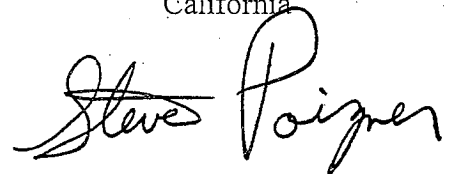


REPORT OF EXAMINATION
OF THE
FAIRMONT SPECIALTY INSURANCE COMPANY
AS OF
DECEMBER 31, 2008

Participating State
and Zone:

California



Insurance Commissioner

FILED 06-17-10

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Los Angeles, California
May 5, 2010

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

Honorable Christina Urias
Secretary, Zone IV-Western
Director of Insurance
Arizona Department of Insurance
Phoenix, Arizona

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

FAIRMONT SPECIALTY INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 250 Commercial Street, Suite 5000, Manchester, New Hampshire 03101. The Company's statutory home office is located at 8880 Rio San Diego Drive, Suite 510, San Diego, California 92108.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2005. This examination covers the period from January 1, 2006 through December 31, 2008. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2008, as deemed necessary under the circumstances.

This examination was conducted in conjunction with the examination of TIG Insurance Company, Fairmont Premier Insurance Company (immediate parent) and affiliates, Fairmont Insurance Company, and TIG Indemnity Company.

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; accounts and records; and sales and advertising.

COMPANY HISTORY

The Company re-domesticated to California, from Delaware, in February 2009.

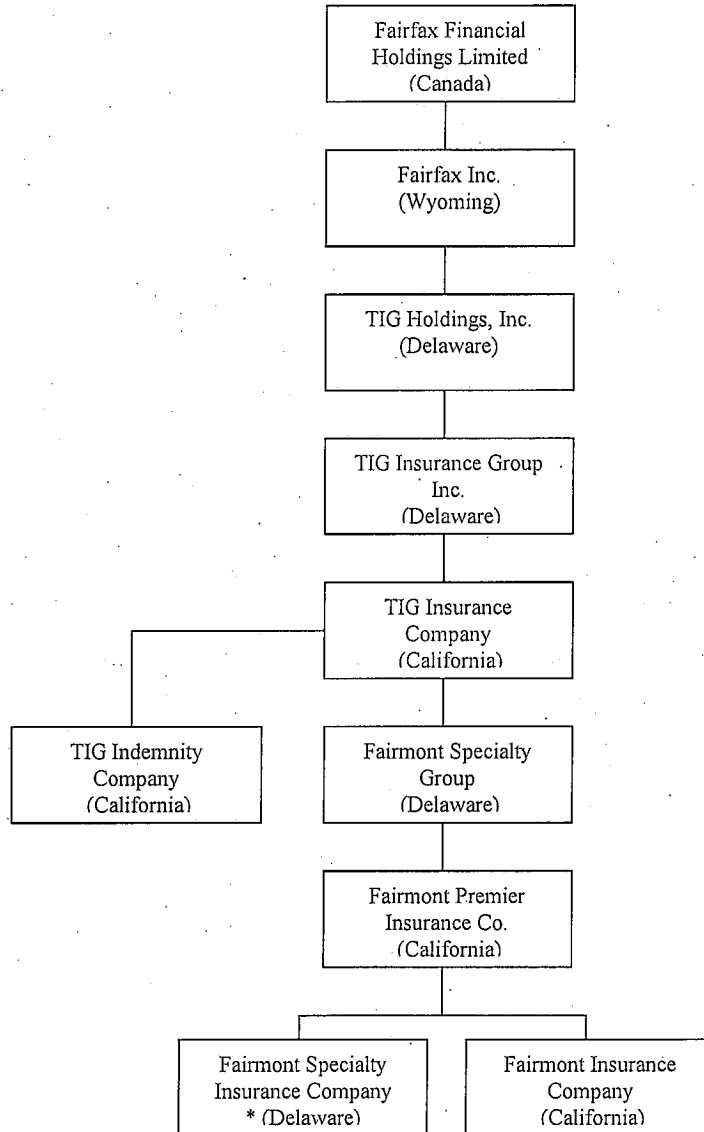
Effective November 20, 2008, Fairmont Specialty Managers Corporation (FSMC), an affiliate of the Company, was dissolved with the Company assuming the remaining assets and liabilities of FSMC.

