REPORT OF EXAMINATION
OF THE

MERCURY CASUALTY COMPANY

AS OF
DECEMBER 31, 2010

Filed December 29, 2011

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Los Angeles, California
October 28, 2011

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

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

MERCURY CASUALTY COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 4484 Wilshire Boulevard, Los Angeles, California, 90010. The Company's statutory home office and main administrative office is located at 555 West Imperial Highway, Brea, California 92821.

## SCOPE OF EXAMINATION

The previous examination of the Company 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 Company's financial condition, to identify prospective risks, and to obtain information about the Company, 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 Company were considered in accordance with the risk-focused examination process.

The Oklahoma Department of Insurance conducted the examination of American Mercury Insurance Company concurrently with the examination of the Company and its three California domiciled affiliates: Mercury Insurance Company, California Automobile Insurance Company, and California General Underwriters Insurance Company, Inc.

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; pensions, stock ownership and insurance plans; growth of company; loss experience; statutory deposits; and sales and advertising .

## COMPANY HISTORY

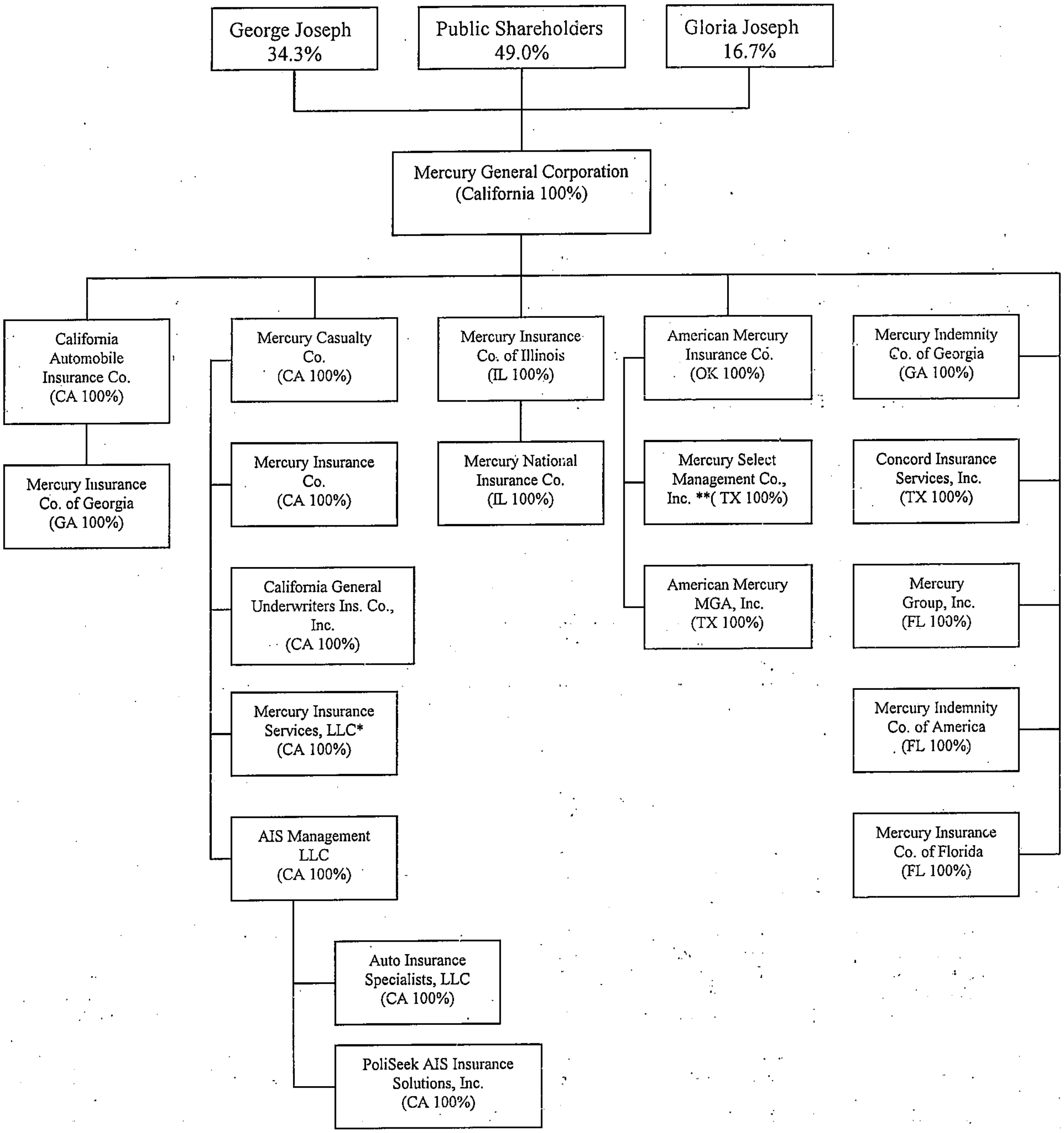
Ordinary dividends paid by the Company to its parent, Mercury General Corporation (MGC), totaled \$140,000,000, \$104,000,000, and \$115,000,000 for the years 2008, 2009, and 2010, respectively.

