

REPORT ON EXAMINATION

OF THE

AMERICAN GUARANTEE AND LIABILITY INSURANCE COMPANY

AS OF

DECEMBER 31, 2003

DATE OF REPORT

JUNE 1, 2005

EXAMINER

JAMES CALL, CFE

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

June 1, 2005

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 22365 dated April 20, 2005 attached hereto, I have made an examination into the condition and affairs of the American Guarantee and Liability Insurance Company as of December 31, 2003, and submit the following report thereon.

Wherever the designation “the Company” appears herein without qualification, it should be understood to indicate American Guarantee and Liability Insurance Company.

Whenever the designation “ZAIG”, appears herein without qualification, it should be understood to indicate Zurich American Insurance Group.

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 1400 American Lane, Schaumburg, Illinois 60196-1056.

1. SCOPE OF EXAMINATION

The previous examination was conducted as of December 31, 1998. The Department conducted an examination of the Company as of December 31, 2001, however, the examination was updated to December 31, 2003. Therefore, this examination covered the five-year period from January 1, 1999 through December 31, 2003. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

The examination comprised a complete verification of assets and liabilities as of December 31, 2003, a review of income and disbursements deemed necessary to accomplish such verification, and utilized, to the extent considered appropriate, work performed by the Company's independent certified public accountants. A review or audit was also made of the following items as called for in the Examiners Handbook of the National Association of Insurance Commissioners ("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 organized under the laws of the State of New York as an affiliate of the United States Branch of the Zurich Insurance Company (“the U.S. Branch”), now known as the Zurich American Insurance Company following its domestication effective December 31, 1998). The Company was incorporated on July 17, 1939 and commenced business on September 6, 1939. Zurich Fire Insurance Company of New York was merged into the Company at the close of business on December 31, 1952.

All outstanding capital stock of the Company was transferred from Zurich Holding Company of America (“ZHCA”), a Delaware holding company, to Zurich American Insurance Company (“ZAIC”), a New York domestic insurer, in December 1998 as a surplus contribution related to the domestication of the U.S. Branch. The Company is a member of the Zurich American Insurance Group.

Capital paid in is \$5,000,027 consisting of 6,636 shares of common stock at \$753.47 par value per share. On December 20, 2002, the Company redeemed and retired 5,864 common shares for \$74,997,672 and on that same date amended its charter to increase the par value of its common shares from \$400 per share to \$753.47. Authorized capital was increased from \$5,000,000 to \$5,000,027. Gross paid in and contributed surplus is \$142,270,401. Gross paid in and contributed surplus decreased by \$74,997,672 during the examination period, as follows:

<u>Year</u>	<u>Description</u>	<u>Amount</u>
1999	Beginning gross paid in and contributed surplus	\$217,268,073
2002	Paid to ZAIC to redeem and retire 5,864 shares of common stock at book value	<u>(74,997,672)</u>
2003	Ending gross paid in and contributed surplus	<u>\$142,270,401</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 or more than twenty-one members. At December 31, 2003, the board of directors was comprised of the following thirteen members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
John J. Amore Staten Island, NY	Chairman, American Guarantee & Liability Ins Co
David A. Bowers Winnetka, IL	Executive Vice President and Corporate Secretary, American Guarantee & Liability Ins Co
James P. Connors Monmouth Beach, NJ	Executive Vice President, American Guarantee & Liability Ins Co
Barry J. Gilway Cockeysville, MD	Executive Vice President, American Guarantee & Liability Ins Co
Donald J. Hurzeler Lake in the Hills, IL	Executive Vice President, American Guarantee & Liability Ins Co
John A. Kelm Crystal Lake, IL	Executive Vice President, American Guarantee & Liability Ins Co
James W. March Forest Hills, NY	Director, American Guarantee & Liability Ins Co
Michael D. Markman Mendota Heights, MN	Executive Vice President, American Guarantee & Liability Ins Co
John J. McCartney Omaha, NE	President, American Guarantee & Liability Ins Co
Nancy D. Mueller Kildeer, IL	Executive Vice President, American Guarantee & Liability Ins Co
Juliet G. Nash Brooklyn, NY	Director, American Guarantee & Liability Ins Co
Frank A. Patalano Barrington, IL	Executive Vice President, American Guarantee & Liability Ins Co
Raymond C. Thomas III Baldwin, MD	Executive Vice President, American Guarantee & Liability Ins Co

The Company's by-laws provide that the board of directors shall meet four times each year with the first meeting on the day of the annual election of directors by the stockholders. A review of the minutes of the meetings held during the examination period indicated that the board of directors physically met only one time each year, on the day of the annual stockholders' meeting. All other corporate actions and resolutions were done by unanimous written consent of the board without a meeting. Article II Section 5 of the Company's by-laws provide that action by unanimous written consent may be used in emergency situations where time is of the essence, but may not be used in lieu of a regular meeting of the board of directors. It is recommended that the Company comply with the provisions of its by-laws with regard to board of directors' meetings.

The minutes of those meetings of the board of directors that were held during the examination period as well as meetings of committees held during the examination period were reviewed. The meetings held were generally well attended.

Committees of the Board of Directors

Those serving on committees as of December 31, 2003, are as follows:

Executive Committee

John J. Amore
Nancy Mueller
John J. McCartney
John A. Kelm

Audit Committee

John J. Amore
Nancy Mueller
John J. McCartney
John A. Kelm

It is noted that although an audit committee was appointed in 2002, the committee did not meet during the examination period.

The review of the board of directors and the appointed subcommittee minutes indicated that the board failed to approve certain investment transactions of the Company. Section 1411(a) of the New York Insurance Law states:

“No domestic insurer shall make any loan or investment, except as provided in subsection (h) hereof, unless authorized or approved by its Board of Directors or a committee thereof responsible for supervising or making such investment or loan. The committee’s minutes shall be recorded and a report submitted to the board of directors at its next meeting”.

It is recommended that the board of directors or a committee thereof approve all investment transactions made by the Company in accordance with Section 1411(a) of the New York Insurance Law.

As of December 31, 2003, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
John J. Amore	Chairman & Chief Executive Officer
John J. McCartney	President
David A. Bowers	Executive Vice President & Corporate Secretary
David A. Levinson	Executive Vice-President & Treasurer
Earl R. Clouser	Executive Vice-President
James P. Connors	Executive Vice-President
James D. Engel	Executive Vice-President
Robert M. Fishman	Executive Vice-President
Craig J. Fundum	Executive Vice-President
Barry J. Gilway	Executive Vice-President
Donald J. Hurzeler	Executive Vice-President
John A. Kelm	Executive Vice-President
Michael D. Markman	Executive Vice-President
Nancy D. Mueller	Executive Vice-President
Frank A. Patalano	Executive Vice President
Steven P. Rand	Executive Vice-President
David J. Saul	Executive Vice President
Raymond C. Thomas III	Executive Vice President
Richmond N. Waller	Executive Vice President
Diana J. Whidden	Executive Vice President

B. Territory and Plan of Operation

As of December 31, 2003, the Company was licensed to write business in all fifty states and the District of Columbia.

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

<u>Paragraph</u>	<u>Line of Business</u>
3	Accident & health
4	Fire
5	Miscellaneous property damage
6	Water damage
7	Burglary and theft
8	Glass
9	Boiler and machinery
10	Elevator
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
28	Service contract reimbursement
29	Legal services insurance

In addition, the Company is licensed to transact 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 as 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 capital structure, and pursuant to the requirements of Articles 13 and 41 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of \$35,000,000.

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

	<u>New York State</u>	<u>Total United States</u>	<u>Percentage of Premiums Written in New York State</u>
1999	40,222,327	418,977,410	9.60%
2000	43,652,149	447,901,839	9.75%
2001	77,689,829	724,331,348	10.73%
2002	80,833,733	1,008,748,102	8.01%
2003	127,833,991	1,231,899,472	10.38%

In 2003, ZAIG's direct written premiums were produced by a combination of approximately 14,000 independent agencies and 300 brokers. Agency produced business accounted for approximately 70% of ZAIG's direct written premiums with the remainder produced by brokers.

Central to ZAIG's business strategy are its Customer-Focused business units ("CFBU") and a dedicated service business unit ("BU"), which provides various services to each of the CFBU's including claims management, risk engineering, information technology and marketing. The CFBU's are based on the type of customer they service and operate through independent agents and brokers and have access to ZAIG's products and services through a nation-wide network of seven regional offices and 63 branch offices. The CFBU's are categorized and focus as follows:

- The Global Corporate North America BU (n/k/a Corporate Customer) serves large corporate and commercial businesses globally and domestically in three major areas: property, casualty, and group captives. Coverages offered by this BU are workers' compensation, general liability, commercial auto, property, and captive structures and services. On December 31, 2003 the group captives moved to Middle Markets.
- The Small Business BU provides a comprehensive, customized coverage portfolio of property, liability, commercial auto, umbrella, and in some locations, workers compensation. It provides

coverages for small businesses in the retail, wholesale, service, office, institutional, builders risk and small trade fields.

