

REPORT OF EXAMINATION
OF THE
WESTERN UNITED INSURANCE COMPANY
AS OF
DECEMBER 31, 2004

Participating State
and Zone:

California

Filed January 12, 2006

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Los Angeles, California
October 28, 2005

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

Honorable John Morrison
Secretary, Zone IV-Western
Commissioner of Insurance and Securities
Montana Department of Insurance
Helena, Montana

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of the

WESTERN UNITED INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 3349 Michelson Drive, Suite 100, Irvine, California 92612.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2004. 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, 2004, as deemed necessary under the circumstances.

This examination was conducted concurrently with the examination of the Company's parent, California State Automobile Association Inter-Insurance Bureau.

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; business in force by states; loss experience; accounts and records; and sales and advertising.

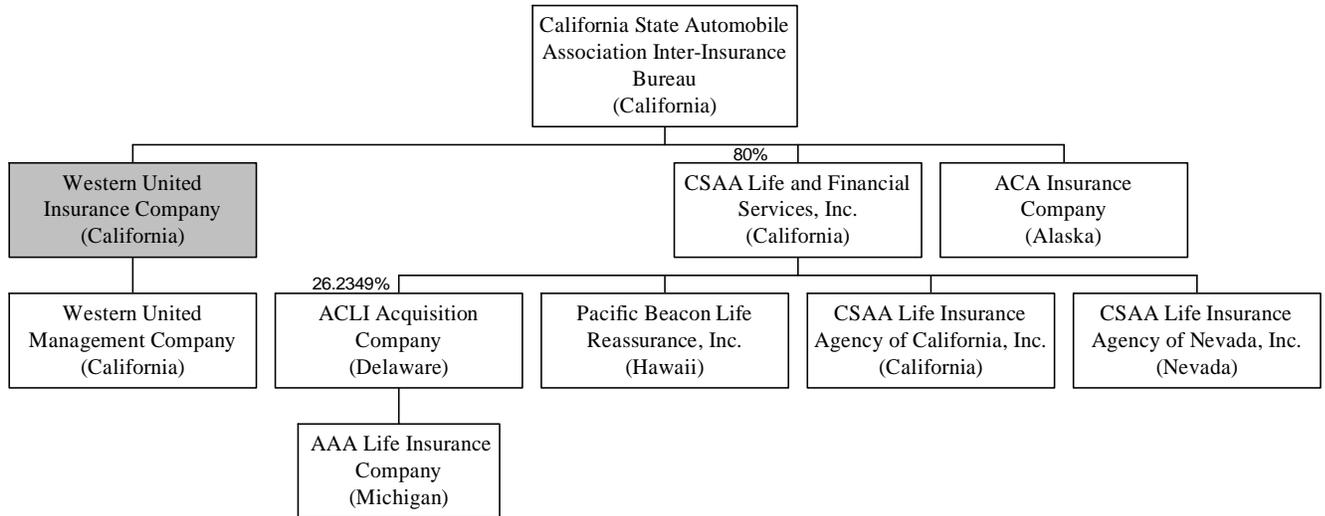
COMPANY HISTORY

The Company was incorporated under the laws of California on June 23, 1987 and commenced business in January 1990. There are 500,000 authorized common stock shares, of which 60,000 were outstanding at year-end 2004.

In June 1999, the Company was acquired by and became a wholly-owned subsidiary of the California State Automobile Association Inter-insurance Bureau (CSAA). In January 2001, the Company entered into an inter-company pooling agreement with CSAA where all premiums, losses and expenses are distributed proportionally among the two pool members. The pooling participation is as follows: 98.87% for CSAA and 1.13% for the Company.

MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of the California State Automobile Association Inter-Insurance Bureau (CSAA). The following organizational chart depicts the Company’s relationship within the holding company system. Each company is 100% owned except as otherwise indicated:



Management of the Company is vested in a six-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2004 follows:

Directors

Name and Residence

Principal Business Affiliation

Eileen F. Braunreiter
Menlo Park, California

Vice President, General Counsel and Secretary
California State Automobile Association and Inter-Insurance Bureau

Paula F. Downey
Mill Valley, California

Senior Vice President and Chief Financial Officer
California State Automobile Association and Inter-Insurance Bureau

Directors (cont)

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Lawrence Pentis San Rafael, California	Senior Vice President, Insurance Operations California State Automobile Association and Inter-Insurance Bureau
James R. Pouliot Alamo, California	President and Chief Executive Officer California State Automobile Association and Inter-Insurance Bureau
James B. Schallert Laguna Niguel, California	President and Chief Executive Officer Western United Insurance Company
Robert D. Wilkes San Francisco, California	Director California State Automobile Association and Inter-Insurance Bureau

Principal Officers

<u>Name</u>	<u>Title</u>
James B. Schallert	President
William Albert Smith	Treasurer
Eileen F. Braunreiter	Secretary
Gerald S. Dias	Assistant Secretary

Management Agreements

Services and Investment Management Agreement: The Company and its parent, California State Automobile Association Inter-Insurance Bureau (CSAA) were parties to a Services and Investment Management Agreement until December 31, 2003. Under the terms of this agreement, CSAA provided the Company with investment management, administrative and operational services on an actual cost reimbursement basis. The Company paid fees of \$84,338 and \$101,532 respectively, to CSAA under the terms of this agreement.

On January 1, 2004, the Company terminated this agreement, and replaced it with the Restated Intercompany Services Agreement. Parties to the restated agreement now include CSAA, the Company and several subsidiaries. In addition, the restated agreement allows the subsidiaries, including the Company, to purchase reinsurance whereas the previous agreement allowed CSAA to make that determination. For 2004, the Company paid CSAA \$108,914 under the terms of this agreement. The Restated Intercompany Services Agreement was approved by the California Department of Insurance (CDI) on August 1, 2005.

Tax Allocation Agreement: The Company and its affiliates are part of a consolidated federal income tax agreement with CSAA. The agreement is administered by CSAA, and allocation of taxes is based upon separate tax return calculations with all settlement of inter-company tax balances made within 90 days after the filing. On January 1, 2004, the Company terminated the Tax Allocation Agreement, and replaced it with a Restated Tax Allocation Agreement. The restated agreement calls for tax settlements to be made within 45 days after the filing. In addition, the Restated Tax Allocation Agreement now defines CSAA's and its subsidiaries' deferred income tax policy. The Restated Tax Allocation Agreement was approved by the CDI on August 1, 2005.

Policy and Claims Administration Services Agreement: The Company has a Policy and Claims Administration Services Agreement with its affiliate, ACA Insurance Company (ACA). Under the terms of the agreement, the Company provides ACA with various policy and claims administration services. ACA reimburses the Company \$50 for each policy issued or renewed, and \$400 for each claim opened with adjustments made annually to fully reimburse the Company for the actual cost in rendering these services. Fees paid under the terms of this agreement were: \$1,962,285 in 2002; \$827,130 in 2003; and \$1,760,830 in 2004. The agreement was approved by the CDI on January 15, 2002.

Claims Administration Services Agreement: On March 1, 2004, the Company entered into a Claims Administration Services Agreement with CSAA. Under the terms of the agreement, CSAA provides claims handling services for the Company's homeowner and homeowner aligned policies, such as watercraft, dwelling fire and mobile home. The Company reimburses CSAA \$400 for each claim opened. Compensation is based on the actual cost of the services. On March 10, 2004, the Claims

Administration Services Agreement was terminated, and replaced by the Restated Claims Administration Services Agreement. The terms of the restated agreement are essentially the same as the original document except for the addition of the monthly settlement of fees and cost reimbursements. For 2004, the Company paid CSAA \$21,600 for the services provided under the terms of this Restated Agreement. The agreement was approved by the CDI on March 22, 2004.

Conflict of Interest

The Company had procedures in place for the completion and review of conflict of interest statements annually for all officers, but not for directors. The Company stated that the directors are all officers of their parent, CSAA and as such, the CSAA conflict of interest statements were sufficient. It is recommended that the Company implement procedures to annually obtain and review completed conflict of interest statements for all directors. The statements should specifically disclose any conflict of interest with the Company and not CSAA.

