

REPORT ON EXAMINATION AS TO THE CONDITION OF

HARBOR SPECIALTY INSURANCE COMPANY

TRENTON, NEW JERSEY

AS OF DECEMBER 31, 2004

NAIC GROUP CODE 0517

NAIC COMPANY CODE 21806

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JON S. CORZINE
Governor



STEVEN M. GOLDMAN
Commissioner

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June 29, 2006

Commissioners:

In accordance with the plan adopted by the National Association of Insurance Commissioners for association examination of insurance companies, a financial condition examination has been made of:

Harbor Specialty Insurance Company
Trenton, New Jersey
NAIC Group Code 0517 NAIC Company Code 21806

Hereinafter referred to as the "Company".

SCOPE OF THE EXAMINATION

This financial condition examination was called by the Commissioner of Banking and Insurance of the State of New Jersey pursuant to the authority granted by N.J.S.A. 17:23-22.

The examination was conducted at the Company's main administrative office located at 7 Times Square New York, NY 10036. The examination was conducted in accordance with the Association Plan of Examination guidelines established by the National Association of Insurance Commissioners. The States of California and Nevada (Western Zone), as well as the State of Mississippi (Southeastern Zone) participated in the examination.

The New Jersey Department of Banking and Insurance has adopted a modified short form report which will only address significant balance sheet accounts, adverse findings and other important regulatory information disclosed by the examination process. All other financial matters were reviewed and determined not to be material for discussion in this report.

The procedures outlined in the National Association of Insurance Commissioners Financial Condition Examiners Handbook and the New Jersey Department of Banking and Insurance Financial Condition Handbook were used as guides for the examination of the various accounts and records and included the use of direct verification as well as numerous tests, some complete and others on a partial basis. In determining the emphasis to be placed on each account, a review was performed to determine the nature and size of each account and its relevancy to solvency.

The following accounts were assigned special emphasis:

- Unearned Premiums
- Losses and Loss Adjustment Expenses
- Amounts Recoverable from Reinsurers
- Premiums and Considerations
- Commissions Payable, Contingent Commissions and other Similar Charges
- Ceded Reinsurance Premiums Payable

The following accounts were assigned standard emphasis:

- Current Federal and Foreign Income Tax Recoverable
- Net Deferred Tax Asset
- Payable to Parent, Subsidiaries and Affiliates
- Taxes, Licenses and Fees
- Accrued Capital Contribution
- Commission Holdbacks
- Funds Held by Company under Reinsurance Treaties
- Bonds
- Stocks
- Cash, Cash Equivalents and Short-term Investments

In addition to the above balance sheet accounts, the following areas were also reviewed:

- Advertising and Sales Material
- Commitments and Contingent Liabilities
- Conflicts of Interest
- Corporate Records
- Fidelity Bond and Other Insurance Coverages
- History and Kind of Business
- Management and Control
- Continuity of Operations
- Policy Forms and Underwriting Practices
- Territory and Plan of Operation
- Treatment of Policyholders
- Accounts and Records

Surplus as regards policyholders determined by the examination, at the examination date, consisted of the following:

Common Capital Stock	\$ 4,100,000
Gross Paid in and Contributed Surplus	26,250,000
Unassigned Funds	<u>(5,014,322)</u>
Surplus as Regards Policyholders	<u>\$ 25,335,678</u>

The change in assets, liabilities and surplus for the period covered by this examination is detailed below(\$000 omitted).

	12/31/04	<u>12/31/03</u>	<u>12/31/02</u>	<u>12/31/01</u>	<u>12/31/00</u>
Assets	\$ 263,180	\$ 280,780	\$ 154,024	\$129,618	\$ 35,366
Liabilities	\$ 237,844	\$ 245,022	\$ 123,295	\$108,522	\$ 15,184
Surplus	\$ 25,335	\$ 35,759	\$ 30,729	\$ 21,096	\$ 20,182

COMPLIANCE WITH PRIOR EXAMINATION REPORT RECOMMENDATIONS

FIDELITY BOND AND OTHER INSURANCE COVERAGE

It is recommended that the Company and its MGAs adhere to all aspects of the New Jersey Statutes including the requirement that the MGAs obtain a fidelity bond to protect the Company.

The Company has partially complied with this recommendation.

REINSURANCE

It is recommended that the Company obtain and maintain complete reinsurance contracts on all reinsurance programs.

The Company has not fully complied with this recommendation.

It is recommended that the payments under these agreements be paid according to the time frames specified or that the agreements be modified to a payment schedule to which the parties can abide.

The Company has complied with this recommendation.

CONTINUITY OF OPERATIONS

It is recommended that the disaster plan be tested as soon as possible.

The Company has complied with this recommendation subsequent to the examination date.

ACCOUNTS AND RECORDS

It is recommended that the Company give special attention to see that the underwriting and loss system (i.e. "Program Accounting System" and related "Pre-processor") is implemented as soon as possible. Past deadlines have not been met causing the implementation of this system to be seriously delayed in becoming a reality, which in turn has caused the Company to use data, in its financial statements, which is often not verified, and, in some instances, is an estimate of top management.

The Company has not yet fully complied with this recommendation.

It is recommended that the Company prepare and maintain supporting records for all General Ledger account balances.

The Company has complied with this recommendation.

It is recommended that the Company apply its year-end estimation methods consistently and evaluate the estimation methods' accuracy.

The Company has not complied with this recommendation.

TREATMENT OF POLICYHOLDERS

It is recommended that the Company communicate the requirement to maintain complaint logs to its agencies, and that it oversees that they are being maintained as required by Statutes.

The Company had not complied with this recommendation as of examination date.

**COMPLIANCE WITH PRIOR EXAMINATION REPORT
RECOMMENDATIONS (continued)**

BONDS AND COMMON STOCKS

It is recommended that the Company revise their custodial agreement to have the two controls noted by the NAIC Section B.5c.

The Company has not complied with this recommendation.

PREMIUMS AND AGENTS' BALANCES IN THE COURSE OF COLLECTION

It is recommended that the Company prepare and maintain supporting records for all General Ledger account balances.

The Company has complied with this recommendation.

It is recommended that the Company ensure that all provisions of their General Agency Agreements are complied with. In addition it is recommended that the Company regularly obtain and reconcile all the detail reports provided by the Agreement. Subsequent to the examination, the Company has stated it has complied with this recommendation.

The Company has not complied with this recommendation.

It is again recommended that the Company report agent's balances that are over 90 days overdue in accordance with the NAIC Annual Statement Instructions.

The Company has not complied with this recommendation.

It is recommended that the Company identify the General Ledger account numbers in use by program.

The Company has complied with this recommendation.

AMOUNTS RECOVERABLE FROM REINSURERS

It is again recommended that the Company properly age its reinsurance recoverable balances in accordance with the Annual Statement Instructions for Schedule F - Part

The Company has not complied with this recommendation.

LOSSES AND LOSS ADJUSTMENT EXPENSE

It is again recommended that the Company establish and maintain a reserve for loss adjustment expenses to cover the ultimate estimated expenses necessary to adjust all unpaid losses irrespective of any agreements other than a valid contract of reinsurance.

The Company has not complied with this recommendation.

It is recommended that the Company develop and maintain an accounting system to accurately and consistently record all claims and loss adjustment expenses paid and payable by the third party claims offices and maintain proper audit trails to amounts reported in its Annual Statements.

The Company has complied with this recommendation.

CONTINGENT COMMISSIONS

It is recommended that the Company prepare and maintain supporting records for its contingent commissions.

The Company has complied with this recommendation.

COMPLIANCE WITH PRIOR EXAMINATION REPORT RECOMMENDATIONS (continued)

UNEARNED PREMIUMS

It is recommended that the Company obtain and retain documentation to support its reported unearned premiums.

The Company has complied with this recommendation.

It is recommended that the Company use consistent estimation methods in the calculation of its unearned premium reserves.

The Company has complied with this recommendation

FUNDS HELD BY COMPANY UNDER REINSURANCE TREATIES

It is recommended that the Company maintain documentation that reconciles funds held on deposit under reinsurance treaties to the Company's General Ledger for each reinsurer listed in Schedule F Part 3 of the statutory Annual Statement.

The Company has complied with this recommendation.

PROVISION FOR REINSURANCE

It is recommended that the Company obtain its letters of credit and proper amendments to its letters of credit prior to year-end.

The Company has complied with this recommendation.

It is recommended that the Company obtain letters of credit in the name of the Company.

The Company has complied with this recommendation.

HISTORY AND KIND OF BUSINESS

The Company was incorporated under the laws of the State of Georgia on July 2, 1981, as First of Georgia Fire and Casualty Insurance Company and commenced business on October 1, 1981. It was acquired by the Clarendon Group on September 8, 1995, and redomiciled to the State of New Jersey on November 9, 1995, at which time it changed its name to Harbor Specialty Insurance Company.

The Company is part of the Clarendon Insurance Group which is owned by Hannover Finance Incorporated, a Delaware corporation. Its ultimate parent is Hannover Ruckversicherung AG (Germany) hereinafter referred to as Hannover Re.

