

REPORT ON EXAMINATION

OF THE

MIDSTATE MUTUAL INSURANCE COMPANY

AS OF

DECEMBER 31, 2007

DATE OF REPORT

JULY 15, 2008

EXAMINER

FRANK P. SCHIRALDI

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STATE OF NEW YORK
INSURANCE DEPARTMENT
ONE COMMERCE PLAZA
ALBANY, NEW YORK 12257

July 15, 2008

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

Sir:

Pursuant to the requirements of the New York Insurance Law, and in compliance with the instructions contained in Appointment Number 22752 dated March 12, 2008 attached hereto, I have made an examination into the condition and affairs of the Midstate Mutual Insurance Company as of December 31, 2007, and submit the following report thereon.

Wherever the designations “the Company” appears herein without qualification, it should be understood to indicate Midstate Mutual 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 home office located at 5612 South Street Road, Auburn, New York 13021.

1. SCOPE OF EXAMINATION

The Department has performed a single-state examination of Midstate Mutual Insurance Company. The previous examination was conducted as of December 31, 2002. This examination covered the five-year period from January 1, 2003 through December 31, 2007. Transactions occurring subsequent to this period were reviewed where deemed appropriate by the examiner.

This examination was conducted in accordance with the National Association of Insurance Commissioners (“NAIC”) *Financial Condition Examiners Handbook*. The Handbook requires that we plan and perform the examination to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the company including corporate governance, identifying and assessing inherent risks within the Company and evaluating system controls and procedures used to mitigate those risks. An examination also includes assessing the principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation, management’s compliance with Statutory Accounting Principles and annual statement instructions when applicable to domestic state regulations.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process. The examiners also relied upon audit work performed by the Company’s independent certified public accountants when appropriate.

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

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

This examination report also includes a summary of significant findings regarding market conduct activities.

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

Midstate Mutual Insurance Company was organized under the laws of the State of New York in 1879 as the Farmers' Mutual Indemnity Association of Moravia, New York ("the Association"), for the purpose of transacting business as an assessment cooperative fire insurance corporation.

On April 8, 1986, the Department approved the merger of the Association with the Cayuga County Farmers Insurance Company, the Cayuga County Patron's Fire Relief Association, the Farmers' Reliance Mutual Insurance Company and the Southern Tier Cooperative Insurance Company, with the Association being the surviving corporation under the title, Midstate Mutual Insurance Company.

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 nine nor more than thirteen members. As of the examination date, the board of directors was comprised of ten members, divided into three groups as evenly as possible, with one group being elected at each annual policyholders' meeting for a term of three years.

Each person insured by the Company is entitled to one vote in person at each of its annual meetings and no one may vote by proxy. The annual meeting of the board of directors is

held immediately after the annual meeting of the Company. The full board met at least four times during each calendar year thereby complying with Section 6624(b) of the New York Insurance Law.

At December 31, 2007, the board of directors was comprised of the following ten members:

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Jeffery A. Armstrong Williamsville, NY	National Sales and Marketing Director, Baptist Life Association
Gregory N. Bruce Union Springs, NY	President and Chief Operating Officer, Midstate Mutual Insurance Company
James P. Chamberlain Auburn, NY	Senior Vice President of Claims and Secretary, Midstate Mutual Insurance Company
Daniel J. Fessenden Union Springs, NY	Executive Director, Fred L. Emerson Foundation
John S. Fessenden King Ferry, NY	Loan Officer, Farm Credit of Western NY
Richard H. Flanagan Syracuse, NY	Public Safety Training Center Director, Onondaga Community College
John A. Karpinski Auburn, NY	Attorney, Private Practice
Lyndon R. Odell Union Springs, NY	Professional Farm Manager, Treasurer, Midstate Mutual Insurance Company
Michael White Clay, NY	Marketing Manager, McNeil and Company, Inc.
Andrew P. White Auburn, NY	Chairman of the Board, Chief Executive Officer, and Chief Investment Officer, Midstate Mutual Insurance Company

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

As of December 31, 2007, the principal officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Andrew P. White	Chairman of Board
Gregory N. Bruce	President
Lyndon R. Odell	Treasurer
James P. Chamberlain	Senior Vice President and Secretary
Diane R. Dechick	Vice President of Underwriting
Joyce A. White	Vice President of Accounting

B. Territory and Plan of Operation

As of December 31, 2007, the Company was licensed to write business in all the Counties of the State of New York excluding the counties of New York, Kings, Queens, Bronx and Richmond.

