

REPORT OF EXAMINATION
OF THE
CONTINENTAL REINSURANCE CORPORATION
AS OF
DECEMBER 31, 2003

Participating State
and Zone:

California

Filed June 30, 2005

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Los Angeles, California
March 18, 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

CONTINENTAL REINSURANCE CORPORATION

(hereinafter also referred to as the Company) at its main administrative office located at CNA Plaza, Chicago, Illinois 60685.

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, 2003. 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, 2003, as deemed necessary under the circumstances.

The examination of the Company was made concurrently with the examinations of various other insurance subsidiaries of the CNA Financial Corporation (CNA) including Pacific Insurance Company and CNA Casualty of California which are both California domiciled entities.

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

The Company and certain of its U.S. affiliates were previously participants in The Continental Insurance Company (CIC) intercompany pooling arrangement (Pool). Each participating affiliate in the CIC Pool ceded 100% of its insurance business to CIC, which then retroceded the pooled insurance businesses, net of external reinsurance, to each participating affiliate in accordance with the Pool participation percentages. During 2002, CNA initiated a project to consolidate its U.S. insurance entity structure to reduce complexity. During the fourth quarter of 2003, the CIC Pool structure was commuted and replaced with separate 100% quota-share reinsurance agreements, effective January 1, 2003, between CIC and each of its Pool participants whereby CIC assumed the net underwriting activity in the former CIC Pool.

The following three reinsurance agreements were implemented in order to consolidate the net risks of the CIC Pool into CIC: (1) the commutation of the CIC Pool agreement effective January 1, 2003, (2) a 100% retroactive reinsurance agreement between CIC and each CIC Pool participant covering all direct in-force business as of December 31, 2002, and (3) a prospective 100% quota-share reinsurance agreement between CIC and each current CIC Pool participant effective January 1, 2003.

The final step in the reorganization plan encompassed a 100% quota-share reinsurance agreement between CIC and CCC, whereby the net underwriting risks residing in CIC are reinsured by CCC on a funds-held reinsurance basis effective January 1, 2003.

Approval to execute and implement the above referenced agreements was received from the California Department of Insurance on November 10, 2003.

As a result of this transaction, all balances currently assumed and ceded under the previously existing CIC Pool agreement were reversed, and transactions reflecting the execution of the new quota-share reinsurance agreements were recorded retroactive to January 1, 2003. Under the new quota-share reinsurance agreements, the former CIC Pool participants cede all in-force business, including outstanding loss reserves, and prospective underwriting activity to CIC, prior to external reinsurance.

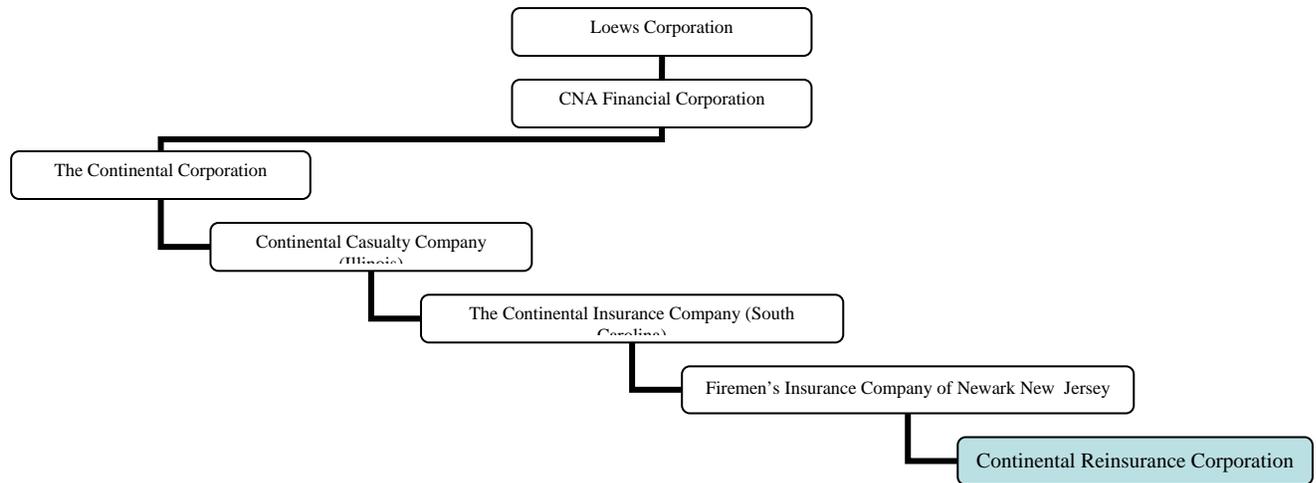
Management has represented that the Company is scheduled to be redomiciled by January 1, 2006.