Its Certificate of Authority dated May 28, 1996 authorized the Company to transact the business of insurance specified in paragraphs "a", "b", "e", "f", "i", "j", "k", "l", "m", "n" and "o-1", "o-2" and "o-3" of N.J.S.A. 17:17-1.

The capital structure of the Company includes 4,100,000 shares of common stock with a par value of \$1 per share totaling \$4,100,000 of common stock. The Company's capital also includes \$26,250,000 of gross paid in and contributed surplus and unassigned funds in the amount of \$3,675,528 (prior to examination changes).

The Company's statutory home office is located at 224 West State Street, Trenton, New Jersey 08608. The registered agent upon whom process may be served is Wesley S. Caldwell III at the Company's statutory home office.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2004, the Company was licensed to write business in 21 States. It writes property and casualty insurance, the largest writings were in the following areas:

	<u>Direct</u>	<u>Net</u>
Workers Compensation	\$ 86,077,652	\$ 14,343,542
Private Passenger Auto Liability	\$ 27,670,775	\$ 5,747,208
Auto Physical Damage	\$ 9,856,256	\$ 1,872,048

The Company's direct written business is primarily program business which consists of homogeneous books of business dedicated to a well defined market segment. Many of these programs have been recommended to the Company by various reinsurers who desire to participate in the program through quota share treaties.

The Company uses reinsurance intermediary brokers to negotiate its reinsurance. These brokers are licensed either in New Jersey or in other accredited states having similar laws of the state of New Jersey.

The Company primarily uses managing general agents (MGAs), general agents (GAs) and third party administrators (TPAs) to actively manage its various programs. These parties conduct a substantial portion of the administrative work associated with premium and claims processing functions, backup supporting records, and reconciliation to Company bank accounts established for their use.

These firms have contracts with the Company whereby their responsibilities and authority are delineated. Our review determined that the Company is requiring that their MGAs obtain fidelity bond insurance as required under N.J.S.A. 17:22-(2-7).

REINSURANCE

Assumed:

At December 31, 2004 the Company's assumed reinsurance was in runoff. During 2004 assumed premiums amounted to \$259 thousand.

Ceded:

The Company makes extensive use of ceded reinsurance in managing its business. During 2004, the Company ceded 85.8% of its direct and assumed premiums written.

The Company's ceded reinsurance arrangements can be grouped into three categories:

1. Program Reinsurance:

All Program business was at least partly ceded to various reinsurers. A reinsurance contract usually starts with a Program which contacts the Company about a proposed book of business to be reinsured. Most of the reinsurance is placed through an

intermediary. The Company (one of the Program Managers) contacts the intermediary and tells them the type of contract that the Company desires for that book of business. The Company supplies the intermediary with a list of contract clauses that the Company would like included in the contract.

The reinsurers utilized by the Company are based on a listing of approved reinsurers maintained by the Company's ultimate parent, Hannover Ruckversicherung AG (Hannover Re). There were minimum standards regarding the financial condition of any reinsurer to be included on that list. These included requirements for certain AM Best's and Standard & Poor's ratings.

2. Global Reinsurance:

Global Reinsurance covers multiple Programs. There was Catastrophe Excess of Loss that covered property business in certain Programs in Florida, California and Texas. Coverage was in four layers with the Company retaining \$60 million under the first layer.

Excess of Loss coverage was placed by the Company for its Workers Compensation business. It was in three layers with the Company retaining the first \$1 million and coverage up to \$50 million.

The Company also ceded certain business from 11 Programs under a quota share agreement. The Company's retention varied, depending on the Program, from 35% to 75%.

3. Affiliated Reinsurance:

Effective December 31, 2003, the Company and its affiliates, Clarendon National Insurance Company and Clarendon America Insurance Company entered into a Loss Portfolio retroactive ceded reinsurance agreement with affiliate Hannover Re, subject to a loss limitation of \$350 million. This agreement was approved by the New Jersey Department of Banking and Insurance. As of December 31, 2004, the inception to date losses and loss adjustment expenses ceded under this contract totaled \$362 million for all three reinsureds. As of December 31, 2005, the inception to date losses and loss adjustment expenses ceded under this contract totaled \$519 million for all three reinsureds.

There is a letter signed by the reinsureds and Hannover Re that the limit of \$350 million excludes all charges relating to legal disputes arising from reinsurance recoverables. Such charges include, but are not limited to, legal fees, settlements and commutations.

As of December 31, 2004, the total ceded premiums and inception to date losses and loss adjustment expenses ceded by the Company were \$3,698,908 and \$7,091,976, respectively. The Company recorded the transaction using the prospective method. Per SSAP 62, retroactive intercompany reinsurance agreements that result in a gain to surplus are required to be accounted for using the retroactive method.

It is recommended the Company report the loss portfolio transaction under the accounting for retroactive reinsurance agreements in accordance with SSAP 62.

Under a Loss Portfolio Reinsurance Agreement, the Company and two affiliates ceded to Hannover Re 100 % of the ultimate net liability (subject to a limit of \$350 million) on a large block of old business.

In a quota share arrangement, effective January 1, 2004, the Company ceded to Hannover Re 30% of all in-force, new and renewal business (with a few exceptions) written by the Company on or after January 1, 2004. If the Company's loss ratio exceeds 95%, no further coverage is provided by Hannover Re.

The Company entered into a Corporate Catastrophe Contract, effective October 1, 2004, with Hannover Re (Bermuda) Ltd. The business covered is property risks produced through certain Programs. After the Company's retention of \$20 million, the coverage provided is a maximum of \$40 million per occurrence and \$80 million for the term of the contract. This contract expired in 2005 and was not renewed.

During the review of reinsurance contracts, it was noted that, in many instances, the Company provided contracts that were incomplete (missing Addendums or Interest & Liabilities Agreements) and/or unsigned. Only after many repeated requests were made did the examiners eventually receive complete signed copies.

The prior Report on Examination recommended that the Company obtain and maintain complete reinsurance contracts on all reinsurance programs. **It is again recommended that the Company ensure its reinsurance files are maintained with complete signed copies of all reinsurance agreements and such agreements are readily available for review by the examiners.**

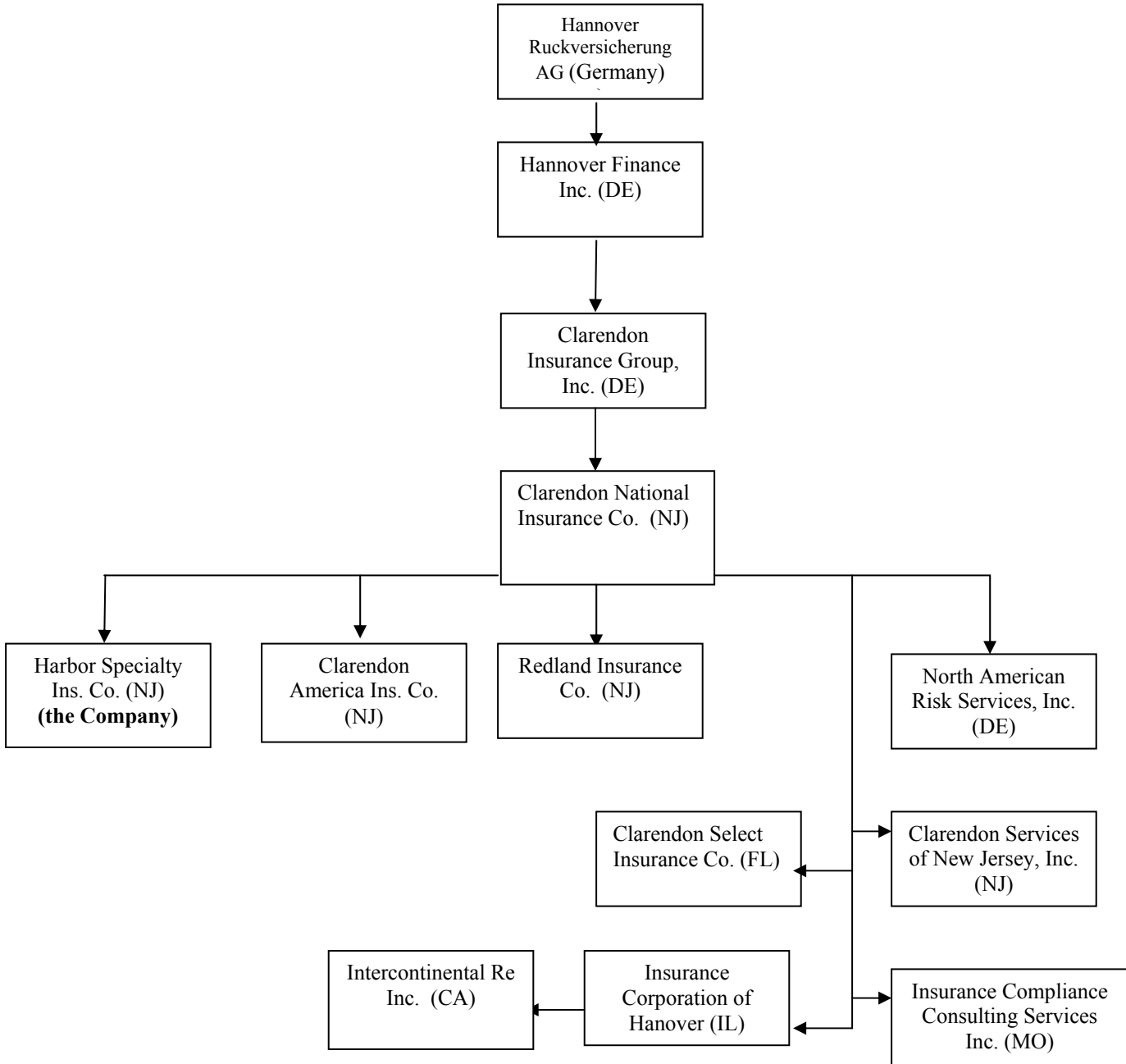
The effect of the Company's reinsurance on premiums written for the period under examination was as follows (\$000 omitted):

