

# STATE OF CONNECTICUT

## INSURANCE DEPARTMENT

### ORDER ADOPTING REPORT OF EXAMINATION

I, Thomas B. Leonardi, Insurance Commissioner of the State of Connecticut, having fully considered and reviewed the Examination Report (the "Report") of American Equity Specialty Insurance Company (the "Company") as of December 31, 2009, do hereby adopt the findings and recommendations contained therein based on the following findings and conclusions,

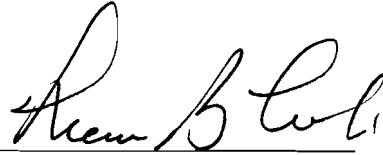
#### **TO WIT:**

1. I, Thomas B. Leonardi, Insurance Commissioner of the State of Connecticut, and as such is charged with the duty of administering and enforcing the provisions of Title 38a of the Connecticut General Statutes.
2. The Company is a domestic insurer authorized to transact the business of insurance in the State of Connecticut.
3. On January 3, 2011, the verified Examination Report of the Company was filed with the Connecticut Insurance Department.
4. In accordance with Conn. Gen. Statutes §38a-14(e) (3), the Company was afforded a period of thirty (30) days within which to submit to the Connecticut Insurance Department a written submission or rebuttal with respect to any matters contained in the Report.
5. On February 14, 2011, the Company notified the Department of certain responses and comments on certain items contained in the Report.
6. Following review of the Report, it was deemed necessary and appropriate to modify the Report. A copy of the Report is attached hereto and incorporated herein as Exhibit A.

**NOW, THEREFORE,** it is ordered as follows:

1. That the Examination Report of the Company hereby is adopted as filed with the Insurance Department.
2. That the Company shall comply with all of the recommendations set forth in the Report, and that the failure of the Company to so comply shall result in sanctions or administrative action as provided by Title 38a of the Connecticut General Statutes.

Dated at Hartford, Connecticut this 14th day of March, 2011

A handwritten signature in cursive script, appearing to read "Thomas B. Leonardi", written over a horizontal line.

Thomas B. Leonardi  
Insurance Commissioner

**Exhibit A**

**ASSOCIATION EXAMINATION REPORT**

**OF**

**AMERICAN EQUITY SPECIALTY INSURANCE COMPANY**

**AS OF**

**DECEMBER 31, 2009**

**BY THE**

**CONNECTICUT INSURANCE DEPARTMENT**

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AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

January 3, 2011

The Honorable Alfred W. Gross  
Chair, Financial Condition (E) Committee  
Commissioner, Virginia State Corporation Commission  
Bureau of Insurance  
Commonwealth of Virginia  
P.O. Box 1157  
Richmond, Virginia 23218

The Honorable Mila Kofman  
Secretary, Northeastern Zone  
Superintendent of Insurance  
Bureau of Insurance  
34 State House Station  
Augusta, Maine 04333-0034

The Honorable Thomas B. Leonardi  
Insurance Commissioner  
State of Connecticut Insurance Department  
153 Market Street, 6<sup>th</sup> Floor  
Hartford, Connecticut 06103

Dear Commissioners/Superintendent:

In compliance with your instructions and pursuant to the requirements of Section 38a-14 of the Connecticut General Statutes (CGS), the undersigned has made an association examination of the conditions and affairs of

**AMERICAN EQUITY SPECIALTY INSURANCE COMPANY**

(hereinafter referred to as the Company), a corporation with capital stock, incorporated under the laws of the State of Connecticut and having its statutory home office and its main administrative office located at One Tower Square, Hartford, Connecticut. The report on such examination is submitted herewith.

**SCOPE OF EXAMINATION**

The previous examination of the Company was conducted by the California Department of Insurance as of December 31, 2006. The current examination, which covers the period from January 1, 2007 to December 31, 2009, was conducted by Financial Regulation Division of the Connecticut Insurance Department (Division) at the administrative office of the Company.

## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

As part of the examination planning procedures, the Division reviewed the following materials submitted by the Company from 2007 through 2009:

- Board of Director (Board) minutes;
- Audit reports completed by the CPA firm retained by the Company;
- Management Discussion and Analysis;
- Statement of Actuarial Opinion;
- Internal Audit Reports; and
- Annual Statements filed with the Division.

A review of the 2007 through 2009 independent audit reports and a comprehensive analysis of the Company's financial statements and other filings submitted to the Financial Analysis Unit of the Division indicated no material concerns with respect to financial condition or regulatory compliance issues.

Workpapers prepared by the Company's independent public accountants, KPMG LLP (KPMG), in connection with its annual statutory audit, were reviewed and relied upon to the extent deemed appropriate.

The examination was conducted on a full scope, comprehensive basis in accordance with the procedures outlined in the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (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 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 compliance with Statutory Accounting Principles and Annual Statement Instructions (Instructions).

All accounts and activities of the Company were considered in accordance with the risk-focused examination process.