Effective December 31, 2007, with the approval of the Texas Department of Insurance, the affiliated Fairmont Specialty Lloyds (Texas), which had a 100% quota share reinsurance agreement with the Company, was dissolved with the Company assuming the remaining assets and liabilities of Fairmont Specialty Lloyds.

Effective January 1, 2006, the Fairmont Specialty Group of Companies (including the Company) were placed into run-off and subject business subsequently produced as the "Fairmont Specialty Division" of the affiliated Crum & Forster Holding Corporation's group of companies.

MANAGEMENT AND CONTROL

The following abridged organizational chart, which is limited to the Company's parents along with its subsidiary insurance companies, depicts the Company's relationship within the holding company system:



All ownership is 100%.

(*) During February 2009, the Company was re-domesticated to California.

Management of the Company is vested in a five-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2008 follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
John J. Bator Bedford, New Hampshire	Senior Vice President, Chief Financial Officer RiverStone Resources, LLC
Nicholas C. Bentley Exeter, New Hampshire	President and Chief Executive Officer, RiverStone Resources, LLC
Frank J. DeMaria Windham, New Hampshire	Senior Vice President RiverStone Resources, LLC
Charles G. Ehrlich Amherst, New Hampshire	Senior Vice President, Secretary RiverStone Resources, LLC
John M. Parker Manchester, New Hampshire	Senior Vice President RiverStone Resources, LLC

Principal Officers

<u>Name</u>	<u>Title</u>
Nicholas C. Bentley	President and Chief Executive Officer
John J. Bator	Senior Vice President and Chief Financial Officer
Charles G. Ehrlich*	Senior Vice President, Secretary, and General Counsel
Frank J. DeMaria	Senior Vice President
Richard J. Klimaszewski**	Executive Vice President
Gary J. McGeddy	Executive Vice President
John M. Parker	Senior Vice President

* On February 10, 2009, Charles Ehrlich resigned as General Counsel. However, he remained as Senior Vice President and Secretary. Richard Fabian, also a Senior Vice President, was elected by the Board as General Counsel on February 10, 2009.

** Richard Klimaszewski no longer serves as a principal officer of the Company effective December 15, 2009, and was not replaced.

Management Agreements

Tax allocation agreement: The Company is a party to an agreement with TIG Holdings, Inc., dated January 1, 2000, whereby it files its federal income taxes on a consolidated basis along with 41 other affiliated companies. Each company computes its federal income tax liability on a separate basis and settles with its parent. The California Department of Insurance (CDI) approved the agreement on January 22, 2001. The Company's portion of the federal income taxes paid for 2006, 2007, and 2008 were \$602,792, (\$644,954), and \$5,910,879, respectively.

Investment Agreement: The Company is party to an affiliated agreement with Hamblin Watsa Investment Counsel Ltd. (HWIC) and Fairfax Financial Holdings Limited (Fairfax), effective January 1, 2003. Pursuant to the agreement, HWIC manages the investments of the Company in accordance with specific investment objectives. All fees are paid by the Company to Fairfax, and Fairfax reimburses HWIC for investment management services. The CDI approved the agreement on December 3, 2003. For 2006, 2007, and 2008, fees paid by the Company were \$389,835, \$384,583, and \$755,587, respectively.

Information Technology Service Agreement: The Company was party to a written agreement with the affiliated Fairfax Information Technology Services, Inc. (FITS) effective August 1, 2001 and expiring July 31, 2006. Pursuant to this written agreement, FITS is authorized to manage and provide information technology services to the Company. Although the initial term has expired the agreement has apparently been extended by the mutual agreement of the parties. It is recommended that an amendment, formalizing the extension to the agreement, be submitted to the CDI for approval. For 2006, 2007, and 2008, fees paid by the Company were \$0, \$866,280, and \$507,341, respectively.

Claims Service and Management Agreement: The Company is party to an agreement, effective January 1, 2006, under which claims and management services are provided to the Fairmont Specialty

Group companies, including the Company, on an actual cost reimbursement basis by an affiliate, United States Fire Insurance Company. This claims service and management agreement was approved by the CDI on December 30, 2006. For 2006, 2007, and 2008, fees paid by the Company were \$8,966,970, \$2,582,549, and \$1,578,781, respectively.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2008, the Company was licensed to transact multiple lines of property and casualty insurance in all states and the District of Columbia.