MANAGEMENT AND CONTROL

As of December 31, 2003, Company was a wholly-owned subsidiary of Firemen's Insurance Company of Newark, New Jersey (Firemen's). Continental Casualty Company (CCC), an insurance company domiciled in Illinois, maintained direct ownership of Firemen's. Effective June 30, 2004, CCC contributed all outstanding Firemen's shares to its wholly-owned subsidiary, The Continental Insurance Company (South Carolina). CCC is wholly-owned by The Continental Corporation, which is wholly-owned by CNA Financial Corporation (CNAF). The Loews Corporation (Loews), the ultimate controlling entity, owns approximately 90% of the outstanding common stock of CNAF.

Members of the Tisch family which includes James S. Tisch, president and chief executive officer of Loews, are beneficial owners of approximately 31% of the outstanding stock of Loews. In addition to its involvement in the insurance business, Loews, through its subsidiaries, is active in the operation of hotels and resorts, production and sale of cigarettes, the operation of offshore oil drilling rigs, the distribution and marketing of watches and clocks, and the operation of a natural gas pipeline system.

The Company is a member of an holding company system. The following abbreviated organizational chart depicts the interrelationship of the members within the system as of June 30, 2004:



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, 2003 follows:

Directors

Name and Residence

Principal Business Affiliation

Robert V. Deutsch*
Farmington, Connecticut

Executive Vice President
and Chief Financial Officer
Continental Casualty Company

Jonathan D. Kantor
Scarsdale, New York

Executive Vice President, Secretary
and General Counsel
Continental Casualty Company

Stephen W. Lilienthal
North Barrington, Illinois

Chief Executive Officer
and President
Continental Casualty Company

Directors (cont.)

Name and Residence

Principal Business Affiliation

Robert L. McGinnis**
Highland Park, Illinois

President and Chief Executive Officer
CNA Life and Group Operations
Continental Casualty Company

Thomas Pontarelli
Glenview, Illinois

Executive Vice President – Human Resources
and Corporate Services
Continental Casualty Company

Principal Officers

Name

Title

Stephen W. Lilienthal
Dennis R. Hemme
Jonathan D. Kantor

Chief Executive Officer and President
Vice President and Treasurer
Executive Vice President, Secretary and
General Counsel

Robert V. Deutsch

Executive Vice President and Chief
Financial Officer

* resigned 10/22/04

** resigned 04/07/04

Management Agreements

CNA Inter-Company Expense Agreement: The Company and its affiliates entered into an expense sharing agreement, which describes how the affiliates will determine, apportion, and settle certain inter-company expenses and allocations. Pursuant to the agreement, the costs of the following services are shared: marketing, human resources, contract administration, treasury and investment, financial reporting, information technology, systems planning and application, legal, underwriting, claims, administrative and other services and such expenses shall include: salaries; rent and facilities; utilities; equipment; legal; auditing; and other expenses related to the provision of services described above. Various allocation bases are employed, including written premiums, paid losses, and salaries, to distribute these expenses to a company level. Substantially all expenses paid by and allocated to the Company are subject to this agreement. The Company does not have employees of its own.

Federal Income Tax Allocation Agreement: The Company, along with all subsidiaries of The Continental Corporation are parties to the Federal Income Tax Allocation Agreement. This agreement provides that the ultimate parent shall file a consolidated federal income tax return for each taxable year the affiliate is required or permitted to file such return. The agreement also provides that the consolidated tax liability of the affiliates will be allocated to each member based on the percentage of the income tax liability of each member computed on a separate return basis.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to transact multiple lines of business in the District of Columbia and the following states:

Alaska	Idaho	Nevada	Pennsylvania
Arizona	Illinois	New Jersey	South Carolina
Arkansas	Indiana	New Mexico	Texas
California	Iowa	New York	Utah
Colorado	Louisiana	North Carolina	Virginia
Delaware	Maryland	North Dakota	Washington
Florida	Michigan	Ohio	West Virginia
Georgia	Mississippi	Oklahoma	Wisconsin
Hawaii	Montana	Oregon	Wyoming

The Company does not write any direct business.

REINSURANCE

Assumed

The Company does not assume reinsurance.

Ceded

In conjunction with the previously referenced reorganization plan, the Company along with all other former members of the CIC Pool cede all in-force business, including outstanding loss reserves, and prospective underwriting activity to Continental Insurance Company. (see Company History)

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2003

Underwriting and Investment Exhibit for the Year Ended December 31, 2003

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2003

Statement of Financial Condition
as of December 31, 2003

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 20,504,841	\$ 20,504,841	
Stocks: Common stocks	7,744,800	7,744,800	
Cash and short-term investments	11,798,530	11,798,530	
Investment income due and accrued	351,543	351,543	
Receivable from parent, subsidiaries and affiliates	<u>58,266,462</u>	<u>58,266,462</u>	(1)
Total assets	<u>\$ 98,666,176</u>	<u>\$ 98,666,176</u>	
 <u>Liabilities, Surplus and Other Funds</u>			
Losses and loss adjustment expenses		\$ -0-	(2)
Current federal and foreign income taxes		4,791,186	
Net deferred tax liability		126,837	
Remittances and items not allocated		(843)	
Payable to parent, subsidiaries and affiliates		<u>951,155</u>	
Total liabilities		5,868,335	
Common capital stock	\$ 4,200,000		
Gross paid-in and contributed surplus	29,707,616		
Unassigned funds (surplus)	<u>58,890,225</u>		
Surplus as regards policyholders		<u>92,797,841</u>	
Total liabilities, surplus and other funds		<u>\$ 98,666,176</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2003

