# REPORT OF EXAMINATION
# OF THE
# ASSOCIATED INDEMNITY CORPORATION
# AS OF
# DECEMBER 31, 2010

Filed: June 8, 2012

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San Francisco, California
May 16, 2012

Honorable Dave Jones
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

ASSOCIATED INDEMNITY CORPORATION

(hereinafter also referred to as the Corporation) at its home office located at 777 San Marin Drive, Novato, California 94998.

## SCOPE OF EXAMINATION

This is a multi-state examination of the Corporation. The previous multi-state examination of the Corporation was made as of December 31, 2007. This examination covers the period from January 1, 2008 through December 31, 2010. The examination was conducted in accordance with the National Association of Insurance Commissioners' Financial Condition Examiners' Handbook. The Handbook requires the planning and performance of the examination to evaluate the Corporation's financial condition, to identify prospective risks, and to obtain information about the Corporation, including corporate governance, identification and assessment of inherent risks, and the evaluation of the system controls and procedures used to mitigate those risks. The examination also included an assessment of the principles used and the significant estimates made by management, as well as an evaluation of the overall financial statement presentation, and management's compliance with Statutory Accounting

Principles and Annual Statement instructions. All accounts and activities of the Corporation were considered in accordance with the risk-focused examination process.

The examination was a coordinated examination and was conducted concurrently with other insurance entities in the holding company group and included participation from the following States: Illinois, Louisiana, Missouri, New Jersey, and Ohio.

In addition to those items specifically commented upon in this report, other phases of the Corporation's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; pensions, stock ownership and insurance plans; growth of company; statutory deposits; and sales and advertising.

## SUBSEQUENT EVENTS

The Corporation's parent, Fireman's Fund Insurance Company (FFIC) and the pooled subsidiaries of FFIC, entered into a Second Amended and Restated Intercompany Reinsurance Agreement (Amended Pooling Agreement), effective January 1, 2012. Under the Amended Pooling Agreement, each of the pooled subsidiaries will continue to cede 100% of its insurance business to FFIC; however, the retroceded shares for all pooled subsidiaries is reduced to zero and FFIC's share is increased to 100%. The new Amended Pooling Agreement was approved by the domiciliary Department of Insurance of each participating company. FFIC provided its 30-day prior notice filing with the California Insurance Commissioner (Commissioner) in accordance with California Insurance Code (CIC) section 1215.5 (b)(3). On February 23, 2012, the California Department of Insurance (CDI) notified the Company that the CDI "does not disapprove" the agreement.

Effective January 1, 2012, FFIC and the pooled subsidiaries entered into an Intercompany Service Agreement (Service Agreement) pursuant to which FFIC, is authorized to provide all services necessary to operate the pooled subsidiaries

insurance business. FFIC provided its 30-day prior notice filing with the Commissioner in accordance with CIC section 1215.5(b)(4), and the agreement was not disapproved by the CDI in February, 2012.

## COMPANY HISTORY

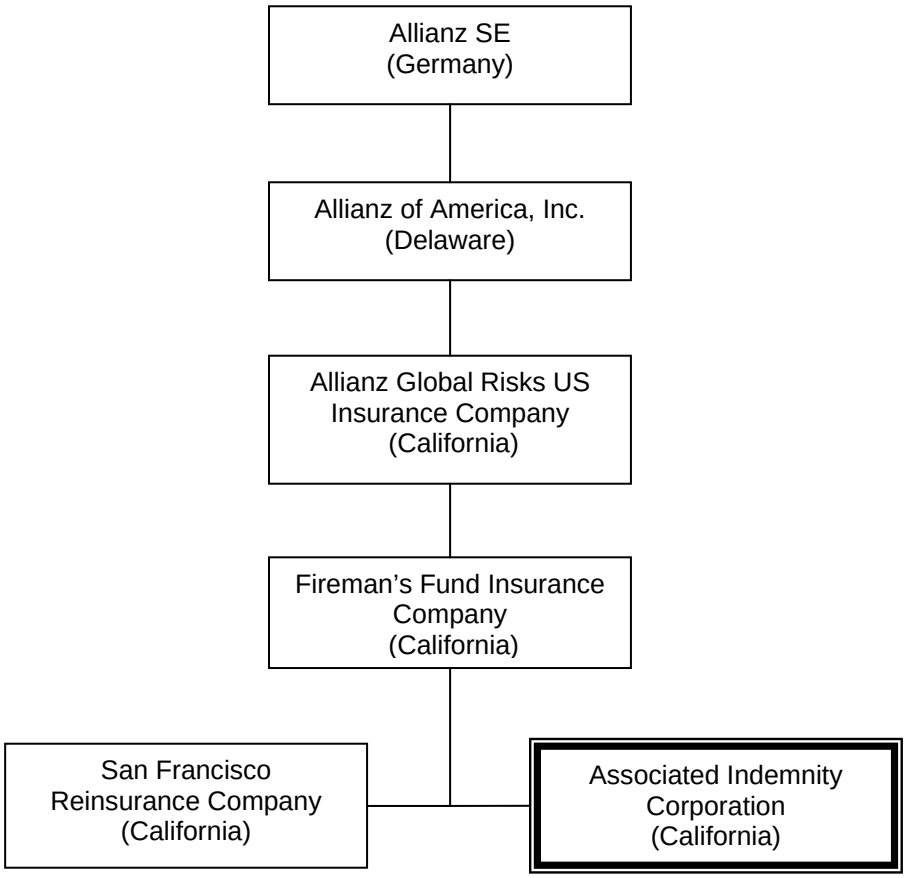
In order to streamline the organizational structure of Fireman's Fund Insurance Company (FFIC), effective November 1, 2009, the Corporation's former parent, American Automobile Insurance Company, a Missouri company, distributed its 100% ownership interest in the Corporation to FFIC, in the form of an extraordinary dividend in the amount of $81,506,676.