The gross premiums written by the Company during the last five years were as follows:

<u>Year</u>	<u>Premiums</u>
2004	\$198,423,020
2005	201,054,382
2006	74,819,114
2007	5,264,187
2008	(798,081)

The Company began discontinuing its operations in 2006. While transitioning that year the Company ceded business to an affiliate, United States Fire Insurance Company (U.S. Fire), pursuant to a quota share reinsurance agreement. During 2006 the Fairmont Specialty Division business could not immediately be written by Crum & Forster Holdings Corporation (C&F) insurers in some jurisdictions due to rate and form filing requirements and the need for certain C&F insurers to be licensed for additional lines of insurance in some states. For these reasons the business continued to be written by the Fairmont Specialty Group of companies, including the Company, and was then 100% reinsured with U.S. Fire.

Prior to discontinuing its operations the Company wrote workers' compensation, commercial multiple perils, commercial auto liability, other liability- occurrence, and various other lines. The Company

specialized in niche markets that required unique underwriting, claims, and loss control expertise, such as propane and agri-products.

REINSURANCE

Inter-Company Reinsurance Pooling Agreement

The Company, its parent Fairmont Premier Insurance Company (FPIC), and affiliate Fairmont Insurance Company (FIC), entered into an inter-company reinsurance pooling agreement effective January 1, 2004. Under the terms of the agreement FIC and the Company cede 100% of their net business to FPIC. FPIC, after retaining 20% of the pooled business, retrocedes the remaining amount back to the participants in the following percentages: 67% to the Company and 13% to FIC. This agreement was approved by the California Department of Insurance (CDI) on December 23, 2003.

Assumed

The Company assumes business from FPIC pursuant to the aforementioned pooling agreement, and from certain mandatory reinsurance pools.

The Company assumed certain excess liability public entity business from the affiliated North River Insurance Company under a 100% quota share reinsurance agreement effective March 1, 1999.

Ceded

The Company is in runoff and there are no active treaties currently in place as of the date of this examination. The following schedule depicts the most recent active principal reinsurance ceded program:

Lines Reinsured or Type	Name of Reinsurer	Company Retention	Treaty Limits
Casualty Lines:			
First Casualty Excess Liability Workers' Compensation	Swiss Reinsurance America Corp - 80%, nSpire Re Ltd - 20%	\$1.5 million	\$4.5 million excess \$1.5 million
Second Casualty Clash Liability Workers' Compensation	Arch Reinsurance - 25%, Endurance Specialty Ins. Ltd. - 20%, Lloyds Syndicates - 25%, nSpire Re. Ltd. - 10%, Platinum Underwrites Reinsurance - 20%	\$6 million	\$5 million excess \$6 million
Third Casualty Clash Liability Workers' Compensation	Arch Reinsurance - 25%, Endurance Specialty Ins. Ltd. - 20%, Lloyds Syndicates - 25%, Hannover Life Reinsurance - 10%, Platinum Underwrites Reinsurance - 20%	\$11 million	\$9 million excess \$11 million
Specialty Umbrella Quota Share Casualty Loss Occurrence	Swiss Reinsurance America Corp - 80%	\$1 million primary plus 20% of \$5 million Umbrella	80% of \$5 million after the primary
Hawaii Umbrella Quota Share Casualty Risk attach	General Reinsurance Co. 80%	\$1 million primary plus 20% of \$5 million Umbrella	80% of \$5 million after the primary
Property Lines:			
Boiler and Machinery property Quota Share, Risks attached	Hartford Steam Boiler	Zero	100% of \$25 million
Property per risk excess of loss occurrence	General Reinsurance Co. 100%	\$1 million	\$1 million excess \$1 million
Property per risk excess of loss occurrence	General Reinsurance Co. 100%	\$2 million	\$3 million excess \$2 million
Property per risk excess of loss occurrence	General Reinsurance Co. 100%	\$5 million	\$5 million excess \$5 million
Hawaii property per risk excess of loss occurrence	General Reinsurance Co. 100%	\$1 million	\$1 million excess \$1 million
Hawaii property per risk excess of loss occurrence	General Reinsurance Co. 100%	\$2 million	\$3 million excess \$2 million
Property Catastrophe per risk excess of loss	General Reinsurance Co. 100%	\$2 million and 5% of \$18 million excess	95% of \$18 million excess \$2 million

Effective January 1, 2006, the Company entered into a "Transition Period Reinsurance and Services Agreement" in which a 100% quota-share of the Fairmont Specialty Group's pooled business was ceded to an affiliate, United States Fire Insurance Company (U.S. Fire). The subject business was

defined as Fairmont Specialty Group policies with effective dates of January 1, 2006 or later. Unearned premiums in-force at December 31, 2005 were not subject to this quota share cession. As part of this agreement the reinsurer agreed to perform underwriting, administration, financial, and claims services with respect to the subject business. This agreement was approved by the California Department of Insurance (CDI) on December 23, 2005.