- The Specialties BU offers coverages for emerging, potentially volatile and unique third-party liability exposures. These include the professional liability risks of group services providers such as architects and engineers, healthcare organizations, financial institutions, environmental contractors, and information technology firms, along with a wide range of specialty liability coverages, such as management, environmental, excess and umbrella products, volatile general and political risk insurance and accident and health, specialty health and disability programs. Liability coverages are also provided for the healthcare, environmental, financial and rail industries.
- The Zurich Programs BU (n/k/a Empire Fire and Marine Insurance Company (“Empire”)) provides specialized insurance and financial coverages to small and mid-sized commercial markets. Empire’s direct sales force distributes products to auto rental, independent auto dealer, recreational vehicle and contractors’ equipment business. Its nationwide network of managing general agents target markets such as long-haul trucking, ambulance and tow truck companies as well as general liability classes including tanning salons and security guard companies.
- The UUG BU (n/k/a Universal Underwriters Group) also includes the operations of Universal Underwriters Insurance Group (“Universal”). Universal became a member of the ZAIG pool as of January 1, 2002. Universal specializes in providing insurance and financial services to franchised auto, truck, equipment and motorcycle dealerships and automotive-related businesses. Universal offers a wide range of commercial insurance-related products and services including property-casualty insurance, workers compensation, risk management services, business life insurance, vehicle service contracts, credit life and disability insurance, GAP insurance, sub-prime financing services and income development programs.
- The Customer Services BU is a dedicated service BU, which unifies the Company’s approach to managing claims, managed care, risk engineering, information technology and marketing and provides support to all its commercial business units.
- The Commercial Business Group (“CBG”) consists of these four business units:
 - The Middle Markets CBG offers package and program coverages to meet the needs of the medium-sized commercial enterprise. Target segments include manufacturing services (including hospitality) and public entities. Middle Markets also offers programs for groups and associations and provides a full array of financial institution bonds, professional liability and property-casualty insurance.
 - The Construction CBG specializes in providing product, service and risk financing coverages for project owners, construction managers, contractors and subcontractors. In addition to all standard property-casualty coverages, this industry-focused business unit also provides a number of specialized products, including surety business. Surety serves the needs of construction project owners, construction contractors and subcontractors and governmental entities, non-profit organizations and commercial enterprises in most industries with a wide array of contract, commercial and environmental surety bond products.

- The Global Energy CBG specializes in providing comprehensive risk management, risk engineering services and claims support tailored to the individual needs of oil and gas, petrochemical, natural resources, mining and power generation customers worldwide. The unit also provides a full range of marine products and services in the United States and London, including ocean cargo protection, hull, liabilities and other marine-related coverages.
- The Surety & Financial Enterprises CBG specializes in contracts, bonds and other liability coverages for the construction industry and financial enterprises.

C. Reinsurance

Intercompany Pooling Agreement

Effective January 1, 1999, the Company entered into an amended ZAIG intercompany pooling agreement which includes ZAIC and seventeen affiliated insurers. Pursuant to the terms of the agreement, the participants cede 100% of all underwriting assets, liabilities and expenses, as well as underwriting income and losses (net of applicable reinsurance) to ZAIC. There is no retrocession from ZAIC to any of the pool participants. Subsequent to the date of the original agreement, six amendments have been made to the agreement, each adding or deleting participants in the pool.

At December 31, 2003, the following eighteen insurers participated in the pool:

American Guarantee and Liability Insurance Company (NY)
 American Zurich Insurance Company (IL)
 Assurance Company of America (NY)
 Colonial American Casualty and Surety Company (MD)
 Empire Fire & Marine Insurance Company (NE)
 Empire Indemnity Insurance Company (OK)
 Fidelity and Deposit Insurance Company of Maryland (MD)
 Maine Bonding and Casualty Company (ME)
 Maryland Casualty Company (MD)
 Maryland Insurance Company (TX)
 National Standard Insurance Company (TX)
 Northern Insurance Company of New York (NY)
 Steadfast Insurance Company (DE)
 Universal Underwriters Insurance Company (KS)
 Universal Underwriters of Texas Insurance Company (TX)
 Valiant Insurance Company (IA)
 Zurich American Insurance Company (NY)
 Zurich American Insurance Company of Illinois (IL)

Prior to cessions to the intercompany pooling agreement described above, the companies reduce their exposure to losses through facultative and treaty reinsurance. Further, Article V of the agreement provides that ZAIC agrees to be liable for any amount disallowed any of the companies on account of reinsurance with unauthorized companies and any amount disallowed the companies for non-admitted assets. Accordingly, there is no provision for reinsurance reported by the Company as of December 31, 2003, as the liability is borne by ZAIC.

After cessions to the pool, the Company is a party to the same pool ceded reinsurance program as that of ZAIC. An examination of ZAIC as of December 31, 2003, was conducted by this Department concurrently with this examination. For a full description of ZAIC's ceded reinsurance program as of December 31, 2003, refer to Appendix A in this report.

Reinsurance Agreements with Affiliates

The report on examination as of December 31, 1998, included a recommendation that the Company file with this Department the applicable cover note for any reinsurance agreement where a related party's participation is 10% or more. Such filing was to be made within thirty days after the agreement's effective date. The complete related party reinsurance contract should be forwarded to this Department within thirty days of ratification. The 1998 examination report was accepted by the Company and filed by the Department.

The Company was also reminded that while related party facultative agreements need not be individually submitted for each risk, the Company is required to file the master facultative reinsurance agreement thirty days prior to entering into such an arrangement. Further, the Company should submit a list of all facultative reinsurance slips entered into with related parties pursuant to the master facultative reinsurance agreement with its annual holding company filing statement.

During the period covered by this examination, instances were noted where neither the affiliated reinsurance agreement nor its cover notes was submitted to the Department in accordance with the requirements of Section 1505(d)(2) of the New York Insurance Law, which states:

“(d) The following transactions between a domestic controlled insurer and any person in its holding company system may not be entered into unless the insurer has notified the superintendent in writing of its intention to enter into any such transaction at least thirty days prior thereto, or such shorter period as he may permit, and he has not disapproved it within such period:

(2) reinsurance treaties or agreements;”

It is again recommended that the Company ensure that in the future, all affiliated company reinsurance transactions are submitted to the Department in compliance with Section 1505(d)(2) New York Insurance Law.

Reinsurance Intermediary Licensing

It was noted that one reinsurance intermediary included on the Company’s approved list of reinsurance intermediaries was not licensed in New York. While the intermediary in the instance noted was on the approved list, no transactions were initiated with the intermediary.

Nevertheless, it is recommended the Company ensure that all intermediaries included on the Company’s approved list are licensed in New York in order to maintain compliance with Section 2102(a)(1) New York Insurance Law.

Multiple Applicant Letters of Credit

Upon examination, it was noted that the Company is a named beneficiary on a letter of credit that lists multiple applicants and that the multiple applicants are not affiliates of the Company. There is nothing in the letter of credit to indicate the amount of credit allocated to each of the reinsurers. However, the Company does maintain a schedule showing the allocation.

It is the position of the Department that multiple applicant letters of credit are allowable as long as the applicants are affiliates of the Company. It is recommended that the Company ensure that it only utilize letters of credit with multiple applicants where the applicants are affiliates of the Company.

Department Regulation 114 Trust Account Agreement Requirements

Department Regulation 114 governs the construction and language of trust agreements for credit for reinsurance. Part 126.2(a) of Regulation 114 reads in part:

“Beneficiary means the entity for whose sole benefit the trust has been established. The trust agreement shall contain a provision that includes within the term beneficiary any successor of the beneficiary by operation of law, including, without limitation, any liquidator, rehabilitator, receiver or conservator....”

A review of the trust agreements utilized by the Company to secure credit for reinsurance from unauthorized reinsurers revealed that the Company maintains reinsurance trust accounts, which contain multiple beneficiaries. Department Regulation 114, Part 126.2(a) and Part 126.3(e) indicate the use of the singular word “beneficiary” and “entity”. Further, Opinion No. 99-104 of the Office of the General Counsel indicates that it is not permissible to have multiple beneficiaries on trust accounts utilized to secure reinsurance balances pursuant to Department Regulation 114. Opinion No. 99-104 specifically cites Section 126.2(a) in its argument for sole beneficiaries to trust accounts.

It is recommended the Company comply with the requirements of Department Regulation 114, Parts 126.2(a) and 126.3(e) and create trust account arrangements that involve only one beneficiary. It is further recommended that the Company ensure that all trust agreements to which it is a party meet the required conditions of Department Regulation 114.