The Corporation is authorized to issue 500,000 shares of common stock with a par value of $40 per share. As of December 31, 2010, there were 87,500 shares outstanding. All outstanding shares of the Corporation's stock are now directly owned by FFIC, a subsidiary of Allianz Global Risks US Insurance Company, which is wholly owned by Allianz of America, Inc. The ultimate parent of the Allianz Group is Allianz SE. Allianz SE operates on a worldwide basis through branch offices, subsidiaries, and affiliated companies.

On December 14, 2010, the Corporation paid an ordinary dividend to FFIC in the amount of $8 million.

## MANAGEMENT AND CONTROL

The Corporation is a member of an insurance holding company system. Allianz SE, formerly Allianz Aktiengesellschaft, is a European Company incorporated in the Federal Republic of Germany and the European Union. Allianz SE is the ultimate controlling entity. The following chart depicts the interrelationship of the Corporation and its California subsidiaries within the holding company system (all ownership is 100%):




Members of the board of directors, who are elected annually, oversee management of the business and affairs of the Corporation. Following are members of the board and principal officers of the Corporation serving at December 31, 2010:

## Directors

| Name and Residence | Principal Business Affiliation |
|---|---|
| Bruce F. Friedberg [(a)]<br>Novato, California | Senior Vice President<br>Fireman's Fund Insurance Company |
| Jeffery F. Johnson<br>San Anselmo, California | Vice President and Controller<br>Fireman's Fund Insurance Company |
| Michael E. LaRocco [(b)]<br>Sonoma, California | Chairman, President and Chief Executive Officer<br>Fireman's Fund Insurance Company |
| Sally B. Narey<br>Larkspur, California | Senior Vice President, General Counsel, and Secretary<br>Fireman's Fund Insurance Company |
| Jill E. Paterson [(c)]<br>Tiburon, California | Executive Vice President, Chief Financial Officer, and Treasurer<br>Fireman's Fund Insurance Company |
| David M. Zona<br>Novato, California | Senior Vice President<br>Fireman's Fund Insurance Company |

## Principal Officers

| Name | Title |
|---|---|
| Michael E. LaRocco [(b)] | Chairman, President, and Chief Executive Officer |
| Jill E. Paterson [(c)] | Executive Vice President, Chief Financial Officer, and Treasurer |
| Sally B. Narey | Senior Vice President, General Counsel, and Secretary |
| Jeffery F. Johnson | Vice President and Controller |

The following changes in management occurred subsequent to the examination date:

[(a)] Effective March 9, 2012, Paul M. Stachura was elected to the Board, replacing Bruce F. Friedberg.

[(b)] Effective July 6, 2011, Lori D. Fouché, formerly President of Commercial Insurance replaced Michael LaRocco as the Corporation's President and CEO.

(c) Effective September 19, 2011, Kevin E. Walker became the Corporation's Senior Vice President, Chief Financial Officer, Treasurer and Director, replacing Jill E. Paterson.