CORPORATE RECORDS

California Insurance Code (CIC) Section 735 states that the Company must inform the board members of the receipt of the examination report. The board should be informed of the report both in the form first formally prepared by the examiners and in the form as finally settled and officially filed by the Commissioner. The board must also enter that fact in the board minutes. A review of the board minutes disclosed that neither the first formally prepared draft by the examiners nor the officially filed report was presented to the board. It is recommended that the Company implement procedures to ensure future compliance with CIC Section 735.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2004, the Company was licensed to transact multiple lines of property and casualty insurance in the following 19 states and the District of Columbia:

Alaska	Montana	Utah
Arizona	Nevada	Virginia
California	Ohio	Washington
Colorado	Oregon	West Virginia
Delaware	Pennsylvania	Wyoming
Idaho	South Carolina	
Maryland	Texas	

In 2005, the Company obtained a license in Indiana and has license applications pending in Connecticut, Kansas and Kentucky. The Company writes non-standard private passenger auto in California, multi-tiered private passenger auto in Nevada, Arizona, Oregon and Utah, and homeowners in Utah. The Company's primary product is a combined automobile policy, offering full coverage protection for multiple vehicles. The Company targets mature drivers with minor infractions and improving driving records.

Business is currently produced through a combination of approximately 2,300 independent brokers and 570 sales representatives. Approximately 55% of the Company's business is written through independent brokers and 45% through sales representatives.

In 2004, the Company wrote \$149.1 million of direct premiums. Of the direct premiums written, 66% or \$99 million was written in California, 21% or \$31.5 million in Nevada, and 6% or \$9.3 million in Utah.

GROWTH OF COMPANY

Although the net premiums written did not experience substantial growth during the examination period, direct premiums written increased from \$53.2 million to \$149.1 million or 180.3%. Net premiums written were reduced as a result of the Reinsurance Pooling Agreement with its parent. In 2005, the Company's direct premiums written are projected to be \$220 million, or a 47.6% increase from the prior year. Also, starting in August 2005 the Company began writing homeowners in Arizona.

The significant increase in direct premiums written is primarily a result of (1) continued strategy of its parent's out of state expansion with additional licensing in 13 states during the examination period, (2) the introduction of an annual policy which doubled the premiums written by independent agents in California and Utah, (3) a significant increase in new business written by California independent brokers in the first half of 2003, and (4) it began writing all new business for its parent in Nevada in 2003.

REINSURANCE

Reinsurance Pooling Agreement

Effective January 1, 2001, the Company and California State Automobile Association Inter-Insurance Bureau (CSAA), entered into an intercompany Reinsurance Pooling Agreement (Agreement). The percentage participation in the pooled results is 98.87% and 1.13% for CSAA and the Company, respectively. All business written by both companies is subject to the Agreement. The CDI approved this agreement on June 15, 2001 pursuant to California Insurance Code Section 1011(c).

Assumed

Other than the Reinsurance Pooling Agreement, the Company did not assume any reinsurance during the period under examination.

Ceded

Other than the Reinsurance Pooling Agreement, the Company did not cede any reinsurance during the period under examination.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2004