Concurrent examinations were conducted for the following Connecticut domiciled property-casualty companies that are a part of the Travelers Reinsurance Pool (Pool):

- Travelers Casualty and Surety Company
- Travelers Personal Insurance Company
- The Standard Fire Insurance Company
- Farmington Casualty Company
- The Charter Oak Fire Insurance Company
- Travelers Property Casualty Insurance Company
- United States Fidelity and Guaranty Company
- Travelers Commercial Casualty Company
- Travelers Commercial Insurance Company
- Travelers Casualty Company of Connecticut
- TravCo Insurance Company
- The Travelers Indemnity Company
- Travelers Casualty Insurance Company of America
- Travelers Excess and Surplus Lines Company

## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

- The Automobile Insurance Company of Hartford, Connecticut
- The Travelers Indemnity Company of Connecticut
- The Travelers Indemnity Company of America
- The Phoenix Insurance Company
- The Travelers Home and Marine Insurance Company
- Travelers Personal Security Insurance Company
- Travelers Property Casualty Company of America

The 2009 Handbook, “encourages states to leverage off of examinations conducted by the domiciliary states or participate in an association examination in lieu of conducting a separate examination. States are encouraged to coordinate examinations of property and casualty insurers that operate pursuant to an intercompany reinsurance and pooling agreement.” As such, Arizona, Delaware, Illinois, Iowa, Minnesota, Texas and Wisconsin, who regulate companies that share in the underwriting results of the Pool or who cede 100% of their direct business to the Pool, participated in the examination with an objective of aligning their exam cycle with Connecticut.

The Division also performed a concurrent examination of the following Connecticut domiciled insurers: Travelers Casualty and Surety Company of America (TCSA), Gulf Underwriters Insurance Company (GUI), First Trenton Indemnity Company (FTI) and Travelers Auto Insurance Company of New Jersey (TAIC).

Comments in this report are generally limited to exceptions noted or to items considered to be of a material nature.

Failure of items in this report to add to totals or for totals to agree with captioned amounts is due to rounding.

### HISTORY

Effective August 20, 2002, the ultimate controlling entity of The Northland Company Insurance Group, which includes the Company, changed from Citigroup, Inc. to Travelers Property Casualty Corporation (TPC).

On November 16, 2003, TPC and subsidiaries entered into an agreement and plan of merger with The St. Paul Companies, Inc. (SPC). Under the terms of the merger agreement, each share of TPC’s Class A and Class B common stock was exchanged for 0.4334 of a share of St. Paul common stock. On March 3, 2004, the merger was approved by the Commissioner of Insurance of the State of Connecticut Insurance Department and became effective on April 1, 2004. Corporate headquarters are based in New York, New York, with significant operations in Hartford, Connecticut.

Effective July 1, 2005, TPC combined the St. Paul Insurance Pool with the Travelers Property Casualty Pool to form the St. Paul Travelers Reinsurance Pool, retroactive to January 1, 2005.

## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

On February 16, 2007, SPC changed its name to The Travelers Companies, Inc. (TRV) and began trading on the New York Stock Exchange under the new symbol “TRV”. Additionally, the St. Paul Travelers Reinsurance Pool changed its name to the Travelers Reinsurance Pool (Pool).

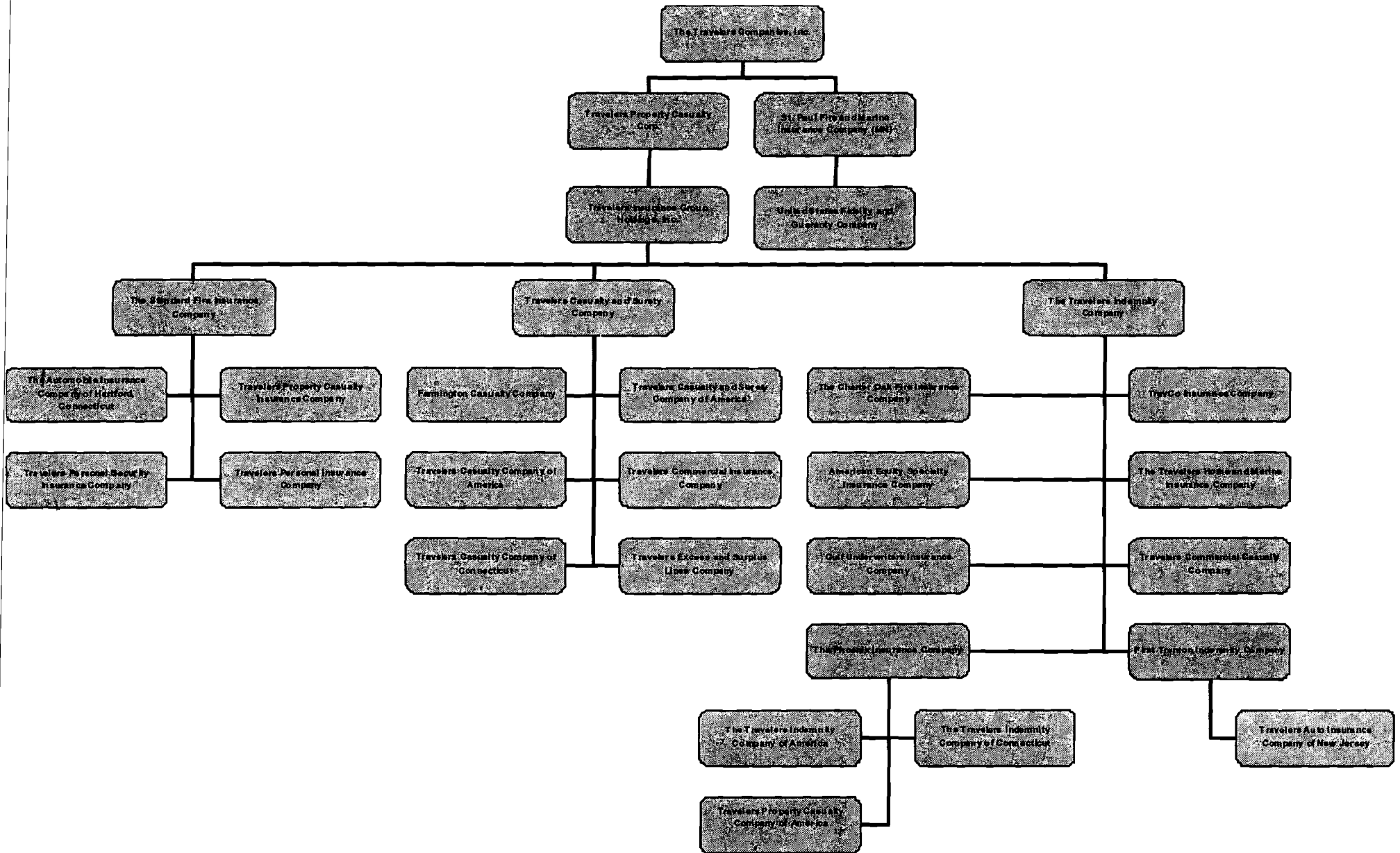
The Company is a wholly-owned subsidiary of American Equity Insurance Company (AEQ), which is a wholly-owned subsidiary of The Travelers Indemnity Company (TINDY), the lead member of the Pool. TINDY is a wholly-owned subsidiary of TIGHI, a non-insurance holding company which is a wholly-owned subsidiary of TPC, a non-insurance holding company which is a wholly-owned subsidiary of TRV, a publicly traded holding company.