Statement of Income

Investment Income

Net investment income earned	\$ 7,673,204	
Net realized capital gains	<u>3,960,214</u>	
Net investment gain		<u>\$ 11,633,418</u>
Net income before federal and foreign income taxes		11,633,418
Federal and foreign income taxes incurred		<u>(2,177,999)</u>
Net income		<u>\$ 13,811,417</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2002		\$ 71,697,768
Net income	\$ 13,811,417	
Change in net unrealized capital gains	405,522	
Change in unrealized foreign exchange capital gain	827,516	
Change in net deferred income tax	(6,414,676)	
Change in nonadmitted assets	3,084,616	
Change in provision for reinsurance	5,977,615	
Aggregate write-ins for gains in surplus	<u>3,408,063</u>	
Change in surplus as regards policyholders		<u>21,100,073</u>
Surplus as regards policyholders, December 31, 2003		<u>\$ 92,797,841</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2003

Surplus as regards policyholders, December 31, 2001, per Examination		\$ (4,533,189)
	<u>Gain in Surplus</u>	
Net income	\$ 78,473,176	
Net unrealized capital gains	1,388,255	
Change in net unrealized foreign exchange capital gain	1,420,674	
Change in net deferred income tax	995,075	
Change in nonadmitted assets	252,508	
Change in provision for reinsurance	11,200,801	
Aggregate write-ins for gains in surplus	<u>3,600,541</u>	
Totals	<u>\$ 97,331,030</u>	
Net increase in surplus as regards policyholders		<u>97,331,030</u>
Surplus as regards policyholders, December 31, 2003, per Examination		<u>\$ 92,797,841</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Receivable from Parent, Subsidiaries and Affiliates

The captioned receivable at December 31, 2003, in the amount of \$58,266,462, was settled in its entirety in February 2004.

(2) Losses and Loss Adjustment Expenses

As referenced in the Company History section of this report, the Continental Casualty Company Pool (CCC Pool) was dissolved and replaced with separate 100% quota share reinsurance agreements between Continental Casualty Company (CCC) and the former pool participants including the Company. In view of such, the Company does not have a reportable loss exposure per se. However, as noted in the 2003 Actuarial Opinion, “Contingent net liability exists with respect to ceded reinsurance which would become an actual liability in the event that the reinsurer would be unable to meet their obligations to the Company under existing reinsurance agreements.”

The actuarial firm of Towers Perrin, Tillinghast (Tillinghast) was retained by the Illinois Department of Financial and Professional Regulation, Division of Insurance (Illinois Department) on behalf of all the applicable domiciliary states (including California) to assess the adequacy of the loss and loss adjustment (LAE) expense reserves of certain business written by the CNA Companies (CNA) as of December 31, 2003, net of reinsurance.

Subsequent to the completion of the actuarial reports, the results of which are described in detail below, the Illinois Department requested and received from Tillinghast an opinion letter. The Tillinghast opinion concludes that “CNA’s net loss and LAE reserves as of December 31, 2003, for the segments reviewed are below our point estimate in total, but fall within a range of reasonable estimates”.

Actuarial Standard of Practice (ASOP) No. 36, Section 3.3 Significant Risks and Uncertainties requires that, when the actuary reasonably believes that there are significant risks and uncertainties

that could result in material adverse deviation, the actuary should also include an explanatory paragraph in the statement of actuarial opinion.....the explanatory paragraph should contain the following:

- (a) the amount of adverse deviation that the actuary judges to be material with respect to the statement of actuarial opinion; and
- (b) a description of the major factors or particular conditions underlying risks and uncertainties that the actuary believes could result in material adverse deviation.

In compliance with the above referenced requirement, the Tillinghast opinion letter reflected the following disclosures:

- Additional risk factors include the position of the Company's carried asbestos, pollution, and other mass tort (APMT) reserves at the low end of our range of reasonable estimates, and the fact that reserves are significant in relation to surplus. Consequently, we believe that there are significant risks and uncertainties that could result in material adverse deviation from the held APMT loss and loss adjustment expense reserves;
- In consideration of the use of this opinion for purposes of solvency monitoring, we consider... (the amount) million to be material for this review;
- The absence of other risk factors from this listing does not imply that additional factors will not be identified in the future as having been a significant influence on CNA's reserves.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

None

Previous Report of Examination

Corporate Records (Page 9): It was recommended that the Company implement procedures in its board meetings to ensure compliance with California Insurance Code (CIC) Section 735. The recommendation has been implemented.

Accounts and Records (Page 11): It was recommended that the Company maintain documentation to support all financial statement accounts. During the course of the current examination, the

procurement of sufficient documentation to support account balances was not found to be problematic.

ACKNOWLEDGEMENT

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

Respectfully submitted,

David A. Fischman, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California