

**STATE OF WASHINGTON
OFFICE OF THE INSURANCE
COMMISSIONER**



**FINANCIAL EXAMINATION
OF
PEMCO MUTUAL INSURANCE COMPANY
SEATTLE, WASHINGTON**

**NAIC CODE 24341
DECEMBER 31, 2008**

**Participating States:
Washington**

Order No. 2010-37
PEMCO Mutual Insurance Company
Exhibit A

SALUTATION

Seattle, Washington
February 23, 2010

The Honorable Mike Kreidler, Commissioner
Washington State Office of the Insurance Commissioner (OIC)
Insurance Building-Capitol Campus
302 Sid Snyder Avenue SW, Suite 200
Olympia, WA 98504

The Honorable Alfred W. Gross, Commissioner
State Corporation Commission
Bureau of Insurance
Commonwealth of Virginia
Chair, NAIC Financial Condition (E) Committee
PO Box 1157
Richmond, VA 23218

The Honorable Christina Urias, Director
NAIC Secretary, Western Zone
Arizona Department of Insurance
2910 North 44th Street, Suite 210
Phoenix, AZ 85018-7256

Dear Commissioners and Director:

In accordance with your instructions, and in compliance with the statutory requirements of RCW 48.03.010, an Association examination was made of the corporate affairs and financial records of

PEMCO Mutual Insurance Company

of

Seattle, Washington

hereinafter referred to as "PMIC," or the "Company" at the location of its home office, 325 Eastlake Avenue East, Seattle, Washington 98109. This report is respectfully submitted showing the condition of PMIC as of December 31, 2008.

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of PEMCO Mutual Insurance Company of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 2008.



Patrick H. McNaughton
Chief Examiner

2-23-10

Date

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SCOPE OF THE EXAMINATION

This examination covers the period January 1, 2004 through December 31, 2008 and comprises a risk focused review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Administrative Code (WAC), the Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook. The examination included identification and disposition of material transactions and events occurring subsequent to the date of examination through the end of field work, December 2, 2009.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. In addition, the Company's certified public accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

This examination was performed in compliance with the 2009 NAIC Financial Condition Examiners Handbook which requires the examiner to consider the Company's risk management process, corporate governance structure, and control environment. The examiners utilized the information obtained during the examination to assess PMIC's overall potential risks both currently and on an on-going basis, allowing the examiners to focus on the Company's greatest areas of risk, and providing assurance on the Company's financial statements as of the examination date.

INSTRUCTIONS

The examiners reviewed the Company's filed 2008 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the NAIC Annual Statement Instructions and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW, Title 284 WAC, and the NAIC Statements of Statutory Accounting Principles (SSAP) as contained in the NAIC Accounting Practices and Procedures Manual (AP&P).

The following summarizes the exceptions noted while performing this review:

1. Investment Custodial Agreements

The Company responded in its 2008 NAIC Annual Statement General Interrogatories 26.01 that its custodial agreement with US Bank complied with the FCEH. However, it did not contain several provisions required by the FCEH. RCW 48.05.250 requires a company to file a true statement of its financial condition, transactions and affairs.

The Company is instructed to comply with RCW 48.05.250 by filing a true statement of its financial condition, transactions and affairs and to follow the NAIC Annual Statement Instructions and the AP&P, as required by WAC 284-07-050(2). The Company is also instructed to execute a revised or amended custodial agreement that complies with the FCEH.

2. Annual Statement Errors

The results of the examination disclosed two instances in which the Company's filing of the 2008 NAIC Annual Statement did not conform to the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions. While the Company needs to correct these practices, neither of the following items in this instruction are believed to be material to the financial statements and no examination adjustments were necessary.

- a. The amount of premium receivable reported on page 2, line 13.1 and 13.2 of the 2008 NAIC Annual Statement is not correct as it includes premium receivable for a subsidiary, PIC. PIC is also reporting the amount as a premium receivable on its books.

The Company is instructed to comply with RCW 48.12.010 and report only assets that belong wholly and exclusively to the insurer.