Management Agreements

Tax Reimbursement Agreement: Effective December 17, 1999, the Corporation entered into a Tax Reimbursement Agreement for the purpose of clarifying an agreement that was in effect since 1991. The Tax Reimbursement Agreement was between Allianz of America, Inc. (AZOA) and its affiliates, including the Corporation. Under the terms of this agreement, the tax liability of the Corporation would be computed as if it filed a separate stand-alone return. AZOA is the party primarily responsible for filing and making all tax payments on behalf of the Corporation.

Investment Management Services Agreement: Effective January 1, 1981, the Corporation and several of its affiliates entered into an investment management services agreement with Fireman's Fund Insurance Company (FFIC). This agreement has been amended on numerous occasions to add or remove affiliates as a party to the agreement. Under the provisions of the agreement, FFIC agrees to supply investment management services to the other parties. In consideration, the other parties agree to share the costs of furnishing the above investment management services.

Related Party Transactions

Allianz SE issued a written commitment for the nominal amount of the Corporation's investment in 10% fixed-to-floating rate junior subordinated Notes of The Hartford Financial Services Group, Inc. ("Issuer"). If at any time during the fixed rate period of the Notes (ending October 15, 2018), the rating attributed by any one of Standard and Poor's (S&P) or Moody's falls below investment grade, or the Issuer is subject to an event of default with its obligations under the Notes, the Corporation has the right to sell the Notes to Allianz SE. The consideration to be delivered by Allianz SE will be equal to

the nominal amount of the Notes. At the option of Allianz SE, such consideration will either be paid in cash or Senior Notes of Allianz SE or one of its financial subsidiaries. At December 31, 2010, the fair value of this investment as reported on Schedule D was $4,681,200.

## TERRITORY AND PLAN OF OPERATION

The Corporation is licensed to transact insurance in all states of the United States and in the District of Columbia. Under the terms of the intercompany reinsurance agreement, most of the underwriting transactions of the Corporation are pooled, reapportioned and then distributed to the eight members of the pool, as discussed under the caption Reinsurance.

The Corporation conducts its operations jointly with other subsidiaries of Fireman's Fund Insurance Company (FFIC) through its home office in Novato, California. As of December 31, 2010, the underwriting operations of the FFIC group of insurance companies (FFIC Group) were conducted through its three business units: Commercial Business, Personal Insurance, and Agribusiness. Businesses that were deemed not profitable or non-strategic were isolated into a discontinued operations unit. While operations are conducted nationally, consolidation has taken place to maximize synergies among the business units. The FFIC Group operates throughout the United States and Puerto Rico utilizing approximately 2,875 agent and broker locations. Approximately 21% of the Group's direct written premiums were generated in the State of California in 2010 and 20% in 2009.

In August 2008, the FFIC Group underwent significant restructuring. Specialty marine business was combined with Allianz Global Corporate & Specialty's (AGCS) global marine business into a new Allianz unit. Agribusiness, a major contributor to the FFIC Group's profitability in the last few years, is now operated as a dedicated unit. The other portions of specialty insurance were combined with commercial business to form a new commercial and specialty risks organization.

As part of the corporate re-alignment, the Allianz Group transferred FFIC's marine business as well as employees and assets directly related to the marine business to Allianz Global Risks U.S. Insurance Company effective January 1, 2010. This was accomplished through the transfer of ownership of one of the Corporation's affiliates – Interstate Indemnity Company, which was a member of the FFIC pool in 2008, and was de-pooled in 2009.

## REINSURANCE

### Intercompany Reinsurance Agreement

The Corporation is a participant in an intercompany reinsurance agreement with seven of its affiliates (the participants). The lead insurer is Fireman's Fund Insurance Company (FFIC). Under the terms of this agreement dated January 1, 1999 and subsequent amendments, the participants cede, and FFIC assumes 100% of the participants' business generated from underwriting operations. The cessions from the participants are combined with FFIC's business, resulting in the pooled balance to be allocated to each company in the pool. The following table illustrates each participant's pooled share as of December 31, 2010:

| Company | State of Domicile | Pooling Share |
|---|---|---|
| Fireman's Fund Insurance Company | CA | 75.8% |
| The American Insurance Company | OH | 11.5% |
| National Surety Corporation | IL | 4.0% |
| Interstate Fire & Casualty Company | IL | 3.5% |
| American Automobile Insurance Company | MO | 2.5% |
| Chicago Insurance Company | IL | 1.5% |
| Associated Indemnity Corporation | CA | 1.0% |
| Fireman's Fund Insurance Company of Ohio | OH | 0.2% |
| Pool Total | | 100.0% |

The agreement authorizes and empowers FFIC to: (1) collect and receive all premiums, (2) adjust and pay all losses, (3) reinsure or cancel any and all policies and contracts of insurance, and (4) act as though the policies and contracts of insurance and reinsurance were issued by FFIC. It further provides for the complete sharing of all income and expenses of the pooled business with the exception of the investment operations, liabilities for federal income tax or other items not relating to the underwriting operations of the parties. Accounts are required to be settled quarterly.

