REPORT OF EXAMINATION
OF THE

SURETY COMPANY OF THE PACIFIC

AS OF
DECEMBER 31, 2007

Filed March 27, 2009

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Los Angeles, California

December 12, 2008

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

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

SURETY COMPANY OF THE PACIFIC

(hereinafter also referred to as the Company) at its statutory home office located at 6345 Balboa Boulevard, Suite II – 325, Encino, California 91316.

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, 2007. 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, 2007, 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: fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; accounts and records; and sales and advertising.

SUMMARY OF SIGNIFICANT FINDINGS

The Company's independent actuary, Petit Actuarial Group, LLC (Petit), performed an interim actuarial review, as of June 30, 2008, which indicated the reserves for loss and loss adjustment expenses were still deficient by $837,000. This $837,000 deficiency was in addition to the $1 million reserve strengthening booked by the Company in the second quarter of 2008, and similarly is in addition to the $1 million of reserve deficiency at December 31, 2007 as determined by the California Department of Insurance Actuary and utilized in the financial statements of this report. The Company did not book the increased levels of reserving determined by Petit into either its June 30, 2008, or September 30, 2008 quarterly financial statements filings because Petit's actuarial review was not finalized until after these financial statements were prepared

The Company's September 30, 2008 statutory quarterly financial statement reported a year-to-date net loss of $2,427,905 and surplus as regards policyholders of $2,400,227. Based on these figures, the ratio of the Company's total adjusted capital to its authorized control level risk-based capital, as computed by using the National Association of Insurance Commissioners' (NAIC) Risk-Based Capital (RBC) System formula, is 112%. Under the NAIC RBC System, a ratio of 112% requires an action level under which the Company must prepare a report to the California Insurance Commissioner (Commissioner) outlining the corrective actions it intends to take. It is recommended that the Company immediately prepare a report to the Commissioner. The report should include, at a minimum, the following:

- Corrective actions the Company intends to take.
- A comprehensive financial plan that identifies the conditions that contributed to the Company's financial condition.
- Proposals to correct the Company's financial problems and provide projections of the Company's financial condition, both with and without the proposed corrections.
- A listing of the key assumptions underlying the projections and identify the quality of, and the problems associated with, the insurer's business.

On November 26, 2008, HCC Insurance Holdings Inc., a Texas holding corporation, through its California surety subsidiary American Contractors Indemnity Company (ACIC), entered into a "Stock Purchase Agreement" to purchase the Company. The stated intention is for the Company, after its purchase, to be merged into ACIC during the first quarter of 2009.

An application (regarding change of control) was submitted to the California Department of Insurance by ACIC on December 11, 2008. Regulatory approval on this application is pending.

MANAGEMENT AND CONTROL

The Company is wholly-owned by the M&L Erwin Trust with Mr. Montgomery Erwin as Trustee. Management of the Company is vested in a one-member board of directors elected annually. A listing of the member of the board and principal officers serving on December 31, 2007 follows:

Directors

Name and Residence	Principal Business Affiliation
Montgomery Erwin Hadlyme, Connecticut	Chairman and Chief Executive Officer Surety Company of the Pacific

Principal Officers

Name	Title
Paul R. Geissler	President
Sharon R. Ahlschwede	Treasurer
Kathleen K. Goodwin	Secretary, and Vice President Operations
George A. Peate	Senior Vice President, Underwriting
Melita Danie	Vice President Claims/Legal Administration
Marla D. Thompson	Vice President Claims
Suzanne C. Chiasson	Vice President Claims
Mary K. Weldon	Vice President Regulatory Compliance

CORPORATE RECORDS

California Insurance Code (CIC) Section 735 states that the Company must inform the board members of the receipt of the examination report. The board should be informed of the report both in the form first formally prepared by the examiners and in the form as finally settled and officially filed by the commissioner. The board must also enter that fact in the board minutes. A review of the board minutes did not disclose either form of the examination report being presented to the board of directors. It is recommended that the Company implement procedures to ensure future compliance with CIC Section 735.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to transact surety business in the State of California. The Company also holds a certificate of authority issued by the United States Department of the Treasury to write federal bonds. The Company had direct premiums written of $13.3 million in 2007.

The Company specializes in contractor's license bonds with a face value of $12,500. These license bonds represent approximately 95% of the direct premiums written, with the balance comprised of standard contract surety bonds, payment, and performance bonds.

The Company's business is produced by approximately 2,100 independent agents located throughout California. Commissions to the agents range between 20% and 39%.

Although requested, the Company was unable to provide written agency agreements with its independent agents. It is recommended that the Company execute written agency agreements addressing the rights and responsibilities of both parties, and the allowed commission rates. Subsequently, a written agency agreement between the Company and its three largest agents (together producing more than 60% of the business) was executed on October 8, 2008.

LOSS EXPERIENCE

The Company reported net operating losses and/or net income/(losses) as follows:

Year	Net Operating Gain or (Loss)	Net Income Or (Loss)
2004	$ (1,461,745)	$ (925,662)
2005	(740,374)	(141,041)
2006	(427,042)	433,797
2007 (*)	(427,093)	480,235

(*) not including examination adjustments

It should be noted that the net adjusted operating loss and net loss in 2007 as a result of this examination are ($1,427,093) and ($519,765).

REINSURANCE

Assumed

The Company did not assume reinsurance during the period under examination.

Ceded

The Company cedes on an excess of loss basis to Endurance Reinsurance Corporation of America. Pursuant to this reinsurance treaty, the Company cedes in two layers as follows:

Section A: The reinsurer's liability is $750,000 per bond (in excess of $250,000 Company retention) on the first $1 million and is subject to an annual aggregate limit of $2,250,000 on all bonds and principals.