Reinsurance settled through inter-company accounts

On examination, it was noted that many of the Company's transactions with affiliates are related to reinsurance agreements. It is the Company's policy to settle reinsurance transactions with affiliates through the inter-company accounts. There are reinsurance related receivables and payables reported as receivable or payable to parent, subsidiaries and affiliates. Statements of Statutory Accounting Principles ("SSAP") No. 62, Paragraph 26 of the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions for Property-Casualty Insurance Companies instruct companies to report reinsurance related receivables/payables on annual statement line items specifically for reinsurance. New York Insurance Law requires companies to prepare their annual statements in accordance with NAIC Annual Statement Instructions.

It is recommended that the Company record its reinsurance related receivables and payables in accordance with Annual Statement Instructions and SSAP No. 62, Paragraph 26 of the NAIC Accounting Practices and Procedures Manual.

D. Holding Company System

The Company is a member of ZAIG. All outstanding shares of the Company are owned by ZAIC, which is, in turn, 100% owned by ZHCA, a business corporation domiciled in the State of Delaware. ZHCA is 99.87% owned by Zurich Insurance Company, Zurich Switzerland, which is 100% owned directly and indirectly by Zurich Financial Services, Switzerland.

A review of the holding company registration statements filed with this Department indicated that such filings were complete and were filed in a timely manner pursuant to Article 15 of the New York Insurance Law and Department Regulation 52 with the following exceptions:

Affiliated Agreements not Provided

The intercompany receivable and payable amounts reported by the Company on its 2003 annual statement included various balances for claims or services provided to or received from various non-pooled affiliated companies for which the Company could not provide written agreements.

In accordance with Section 1505(b) of the New York Insurance Law:

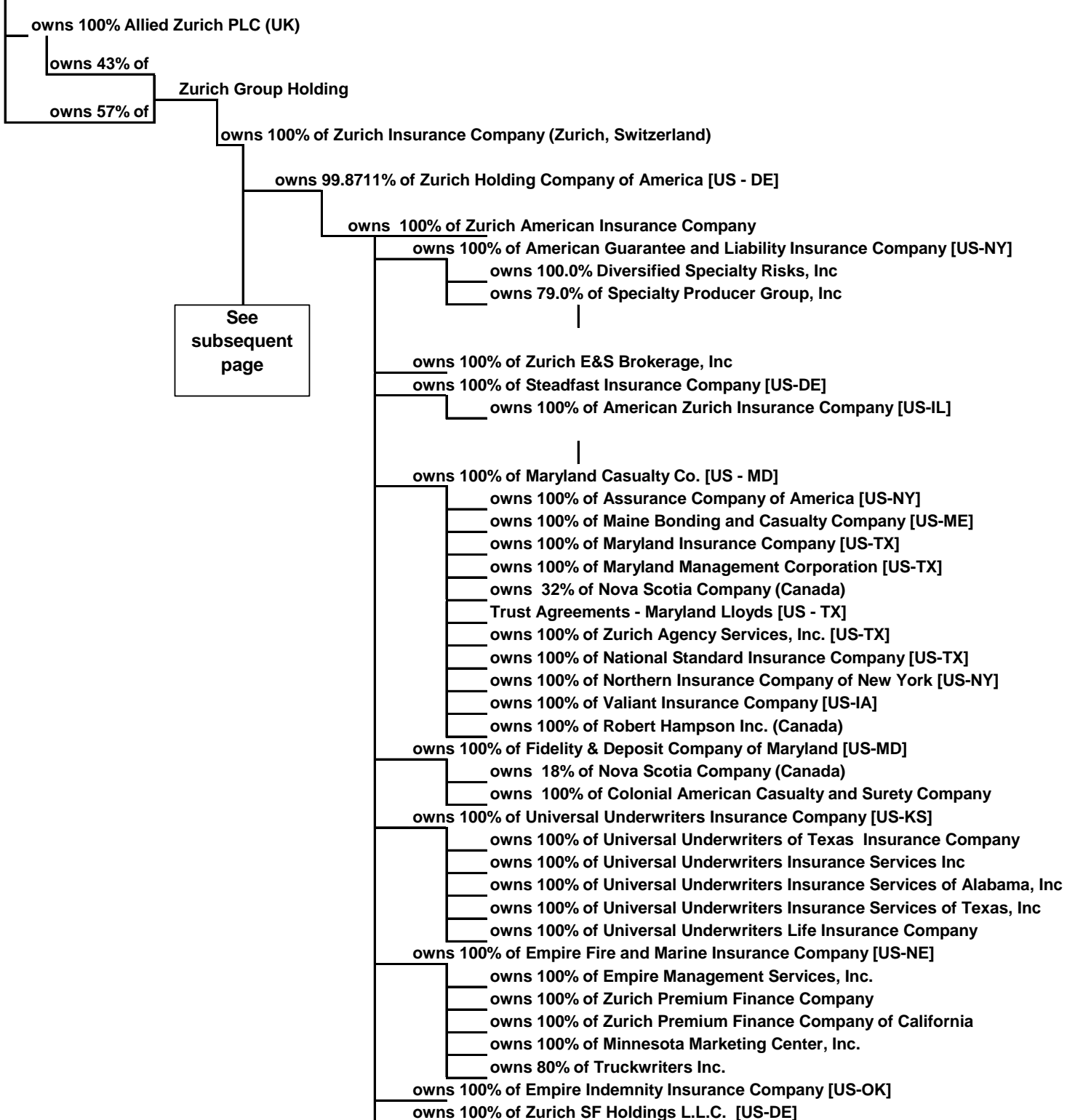
"the books, accounts and records of each party to all such transactions shall be so maintained as to clearly and accurately disclose the nature and details of the transactions . . ."

The amounts were not material as of the examination date; however, it is recommended that the Company comply with Section 1505(b) of the New York Insurance Law by maintaining adequate records to include written agreements for all transactions with affiliates.

The following is an abbreviated chart of the holding company system at December 31, 2003:

Zurich American Insurance Group

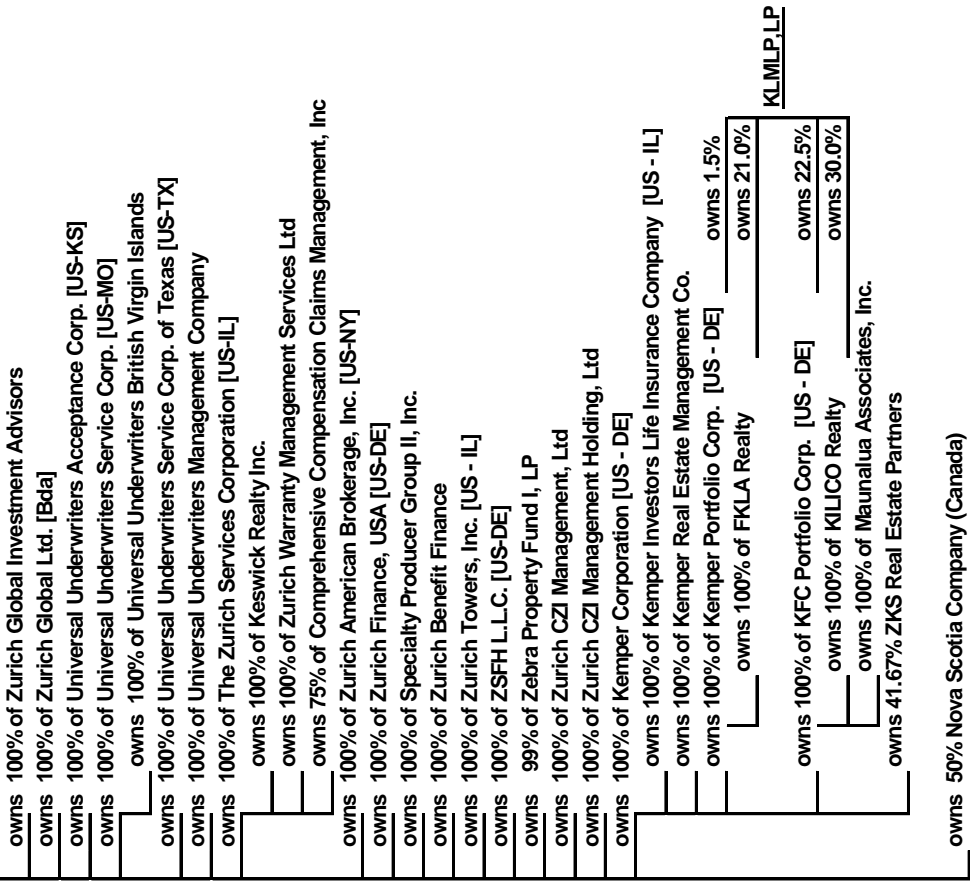
Zurich Financial Services
(Zurich, Switzerland)



See
subsequent
page

Zurich American Insurance Group

See preceding page



In addition to the intercompany pooling agreement previously discussed in the Reinsurance section of this report, the Company was party to the following agreements with other members of its holding company system at December 31, 2003:

Amended and Restated Tax Allocation Agreement

Since 1998, the Company has been a party to a tax sharing agreement between ZHCA and its subsidiaries. The participants of the agreement record their apportioned tax liabilities and estimated tax payments according to terms of the agreement. Those terms provide for allocation of the consolidated federal income tax in an amount equal to the consolidated tax liability multiplied by a fraction, the numerator of which is the separate taxable income of the member and the denominator of which is the sum of the taxable income of all the members of the consolidated group having taxable income. If a member has no taxable income, its share shall be zero. The allocation method is consistent with Financial Accounting Standards (“FAS”) No. 109 as modified by SSAP No. 10.

