a policy and permit the board of directors to properly oversee and handle any conflicts disclosed. 22

The Company has complied with this recommendation.

- iii. It is recommended that the board of directors maintain complete minutes of its proceedings on such matters. 23

The Company has complied with this recommendation.

D. Accounts and Records

- i. It is recommended that for future examinations the Company make every effort to facilitate such examinations. 23

The Company has not complied with this recommendation. A similar comment is made in this report.

- ii. It is recommended that the Company maintain accurate and complete workpapers supporting amounts reported in its filed annual statements. 24

The Company has not complied with this recommendation. A similar comment is made in this report.

- iii. It is recommended that the Company institute procedures that will enable the Company to provide Schedule P loss run-off data in the form requested by the Insurance Department. 24

The Company has not complied with this recommendation. A similar comment is made in this report.

- iv. It is recommended that the Company modify its R2K system to ensure that the aging of the recoverable begins at the date the billing in accordance with Chapter 22 of the NAIC Accounting Practices and Procedures Manual. 25

The Company could not provide substantiation that the reinsurance recoverables were aged in accordance with the NAIC's Accounting Practices and Procedures Manual. On examination the Company reported that they could not substantiate the aging of receivables because the data had been overwritten. A similar comment is made in this report.

ITEMPAGE NO.

- v. It is recommended that the Company amend its agency and/or broker agreements to include the incentive bonus plan provisions. 26

The examination did not review the incentive bonus plan provisions to the agency or broker agreements.

- vi. It is recommended that the Company review all letters of credit and trust agreements to ensure that the information is accurate and is in compliance with Department Regulation 133. The Company should then amend any letters of credit and trust agreements that do not contain accurate information and comply with the provisions set forth in Department Regulation 133. 27

The Company has not complied with this recommendation. A similar comment is made in this report.

## **20. SUMMARY OF COMMENTS AND RECOMMENDATIONS**

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Management</u>	
<p>It is recommended that the Company comply with Section 312 of the New York Insurance Law and submit a copy of the reports on examination to each of the members of the board of directors in a timely manner so that the board of directors can take the appropriate action on the comments and recommendations contained therein.</p>	6
B. <u>Territory and Plan of Operation</u>	
i. It is recommended that the Company properly report cessions under the warranty program in all future annual statements.	10
ii. It is recommended that the Company maintain its loss data at a transaction level detail.	10
iii. It is recommended that the Company maintain adequate documentation to support its calculation of the reserve for unearned premiums.	11
iv. It is recommended that the Company establish adequate internal controls over the premiums and losses for warranty business.	11
v. It is recommended that the Company respond accurately to all future questions posed by this Department.	12
vi. It is recommended that the Company institute the recommendations contained in its internal audit report.	12
vii. It is recommended that the Company refrain from writing retrospective insurance policies.	13
viii. It is recommended that the Company comply with the limit of exposure set forth in Section 1115(c)(2) of the New York Insurance Law.	14
ix. In reaction to an investigation conducted by the Attorney General of the State of New York, ACE paid a substantial fine, fired three officers and accepted the resignation of Susan Rivera, the president of ACE INA Holdings and a member of WFIC's Board of Directors as of December 31, 2002. On examination, the Company could not produce the brokerage agreements between WFIC and Marsh & McLennan and its affiliated companies.	16
C. <u>Reinsurance</u>	