- b. PMIC's premiums receivable and premium income are based on estimates which are never reconciled to actual numbers as necessary to report accurate financial statements.

The Company is instructed to comply with RCW 48.05.250 by filing a true statement of its financial condition, transactions and affair and to follow the NAIC Annual Statement Instructions and the AP&P, as required by WAC 284-07-050(2).

3. Cost and Service Sharing Agreement

The Company is not collecting and depositing premiums in accordance with its inter-company agreement with a subsidiary, PEMCO Insurance Company (PIC). According to the agreement, each company will collect and deposit premiums in a separate account of each company.

The Company is instructed to comply with RCW 48.31B.030 and adhere to the inter-company agreement approved by the Board of Directors and filed with the OIC.

COMMENTS AND RECOMMENDATIONS

1. Conflict of Interest Disclosures

PMIC's conflict of interest policy requires that conflict of interest disclosures be updated annually. The Company was unable to provide the current conflict of interest disclosure forms for six key employees.

In order to demonstrate compliance with RCW 48.05.370, it is recommended that the Company obtain and review conflict of interest declarations from appropriate personnel

and to report the results to the Company's Board of Directors, as required by the Company's conflict of interest policy.

COMPANY PROFILE

Company History

PMIC was organized as a mutual insurer in the state of Washington during October 1948 and commenced business during February 1949 under the name, Public Employees Mutual Insurance Company. In January 1977, pursuant to RCW 48.31.010, the merger of Public Employees Mutual Casualty Company into Public Employees Mutual Insurance Company was approved. The name was later changed to PEMCO Mutual Insurance Company in January 1989. PMIC is the ultimate controlling entity in the insurance holding company system.

Territory and Plan of Operation

The Company is licensed to operate in the states of Washington and Oregon and its Certificates of Authority were issued on February 8, 1949 and January 21, 2004, respectively. It writes multiple-line property and casualty coverage for the general public.

PMIC utilizes direct and independent agents to acquire new business in Washington. Servicing of customers can be accomplished either by an independent agent or by the Company.

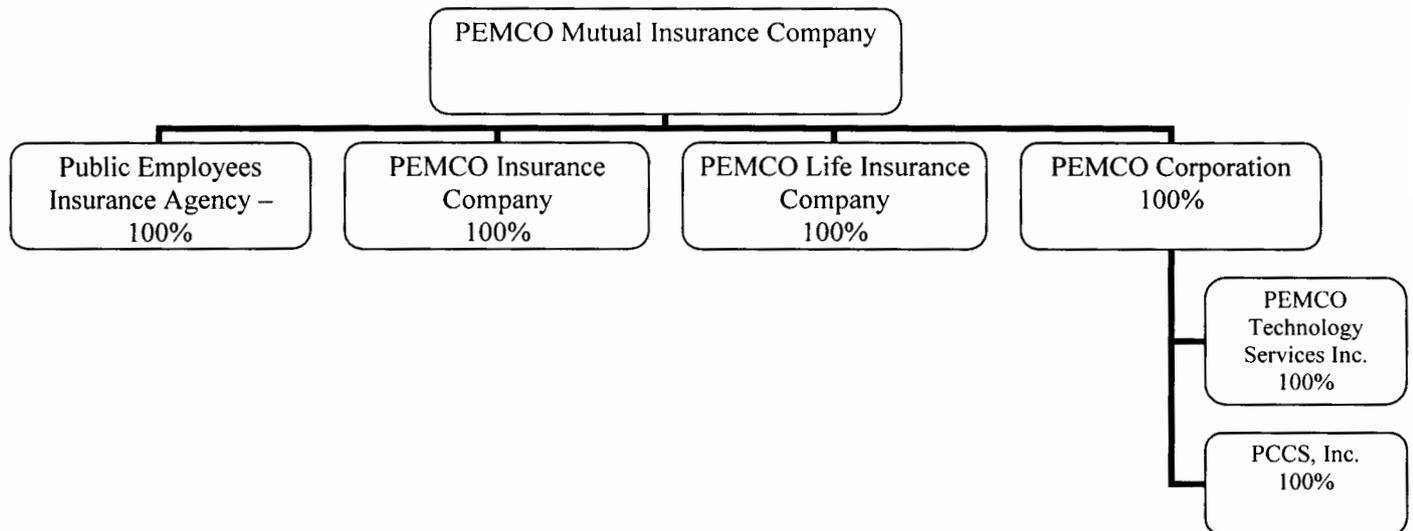
Growth of Company

The Company's growth, as reported in its filed NAIC Annual Statements, is illustrated below.

