

REPORT OF EXAMINATION
OF THE
CALIFORNIA CAPITAL INSURANCE COMPANY
AS OF
DECEMBER 31, 2007

Participating State
and Zone:

California

Filed November 19, 2008

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION	1
COMPANY HISTORY	2
MANAGEMENT AND CONTROL:	2
Intercompany Agreements	4
TERRITORY AND PLAN OF OPERATION	5
REINSURANCE:	6
Pooling Agreement	6
Assumed.....	6
Ceded	7
ACCOUNTS AND RECORDS:.....	8
Information Systems Controls	8
FINANCIAL STATEMENTS:.....	9
Statement of Financial Condition as of December 31, 2007	10
Underwriting and Investment Exhibit for the Year Ended December 31, 2007.....	11
Reconciliation of Surplus as Regards Policyholders from December 31, 2003 through December 31, 2007	12
COMMENTS ON FINANCIAL STATEMENT ITEMS:	13
Other Invested Assets	13
Losses and Loss Adjustment Expenses	14
SUMMARY OF COMMENTS AND RECOMMENDATIONS:	14
Current Report of Examination.....	14
Prior Report of Examination.....	14
ACKNOWLEDGMENT	16

San Francisco, California
September 26, 2008

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Morris Chavez
Secretary, Zone IV-Western
Superintendent of Insurance
New Mexico Insurance Division
Santa Fe, New Mexico

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

CALIFORNIA CAPITAL INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office, located at 2300 Garden Road, Monterey, California 93940.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2007. The examination was conducted pursuant to the National Association of Insurance Commissioners' plan of examination. The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, and an evaluation of the assets, and a determination of liabilities as of December 31, 2007, as deemed necessary under

the circumstances. The examination was conducted concurrently with the Company's California subsidiaries, Eagle West Insurance Company and Monterey Insurance Company, and its Nevada subsidiary, Nevada Capital Insurance Company. These insurers are collectively referred to as the Capital Insurance Group (Group) hereinafter.

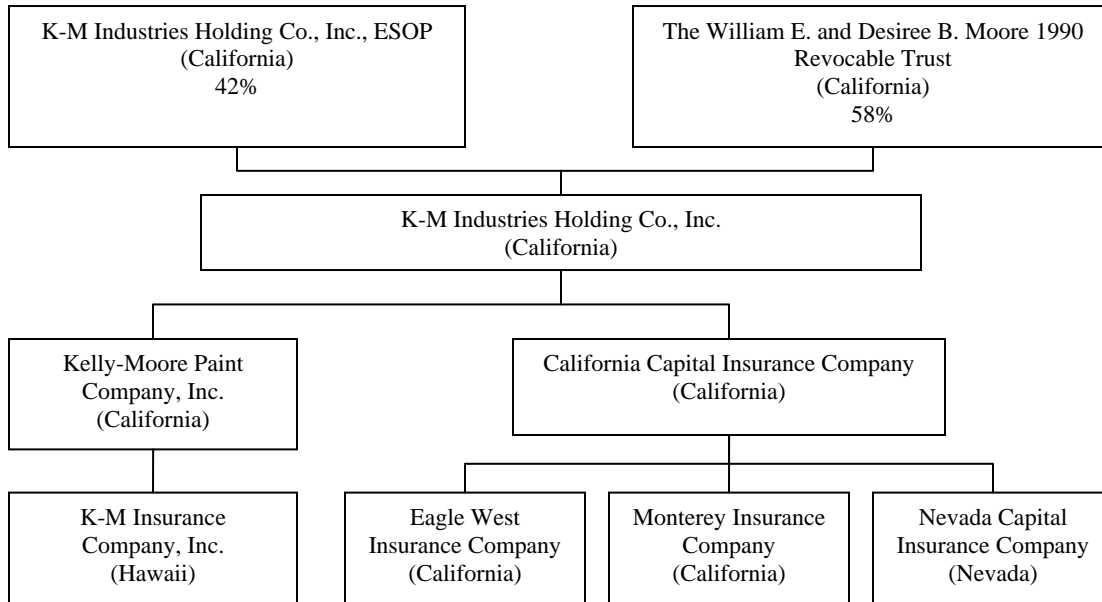
In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

COMPANY HISTORY

On January 9, 2004, the Company made a \$5 million capital contribution to its subsidiary, Nevada Capital Insurance Company (NCIC), to allow NCIC to meet the minimum statutory surplus requirements to write surplus lines business on a non-admitted basis in California. This contribution was made pursuant to California Insurance Code (CIC) Section 1215.1 and required no prior approval.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which Desiree B. Moore is the ultimate controlling person. The following chart depicts the interrelationship of the companies within the holding company system:



(*) all ownership is 100% unless otherwise noted.