On December 16, 2010, the California Department of Insurance granted approval for the payment of a \$270,000,000 extraordinary dividend by the Company to its parent, MGC, payable in 2011.

Effective January 1, 2009, the Company acquired all of the membership interests of AIS Management, LLC, which is the parent company of two independent agencies: Auto Insurance Specialists, LLC (AIS) and PoliSeek AIS Insurance Solutions, Inc. AIS is the largest producer of automobile business for MGC's insurance subsidiaries.

## MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of Mercury General Corporation (MGC), a publicly traded insurance holding company. The controlling stockholders, George Joseph and Gloria Joseph, own 34.3% and 16.7%, respectively, of MGC's stock with the remaining 49.0% held by public shareholders. The following organizational chart depicts the Company's relationship within the holding company system:




* Mercury Insurance Services, LLC manages and controls Mercury County Mutual Insurance Company, a Texas County Mutual Insurer, through a Management agreement.

** Mercury Select Management Company, Inc. is Attorney-in-fact for American Mercury Lloyds Insurance Company, a Texas Lloyds plan Insurer.

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

## Directors

| Name and Residence | Principal Business Affiliation |
|---|---|
| Nathan Bessin<br>Los Angeles, California | Senior Partner<br>J. Arthur Greenfield & Company |
| Bruce A. Bunner<br>Fernandina Beach, Florida | Retired President<br>Financial Structures, Ltd. |
| Michael D. Curtius<br>Carlsbad, California | Executive Consultant<br>Mercury General Corporation |
| Richard E. Grayson<br>Murrieta, California | Retired Senior Vice President<br>Union Bank |
| George Joseph<br>Los Angeles, California | Chairman of the Board<br>Mercury General Corporation |
| Martha E. Marcon<br>Glendale, California | Retired Partner<br>KMPG LLP |
| Donald P. Newell<br>Pinehurst, North Carolina | Retired Partner<br>Law Firm of Latham & Watkins LLP |
| Donald R. Spuehler<br>Los Angeles, California | Retired Partner<br>Law Firm of O'Melveny & Meyers, LLP |
| Gabriel Tirador<br>Tustin, California | President and Chief Executive Officer<br>Mercury General Corporation |

Principal Officers

| Name | Title |
|---|---|
| Gabriel Tirador | President and Chief Executive Officer |
| Theodore R. Stalick | Vice President, Chief Financial Officer and Treasurer |
| Judith A. Walters | Secretary |
| Christopher W. Graves | Vice President |
| John E. Sutton | Vice President |

Management Agreements:

Management Agreement: Since January 1, 2001, the Company has been party to a management agreement with its subsidiary, Mercury Insurance Services, LLC (MIS). Under the terms of this agreement, MIS performs underwriting and loss adjustment services for the MGC group of companies. The management fee is based on actual incurred expenses. The underwriting portion of the management fee is allocated between the Company and its affiliates based upon their proportionate share of direct premiums written. The fee for allocated loss adjustment expenses is based on actual payments by MIS for claims on policies issued by the Company. The unallocated loss adjustment expenses portion of the management fee is allocated between the Company and its affiliates based upon their proportionate share of net losses incurred. The Company incurred management fees of $232,472,000, $233,028,000, and $237,451,000 during the years 2008, 2009, and 2010, respectively. Approval of the agreement was granted by the California Department of Insurance (CDI) on January 1, 2001.

