

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



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

**NAIC CODE 18805
DECEMBER 31, 2008**

**Participating States:
Washington**

Order No. 2010-36
PEMCO 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 Insurance Company

of

Seattle, Washington

hereinafter referred to as "PIC," 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 PIC as of December 31, 2008.

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of PEMCO 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 PIC'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 Error

The results of the examination disclosed an instance 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 this practice, this instruction is believed not to be material to the financial statements and no examination adjustment was necessary.

- a. PIC'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 its parent, PEMCO Mutual Insurance Company (PMIC). 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

PIC'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

PIC was incorporated on May 4, 1972, as a stock multiple line property and casualty insurance company under the laws of the state of Washington. The Company currently writes auto insurance to educators in the state of Washington. PIC is a wholly-owned subsidiary of PMIC.

Territory and Plan of Operation

PIC is licensed to operate in the states of Washington, and Oregon and its Certificates of Authority were issued on August 22, 1972, and February 10, 2004, respectively.

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

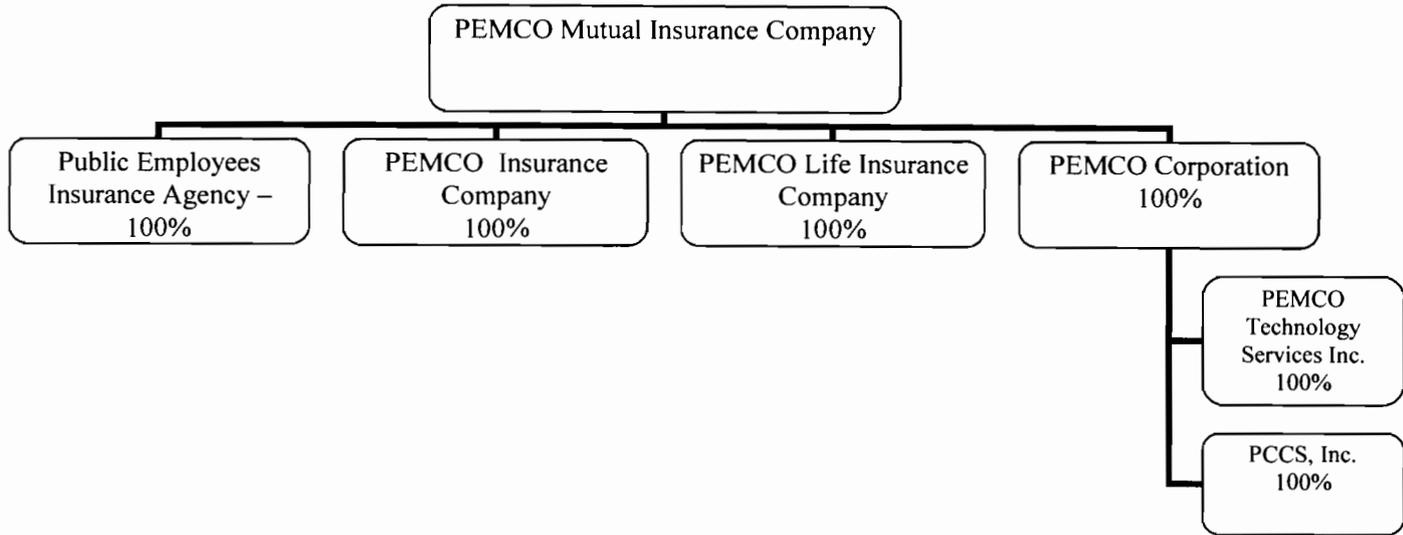
Growth of Company

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	\$133,894,589	\$83,178,953	\$50,715,636
2007	144,405,111	84,715,793	59,689,318
2006	150,420,580	91,569,734	58,850,846
2005	160,816,968	102,030,248	58,786,720
2004	162,721,647	100,364,280	62,357,367

<u>Year</u>	<u>Premiums Earned</u>	<u>Net Underwriting Gain (Loss)</u>	<u>Net Investment Gain (Loss)</u>	<u>Net Income</u>
2008	\$70,392,841	(\$4,479,233)	(\$1,021,256)	(\$5,497,588)
2007	72,069,616	1,527,784	5,757,673	5,311,481
2006	74,883,853	1,635,767	6,008,490	7,135,755
2005	78,770,217	(1,935,449)	6,042,700	3,201,979
2004	78,501,259	(3,024,811)	6,493,147	2,509,621

AFFILIATED COMPANIES



Intercompany Contracts

The Company is a party to intercompany contracts with PMIC and affiliates. Significant agreements in force at December 31, 2008 were: Tax Sharing Agreement, used to determine allocation of federal income tax among affiliates; and the Cost Sharing Agreement, used for allocation of operational expenses performed on its behalf by PMIC.

MANAGEMENT AND CONTROL

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 one-year term at the annual stockholders' meeting.

Board of Directors:

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

Officers:

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

Committees

The BOD has appointed an Investment Committee, consisting of the Company's CEO, CFO, treasury director, and director of enterprise services. The Audit Committee of the BOD of PMIC also serves as the Audit Committee for the Company.