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>
4	Fire
5	Miscellaneous property
6	Water damage
7	Burglary and theft
8	Glass
9	Boiler and machinery
12	Collision
13	Personal injury liability
14	Property damage liability
15	Workers' compensation and employers' liability (excluding workers' compensation)
19	Motor vehicle and aircraft physical damage (excluding aircraft physical damage)
20	Marine and inland marine (inland marine only)

Paragraphs 5, 6, 7, 8, 13, 14 and 15 can be written solely in conjunction with fire insurance written under the same policy and covering the same premises. The Company is also

authorized to accept and cede reinsurance as provided in Section 6606 of the New York Insurance Law.

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

<u>Calendar Year</u>	<u>Direct Premiums Written(000)</u>
2003	\$10,847
2004	11,158
2005	11,770
2006	11,772
2007	11,884

Based on the lines of business for which the Company is licensed and pursuant to the requirements of Articles 13 and 66 of the New York Insurance Law, the Company is required to maintain a minimum surplus to policyholders in the amount of \$100,000.

The Company underwrites predominantly the commercial multiple peril and the homeowners multiple peril lines of business, which accounted for 67% and 23%, respectively, of the 2007 net premium writings.

The Company obtains business through approximately 184 producers.

C. Reinsurance

During the current period under examination, the Company did not assume any reinsurance.

As of December 31, 2007, the Company had the following multi-line excess of loss reinsurance program in place:

Property 2 layers	\$800,000 excess of \$200,000 ultimate net loss, each risk each loss, subject to a limit of liability to the Reinsurer for each layer, respectively of \$900,000 and \$1,000,000 in respect of each occurrence.
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Casualty 2 layers	\$800,000 excess of \$200,000 ultimate net loss, each loss occurrence.
Casualty (Clash)	\$2,000,000 excess of \$1,000,000 ultimate net loss each and every loss occurrence.
Property Casualty Combined	\$200,000 excess \$200,000 ultimate net loss each loss occurrence in the event of a loss occurrence involving at least one casualty policy and one property policy, subject to a limit of liability to the Reinsurer of \$200,000 for each loss occurrence; Recoveries under the Property and Casualty coverages above shall reduce the ultimate net loss subject to the combined coverage.

As of December 31, 2007, the Company had the following Property Facultative Pro Rata reinsurance in place:

Property Facultative Pro Rata	Ten (10) times the Company's net retention plus the amount ceded to the Company's working reinsurance contracts, subject to a minimum net retention of \$50,000 and to a maximum cession hereunder of \$1,000,000 on any one risk. If the cession is greater than \$250,000, the maximum cession as respects any one animal shall not exceed \$250,000.
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As of December 31, 2007, the Company had the following Property Catastrophe reinsurance in place:

Property 4 layers	100% excess of \$500,000 each loss occurrence subject to a limit of liability to the Reinsurer of \$500,000, \$1,000,000 and \$1,000,000 on the First, Second and Third Excess Layers, respectively. However, no claim shall be made unless the loss occurrence involves three or more risks.
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As of December 31, 2007, the Company ceded 100% of its boiler and machinery liability.

All of the Company's cessions during the period under examination were to authorized reinsurers. It is noted that the Company's retention has increased from \$50,000 to \$200,000 on both its property and casualty lines of business during the examination period.

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

Examination review of the Schedule F data reported by the Company in its 2007 filed annual statement was found to accurately reflect its reinsurance transactions. Additionally, management has represented that all material ceded reinsurance agreements transfer both underwriting and timing risk as set forth in the NAIC's Accounting Practices and Procedures Manual, Statement of Statutory Accounting Principles ("SSAP") No. 62. Representations were supported by appropriate risk transfer analyses and an attestation from the Company's Chief Executive Officer pursuant to the NAIC Annual Statement Instructions. Additionally, examination review indicated that the Company was not a party to any finite reinsurance agreements. All ceded reinsurance agreements were accounted for utilizing reinsurance accounting as set forth in paragraphs 17 through 26 of SSAP No. 62.

D. Holding Company System

As of December 31, 2007, the Company is not a member of any holding company system.

E. Significant Operating Ratios

The following ratios have been computed as of December 31, 2007, based upon the results of this examination:

Net premiums written to surplus as regards policyholders	47%
Liabilities to liquid assets (cash and invested assets less investments in affiliates)	38%
Premiums in course of collection to surplus as regards policyholders	5%

All of the above ratios fall within the benchmark ranges set forth in the Insurance Regulatory Information System of the National Association of Insurance Commissioners.

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

	<u>Amounts</u>	<u>Ratios</u>
Losses and loss adjustment expenses incurred	\$27,646,171	60.26%
Other underwriting expenses incurred	17,551,362	38.25%
Net underwriting gain	<u>682,283</u>	<u>1.49%</u>
Premiums earned	<u>\$45,879,816</u>	<u>100.00%</u>

F. Accounts and Records

i. Written Contract with Certified Public Accountant

The review of the Company’s contract with its independent certified public accountant (“CPA”) revealed that the contract does not comply with certain requirements specified in Section 89.2 of Regulation 118. Specifically, Section 89.2 of Regulation 118 states that the contract between the Company and its CPA must state that the CPA will notify the superintendent within 15 calendar days following a determination 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. The Company’s contract with its CPA states that the CPA will notify the Insurance Department in the event that there is material misstatement of the financial condition or that the insurer does not meet minimum capital and surplus to policyholder requirements. Additionally, Section 89.2 requires that the contract between the Company and its CPA must state that “on or before May 31st, the CPA will provide an audited financial statement of such insurer...for the prior calendar year.” The Company’s contract with its CPA has modified this wording by adding the words “circumstances permitting”.