Directors

Name and Residence

Principal Business Affiliation

Peter M. Cazzolla
Reno, Nevada

President and Chief Executive Officer
Capital Insurance Group

Steven W. DeVoe*
San Carlos, California

President
Kelly-Moore Paint Company, Inc.

Christine McCall*
Missoula, Montana

Director
K-M Industries Holding Company, Inc.

Desiree B. Moore
Woodside, California

Chairwoman of the Board
K-M Industries Holding Company, Inc.

William E. Moore II
Escondido, California

Director
K-M Industries Holding Company, Inc.

**These directors were added in 2008.*

Principal Officers

<u>Name</u>	<u>Position</u>
Peter M. Cazzolla	President and Chief Executive Officer
Robert M. Erickson	Secretary, Treasurer and Chief Financial Officer
Thomas H. Scherff	Vice President of Claims
Robert D. Winn	Vice President of Underwriting

Intercompany Agreements

Allocation of Federal Income Taxes Agreement: Effective December 26, 2001, K-M Industries Holding Co., Inc. and the Company and its subsidiaries, Eagle West Insurance Company (EWIC), Monterey Insurance Company (MIC) and Nevada Capital Insurance Company (NCIC) entered into a federal income tax allocation agreement. This agreement provides for allocation of the year-end consolidated tax liability among participants in the agreement. The year-end tax liability is computed on a consolidated basis; however, each participant's tax provision is calculated individually. Pursuant to California Insurance Code (CIC) Section 1215.5(b)(4), this agreement was submitted to and approved by the California Department of Insurance (CDI) on March 22, 2002.

Management Agreement: Effective January 1, 2002, the Company entered into a management agreement with each of its subsidiaries, EWIC, MIC and NCIC. Under the terms of the agreements, the Company provides sales, reinsurance, underwriting, claims payments, investment and various other administrative services to its subsidiaries based on actual cost. The agreements were submitted to the CDI pursuant to CIC Section 1215.5(b)(4) in 2002 and are pending approval.

Lease Agreement: Effective December 10, 2007, the Company entered into a lease agreement whereby the Company leases its home office in Monterey, California from Kelly-Moore Paint Company, Inc. The term of the lease is for five years commencing April 1, 2008 and ending March 31, 2013. The base rent is \$65,422 per month commencing April 1, 2008 and is subject to fixed rental adjustments on April 1st of each year thereafter as specified in the agreement. The

Company is responsible for maintenance, repairs, insurance, and taxes related to the leased property. The lease agreement was filed with the CDI pursuant to CIC Section 1215.5(b)(4) on September 24, 2008.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2007, the Company was licensed to transact business in Arizona, California, Idaho, Montana, Nevada, and Texas. The Company is also an authorized reinsurer in Oregon.

Direct premiums written of \$225.9 million during 2007 were all written in California. The Company's primary lines of business written during 2007 were commercial multiple peril (39.4%), homeowners multiple peril (20.6%), private passenger auto liability (9.7%), and auto physical damage (9.2%). The Company also wrote a small amount of fire, allied lines, farmowners multiple peril, inland marine, earthquake, other liability-occurrence, commercial auto liability, burglary and theft, and boiler and machinery insurance.

Business for the Company is produced entirely by independent agents and brokers. There were approximately 500 agents and brokers appointed by the Company as of the examination date.

The Company operates on a joint basis with its subsidiaries Eagle West Insurance Company (EWIC), Monterey Insurance Company (MIC) and Nevada Capital Insurance Company (NCIC), pursuant to an inter-company reinsurance pooling agreement. Each company uses a different marketing approach. The Company and EWIC write all standard lines of business on a preferred basis. MIC writes direct commercial multiple peril business at deviated rates. NCIC writes policies only in Nevada.