Service Agreement: Since January 17, 2005, the Company has been party to a service agreement with Mercury Insurance Company (MIC) and California Automobile Insurance Company (CAIC). Under the terms of this agreement, the Company collects all premiums and pays claims, commissions, and return premiums on behalf of MIC and CAIC. The Company does not charge for these services as there are no additional incurred costs for the provider. Approval of the agreement was granted by the CDI on January 11, 2005.

Tax Allocation Agreement: Since January 1, 1983, the Company and various affiliates have been parties to a consolidated federal income tax agreement with the ultimate parent, MGC. Under the terms of this agreement, the tax liability of the Company and its affiliates are computed as if each entity filed a separate stand-alone return with current credit for net losses incurred by the insurance subsidiaries to the extent it can be used in the current consolidated return. Taxes paid by the Company totaled $24,302,000, $137,000, and $(2,237,000) for the years 2008, 2009, and 2010, respectively. The agreement was not subject to prior approval by the CDI due to the effective date of the agreement.

Furniture and Equipment Rental Agreement: Since January 1, 1993, the Company has provided the use of furniture and equipment to affiliates, including MIC and CAIC. Rental charges are predicated upon the depreciation of the assets utilized. Combined rental income received by the Company from the above referenced affiliates totaled $11,567,000, $11,829,000, and $15,501,000 for the years 2008, 2009, and 2010, respectively. The agreement was not subject to prior approval by the CDI due to the effective date of the agreement.

## TERRITORY AND PLAN OF OPERATION

As of December 31, 2010, the Company was licensed to write various property and casualty coverages in Arizona, California, Florida, Nevada, New York, Texas, Virginia, and Washington.

During 2010, the Company wrote $695.3 million of direct premiums; 53.4 % of the writings pertained to private passenger automobile business and the remainder consisted primarily of homeowners multi-peril coverages. Of the total direct premiums written, $604.6 million (86.9%) was written in California. Business is produced through approximately 1,100 independent agents. Branch offices are maintained in Anaheim, Brea, Camarillo, Folsom, Gilroy, Los Angeles, Rancho Cucamonga, San Diego, and Valencia, California.

## REINSURANCE

### Assumed

Assumed reinsurance is limited to business ceded to the Company from various affiliates. The following schedule depicts the Company's assumed reinsurance contracts in-force as of December 31, 2010:

| Type of Reinsurance | Lines of Business | Affiliate Cedant* | Ceding Company Retention | Reinsurer's Maximum Limits |
|---|---|---|---|---|
| 100% Quota Share | Private Passenger Automobile Liability & Physical Damage and Commercial Automobile Liability written in Florida and Pennsylvania | MICFL | | |
| 100% Quota Share | Private Passenger Automobile Liability & Physical Damage written in Florida | MIDA | | |
| 100% Quota Share | Private Passenger Automobile Liability & Physical Damage & Homeowners Multiple Peril written in New Jersey | MIDA | | |
| 100% Quota Share | Private Passenger Automobile Liability & Physical Damage written in Michigan | MNIC | | |
| 100% Quota Share | All Lines | MICGA<br>MIDGA<br>MICIL | | |
| Excess of Loss | Private Passenger Automobile Liability written in Georgia | AMI | $100,000 per occurrence | $1,000,000 per occurrence |
| Excess of Loss | Homeowners written in Oklahoma | AMI | $25,000 per occurrence | $475,000 per occurrence<br><br>$4,750,000 in any one calendar year |
| Excess of Loss | Commercial Property and Liability – all states | AMI | $250,000 per occurrence | $250,000 per occurrence<br><br>$2,500,000 in any one calendar year |
| Aggregate Catastrophe | Homeowners Multiple Peril & Automobile Physical Damage written in Oklahoma, Texas and Florida | AMI | $5,000,000 | 95% of $35 million in excess of coverage provided by the Florida Hurricane Catastrophe Fund |