The agreement provides that when a member exits, a settlement payment shall be made to ZHCA for any benefit realized by the exiting member due to lower tax payments as a result of being part of ZHCA (less than what would have been due on a separate return basis). Conversely, a settlement payment shall be made to the exiting member for any benefit realized by ZHCA resulting from utilization of losses or credits generated by the exiting member. As this provision had the potential for creating significant contingent liabilities for all members of the ZHCA, beginning with the year ending December 31, 2000, the companies with losses agreed by written declaration to forego tax benefits (rights to settlement payments) related to the use of their losses by ZHCA.

The agreement was submitted to the Department and non-disapproved on November 30, 1998.

Investment Advisory Agreement

On January 1, 2003 ZAIC and its direct and indirect subsidiaries (including the Company) entered into an investment advisory agreement with Zurich Global Investment Advisors and Zurich Investment Services.

Under the terms of the agreement Zurich Global Investment Advisors provides investment advice and develops investment guidelines for the Company's investment committee.

Zurich Investment Services provides record keeping services for the Companies. Services include investment accounting and reporting such as, monthly security acquisition and disposition information and investment income summaries.

This agreement was submitted to the Department and non-objected to January 6, 2003.

Information Technology Services Agreement

The Company participates as an affiliate in an information technology services agreement, which was signed by ZAIC on July 24, 2003. The agreement consolidates and transfers the entire mainframe-based computer processing functions currently performed by ZAIC in Schaumburg, Illinois to the Data Center of Farmers Group, Inc., an affiliate, in Los Angeles, California. This data center consolidation affects the data processing for all of the member companies of ZAIG operating within North America. The primary objective of this data center consolidation is to reduce mainframe hardware and software costs for Zurich Financial Services' North American operations.

This agreement was submitted to the Department and non-objected to September 9, 2003.

E. Abandoned Property Law

Section 1316 of the New York Abandoned Property Law provides that amounts payable to a resident of this state from a policy of insurance, if unclaimed for three years, shall be deemed to be abandoned property. Such abandoned property shall be reported to the comptroller on or before the first day of April each year. Such filing is required of all insurers regardless of whether or not they have any abandoned property to report.

The Company's abandoned property reports for the period of this examination were all filed on a timely basis pursuant to the provisions of Section 1316 of the New York Abandoned Property Law.

F. Significant Operating Ratios

Due to the fact that the Company cedes 100% of all underwriting assets, liabilities and expenses, as well as underwriting income and losses (net of applicable reinsurance) to ZAIC with no retrocession from ZAIC to the Company, all net underwriting ratios are zero.

G. Accounts and Records

The general books of the company are maintained by the use of electronic data processing equipment and applicable pre-programmed insurance related software packages. Basic data consists of cash receipts documents, cash disbursements vouchers, working papers, reports of premium and losses and various other documents and memoranda of a journal nature. Standardized insurance accounting procedures are employed in transactions involving premiums, losses, expenses and valuation of assets and liabilities resulting from the operation of the company.

During the course of the review of the Company's accounts and records the operational and organizational controls in place were analyzed. In general, it appears the Company has a sufficient level of controls in place.

However, the following record keeping deficiencies were noted during the course of the current examination:

Securities Lending Agreement

It was noted during the examination that various members of the ZAIG group, including the Company, have been participating in a securities lending program with the Bank of New York without an agreement. The Company indicated that Northern Insurance Company of New York entered into a securities lending agreement with the Bank of New York effective February 12, 1998 and it considers that agreement to be the master agreement for all entities, even though they are not named on the agreement.

It is recommended that the Company not participate in a securities lending program unless it is a named party on a securities lending agreement.

Custody Agreement

The Company was not able to provide evidence that the Company's board of directors authorized entering into the insurance company custody agreement with the Bank of New York. The NAIC Financial Examiners' Handbook, Part 1, Section IV, J Paragraph 1, requires authorization by board resolution.

It is recommended that the Company's board of directors approve the insurance company custody agreement with the Bank of New York in accordance with the NAIC Financial Examiners' Handbook, Part 1, Section IV, J Paragraph 1.

It was noted that management answered affirmatively to the following General Interrogatory in its December 31, 2003 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?”

Examination review indicated that the insurance company custody agreement entered into with the BONY did not contain any provision for notification to the Superintendent if the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn. Part 1, Section IV, J Paragraph 2(f) of the NAIC Financial Condition Examiners Handbook suggests that the custodian, BONY, 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 custody agreement with BONY to provide that the custodian provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner.

It is also recommended that the Company respond appropriately to the General Interrogatory regarding custodial or safekeeping agreements in future statements filed with this Department.

Failure to Comply with Department Regulation 118, Part 89.2

The engagement letter between the Company and its independent auditor was reviewed for compliance with Part 89.2 of Department Regulation No. 118. Pursuant to the Regulation, the contract must specify that:

“(a) on or before May 31st, the CPA shall provide an audited financial statement of such insurer and of any subsidiary required by section 307(b)(1) of the Insurance Law together with an opinion on the financial statements of such insurer and any such subsidiary for the prior calendar year and an evaluation of the insurer’s and any such subsidiary’s accounting procedures and internal control systems as are necessary to the furnishing of the opinion;

(b) any determination by the CPA that the insurer has materially misstated its financial condition as reported to the superintendent or that the insurer does not meet minimum capital or surplus to policyholder requirements set

forth in the Insurance Law shall be given by the CPA, in writing, to the superintendent within 15 calendar days following such determination; and

(c) the workpapers and any communications between the CPA and the insurer relating to the audit of the insurer shall be made available for review by the superintendent at the offices of the insurer, at the Insurance Department or at any other reasonable place designated by the superintendent. The CPA must retain for review such workpapers and communications in accordance with the provisions of Part 243 of this Title (Regulation 152). More specifically, such workpapers and communications must be retained by the CPA for the period specified in sections 243.2(b)(7) and (c) of this Title. For the purposes of this subdivision, the workpapers and communications shall be deemed to have been created on the date the filing required by section 89.2(a) of this Part was submitted to the superintendent.”

Based upon the review, the letter for the 2003 engagement did not contain the above language.

It is recommended that the Company comply with Department Regulation 118, Part 89.2 and incorporate the appropriate language in all future engagement letters or similar contracts with its independent certified public accountants.

Deferred Tax Asset/Liability

SSAP No. 10, paragraph 6a states:

"Temporary differences are identified and measured using a 'balance sheet' approach whereby statutory and tax basis balance sheets are compared".

The Company supplied a Schedule of Deferred Taxes that uses an income statement approach. The schedule focuses on the differences in book and taxable incomes, rather than the book/tax differences of the underlying assets or liabilities. The advantage of the balance sheet approach is that the statutory and tax bases of all assets and liabilities are considered in the calculation of the deferred taxes. This helps to ensure that all book/tax differences are identified and considered in the measurement of the deferred taxes.

It is recommended that the Company identify and measure their deferred taxes using a balance sheet approach as prescribed by SSAP No. 10, Paragraph 6a.

Failure to comply with Circular Letter No. 10 (2001)

Department Circular Letter No. 10 (2001) provides for the proper method for collecting and paying premium tax on workers' compensation and employers' liability policies containing deductibles in New York State. The letter advises that the amount of deductible paid by the policyholder to the insurer should be treated as a premium paid to the insurer for the purpose of Section 1510 of the New York Tax Law. Examination review indicated that the participants of the ZAIG Pool did not recognize the reimbursements as premiums.

It is recommended that the ZAIG Pool, and specifically the Company, comply with Department Circular Letter No. 10 (2001) and treat the amount of deductible paid by the policyholder to the insurer under high deductible policies as premium paid to the insurer for the purpose of Section 1510 of the New York Tax Law.

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, 2003. This statement is the same as the balance sheet filed by the Company.

