

REPORT OF EXAMINATION
OF THE
NEIGHBORHOOD SPIRIT PROPERTY
AND CASUALTY COMPANY
AS OF
DECEMBER 31, 2009

Participating State
and Zone:

California

Filed June 28, 2011

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Los Angeles, California
April 25, 2011

Honorable Joseph Torti, III
Chairman of the NAIC Financial
Condition Subcommittee
Superintendent of Rhode Island Business
Regulation, Division of Insurance
Cranston, Rhode Island

Honorable Linda S. Hall
Secretary, Zone IV – Western
Director of Insurance
Alaska Division of Insurance
Anchorage, Alaska

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

Dear Chairman, Secretary, and Commissioner:

Pursuant to your instructions, an examination was made of the

NEIGHBORHOOD SPIRIT PROPERTY AND CASUALTY COMPANY

(hereinafter also referred to as the Company) at its statutory home office and main administrative office located at 4680 Wilshire Boulevard, Los Angeles, California 90010.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2006. This examination covers the period from January 1, 2007 through December 31, 2009. 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, 2009, as deemed necessary under the circumstances. This examination was conducted concurrently with the Company's California parents, Farmers Insurance Exchange, Fire Insurance Exchange, and Truck

Insurance Exchange, and affiliates; Mid-Century Insurance Company, Civic Property and Casualty Company, Exact Property and Casualty Company, and Farmers Reinsurance 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.