<u>ITEM</u>	<u>PAGE NO.</u>
i. It is recommended that the Company comply with the National Association of Insurance Commissioners' annual statement instructions and report the balances assumed from each reinsurer separately as defined by those instructions.	17
ii. It is recommended that the Company maintain adequate supporting documentation for all assumed reinsurance transactions reported in its filed annual statements.	17
iii. It is recommended that the Company implement internal controls to assure that the reinsurance assumptions are properly recorded in its filed annual statements.	17
iv. It is recommended that the Company report and account for all reinsurance agreements not reduced to writing and signed by the parties within nine months of inception as retroactive reinsurance using "deposit accounting" in all future filed statements.	22
v. It is recommended that the Company assure that all ceded reinsurance contracts entered into specify that arbitration shall be governed by the laws of New York State.	23
vi. It is recommended that the Company comply with the requirements of SSAP No. 62 and report all reinsurance transactions in the appropriate balance sheet accounts.	23
vii. It is recommended that the Company report reinsurance transactions in its filed annual statement in accordance with the NAIC's Annual Statement Instructions.	24
viii. It is recommended that the Company only take credit for assets held in trust accounts that comply with New York Regulation 114, Part 126.5(a)(2).	24
ix. It is recommended that the Company comply with Department Regulation 133 and report letters of credit as reinsurance recoverable collateral only when the Company is the named beneficiary on the letter of credit and only at the available amount of the letters of credit at the date of the annual statement.	25
x. It is recommended that the Company adhere to its established guidelines by placing its reinsurance business only with reinsurers approved by ACE Limited's Reinsurance Financial Security Committee and that all of their reinsurers meet the minimum guidelines established by the committee or that the Company applies to the committee for an exception.	27
xi. It is recommended that the Company institute internal controls over the preparation of Schedule F that ensure the integrity and reliability of its filed annual statements.	28
xii. It is recommended that the Company enter into authorization letters with appointed intermediaries that comply with Insurance Department Regulation 98.	29

ITEMPAGE NO.D. Holding Company System

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| i.    | It is recommended that the Company comply with Department Regulation 52 and disclose all material transactions in the holding company registration statement.  | 29 |
| ii.   | It is further recommended that the Company prepare Schedule Y in accordance with the NAIC annual statement instructions.   | 29 |
| iii.  | It is recommended that the Company file all inter-company agreements pursuant to the requirements of Sections 1505(c) and (d) of the New York Insurance Law.   | 31 |
| iv.   | It is recommended that the Company reduce all inter-company agreements to writing and submit those agreements to this Department pursuant to Section 1505 of the New York Insurance Law.   | 31 |
| v.    | It is recommended that the Company comply with Section 1505(d) of the New York Insurance Law and Department Circular Letter #33 (1979) by submitting any amendments to its non-disapproved tax allocation agreement, 30 days prior to affecting changes to the agreement.  | 33 |
| vi.   | It is further recommended that the Company amend its approved tax allocation agreement to reflect the current parties to the agreement.  | 33 |
|       | Subsequent to the examination date, the Company submitted a revised tax allocation agreement to the Department for non-disapproval pursuant to Section 1505(d) of the New York Insurance Law. The revised agreement was submitted to the Company's board of directors of their approval pursuant to Circular Letter No. 33 (1979). |    |
| vii.  | It is recommended that the Company comply with the terms of Section 4(b) of its inter-company tax allocation agreement and Circular Letter No. 33 (1979) and establish an escrow account or obtain a letter of credit in an amount equal to the amount of payments exceeding the actual income tax payments made by the group.     | 34 |
| viii. | It is recommended that the Company ensure that any board of directors approval of agreements be reflected in the minutes of the board meetings.  | 34 |
| ix.   | It is recommended that the ACE Limited reimburse WFIC in the amount of \$8,800,000 that was paid pursuant to ACE Limited's legal obligations.  | 35 |
| x.    | It is recommended that the Company comply with the terms of its service agreement with Ace American and settle the transactions in the time and manner specified therein.  | 36 |
| xi.   | It is recommended that the Company comply with the terms of its service agreement with WSLIC and settle the transactions in the time and manner  | 36 |

specified therein.

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| xii.  | It is recommended that the Company comply with the terms of its non-disapproved inter-company quota share reinsurance agreement with Westchester Surplus Lines Insurance Company and settle all balances due within sixty days of the close of the calendar quarter in cash. | 37 |
| xiii. | It is recommended that the Company comply with the terms of its inter-company reinsurance agreement with IUICO and settle the transactions associated in the time and manner specified therein.  | 38 |
| xiv.  | It is recommended that transactions within the holding company system that occur on a "regular or systematic basis" be made part of an intercompany agreement and submitted to the Department pursuant to the requirements of Section 1505 of the New York Insurance Law.    | 38 |
| xv.   | It is further recommended that the Company expunge all balances from its books and records for which it cannot identify the transactions creating the balance.   | 38 |