*Mercury Insurance Company of Florida (MICFL); Mercury Indemnity Company of America (MIDA); Mercury National Insurance Company (MNIC); Mercury Insurance Company of Georgia (MICGA); Mercury Indemnity Company of Georgia (MIDGA); Mercury Insurance Company of Illinois (MICIL); American Mercury Insurance Company (AMI)

Ceded

Since July 1, 1999, the Company has been party to a 100% quota share agreement under which the Company cedes to California General Underwriters Insurance Company, Inc.(CGUI), an affiliate, the fleet automobile policy written by the Company, which covers substantially all vehicles owned by affiliated entities within the Mercury General Group.

Aside from various in place excess of loss facultative arrangements covering individual commercial and personal property risks, the Company's reinsurance program is limited to a 100% quota share agreement with an authorized reinsurer that covers commercial umbrella business and provides coverage up to $5,000,000 per occurrence.

## ACCOUNTS AND RECORDS

Section 44 of the Statement of Statutory Accounting Principles Number 65 eliminated the requirement to record the excess statutory reserves. In conjunction therewith, the California Legislature passed Assembly Bill 2002, which eliminated the minimum reserve requirement effective January 1, 2011. Accordingly, the Company did not report the applicable excess statutory reserves (Schedule P Penalty) as of December 31, 2010. If the reporting requirement were still in effect, the calculated liability would have been $5,798,000. The Company did report the applicable excess of statutory over statement reserves as of December 31, 2009 in the amount of $3,222,000.

## 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 | $ 969,288,007 | $ | $ 969,288,007 | (1) |
| Preferred stocks | 4,277,390 | | 4,277,390 | |
| Common stocks | 864,998,947 | | 864,998,947 | |
| Real estate – Properties occupied by the company | 112,784,185 | | 112,784,185 | |
| Cash and short-term investments | 72,353,018 | | 72,353,018 | |
| Other invested assets | 131,337,253 | 10,246,737 | 121,090,516 | |
| Receivable for securities | 287,711 | | 287,711 | |
| Investment income due and accrued | 13,605,320 | | 13,605,320 | |
| Premiums and agents' balances in course of collection | 36,075,022 | 326,992 | 35,748,030 | |
| Premiums, agents' balances and installments booked but deferred and not yet due | 73,649,873 | | 73,649,873 | |
| Amount recoverable from reinsurers | 5,568 | | 5,568 | |
| Current federal and foreign income tax recoverable and interest thereon | 17,474,745 | | 17,474,745 | |
| Net deferred tax asset | 62,319,637 | 25,459,297 | 36,860,340 | |
| Electronic data processing equipment and software | 63,457,067 | 50,223,737 | 13,233,330 | |
| Furniture and equipment, including health care delivery assets | 16,011,479 | 16,011,479 | | |
| Receivable from parent, subsidiaries and affiliates | 8,289,825 | | 8,289,825 | |
| Health care ($0) and other amounts receivable | 7,545,492 | | 7,545,492 | |
| Aggregate write-ins for other than invested assets | 1,898,371 | 68,434 | 1,829,937 | |
| Total assets | $ 2,455,658,910 | $102,336,676 | $ 2,353,322,234 | |

| Liabilities, Surplus and Other Funds | | | Notes |
|---|---|---|---|
| Losses and loss adjustment expenses | | $ 544,371,784 | (2) |
| Reinsurance payable on paid loss and loss adjustment expenses | | 26,000,113 | |
| Commissions payable, contingent commissions and other similar charges | | 18,897,693 | |
| Other expenses | | 925,926 | |
| Taxes, licenses and fees | | 1,560,866 | |
| Borrowed money and interest thereon | | 138,283,646 | |
| Unearned premiums | | 345,614,219 | |
| Advance premiums | | 13,150,319 | |
| Dividends declared and unpaid: stockholders | | 270,000,000 | |
| Ceded reinsurance premiums payable | | 309,020 | |
| Remittances and items not allocated | | 267,400 | |
| Payable to parent, subsidiaries and affiliates | | 4,212,612 | |
| Derivatives | | 4,992,789 | |
| Payable for securities | | 4,478,379 | |
| Aggregate write-ins for liabilities | | 4,292,841 | |
| Total liabilities | | 1,377,357,607 | |
| Common capital stock | $ 10,000,000 | | |
| Gross paid in and contributed surplus | 100,774,124 | | |
| Unassigned funds (surplus) | 865,190,503 | | |
| Surplus as regards policyholders | | 975,964,627 | |
| Total liabilities, surplus and other funds | | $ 2,353,322,234 | |

