REPORT OF EXAMINATION
OF

PACIFIC SPECIALTY INSURANCE COMPANY

AS OF
DECEMBER 31, 2008

Participating State
and Zone:

California

FILED: May 27th, 2010

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San Francisco, California
May 17, 2010

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

Honorable Christina Urias
Secretary, Zone IV-Western
Director of Insurance
Arizona Department of Insurance
Phoenix, Arizona

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary, and Commissioner:

Pursuant to your instructions, an examination was made of the

PACIFIC SPECIALTY INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 3601 Haven Avenue, Menlo Park, California 94025.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2004. This examination covers the period from January 1, 2005 through December 31, 2008. The examination was conducted 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, and an evaluation of assets and a determination of liabilities as of December 31, 2008, as deemed necessary under the circumstances.

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.

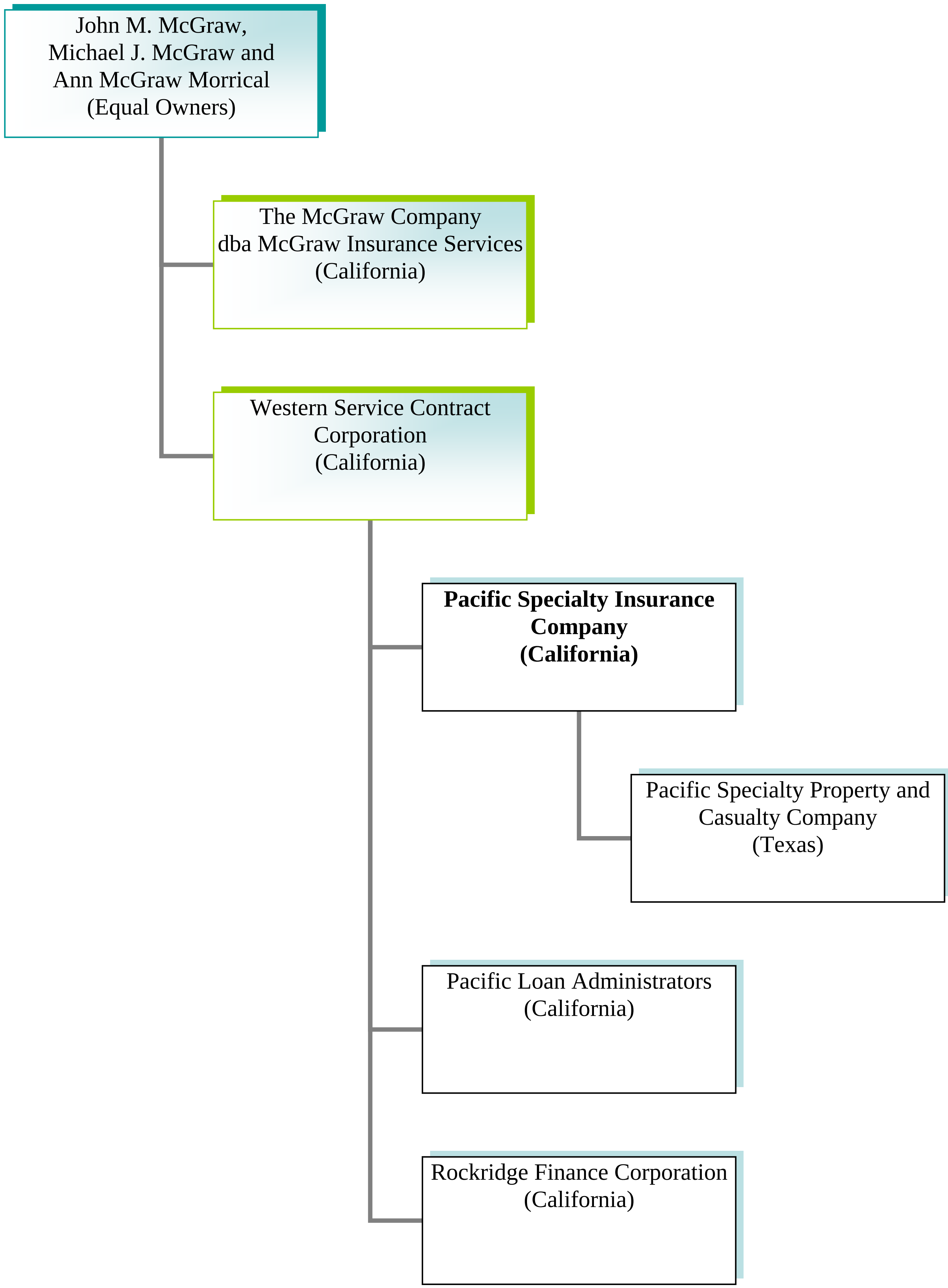
COMPANY HISTORY

The Company paid an ordinary cash dividend to its parent, Western Service Contract Corporation (WSCC) in 2006 for $7 million. No other dividend was paid during the examination period.

The Company's gross paid-in and contributed surplus increased $5,384,419 in 2008 through the contribution of an airplane by WSCC. Since the airplane was recorded as a non-admitted asset, there was no overall impact to surplus as regards policyholders as a result of the contribution.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system which is ultimately controlled by John M. McGraw, Michael J. McGraw, and Ann M. Morrical. The following chart depicts the interrelationship of the Company within the holding company system as of December 31, 2008:


John M. McGraw,
Michael J. McGraw and
Ann McGraw Morrical
(Equal Owners)
The McGraw Company
dba McGraw Insurance Services
(California)
Western Service Contract
Corporation
(California)
Pacific Specialty Insurance
Company
(California)
Pacific Specialty Property and
Casualty Company
(Texas)
Pacific Loan Administrators
(California)
Rockridge Finance Corporation
(California)

The Company was managed by a seven-member board of directors. The directors serve staggered terms of three years each. Elections are held annually for the terms that are expiring. The directors and principal officers serving as of December 31, 2008 are as follows:

Directors

Name and Residence	Principal Business Affiliation
Eugene E. Becker [(1)] Naples, Florida	Retired
William F. McCauley [(1)] Coronado, California	Retired
Michael J. McGraw Atherton, California	President Pacific Specialty Insurance Company
John V. McGraw Jr. [(1)] Atherton, California	Retired
Brian J. McSweeney Redwood City, California	Treasurer and Vice President Pacific Specialty Insurance Company
Ann McGraw Morrical San Francisco, California	Director Pacific Specialty Insurance Company
Timothy J. Summers Redwood City, California	Secretary and Vice President Pacific Specialty Insurance Company

(1) Directors Becker and McCauley resigned in November 2009 and have not yet been replaced. John V. McGraw resigned as Chairman in November 2009 and was replaced by John M. McGraw. The directors now stand at five, the minimum number authorized per the Company's bylaws.

Principal Officers

Name	Title
Michael J. McGraw [(a)]	President
Timothy J. Summers	Secretary and Vice President
Brian J. McSweeney	Treasurer and Vice President

Name	Title
William H. Guthrie	Vice President, Strategic Initiatives
Robert K. Large	Vice President, Product Development
Donald A. McAllister	Vice President, Chief Information Officer
David L. Sacks	Vice President, Chief Financial Officer
Susan Valencia	Vice President, Underwriting
Brian F. Weaver	Vice President, Sales and Marketing

[a] Michael McGraw resigned as President in November 2009 and was replaced by Timothy Summers. He currently serves as director.

Management Agreements and Related Party Transactions

The Company was party to the following intercompany agreements and transactions at December 31, 2008:

Allocation of Overhead Charges

Under this agreement, The McGraw Company, dba McGraw Insurance Services (McGraw), charges the Company a reasonable allocation of overhead costs paid by McGraw on its behalf. Costs include office space, supplies, salaries, advertisement, and other overhead expenses. Allocation is based on time studies of actual costs incurred. The agreement was effective January 1, 2007 and was approved by the California Department of Insurance (CDI) on March 28, 2007. This agreement replaced an earlier agreement effective January 1, 2002. The Company paid $268,506 to McGraw for these services in 2008.