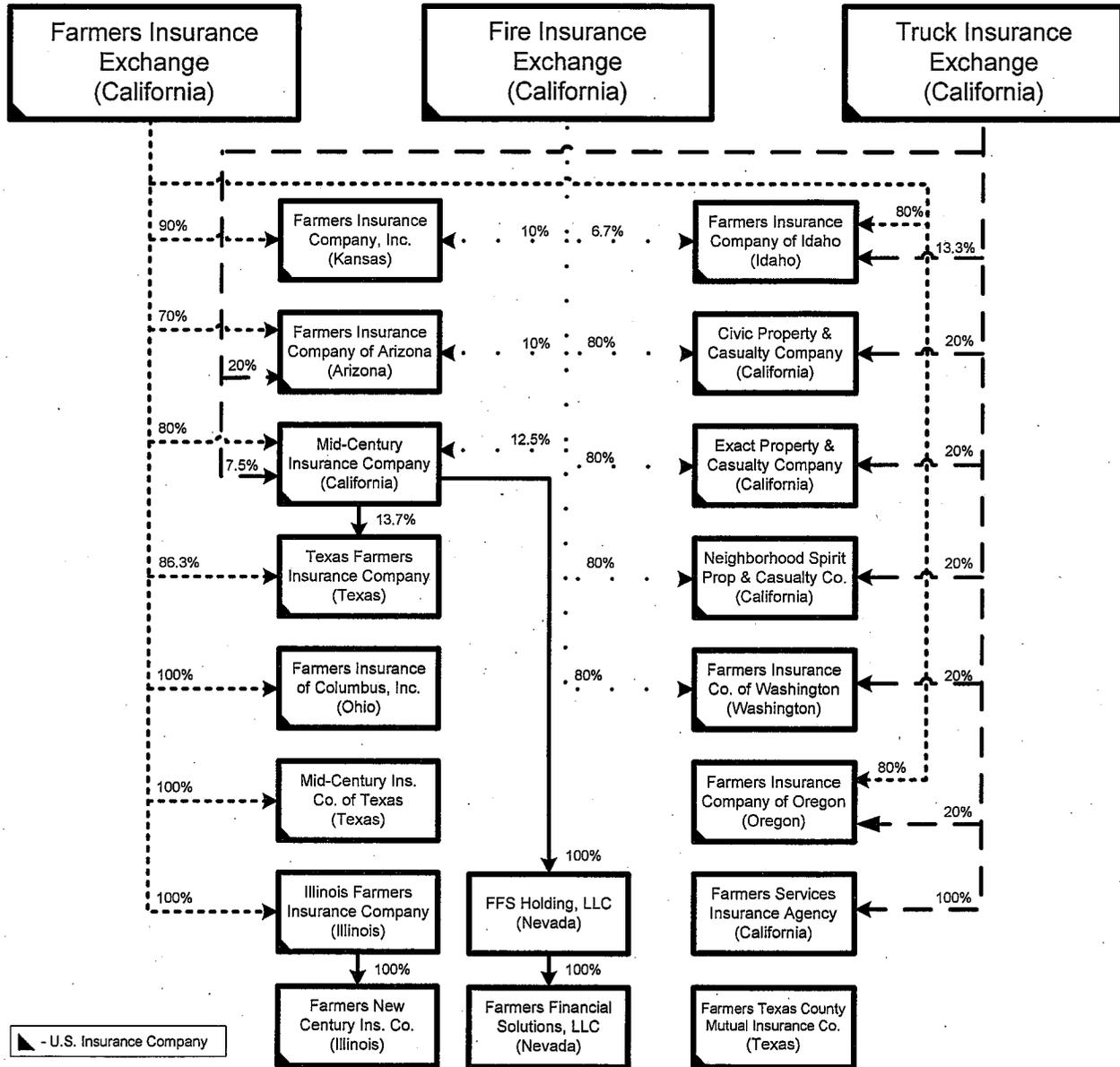
COMPANY HISTORY

On September 30, 2008, the Company parent, Farmers Insurance Exchange sold its 80% ownership interest in the Company, Civic Property and Casualty Company, and Exact Property and Casualty Company to Truck Insurance Exchange and Fire Insurance Exchange for \$182.9 million. At December 31, 2009, the outstanding shares of the Company were owned 80% by Fire 20% owned by Truck.

MANAGEMENT AND CONTROL

The following abridged organizational charts depict the Company's relationship within the holding company system as of December 31, 2009:

EXCHANGES/FARMERS ENTITIES ORGANIZATION



Management of the Company is vested in a seven member board of directors, elected annually. A listing of the members of the board and principal officers serving on December 31, 2009 follows:

Board of Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Jeffrey John Dailey Los Angeles, California	Executive Vice President Farmers Group, Inc.
John Joseph Hannigan Ada, Michigan	Executive Vice President and Director Foremost Insurance Company Grand Rapids, Michigan
Scott Robert Lindquist Westlake Village, California	Executive Vice President, Chief Financial Officer, and Director Farmers Group, Inc.
Ronald Gregory Myhan Laguna Beach, California	Executive Vice President and Treasurer Farmers Insurance Exchange
Mhayse Gokul Samalya Topanga, California	Executive Vice President Farmers Group, Inc.
Mark Bailey Smith Calabasas, California	Senior Vice President Farmers Group, Inc.
F. Robert Woudstra Los Angeles, California	President, Chief Executive Officer and Director Farmers Group, Inc.

Principal Officers

<u>Name</u>	<u>Title</u>
John Joseph Hannigan	President
Ronald Gregory Myhan	Vice President and Treasurer
Doren Eugene Hohl	Secretary
Frank Joseph Ceglar, Jr.	Vice President
Jeffrey John Dailey	Vice President

Principal Officers

<u>Name</u>	<u>Title</u>
Dan Curtis Dunmoyer *	Vice President
Scott Robert Lindquist	Vice President
Bryan Francis Murphy	Vice President
James Leslie Nutting	Vice President
Mhayse Gokul Samalya	Vice President
Mark Bailey Smith	Vice President
F. Robert Woudstra	Vice President

(*) Dan Curtis Dunmoyer was replaced by Denise Elaine Ruggiero on March 19, 2010.

Management Agreements

During the period covered by this examination Farmers Group, Inc. (FGI), the Attorney-In-Fact for Farmers Insurance Exchange (Farmers) provided operating services, including staffing and occupancy, except claims adjustment services to the Company. During the period covered by this examination there was no existing written management services agreement between the Company and FGI. The Company indicated that rather than utilizing separate written services agreements, the services and related fees were anticipated and covered under the intercompany reinsurance pooling agreement. It was recommended during the previous examination that a separate management services agreement between the Company and the appropriate management services provider(s) be filed with the California Department of Insurance (CDI) under California Insurance Code (CIC) Section 1215.5 to clearly define the related-party service providers' roles and responsibilities. For 2007, 2008 and 2009, the net fees paid allocable to the Company and paid by Farmers as a result of the Company's participation in the intercompany reinsurance pooling agreement were \$17,131,097, \$18,781,146, and \$20,992,570, respectively.