<u>Year</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Capital & Surplus</u>
2008	\$502,884,466	\$290,397,944	\$212,486,522
2007	525,306,935	286,560,158	\$238,746,777
2006	537,189,682	320,987,997	\$216,201,685
2005	498,377,286	300,484,829	\$197,892,457
2004	475,894,563	294,811,138	\$181,083,425

<u>Year</u>	<u>Premiums Earned</u>	<u>Net Underwriting Gain (Loss)</u>	<u>Net Investment Gain (Loss)</u>	<u>Net Income</u>
2008	\$231,880,451	(\$10,883,813)	\$11,923,673	(\$509,562)
2007	228,609,054	7,406,549	20,660,420	22,089,895
2006	232,500,575	(16,336,040)	27,834,724	12,375,695
2005	238,525,408	7,580,174	19,789,162	24,628,676
2004	235,569,051	(667,162)	24,851,656	21,284,212

AFFILIATED COMPANIES



Intercompany Contracts

The Company was a party to intercompany contracts with affiliates. Significant agreements in force at December 31, 2008 were: Tax Sharing Agreement, used to determine allocation of federal income tax among affiliates; Shared Services Agreement, used to define the parties' responsibilities regarding payment of the 401K Plan's expenses and to define the applicable cost allocation methodology for the companies; and the Cost Sharing Agreement, used for allocation of operational expenses performed by the Company on behalf of its affiliates.

MANAGEMENT AND CONTROL

Board of Directors (BOD)

As of December 31, 2008, the Company was controlled by a ten member BOD of which eight are outside directors. All BOD members are elected for a three-year term at the annual meeting of the policyholders.

Directors:

Stan McNaughton Chairman
Brian Benzel
Linda Cowan
Shirley Hodgson
Sandra Kurack
Roger Reimer
Richard Rutowski
Borje Saxberg
Carl Tingelstad
Richard White

Officers:

Stan McNaughton	President and CEO
Steven Ricco	Vice President, Treasurer and CFO
Rodney Brooks	Vice President and CMO
Jack Brown	Vice President and CIO
Susan McNab	Vice President and CHRO
Stephen Miller	Vice President and COO
Denice Town	Secretary

Committees

PMIC's corporate bylaws provide that the BOD designate an Executive Committee at its first regular meeting of each year. Additionally, the BOD has the authority to appoint such additional standing or temporary committees as the Board deems necessary. Active committees during the period of the examination were the Executive Committee, Investment Committee, Proxy Committee, Nominating Committee, Audit Committee and Compensation Committee.

Conflict of Interest

All affiliated companies have a combined Conflict of Interest and Confidentiality Policy which requires completion of a Conflict of Interest Statement by officers, directors and employees annually. All are required to disclose relevant outside interests, memberships, associations and affiliations. The Company was unable to provide six signed conflict of interest disclosure forms for key employees. (See Comment and Recommendation No. 1.)

Fidelity Bond and Other Insurance

The Company has a fidelity institution bond from Hartford Fire Insurance Company with a single loss limit of liability of \$5,000,000 and a single loss deductible of \$25,000. This bond covers all Company employees. The Company's fidelity coverage meets the NAIC's minimum recommended amount.

Officers', Employees', and Agents' Welfare and Pension Plans

The Company sponsors a 401(k) plan. This is a defined contribution retirement plan and substantially all employees are eligible to participate. Eligible employees may contribute up to \$15,500 (in 2008) of their salary to the plan, which is subject to a two-for-one Company match of the first 6%.

The Company offers a non-qualified deferred compensation plan for certain senior executives and directors of the Company.