Tax Allocation Agreement

The Company is party to a tax allocation agreement with its parent, Western Service Contract Corporation (WSCC), and affiliates, Pacific Loan Administrators (PLA) and Rockridge Finance Corporation (RFC). The allocation of the tax liability is based on the Company’s taxable income as a percent of the consolidated taxable income of the group. Members are reimbursed for net operating losses and other tax credits upon the tax savings realized when the loss or credit is utilized.

Tax liability is limited to the amount each party would pay if it filed a separate income tax return. The agreement was effective January 1, 2006 and approved by the CDI on February 8, 2007. It replaced an earlier agreement effective January 1, 1996.

General Agency Agreement

The Company has operated under a general agency agreement with its affiliate, McGraw, a licensed agent, since September 1, 1995. McGraw receives and accepts proposals for insurance, performs underwriting functions, issues and cancels policies, and collects premiums. McGraw is required to remit premiums to the Company within 45 days and receives 25% commission. It was noted during the prior examination that the agency agreement limited maximum premium volume to $50 million, and needed to be amended to reflect current, higher premium levels. The agreement was amended effective March 1, 2006 to set maximum premium volume to $250 million annually. The Company paid McGraw $43.5 million in commissions in 2008.

Service Contract Reimbursement Policy

The Company has entered into a service contract reimbursement policy with WSCC to guarantee certain third-party motorcycle extended service contracts administered by, but not the liability of, WSCC. In 2008, the Company received $274,615 for such guarantees. No claims were made by WSCC or any other party for these guarantees.

Other Related Party Transactions

Other related party transactions which have occurred during the examination period include a mortgage loan granted to John M. McGraw for $1.5 million in May 2008. The appraised value of the property per Schedule B was $2.2 million as of December 31, 2008. At the time the loan was made, John McGraw was not serving as an officer or director of the Company. Review of the deed and loan documents indicated the transaction was appropriately handled. Another significant transaction was the transfer of an airplane in 2008 from WSCC to the Company. The airplane was 94% owned by WSCC and 6% by The McGraw Company. The book value, net of depreciation, at the time of transfer was $5.7 million, of which 94% or $5.38 million was transferred as additional paid-in capital by WSCC. The Company purchased the remaining 6% from McGraw. The entire balance for the plane was non-admitted by the Company. The Company's external auditors reviewed the transaction and confirmed the appraised value of the plane at $7.03 million.

TERRITORY AND PLAN OF OPERATION

The Company was licensed and wrote business in all 50 states, and in the District of Columbia, where it was licensed but did not write. The primary lines written by the Company are homeowners and related lines, followed by automobile, earthquake, and other liability. Programs in the automobile lines which the Company specializes in include motorcycle, personal watercraft, and other types of off-road and recreational vehicles. Programs within the other liability line included commercial multiple peril for used car dealerships. The majority of the Company's direct business in 2008 was written in the following states: California (81%), Texas (6%), Georgia (6%), and 3% or less in all other states. Business was produced through its affiliated general agency, The McGraw Company. Other distribution channels used are licensed dealerships for motorcycle and personal watercraft, and independent agents and brokers for states other than California.

REINSURANCE

Assumed

The Company assumed 100% of the motorcycle business written by Old American County Mutual Fire Insurance Company, a Texas domiciled insurer. No other assumed contracts existed at December 31, 2008.

Ceded

The Company had a 15% quota share reinsurance agreement with its subsidiary, Pacific Specialty Property and Casualty Company (PSPCC) effective November 1, 2007, under which the Company ceded homeowners multiple peril coverage written in Texas to PSPCC. This agreement was terminated August 31, 2008. Following is a summary of the principal ceded reinsurance treaties inforce as of December 31, 2008:

Type of Contract and Lines of Business	**Reinsurer(s)**	**Company Retention**	**Reinsurer's Limits**
Multiple Line Excess of Loss – (covers both property and casualty lines of business)	6 authorized reinsurers. Percentages vary by layer.	1st Layer:	1st Layer:
		$1 million	$1.5 million
		2nd Layer:	2nd Layer:
		$2.5 million	$1 million
		3rd Layer:	3rd Layer:
		$3.5 million	$5 million
Property Catastrophe Excess of Loss Reinsurance Contract	21 authorized and unauthorized reinsurers from domestic, foreign, Bermuda, and London markets.	1st Layer:	1st Layer:
		$10 million	$10 million
		2nd Layer:	2nd Layer:
		$20 million	$25 million
		3rd Layer:	3rd Layer:
		$45 million	$45 million

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2008

Underwriting and Investment Exhibit for the Year Ended December 31, 2008

Reconciliation of Surplus as Regards Policyholders
from December 31, 2004 through December 31, 2008

Reconciliation of Examination Changes as of December 31, 2008

Statement of Financial Condition
as of December 31, 2008

Assets	Ledger and Nonledger Assets	Nonadmitted Assets	Net Admitted Assets	Notes
Bonds	$ 201,512,689	$	$ 201,512,689	
Preferred stocks	1,391,075		1,391,075	
Common stocks	5,360,052		5,360,052	
Mortgage loans on real estate:				
First liens	4,410,065		4,410,065	
Cash, cash equivalents and short-term investments	(146,327)		(146,327)	
Other invested assets	420,754		420,754	
Receivable for securities	11,611		11,611	
Investment income due and accrued	3,071,617		3,071,617	
Premiums and considerations:				
Uncollected premiums and agents' balances in the course of collection	(393,548)		(393,548)	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	4,131,101		4,131,101	
Amounts recoverable from reinsurers	242,696		242,696	
Current federal and foreign income tax recoverable	2,147,580		2,147,580	
Net deferred tax asset	18,741,792	13,257,785	5,484,007	
Electronic data processing equipment and software	227,207	227,207		
Furniture and equipment	7,577,969	7,577,969		
Receivables from parent, subsidiaries and affiliates	1,445		1,445	
Total assets	$ 248,707,778	$ 21,062,961	$ 227,644,817	

Liabilities, Surplus and Other Funds			Notes
Losses		$ 21,775,470	(1)
Loss adjustment expenses		11,750,263	(1)
Other expenses		1,695,970	
Taxes, licenses and fees		468,094	(2)
Unearned premiums		64,035,219	
Advance premiums		2,309,251	
Ceded reinsurance premiums payable		(719,649)	
Provision for reinsurance		61,073	
Payable to parent, subsidiaries, and affiliates		294,780	
Payable for securities		433,038	
Aggregate write-ins for liabilities		16,845,000	(3)
Total liabilities		118,948,509	
Common capital stock	$ 3,500,000		
Gross paid-in and contributed surplus	11,384,419		
Unassigned funds (surplus)	93,811,889		
Surplus as regards policyholders		108,696,308	
Total liabilities, surplus and other funds		$ 227,644,817	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2008

Statement of Income

Underwriting Income		
Premiums earned		$ 123,048,707
Deductions:		
Losses incurred	$ 60,616,711	
Loss expenses incurred	8,881,655	
Other underwriting expenses incurred	54,053,358	
Total underwriting deductions		123,551,724
Net underwriting loss		(503,017)
Investment Income		
Net investment income earned	$ 10,679,815	
Net realized capital losses	(10,835,137)	
Net investment loss		(155,322)
Other Income		
Finance and service charges not included in premiums	$ 1,391,958	
Total other income		1,391,958
Net income before federal income taxes		733,619
Federal income taxes incurred		8,504,002
Net loss		$ (7,770,383)

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2007		$ 137,104,849
Net loss	$ (7,770,383)	
Change in net unrealized capital losses	(9,713,667)	
Change in net deferred income tax	5,182,710	
Change in nonadmitted assets	(17,690,345)	
Change in provision for reinsurance	167,123	
Paid in surplus	5,384,419	
Aggregate write-ins for losses in surplus	(3,968,398)	
Change in surplus as regards policyholders for the year		(28,408,541)
Surplus as regards policyholders, December 31, 2008		$ 108,696,308