Claims Adjustment Services Arrangement

The Farmers claims department provides adjusting services for certain of its affiliated insurance companies' claims, including the Company. The claims adjustment services arrangement in place

between Farmers and the Company was not in written form. During 2007, 2008, and 2009, net claims adjustment service fees paid by the Company to Farmers as a result of its participation in the intercompany reinsurance agreement were \$10,600,000, \$10,600,000, and \$8,726,000, respectively.

It was recommended during the previous examination that the Company, and its California affiliates, enter into written claims adjustment services agreements and submit the agreements to the CDI for approval pursuant to CIC Section 1215.5.

Service Agreement

The Company subsequently became party to a services agreement, effective March 1, 2010, with Farmers. Farmers provides both management services and claims adjusting services to the Company via this agreement, which was approved by the CDI on January 22, 2010. The service agreement has a five-year term and Farmers shall provide or arrange for the provision of services at its cost, and allocated in accordance with the methods prescribed in the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual—Statement of Statutory Accounting Principles No. 70. Amounts are to be determined and settled monthly.

Tax Sharing Agreement

The Company's federal income tax return was consolidated with various insurance and non-insurance affiliates thru 2007. Pursuant to a new agreement, effective September 30, 2008, the federal income tax returns for the Company, and several affiliates, were consolidated with Fire Insurance Exchange. This agreement was approved by the California Department of Insurance on August 17, 2010. The tax allocations were based on separate return calculations with current credit for net losses. The Company's portion of the federal income taxes paid or recovered for 2007, 2008, and 2009, was \$3,052,000, (\$919,000), and \$2,755,000, respectively.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to transact insurance business in the states of California, Michigan, Missouri, Ohio and Pennsylvania. The Company was authorized to write fire, marine, surety, plate glass, liability, workers' compensation, common carrier liability, boiler and machinery, burglary, sprinkler, team and vehicle, automobile, aircraft, and miscellaneous business.

The Company offers a broad range of personal lines property coverage to "underserved" communities. During 2009, 36.2% of total direct premiums written were fire lines of business and 27.6% in homeowners multiple peril. The products are marketed through independent agents. In 2009, the Company wrote \$26.6 million of direct premiums. Of the direct premiums written, \$24.0 million (90.5%) was written in California, \$2.2 million (8.3%) was written in Pennsylvania, and \$300 thousand (1.2%) was written in the remaining states.

REINSURANCE

Intercompany Reinsurance Pooling Agreement

Farmers Insurance Exchange (Farmers), and certain affiliated property and casualty companies participated in an intercompany reinsurance pooling agreement. Under this agreement, the participants ceded all of their business, net of reinsurance, to Farmers (the lead company). Farmers then retroceded a share of the business back to certain participants based on percentages prescribed under the pooling agreement. The most recent amendment to this agreement was approved by the California Department of Insurance (CDI) on January 12, 1999.

The participants in the intercompany reinsurance pooling agreement, and their respective participation percentages as of December 31, 2009, were as follows:

<u>Pool Participant</u>	<u>Percentage</u>
Farmers Insurance Exchange	51.75
Mid-Century Insurance Company	16.00
Truck Insurance Exchange	7.75
Fire Insurance Exchange	7.50
Farmers Insurance Company of Oregon	7.00
Farmers Insurance Company of Washington	2.00
Farmers Insurance of Columbus, Inc.	1.00
Civic Property and Casualty Company	1.00
Exact Property and Casualty Company	1.00
Neighborhood Spirit Property and Casualty Company	1.00
Texas Farmers Insurance Company	1.00
Farmers Insurance Company, Inc.	0.75
Illinois Farmers Insurance Company	0.75
Farmers New Century Insurance Company	0.75
Farmers Insurance Company of Idaho	<u>0.75</u>
Total	<u>100.00</u>

Assumed

Other than a participation in the aforementioned reinsurance pool, the Company has no reinsurance assumed.