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Direct premiums written	\$ 133,738	\$ 290,102	\$ 194,577	\$ 128,586	\$ 115,813
Assumed	259	(416)	2,147	7,443	881
Ceded	114,906	219,246	154,612	111,650	110,766
Net prem written	<u>\$ 19,091</u>	<u>\$ 70,440</u>	<u>\$ 42,112</u>	<u>\$ 24,379</u>	<u>\$ 5,928</u>

PARENT, SUBSIDIARIES AND AFFILIATES

The Company is a member of an insurance company holding system as defined in N.J.S.A. 17:27A-1 et seq. Accordingly, the Company has registered with the State of New Jersey under the registration it filed as required under N.J.S.A. 17:27A-3. The review of the Company’s Schedule Y Part 2 did not disclose transactions with affiliate North American Risk Services (NARS). **It is recommended that all affiliated transactions be reported in Schedule Y Part 2 in accordance with NAIC Annual Statement Instructions.**

A chart of the holding company system, as it relates to the Company follows (all ownership is 100%):



INTERCOMPANY AGREEMENTS

Federal Income Tax Allocation and Settlement Policy Agreement

The Company is party to a Federal Income Tax Allocation and Settlement Policy Agreement dated January 1, 2003. This agreement was made between the Company's parent, Hannover Finance Incorporated and its subsidiaries.

The provisions of this agreement call for each subsidiary to calculate the amount of federal income tax it would be required to pay as a stand alone company. All applicable rates of the federal income tax laws are required to be applied by each subsidiary in preparing their individual returns.

A consolidated return consisting of all of the subsidiaries in the Clarendon Insurance Group is prepared by the Clarendon National Insurance Company (immediate parent) and submitted to Hannover Finance Incorporated for inclusion in its consolidated federal income tax filing as required under this agreement.

The specific settlement terms of this agreement call for each subsidiary to pay the annual settlement of their tax assessment on or before the prescribed due date of the consolidated income tax return. In the event that the Hannover Finance Corporation owes the subsidiary an overpaid amount, that corporation is required to remit that overpayment to the subsidiary on or before the due date of the consolidated federal tax return.

Expense Allocation Agreement

The Company is party to an expense allocation agreement that provides provisions to allocate certain expenses to various affiliated companies. The agreement calls for the Company's immediate parent to provide services as the participating companies may request including, but not limiting to these services, accounting, underwriting, actuarial, consulting, claims and other administration services.

The Company shall remit payment to the immediate parent within fifteen days of the receipt of this report. Within forty-five days after the end of each calendar quarter, the immediate parent must make a final determination of each of the participant's expense allocation. These Companies must make payments within ten days after receipt of the final determination.

The agreement shall be negotiated every three years and may be terminated at any time by mutual agreement of the parties involved with not less than sixty days notice to the other participants.

A review of the inter-company service agreements disclosed that no dates were found as to when the agreements were signed. The original agreements and any amendments attached all were undated as to when signatures were affixed. **It is recommended that signatures affixed to a service agreements be accompanied by the date the signature was attached in order to make the document a legal binding agreement.**

Claims Administration Agreement

The Company is a party to a Claims Administration Agreement dated, January 1, 1999. The agreement administrator is North American Risk Services, Inc. (NARS). The administrator shall service and adjust all claims arising under policies of insurance or reinsured by the Company.

Administration compensation is based on a per hour basis for claims processing and a fee per claim. Compensation varies based on the line of business of each program. Payment of Administrator's compensation is remitted monthly.

The Administrator provides claims reports to the Company in a timely manner. The agreement may be terminated at any time by either party giving the other party not less than sixty days prior notice.

MANAGEMENT AND CONTROL

On February 25, 1999, the Company became a subsidiary of Hanover Finance Incorporated when that company acquired 100% of Clarendon National Insurance Company (the Company's immediate parent). The Company's ultimate parent is Hannover Re, which owns 100% of Hannover Finance Inc.

Shareholders

The By-laws provide for an annual meeting of the shareholders at a time and place to be designated by the Board of Directors. This meeting shall be for the election of Directors and for the completion of any other business concerned with the Corporation.

The By-laws also state that special meetings of the shareholders may be called by the Chairman of the Board, the President, the Secretary, the Board of Directors or by the holders of at least one-half of all of the outstanding shares of stock of the Company.

A quorum at all shareholder meetings shall be a majority of the outstanding shares of the Corporation represented either in person or by proxy. In the absence of a quorum, a majority of the represented shares may adjourn the meeting without further notice.

Directors

The affairs of the Corporation are managed by its Board of Directors. The number of Directors shall be fixed from time to time by resolution of the Board of Directors or the shareholders. Each Director holds office until the next annual shareholders meeting or until his successor shall have been elected and qualified. Directors may be removed with or without cause as provided by law. A successor Director shall be elected to replace the removed Director by a plurality of the votes cast by a quorum of the Board present at the meeting to remove the Director in question.

The regular meeting of the Board shall be held immediately following and at the same place as the annual shareholders meeting. The Board may provide, by resolution, the time and place for additional meetings without notice other than the resolution. Special meetings of the Board may be called by the Chairman of the Board, the Vice Chairman of the Board, the President or the Secretary at the request of a majority of the Board of Directors. A majority of the number of Directors shall constitute a quorum at all meetings of the Board providing that, in the absence of a quorum, a majority of the Directors that are present can adjourn the meeting which shall be rescheduled with at least twenty-four hours notice.

A review was made of the Board minutes for the period of the examination. It was determined that Board minutes adequately support all major Company decisions. However, it was noted that in the Board minutes provided to the examiner, there was a decrease in the number of Directors and no resolution noting that change. **It is recommended that the Company comply with its By-laws regarding the required number of Directors.**

During the examination, the minutes did not document the appointment of the Director of Internal Audit. **It is recommended that the appointment of the Director of Internal Audit be documented in the corporate minutes of either the Board of Directors or the Audit Committee thereof. A new Director of Internal Audit was appointed in 2005 and indicated in corporate records provided by the Company.**

At December 31, 2004, the Board of Directors was comprised of the following members:

Name and Address of Director

Steven B. Najjar
5 Clark Street
Old Greenwich, CT 06870

Principal Occupation

CEO & President
Clarendon Insurance Group

Anders Larsson
14 Stoneboat Road
Westport, CT 06880

Chief Financial Officer & Treasurer

Gerhard Ketels
427 Beach Avenue
Mamaroneck, NY 10543

Senior Vice President & Secretary

The By-laws state that the Board may, by resolution, designate one or more committees. As of the examination, the Board had established the following Committees:

<u>Committee</u>	<u>Members</u>
Actuarial Committee	Ming-I Huang (Chairwoman) Anders Larsson Eberhard Mueller Steven B. Najjar
Audit Committee	Elke Koenig (Chairwoman) William Kelty III Anders Larsson Roland Vogel
Compensation Committee	Wilmhelm Zeller (Chairman) William Kelty III Steven B. Najjar
Investment Committee	Elke Koenig (Chairwoman) Rainer Decker Anders Larsson
Litigation Committee	Gerhard Ketels (Chairman) William Kelty III Elke Koenig Steven B. Najjar Michael Pickel
Underwriting Committee	Ming-I Huang (Chairwoman) Juergen Graeber Juergen Lang Hans-Dieter Rohlf

Though the Company is not in compliance with N.J.S.A. 17:27A-4d (3)(4) whereby at least one third of its directors must be outside members and not associated with the Company, its ultimate parent does meet the requirements of New Jersey Statutes regarding the make-up of its Board of Directors.

Article V of the By-laws dictates the corporate officers, their powers and duties. Under this article, the officers of the corporation shall be the following:

Chairman of the Board
Vice Chairman of the Board
President
Vice Presidents
Secretary
Treasurer

The duties of the above listed officers, as stated in the by-laws are as follows:

Chairman of the Board – shall be the Chief Executive Officer of the Corporation and subject only to the Board of Directors, shall have general authority over the property and business affairs of the Company. The Chairman shall preside at all meetings of stockholders and of the Board of Directors. In the event of the absence or disability of the President, the Chairman of the Board shall discharge all of the duties of the President.