<u>Assets</u>	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Admitted Assets</u>
Bonds	\$83,075,144	\$0	\$83,075,144
Common stocks	1,000	0	1,000
Cash, cash equivalents and short- term investments	3,005,125	0	3,005,125
Other invested assets	6,293,348	0	6,293,348
Investment income due and accrued	757,330	0	757,330
Receivables from parent, subsidiaries and affiliates	<u>855,226</u>	<u>0</u>	<u>855,226</u>
Total assets	<u>\$93,987,173</u>	<u>\$0</u>	<u>\$93,987,173</u>

Liabilities, surplus and other funds

Other expenses (excluding taxes, licenses and fees)	\$13,648
Current federal and foreign income taxes	149,267
Net deferred tax liability	<u>95,284</u>
Total liabilities	\$258,199

Surplus and Other Funds

Common capital stock	\$5,000,027
Gross paid in and contributed surplus	142,270,401
Unassigned funds (surplus)	<u>(53,541,454)</u>
Surplus as regards policyholders	<u>93,728,974</u>
Total liabilities, surplus and other funds	<u>\$93,987,173</u>

NOTES:

(1) The Internal Revenue Service has completed its audits of the Company's (consolidated) federal income tax returns through tax year 2002. 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. The Internal Revenue Service has not yet begun to audit tax returns covering tax year 2003. 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.

(2) Pursuant to the amended intercompany pooling agreement, discussed in Section 2C of this report, the Company cedes 100% of all underwriting assets, liabilities and expenses, as well as underwriting income and losses (net of applicable reinsurance) to Zurich American Insurance Company ("ZAIC"). The results of the December 31, 2003 examination of Zurich American Insurance Company indicated that ZAIC was insolvent in the amount of \$1,053,938,846 and its capital was impaired by \$1,058,938,846. Additionally, its minimum surplus to be maintained of \$35,000,000 was impaired in the amount of \$1,088,938,846.

The insolvency at December 31, 2003 was eliminated by a combination of surplus contributions made by ZAIC's parent, as well as the receipt of proceeds from the issuance of surplus notes, also from the parent. Subsequent to December 31, 2003, ZAIC received proceeds of \$1,000,000,000 in surplus notes issued to its parent, of which \$800,000,000 was received in 2004 and \$200,000,000 was received on January 27, 2005. During 2004 ZAIC repaid \$38,700,000 in principal relating to a previously issued surplus note. ZAIC's parent also contributed \$1,300,000,000 to ZAIC's surplus, which was reported by ZAIC as a Type 1 subsequent event in its' December 31, 2004 filed annual statement. ZAIC received the surplus contribution on February 22, 2005.

In light of the subsequent events, the reinsurance with ZAIC has been accepted for this report on examination.

B. Underwriting and Investment Exhibit

Surplus as regards policyholders decreased \$375,763,208 during the five-year examination period January 1, 1999 through December 31, 2003, detailed as follows:

Underwriting Income

Premiums earned		\$0
Deductions:		
Other underwriting expenses incurred	<u>\$(10,691,511)</u>	
Total underwriting deductions		<u>(10,691,511)</u>
Net underwriting gain or (loss)		\$10,691,511

Investment Income

Net investment income earned	\$39,431,875	
Net realized capital gain	<u>146,163,507</u>	
Net investment gain or (loss)		185,595,382

Other Income

Aggregate write-ins for miscellaneous income	<u>\$378,034</u>	
Total other income		<u>378,034</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$196,664,927
Federal and foreign income taxes incurred		<u>1,836,409</u>
Net Income		<u>\$194,828,518</u>

Capital and Surplus Accounts

Surplus as regards policyholders per report on
examination as of December 31, 1998

\$469,492,181

	<u>Gains in Surplus</u>	<u>Losses in Surplus</u>	
Net income	\$194,828,518		
Net unrealized capital gains or (losses)		\$138,097,836	
Change in net deferred income tax		95,284	
Change in nonadmitted assets	11,084,221		
Change in provision for reinsurance	6,349,569		
Change in net unrealized foreign exchange capital gain (loss)	134,676		
Cumulative effect of changes in accounting principles	30,573		
Capital changes paid in	27		
Surplus adjustments paid in		74,997,672	
Dividends to stockholders	<u> </u>	<u>375,000,000</u>	
Total gains and losses	<u>\$212,427,584</u>	<u>\$588,190,792</u>	
Net increase (decrease) in surplus			<u>(375,763,208)</u>
Surplus as regards policyholders per report on examination as of December 31, 2003			<u>\$93,728,973</u>

4. MARKET CONDUCT ACTIVITIES

In the course of this examination, a review was made of the manner in which the Company conducts its business 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. Sales and advertising
- B. Underwriting
- C. Claims and complaint handling

The following exceptions were noted:

Testing performed relative to the licensing and appointment of agents for various ZAIG Pool participants revealed instances where the agent was not properly licensed and/or appointed.

It is recommended that the ZAIG Pool, and specifically the Company, initiate procedures to ensure that the agents utilized to market its products are properly licensed and appointed.

The Company's complaint log was not in compliance with the requirements of Department Circular Letter No. 11 (1978). The following columns were found to be missing:

1. The person in the company with whom the complainant has been dealing.
2. The dates of correspondence to the Insurance Department's Consumer Services Bureau
3. Chronology of further contacts with the Department.
4. Remarks about internal remedial action taken as a result of the investigation.

In view of the above, it is recommended that the Company fully comply with the requirements of Circular Letter No.11 (1978) and going forward maintain a complaint log that encompasses the eleven subject matters required in this circular letter.

5. LEGAL DISCLOSURE

Subsequent to the examination date, in August 2004, ZAIC was served with four subpoenas by the Office of the New York State Attorney General (“NYAG”) for documents/ information concerning incentive compensation arrangements and various alleged anti-competitive behaviors involving brokered transactions. Subpoenas and information requests also were served by various other state governmental entities. In connection with the subpoenas and information requests, the Company advises that they have carried out certain reviews under the guidance of external counsel and that they are actively cooperating with the authorities in these industry-wide investigations. During late 2004 and 2005, ZAIC also received follow-up inquiries from various governmental agencies related to these investigations. Two of ZAIC’s former employees each plead guilty on November 16, 2004 to an attempted violation of New York General Business Law Sections 340 and 341, a class A misdemeanor which carries a maximum sentence of one-year in prison and a monetary fine.

Beginning on or about November 15, 2004, Zurich Financial Services (“ZFS”) and several other ZFS subsidiaries received two subpoenas from the United States Securities and Exchange Commission (“SEC”) and one subpoena from the NYAG concerning finite reinsurance and other nontraditional products. In April of 2005, the Georgia Insurance Commissioner also served a subpoena related to finite reinsurance and other nontraditional products on ZAIC and other of its subsidiaries. On or about June 14, 2005, ZFS received a grand-jury subpoena issued by the United States Attorney for the Southern District of New York. The subpoena has not been officially served on ZFS or any of its subsidiaries or affiliates and ZFS has not otherwise accepted service of the subpoena. The subpoena purports to require ZFS and all affiliates and subsidiaries, to provide the grand jury with certain documents, largely relating to finite, stop-loss, funding and limit-of-liability cover agreements, and reinsurance agreements affected by side agreements. The Company has advised that they are fully cooperating with the regulatory authorities investigating these matters.

Since January 2005, eight lawsuits have named various entities as defendants. ZAIC has been named as a defendant in seven of these lawsuits, six of which are class actions and one of which is not. The six class actions are 1) Shell Vacations LLC v. Marsh & McLennan Cos., et al.; (2) Redwood Oil Co. v. Marsh and McLennan Cos. Inc., et al.; (3) Boros v. Marsh & McLennan Cos., et al.; (4) Mulcahy v. Arthur J. Gallagher & Co., et al.; (5) Golden Gate Bridge, Highway and Transp. Dist. V. Marsh & MacLennan Cos., Inc., et al.; and (6) Bensley Construction, Inc. v. Marsh & McLennan Cos., Inc. It is noted that ZAIC states that to the best of its knowledge, it has not been served with process or of the Mulcahy or Golden Gate Bridge complaints. The one suit that is not a class action is Office Depot v. Marsh McLennan Cos., et al. This suit also names the Company and was served on both ZAIC and the Company on July 1, 2005. Steadfast Insurance Company has been named and served as a defendant in one of these eight lawsuits, a Massachusetts state court class action: Van Emden Mgmt. Corp. v. Marsh & McLennan Cos., et al. All of these eight lawsuits allege that the defendants unlawfully participated in bid-rigging and/or a contingent commission scheme in violation of state and/or federal laws. They seek unspecified damages and injunctive relief. The lawsuits are in their preliminary stages and accordingly, the Company cannot predict the outcome of the matters described above or estimate the potential costs related to such matters.

Through June of 2005, ZAIC has paid and incurred approximately \$23 million in legal fees and expenses related to these investigations and lawsuits. At this time, the Company believes the ultimate liability for the matters referred to above is not likely to have a material adverse affect on the Company's combined statutory financial position; however, it is possible the effect could be material to the Company's results of operations for any future reporting period.