In addition, the Company provides certain medical and dental insurance coverage to eligible employees, directors and retirees.

CORPORATE RECORDS

The initial Articles of Incorporation were adopted by the Company organizers on September 7, 1948 and were filed with the state of Washington in accordance with the Washington Insurance Code. There have been four subsequent amendments to the original Articles of Incorporation, the latest being in 1989.

The BOD meetings were well attended and the minutes demonstrated that the BOD members were actively involved in the administration of the Company's affairs. All meetings were documented in writing, noting discussion items, and specific actions taken.

UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSE RESERVES

<u>Year</u>	<u>Loss Reserves</u>	<u>LAE Reserves</u>
2008	\$84,986,787	\$22,917,714
2007	89,602,621	23,386,298
2006	120,743,864	28,388,469
2005	105,261,678	24,496,205
2004	97,227,012	22,827,513

The reserves carried by the Company for these liabilities were \$84,986,787 and \$22,917,714, respectively, as of December 31, 2008.

These reserves were reviewed by the casualty actuarial staff employed by the OIC. The Company provided loss and loss adjustment expense development data by accident year and sub-line. Actuarial staff obtained additional information by interviewing Company employees. They also reviewed an actuarial report prepared by PricewaterhouseCoopers, the Company's consulting actuarial firm.

The OIC actuarial staff's estimates indicate that the reserves for both losses and loss adjustment expenses, on a net basis, are within a reasonable range. Therefore, these reserves are accepted as they appear in the Company's 2008 NAIC Annual Statement.

REINSURANCE

PMIC participates in quota share, excess loss and catastrophic treaties. The Company does not assume any business. Reinsurance agreements were found to be in compliance with Washington State reinsurance statutes and are all properly classified in Schedule F of the Company's 2008 NAIC Annual Statement. The Company has controls in place to monitor its reinsurance program including the financial condition of the reinsurers.

PMIC utilizes the services of a reinsurance intermediary, Guy Carpenter & Company, Inc., to solicit, negotiate, and place reinsurance cessions on its behalf. Guy Carpenter & Company, Inc. is an international reinsurance intermediary owned by Marsh & McLennan and is licensed in Washington State.

ACCOUNTING RECORDS AND INFORMATION SYSTEMS

The Company maintains its accounting records on a Statutory Accounting Principles (SAP) basis for NAIC Annual Statement reporting. The Company is audited annually by the certified public accounting firm of PriceWaterhouseCoopers. The Company received an unqualified opinion for all years under review. The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning and testing phase of the examination and no exceptions were noted.

The management of the Company is sufficiently knowledgeable of the information systems (IS) process. Systems development, acquisition, and maintenance controls were evaluated to gain assurance that appropriate controls are in place. Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; backup and recovery facilities employed; and the controls exercised to maintain data security. Sufficient internal controls are in place and monitored by the Company. The Company's IS Department has the ability to recover from an incident or disaster and has documented these procedures in a detailed, written disaster recovery plan.

SUBSEQUENT EVENTS

1. On October 16, 2009, PMIC loaned \$500,000 to PLIC. This is a short-term loan and was paid in full on October 28, 2009. Form D was filed with the OIC on August 31, 2009.
2. On October 22, 2009, the BOD approved the capital contribution of \$1,650,000 to PLIC to maintain the PLIC surplus level of \$3.5 million. An amendment to the 2008 Form B was filed with the OIC on November 13, 2009.
3. The Company's wholly-owned subsidiary, PEMCO Corporation (Corp) sold its subsidiary, PEMCO Technology Services, Inc. (PTSI), on October 29 2009. An amendment to the 2008 Form B was filed with the OIC on November 13, 2009.
4. PMIC received a cash dividend from PEMCO Corporation of \$32 million on October 30, 2009 as a result of the sale of PTSI.

FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS

All previous report instructions and comments have been addressed and corrected.