Vice Chairman of the Board – shall exercise all powers of the Chairman of the Board in his absence or disability. At the direction of the Chairman, he shall preside at meetings of the Board of Directors and of the stockholders.

President – shall be the Chief Operating Officer of the Corporation and subject only to the Chairman of the Board and to the Board of Directors. He shall direct the everyday business of the Corporation. The President shall have such specific duties as may be assigned by the Chairman of the Board and the Board of Directors. During the absence or disability of the Chairman and the Vice Chairman, he shall exercise all powers of the Chairman. In the event of the absence of the Chairman and the Vice Chairman, the President shall preside at meetings of the Board of Directors and of the Shareholders.

In the absence of the Chairman of the Board, the Vice Chairman and the President, the Board of Directors may direct a Vice President or some other person to be the acting Chief Executive Officer and Acting Chief Operating Officer to perform all duties prescribed for the Chairman of the Board and the President.

Vice Presidents – The Board of Directors shall elect one or more Vice Presidents to serve in such capacities as shall be directed by the Chairman, the Vice Chairman, the President or the Directors.

Secretary – shall have custody of the seal of the corporation which he or an Assistant Secretary may affix to any corporate documents on which it is required. The Secretary shall perform all duties incidental to that office and such other duties as may be assigned to him by the Chairman of the Board, the Vice Chairman of the Board, the President or the Board of Directors. In the absence of the Secretary, any Assistant Secretary may perform the duties of the Secretary.

Treasurer – Shall be the custodian of the funds and securities of the Corporation. He shall perform all duties incidental to the office of the Treasurer as well as any other duties which may be assigned to him by the Chairman of the Board, the Vice Chairman of the Board, the President or the Board of Directors. In the absence of the Treasurer, the President or any Assistant Treasurer may perform the duties of the Treasurer.

As of December 31, 2004, the officers of the Company were as follows:

<u>Name</u>	<u>Title</u>
Steven Najjar	President & CEO
Gerhard Ketels	Sr. Vice President & Secretary
Anders Folke Larsson	Sr. Vice President & Treasurer
Christopher Foy	Sr. Vice President
Ming-I Huang	Sr. Vice President
Grace Ann Meek	Sr. Vice President
Joel Yatskowitz	Sr. Vice President
Dominic Hagger	Sr. Vice President
Bryan Triplett McCully	Sr. Vice President
Joseph Peloso	Sr. Vice President

A review of the minutes of the Board of Directors indicated that the Board approves all major company actions.

CONTINUITY OF OPERATIONS

The Company stores its paper files, backup tapes and other important physical documentation at:

Iron Mountain
Offsite Data Protection
203 Moonachie Road
Moonachie, NJ 07074

Also, at that same location, its computer system is incrementally backed up on a daily basis and its systems are fully backed up weekly.

The Company has in place a disaster recovery plan. Under this plan, the Company's backup computer tapes are stored off site for retrieval if a major disaster were to occur. This plan includes the appointment of a recovery executive committee who has overall responsibility for the implementation of the plan.

If the Company were to lose the use of its home office or its computer facility, it will set up at ICH office, an affiliate, in Itasca, IL. From this location, the Company will have key personnel and team leaders from all of its major business areas work in restoring the Company's ability to operate as a viable entity.

The plan is comprehensive and appears to cover most disasters that might harm the Company's ability to act as a viable operation.

The Company has not yet tested its disaster recovery plan due to a pending update of technological equipment. **It is again recommended that the disaster plan be fully tested. Before completion of this examination the Company provided documentation they had performed disaster recovery plan test subsequent to the examination date.**

The continuity of management is provided for in the Company's By-laws, which state, under the section dealing with the duties of officers, the Chairman of the Board shall be the Chief Executive Officer of the Corporation and shall have general authority over the general management of the corporation. The By-laws also state that the President shall be the Chief Operating Officer of the Corporation. In the case of the disability or absence of either the Chairman of the Board or of the President, the duties of the unavailable officer shall be assumed by the remaining one. If both the above officers should be unavailable to serve, the Board of Directors may select a Vice President or some other party to act instead.

POLICY ON CONFLICTS OF INTEREST

The Company has an all encompassing conflict of interest policy. This policy states that all directors, officers and employees should conduct business in the spirit of the law, and to refrain from any illegal, dishonest and unethical conduct. If a situation arises which makes it difficult to determine a proper course of action, the matter should be discussed with immediate supervisors or the Human Resource Department.

Transactions with outside firms must be conducted and controlled by the executive level of the Clarendon Insurance Group. Business dealings with outside firms should not result in unusual gains for those firms. Unusual gains refers to bribes, product bonuses, special fringe benefits unusual price breaks and other windfalls designed to ultimately benefit either the employee, the employer or both. Promotional plans that could be interpreted to involve unusual gain require specific executive level approval.

This policy is all encompassing and helps the Company to seek out any potential conflicts and decide on a course of action regarding the same.

FIDELITY BOND AND OTHER INSURANCE COVERAGES

The Company's bonding and all other insurance coverage are part of the overall insurance program administered by Hanover Finance, Inc., for itself and its network of subsidiaries. The types of coverage for the Company are summarized as follows:

Fidelity Coverage – a fidelity bond with an aggregate amount of liability of \$30,000,000 was in force at the time of our examination. This fidelity bond included blanket coverage of Hanover Finance, Inc., and its related subsidiaries. Based on the consolidated audited financial statements of the ultimate parent, the suggested minimum amount of fidelity insurance was calculated using NAIC guidelines. It was determined, through our analysis and NAIC calculations, that the coverage in force for Hannover Finance, Inc. and its related subsidiaries was in compliance with the NAIC prescribed amounts. The fidelity bond includes a single loss limit of liability of \$15,000,000 deductible, applied to the single loss deductible in the amount of \$100,000. This deductible shall be part of and not in addition to the aggregate limit of liability. The single loss limit of liability applies to the following actions: Dishonesty, on premises, in transit, forgery and alteration, securities and computer systems.

Other Insurance Coverage:

Commercial Auto Policy - \$1,000,000 limit for liability, \$1,000,000 limit for uninsured motorist and \$1,000,000 limit for underinsured motorists for any one accident or loss and \$10,000 in auto medical payments. Each limit of coverage and deductible, under this policy, varies by region and state in which the Company conducts business.

International Commercial Insurance Policy includes:

- International Automobile provides hired and non-owned automobile liability coverage with a limit of \$1,000,000.
- International General Liability which includes:
 - General aggregate limit of \$1,000,000
 - Products completed operations with an aggregate limit of \$1,000,000
 - Each occurrence limit of \$1,000,000
 - Advertising and Personal Injury Limit of \$1,000,000
 - Damage to Premises rented to you of \$250,000
 - Medical Expense of \$10,000

Commercial Excess & Umbrella Insurance - \$10,000,000 per occurrence, \$10,000,000 products completed operations aggregate, \$10,000,000 excess coverage other aggregate limit, \$10,000,000 Umbrella coverage aggregate limit, \$10,000,000 advertising injury and personal injury aggregate limit.

Umbrella/Excess Liability Insurance Policy - is \$10,000,000 per occurrence with Federal Insurance Company and \$25,000,000 excess of \$10,000,000 with St Paul Fire & Marine

Insurance Company and \$25,000,000 excess of \$35,000,000 with Great American Insurance Company.

Workers' Compensation Insurance Policy – Each limit of coverage under the workers compensation policy varies by region and or state due to legal requirements. The limits of liability are \$100,000 bodily injury by accident, each accident; bodily injury by disease \$500,000 policy limit; bodily injury by disease \$100,000 for each employee.

Employers Liability includes Bodily Injury by Accident for each occurrence \$1,000,000, Bodily Injury by disease per policy limit of \$1,000,000, and Bodily Injury by disease each employee of \$1,000,000

Directors and Officers Liability Insurance Policy – Coverage for Directors and Officers for payment of financial loss for which insured persons become legally liable on account of any claim made against them for wrongful acts committed by such insured persons and a \$24,875,196 aggregate limit for all losses, arising out of each and any claim made against the Insured.

Errors and Omissions Policy – \$10,000,000 Single limit of liability and single retention of \$1,000,000.

Property Insurance Policy – The “Blanket” limits of insurance on premises coverage is as follows: personal property is \$4,971,589 which includes personal property, valuable papers and personal property of others and Leasehold Interest Improvements and Other Betterments limits of insurance are \$2,000,000. Business income limits of insurance is \$8,898,603 and EDP Property limits of insurance is \$5,415,000.