The Company has regional and branch offices in Bakersfield, Camarillo, Campbell, Ferndale, Gold River, Modesto, Orange, San Diego, and Visalia, California, in Reno, Nevada, and in Salem, Oregon. Most branch offices perform both underwriting and claims adjusting functions. The Visalia and Bakersfield branch offices perform only claims adjusting. The San Diego branch office performs only underwriting.

Underwriting for personal lines is performed at the Company's home office in Monterey and the branch office in Reno. Underwriting for the farm business is performed at the Modesto and Salem branches. Commercial lines underwriting is performed at all branches for amounts within the authority of the branch. Larger policies are underwritten at the home office.

REINSURANCE

Pooling Agreement

A revised pooling agreement was approved by the California Department of Insurance effective January 1, 2006. The agreement authorizes the Company to collect and receive all premiums, to adjust and pay all losses and to reinsure or cancel all contracts and policies for the pool. Under the terms of this agreement, Eagles West Insurance Company, Monterey Insurance Company, and Nevada Capital Insurance Company cede 100% of all premiums, losses, loss adjustment expenses and most underwriting expenses to the Company, which then retrocedes a prorated amount to each company based on the following pooling percentages:

California Capital Insurance Company	61%
Eagle West Insurance Company	16%
Monterey Insurance Company	11%
Nevada Capital Insurance Company	<u>12%</u>
Total	100%

Assumed

Effective July 1, 2004, the Company entered into a quota share reinsurance agreement with State National Insurance Company, Inc. (SNIC). Under the terms of the agreement, the Company assumes 100% of SNIC's gross liability under all policies classified as commercial multiple peril and miscellaneous coverages as endorsed in California and produced by SureProducts Insurance Agency, a general agent. Maximum policy limits for the assumed policies are \$10 million per risk for property and \$1 million per occurrence, \$2 million in the aggregate, for general liability. The Company assumed premiums of \$9.5 million under this reinsurance agreement during 2007.

The Company assumed a 4% share of the Mutual Reinsurance Bureau's Regional Catastrophe pool. The Company's 4% share covers a maximum risk of \$1 million per occurrence. The Company assumed premiums of \$541,000 under this agreement during 2007.

Ceded

The following is a summary of principal reinsurance agreements in effect as of December 31, 2007. All reinsurers are authorized unless indicated otherwise. Reinsurers with less than 5% participation have been accumulated and listed in aggregate.

<u>Type of Contract</u>	<u>Line(s) of Business</u>	<u>Reinsurer(s)</u>	<u>Company's Retention</u>	<u>Reinsurer's Limits</u>	
Mutli-line XOL	1 st Layer	Property and Casualty	Motors Insurance Corporation	Property: \$750,000 per risk	Property: \$250,000 per risk, \$750,000 per occurrence
				Casualty: \$750,000 per occurrence	Casualty: \$250,000 per occurrence
	2 nd Layer	Property and Casualty	Motors Insurance Corporation	Property: \$1 million per risk	Property: \$5 million per risk, \$10 million per occurrence
				Casualty: \$1 million per occurrence	Casualty: \$5 million per occurrence
Catastrophe	1 st Layer	Property	Lloyd's (11.5%) Various (4%) Nonadmitted: AXIS Specialty Ltd (25%) Flagstone Reinsurance Ltd. (7.5%) Max Re Ltd. (7.5%) Validus Reinsurance, Ltd. (8.5%) Amlin Bermuda Ltd. (5%) AXA Re (5%) R+V Versicherung A.G. (10%) Various (11%)	\$10 million per occurrence	95% of \$15 million excess of \$10 million, loss limit of \$30,000,000
				2 nd Layer	Property

<u>Type of Contract</u>	<u>Line(s) of Business</u>	<u>Reinsurer(s)</u>	<u>Company's Retention</u>	<u>Reinsurer's Limits</u>
		AXIS Specialty Ltd (25%) Flagstone Reinsurance Ltd. (7.5%) Mapfre Re Compania de Reaseguros, S.A. (5%) Max Re Ltd. (5.5%) Validus Reinsurance, Ltd. (8.5%) Amlin Bermuda Ltd. (5%) AXA Re (5%) R+V Versicherung A.G. (10%) Various (8%)		\$50 million
3 rd Layer	Property	Lloyd's (11.5%) Various (4%) Nonadmitted: AXIS Specialty Ltd (25%) Flagstone Reinsurance Ltd. (7.5%) Mapfre Re Compania de Reaseguros, S.A. (5%) Max Re Ltd. (5.5%) MS Frontier Reinsurance Ltd. (5%) Validus Reinsurance, Ltd. (8.5%) Amlin Bermuda Ltd. (5%) AXA Re (5%) R+V Versicherung A.G. (5%) Various (8%)	\$50 million per occurrence	95% of \$35 million excess of \$50 million, loss limit of \$70 million
Top Layer	Property	Mutual Reinsurance Bureau: Country Mutual Ins. Co. (20%) Employers Mutual Cas. Co. (20%) Kentucky Farm Bureau Mutual Ins. Co. (20%) Motorists Mutual Ins. Co. (20%) Nonadmitted: Auto-Owners Ins. Co. (20%)	\$85 million per occurrence	\$25 million excess of \$85 million, loss limit of \$50 million