Reconciliation of Surplus as Regards Policyholders
from December 31, 2004 through December 31, 2008

Surplus as regards policyholders, December 31, 2004, per Examination			$ 74,835,413
	Gain in Surplus	Loss in Surplus	
Net income	$ 62,142,005	$	
Change in net unrealized capital gains or losses		8,056,859	
Change in net deferred income tax	6,783,643		
Change in nonadmitted assets		19,289,338	
Change in provision for reinsurance	5,565,927		
Surplus paid in	5,384,419		
Dividends to stockholders		7,000,000	
Aggregate write-ins for losses in surplus		11,668,902	
Total gains and losses	$ 79,875,994	$ 46,015,099	
Net increase in surplus as regards policyholders			33,860,895
Surplus as regards policyholders, December 31, 2008, per Examination			$ 108,696,308

Reconciliation of Examination Changes
as of December 31, 2008

	Per Company	Per Examination	Surplus Increase (Decrease)	Note
Liabilities				
Aggregate write-ins for liabilities	$ 5,255,050	$ 16,845,000	$ (11,589,950)	(3)
Net decrease to surplus			(11,589,950)	
Surplus as regards policyholders, December 31, 2008, per Company			120,286,258	
Surplus as regards policyholders, December 31, 2008, per Examination			$ 108,696,308	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Based on an analysis by a Senior Casualty Actuary for the California Department of Insurance, the Company's loss and loss adjustment expense reserves as of December 31, 2008 were found to be reasonably stated and have been accepted for purposes of this examination.

(2) Taxes, Licenses and Fees

California Insurance Code (CIC) Section 1872.8(a) states, in part, that each insurer doing business in the State of California must pay an annual Vehicle Fraud Assessment Fee for each vehicle insured under an insurance policy it issues in California. The fee provides funding for the increased investigation and prosecution of fraudulent automobile insurance claims and automobile theft in the State of California. It was noted that the Company failed to include insured trailers in its count of the number of vehicles for 2005 through the first quarter 2009. The additional fees due the California Department of Insurance were determined to be $38,853 for the period reviewed. It is recommended the Company submit amended vehicle assessment filings for the period reviewed, as well as through the current filing periods. No adjustment has been made as the amount due is deemed immaterial.

(3) Aggregate Write-ins for Liabilities: Excess of Statutory Over Statement Reserves

An examination increase of $11,589,950 was made to the Company's reported minimum reserve liability in order to include the automobile liability lines of business as required by CIC Section 11558. It is recommended the Company include these lines of business in the future when establishing this reserve.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Comments on Financial Statement Items - Taxes, Licenses and Fees (Page 13): It was noted that the Company failed to include insured trailers in its count of the number of vehicles for 2005 through the first quarter 2009, and subsequent periods. It is recommended the Company submit amended vehicle assessment filings for the affected quarters, as well as through the current filing periods.

Comments on Financial Statement Items - Excess of Statutory Over Statement Reserves (Page 13): It was noted the Company did not include the automobile liability lines in its calculation of this reserve as required by California Insurance Code (CIC) Section 11558. It is recommended the Company include these lines of business in the future when establishing this reserve.

Previous Report of Examination

Management and Control – Management Agreements – General Agency Agreement (Page 5): It was recommended the Company amend the General Agency Agreement with The McGraw Company (McGraw) to reflect the maximum premium volume that can be written under the contract. The Company has complied with this recommendation.

Accounts and Records (Page 9): It was recommended the Company report all transactions with affiliates on Schedule Y, Part 2 of the Annual Statement. It was also recommended the Company evaluate the examiners' recommendations and make appropriate changes to its information systems. The Company has complied with these recommendations.

Comments on Financial Statement Items – Amounts Recoverable from Reinsurers (Page 14): It was recommended the Company maintain an aging report to keep track of its reinsurance recoverable. The Company has complied with the request.

ACKNOWLEDGEMENT

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

Respectfully submitted,

/s/

Isabel Spiker, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California