6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

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

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Management</u>	
i. <u>Board of Directors' Meetings</u>	
<p>It is recommended that the Company hold regular meetings of its board of directors and amend its by-laws to restrict the use of unanimous written consent in lieu of regular meetings to emergency situations only.</p> <p>The Company has not complied with this recommendation. A similar comment is made in this report.</p>	6
ii. <u>Approval of Investments</u>	
<p>It is recommended that the board of directors approve all investment transactions made by the Company and that the minutes include a listing of the transactions so approved, pursuant to Section 1411(a) of the New York Insurance Law.</p> <p>The Company has not complied with this recommendation. A similar comment is made in this report.</p>	6
B. <u>Reinsurance with Affiliates</u>	
i.	
<p>It is recommended that the Company file with this Department the applicable cover notes for any reinsurance agreement where a related party's participation is 10% or more. Such filing is to be made within thirty days after the agreements' effective date. The complete related party reinsurance contract should be forwarded to this Department within 30 days of ratification; however, the filing should be no later than nine months after the effective date of the agreement.</p> <p>The Company has not complied with this recommendation. A similar comment is made in this report.</p>	34
ii.	
<p>The Company is required to file the master facultative reinsurance agreement thirty days prior to entering into such an arrangement. Further, the Company should submit a list of all facultative reinsurance slips entered into with related parties pursuant to the master facultative reinsurance agreement with its annual holding company filing statement.</p> <p>The Company did not comply with this recommendation. A similar recommendation is made in this report.</p>	34

7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>	<u>PAGE NO.</u>
A. <u>Management</u>	
i. It is recommended that the Company comply with the provisions of its by-laws with regard to board of directors' meetings.	5
ii. It is recommended that the board of directors or a committee thereof approve all investment transactions made by the Company in accordance with Section 1411(a) New York Insurance Law.	6
B. <u>Reinsurance</u>	
i. It is recommended that the Company ensure that in the future, all affiliated company reinsurance transactions are submitted to the Department in compliance with Section 1505(d)(2) New York Insurance Law.	12
ii. It is recommended that the Company ensure that all intermediaries included on the Company's approved list are licensed in New York in order to maintain compliance with Section 2102(a)(1) of the New York Insurance Law.	12
iii. It is recommended that the Company only utilize letters of credit with multiple applicants where the applicants are affiliates of the Company.	13
iv. It is recommended that the Company comply with the requirements of Department Regulation 114, Parts 126.2(a) and 126.3(e) and create trust account arrangements that involve only one beneficiary. It is further recommended that the Company ensure that all trust agreements to which it is a party meet the required conditions of Department Regulation 114.	13
v. It is recommended that the Company record its reinsurance related receivables and payables in accordance with the Annual Statement Instructions and SSAP No. 62, Paragraph 26 of the NAIC Accounting Practices and Procedures Manual.	14
C. <u>Holding Company System</u>	
i. It is recommended that the Company comply with Section 1505(b) of the New York Insurance Law by maintaining adequate records to include written agreements for all transactions with affiliates.	15
D. <u>Accounts and Records</u>	
i. It is recommended that the Company not participate in a securities lending program unless it is a named party on a securities lending agreement.	21
ii. It is recommended that the Company's board of directors approve the insurance company custody Agreement with the Bank of New York in accordance with the	21

<u>ITEM</u>	<u>PAGE NO.</u>
NAIC Financial Examiners' Handbook, Part 1, Section IV J, Paragraph 1.	
iii. It is recommended that the Company revise its custody agreement with BONY to provide that the custodian provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner.	22
iv. It is recommended that the Company respond appropriately to the General Interrogatory regarding custodial or safekeeping agreements in future statements filed with this Department.	22
v. It is recommended that the Company comply with Regulation 118, Part 89.2 and incorporate the appropriate language in all future engagement letters or similar contracts with its independent certified public accountants	23
vi. It is recommended that the Company identify and measure their deferred taxes using a balance sheet approach as prescribed by SSAP No. 10, Paragraph 6a.	24
vii. It is recommended that the ZAIG pool, and specifically the Company, comply with Department Circular Letter No. 10 (2001) and treat the amount of deductible paid by the policyholder to the insurer under high deductible policies as premium paid to the insurer for the purpose of Section 1510 of the New York Tax Law.	24
E. <u>Market Conduct</u>	
i. It is recommended that the ZAIG pool, and specifically the Company, initiate procedures to ensure that the agents utilized to market its products are properly licensed and appointed.	29
ii. It is recommended that the Company fully comply with the requirements of Circular Letter No. 11(1978) and going forward maintain a complaint log that encompasses the eleven subject matters required in this circular letter.	29

APPENDIX A

Reinsurance treaty placements are based on the needs of the business units as well as the overall reinsurance strategy of ZAIG. Retentions have been increased vertically as well as horizontally (through increased proportional reinsurance) to limit the number of treaties with retention below \$5 million.

During the examination, significant ceded reinsurance contracts were reviewed. All contracts contained the required standard clauses including insolvency clauses meeting the requirements of Section 1308 of the New York Insurance Law.

ZAIG provides insurance to companies that operate internationally through two units, the global unit and the reverse flow unit.

The global unit provides insurance through international affiliates of branches of Zurich Insurance Company to United States companies with worldwide exposures. Business produced by the global unit is assumed by American Guarantee and Liability Insurance Company on a facultative basis, either proportionally or non-proportionally (generally, a 90% quota share of the primary layer), through the all lines open reinsurance agreement (“ALORA Treaty”).

The reverse flow unit provides insurance to foreign companies with U.S. subsidiaries through any of the participants in the intercompany pooling agreement, which is in turn ceded by the Company to an affiliate, Zurich Insurance Bermuda Branch (“ZIBB”), on a facultative basis, either proportionally or non-proportionally (although generally a 90% quota share of the primary layer), through the reverse ALORA treaty.

The treaties in place at December 31, 2003 are summarized below:

Capital Covers (Net line after Corporate Covers)

In effect for 2003 were three capital treaties for the benefit of all business units on a loss occurring basis and attaching to the net line after the corporate program addressed in the following paragraph. Two of the capital treaties are multi-line quota share treaties, one ceding 15% to ZIBB and one ceding 10% to a non-affiliate.

Additionally, stop loss treaties between ZAIC and Hannover Reinsurance (Ireland) Limited (“Hannover Re”) cover the entire book for accident years 1999 through 2003. Based on the information provided by the Company, related stop loss data for each of the periods under review is as follows:

	1999	2000	2001	2002	2003
Subject Net Earned Premiums	\$ 2,472,615,973	\$ 3,057,624,520	\$ 4,916,553,433	\$ 7,788,599,732	\$ 6,897,670,885
Attachment Point	68.0%	65.0%	65.0%	74.0%	72.0%
Top of Cover	85.0%	82.0%	82.0%	80.0%	78.0%
Points of Cover	17	17	17	6	6
Available Coverage (\$) (Exposure Year Net Earned Premium)	\$ 420,344,715	\$ 519,796,168	\$ 835,814,083	\$ 467,315,983	\$ 413,860,253
Ceded Premium Rate	5.5275%	7.5375%	8.0402%	2.1266%	2.5650%
Ceded Premiums *	\$ 136,673,848	\$ 230,468,448	\$ 395,300,729	\$ 165,632,362	\$ 189,810,000
Incurred Losses **	\$ 2,569,043,034	\$ 2,903,521,035	\$ 3,886,871,131	\$ 5,226,092,628	\$ 4,371,288,000
Booked Loss Cession to Stop Loss ***	(\$ 420.4)	(\$ 519.8)	(\$ 691.1)	\$ 0	\$ 0
Paid Loss Recoveries	\$ 420,000,000	\$ 361,000,000	\$ 0	\$ 0	\$ 0
Maximum Cession to Stop Loss	(\$ 420.4)	(\$ 519.8)	(\$ 835.8)	(\$ 467.3)	(\$ 413.9)
Remaining Coverage	\$ 0	\$ 0	(\$144.7)	(\$ 467.3)	(\$ 413.9)

* Based on minimum premium of \$7,400,000,000 per treaty in 2003

** Annualized number in 2003

*** As reported

In relation to the Hannover Re stop loss treaties, effective October 1, 2003, Zurich Insurance Company, Zurich, Switzerland (“ZIC”) entered into an adverse development reinsurance agreement with Hannover Re. Pursuant to this agreement, ZIC agrees to indemnify Hannover Re for 100% of the ultimate losses under the whole account aggregate stop loss treaties between ZAIC and Hannover Re for accident years 2001, 2002, and 2003 (for accident year 2001, only losses in excess of the accident year treaty attachment point plus 13.5% count as ultimate loss) in excess of a \$35 million retention.

In addition, ZIC agreed to provide a letter of credit to ZAIC where a claim notification by ZAIC under the 1999, 2000, 2001, 2002 or 2003 stop loss treaties combined creates a letter of credit requirement for Hannover Re in excess of \$490 million. As of December 31, 2003, ZIC had provided a parental letter of credit in the amount of \$75 million in place for the benefit of ZAIC securing reinsurance recoverables from Hannover Re pursuant to the stop loss treaties.

It is the position of the Department that the 2003 agreement between Hanover Re and ZIC constitutes an attempt by ZAIC to circumvent the requirement for prior notice to the Superintendent before entering into a reinsurance agreement with any person in its holding company system as set forth in Section 1505(d)(2) of the New York Insurance Law.