Underwriting and Investment Exhibit for the Year Ended December 31, 2004

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2004

Statement of Financial Condition
as of December 31, 2004

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 65,489,938	\$	\$ 65,489,938	
Stocks:				
Common stocks	142,010		142,010	
Cash and short-term investments	1,970,688		1,970,688	
Investment income due and accrued	734,727		734,727	
Agents' balances or uncollected premiums:				
Premiums and agents' balances in course of collection	8,126,293	889,904	7,236,389	
Reinsurance:				
Amounts recoverable from reinsurers	(22,457)		(22,457)	
Net deferred tax asset	2,165,797	373,909	1,791,888	
Electronic data processing equipment	2,580,888	1,399,166	1,181,722	
Furniture and equipment	367,039	367,039	0	
Receivable from parent, subsidiaries and affiliates	(29,589)		(29,589)	
Other assets nonadmitted	1,613,939	1,613,939	0	
Aggregate write-ins for other than invested assets	<u>1,686,441</u>	<u> </u>	<u>1,686,441</u>	
Total assets	<u>\$ 84,825,714</u>	<u>\$ 4,643,957</u>	<u>\$ 80,181,757</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 7,254,651	(1)
Loss adjustment expenses			1,900,112	(1)
Commissions payable, contingent commissions and other similar charges			17,744	
Other expenses			2,929,250	
Taxes, licenses and fees			59,706	
Current federal and foreign income taxes			3,594,434	
Unearned premiums			11,965,462	
Advance premiums			1,329,497	
Ceded reinsurance premiums payable			505,245	
Amounts withheld or retained by company for account of others			4,052,284	
Provision for reinsurance			831,258	
Payable to parent, subsidiaries and affiliates			<u>(387,165)</u>	
Total liabilities			34,052,478	
Common capital stock		\$ 3,000,000		
Gross paid-in and contributed surplus		25,528,693		
Unassigned funds (surplus)		<u>17,600,586</u>		
Surplus as regards policyholders			<u>46,129,279</u>	
Total liabilities, surplus and other funds			<u>\$ 80,181,757</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2004

Statement of Income

Underwriting Income

Premiums earned		\$ 23,360,772
Deductions:		
Losses incurred	\$ 12,339,163	
Loss expense incurred	3,359,761	
Other underwriting expenses incurred	<u>5,755,227</u>	
Total underwriting deductions		<u>21,454,151</u>
Net underwriting gain		1,906,621

Investment Income

Net investment income earned	\$ 2,709,899	
Net realized capital gains	<u>204,431</u>	
Net investment gain		2,914,330

Other Income

Net loss from agents' balances charged off	\$ (1,558,565)	
Finance and service charges not included in premiums	7,426,818	
Aggregate write-ins for miscellaneous income	<u>(18,473)</u>	
Total other income		<u>3,707,420</u>
Net income before federal income taxes		10,670,731
Federal income taxes incurred		<u>3,237,622</u>
Net income		<u>\$ 7,433,109</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2003		\$ 39,390,730
Net income	\$ 7,433,109	
Change in net unrealized capital gains	715	
Change in net deferred income tax	(91,630)	
Change in nonadmitted assets	(784,961)	
Change in provision for reinsurance	<u>181,316</u>	
Change in surplus as regards policyholders		<u>6,738,549</u>
Surplus as regards policyholders, December 31, 2004		<u>\$ 46,129,279</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2004

Surplus as regards policyholders, December 31, 2001, per Examination			\$ 26,817,397
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 21,993,419	\$	
Change in net unrealized capital gain	22,084		
Change in net deferred income tax		163,223	
Change in nonadmitted assets		1,709,139	
Change in provision for reinsurance	_____	<u>831,259</u>	
Totals	<u>\$ 22,015,503</u>	<u>\$ 2,703,621</u>	
Net increase in surplus as regards policyholders			<u>19,311,882</u>
Surplus as regards policyholders, December 31, 2004, per Examination			<u>\$ 46,129,279</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The California Department of Insurance (CDI), pursuant to California Insurance Code (CIC) Section 733(g), retained an independent actuary for the purpose of providing a full actuarial evaluation of the Company's loss and loss adjustment expense reserves as of December 31, 2004. Based on the analysis by the independent actuary and the review of their work by a Casualty Actuary from the CDI, the Company's December 31, 2004 reserves for losses and loss adjustment expenses were determined to be reasonably stated and have been accepted for purposes of this examination.

Claim Review

An analysis of the detail claims listing as of December 31, 2004 initially disclosed various inconsistencies in which the claim numbers were not assigned as claims were reported. Further investigation and a review of a random sample of these claims revealed discrepancies with the report date contained in the detail claim download as compared to the information contained in the activity notes on the Company's claim system. It appears that these claims all had coverage issues and the report date entered in the system was the date the coverage issue was resolved and reserves set and not the date the claim was initially reported. The Company stated that this was a procedural error and their normal procedure is to assign the report date when the loss report is taken. The procedural error occurred when the claim was initially entered into the claim system without a report date, which was subsequently filled in once the coverage issue was resolved and reserves set.