Section B: The reinsurer's liability is $1 million per bond (in excess of $1 million Company retention) on 95% of the second $1 million and is subject to an annual aggregate limit of 95% of $2,000,000.

As of December 31, 2007 there were no reinsurance recoverables on paid and unpaid losses or loss adjustment expenses.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2007

Underwriting and Investment Exhibit for the Year Ended December 31, 2007

Reconciliation of Surplus as Regards Policyholders
from December 31, 2004 through December 31, 2007

Reconciliation of Examination Changes as of December 31, 2007

Statement of Financial Condition
as of December 31, 2007

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Note
Bonds	$ 14,622,783	$	$ 14,622,783	
Stocks:				
Common stocks	2,391,873		2,391,873	
Cash and short-term investments	2,503,407		2,503,407	
Investment income due and accrued	167,047		167,047	
Uncollected premiums and agent's balances in course of collection	283,898		283,898	
Net deferred tax asset	809,319	360,679	448,640	
Electronic data processing equipment	6,632		6,632	
Furniture and equipment	44,942	44,942		
Aggregate write-ins for other than invested assets	125,313	125,313		
Total assets	$ 20,955,214	$ 530,934	$ 20,424,280	
Liabilities, Surplus and Other Funds				
Losses and loss adjustment expenses			$ 4,245,981	(1)
Other expenses			30,266	
Taxes, licenses and fees			36,761	
Unearned premiums			10,849,927	
Advance premium			1,013,469	
Ceded reinsurance premiums payable			10,435	
Drafts outstanding			146,875	(2)
Capital notes			2,042	
Aggregate write-ins for liabilities			7,168	
Total liabilities			16,342,924	
Common capital stock		$ 1,000,000		
Gross paid-in and contributed surplus		1,588,662		
Unassigned funds (surplus)		1,492,694		
Surplus as regards policyholders			4,081,356	
Total liabilities, surplus and other funds			$ 20,424,280	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2007

Statement of Income

Underwriting Income		
Premiums earned		$ 13,166,222
Deductions:		
Losses and loss expenses incurred	$ 6,613,320	
Other underwriting expenses incurred	7,979,995	
Total underwriting deductions		14,593,315
Net underwriting loss		(1,427,093)
Investment Income		
Net investment income earned	$ 627,651	
Net realized capital gains	279,920	
Net investment gain		907,571
Other Income		
Net loss from agents' balances charged off	$ (243)	
Total other income		(243)
Net loss		$ (519,765)

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2006		$ 4,822,711
Net loss	$ (519,765)	
Change in net unrealized capital gains or (losses)	(200,949)	
Change in net deferred income tax	(74,624)	
Change in non-admitted assets	53,983	
Change in surplus as regards policyholders		(741,355)
Surplus as regards policyholders, December 31, 2007		$ 4,081,356

Reconciliation of Surplus as Regards Policyholders
from December 31, 2004 through December 31, 2007

Surplus as regards policyholders, December 31, 2004, per Examination			$ 4,316,313
	Gain in Surplus	Loss in Surplus	
Net loss	$	$ 227,009	
Net unrealized capital losses		109,143	
Change in net deferred income tax		262,299	
Change in non-admitted assets	202,317		
Aggregate write-ins for gains and losses in surplus	161,177		
Totals	$ 363,494	$ 598,451	
Net decrease in surplus as regards policyholders for the examination			(234,957)
Surplus as regards policyholders, December 31, 2007, per Examination			$ 4,081,356

Reconciliation of Examination Changes
as of December 31, 2007

Liabilities	Per Company	Per Examination	Surplus Increase (Decrease)	Note
Losses and loss adjustment expenses	$ 3,245,981	$ 4,245,981	$ (1,000,000)	(1)
Net decrease to surplus as regards policyholders			$ (1,000,000)	
Surplus as Regards Policyholders, December 31, 2007 per Company			5,081,356	
Surplus as Regards Policyholders, December 31, 2007 per Examination			$ 4,081,356	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

A Casualty Actuary from the California Department of Insurance (CDI) reviewed the work performed by the Company's independent actuary as of December 31, 2007. The CDI actuary determined that the reserves for losses and loss adjustment expenses were deficient by $1 million. An examination adjustment has been made to the Company's surplus.

(2) Draft Outstanding

The Company, in its 2007 Annual Statement, incorrectly classified $114,185 of outstanding check balances as "drafts outstanding" rather than as a reduction from "cash". It is recommended that the Company follow the classification methodology for cash as presented in the Annual Statement Instructions.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Summary of Significant Findings (Page 2): The Company's revised Risk Based Capital (RBC) ratio of approximately 112%, at September 30, 2008, places the Company within company action level under which the Company must prepare a report to the California Insurance Commissioner (Commissioner) outlining the corrective actions it intends to take. It is recommended that the Company immediately prepare a report to the Commissioner.

Corporate Records (Page 4): It is recommended that the Company implement procedures in its board meetings to ensure compliance with California Insurance Code (CIC) Sections 735.

Territory and Plan of Operation (Page 4): It is recommended that the Company execute written agency agreements with its independent agents.

Previous Report of Examination

Summary of Significant Findings: (Page 2): It was recommended that the Company develop a Comprehensive Surplus Plan and present it to the California Department of Insurance (CDI) for review. The Company presented a surplus plan to the CDI on March 10, 2006.

Accounts and Records: Losses (Page 5): It was recommended that the Company report the additional claims included in the claims tracking system to the claims accounting system in order to show a true claims count in its Annual Statement. Subsequently, the Company began including the additional claims from the claims tracking system into the counts for the Annual Statement, Schedule P.

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