It is recommended that the Company ensure that the contract entered into with its independent certified public accountant is in full compliance with Department Regulation 118.

ii. Amortization of Bonds

The examination review of the method used to amortize bonds revealed that the Company did not comply with paragraph 6 of SSAP No. 26. Specifically, the Company uses the

straight line method to amortize its bonds while SSAP No. 26 requires that the scientific method of amortization be used to calculate the amortization of bond premium or discount.

It is recommended that the Company comply with paragraph 6 of SSAP No. 26 and use the scientific method to calculate the amortization of bond premium or discount.

iii. Premiums in the Course of Collection and Deferred Premiums

The NAIC Annual Statement Instructions require that the Company distinguish the amounts of uncollected premiums in the course of collection from those amounts booked but deferred and not yet due, and report the actual amount of each on a separate line of the filed annual statement. The Company uses a formula to allocate the total amount of uncollected premiums between the two lines instead of reporting the actual amounts.

It is recommended that the Company comply with the NAIC Annual Statement Instructions and report the actual amount of uncollected premiums and agents' balances in the course of collection, and deferred premiums, agents' balances and installments booked but deferred and not yet due in all future filings with this Department.

iv. Reporting of Ceded Loss Adjustment Expenses

It was noted that the Company did not accurately report its outstanding ceded loss adjustment expense amounts on Schedule P, Part 1. Specifically, the Company incorrectly reported amounts for accident years 2002, 2003 and 2004, but reported the correct amount, in total, for all accident years.

It is recommended that the Company accurately report, by accident year, its outstanding ceded loss adjustment expenses on Schedule P, Part 1 in all future filings with this Department.

3. FINANCIAL STATEMENTS

A Balance Sheet

The following shows the assets, liabilities and surplus as regards policyholders as of December 31, 2007. 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>Net Admitted Assets</u>
Bonds	\$26,365,770	\$ 0	\$26,365,770
Common stocks	3,273,703	0	3,273,703
Real Estate: Properties occupied by the company	700,075	0	700,075
Cash, cash equivalents and short-term investments	538,354	0	538,354
Investment income due and accrued	349,290	0	349,290
Uncollected premiums and agents' balances in the course of collection	1,124,878	3,101	1,121,777
Deferred premiums, agents' balances and installments booked but deferred and not yet due	1,687,317	0	1,687,317
Amounts recoverable from reinsurers	35,594	0	35,594
Other amounts receivable under reinsurance contracts	115,960	0	115,960
Net deferred tax asset	647,600	0	647,600
Electronic data processing equipment and software	42,496	0	42,496
Furniture and equipment, including health care delivery assets	131,638	131,638	0
Aggregate write-ins for other than invested assets	<u>132,190</u>	<u>132,190</u>	<u>0</u>
Total assets	<u>\$35,144,865</u>	<u>\$266,929</u>	<u>\$34,877,936</u>

Liabilities, surplus and other fundsLiabilities

Losses and loss adjustment expenses	\$ 5,240,122
Commissions payable, contingent commissions and other similar charges	876,768
Other expenses (excluding taxes, licenses and fees)	18,281
Taxes, licenses and fees (excluding federal and foreign income taxes)	2,579
Current federal and foreign income taxes	200,678
Unearned premiums	6,027,934
Advance premium	79,119
Ceded reinsurance premiums payable (net of ceding commissions)	54,663
Remittances and items not allocated	41,110
Aggregate write-ins for liabilities	<u>805,292</u>
 Total liabilities	 \$13,346,546

Surplus and Other Funds

Minimum required surplus	\$ 100,000
Unassigned funds (surplus)	<u>21,431,390</u>
 Surplus as regards policyholders	 <u>21,531,390</u>
 Total liabilities, surplus and other funds	 <u>\$34,877,936</u>

Note: The Internal Revenue Service has completed its audits of the Company's Federal Income Tax returns for tax years 2005 and 2006. 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. No tax audits are currently in progress. The Internal Revenue Service has not yet begun to audit tax returns covering tax years 2003, 2004 or 2007. 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 increased \$5,244,066 during the five-year examination period January 1, 2003 through December 31, 2007, detailed as follows:

Underwriting Income

Premiums earned		\$45,879,816
Deductions:		
Losses and loss adjustment expenses incurred	\$27,646,171	
Other underwriting expenses incurred	<u>17,551,362</u>	
Total underwriting deductions		<u>45,197,533</u>
Net underwriting gain or (loss)		\$ 682,283

Investment Income

Net investment income earned	\$ 5,281,369	
Net realized capital loss	<u>(84,187)</u>	
Net investment gain or (loss)		5,197,182

Other Income

Finance and service charges not included in premiums	\$ 531,019	
Aggregate write-ins for miscellaneous income	<u>18,169</u>	
Total other income		<u>549,188</u>
Net income before dividends to policyholders and before federal and foreign income taxes		\$ 6,428,653
Dividends to policyholders		<u>0</u>
Net income after dividends to policyholders but before federal and foreign income taxes		\$ 6,428,653
Federal and foreign income taxes incurred		<u>2,003,028</u>
Net Income		<u>\$ 4,425,625</u>

Surplus as regards policyholders per report on examination as of December 31, 2002			\$16,287,324
	<u>Gains in</u>	<u>Losses in</u>	
	<u>Surplus</u>	<u>Surplus</u>	
Net income	\$4,425,625	\$ 0	
Net unrealized capital gains or losses	513,520		
Change in net deferred income tax	399,487		
Change in nonadmitted assets	<u>0</u>	<u>94,566</u>	
Total gains or losses in surplus	<u>\$5,338,632</u>	<u>\$94,566</u>	
Net increase in surplus			<u>5,244,066</u>
Surplus as regards policyholders per report on examination as of December 31, 2007			<u>\$21,531,390</u>

4. **LOSSES AND LOSS ADJUSTMENT EXPENSES**

The examination liability for the captioned items of \$5,240,122 is the same as reported by the Company as of December 31, 2007. The examination analysis was conducted in accordance with generally accepted actuarial principles and practices and was based on statistical information contained in the Company's internal records and in its filed annual statements.

It is noted that subsequent to the examination field work, the Company's reported nine month runoff of losses, defense and cost containment expenses, and adjusting and other expenses, for accident years 2007 and prior shows a deficiency of \$100,000. The deficiency noted is not considered material and therefore no examination changes were made to the financial statements presented in this report.

5. **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. Rating
- D. Claims and complaint handling

No problem areas were encountered.

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>
<p>A. <u>Management</u></p> <p>It was recommended that the Company comply with Article III Section 3 of its by-laws and have salaries of all officers set by the board of directors.</p> <p>The Company has complied with this recommendation.</p>	<p>3-4</p>
<p>B. <u>Custodial Agreement</u></p> <p>It was recommended that the Company comply with the NAIC requirements, reinforced by Circular Letter No. 2 of 1977 and obtain a custodial agreement that includes the requirements specified by the NAIC and the New York Insurance Department.</p> <p>The Company has complied with this recommendation.</p>	<p>8</p>
<p>C. <u>Accounting</u></p> <p>i. It was recommended that the Company comply with the annual statement instructions and move the money market funds to Schedule D Part 2 Section 2 of the annual statement.</p> <p>The Company has complied with this recommendation.</p>	<p>9</p>

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| ii. | It was recommended that the Company comply with Paragraph 4 of SSAP No. 45 and record repurchase agreements as short-term investments on all financial statements filed with the Department. | 9 |
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The Company has complied with this recommendation.

7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

ITEMPAGE NO.

A. Accounts and Records

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|------|---|----|
| i. | It is recommended that the Company ensure that the contract entered into with its independent certified public accountant is in full compliance with Department Regulation 118. | 9 |
| ii. | It is recommended that the Company comply with paragraph 6 of SSAP No. 26 and use the scientific method to calculate the amortization of bond premium or discount. | 10 |
| iii. | It is recommended that the Company comply with the NAIC Annual Statement Instructions and report the actual amount of uncollected premiums and agents' balances in the course of collection, and deferred premiums, agents' balances and installments booked but deferred and not yet due in all future filings with this Department. | 10 |
| iv. | It is recommended that the Company accurately report, by accident year, its outstanding ceded loss adjustment expenses on Schedule P, Part 1 in all future filings with this Department. | 10 |

Respectfully submitted,

Frank P. Schiraldi
Senior Insurance Examiner

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

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

Frank P. Schiraldi

Subscribed and sworn to before me

this _____ day of _____, 2009.

Appointment No 22752

STATE OF NEW YORK
INSURANCE DEPARTMENT

I, Eric R. Dinallo, Superintendent of Insurance of the State of New York, pursuant to the provisions of the Insurance Law, do hereby appoint:

Frank Schiraldi

as proper person to examine into the affairs of the

Midstate Mutual 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 12th day of March 2008



A handwritten signature in black ink that reads "Eric Dinallo".

Eric R. Dinallo
Superintendent of Insurance