Ceded

Affiliated

Affiliated reinsurance cessions that Farmers and certain of its affiliates (including the Company) engaged in included an auto physical damage (APD agreement) 100% quota share agreement with affiliates Zurich Insurance Company (Zurich) and Farmers Reinsurance Company (Farmers Re). The subject premium for the APD 100% quota share agreement effective January 1, 2006, was \$1 billion annually with Zurich assuming 80% and Farmers Re assuming 20%. The CDI approved this agreement on December 28, 2005. The 2006 APD agreement was then replaced with the same terms

effective January 1, 2009, for a three-year term. The CDI approved this latest APD agreement on April 27, 2009.

On December 31, 2002, Farmers entered into 10% all-lines quota share reinsurance with Zurich and Farmers Re. This agreement covered all lines directly written, assumed by the affiliates, and assumed from pools, associations, or syndicates. This agreement was amended, effective December 31, 2004, to increase the percentage to 12% and amended again effective December 31, 2005, to decrease the percentage to 6% (Zurich 4.8% and Farmers Re 1.2%). The agreement was amended effective December 31, 2007 to decrease the percentage to 5% (Zurich 4% and Farmers Re 1%) and extend the duration to December 31, 2010. The 2007 amendment was approved by the CDI on December 28, 2007. An amendment effective September 30, 2008 increased the percentage to 25%, but was then terminated effective June 30, 2009, and replaced with a new 37.5% all lines quota share agreement (Zurich 30% and Farmers Re 7.5%). The CDI approved this replacement agreement on June 29, 2009. An amendment, effective December 31, 2009, decreased the percentage ceded to 35%, and was approved by the CDI on May 25, 2010.

Non-affiliated

The Company, along with its parents and affiliates, were listed as cedents on various treaties ceding risk on an excess-of-loss basis to non-affiliated reinsurers.

As of December 31, 2009, reinsurance recoverables for all ceded reinsurance totaled \$28.7 million, or 32.7% of surplus as regards policyholders. Of the reinsurance recoverables, 100% were from admitted affiliates resulting from the pooling arrangement.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2009

Underwriting and Investment Exhibit for the Year Ended December 31, 2009

Reconciliation of Surplus as Regards Policyholders
from December 31, 2006 through December 31, 2009

Statement of Financial Condition
as of December 31, 2009

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$134,857,949	\$	\$134,857,949	
Stocks:				
Common stocks	30,415,512		30,415,512	
Cash, cash equivalents and short-term investments	16,809,435		16,809,435	
Other invested assets	5,081,520		5,081,520	
Investment income due and accrued	1,502,557	757	1,501,800	
Premiums and consideration:				
Uncollected premiums and agents balances in the course of collection	3,972,521	1,004,398	2,968,123	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	18,048,780		18,048,780	
Accrued retrospective premiums	38,015		38,015	
Reinsurance:				
Amounts recoverable from reinsurers	1,307,710		1,307,710	
Net deferred tax asset	4,506,765		4,506,765	
Guaranty funds receivable or on deposit	33,133		33,133	
 Total assets	 <u>\$216,573,897</u>	 <u>\$ 1,005,155</u>	 <u>\$215,568,742</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 54,837,733	(1)
Reinsurance payable on paid losses and loss adjustment expenses			6,218,344	
Loss adjustment expenses			16,210,850	(1)
Commissions payable, contingent commissions and other similar charges			370,477	
Taxes, licenses and fees			53,330	
Unearned premiums			42,047,588	
Advance premium			981,454	
Dividends declared and unpaid: Policyholders			30,766	
Ceded reinsurance premiums payable			1,571,059	
Amounts withheld or retained by company for account of others			21,889	
Remittances and items not allocated			755,812	
Payable to parent, subsidiaries and affiliates			3,183,403	
Aggregate write-ins for liabilities			<u>1,585,831</u>	
Total liabilities			127,868,536	
Common capital stock		\$ 5,000,000		
Gross paid in and contributed surplus		60,000,000		
Unassigned funds (surplus)		<u>22,700,206</u>		
Surplus as regards policyholders			<u>87,700,206</u>	
Total liabilities, surplus and other funds			<u>\$215,568,742</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2009