E. Accounts and Records

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|------|--|----|
| i.   | It is recommended that the Company comply with Department Circular Letters No. 1 (1975) and 2 (1977) and ensure that all securities not physically held in its offices, vaults or safety deposit boxes are held by a proper custodian pursuant to a custodial agreement.                   | 41 |
| ii.  | It is further recommended that the Company respond appropriately to the General Interrogatories in all future statements filed with this Department.   | 41 |
| iii. | It is recommended that the Company revise its custodial agreement to include the protective safeguards and controls in accordance with Part 1 General - Section IV (H) of the NAIC Financial Condition Examiner's Handbook.  | 42 |
| iv.  | It is recommended that the Company submit the agreement entered into between ACE US Holdings, Inc. and Hyperion Capital Management, Inc. to the Superintendent of Insurance of the State of New York for non-disapproval in accordance with Section 1505(d) of the New York Insurance Law. | 43 |
| v.   | It is recommended that ACE US Holdings, Inc. cease collecting these fees until receiving non-disapproval from the Department.  | 43 |
| vi.  | It is recommended that the Company properly disclose the existence of this agreement in the Notes to the Financial Statements.   | 44 |
| vii. | It is recommended that the WFIC board of directors and investment committee fulfill their fiduciary duty to the Company by protecting its assets.  | 44 |

<u>ITEM</u>	<u>PAGE NO.</u>
viii. It is recommended that the Company provide and maintain documentation of special studies to justify the basis of inter-company expense allocations as described in subdivision (a) of Section 105.25 of Regulation No. 30.	44
ix. It is further recommended that the Company provide records of the effects of the application to each operating expense classification of all bases of allocation as described in Section 109.2 of Regulation No. 30.	45
x. It is recommended that the Company comply with Section 1505(b) of the New York Insurance Law and maintain the accounting information necessary to support the reasonableness of the charges or fees to the respective parties and produce such information upon examination.	45
xi. It is recommended that the Company maintain supporting records for all liabilities reported in its financial statements.	45
xii. It is recommended that the Company enter into a written contract with its appointed independent certified public accountant that complies with Department Regulation 118.	48
xiii. It is recommended that the Company comply with Section 307(b)(1) and file its future audited financial statement and the opinion of its auditor by June 1.	49
xiv. It is recommended that management ensure that the reserves included in the scope of the actuarial opinion are accurate.	50
xv. It is recommended that the Company exhibit greater care in the preparation of its Annual Statement and complete said statement in compliance with the NAIC Annual Statement Instructions.	51
F. <u>Facilitation of the Examination</u>	
It is recommended that the Company comply with Section 310(a)(3) of the New York Insurance Law by facilitating the examination and aid the examiners in the performance of their duties in future examinations.	52
G. <u>Data Integrity</u>	
i. It is recommended that the Company establish controls in its premium data systems to identify duplicate policy numbers coming from different sources.	54
ii. It is recommended that the Company modify its premium system so that premium data is segregated by proper annual statement line of business.	55
iii. It is recommended that the Company institute data edit procedures to ensure that specific fields are captured in the accounting database, that the data from the claims system is in agreement with the data in the accounting database relative to claims, and that the data is accurate.	56

<u>ITEM</u>	<u>PAGE NO.</u>
iv. It is further recommended that adequate controls be implemented to prevent claims against policies issued by one company from being coded to another company.	56
<b>H. <u>Business Contingency Plan</u></b>	
It is recommended that the Company complete its business contingency plan and test it prior to implementation.	56
<b>I. <u>Information System Controls</u></b>	
i. It is recommended that the Company institute the development of the life cycle procedures that ensures that all necessary steps are appropriately included in a project plan.	57
ii. It is recommended that the Company maintain systems design, programming standards, and technical documentation manuals pursuant to Department Regulation 152.	57
iii. It is recommended that the Company compile and employ a standards manual for system documentation.	58
iv. It is recommended that the Company implement a system to scan or filter outgoing e-mail or files for either offensive or potentially damaging content.	58
<b>J. <u>Premiums and Agents' Balances in the Course of Collection</u></b>	
It is recommended that the Company only report as admitted assets premiums in course of collection not more than ninety days past due in accordance with Section 1301(a)(11) of the New York Insurance Law and SSAP No. 6.	66
<b>K. <u>Receivables from Parent, Subsidiaries and Affiliates</u></b>	
i. It is recommended that the Company comply with Circular Letter 15 (1975) and report all assets more than 90 days past due as non-admitted in future filed annual statements.	67
ii. It is recommended that the Company comply with SSAP No. 64 and only offset balances where a valid right of setoff exists.	68
<b>L. <u>Losses and Loss Adjustment Expenses</u></b>	
i. It is recommended that the Company comply with the NAIC Annual Statement Instructions and ensure that the workpapers underlying the statement of actuarial opinion are clear and map the underlying raw data to the top-level summary exhibits.	70