FINANCIAL STATEMENTS

Assets, Liabilities, Surplus and Other Funds

Summary of Operations

Reconciliation of Capital and Surplus For the Period Since the Last Examination

PEMCO Mutual Insurance Company
Assets, Liabilities, Surplus and Other Funds
December 31, 2008

Assets	Balance Per Company	Examination Adjustments	Balance Per Examination
Bonds	\$255,600,804	\$0	\$255,600,804
Common stocks	91,721,933		91,721,933
Real Estate:			
Properties occupied by the company	11,667,071		11,667,071
Properties held for the production of income	926,137		926,137
Cash and short-term investments	9,731,711		9,731,711
Other invested assets	7,373,082		7,373,082
Aggregate write-ins for invested assets	1,664,235		1,664,235
Subtotal, cash and invested assets	378,684,973	0	378,684,973
Investment income due and accrued	2,527,833		2,527,833
Uncollected premiums and agents' balances in course of collection	11,419,244		11,419,244
Deferred Premiums, and agents' balances and installments booked but deferred and not yet due	80,880,276		80,880,276
Net deferred tax asset	11,470,156		11,470,156
Electronic data processing equipment and software	3,931,900		3,931,900
Current federal and foreign income tax recoverable and interest thereon	7,671,922		7,671,922
Receivable from parent, subsidiaries and affiliates	6,237,347		6,237,347
Aggregate write-ins for other than invested assets	60,815		60,815
Total Assets	\$502,884,466	\$0	\$502,884,466
Liabilities, Surplus and other Funds			
Losses	\$84,986,787	\$0	\$84,986,787
Loss adjustment expenses	22,917,714		22,917,714
Commissions payable, contingent commissions and other similar charges	2,729,104		2,729,104
Other expenses	24,130,871		24,130,871
Taxes, licenses and fees (excluding federal and foreign income taxes)	287,156		287,156
Unearned premiums	121,250,368		121,250,368
Advanced premium	1,850,067		1,850,067
Ceded reinsurance premiums payable	659,759		659,759
Amounts withheld or retained for account of others	1,700		1,700
Payable to parent, subsidiaries and affiliates	6,869,409		6,869,409
Aggregate write-ins for liabilities	24,715,009		24,715,009
Total Liabilities	290,397,944	0	290,397,944
Common capital stock	0		0
Gross paid in and contributed surplus	0		0
Unassigned funds (surplus)	212,486,522		212,486,522
Surplus as regards policyholders	212,486,522		212,486,522
Total Liabilities, Surplus and other Funds	\$502,884,466	\$0	\$502,884,466

PEMCO Mutual Insurance Company
Statement of Income and Capital and Surplus Account
December 31, 2008

	<u>Balance Per Company</u>	<u>Examination Adjustments</u>	<u>Balance Per Examination</u>
Underwriting Income			
Premiums earned	\$231,880,451	\$0	\$231,880,451
Deductions			
Losses incurred	119,372,943		119,372,943
Loss expenses incurred	42,716,397		42,716,397
Other underwriting expenses incurred	80,674,924		80,674,924
Total underwriting deductions	<u>242,764,264</u>		<u>242,764,264</u>
Net underwriting gain or (loss)	<u>(10,883,813)</u>	<u>0</u>	<u>(10,883,813)</u>
Investment Income			
Net investment income earned	19,652,381		19,652,381
Net realized capital gains or (losses)	<u>(7,728,708)</u>		<u>(7,728,708)</u>
Net investment gain or (loss)	<u>11,923,673</u>	<u>0</u>	<u>11,923,673</u>
Other Income			
Finance and service charges not included in premiums	434,929		434,929
Total other income	<u>434,929</u>	<u>0</u>	<u>434,929</u>
Net income, after dividends to policyholders but before federal and foreign income taxes	1,474,789		1,474,789
Federal and foreign income taxes incurred	<u>1,984,351</u>		<u>1,984,351</u>
Net income	<u>(\$509,562)</u>	<u>\$0</u>	<u>(\$509,562)</u>
Capital and Surplus Account			
Surplus as regards policyholders, December 31 prior year	<u>\$238,746,777</u>	<u>\$0</u>	<u>\$238,746,777</u>
Gains and (Losses) in Surplus			
Net income	(509,562)		(509,562)
Change in net unrealized capital gains or (losses)	(19,802,320)		(19,802,320)
Change in net deferred income tax	2,607,987		2,607,987
Change in nonadmitted assets	(7,939,141)		(7,939,141)
Aggregate write-ins for gains and losses in surplus	<u>(617,219)</u>		<u>(617,219)</u>
Change in surplus as regards policyholders for the year	<u>(26,260,255)</u>	<u>0</u>	<u>(26,260,255)</u>
Surplus as regards policyholders, December 31 current year	<u>\$212,486,522</u>	<u>\$0</u>	<u>\$212,486,522</u>