Further, the \$75 million parental letter of credit for the above agreement was not approved as of December 31, 2003 pursuant to the requirements of Department Regulation 20 Part 125.4(g)(1). Therefore, credit for it has been disallowed in this report.

Corporate Covers

For property catastrophe losses, two internal treaties are placed with ZIC to address the difference between the business unit's retention and the attachment of the corporate property catastrophe cover. The first, the property "Gap" excess of loss treaty ("GAP"), addresses losses in excess of the business unit's individual retention (deemed a fixed amount under the contract). Individual business units' retentions range from \$5 million to \$25 million; therefore, the GAP contract provides from \$70 to \$50 million of coverage. The second treaty, the property "step-up" excess of loss ("Step Up"), provides an additional \$25 million layer above the \$75 million sum of the business unit retention and the portion reinsured under the GAP coverage.

The six layer "Group Property Catastrophe Excess of Loss Contract", which reinsures the eighteen members of the ZAIG pool, plus Maryland Lloyds (collectively referred to as "Zurich North America")

provides up to \$675 million of coverage for occurrences in excess of \$100 million. The agreement provides for a 5% retention of each layer. The annual limit is two times the cover. Coverage up to \$50 million in excess of \$725 million is provided under a third event excess of loss contract that has a \$100 million aggregate deductible and a \$50 million annual limit.

ZIC provides up to \$20 million of coverage on workers' compensation and employers' liability losses in excess of \$5 million under a two layer excess of loss contract. The annual limit on the \$10 million in excess of \$5 million layer is \$10 million. The top layer of \$10 million in excess of \$15 million has a \$30 million annual limit.

The "Group Casualty Catastrophe Excess of Loss Contract" reinsures Zurich North America and provides \$50 million in excess of \$25 million with an annual limit of \$100 million. The coverage is written on an earned premium basis.

The first three layers of a five layer "Group Workers' Compensation Catastrophe Contract" reinsures Zurich North America and provides up to \$85 million in excess of \$15 million of losses. Terrorism is excluded on these layers. A fourth layer provides up to \$100 million in excess of \$100 million and provides coverage for terrorism, including nuclear, chemical and biological events. A fifth layer provides up to \$50 million in excess of \$100 million and provides coverage for terrorism, excluding nuclear, chemical and biological events. The annual limit is \$200 million on the fourth layer and \$100 million on the fifth layer.

The "Group Multi-Line Terrorism Excess of Loss Contract" reinsures Zurich North America and provides \$200 million of coverage in excess of \$100 million and has an annual limit of \$200 million.

Business Units

ZAIG writes business through 10 strategic business units: Canadian Unit (“CU”), Construction (“CON”), Corporate Customer (“CC”) Corporate Solutions (“ZCS”), Empire Fire and Marine Insurance Company (“Empire”), Global Energy (“ZGE”), Small Business (“ZSB”), Middle Market (“MM”), Specialties (“ZAS”) and Universal Underwriters (“UUIC”). Reinsurance covers benefiting each business unit are as follows:

Multiunit Coverage

A general property per risk contract provides up to \$50 million of coverages on losses in excess of \$25 million that are incurred on policies written by CON, CC, MM and ZSB. ZIC has a 10% participation across all units.

For property risks not in the United States, Canada or Europe but written by CC, CON and the Global Express and Financial Enterprises divisions of MM, catastrophe coverage is provided through an international excess of loss treaty that provides \$30 million of coverage in excess of \$25 million per occurrence. There is a 5% retention of losses falling in the \$30 million layer. ZIC’s participation as a reinsurer is 45%.

A commercial property per risk treaty provides two layers of protection for MM and SB. The first layer is \$5 million in excess of \$5 million. The second layer is \$15 million in excess of \$10 million. ZIC’s participation as a reinsurer is 7.5% in the second layer only. Separate treaty codes for each unit reinsured under the treaty facilitate application of different reinsurance premium rates.

Canadian Unit (“CU”)

The primary coverages on property business insured through CU are a seven line, first surplus share treaty providing proportional coverage above a \$5 million probable maximum loss (“PML”)

retained line up to \$35 million PML any one risk and a six line, second surplus share treaty providing proportional coverage on both large industrial and global risks above a \$5 million retained line up to \$30 million any one risk. Both surplus share treaties provide for a provisional ceding commission, which is subsequently adjusted on a sliding scale basis. ZIB, an insurer owned jointly by ZIC and two subsidiaries, has a 2.5% participation in the first surplus treaty and 95% in the second surplus treaty. The Canadian Branch of Zurich Insurance Company has a 5% participation in the second surplus treaty.

A five layer property catastrophe excess of loss agreement provides \$330 million of coverage above an occurrence of \$20 million. Catastrophe covers on Canadian produced, United States located risks are covered under the corporate catastrophe program.

A net account PML error excess of loss property treaty provides coverage of \$19.5 million in excess of \$6.5 million ultimate net loss any one location, any one event. ZIB's participation as a reinsurer is 24.5%.

On boiler and machinery risks, CU has in place a \$4.75 million line surplus share treaty with a \$5 million PML retention per risk.

A PML error excess of loss contract covering boiler and machinery provides up to \$15 million of coverage in excess of \$5 million ultimate net loss on any one risk. ZIB's participation as a reinsurer is 60%.

Further, a three layer automobile and casualty excess of loss agreement covers liability losses up to \$25 million in excess of \$5 million ultimate net loss each and every accident or occurrence.

Construction Unit (“CON”)

Property risks written through CON are reinsured under two excess of loss contracts below and above the corporate general property per risk contract. The lower layer is \$15 million excess of \$10 million of which the ceding company retains 25%. The upper layer is \$25 million excess of \$75 million.

Surety bonds written through CON are reinsured under a four layer surety excess of loss contract attaching on a loss discovered basis and providing \$85 million of coverage on losses in excess of \$15 million. CON retains 5% on each layer.

Construction professional liability is covered under a 40% quota share contract.

CON has multi-section casualty blanket excess of loss treaties providing the following protection:

Workers’ compensation losses are covered up to \$10 million in excess of \$5 million with CON retaining 85%. Homebuilders’ protective policies are covered under a 57% quota share treaty having a \$15 million risk limit. General liability and umbrella policies are covered by an excess of loss contract that provides up to \$25 million in excess of \$1 million, with CON retaining 44%. Policies written under CON’s subguard program are covered under an excess of loss contract providing up to \$18 million in excess of \$2 million with CON retaining 32.55%. A second excess of loss treaty on the subguard program provides \$20 million of coverage in excess of \$30 million with CON retaining 22.5%.

CON benefits from all the previously listed corporate covers, including the general property per risk, as well as the international property catastrophe coverages.

Corporate Customer Unit (“CC”)

CC has an underlying property per risk excess of loss treaty providing \$15 million coverage in excess of a \$10 million loss. It is subject to an annual aggregate deductible of \$15 million with an

occurrence limit of \$45 million and an annual limit of \$90 million. ZIC, as a reinsurer, has a 10% participation in this layer.

The two layered, global property excess facultative facility provides \$50 million in excess of \$7.5 million of coverage per risk.

CC benefits from all corporate covers including the general property per risk, the step up coverage, and the international property catastrophe coverage.

Corporate Solutions Unit (“ZCS”)

“ZCS” is covered by the multi-line 60% ZCS integrated quota share. All corporate covers apply.

Empire Fire and Marine Insurance Company Unit (“Empire”)

Empire has a 3 layer property per risk program with the first and second layers providing \$13.5 million in excess of \$1.5 million. There is a \$7 million occurrence limit for the \$3.5 million first layer and a \$10 million occurrence limit for the second layer. These layers cover business written through Empire’s special operations (“SPOPS”) division as well as risks produced through Hull & Co. The third layer of \$5 million in excess of \$15 million has an occurrence limit of \$5 million and provides additional coverage only for the Hull & Company produced business.

Various property catastrophe treaties exist. An underlying catastrophe treaty of \$3 million in excess of \$2 million supports the SPOPS division. There is five layer catastrophe excess of loss covering wind and earthquake which provides \$155 million in excess of \$15 million per occurrence. This coverage is supplemented with a top layer cover of \$40 million in excess of \$170 million. In addition, as Empire has significant California exposure, a California catastrophe cover provides an additional five layer coverage of \$100 million excess of \$15 million for earthquake only. Primary, difference in condition

("DIC") exposure is reinsured for up to \$40 million in excess of \$15 million through the three layer catastrophe reinsurance program.

Empire's casualty exposures are reinsured through a three layer per occurrence program providing \$3.5 million in excess of \$1.5 million with a \$14 million annual limit, \$5 million in excess of \$5 million with a \$10 million annual limit, and \$10 million in excess of \$10 million with a \$20 million annual limit. In addition, a major medical 90% quota share treaty with a \$5 million lifetime maximum is in place. Umbrella business is written with policy limits up to \$10 million. The first \$5 million of non contractor risks is covered under a 75% quota share. The second \$5 million of non contractor risks as well as the full amount of contractor umbrella coverages are ceded under a 100% quota share.