It is recommended that the Company strengthen its controls to prevent procedural errors. It is also recommended that the Company continue to review and monitor its historical data maintained on its claim system and implement corrective action should the Company find material discrepancies. The Company agreed and is working on a system enhancement to require the report date as a mandatory field.

In addition, it appears that the majority of claims with coverage issues involve non-listed drivers where the Company's procedure is to not set reserves until the coverage issues are resolved. The

Company stated that this was due to the uncertainty of the outcome of the investigation. The investigation, however, sometimes could take up to a month, during which time there were no reserves established. In most cases, non-listed drivers are usually covered with the exception of excluded drivers, stolen vehicles and misrepresentation. It is recommended that the Company change its procedures to set reserves from inception for claims involving non-listed drivers. The Company agreed and has changed its procedures to comply.

Excess of Statutory Reserve

The Company is not in compliance with California Insurance Code (CIC) Section 11558. Excess of statutory reserves over statement reserves were recalculated based on the Company's reserve estimates. Based on the results, a statutory reserve of \$13,000 was required for the other liability line. For liability other than automobile liability, the Company reported a loss ratio of 43% for the 2004 accident year. CIC Section 11558 states, in part, that the minimum reserve requirement prescribed for liability other than automobile liability must be 60% of earned premiums. It is recommended that the Company establish a Schedule P Penalty reserve for the other liability line of business as required by CIC Section 11558.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Conflict of Interest (Page 6): It is recommended that the Company implement procedures to annually obtain and review completed conflict of interest statements for all directors. This was also recommended in the prior examination.

Corporate Records (Page 6): It is recommended that the Company implement procedures to ensure compliance with California Insurance Code (CIC) Section 735.

Comments on Financial Statement Items – Losses and Loss Adjustment Expenses (Page 13):

- (1) It is recommended that the Company strengthen its controls to prevent procedural errors. The Company agreed and is working on a system enhancement to require the report date as a mandatory field.
- (2) It is recommended that the Company continue to review and monitor its historical data maintained on its claim system and implement corrective action should the Company find material discrepancies.
- (3) It is recommended that the Company change its procedures to set reserves from inception for claims involving non-listed drivers. The Company agreed and has changed its procedures to comply.

Comments on Financial Statement Items - Excess of Statutory Reserve (Page 14): It is recommended that the Company establish a Schedule P Penalty reserve for the other liability line of business as required by CIC Section 11558.

Previous Report of Examination

Management and Control - Management Agreements (Page 4): It was recommended that the Company submit the Services and Investment Management agreement to the California Department of Insurance (CDI) for approval pursuant to CIC Section 1215.5(b). On January 1, 2004, the Company terminated this agreement and replaced it with the Restated Intercompany Services Agreement. This agreement was approved by the CDI on August 1, 2005.

Management and Control – Management Agreements (Page 4): It was recommended that the Company submit its amended tax allocation agreement to the CDI for approval pursuant to CIC Section 1215.5(b). On January 1, 2004, the Company terminated this agreement and replaced it with the Restated Tax Allocation Agreement. This agreement was approved by the CDI on August 1, 2005.

Management and Control – Conflict of Interest (Page 5): It was recommended that the Company implement procedures to annually obtain and review completed conflict of interest statements from all of its officers, directors and key employees. The Company has not fully complied with the

recommendation. The Company currently does not have procedures in place to annually obtain and review completed conflict of interest statements for all directors.

Reinsurance – Reinsurance Pooling Agreement (Page 7): It was recommended that the Company submit a copy of the fully executed Reinsurance Pooling Agreement to the CDI after it was approved on June 15, 2001 pursuant to CIC Section 1215.5(b). The Company complied with this recommendation.

ACKNOWLEDGEMENT

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

Respectfully submitted,

_____/S/_____
Duane Armstrong, CFE
Examiner-In-Charge
Senior Insurance Examiner (Supervisor)
Department of Insurance
State of California