ACCOUNTS AND RECORDS

During examination planning, the examiners visited various general agencies and third party administrators to confirm the accuracy of data submitted to the Company by those firms ("programs"). Detail data files containing loss, premium, reinsurance and other data were obtained and traced through home office accounting records to amounts reported in the 2003 Annual Statement to determine the accuracy, consistency, timeliness and overall system controls. The scope of review was the same for each location visited, which included premium and loss data testing, data inclusion tests, fraud review, and complaint handling. It was noted by the examiners that programs varied in the type, timing and method of data provided the Company. **It is recommended that the Company have and require consistent data and record keeping standards and uniform data submission requirements within all producing agencies and third party administrators.**

As previously stated, this examination was initially planned to be conducted as of December 31, 2003. During the course of planning it was decided that it would be more meaningful and useful to regulators to change the examination date to December 31, 2004. Considering the amount of examination test work performed at the various

programs around the country, it was also decided that this test work should be supplemented and updated by obtaining confirmations of data balances directly from each program previously visited. During this process, exceptions and differences were noted between home office balances and program confirmed balances. These were generally found to be the result of differences in cutoff dates and reporting formats.

The Company utilizes estimates for both claims paid and premiums received to attempt to true up its year end account balances. It was noted that these estimates were in some cases inaccurate which could and did misstate 2004 yearend balances. **It is again recommended that the Company have consistent claims and premium accounting cut-off dates and limit or eliminate the use of estimates of premium and claims activity.**

It was noted during review of the Company's internal and external accounting systems that at examination date, the Company accumulated accounting data from its programs utilizing both automated and manual systems. Approximately 60% of the data was submitted to the Company using a manual system generally employing electronic spreadsheets, while the remainder was submitted using an internet based format. Company personnel then reviewed the resulting accounting data for reasonableness and developed estimates to allow for early accounting cutoff dates within the program. Claims and premium data are then manually accumulated and summarized in a comprehensive electronic spreadsheet in which most significant data related to each program's loss, premium, reinsurance and other data is recorded. The summarized amounts in this spreadsheet provide substantial input in the development of the Company's financial statements. Use by the Company of this primarily manual spreadsheet based accounting system is inherently exposed to the possibility of misstatements of accounting results that may be intentional or unintentional. Several prior deadlines regarding implementation of an integrated accounting system have not yet been met. The Company has repeatedly replaced these initiatives with updated and/or revised initiatives. These newer initiatives, while generally more comprehensive, are also more difficult to implement, with the result being the continuance of a primarily manual financial reporting/recordkeeping system. **It is again recommended that the Company implement a comprehensive accounting system, with both physical and electronic controls, to collect and monitor claims, premiums, reinsurance and other related accounting data.**

TREATMENT OF POLICYHOLDERS

N.J.S.A. 17:29-4 (10) requires the maintenance of a complete record of all complaints received by the Company since the date of the prior examination. The Company informed the examiners that the complaint logs are maintained at their various agency offices.

During visits to the field offices, the examiners asked to review the complaint logs. Some of these offices maintained logs while others did not. Since the Statute requires the Company to maintain these logs, it should ensure that this is being done. **It is again**

recommended that the Company communicate to its agencies the requirement to maintain complaint logs, and that it ensures they are being maintained as required by the above named Statute.

Prior to completion of this examination, the Company stated that it had made improvements in this area.

STATUTORY DEPOSITS

The following is a list of deposits as of December 31, 2004 for the states that require the Company to maintain a deposit for the benefit of all policyholders or the policyholders of the particular state.

The securities held are either US Treasury Notes or a specific security and are in the following amounts and for the following states:

<u>State</u>	<u>Statement Value</u>
California	\$153,904,327
Delaware	101,120
Georgia	84,687
Louisiana	20,000
Missouri	252,801
New Jersey	1,594,112
North Carolina	527,153
South Carolina	525,000
Tennessee	90,263
Virginia	<u>500,000</u>
Total	<u>\$157,599,463</u>

The New Jersey deposit was held for the protection of all policyholders while the other deposits were held for the protection of the policyholders in the named states.

SUBSEQUENT EVENTS

In the fourth quarter of 2005, the Company's immediate parent announced its plans to transfer all common stock of two affiliated companies, Insurance Corporation of Hannover (ICH) and Redland Insurance Company, into a newly formed holding Company to be named "Praetorian Insurance Group, Inc". The Company is to stay the subsidiary of Clarendon National Insurance Company.

The following excerpt is taken from the CNIC's 2005 Annual Statement - Notes to the Financial Statements disclosing this transaction:

- “Effective July 01, 2005, CNIC sold Insurance Corporation of Hanover (ICH) and Redland Insurance Company (Redland), two of its insurance subsidiaries to Hannover Finance, Inc. (HFI), its ultimate parent for \$226,882,909 and \$36,042,866, respectively, realizing a gain on the sales of \$65,109,810 and \$15,378,190, respectively. HFI in turn contributed ICH and Redland to Praetorian Insurance Group, Inc., a Delaware Corporation, and affiliate, which was formed by HFI on October 26, 2005. The sale had the effect of reducing the CNIC’s leverage arising from investments in subsidiaries. The proceeds from the sale were received by CNIC on November 08, 2005”.

The following excerpt is from the Company’s 2005 Annual Statement - Notes to the Financial Statements disclosing this transaction and the changes to Capital and Surplus resulting from this Quasi-Reorganization:

- “In conjunction with this transaction, on July 01, 2005, the Company and its remaining Insurance affiliates, Clarendon National Insurance Company and Clarendon America Insurance Company, entered into an Adverse Development Cover Reinsurance agreement with Hannover Re. This agreement is retroactive, but will be accounted for prospectively as an “inter-company reinsurance agreement” with no gain in surplus as a result of the transaction, and the terms of the agreement are “arms length”. Under this agreement \$62,500,000 of premiums were ceded, of which the Company’s share was \$2,948,000.”

Hannover Re’s explanation of the formation of the Praetorian Financial Group was to enable them to focus on growing the specialty business with unencumbered capital, while leaving the CNIC to more effectively manage the existing commodity business. According to CNIC, as a result of this transaction, Praetorian will focus on writing higher margin business.

**Comparative Statement of Assets,
Liabilities, Surplus and Other Funds at
December 31, 2004 and December 31, 1999**

Exhibit A

	<u>12/31/2004</u>	<u>12/31/1999</u>	<u>Note</u>
Assets:			
Bonds	\$ 166,661,414	\$ 52,999,903	1
Common stocks		102,654,376	1
Cash & Short term investments	16,232,651	52,006,399	
Other invested assets		5,883,416	
Receivable for securities	112,000		
Investment income due and accrued	2,227,660		
Uncollected premiums and agents' balances in course of collection	14,619,491	17,340,886	2
Deferred premiums, agents' balances and installments booked but deferred and not yet due	6,333,361	82,535,432	2
Amounts recoverable from reinsurers	28,045,133	122,042,150	3
Funds held by or deposited with reinsured companies	566	736,480	
Bills receivable, taken for premiums		27,575	
Current federal and foreign income tax recoverable and interest thereon	9,087,516	488,174	
Net deferred tax asset	1,593,692		
Electronic data processing equipment		4,220,469	
Interest, dividends and real estate income due & accrued		961,433	
Receivable from parent, subsidiaries and affiliates		4,086,669	
Accrued capital contribution	18,250,000		
Equities and deposits in pools and associations	16,625	1,699,834	
Total Assets	<u>\$ 263,180,109</u>	<u>\$ 447,683,195</u>	
Liabilities, Surplus and Other Funds:			
Losses	\$ 45,620,795	\$ 124,087,061	4
Loss adjustment expenses	1,418,205	16,725,890	4
Commissions Payable, contingent commissions and other similar charges	(248,682)	842,591	
Other expenses		4,500,746	
Taxes, licenses and fees	(3,842,764)	13,373,294	
Unearned premiums	14,455,909	54,949,880	
Ceded reinsurance premiums payable	9,392,175		5
Funds held by company under reinsurance treaties	153,898,772	28,810,921	5
Amounts withheld or retained by Company for account of others	150,000	591,212	
Provision for reinsurance	4,553,497	14,515,182	6
Agent credit balances	2,101,367		2
Payable to parent, subsidiaries and affiliates	6,916,897	576,757	
Commission/fee holdback	3,331,648		
Escheat liability	121,687		
Gross claims outstanding	(25,074)		
Aggregate write-ins for liabilities		(12,132,346)	
Total Liabilities	<u>\$ 237,844,431</u>	<u>\$ 246,841,186</u>	
Aggregate write-ins for special surplus funds	\$	\$ 883,315	
Common capital stock	4,100,000	4,800,000	
Gross paid in and contributed surplus	26,250,000	161,537,332	
Unassigned Funds	(5,014,322)	33,621,362	
Surplus as regards policyholders	25,335,678	200,842,009	
Total Liabilities and Surplus and Other Funds	<u>\$ 263,180,109</u>	<u>\$ 447,683,195</u>	