<u>ITEM</u>	<u>PAGE NO.</u>
ii. It is recommended that the Company comply with Section 1303 of the New York Insurance Law.	70
iii. It is recommended that the Company institute procedures that will enable it to provide Schedule P loss run-off data in the form requested by this Department.	71
iv. It is recommended that the Company allocate its loss adjustment expenses in compliance with SSAP No. 55, paragraph 5, subparagraph c.	71
v. It is recommended that the Company report its claims payments in the proper accounting period.	71

APPENDIX AA) Agreements Filed For Which Non-disapproval Letters or Some Equivalent Have Been Received

1. Various assumption and indemnity reinsurance agreements by and among the formerly affiliated Crum & Forster Insurance Companies ("Crum & Forster") related to the restructuring of Crum & Forster. Effective January 1, 1993. Filed and approved as part of the Crum & Forster restructuring plan.
2. Reinsurance agreement between Westchester Fire Insurance Company and Industrial Underwriters Insurance effective January 1, 1993. Includes service agreement language in paragraph 4; effective January 1, 1993. WFIG reinsured and assumed one hundred per cent (100%) of the gross liability of the reinsured under all business written by the reinsured on and after January 1, 1993. This agreement was also filed and approved as part of the Crum & Forster restructuring.
3. Correspondent agreement between Westchester Fire Insurance Company and Westchester Specialty Insurance Services, Inc. ("WSIS"); effective January 1, 1995. Westchester Specialty Insurance Services agrees to provide its services as underwriter, manager and agent to Westchester Fire Insurance Company subject to specific terms and conditions. Agreement filed and non-disapproved.
4. Quota share reinsurance contract between Westchester Surplus Lines Insurance Company (GA), Westchester Specialty Insurance Services (GA & CA), and Westchester Fire Insurance Company (NY); effective January 1, 1995. Westchester Fire assumes by quota share reinsurance ninety percent (90%) of WSLIC's "Net liability" under the "policies" in force on or after January 1, 1995 but not those risks in the State of New York. Agreement filed and non-disapproved.
5. Reinsurance agreement between Westchester Fire Insurance Company and ACE Bermuda Insurance Ltd. (formerly A.C.E. Insurance Company, Ltd.); effective January 1, 1997. ACE to provide coverage for reinsuring the 25% retention held by WFIG (and it affiliates) under their reinsurance agreement with National Indemnity Company. Agreement filed and non-disapproved.
6. First through fourth property catastrophe excess of loss reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, by and on behalf of each member of the ACE INA Group of Companies, and the Subscribing Reinsurers (including Lloyd's syndicate #2488, ACE Global Property).

Effective January 1, 1999. Agreement filed and non-disapproved.

7. Tax allocation agreement by and among ACE US Holdings, Inc. (DE), ACE USA, Inc. (DE), Westchester Fire Insurance Company (NY), Westchester Surplus Lines Insurance Company (GA), Industrial Underwriters Insurance Company (TX), Industrial Excess & Surplus Lines Insurance Brokers (CA), and Westchester Specialty Insurance Services, Inc. (NV); effective January 2, 1998. The Parent (ACE US Holdings) agrees to file a consolidated tax return statement for the group of companies. Agreement filed and non-disapproved.
8. General services agreement between Westchester Fire Insurance Company and Oasis Insurance Services Limited ("Oasis"); effective April 30, 1998. Oasis will render certain general services on a consulting and or administrative support basis for WFIC. Agreement filed and non-disapproved.
9. Intercompany master facultative reinsurance agreement between Westchester Fire Insurance Company and ACE Bermuda Insurance Ltd. (formerly A.C.E. Insurance Company, Ltd.); effective July 1, 1998. Agreement filed and non-disapproved.
10. First through fourth property catastrophe excess of loss reinsurance agreement between Westchester Fire Insurance Company (NY), Westchester Surplus Lines Insurance Company (GA), and Industrial Underwriters Insurance Company and any company now or hereafter affiliated with the ACE USA, Inc. (formerly known as Westchester Specialty Group, Inc.), and subscribing reinsurers; effective January 1, 1999. Agreement filed and non-disapproved. [Note that this entry is a duplicate of #6].
11. First through fourth property catastrophe excess of loss reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and the Subscribing Reinsurers (including Lloyd's Syndicate #2488). Effective January 1, 2000. Agreement filed and non-disapproved.
12. First through fourth property catastrophe excess of loss reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE NA Group of Companies, and Underwriting Members of Lloyd's (including Lloyd's Syndicate #2488). Effective January 1, 2001. Agreement filed and non-disapproved.
13. Excess of loss reinsurance agreement between Westchester Fire Insurance Company and ACE Bermuda Insurance Ltd. Effective July 1, 2001. Agreement filed and non-disapproved.