ACCOUNTS AND RECORDS

Information Systems Controls

A review was made of the Company's general controls over its information systems. As a result of the review, weaknesses were noted in the area of business continuity planning. The weaknesses noted were presented to the Company along with recommendations to strengthen its controls. It is recommended that the Company evaluate these recommendations and make appropriate changes to strengthen its information systems controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2007

Underwriting and Investment Exhibit for the year ended December 31, 2007

Reconciliation of Surplus as Regards Policyholders from December 31, 2003
through December 31, 2007

Statement of Financial Condition
as of December 31, 2007

	Ledger and Non-ledger Assets	Non- Admitted Assets	Net Admitted Assets	Notes
<u>Assets</u>				
Bonds	\$ 288,359,011	\$	\$ 288,359,011	
Common stocks	84,650,979		84,650,979	
Cash and short-term investments	18,997,739		18,997,739	
Other invested assets	22,707,297	22,707,297		(1)
Investment income due & accrued	4,538,743		4,538,743	
Premiums and agents' balances in course of collection	10,073,173	934,685	9,138,448	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	15,348,725		15,348,725	
Reinsurance recoverables	26,385		26,385	
Net deferred tax asset	10,108,310	1,904,420	8,203,890	
Electronic data processing equipment and software	5,257,180	3,762,211	1,494,969	
Furniture and equipment	2,156,849	2,156,849		
Receivable from parent, subsidiaries, and affiliates	524,291		524,291	
Aggregate write-ins for other than invested assets	3,266,828	1,444,215	1,822,613	
Total assets	\$ 466,015,510	\$ 32,909,677	\$ 433,105,833	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 61,725,260	(2)
Loss adjustment expenses			24,650,093	(2)
Commissions payable, contingent commissions and other similar charges			10,917,490	
Other expenses			3,916,342	
Taxes, licenses and fees			64,299	
Current federal and foreign income taxes			442,821	
Unearned premiums			79,089,466	
Advanced premiums			732,345	
Ceded reinsurance premiums payable			3,454,319	
Amounts withheld or retained by company for account of others			23,704,566	
Remittances and items not allocated			1,304,559	
Provision for reinsurance			25,671	
Drafts outstanding			5,432,038	
Total liabilities			\$ 215,459,269	
Common capital stock		\$ 2,660,000		
Gross paid- in and contributed surplus		22,887,034		
Unassigned funds		192,099,530		
Surplus as regards policyholders			217,646,564	
Total liabilities, surplus and other funds			\$ 433,105,833	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2007

Statement of Income

Underwriting Income

Premiums earned		\$ 164,231,513
Deductions:		
Losses incurred	\$ 73,233,934	
Loss expenses incurred	20,068,356	
Other underwriting expenses incurred	<u>63,337,632</u>	
Total underwriting deductions		<u>156,639,922</u>
Net underwriting gain		7,591,591

Investment Income

Net investment income earned	\$ 15,204,850	
Net realized capital gains	<u>1,432</u>	
Net investment gain		15,206,282

Other Income

Net loss from agents' balances or premium balances charged off	\$ (53,492)	
Finance and service charges not included in premiums	1,529,333	
Aggregate write-in for miscellaneous income	<u>231,713</u>	
Total other income		<u>1,707,554</u>
Net income before federal income taxes		24,505,427
Federal income taxes incurred		<u>8,432,277</u>
Net income		<u>\$ 16,073,150</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2006		\$ 190,792,010
Net income	\$ 16,073,150	
Change in net unrealized capital gains or losses	9,890,577	
Change in deferred income tax	871,080	
Change in nonadmitted assets	38,715	
Change in provision for reinsurance	<u>(18,968)</u>	
Change in surplus as regards policyholders for the year		<u>26,854,554</u>
Surplus as regards policyholders, December 31, 2007		<u>\$ 217,646,564</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2007