As of December 31, 2008, reinsurance recoverable for all ceded reinsurance totaled \$153.8 million or 113% of surplus as regards policyholders. The affiliated ceded reinsurance recoverables of \$71.9 million and \$16.2 million were from FPIC and U.S. Fire, respectively.

Effective February 1, 2007, the Delaware Department of Insurance (DDOI) approved the Company's commutation of both a Loss Portfolio Transfer agreement and a quota share treaty (both originally effective January 1, 2004, and previously accounted for as prospective reinsurance) with an affiliate, nSpire Re Ltd. (nSpire). The Company received proceeds of \$41.5 million against cessions of \$34.9 million for the commutations of these two treaties.

Effective September 30, 2001, the Company entered into a loss purchase agreement with an affiliate, CRC (Bermuda) Reinsurance Limited (CRC), whereby the Company transferred \$60 million in cash and investments to CRC in exchange for CRC's purchase of \$60 million of the Company's net loss and loss adjustment expense reserves, representing 100% of the Company's exposure to certain "artisan contractors" claims incurred. This transaction, a sale of reserves rather than reinsurance, was approved by the DDOI. Fairfax Financial Holdings Limited (Fairfax) had guaranteed the performance of CRC with respect to the payment of these claims. CRC re-sold these reserves to a Company affiliate, nSpire. Effective December 31, 2008, the Company remained contingently liable for \$25.6 million of estimated unpaid claims obligations related to these reserves.

Effective December 31, 2001, the Company entered into a loss purchase agreement with an affiliate, CRC (Bermuda) Reinsurance Limited (CRC), whereby the Company transferred \$35.6 million in cash and other assets to CRC in exchange for CRC's purchase of \$35.6 million of the Company's net loss

and loss adjustment expense reserves, representing 100% of the Company's exposure to certain "Assumed Re" claims incurred. This transaction, a sale of reserves rather than reinsurance, was approved by the DDOI. Fairfax has guaranteed the performance of CRC with respect to the payment of these claims. CRC re-sold these reserves to a Company affiliate, nSpire. Effective December 31, 2008, the Company remained contingently liable for \$21 million of estimated unpaid claims obligations related to these reserves.

Subsequently, effective December 31, 2009, with the approval of the CDI, the Company purchased back from nSpire the two aforementioned sales of reserves for \$46 million.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2008

Underwriting and Investment Exhibit for the Year Ended December 31, 2008

Reconciliation of Surplus as Regards Policyholders
from December 31, 2005 through December 31, 2008

Statement of Financial Condition
as of December 31, 2008

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Note</u>
Bonds	\$110,951,190	\$	\$110,951,190	
Stocks:				
Common stocks	16,771,081		16,771,081	
Cash and short-term investments	81,062,751		81,062,751	
Premiums and considerations:				
Premiums and agents' balances in course of collection	622,566	622,566		
Amounts recoverable from reinsurers	3,240,667		3,240,667	
Funds held by or deposited with reinsured companies	884,617		884,617	
Net deferred tax asset	4,579,196	4,341,393	237,803	
Investment income due and accrued	1,770,291		1,770,291	
Receivables from parent, subsidiaries and affiliates	2,655,801	97,358	2,558,443	
Aggregate write-ins for other than invested assets	<u>5,122,347</u>	<u>4,558,436</u>	<u>563,911</u>	
Total assets	<u>\$ 227,660,507</u>	<u>\$ 9,619,753</u>	<u>\$ 218,040,754</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 43,552,686	(1)
Loss adjustment expenses			20,827,161	(1)
Commissions payable, contingent commissions			137,288	
Other expenses			2,363,847	
Current federal and foreign income taxes			1,303,195	
Ceded reinsurance premiums payable			(372,915)	
Funds held by company under reinsurance treaties			726,205	
Amounts withheld or retained by company for others			472,793	
Provision for reinsurance			3,164,245	
Payable to parent, subsidiaries and affiliates			233,173	
Payable for securities			<u>9,999,204</u>	
Total liabilities			82,406,882	
Common capital stock		\$ 3,100,000		
Gross paid-in and contributed surplus		92,709,892		
Unassigned funds (surplus)		<u>39,823,980</u>		
Surplus as regards policyholders			<u>135,633,872</u>	
Total liabilities, surplus and other funds			<u>\$ 218,040,754</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2008