14. Excess of loss reinsurance agreement between Westchester Fire Insurance Company and ACE Bermuda Insurance Ltd; originally effective July 1, 2001, amended to January 1, 2002. Policies underwritten by Westchester Fire or other ACE USA pool companies to cover the Knapp Schenck Municipal Property Program reinsured by ACE Bermuda. Agreement filed December 17 2001, non-disapproval letter dated January 4, 2002.
15. Service agreement by and between Century Indemnity Company (“Century Indemnity”) and Westchester Fire Insurance Company (NY), Westchester Surplus Lines Insurance Company (GA), and Industrial Underwriters Insurance Company (TX); effective October 1, 2001. Century Indemnity to provide certain claims adjusting services for claims arising from asbestos and exposure and environmental liabilities. Agreement filed and non-disapproved.
16. Underwriting facility manager-company agreement between ACE Tempest Re USA, Inc. (CT) and Westchester Fire Insurance Company (NY); effective December 5, 2001. WFIC intends to provide surety reinsurance projects primarily, though not exclusively, through brokers. Agreement filed and non-disapproved.
17. Excess of loss reinsurance agreement between Westchester Fire Insurance Company and ACE Bermuda Insurance Ltd., effective January 1, 2002. Agreement filed and non-disapproved.
18. Administrative services agreement between ACE American Insurance Company (PA) and Westchester Fire Insurance Company (NY); effective February 21, 2002. ACE American will make available to WFIC, upon request, such services as accounting, data processing, tax and auditing, functional support, policyholder services, collection, payroll, commission payment, underwriting, claims administration, reinsurance recovery, public relations and promotional services. ACE American will also provide, upon request, such facilities as data processing equipment, payroll processing equipment, business property and communications equipment. Agreement filed and non-disapproved.
19. Investment advisory service agreement between Westchester Fire Insurance Company (NY) and ACE Asset Management Inc. (DE); executed October 17, 2002 and made effective as of September 13, 2002. ACE Asset will assist with the evaluation and selection of WFIC’s investment advisors, and monitor the performance, compliance and risk profile of WGIC’s portfolio. Agreement filed and non-disapproved.

B) Agreements Filed For Which the Company Has Not Received a Response

20. Group property catastrophe agreement between ACE American Insurance Company, ACE

Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, by and on behalf of each member of the ACE INA Group of Companies, and the subscribing reinsurers (including ACE Tempest Reinsurance Ltd.). Effective January 1, 2000. Agreement filed October 18, 2002, no reply found by Company.

21. Reinsurance agreement with Westchester Fire Insurance Company and ACE Insurance Company (PR); effective April 1, 2000. WFIC no longer doing business in Puerto Rico; ACE Insurance Company will write the direct business formerly written by WFIC, and WFIC will reinsure those risks. Agreement filed June 8, 2000; no reply found by Company.
22. Reinsurance agreement between Westchester Fire Insurance Company (NY) and ACE Capital Re Overseas Ltd.; effective January 1, 2001. ACE Capital will assume facultative reinsurance from WFIC for lines of business for which WFIC is licensed. Agreement filed December 4, 2000; no reply found by Company.
23. Casualty catastrophe excess of loss reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and Underwriting Members of Lloyd's (including Lloyd's Syndicate #2488). Effective July 1, 2001. Agreement filed June 23, 2003; no reply found by Company.
24. Group property catastrophe excess of loss reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and the subscribing reinsurers (including #2488 and ACE Tempest Reinsurance Ltd.). Effective March 1, 2002. Agreement filed October 18, 2002; no reply found by Company.
25. Casualty catastrophe excess of loss reinsurance contract by and between ACE American Insurance Company (PA), ACE Property and Casualty Insurance Company (CT), Westchester Fire Insurance Company (NY), Westchester Surplus Lines Insurance Company (GA), for themselves and on behalf of each member of the ACE INA Group of Companies, and various reinsurers; effective August 1, 2002. Agreement filed June 23, 2003; no reply found by Company.