			<u>Notes</u>
Surplus as regards policyholders, December 31, 2003, per Examination	\$	135,344,279	
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 69,979,738	\$	
Change in net unrealized capital gains	38,052,932		
Change in net deferred income tax	2,827,610		
Change in nonadmitted assets		28,621,315	(1)
Change in provision for reinsurance	<u>63,320</u>	<u> </u>	
Totals	<u>\$110,923,600</u>	<u>\$ 28,621,315</u>	
Net increase in surplus as regards policyholders		<u>82,302,285</u>	
Surplus as regards policyholders, December 31, 2007, per Examination	\$	<u>217,646,564</u>	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Other Invested Assets

On June 30, 2005, the Board of Directors adopted a resolution amending a \$20 million promissory note due from K-M Industries Holding Co., Inc. (K-M). Under the amended promissory note, the term of the loan was changed from three annual principal payments of \$5.6 million with a balloon payment of \$3.2 million on March 18, 2008 to nine annual principal payments of \$2 million and a balloon payment of \$2 million on December 31, 2014. The interest rate on the note was also changed from one-month LIBOR plus 1.65% per annum to simply 4.75% per annum. In addition, the Board of Directors also adopted a resolution converting a \$12 million intercompany receivable from K-M into an interest bearing promissory note. The note bears interest at 4.75% per annum and is to be repaid in nine annual principal payments of \$1.2 million beginning December 31, 2005 with a balloon payment of \$1,249,478 plus all accrued and unpaid interest on December 31, 2014. Although payments are current on both notes, the Company decided to nonadmit both promissory notes due to the financial uncertainty of K-M.

The amended promissory note of \$20 million and the new \$12 million promissory note were not submitted to nor approved by the Commissioner pursuant to California Insurance Code (CIC) Section 1215.5(b)(1). It is recommended that the Company comply with CIC Section 1215.5(b)(1).

Additionally, no collateral is held for the \$12 million promissory note in violation of CIC Section 1196(c). Both promissory notes also exceed the maximum loan amount that can be made to any one borrower under Section 1197. It is recommended that the Company comply with CIC Sections 1196(c) and 1197.

On July 25, 2008, the Company received approval from the Board of Directors to loan up to \$4.6 million to the K-M Industries Holding Co. Inc. Employee Stock Ownership Trust (ESOP Trust) for a portion of the 2008 obligations of the ESOP Trust for the Group's employees. The loan will be to the ESOP Trust and will be considered a non-admitted asset on the books of the

Company. The exact amount of the loan will be determined in September 2008 when all of the distribution elections are received and verified. As of December 31, 2007, the Company had accrued \$1,185,990 for the projected effect of the change in distribution policy, and is currently accruing approximately \$500,000 per month for projected 2008 ESOP contributions. The estimated loan is below the statutory threshold required for prior approval under CIC Section 1215.5(b)(1).

(2) Losses and Loss Adjustment Expenses

Based on an analysis by a Casualty Actuary for the California Department of Insurance, the Company's loss and loss adjustment expense reserves as of December 31, 2007 were found to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Accounts and Records – Information Systems Controls (Page 8): It is recommended that the Company evaluate the recommendations from the Information Systems review and make appropriate changes to strengthen its information systems controls.

Comments on Financial Statement Items – Other Invested Assets (Page 13): It is recommended that the Company ensure that the promissory notes comply with California Insurance Code Sections 1215.5(b)(1), 1196(c), and 1197.

Prior Report of Examination

Accounts and Records – Information Systems Controls (Page 8): It was recommended that the Company evaluate the recommendations from the Information Systems review and make appropriate changes to strengthen its information system controls. Some recommendations have been implemented.

Comments on Financial Statement Items – Cash (Page 13): It was noted that the Company did not comply with California Insurance Code (CIC) Section 1100. The Company has complied.

Comments on Financial Statement Items – Losses and Loss Adjustment Expenses (Page 13): It was recommended the Company comply with Statement of Statutory Accounting Principals No. 65, paragraph 32. The Company has implemented this recommendation.