Statement of Income

Underwriting Income

Premiums earned		\$101,669,104
Deductions:		
Losses incurred	\$ 54,985,995	
Loss adjustment expenses incurred	11,438,530	
Other underwriting expenses incurred	<u>31,658,306</u>	
Total underwriting deductions		<u>98,082,831</u>
Net underwriting gain		3,586,273

Investment Income

Net investment income earned	\$ 7,056,519	
Net realized capital gains	<u>102,564</u>	
Net investment gain		7,159,083

Other Income

Net loss from agents' or premium balances charged off	\$ (1,034,937)	
Finance and service charges not included in premiums	849,657	
Aggregate write-ins for miscellaneous loss	<u>(1,082,445)</u>	
Total other losses		<u>(1,267,725)</u>
Net income before dividends to policyholders, and federal and foreign income taxes		9,477,631
Dividends to policyholders		17,418
Federal and foreign income taxes incurred		<u>2,692,925</u>
Net income		<u>\$ 6,767,288</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2008		\$ 74,913,404
Net income	\$ 6,767,288	
Change in net unrealized capital gains less capital gains tax	3,997,069	
Change in net deferred income tax	(47,788)	
Change in nonadmitted assets	1,650,233	
Cumulative effect of changes in accounting principles	165,879	
Aggregate write-ins for gains and losses in surplus	<u>254,121</u>	
Change in surplus as regards policyholders		<u>12,786,802</u>
Surplus as regards policyholders, December 31, 2009		<u>\$ 87,700,206</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2006 through December 31, 2009

Surplus as regards policyholders, December 31, 2006, per Examination			\$71,551,360
	Gain in Surplus	Loss in Surplus	
Net income	\$14,595,426	\$	
Change in net unrealized capital gain	1,148,962		
Change in net deferred income tax		585,211	
Change in nonadmitted assets	488,087		
Change in surplus notes	165,879		
Aggregate write-ins for gains in surplus	335,703		
Totals	<u>\$16,734,057</u>	<u>\$ 585,211</u>	
Net increase in surplus as regards policyholders			<u>16,148,846</u>
Surplus as regards policyholders, December 31, 2009, per Examination			<u>\$87,700,206</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The Company was directed by the California Department of Insurance (CDI), pursuant to California Insurance Code Section 733(g), to retain the American Actuarial Consulting Group, LLC, (AACG) for the purpose of assisting this examination in determining the reasonableness of the Company's loss and loss adjustment expense reserves. Because the business of the Farmers property and casualty companies was pooled, it was necessary to review the losses on a group-wide basis. Based on the analysis by AACG and the review of their work by a Casualty Actuary from the CDI, the Company's December 31, 2009, reserves for losses and loss adjustment expenses were determined to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

None

Previous Report of Examination

Management and Control - Management Agreements (Page 7): Farmers Group, Inc. (FGI), the Attorney-In-Fact for Farmers Insurance Exchange (Farmers) provided operating services (including staffing and occupancy) except claims adjustment services to the Company. There was no existing written management services agreement between the Company and FGI, the service provider. It was recommended that a separate management services agreement between the Company and the appropriate management services provider(s) be filed with the California Department of Insurance (CDI) under California Insurance Code (CIC) Section 1215.5 to clearly define roles and responsibilities in the provisions of such services. The Company subsequently became party to a

management services agreement, effective March 1, 2010, with Farmers. Farmers provides both management services and claims adjusting services via this agreement, which was approved by the CDI on January 22, 2010.

Management and Control - Claims Adjustment Services Arrangement (Page 8): The claims adjustment services arrangement in place between Farmers and the Company, with Farmers providing all of their claims adjustment services, was not in written form. It was recommended that the Company and Farmers enter into a written claims adjustment services agreement and submit it to the CDI for approval pursuant to CIC Section 1215.5. The Company subsequently became party to a management services agreement, effective March 1, 2010, with Farmers. Farmers provides both management services and claims adjusting services combined via this agreement, which was approved by the CDI on January 22, 2010.

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/

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