### ORGANIZATIONAL CHART

The following is an organizational chart for the Company and its major affiliates:



# AMERICAN EQUITY SPECIALTY INSURANCE COMPANY



**ALL INSURANCE COMPANIES ARE CT DOMICLED WITH THE EXCEPTION OF ST. PAUL FIRE & MARINE INSURANCE COMPANY WHICH IS MN DOMICLED**

# AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

## MANAGEMENT AND CONTROL

The members of the Pool operate under an intercompany pooling agreement, and the respective companies have the same directors and principal officers. These companies occupy the same home office and share accounting systems and personnel. Pursuant to various agreements, services such as financial management, operational management, accounting, payroll, internal audit, human resources management, tax, legal, investment advisory and data processing are provided for or by the members of the Pool.

The Company's bylaws provide that an annual meeting of the shareholders shall be held at such time and place as the Board may appoint. Special meetings of the shareholders may be called at any time by the chairman of the board (Chairman) or the president or by a majority of directors.

There shall be a minimum of three and a maximum of twelve directors. At each meeting of the shareholders, directors shall be elected, each to hold office until the next succeeding annual meeting of the shareholders or until a successor has been elected and qualified.

A majority of the shares of voting capital stock outstanding shall constitute a quorum for the transaction of business at such meetings.

Regular meetings of the Board shall be held at such place and time as the directors may designate by vote. Special meetings of the Board may be called at any time by the Chairman or the president or by any three directors.

Not less than one-third of the Board shall constitute a quorum for the transaction of business at any meeting of the Board. At any special meeting called by three directors, not less than seven directors shall constitute a quorum.

At the annual meeting, the Board shall elect from its members a Chairman and may elect a president and one or more vice chairmen.

The Board, by resolution, shall annually appoint from among its members or otherwise, an investment committee and an audit committee. The Board may also appoint and prescribe the duties and authority of other committees.

The investment committee shall consist of not less than three members. It shall be the duty of the investment committee to authorize or approve each loan or investment transaction made by the Company and to review the investment policy and program of the Company. Not less than two members shall constitute a quorum for the transaction of business. The investment committee may appoint from among the officers of the Company or an affiliated company, a management investment committee to review the authorizations of loans and investments of the Company.

## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

Members of the Board serving the Company at December 31, 2009, were as follows.

<b><u>Director</u></b>	<b><u>Title and Principal Business Affiliation</u></b>
Jay S. Benet	Vice Chairman and Chief Financial Officer, The Travelers Companies, Inc.
William H. Heyman	Vice Chairman and Chief Investment Officer, The Travelers Companies, Inc.
Brian W. MacLean	President and Chief Operating Officer, The Travelers, Companies, Inc.
Doreen Spadorcia	Executive Vice President and Chief Executive Officer – Claims Services and Personal Insurance, The Travelers Companies, Inc.
Gregory C. Toczydowski	President – Personal Insurance, The Travelers Companies, Inc.