C) Agreements not filed because Company claims filing is not required

26. First through fifth property per risk excess of loss reinsurance agreement between Westchester Fire Insurance Company, ACE Property and Casualty Insurance Company, Westchester Surplus Lines Insurance Company, ACE American Insurance Company, for

themselves and on behalf of each member of ACE INA Group of Companies, and the subscribing reinsurers (including ACE Bermuda Insurance Ltd.). Effective January 1, 1994.

27. First through fifth property per risk excess of loss reinsurance agreement between Westchester Fire Insurance Company, ACE Property and Casualty Insurance Company, Westchester Surplus Lines Insurance Company, ACE American Insurance Company, for themselves and on behalf of each member of ACE INA Group of Companies, and the subscribing reinsurers (including ACE Bermuda Insurance Ltd.). Effective January 1, 1998.
28. Reinsurance agreement between Westchester Fire Insurance Company (NY) and A.C.E. Insurance Company, Ltd. (Bermuda). Effective October 1, 1998, and revised July 28, 1999. WFIC will assume facultative reinsurance from A.C.E. Insurance Company, Ltd.
29. First through fourth property per risk excess of loss reinsurance agreement between Westchester Fire Insurance Company (NY), Westchester Surplus Lines Insurance Company (GA), and Industrial Underwriters Insurance Company and any company now or hereafter affiliated with the ACE USA, Inc. (formerly known as Westchester Specialty Group, Inc.), and subscribing reinsurers; effective January 1, 1999.
30. Westchester Specialty Division fifth property per risk excess cessions reinsurance agreement between ACE American Insurance Company (PA), ACE Property and Casualty Insurance Company (CT), Westchester Fire Insurance Company (NY), and Westchester Surplus Lines Insurance Company (GA), Industrial Underwriters Insurance company (TX), for themselves and on behalf of each member of the ACE INA Group of Companies, and various Reinsurers; effective January 1, 1999.
31. Westchester Specialty Division first through fourth property per risk excess of loss reinsurance agreement between ACE American Insurance Company (PA), ACE Property and Casualty Insurance Company (CT), Westchester Fire Insurance Company (NY), and Westchester Surplus Lines Insurance Company (GA), for themselves and on behalf of each member of the ACE INA Group of Companies, and various Reinsurers; effective January 1, 2000.
32. Fifth property per risk excess cessions reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and ACE Bermuda Insurance Ltd. Effective January 1, 2000.
33. First through fifth property per risk excess of loss reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company,

Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and the Subscribing Reinsurers (includes ACE Bermuda Insurance Ltd.). Effective January 1, 2001

34. First through third property per risk excess of loss reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE USA Group of Companies and the ACE NA Group of Companies which now or in the future underwrites business covered by this agreement and the subscribing reinsurers. Effective January 1, 2002.
35. First through third property per risk excess of loss reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and the Reinsurers (including ACE Bermuda Insurance Ltd.). Effective January 1, 2002.
36. Reinsurance agreement between ACE American Insurance Company (PA) and Westchester Fire Insurance Company (NY); no effective date. The contract is written such that ACE American will assume facultative reinsurance from Westchester Fire.

D) Agreements that have not been filed

37. Administrative agreement between Westchester Specialty Insurance Services, Inc., and Westchester Fire Insurance Company. Effective March 1, 1999. WSIS agrees to develop, market, and administer various vehicle service contract programs for WFIC. The Company could provide no substantiation that this agreement was filed with this Department.
38. Airport liability first excess of loss reinsurance treaty between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and the subscribing reinsurers (including ACE Bermuda). Effective May 1, 2000. The Company could provide no substantiation that this agreement was filed with this Department.
39. Airport liability second excess of loss reinsurance treaty between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and the subscribing reinsurers (including ACE Bermuda). Effective May 1, 2000. The Company could provide no substantiation that this agreement was filed with this Department.