**Underwriting and Investment
Exhibit for the period
December 31, 2000 to December
31, 2004**

	Exhibit B				
	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
<u>Premiums earned</u>	\$ 32,789,908	\$ 58,797,487	\$ 32,520,690	\$ 20,214,847	\$ 5,741,300
Deductions:					
Losses incurred	47,952,111	37,271,966	13,033,304	11,381,191	1,034,895
Loss expenses incurred	7,151,071	5,856,623	2,851,705	950,575	396,196
Other underwriting expenses incurred	10,897,173	8,871,638	7,435,526	3,056,097	(2,596,106)
Total underwriting deductions	<u>66,000,355</u>	<u>52,000,227</u>	<u>23,320,535</u>	<u>15,387,863</u>	<u>(1,165,015)</u>
Net underwriting gain or loss	<u>(33,210,447)</u>	<u>6,797,260</u>	<u>9,200,155</u>	<u>4,826,984</u>	<u>6,906,315</u>
<u>Investment income</u>					
Net investment income earned	4,076,856	1,303,991	821,171	1,016,008	1,261,227
Net realized capital gains	(92,402)	28,867	309,838		(100,338)
Net investment gain	<u>3,984,453</u>	<u>1,332,858</u>	<u>1,131,009</u>	<u>1,016,008</u>	<u>1,160,889</u>
<u>Other income</u>					
Net gain or loss from agents' or premium balances charged off	(460,479)		(110,845)		
Aggregate write-ins for miscellaneous income		139			
Total other income	<u>(460,479)</u>	<u>139</u>	<u>(110,845)</u>		
Net income before dividends to policyholders and before federal and foreign income taxes	(29,686,473)	8,130,257	10,220,319	5,842,992	8,067,204
Less: Federal & foreign income taxes incurred	(9,087,515)	4,485,210	4,279,703	2,610,827	2,779,447
Net income	<u>\$ (20,598,958)</u>	<u>\$ 3,645,047</u>	<u>\$ 5,940,616</u>	<u>\$ 3,232,165</u>	<u>\$ 5,287,757</u>

**CAPITAL AND SURPLUS
ACCOUNT
For the period December 31,
2000
to December 31, 2004**

Exhibit C

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Gains and losses in surplus:					
Net income or (loss)	\$ (20,598,958)	\$ 3,645,047	\$ 5,940,616	\$ 3,232,165	\$ 5,287,757
Change in net deferred income tax	1,391,148	1,720,924	804,797	624,208	0
Change in non-admitted assets	(2,275,364)	(2,287,791)	(329,073)	(70,261)	0
Change in provision for reinsurance	107	1,951,284	3,216,793	(3,862,204)	(644,790)
Cumulative effect of changes in Accounting principles				990,457	
Capital changes:					
Paid In					
Transferred from surplus					
Surplus adjustments:					
Paid In	19,750,000				
Transferred to capital (stock dividend)					
Dividends to stockholders					(2,800,000)
Extraordinary amounts of taxes for prior yr					
Aggregate write-ins for gains and losses in surplus					(667,857)
Change in surplus as regards policyholders for the year	(1,733,067)	5,029,464	9,633,133	914,365	1,175,110
Surplus at beginning of period	35,758,595	30,729,130	21,095,998	20,181,633	19,006,523
Examination Adjustment	(8,689,850)				
Surplus at end of period	<u>\$ 25,335,678</u>	<u>\$ 35,758,595</u>	<u>\$ 30,729,130</u>	<u>\$ 21,095,998</u>	<u>\$ 20,181,633</u>

**SCHEDULE OF EXAMINATION
ADJUSTMENTS TO SURPLUS
as of December 31, 2004**

Exhibit D

	<u>Per Company</u>	<u>Per Examination</u>	<u>Surplus Increase (Decrease)</u>	<u>Note</u>
<u>Assets</u>				
Uncollected premiums and agents' balances in the course of collection	\$ 1,847,494	\$ 14,619,491	\$ 12,771,997	2
Deferred premiums, agents' balances and installments booked but deferred and not yet due	17,943,547	6,333,361	(11,610,186)	2
<u>Liabilities</u>				
Losses	42,423,998	45,620,795	(3,196,797)	4
Provision for Reinsurance		4,553,497	(4,553,497)	6
Agents Credit Balances		2,101,367	<u>(2,101,367)</u>	2
Net Change in Surplus Per Examination			<u>(8,689,850)</u>	
Surplus Per Company			34,025,528	
Surplus Per Examination			<u><u>\$ 25,335,678</u></u>	

NOTES TO FINANCIAL STATEMENTS

1. Bonds and Common Stocks

The Company employs an outside service provider to prepare Schedule D (all Parts) and Schedule E for its quarterly and annual statements. During our reconciliation of Schedule D part 1 of the December 31, 2004 Annual Statement to the Custody Statement provided by Wachovia Bank, N.A., we noted securities that had matured prior to December 31, 2004 that were still being carried on Schedule D, Part 1 at their carrying value. **It is recommended that the Company ensure that the data reported on its Schedule D and Schedule E is reconciled to the amounts reported by their outside investment service provider**

The Company, as of December 31, 2004, had a custodial agreement with its custodial bank, Wachovia that was not in compliance with the guidelines set forth by the NAIC. Although the financial institution was approved by the State of New Jersey, the agreement was missing key provisions that would protect the Company against potential losses due to improper actions of the custodial bank. Two of the key provisions missing, in addition to other provisions, were that the custodian was obligated to indemnify the Company for any losses incurred by the loss of securities by the custodian and that the custodian was to promptly replace or reimburse the Company for the value of the securities resulting from such a loss occurring. **It is again recommended that the Company revise their custodial agreement to meet all the requirements and contain the satisfactory safeguards and controls as outlined in the provisions of the NAIC guidelines. (Subsequent to the examination date, the Company complied with this recommendation and currently has a custodial agreement in compliance with the NAIC standards.)**

The Company, as of December 31, 2004, had identified and listed on Schedule E - Part 3- Special Deposit schedule a US Treasury Note being held for the protection of the policyholders in the State of Montana in the amount of \$252,801, statement value. Through direct confirmation, the examination determined that this bond was identified incorrectly. This bond should have been listed for the protection of the policyholders of the State of Missouri for \$252,801, statement value. **It is recommended that the Company ensure that the correct jurisdiction be identified for all securities listed on the Special Deposit Schedule. (Subsequent to the examination date, the Company complied with this recommendation and it is identified correctly on the 2005 Annual Statement.)**

**2. Uncollected Premiums and Agents' Balances In The Course of Collection
Deferred Premiums, Agents' Balances and Installments Booked but Deferred
and Not Yet Due
Agents Credit Balances**

The above accounts were reviewed on a combined basis for all Clarendon companies under examination by the New Jersey Department of Banking and Insurance; the Company, Clarendon National Insurance Company, Clarendon America Insurance Company and Redland Insurance Company. The resulting examination amounts differ significantly from those reported by the Company, as detailed below:

	<u>Per. Co</u>	<u>Per Exam</u>	<u>Surplus Adj.</u>
Agents' Credit Balances (liability)	\$ -0-	\$ (2,101,367)	\$ (2,101,367)
In Course of Collection	\$ 1,847,494	\$ 14,619,491	\$ 12,771,997
Deferred and Uncollected	\$ 17,943,547	\$ 6,333,361	<u>\$ (11,610,186)</u>
Net Surplus Adjustment:			<u>\$ (939,556)</u>

A detail breakdown of agents' balances, by program, was obtained and reviewed. The total balance per Company was tied to the reported December 31, 2004 Agents' Balances asset without exception.

The Company has two separate non-admitted components, an "Allowance for Uncollectible" and a "Non-admitted" provision. The "allowance" provision is for specific programs where the Company estimates an uncollectible balance. The "non-admitted" is a general unallocated provision for all programs, calculated based upon actual historical write-offs over several years. Carried balances for these components, as of December 31, 2004 were \$610,771 and \$1,130,443 respectively.

For Annual Statement reporting, the Company nets the allowance for doubtful accounts against the agents balances account, and only the "non-admitted" component is shown as non-admitted. Both components should be reported as non-admitted in the Annual Statement. **Therefore, it is recommended that all provisions and components of uncollectible agents balances be recorded in the "Allowance for Uncollectibles" general ledger account, and also be included in the "Non-Admitted" column of Page 2 on the Annual Statement.**

After tie-in to the December 31, 2004 Annual Statements, the program-level listing of agents' balances was visually scanned noting several programs with net credit balances. These credit balances amounted to \$2,101,367. The Company combined these balances against unrelated programs with debit balances, and only the net debit balance was shown in the filed Annual Statement. The Company's rationale for netting seemingly unrelated debit and credit balances was questioned; however, no response was ever received.

As no right of offset exists between these programs, the credit balances represent a liability per SSAP #5 and should be reported on page 3 of the Annual Statement. The

Company should then report the resulting larger debit balance as "Agents Balances" in Column 1 of Page 2 on the Annual Statement. While there is no net surplus impact from this reclassification, there may be an impact on RBC and/or leverage ratio results.

Therefore, it is recommended that agents' credit balances be reported separately as a liability in accordance with SSAP #5.