The executive officers serving the Company were:

<b><u>Name</u></b>	<b><u>Title</u></b>
Brian W. MacLean	Chairman of the Board, President and Chief Executive Officer
Jay S. Benet	Vice Chairman and Chief Financial Officer
Charles J. Clarke	Vice Chairman
William H. Heyman	Vice Chairman and Chief Investment Officer
Alan D. Schnitzer	Vice Chairman and Chief Legal Officer
John J. Albano	Executive Vice President, Business Insurance
Andy F. Bessette	Executive Vice President and Chief Administrative Officer
William A. Bloom	Executive Vice President, Insurance Operations and Information Technology and Chief Information Officer
John P. Clifford, Jr.	Executive Vice President, Human Resources
William P. Hannon	Executive Vice President, Enterprise Risk Management and Business Conduct Officer
Samuel G. Liss	Executive Vice President, Strategic Development
Maria Olivo	Executive Vice President and Treasurer
Doreen Spadorcia	Executive Vice President, Claim
Kenneth F. Spence, III	Executive Vice President and General Counsel
Gregory C. Toczydowski	Executive Vice President, Personal Insurance
Douglas Keith Bell	Senior Vice President, Accounting Standards
Douglas K. Russell	Senior Vice President and Corporate Controller

## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

<b><u>Name</u></b>	<b><u>Title</u></b>
Scott W. Rynda	Senior Vice President, Corporate Tax
Wendy C. Skjerven	Associate Group General Counsel, Corporate and Corporate Secretary
Smitesh Dave	Vice President and Chief Corporate Actuary

### INSURANCE COVERAGES

The Company is insured under policies covering TRV. The Company is covered for losses resulting from employee dishonesty (e.g., embezzlements) by a financial institution bond (fidelity bond) issued by Federal Insurance Company and by excess policies with various insurers. The limit of liability on the primary layer financial institution bond is \$15 million, which exceeds the suggested minimum limits of insurance pursuant to the Handbook.

In addition to fidelity bond coverage, the Company and its affiliates maintain insurance coverages with various insurers including the following lines:

<b><u>Company (in primary or lead role)*</u></b>	<b><u>Coverage</u></b>
Chubb Group of Insurance Companies	Directors and Officers Liability and Fiduciary Liability
American International Group, Inc.	General Liability, Automobile Liability and Workers' Compensation/Employers Liability
Zurich Financial Services Group	Umbrella/Excess Casualty
Lexington Insurance Company	Property

\* Actual policies may be issued by underwriting subsidiaries of the companies listed above

### TERRITORY AND PLAN OF OPERATION

The Company is licensed in all states, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands.

The Pool's operations are organized into three business segments: Business Insurance (BI); Personal Insurance (PI); and Financial, Professional and International Insurance (FP&II) (only a portion of FP&II written in U.S. companies is included in the Pool).

### BUSINESS INSURANCE

The BI segment offers a broad array of property and casualty insurance and insurance-related services to its clients primarily in the United States. BI is organized into the following six groups:

## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

*Select Accounts* - serves small business for property and casualty products including commercial multi-peril, property, general liability, commercial auto and workers' compensation insurance.

*Commercial Accounts* - serves mid-sized business for property and casualty products including property, general liability, commercial multi-peril, commercial auto and workers' compensation.

*National Accounts* - serves large companies with particular emphasis on workers' compensation both in the voluntary and residual markets, general liability and automobile liability, generally utilizing loss-sensitivity products and products that unbundle services using third-party administrators.

*Industry-Focused Underwriting* - serves targeted industries, i.e., construction, technology, public sector entities oil and gas, and agribusiness with differentiated combinations of insurance coverage, risk management, claims handling and other products.

*Target Risk Underwriting* - serves commercial businesses, i.e., national property, inland and ocean marine, excess casualty, boiler and machinery and global accounts requiring specialized product underwriting, claims handling and risk management services.

*Specialized Distribution* - provides insurance coverages for the commercial transportation industry through Northland and offers tailored property and casualty programs on an admitted basis for customers with common risk characteristics or coverage requirements.

BI also includes the Special Liability Group (SLG) which manages the Company's asbestos and environmental liabilities.

BI distributes its products through approximately 8,500 independent agencies and brokers located throughout the United States that are serviced by approximately 100 field offices and three customer service centers.

### PERSONAL INSURANCE

PI writes a broad range of property and casualty insurance covering personal risks. The primary coverages in PI are automobile and homeowners insurance sold to individuals. These products are distributed through approximately 10,100 independent agents who are supported by personnel in 13 marketing regions and five service centers, as well as sponsoring organizations such as employee affinity groups, joint marketing arrangements with other insurers and direct marketing.

## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

### FINANCIAL, PROFESSIONAL AND INTERNATIONAL INSURANCE

The FP&I segment includes surety and financial liability coverages which primarily use credit-based underwriting processes. This segment's Pool business is underwritten by the Bond and Financial Products group:

*Bond and Financial Products* - provides a wide range of customers with bond and insurance products and risk management services. The range of coverages includes: performance, payment and commercial surety and fidelity bonds for construction and general commercial enterprises; management liability for losses caused by the negligence or misconduct of directors and officers, employees dishonesty, employment practices liability and fiduciary coverage for public corporations, private companies and not-for-profit organizations and; professional liability for errors and omissions committed in the course of professional conduct or practice for a variety of professionals including lawyers, auto and general liability and fidelity insurance for financial institutions, with special focus on community banks.