40. Airport Liability Third Excess of Loss Reinsurance Treaty between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE NA Group of Companies, and the subscribing reinsurers (including #2488). Effective May 1, 2000. The Company could provide no substantiation that this agreement was filed with this Department.
41. Aviation voluntary settlements and medical expenses quota share reinsurance contract between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and Certain Underwriting Members of Lloyd's (including #2488). Effective July 1, 2000. The Company could provide no substantiation that this agreement was filed with this Department.
42. Airport owners and operators facility "JAR 53B" between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, by and on behalf of each member of the ACE INA Group of Companies, and the subscribing reinsurers (including Lloyd's syndicate #2488, ACE Global Property). Effective October 21, 2000. The Company could provide no substantiation that this agreement was filed with this Department.
43. Residential earthquake quota share reinsurance agreement between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and the subscribing reinsurers (including ACE Tempest Reinsurance Ltd.). Effective November 1, 2000. The Company could provide no substantiation that this agreement was filed with this Department.
44. Airmeet legal liability quota share reinsurance contract between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and Certain Underwriting Members of Lloyd's (including #2488). Effective January 15, 2001. The Company could provide no substantiation that this agreement was filed with this Department.
45. Airport liability first excess of loss reinsurance treaty between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, for themselves and on

behalf of each member of the ACE INA Group of Companies, and the subscribing reinsurers (including #2488). Effective May 1, 2001. The Company could provide no substantiation that this agreement was filed with this Department.

46. Airport liability second excess of loss reinsurance treaty between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and the subscribing reinsurers (including #2488). Effective May 1, 2001. The Company could provide no substantiation that this agreement was filed with this Department.
47. Airport liability third excess of loss reinsurance treaty between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company, and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and the subscribing reinsurers (including #2488). Effective May 1, 2001. The Company could provide no substantiation that this agreement was filed with this Department.
48. Trust agreement between ACE Bermuda Insurance Ltd. and Westchester Fire Insurance Company (NY) and State Street Bank and Trust Company effective December 20, 2001. Agreement between ACE Bermuda as Grantor and WFIC as Beneficiary, with assets held by State Street as Trustee in connection with reinsurance agreements between ACE Bermuda and WFIC. The Company could provide no substantiation that this agreement was filed with this Department.
49. Airmet legal liability quota share reinsurance contract between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and Certain Underwriting Members of Lloyd's (including #2488). Effective January 15, 2002. The Company could provide no substantiation that this agreement was filed with this Department.
50. Aviation voluntary settlements and medical expenses quota share reinsurance contract between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE NA Group of Companies, and Certain Underwriting Members of Lloyd's (including #2488). Effective May 1, 2002. The Company could provide no substantiation that this agreement was filed with this Department.
51. Aviation excess liability reinsurance contract between ACE American Insurance Company, ACE Property and Casualty Insurance Company, Westchester Fire Insurance

Company and Westchester Surplus Lines Insurance Company, for themselves and on behalf of each member of the ACE INA Group of Companies, and Certain Underwriting Members of Lloyd's (including #2488). Effective May 1, 2002. The Company could provide no substantiation that this agreement was filed with this Department.

52. Administration agreement in effect since December 1, 1998, by and between Westchester Fire Insurance Company and Dimension Service Corporation. The Company reports that the agreement has not been reduced to writing and has, therefore, not been submitted to this Department.



Appointment No. 21978

**STATE OF NEW YORK  
INSURANCE DEPARTMENT**

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

**Alfred Bloomer**

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

**WESTCHESTER FIRE INSURANCE COMPANY**

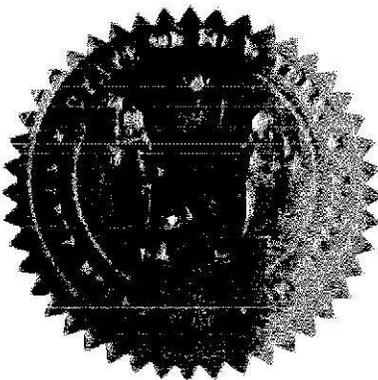
*and to make a report to me in writing of the condition of the said*

**COMPANY**

*with such other information as she 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 9th day of December, 2002*





**GREGORY V. SERIO**  
*Superintendent of Insurance*