Other companies within the Fireman's Fund Group, referred to as Specialty Companies, cede 100% to FFIC. These companies receive a commission from FFIC, and also pay FFIC a management fee, resulting in minimal income. Two companies in the pool, Interstate Fire & Casualty Company and Chicago Insurance Company, submit business to the pool net of external reinsurance arrangements with third parties.

Assumed

The Corporation does not assume reinsurance from third parties.

Ceded

Reinsurance, other than intercompany, is placed by FFIC for the FFIC Group. All members of the FFIC Group, either individually or collectively, may utilize the reinsurance of the various contracts that are in effect.

## ACCOUNTS AND RECORDS

Information Systems Controls

During the course of the examination, a review was conducted of the Corporation's general controls over its information systems. As a result of this review, weaknesses

were noted in the following areas: logical security, change management and vendor management. The weaknesses noted were presented to the Corporation, along with recommendations to strengthen its controls. The Corporation should evaluate the 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, 2010

Underwriting and Investment Exhibit for the Year Ended December 31, 2010

Reconciliation of Surplus as Regards Policyholders from December 31, 2007 through December 31, 2010

Statement of Financial Condition
as of December 31, 2010

| Assets | Ledger and Nonledger Assets | Assets Not Admitted | Net Admitted Assets | Notes |
|---|---|---|---|---|
| Bonds | $ 140,762,101 | $ | $ 140,762,101 | |
| Cash and short-term investments | 3,816,278 | | 3,816,278 | |
| Other invested assets | | | | |
| Receivable for securities | 123,868 | | 123,868 | |
| Investment income due and accrued | 1,568,231 | | 1,568,231 | |
| Premiums and agents' balances in course of collection | 7,099,464 | 326,497 | 6,772,967 | |
| Premiums, agents' balances and installments booked but deferred and not yet due (including $124,464 earned but unbilled premiums) | 3,822,026 | 13,689 | 3,808,337 | |
| Accrued retrospective premiums | 13,305 | 1,261 | 12,044 | |
| Amount recoverable from reinsurers | 10,437,024 | | 10,437,024 | |
| Net deferred tax asset | 3,511,133 | 1,060,032 | 2,451,101 | |
| Guaranty funds receivable or on deposit | 180,472 | | 180,472 | |
| Aggregate write-ins for other than invested assets | 181,949 | | 181,949 | |
| Total assets | $ 171,515,851 | $ 1,401,479 | $ 170,114,372 | |
| Liabilities, Surplus and Other Funds | | | | |
| Losses and loss adjustment expenses | | | $ 60,632,360 | (1) |
| Reinsurance payable on paid loss and loss adjustment expenses | | | 1,901,459 | |
| Commissions payable, contingent commissions and other similar charges | | | 1,418,260 | |
| Other expenses | | | 577,325 | |
| Taxes, licenses and fees | | | 248,315 | |
| Current federal and foreign income taxes | | | 2,524,393 | |
| Unearned premiums | | | 13,687,784 | |
| Advance premiums | | | (1,381) | |
| Dividends declared and unpaid: Policyholders | | | 43,819 | |
| Ceded reinsurance premiums payable | | | 10,822,608 | |
| Payable to parent, subsidiaries and affiliates | | | 516,691 | |
| Payable for securities | | | 199,999 | |
| Aggregate write-ins for liabilities | | | 6,380 | |
| Total liabilities | | | 92,578,012 | |
| Aggregate write-ins for special surplus funds | | $ 550,653 | | |
| Common capital stocks | | 3,500,000 | | |
| Gross paid in and contributed surplus | | 13,005,856 | | |
| Unassigned funds (surplus) | | 60,479,851 | | |
| Surplus as regards policyholders | | | 77,536,360 | |
| Total liabilities, surplus and other funds | | | $ 170,114,372 | |