### REINSURANCE

The Company is a participant in the "Travelers Reinsurance Pool Amended and Restated Quota Share Reinsurance Agreement". Under the terms of the Quota Share Reinsurance Agreement, which was effective January 1, 2005 (and amended on February 26, 2007), the property-casualty underwriting risks for substantially all lines of business of the intercompany pool participants are reinsured with the Company. The pool of underwriting risks remaining after reinsurance is transacted with third parties is then retroceded to the pool participants based on participation percentages.

Each participant in the Pool agrees to cede to the Company and the Company accepts and reinsures 100% of the liability of the pool participants under all non-bond business. After the Company places external ceded reinsurance, the Company cedes to each of the other participants and each participant accepts and reinsures its respective quota share percentage of the Company's net liability for all non-bond business written by the parties of the quota share reinsurance agreement. Each cedent and reinsurer is liable to the other for its respective quota share of written premiums, unearned premiums, paid losses, loss reserves and loss expenses, commissions, other underwriting expenses and premium and other underwriting taxes resulting from business assumed from and ceded to the other.

Accounts between and among the Company and the other Pool members are settled on a daily basis through cash or the intercompany money market pool. Any items open at the end of the month are settled in the following month.

The names and intercompany pool percentages of the companies participating in the Pool are as follows:

AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

<u>Pool Participant</u>	<u>Pool Participation</u>
St. Paul Fire and Marine Insurance Company	24.79%
The Travelers Indemnity Company	23.29%
Travelers Casualty and Surety Company	20.36%
The Phoenix Insurance Company	5.00%
The Standard Fire Insurance Company	4.84%
United States Fidelity and Guaranty Company	4.41%
Travelers Casualty Insurance Company of America	2.73%
Farmington Casualty Company	1.48%
The Automobile Insurance Company of Hartford, Connecticut	1.37%
The Travelers Indemnity Company of Connecticut	1.37%
The Charter Oak Fire Insurance Company	1.27%
Northland Insurance Company	1.22%
St. Paul Surplus Lines Insurance Company	0.88%
The Travelers Indemnity Company of America	0.77%
St. Paul Protective Insurance Company	0.58%
Northfield Insurance Company	0.52%
Travelers Casualty Company of Connecticut	0.47%
Travelers Commercial Casualty Company	0.47%
Travelers Commercial Insurance Company	0.47%
St. Paul Mercury Insurance Company	0.40%
Travelers Property Casualty Company of America	0.36%
Travelers Property Casualty Insurance Company	0.30%
Athena Assurance Company	0.29%
St. Paul Medical Liability Insurance Company	0.29%
TravCo Insurance Company	0.27%
Travelers Excess and Surplus Lines Company	0.27%
The Travelers Home and Marine Insurance Company	0.27%
Travelers Personal Security Insurance Company	0.27%
Travelers Personal Insurance Company	0.27%
Discover Property & Casualty Insurance Company	0.14%
Discover Specialty Insurance Company	0.14%
Northland Casualty Company	0.14%
<b>American Equity Specialty Insurance Company</b>	<b>0.10%</b>
Fidelity and Guaranty Insurance Underwriters, Inc.	0.10%
St. Paul Guardian Insurance Company	<u>0.10%</u>
 <b>Pool Total</b>	 <b><u>100.00%</u></b>

# AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

## INFORMATION TECHNOLOGY (IT) AND CONTROLS

The Minnesota Department of Commerce (MNDOC), on behalf of the Division, engaged RSM McGladrey (RSM) to conduct an evaluation of IT controls.

RSM performed a risk-based assessment and review of the Company's IT General Controls and General Application Controls (GACs) based on the responses to the Exhibit C - Evaluation of Controls in IT of the Handbook (Exhibit C). The IT examination team used the new Exhibit C – Part 2, which was released by the NAIC in the spring of 2009.

RSM's objectives were to obtain reasonable assurance about whether:

- The Company's responses to Exhibit C indicate the existence of internal controls, including policies and procedures that may be relevant to governing its IT internal control structure.
- The Company has a process in place to effectively identify, mitigate and manage its IT risks.
- The Company's control structure policies and procedures were suitably designed to achieve the control objectives specified in the Exhibit C, and if those policies and procedures were complied with.
- The Company's policies and procedures were in place during the examination period (i.e., from January 1, 2005 to December 31, 2009).

The objectives above were achieved through a combination of reviewing the Company's policies and procedures, testing in key areas related to the Exhibit C, interviewing the Company's IT senior management at the Company and reviewing IT risk assessment processes and leveraging the annual risk assessment procedures performed by KPMG.

In addition, a review of GAC's was performed over the following financially significant systems:

- Revenue Data Base system (RevDB)
- Loss Data Base system (LossDB)
- Written and Paid Utility Processing system (WRAPUP)
- Loss Financial Reporting system (LOFIR)
- Bond Management Information system (BOND MIS)
- Investment Accounting system (CAMRA)
- Investment system (SMART)
- Enterprise Resourcing system (PEOPLESOFT G/L) – This system was implemented in January of 2009 and replaced a number of independent financial applications (also referred to the Financial and Accounting Comprehensive Tool Suite (FACTS)).



## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

RSM also performed independent testing in the following areas: IT governance, end-user computing, logical security, and user access and application security. The IT examination team received and reviewed the results from the post-implementation review performed by PricewaterhouseCoopers and Corporate Audit for the FACTS system.

Based upon the risk-based assessment and review, no material findings were noted which affected the overall reliance on the Company's IT controls.

### ACCOUNTS AND RECORDS

The FACTS general ledger feeds accounting data to the Hyperion Financial Management (HFM) consolidation system. HFM then feeds The Complete Package by Booke, the annual statement preparation software package used by the Company to prepare the quarterly and annual statutory financial statements for each legal entity.

General ledger account balances were reconciled and traced to the amounts reported in the annual statement for 2009. Further detail analyses were performed on the individual accounts throughout the examination.

AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

FINANCIAL STATEMENTS

The following statements reflect the assets, liabilities, surplus and other funds, and statement of income as of December 31, 2009, as reported by the Company and as determined by the examination:

**ASSETS**

	1	2	3
	Ledger Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	\$70,654,325	\$0	\$70,654,325
Cash, cash equivalents and short-term investments	279,923	0	279,923
Investment income due and accrued	1,002,709	0	1,002,709
Uncollected premiums and agents' balances in the course of collection	1,103,255	184,858	918,397
Deferred premiums, agents' balances and installments booked but deferred and not yet due	3,602,865	27,285	3,575,580
Accrued retrospective premiums	485,510	2,029	483,481
Net deferred tax asset	1,797,294	502,240	1,295,054
Guaranty funds receivable or on deposit	5,631	0	5,631
Aggregate write-ins for other than invested assets	244,318	15,413	228,905
Total	<u>\$79,175,829</u>	<u>\$731,826</u>	<u>\$78,444,004</u>

AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

**LIABILITIES, SURPLUS AND OTHER FUNDS**

Losses	\$29,536,563
Loss adjustment expenses	6,934,974
Commissions payable, contingent commissions and other similar charges	531,428
Other expenses	483,581
Taxes, licenses and fees	418,418
Current federal and foreign income taxes	708,996
Unearned premiums	8,010,831
Dividends declared and unpaid - policyholders	36,974
Ceded reinsurance premiums payable, net ceding commissions	501,075
Amounts withheld or retained by company for account of others	127,145
Remittances and items not allocated	(6,516)
Payable to parent, subsidiaries and affiliates	113,172
Aggregate write-ins for liabilities	99,207
Total liabilities	47,495,849
Aggregate write-ins for special surplus funds	511,933
Common capital stock (6,000 shares authorized, 3,500 shares issued and outstanding, \$1,000 par)	3,500,000
Gross paid in and contributed surplus	21,000,000
Unassigned funds (surplus)	5,936,222
Surplus as regards policyholders	30,948,155
Totals	<u>\$78,444,004</u>

AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

**STATEMENT OF INCOME**

UNDERWRITING INCOME		
Premiums earned		\$18,153,649
DEDUCTIONS		
Losses incurred		8,368,997
Loss adjustment expenses incurred		2,217,004
Other underwriting expenses incurred		5,815,859
Total underwriting deductions		16,401,860
Net underwriting gain (loss)		1,751,789
INVESTMENT INCOME		
Net investment income earned		2,749,273
Net realized capital gains (losses)		21,274
Net investment gains		2,770,547
OTHER INCOME		
Net gain (loss) from agents' or premium balances charged off		(60,946)
Finance and service charges not included in premiums		94,209
Aggregate write-ins for miscellaneous income		(11,335)
Total other income		21,928
Net income before dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes		4,544,265
Dividends to policyholders		17,481
Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes		4,526,784
Federal and foreign income taxes		701,167
Net income		3,825,617
<b>CAPITAL AND SURPLUS ACCOUNT</b>		
Surplus as regards policyholders, December 31 prior year		30,208,425
Net income		3,825,617
Change in net deferred income tax		(135,352)
Change in nonadmitted assets and related items		186,087
Dividends to stockholders		(3,500,000)
Aggregate write-ins for gains and losses in surplus		363,377
Change in surplus as regards policyholders for the year		739,730
Surplus as regards policyholders, December 31 current year		<u>\$30,948,155</u>

## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

AGGREGATE WRITE-INS FOR OTHER THAN INVESTED ASSETS \$228,905

Within the captioned account the Company reported a "reinsurance receivable intercompany" amount of \$14,210. This balance related to the net unsettled pooled underwriting activity as of December 31, 2009 pursuant to the Quota Share Reinsurance Agreement (Agreement) which the Company is a party to.

As reported in its 2008 Annual Statement, Note 2 to the Financial Statements, "The Company adopted amended guidance in SSAP No. 63, Underwriting Pools and Associations Including Intercompany Pools (SSAP No. 63) effective in 2008, regarding the reporting of amounts due to/from affiliates for reinsurance. Amounts related to reinsurance agreements with affiliates are reported as an aggregate write-in rather than as a receivable from/payable to parent, subsidiaries and affiliates."