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

### Statement of Income

| | | |
|---|---|---|
| **Underwriting Income** | | |
| Premiums earned | | $ 1,007,552,179 |
| Deductions: | | |
| Losses and loss adjustment expenses incurred | $ 732,894,578 | |
| Other underwriting expenses incurred | 289,497,124 | |
| Total underwriting deductions | | 1,022,391,702 |
| Net underwriting loss | | (14,839,523) |
| **Investment Income** | | |
| Net investment income earned | $ 174,323,315 | |
| Net realized capital gain | 13,750,159 | |
| Net investment gain | | 188,073,474 |
| **Other Income** | | |
| Net loss from agents' or premium balances charged off (amount recovered $423,418 amount charged off $1,786,600) | $ (1,363,182) | |
| Finance and service charges not included in premiums | 13,583,990 | |
| Aggregate write-ins for miscellaneous income | 802,701 | |
| Total other income | | 13,023,509 |
| Net income after capital gains tax and before federal income taxes | | 186,257,460 |
| Federal income taxes incurred | | 6,187,196 |
| Net income | | $ 180,070,264 |

### Capital and Surplus Account

| | | |
|---|---|---|
| Surplus as regards policyholders, December 31, 2009 | | $ 1,176,676,881 |
| Net income | $ 180,070,264 | |
| Change in net unrealized capital losses | (2,481,077) | |
| Change in net deferred income tax | 19,800,544 | |
| Change in nonadmitted assets | (16,323,985) | |
| Dividends to stockholders | (385,000,000) | |
| Aggregate write-ins for gains in surplus | 3,222,000 | |
| Change in surplus as regards policyholders for the year | | (200,712,254) |
| Surplus as regards policyholders, December 31, 2010 | | $ 975,964,627 |

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

| | Gain in Surplus | Loss in Surplus | |
|---|---|---|---|
| Surplus as regards policyholders, December 31, 2007 per Examination | | | $ 1,391,584,182 |
| Net income | $ 288,670,096 | $ | |
| Change in net unrealized capital losses | | 65,792,156 | |
| Change in net deferred income tax | 46,703,261 | | |
| Change in nonadmitted assets | | 58,916,756 | |
| Dividends to stockholders | | 629,000,000 | |
| Aggregate write-ins for gains in surplus | 2,716,000 | | |
| Total gains and losses | $ 338,089,357 | $ 753,708,912 | |
| Net decrease in surplus as regards policyholders | | | (415,619,555) |
| Surplus as regards policyholders, December 31, 2010, per Examination | | | $ 975,964,627 |

## COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Bonds

As referenced in the "Company History" section of this report, the Company acquired all of the issued and outstanding stock of AIS Management, LLC on January 1, 2009. The transaction was funded via a $120 million term loan which is due January 2, 2012. For the purpose of assuring repayment of the obligation, the Company pledged as collateral certain municipal bonds which are maintained within a collateral account. As reported by the custodian of the collateral account, the year-end 2010 market valuation of the pledged securities totaled $175.3 million.

The Company is subject to an additional $18 million collateralized term loan which is due and payable on March 1, 2013. At year-end 2010, the reported market valuation of the pledged municipal bonds maintained in the separate collateral account totaled $26.1 million.

(2) Losses and Loss Adjustment Expenses

Based upon a review conducted by a Casualty Actuary from the California Department of Insurance, the Company's reserves for losses and loss adjustment expenses as of December 31, 2010 were found to be reasonably stated.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

None.

Previous Report of Examination

Common and Preferred Stocks (Page 17): It was recommended that the Company maintain all of its securities with a qualified custodian. The Company is in compliance with the 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/____________________

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