PEMCO Mutual Insurance Company
Five Year Reconciliation of Surplus
For the Years Ended December 31

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Capital and Surplus, December 31, previous year	\$ 238,746,777	\$ 216,201,685	\$ 197,892,457	\$ 181,083,425	\$ 170,751,844
Net income	(509,562)	22,089,895	12,375,695	24,628,676	21,284,212
Change in net unrealized capital gains or (losses)	(19,802,320)	2,452,974	4,874,827	(1,494,050)	(4,582,123)
Change in net deferred income tax	2,607,987	(1,881,625)	1,002,244	(723,666)	3,222,829
Change in nonadmitted assets	(7,939,141)	(173,382)	(2,554,960)	(6,131,215)	(9,605,167)
Cumulative effects of changes in accounting principles	0	0	0	505,847	0
Aggregate write-ins for gains and losses in surplus	(617,219)	57,230	2,611,422	23,440	11,830
Change in surplus as regards policyholders for the year	(26,260,255)	22,545,092	18,309,228	16,809,032	10,331,581
Capital and Surplus, December 31, current year	<u>\$ 212,486,522</u>	<u>\$ 238,746,777</u>	<u>\$ 216,201,685</u>	<u>\$ 197,892,457</u>	<u>\$ 181,083,425</u>

NOTES TO FINANCIAL STATEMENTS

None

ACKNOWLEDGMENT

Acknowledgment is hereby made of the cooperation extended to the examiners by the officers and employees of PEMCO Mutual Insurance Company during the course of this examination.

In addition to the undersigned, Michael V. Jordan, CPA, CFE, MHP, Assistant Chief Examiner; Timoteo L. Navaja, CFE, CIE, Property and Casualty Field Supervisor; Jerry Epler, CPA, CFE, ABV; John Jacobson, AFE, CISA, AES, Automated Examination Specialist; D. Lee Barclay, FCAS, MAAA, Senior Actuary; Eric Slavich, Actuarial Analyst; Dan Forsman, Actuarial Analyst; Albert Karau, Jr. CPA, CFE, FLMI Financial Examiner, and Zairina Othman, Financial Examiner, all from the Washington State Office of the Insurance Commissioner, participated in the examination and in the preparation of this report.

Respectfully submitted,

A handwritten signature in cursive script that reads "Susan Campbell". The signature is written in black ink and is positioned above a horizontal line.

Susan Campbell, CPA, FLMI, CFE, ARA
Examiner in Charge
State of Washington

AFFIDAVIT

STATE OF WASHINGTON }
 } ss
COUNTY OF KING }

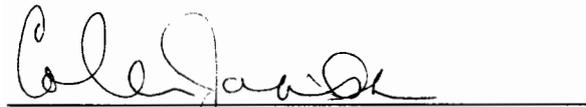
Susan Campbell, CPA, FLMI, CFE, ARA, being duly sworn, deposes and says that the foregoing report subscribed by her is true to the best of her knowledge and belief.

She attests that the examination of PEMCO Mutual Insurance Company was performed in a manner consistent with the standards and procedures required or prescribed by the Washington State Office of the Insurance Commissioner and the National Association of Insurance Commissioners (NAIC).



Susan Campbell, CPA, FLMI, CFE, ARA
Examiner-in-Charge
State of Washington

Subscribed and sworn to before me this 23rd day of February, 2010.



Notary Public in and for the
State of Washington