According to SSAP No. 63, paragraph 8 of the NAIC Practices and Procedures Manual (Manual), "Underwriting results relating to voluntary and involuntary pools shall be accounted for on a gross basis where the participant's portion of premiums, losses, expenses, and other operations of the pools are recorded separately in the financial statements rather than netted against each other. Premiums and losses shall be recorded as direct, assumed, and/or ceded as applicable." In addition, SSAP No. 63, paragraph 9 states that "While it is acceptable that intercompany pooling transactions be settled through intercompany arrangements and accounts, intercompany pooling transactions shall be reported on a gross basis in the appropriate reinsurance accounts consistent with other direct, assumed and ceded business."

It is recommended that commencing with the 2010 Annual Statement, the Company report intercompany reinsurance receivables in the appropriate reinsurance accounts (e.g., uncollected premiums and agents' balances in course of collection, amounts recoverable from reinsurers, reinsurance paid on paid loss and losses adjustment expenses and ceded reinsurance premiums payable) in accordance with SSAP No. 62R and SSAP No. 63 of the Manual. Additionally, Schedule F and the Notes to Financial Statements should be reviewed and corrected where necessary pursuant to the Instructions. The Company should also amend the "prior year" column in the 2010 Annual Statement to comply with the Manual. Implementation of this recommendation by the Company will not effect the Company's surplus position.

Prior to the March 1, 2011 filing deadline, the Company provided the Division with an example of a 2010 Annual Statement to demonstrate its compliance with the above recommendations.

## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

LOSSES AND LOSS ADJUSTMENT EXPENSES (LAE) \$36,471,537

The following items were included in the captioned account:

Losses	\$29,536,563
LAE	<u>6,934,974</u>
	<u>\$36,471,537</u>

The Division engaged Milliman, Inc. (Milliman) to conduct a comprehensive actuarial analysis of the loss and LAE reserves of the Company as of December 31, 2009. This included an assessment of the following risks:

*Reserving Risk* (i.e., the risk that actual losses or other amounts the Pool is contractually liable to pay will be greater than the corresponding carried liabilities) – Milliman’s assessment of reserve risk included 1) an evaluation of the reconciliation of actuarial data to Schedule P within the Annual Statement, 2) a review of the claim handling procedures and processes used to estimate loss and LAE liabilities for large risks related to asbestos environmental/pollution and cumulative injury other than asbestos (“CIOTA”) and surety, directors and officers and errors and omissions liability claims, and 3) a qualitative review of workpapers and documentation supporting estimates of the loss and loss adjustment expense liabilities for selected business segments and units. Such review included an assessment as to the appropriateness of methodologies and quality of assumptions.

*Pricing and Underwriting Risk* – The assessment of pricing and underwriting risk included 1) an evaluation of the actuarial process for the development of rate indications 2) an evaluation of price monitoring processes and controls, and 3) a review on the frequency of and processes for reporting price and underwriting considerations to management.

*Liquidity Risk* – The assessment of liquidity risk included 1) a qualitative review of the processes for assessing catastrophe exposure and risk concentration 2) a review on the frequency of and processes for reporting assessments to management, and 3) a qualitative review of the reinsurance program with specific attention to:

- Concentration of protection within individual reinsurers
- Aggregation of protection within reinsurers with potential for financial weakness
- Adequacy of reinsurance limits relative to benchmarks such as probable maximum loss, gross policy limits, surplus, etc.

The Division performed data validation and inclusion testing in order to gain confidence that the extraction files were complete and correct. It was concluded that the Company’s reserves were based upon data files that were complete and free of error.

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Based upon the risk-based assessment and review, no material findings were noted which affected the Company's ability to manage its reserving, pricing and underwriting or liquidity risk.

### REMITTANCES AND ITEMS NOT ALLOCATED (\$6,516)

While reviewing the composition of the captioned account it was noted that Company's current process is to reconcile accounts at a business group level and not at a legal entity level. This resulted in some accounts prepared on a legal entity basis having unsettled amounts due to/from affiliates. It is recommended that the Company implement controls to ensure that the reconciliation of accounts is performed at a legal entity level, including the timely settlement of resulting amounts due to/from affiliates.

Effective December 2010, the Company implemented a new policy to ensure that account reconciliations are performed at a legal-entity level and, when necessary, settled through intercompany timely.

### AGGREGATE WRITE-IN FOR LIABILITIES \$99,207

The Company's Discover Re (DRE) business unit recorded accrued retrospective premium amounts in the captioned account. According to the Instructions and SSAP No. 66 of the Manual, the Company should have reported one net asset or liability, as it had been reporting for its National Account business unit's retrospectively rated contracts. Additionally, it was noted that individual DRE policies were being inappropriately grossed-up within the captioned account and in the "accrued retrospective premiums" asset." It is recommended that the Company strengthen controls surrounding the netting and presentation of the accrued retrospective premium reserve for retrospectively rated contracts. As of March 31, 2010, the Company corrected this error and conformed its accounting to be consistent with the Company's accounting policy and SSAP No. 66 of the Manual.