Another notable observation in the reconciliation from the general ledger to the annual statement was that of allocation of agents' balances in course of collection (ICOC) reported on annual statement line 12.1 and premiums deferred and uncollected (Deferred) reported on annual statement line 12.2. It was noted that the Company first determines net receivables in total for all programs, then allocates one-sixth (1/6) of the total to ICOC and five-sixths (5/6) to Deferred. The rationale for this presentation was researched, and the Company indicated that they assume that there is approximately a two-month collection lag between when policies are written, and when they are collected. Therefore, two months (2/12ths) are considered "In Course of Collection" and the remaining 10 months (5/6) considered "Deferred".

This rationale is flawed in several fundamental ways. First and mostly, it assumes that 100% of business written is on the deferred payment basis, which is not the case. Of the twenty-eight (28) programs tested on a combined basis for the New Jersey domiciled Clarendon companies, only twelve (12) programs representing 46% of the reported balance include the option to defer premiums. For all other programs, amounts written are due immediately (based upon terms of the contracts). This was confirmed by review of the related contracts on a test basis.

Secondly, the Company's method assumes all policyholders with the option to pay on a deferred basis, will actually exercise that option, rather than pay the full term premium.

Thirdly, it assumes premiums deferred are evenly spread over a twelve-month period. In practice, this is not the case. Generally for annual policies, there is a 20%-25% down payment made at inception, with the remaining balance paid in equal installments over the next 7 months (not 12 months). This was borne out in field testing.

Fourth, it assumes all deferred premiums are written on an annual basis, whereas for many of the programs tested, six-month period terms were noted.

Finally, it assumes that the entire receivable is represented by policies at their inception date (12 full months to go), rather than an evenly balanced book of business spread over the entire year (or period).

While any of these factors could be considered in estimating the ICOC vs. Deferred allocation, the examination team used only the first and third. First, the ratio of the Company's tested balances "subject-to-deferred" (46%) was applied to the total Company combined agents' debit balances arriving at the initial estimate of deferred. The balance thus determined as "subject-to-deferred" was then estimated to be 2/7th ICOC and 5/7th deferred. This provided the examination estimate of the amount that should have been reported by the Company as "deferred" (before subsequent examination adjustments).

The remaining balance (total agents' balance minus "deferred") was then considered to be ICOC, from which the Company's "non-admitted" balance was deducted to arrive at the net admitted ICOC. Each of these components was then adjusted by the results of examination testing, which was performed on a program-by-program basis. Any examination adjustments were applied to either ICOC or deferred as appropriate to each such program.

While there is no direct surplus impact to the classification of agent's balances between those in course of collection and those deferred, the balances thus reported do play an important role in resulting liquidity ratios. This is an important measure of the Company's ability to meet short and long term obligations. **Therefore, it is recommended that the Company identify and report deferred premiums based upon the actual balances deferred.**

Until such time, if an "allocation" method is used, the basis should utilize criteria reflective of actual balances outstanding on a program-by-program basis. The Company should first separate all balances between those that include the option for deferred premiums and those that do not. For those that do not, 100% of the balance from those programs should be reported as "In Course of Collection". For those that do, an analysis should be performed to reflect actual business characteristics in place, including recording and settlement practices, for each respective program.

The prior examination of the Company noted that the Company does not report agents' balances that are over 90 days due in accordance with the NAIC Annual Statement Instructions (SSAP#6). The Company responded to that report, indicating, "*The Company will report agent's balances that are 90 days overdue in accordance with the NAIC Annual Statement Instructions.*" A request was made for an aged receivables report; however, no such report is yet available. Instead, the Company provided a description of various initiatives implemented throughout 2004 and 2005 designed to enhance controls (data acceptance procedures, analytical reviews, "Project Clarity", etc.)

The Company continues to estimate non-admitted Agents' Balances on a GAAP basis (bad debt provision) rather than statutory basis (aged over-90 day balances). Accordingly, they are not in compliance with the prior examination recommendation, nor their indicated response thereto. **Therefore, it is again recommended that the Company properly age all Agents' Balances and non-admit all receivables in excess of 90 days due (aged from inception date of coverage) in compliance with statutory accounting procedures (SSAP#6).** The Company informed the examination team that they are currently implementing system solutions that will enable an aging report. The internally developed solution which was under development during the prior examination has been replaced with customized vendor solutions.

The prior examination also noted that the Company does not consistently enforce compliance with all provisions of their agency agreements. It was recommended that the Company regularly obtain and reconcile all the detail reports required by the Agreement. During testing of some of the programs in the current examination, certain records were

requested that are specified in agency agreements (“Receivable Register, Cash Collected Register). Though required by the agency agreements, these records were not available at the Company and were no longer available from the related agency. **Therefore, it is again recommended that the Company ensure that all provisions of their agency agreements are complied with, specifically, required data files.**

Company Methodology:

As indicated, the Company does not have an aged receivables report, and does not attempt to age their agents’ balances. A quarterly "roll-forward" method is used that starts with the prior quarter’s balance, adds production results (written premium minus related commissions) then subtracts cash collected to arrive at the current balance. They then non-admit certain balances and also calculate a general unallocated "bad debt" provision as described above. Resulting net totals are then allocated between “In Course of Collection (1/6) and Deferred (5/6).

Examination Methodology:

An attempt was made by the examination to age selected programs' reported receivable as of December 31, 2004. Due to the distinctive nature of "Program Business", each of these balances was reviewed independently. Each has unique circumstances (nature/line of business, related settlement practices, availability of supporting data files, status of receivable and related reconciliations, etc.), and these circumstances varied considerably. Due to these varying characteristics, the examination approach varied accordingly.

Twenty-eight (28) programs were selected for detail agents' balances testing, representing balances from each of the Companies under examination, and collectively representing 76% of the combined agents net debit balances as of December 31, 2004.

The following table summarizes the examination adjustments resulting from this review, showing the combined (consolidated) adjustment for all New Jersey domiciled insurers under examination, and the corresponding examination amounts related to each.

Summary of Consolidated Agents Balances Adjustments to Surplus

	<u>Combined Results of Testing</u>	<u>Clarendon National Ins. Company</u>	<u>Clarendon America Ins. Company</u>	<u>Harbor Specialty Ins. Company</u>	<u>Redland Insurance Company</u>
Gross Examination Surplus Adjustments	\$ (90,865,477)	\$ (69,989,390)	\$ (18,195,317)	\$ (2,680,770)	\$ _____ 0
Less Company Non-Admitted	*21,276,699 **17,427,893 <u>38,704,592</u>	*17,975,913 **15,204,356 <u>33,180,269</u>	*2,690,015 **1,093,094 <u>3,783,109</u>	*610,771 **1,130,443 <u>1,741,214</u>	N/A N/A
Net Examination Surplus Decrease	\$ <u>(52,160,885)</u>	\$ <u>(36,809,121)</u>	\$ <u>(14,412,208)</u>	\$ <u>(939,556)</u>	\$ _____ 0
<u>Breakdown:</u>					
Agent Credit Balances	<u>(34,478,115)</u>	<u>(23,806,176)</u>	<u>(7,898,706)</u>	<u>(2,101,367)</u>	<u>***(671,866)</u>
Agent Debit Balances (Non-admitted)	<u>(17,682,771)</u>	<u>(13,002,946)</u>	<u>(6,513,503)</u>	<u>1,161,811</u>	<u>*** 671,866</u>
Total	\$ <u>(52,160,885)</u>	\$ <u>(36,809,121)</u>	\$ <u>(14,412,208)</u>	\$ <u>(939,556)</u>	\$ _____ 0

* Provisions for specific programs.

** Judgmental estimate of uncollectible (bad debt).

*** Reclassification of Agent Credit Balances, results in increase of debit balance. No net adjustment to Redland.

3. Amounts Recoverable from Reinsurers

Schedule F - Part 4, Aging of Ceded Reinsurance, in the Company's 2004 Annual Statement indicated all reinsurance recoverable on paid losses and paid loss adjustment expenses to be 1 to 29 days overdue. The examination indicated amounts that were actually greater than 29 days overdue. The two previous Reports on Examination recommended that the Company properly age its reinsurance recoverable balances **It is again recommended the Company properly age its reinsurance recoverable balances in accordance with NAIC Annual Statement Instructions. It was noted that the Company's 2005 Annual Statement indicated aging of these balances.**

4. Losses and Loss Adjustment Expenses

As of December 31, 2004, the Company reported a reserve for losses, net of reinsurance, in the amount of \$42,423,998 and loss adjustment expense reserves of \$1,418,205. During this examination, these reserves were reviewed by the Actuarial Division of the Department of Banking and Insurance of the State of New Jersey and Mercer Oliver Wyman Actuarial Consulting, Inc. under the direction of that Division. It was determined that the reserve for losses was understated by \$3,196,797. **It is recommended that the Company establish and maintain adequate reserves to cover both reported and unreported claims.**

During the above review, it was also determined that the reserves for loss adjustment expenses were understated by \$2,776,000. The Company reported, before reinsurance, gross loss adjustment expense reserves of \$5,926,611, ceded loss adjustment expense reserves of \$4,508,406; with the net resulting reserve being reported as \$1,418,205.