## Underwriting and Investment Exhibit
## for the Year Ended December 31, 2010

### Statement of Income

| | | |
|---|---|---|
| **Underwriting Income** | | |
| Premiums earned | | $ 36,019,515 |
| Deductions: | | |
| Losses and loss expenses incurred | $ 28,114,331 | |
| Other underwriting expenses incurred | 11,370,456 | |
| Total underwriting deductions | | 39,484,787 |
| Net underwriting loss | | (3,465,272) |
| **Investment Income** | | |
| Net investment income earned | $ 7,107,582 | |
| Net realized capital gain | (82,307) | |
| Net investment gain | | 7,025,275 |
| **Other Income** | | |
| Net loss from agents' or premium balances charged off | $ (49,199) | |
| Aggregate write-ins for miscellaneous income | (172,598) | |
| Total other income | | (221,797) |
| Net income before dividends to policyholders, after capital gains and before federal and foreign income taxes | | 3,338,206 |
| Dividends to policyholders | | 48,818 |
| Net income after dividends to policyholders, after capital gains and before federal and foreign income taxes | | 3,289,388 |
| Federal and foreign income taxes incurred | | 642,748 |
| Net income | | $ 2,646,640 |

### Capital and Surplus Account

| | | |
|---|---|---|
| Surplus as regards policyholders, December 31, 2009 | | $ 82,347,124 |
| Net income | $ 2,646,640 | |
| Change in net unrealized foreign exchange capital gain | (464) | |
| Change in net deferred income tax | (422,670) | |
| Change in nonadmitted assets | 250,930 | |
| Dividends to stockholders | (8,000,000) | |
| Aggregate write-ins for losses in surplus | 714,800 | |
| Change in surplus as regards policyholders for the year | | (4,810,764) |
| Surplus as regards policyholders, December 31, 2010 | | $ 77,536,360 |

Reconciliation of Surplus as Regards Policyholders
from December 31, 2007 through December 31, 2010

| | | | |
|---|---|---|---|
| Surplus as regards policyholders, December 31, 2007 per Examination | | | $ 63,765,313 |
| | Gain in Surplus | Loss in Surplus | |
| Net income | $ 21,143,962 | $ | |
| Change in net foreign exchange capital losses | | $361 | |
| Change in net deferred income tax | | $1,576,384 | |
| Change in non-admitted assets | $ 2,203,829 | | |
| Dividends to stockholders | | $ 8,000,000 | |
| Total gains and losses | $ 23,347,791 | $ $9,576,745 | |
| Net increase in surplus as regards policyholders | | | $ 13,771,046 |
| Surplus as regards policyholders, December 31, 2010, per Examination | | | $ 77,536,360 |

## COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The California Department of Insurance (CDI) retained an independent Consulting Actuary, pursuant to authority granted in California Insurance Code (CIC) Section 733, to evaluate the loss and loss adjustment expense reserves (loss reserves) as of December 31, 2010. In addition, a Senior Casualty Actuary with the CDI reviewed the work of the Consulting Actuary, and performed additional analysis as deemed appropriate. The Consulting Actuary's estimate of net reserves for the FFIC pool was $230.9 million, or 3.8% higher than the carried reserves. The Consulting Actuary concluded that the pooled companies' reserve estimates were based on commonly employed actuarial methodologies and on reasonable and consistently applied assumptions and judgments and that the amounts recorded are reasonable estimates of its unpaid net claims loss and loss adjustment expense as of December 31, 2010. Based on the analyses performed by the Consulting Actuary and CDI's Senior Casualty Actuary, the CDI has determined that the loss and loss adjustment expense reserves as reported by the Corporation are reasonable and have been accepted for the purposes of this examination.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Accounts and Records – Information Systems Controls (Page 9): As a result of the review of the Corporation's information systems controls, recommendations for improving these controls were presented to the Corporation. The Corporation should evaluate these recommendations and make appropriate changes to strengthen its controls over its information systems.

Previous Report of Examination

Accounts and Records – Information Systems Controls (Page 9): It was recommended that the Corporation evaluate the recommendations from the Information Systems review and make appropriate changes to strengthen its information system controls. The Corporation has implemented changes to strengthen some of its controls over information systems.

Accounts and Records – Federal Income Taxes (Page 9): It was recommended that the Corporation identify and measure temporary differences using a balance sheet approach in compliance with Statement of Statutory Accounting Principles No. 10, paragraph 6.a. The Corporation has complied with this recommendation.

ACKNOWLEDGEMENT

Acknowledgement is made of the cooperation and assistance extended by the Corporation's officers and employees during the course of this examination.

Respectfully submitted,

_____/S/_____
Gordon M. Curtis, CFE, CISA
Examiner-In-Charge
Contract Examiner
Department of Insurance
State of California