### POLICYHOLDERS SURPLUS \$30,948,155

The following is a reconciliation of policyholders' surplus during the period under examination:

Surplus as regards policyholders, December 31, 2007	\$22,308,557
Net Income/(Net Loss)	9,343,348
Change in net unrealized capital gain (loss)	70
Change in net unrealized foreign exchange capital gain (loss)	(201)
Change in net deferred income tax	585,433
Change in nonadmitted assets	(459,693)

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Change in provision for reinsurance	207,263
Surplus adjustments paid in	5,000,000
Dividends to stockholders	(6,400,000)
Change in aggregate write-ins for gains and losses in surplus	363,378
Surplus as regards policyholders, December 31, 2009	<u>\$30,948,155</u>

As indicated above, changes to the Company's policyholder surplus over the exam period were largely due to results from operations and the payment of ordinary dividends to AEQ. The change in aggregate write-ins for gains and losses in surplus primarily represents the incremental increase to the deferred tax asset as part of the Company's 2009 adoption of SSAP No. 10R which changed the calculation to include Deferred Tax Assets to be realized within 3 years (an increase in 2 years from SSAP No. 10) subject to a cap of 15% of capital and surplus (an increase of 5% from SSAP No. 10).

### RECOMMENDATIONS

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#### 17. AGGREGATE WRITE-INS FOR OTHER THAN INVESTED ASSETS

It is recommended that commencing with the 2010 Annual Statement, the Company report intercompany reinsurance receivables in the appropriate reinsurance accounts in accordance with SSAP No. 62R and SSAP No. 63 of the Manual. Additionally, Schedule F and the Notes to Financial Statements should be reviewed and corrected where necessary pursuant to Instructions. The Company should also amend the "prior year" column in the 2010 Annual Statement to comply with the Manual.

Prior to the March 1, 2011 filing deadline, the Company provided the Division with an example of a 2010 Annual Statement to demonstrate its compliance with the above recommendations.

#### 19. REMITTANCES AND ITEMS NOT ALLOCATED

It is recommended that the Company implement controls to ensure that the reconciliation of accounts is performed at a legal entity level, including the timely settlement of resulting amounts due to/from affiliates.

Effective December 2010, the Company implemented a new policy to ensure that account reconciliations are performed at a legal-entity level and, when necessary, settled through intercompany timely.



## AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

### 19. AGGREGATE WRITE-INS FOR LIABILITIES

It is recommended that the Company strengthen controls surrounding the netting and presentation of the accrued retrospective premium reserve for retrospectively rated contracts. As of March 31, 2010, the Company corrected this error and conformed its accounting to be consistent with the Company's accounting policy and SSAP No. 66 of the Manual.

### SUBSEQUENT EVENT

On August 20, 2010, in a reinsurance dispute in New York state court captioned *United States Fidelity & Guaranty Company (USFG) v. American Re-Insurance Company, et al.*, the trial court granted summary judgment for USFG, awarding it \$251 million (after taking into account a settlement with one of the defendants), plus prejudgment interest in the amount of \$166 million. USFG is a participant in the Pool. The Company's Pool participant share of the \$251 million awarded by the court represents the amount owed to the Company under the terms of the reinsurance agreements and is reported as part of reinsurance recoverables in the Company's statutory financial statements. The Company's Pool participation share of interest awarded by the Court is treated for accounting purposes as a gain contingency in accordance with SSAP No. 5, *Liabilities, Contingencies and Impairment of Assets*, and accordingly has not been recognized in the Company's statutory financial statements.

### CONCLUSION

The results of this examination disclosed that as of December 31, 2009, the Company had admitted assets of \$78,744,004, liabilities of \$47,495,849, and capital and surplus of \$30,948,155. During the period under examination, admitted assets increased \$31,697,409, liabilities increased \$23,057,812, and capital and surplus increased \$8,639,597.

It was determined that the Company's assets and liabilities were fairly stated in accordance with guidance outlined in the Manual. Assets were acceptable under Section 38a-102 of the CGS. The liabilities established were adequate to cover the Company's obligations to policyholders.

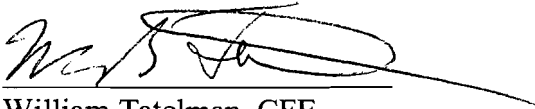
AMERICAN EQUITY SPECIALTY INSURANCE COMPANY

SIGNATURE

In addition to the undersigned, William Arfanis, CFE, Donna Nowakowski, AFE, Grace Jiang, CFE, Gerald F. Burke, CFE, Chiffon King, AFE, Edna Bosley, AFE, Kenneth Roulier, AFE, CISA, AES, Richard J. Marcks, FCAS, MAAA, Michael Estabrook, AFE, and Michael Shanahan, of the State of Connecticut Insurance Department, Milliman, Inc. and RSM McGladrey Inc. participated in this examination.

I, William Tatelman, do solemnly swear that the foregoing report of examination is hereby represented to be a full and true statement of the condition and affairs of the subject insurer as of December 31, 2009, to the best of my information, knowledge and belief.

Respectfully submitted,



William Tatelman, CFE  
Examiner-in-Charge  
State of Connecticut  
Insurance Department

State of Connecticut                      ss

County of Hartford

Subscribed and sworn before me, Patricia Butler, Notary  
Public/Commissioner of the Superior Court, on this 3<sup>rd</sup> day of January, 2011.

Patricia A Butler  
Notary Public/Commissioner of the Superior Court

**My Commission Exp. Sep. 30, 2013**

My Commission Expires \_\_\_\_\_