Consistent with the allowance made in the 1999 examination performed by the NJDOBI, the examiners reduced the understatement by that same amount as a result of credit being given for amounts withheld by the Company on funds due the claims administrators. The resulting loss adjustment expense reserve was determined to be the same as reported by the Company. Pursuant to the service agreements between the Company and various managing general agents or third party administrators, the Company has been paying service fee to these entities for all work necessary to process claims to completion. A portion of the service fee represented the Company's prepayment of future claim adjustment expenses incurred by entities in settling claims and under the terms of the agreements, the Company withheld a portion of this prepayment of claims fees. The reduction of Loss Adjustment Expenses by \$2,776,000 represented the withhold portion of the fee that remained under the Company's control on the examination date. Only credit was given to reduce the examination increase in unallocated loss adjustment expenses and therefore, the Company reported reserve was the resulting amount.

Issue Paper # 55, as referenced by the Statement of Statutory Accounting Principles #55, as adopted by the National Association of Insurance Commissioners, states as follows:

"This liability for unpaid loss adjustment expenses should provide for the estimated expenses necessary to adjust all unpaid losses irrespective of payments made to third party administrators, management companies or other entities not specifically covered by a contract of insurance."

While the Company has established reserves for loss adjustment expenses, it did not determine the true possible future loss adjustment expense portion of this liability without considering or regarding its contracts with third party administrators. The Company has historically based its LAE reserves on amounts that it was paying third party claims administrators and not on its ultimate loss adjustment (as required) that it would incur if these administrators were not under such contracts or unable or unwilling to perform. **Therefore, it is again recommended that, the Company establish and maintain a reserve for loss adjustment expenses to cover the ultimate estimated expenses necessary to adjust all unpaid losses irrespective of any agreements other than a valid contract of reinsurance.**

5. Ceded Reinsurance Premiums Payable

The Company was requested to identify all instances of offsets as noted in SSAPs 62 and 64. The same request also asked the Company to describe their method of determining ceded premiums payable. After both second and third written requests for a response, as well as multiple verbal requests spanning several months, the examiners closed the examination of this liability without answers to the above questions. **It is recommended that the Company develop and maintain its reinsurance related records to enable it to respond and respond promptly to requests for information made by the examiners in future examinations.**

6. Provision for Reinsurance

During our review of the asset "Amounts recoverable from reinsurers," the examiners noted certain balances greater than ninety days overdue that the Company failed to indicate as such in the 2004 Annual Statement. Such overdue receivables impact the liability "Provision for reinsurance." The Company reported \$0 for this liability in their 2004 Annual Statement. The examiners have increased that amount by \$4,553,497 to \$4,553,497. It should be noted that the examination of "Amounts recoverable from reinsurers" was based on a judgmental sample of such balances. Consequently, the increase in this liability may not reflect the true extent of reinsurance recoverable balances in excess of ninety days overdue. **It is recommended that the Company properly report its provision for reinsurance.**

EXAMINATION RECOMMENDATIONS

Page

Repeat Recommendations from Prior Examination Report

- 9 **Reinsurance** - It is again recommended that the Company ensure its reinsurance files are maintained with complete signed copies of all reinsurance agreements and such agreements are readily available for review by the examiners.
- 17 **Continuity of Operations** - It is again recommended that the disaster plan be fully tested. Before completion of this examination the Company provided documentation they had performed disaster recovery plan test subsequent to the examination date.
- 20 **Accounts and Records** - It is again recommended that the Company implement a comprehensive accounting system, with both physical and electronic controls, to collect and monitor claims, premiums, reinsurance and other related accounting data.
- 20 It is again recommended that the Company have consistent claims and premium accounting cut-off dates and limit or eliminate the use of estimates of premium and claims activity.
- 20 **Treatment of Policyholders** - It is again recommended the Company ensure that all of its program writers maintain a complaint log in compliance with New Jersey Code, NJSA 17:29B-4 (10).
- 27 **Bonds and Stocks** - It is again recommended that the Company revise their custodial agreement to meet all the requirements and contain the satisfactory safeguards and controls as outlined in the provisions of the NAIC guidelines. Subsequent to the examination date, the Company complied with this recommendation and currently has a custodial agreement in compliance with the NAIC standards.
- 30 **Uncollected Premiums and Agents' Balances In The Course Of Collection**
It is again recommended that the Company properly age all Agents' Balances and non-admit all receivables in excess of 90 days due (aged from inception date of coverage) in compliance with statutory accounting procedures (SSAP#6).
- 31 It is again recommended that the Company ensure that all provisions of their agency agreements are complied with, specifically, required data files.
- 33 **Amounts Recoverable From Reinsurers** - It is again recommended that the Company properly age its reinsurance recoverable balances in accordance with the Annual Statement Instructions for Schedule F - Part 4.

Page

Repeat Recommendations from Prior Examination Report (continued)

- 34 **Losses and Loss Adjustment Expenses** - It is again recommended that, the Company establish and maintain a reserve for loss adjustment expenses to cover the ultimate estimated expenses necessary to adjust all unpaid losses irrespective of any agreements other than a valid contract of reinsurance.

ADDITIONAL RECOMMENDATIONS FROM THIS EXAMINATION

REINSURANCE

- 8 It is recommended the Company report the loss portfolio transaction under the accounting for retroactive reinsurance agreements in accordance with SSAP 62.

PARENT, SUBSIDIARIES AND AFFILIATES

- 10 It is recommended that all affiliated transactions be reported in Schedule Y Part 2 in accordance with NAIC Annual Statement Instructions.

INTERCOMPANY AGREEMENTS

- 11 It is recommended that signatures affixed to a service agreements be accompanied by the date the signature was attached in order to make the document a legal binding agreement.

MANAGEMENT AND CONTROL

- 13 It is recommended that the Company comply with its By-laws regarding the required number of Directors.
- 13 It is recommended that the appointment of the Director of Internal Audit be documented in the corporate minutes of either the Board of Directors or the Audit Committee thereof. A new Director of Internal Audit was appointed in 2005 and indicated in corporate records provided by the Company.

ACCOUNTS AND RECORDS

- 19 It is recommended that the Company have and require consistent data and record keeping standards and uniform data submission requirements within all producing agencies and third party administrators.

BONDS AND COMMON STOCKS

- 27 It is recommended that the Company ensure that the data reported on its investment schedules for reporting purposes, (Schedule D, all parts, Schedule E all parts) is reconciled to the amounts reported by their outside investment service provider.
- 27 It is recommended that the Company ensure that the correct jurisdiction be identified for all securities listed on the Special Deposit Schedule. (Subsequent to the examination date, the Company complied with this recommendation and it is identified correctly on the 2005 Annual Statement.)

**UNCOLLECTED PREMIUMS AND AGENTS' BALANCES IN THE
COURSE OF COLLECTION
DEFERRED PREMIUMS, AGENTS' BALANCES AND INSTALLMENTS
BOOKED BUT DEFERRED AND NOT YET DUE
AGENTS CREDIT BALANCES**

- 28 It is recommended that all provisions and components of uncollectible agents balances be recorded in the "Allowance for Uncollectibles" general ledger account, and also be included in the "Non-Admitted" column of Page 2 on the Annual Statement.
- 29 It is recommended that agents' credit balances be reported separately as a liability in accordance with SSAP #5.
- 30 It is recommended that the Company identify and report deferred premiums based upon the actual balances deferred.

LOSSES AND LOSS ADJUSTMENT EXPENSES

- 33 It is recommended that the Company establish and maintain adequate reserves to cover both reported and unreported claims.

CEDED REINSURANCE PREMIUMS PAYABLE

- 34 It is recommended that the Company develop and maintain its reinsurance related records to enable it to respond and respond promptly to requests for information made by the examiners in future examinations.

PROVISION FOR REINSURANCE

- 34 It is recommended that the Company properly report its provision for reinsurance.

CONCLUSION

I, Hails W. Taylor, do solemnly swear that the foregoing report of examination is hereby presented to be a full and true statement of the condition and affairs of the Harbor Specialty Insurance Company as of December 31, 2004 to the best of my knowledge and belief.

Respectfully submitted,

/S/

Hails W. Taylor

Hails W. Taylor, CFE
Examiner-In-Charge
Representing State of New Jersey

/S/

James J. Whelan

James J. Whelan, CFE, CIE
Representing State of Mississippi
Southeastern Zone

/S/

Richard Fluhr

Richard Fluhr, CFE
Representing State of Nevada
Western Zone

/S/

Sandra K. Bailey

Sandra K. Bailey, CFE
Representing State of California
Western Zone

State of New Jersey
County of Mercer

Subscribed and sworn to before me.
On this 29th day of June, 2006.

/S/

Catherine M. Liptak

Notary Public of New Jersey
My commission expires January 21st, 2008