Statement of Income

Underwriting Income

Premiums earned		\$ (683,032)
Deductions:		
Losses incurred	\$ (4,019,825)	
Loss adjustment expense incurred	4,365,988	
Other underwriting expenses incurred	<u>4,148,832</u>	
Total underwriting deductions		<u>4,494,995</u>
Net underwriting loss		(5,178,027)

Investment Income

Net investment income earned	\$ 6,508,737	
Net realized capital gains	<u>9,080,154</u>	
Net investment gain		15,588,891

Other Income

Net loss from agents' balances charged off	(48,723)	
Aggregate write-ins for miscellaneous income	<u>\$ (108,001)</u>	
Total other income		<u>(156,724)</u>
Net income before federal income taxes		10,254,140
Federal income taxes incurred		<u>(4,601,946)</u>
Net income		<u>\$ 14,856,086</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2007		\$ 125,151,539
Net income	\$ 14,856,086	
Change in net unrealized capital loss	(3,382,443)	
Change in net unrealized foreign exchange capital losses	(2,289,307)	
Change in net deferred income tax	(2,142,570)	
Change in nonadmitted assets	2,258,967	
Change in provision for reinsurance	<u>1,181,600</u>	
Change in surplus as regards policyholders		<u>10,482,333</u>
Surplus as regards policyholders, December 31, 2008		<u>\$ 135,633,872</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2005 through December 31, 2008

Surplus as regards policyholders, December 31, 2005, per Examination		\$ 90,594,282		
	<table border="0" style="margin-left: auto; margin-right: auto;"> <tr> <td style="text-align: center; border-bottom: 1px solid black;">Gain in Surplus</td> <td style="text-align: center; border-bottom: 1px solid black;">Loss in Surplus</td> </tr> </table>	Gain in Surplus	Loss in Surplus	
Gain in Surplus	Loss in Surplus			
Net income	\$ 41,208,070	\$		
Net unrealized capital gains	1,309,393			
Change in net unrealized foreign exchange capital loss		2,060,660		
Change in net deferred income tax		9,023,799		
Change in non-admitted assets	17,988,762			
Change in provision for reinsurance		1,367,529		
Cumulative effect of changes in accounting principles		3,014,647		
 Totals	 <u>\$ 60,506,225</u>	 <u>\$ 15,466,635</u>		
 Net increase in surplus as regards policyholders		 45,039,590		
 Surplus as regards policyholders, December 31, 2008, per Examination		 <u>\$ 135,633,872</u>		

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The Company was directed by the California Department of Insurance (CDI), under CIC Section 733, to retain the actuarial firm of AMI Risk Consultants, Inc. (AMI) for the purpose of assisting this examination in determining the reasonableness of the Company's loss and loss adjustment expense reserves. Based on the analysis by AMI and the review of their work by a Casualty Actuary from the CDI, the Company's December 31, 2008 reserves for losses and loss adjustment expenses were deemed to be reasonably stated.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control - Information Technology Service Agreement (Page 5): The Company was party to a written agreement with the affiliated Fairfax Information Technology Services, Inc. (FITS). This initial agreement expired on July 31, 2006. However, the agreement has apparently been extended by the mutual agreement of the parties. It is recommended that an amendment, formalizing the extension to the agreement, be submitted to the California Department of Insurance for approval in accordance with California Insurance Code Section 1215.4.

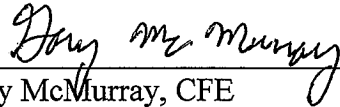
Previous Report of Examination

Aggregate Write-Ins for Other Than Invested Assets (Page 27): It was recommended that the Company investigate the contents of the A&H Loss Funding and TRG Loss Draft Payable accounts and comply with Statement of Statutory Accounting Principles No. 6, paragraph 9.a regarding the aging of accounts. The Company is currently in compliance.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

A handwritten signature in cursive script that reads "Gary McMurray". The signature is written in black ink and is positioned above a horizontal line.

Gary McMurray, CFE
Examiner-In-Charge
Department of Insurance
State of California