Primary crop hail under the Rural Community Insurance program is reinsured through a 95% multi-peril stop loss attaching at 101%, and providing layered coverage up to a 140% loss ratio. A second crop hail and named peril 95% stop loss attaches at a 90% loss ratio and provides layered coverage up to a 130% loss ratio. Assumed crop hail business is retroceded to a two layer 95% stop loss attaching at a 101% loss ratio and applying up to a 109% loss ratio.

Empire writes forced-placed mortgage insurance through ZC Sterling, an MGA, which was ceded 100% to its affiliate, Centre Reinsurance Company. Subsequent to the examination date, effective January 1, 2005, Empire retained this business. Empire also writes policies protecting businesses from income loss due to computer hacking ("E-Risk" business), which is ceded 100% to its affiliate, Fidelity and Deposit Company of Maryland.

Empire is covered under all corporate covers, except for the GAP and step-up treaties.

Global Energy Unit (“ZGE”)

Three reinsurance contracts cover risks identified as onshore property. A 40% quota share covers losses up to \$20 million with the cedent retaining \$12 million. This contract provides for a provisional commission with subsequent adjustments made on a sliding scale basis. A two layer excess of loss contract covers \$55 million of losses (except for a 10% retention) in excess of \$20 million. A 10% quota share covers losses above \$75 million.

Five reinsurance contracts cover risks associated with onshore and offshore oil, gas or other extractive businesses. The cedents retain \$7 million per risk, per occurrence after application of a four layer excess of loss contract and a 70% quota share contract. Up to \$65 million in excess a \$10 million of coverage is provided under the excess of loss contract with the cedents’ retention being 14% on each of the first two layers, 7% on the third and 10% on the highest layer. The excess of loss cover is a common account cover and is applied on a pre quota share basis.

A catastrophe excess of loss treaty provides up to \$50 million in excess of \$75 million on any one loss or any one series of losses and requires maximum acceptance on any one rig or platform to \$75 million. A facultative facility makes available \$25 million of coverage on risks in excess of \$75 million. A two layer net retained run-off cover provides up to \$30 million in excess of \$10 million per risk. The cedent retains 15% participation in the first layer and 20% in the second layer.

ZGE’s ocean marine business is protected by a five layer excess of loss treaty that provides up to \$49 million in excess of \$1 million each loss, casualty or disaster. Marine cargo is covered by a three layer excess of loss facility that provides up to \$9 million of coverage in excess of \$1 million.

Middle Market Unit (“MM”)

MM’s benchmark program is reinsured under an excess of loss agreement on a per risk basis on property losses and a per occurrence basis on general liability up to \$500,000 excess of \$500,000. A retention of 25% applies to the general liability portion.

An 82% quota share contract applies to losses up to \$25 million incurred under umbrella policies issued by MM.

Losses related to Riverboat Casino coverages are covered under a two layer excess of loss contract that provides up to \$40 million in excess of \$10 million per loss. ZIC’s participation as a reinsurer is 8% in the second layer, which is \$25 million in excess of \$25 million.

Auto and garage liability exposures arising from the unit’s Falcon Trust program are covered under an excess of loss contract which provides up to \$650,000 above a \$350,000 retention.

Fidelity bond exposures are covered under a four layer excess of loss contract with provides up to \$23 million in excess of \$2 million; however, a retention of 10% of each layer applies.

Certain business classified as E-Risk and Net Secure and including fidelity, professional liability and property risks is covered under a 66.6666% quota share for risks up to \$15 million.

Two reinsurance contracts covering professional liability exposure benefit MM. Primary policies are covered by an excess of loss contract of \$24 million in excess of \$1 million per policy, per loss subject to a 25% retention of the covered layer. The second contract, a 75% quota share, provides coverage for MM’s excess policies up to a limit of \$25 million per risk.

MM benefits from all corporate covers and the multi-unit commercial property contract previously described. Also, the global express and financial enterprise units of MM are provided coverage under the international property excess of loss contract described in the multi-unit section.

Small Business Unit (“ZSB”)

ZSB writes commercial lines property and workers’ compensation business with limits up to \$25 million, which it reinsures under two excess per risk contracts, each of which provides \$3 million of coverage in excess of \$2 million per loss. However, the insurer retains 24% and 25% of each cover, respectively.

An umbrella excess of loss contract covers up to \$9 million in excess of a \$1 million loss. The insuring entity has a retention of 5% on this coverage. ZSB benefits from all corporate covers.

Specialties Unit (“ZAS”)

ZAS benefits from two 17.5 % quota share contracts that cover A & H medical expenses. One is specific to business underwritten by a particular underwriter and one applies to business written on a direct basis. The reinsurer pays its share of the contingency fee and profit commission. ZAS business is also covered under an excess contract that provides up to \$4 million in excess of \$1 million per person, per policy year.

An A & H Critical Care 45% quota share contract covers business classified by the Company as Managed Transplant.

Monthly benefits payable under A & H long term disability policies are covered under a two part reinsurance contract. The first part provides 70% quota share up to a monthly maximum of \$15,000. The second part provides for a 100% facultative cession for monthly benefits between \$15,000 and \$30,000.

Two treaties provide catastrophe excess of loss coverage on group accident business. Up to \$55 million in excess of \$5 million is provided by the first contract in three layers. The second contract provides up to \$40 million in excess of the \$60 million of losses under the first contract.

The healthcare excess cover provides up to \$25 million in excess of \$5 million; however there is a retention of 62.5% on the first \$5 million layer and a 20% retention on the second layer.

Political and trade credit risks are covered under a 78.29% quota share treaty and a 75% quota share treaty, respectively. ZIC, as a reinsurer, has a 14.29% share (based on the full loss) of the political risk cession and a 13.69% share of the trade credit risk cession.

Business classified by ZAS as railroad business is covered under a 20% net quota share contract placed with a licensed insurer. The maximum risk ceded is \$10 million.

General liability coverage provided to California residential subcontractors is reinsured under a 38.10% quota share contract for losses up to \$525,000.

Professional liability coverage up to \$2 million for small law and accountant entities is reinsured under a 20% quota share contract.

Two portfolios of non medical professional liability, diversified financial institutions and large professional liability policies, are each covered by a variable quota share contract. Losses on underlying policies with limits less than \$2 million are retained; limits from \$2 million to \$10 million are ceded on a 50% basis; and limits from \$10 million to \$25 million are ceded on a 60% basis.

The ZAS top risk excess cover provides up to \$20 million in excess of \$30 million of losses on specialty products with the exception of accident and health, political risks, and financial liability lines.

The combined excess of loss contract provides separate coverages for casualty, railroad, and fidelity exposures. Each provides up to \$20 million in excess of \$10 million with a retention of 10%.

Directors' and officers' liability and employers' practices liability policies are reinsured under a 57.5 % quota share treaty. ZIC assumes 5%.

Universal Underwriters ("UUIC")

In addition to reinsurance provided under the group covers, UUIC has four treaties in place.

Property and automobile inventory risks are covered under a three layer excess of loss contract which covers up to \$12 million in excess of \$2 million. Umbrella policies are subject to a semi automatic facultative treaty providing up to \$25 million of coverage for losses in excess of \$12 million. A property catastrophe contract provides up to \$100 million of coverage in excess of \$15 million per occurrence with 5% of the layer being retained.

Casualty and group workers' compensation exposures are covered under a two layer excess of loss contract with coverage up to \$10 million on casualty losses in excess of \$2 million. UUIC retains a 27.5% participation on the first layer's \$3 million coverage. A casualty catastrophe treaty provides \$13 million in excess of \$12 million per occurrence.

Respectfully submitted,

_____/S/
James Call, CFE

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

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

_____/S/
James Call, CFE

Subscribed and sworn to before me
this _____ day of _____, 2005.

Appointment No 22365

STATE OF NEW YORK
INSURANCE DEPARTMENT

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

James Call

as proper person to examine into the affairs of the

AMERICAN GUARANTEE AND LIABILITY INSURANCE COMPANY

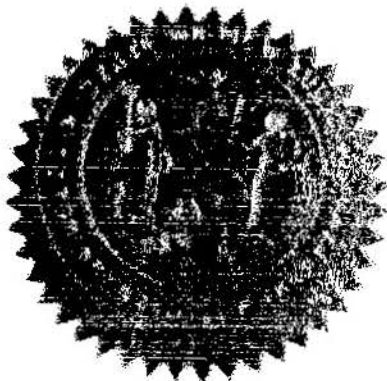
and to make a report to me in writing of the condition of the said

Company

with such other information as he shall deem requisite.

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

this 20th day of April, 2005



A handwritten signature in black ink, appearing to read "Howard Mills", written over a horizontal line.

HOWARD MILLS

Acting Superintendent of Insurance