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 with 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 employees of the Company.

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

PIC has no direct employees; however, employees of PMIC provide services to the Company and a portion of PMIC's employee costs are allocated to the Company. Sponsored plans include a 401(k) plan that covers substantially all of PMIC's employees, a non-qualified deferred compensation plan for certain executives and directors, and 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 April 26, 1972 and were filed with the state of Washington. There have been no subsequent amendments to the original Articles of Incorporation.

The BOD was active during the examination period. Meetings were well attended and the minutes were in sufficient detail and substance to demonstrate that the BOD members were actively involved in the administration of the affairs of the Company. 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	\$32,779,147	\$8,522,494
2007	35,491,175	8,882,709
2006	41,184,831	9,571,816
2005	44,907,340	9,663,883
2004	42,956,234	9,008,129

The reserves carried by the Company for these liabilities were \$32,779,147 and \$8,522,494, respectively, as of December 31, 2008.

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

The OIC's casualty 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

PIC 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.

PIC 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 PIC 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

None

FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS

All previous report instructions and comments have been addressed or 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 Insurance Company
Assets, Liabilities, Surplus and Other Funds
December 31, 2008

Assets	Balance Per Company	Examination Adjustments	Balance Per Examination
Bonds	\$90,082,524	\$0	\$90,082,524
Common stocks	9,221,099		9,221,099
Cash and short-term investments	5,426,897		5,426,897
Subtotal, cash and invested assets	104,730,520	0	104,730,520
Investment income due and accrued	1,063,990		1,063,990
Uncollected premiums and agents' balances in course of collection	1,101,407		1,101,407
Deferred Premiums, and agents' balances and installments booked but deferred and not yet due	20,968,901		20,968,901
Current federal and foreign income tax recoverable and interest thereon	1,256,547		1,256,547
Net deferred tax asset	3,100,476		3,100,476
Guaranty funds receivable or on deposit	0		0
Receivables from parent, subsidiaries and affiliates	1,624,924		1,624,924
Aggregate write-ins for other than invested assets	47,824		47,824
Total Assets	\$133,894,589	\$0	\$133,894,589
Liabilities, Surplus and other Funds			
Losses	\$32,779,147	\$0	\$32,779,147
Loss adjustment expenses	8,522,494		8,522,494
Commissions payable, contingent commissions and other similar charges	527,023		527,023
Other expenses	1,500		1,500
Taxes, licenses and fees (excluding federal and foreign income taxes)	60,666		60,666
Unearned premiums	36,252,037		36,252,037
Payable to parent, subsidiaries and affiliates	4,913,972		4,913,972
Aggregate write-ins for liabilities	122,114		122,114
Total Liabilities	83,178,953	0	83,178,953
Common capital stock	1,000,000		1,000,000
Gross paid in and contributed surplus	1,000,000		1,000,000
Unassigned funds (surplus)	48,715,636		48,715,636
Surplus as regards policyholders	50,715,636		50,715,636
Total Liabilities, Surplus and other Funds	\$133,894,589	\$0	\$133,894,589

PEMCO 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	\$70,392,841	\$0	\$70,392,841
Deductions			
Losses incurred	39,436,185		39,436,185
Loss expenses incurred	12,812,507		12,812,507
Other underwriting expenses incurred	22,623,382		22,623,382
Total underwriting deductions	<u>74,872,074</u>		<u>74,872,074</u>
Net underwriting gain or (loss)	<u>(4,479,233)</u>	<u>0</u>	<u>(4,479,233)</u>
Investment Income			
Net investment income earned	4,538,178		4,538,178
Net realized capital gains or (losses)	(5,559,434)		(5,559,434)
Net investment gain or (loss)	<u>(1,021,256)</u>	<u>0</u>	<u>(1,021,256)</u>
Other Income			
Finance and service charges not included in premiums	110,773		110,773
Total other income	<u>110,773</u>	<u>0</u>	<u>110,773</u>
Net income, after dividends to policyholders but before federal and foreign income taxes	(5,389,716)		(5,389,716)
Federal and foreign income taxes incurred	107,872		107,872
Net income	<u><u>(\$5,497,588)</u></u>	<u><u>\$0</u></u>	<u><u>(\$5,497,588)</u></u>
Capital and Surplus Account			
Surplus as regards policyholders, December 31 prior year	<u>\$59,689,318</u>	<u>\$0</u>	<u>\$59,689,318</u>
Gains and (Losses) in Surplus			
Net income	(5,497,588)		(5,497,588)
Change in net unrealized capital gains or (losses)	(2,771,317)		(2,771,317)
Change in net deferred income tax	233,842		233,842
Change in nonadmitted assets	(706,619)		(706,619)
Aggregate write-ins for gains and losses in surplus	(232,000)		(232,000)
Change in surplus as regards policyholders for the year	<u>(8,973,682)</u>	<u>0</u>	<u>(8,973,682)</u>
Surplus as regards policyholders, December 31 current year	<u><u>\$50,715,636</u></u>	<u><u>\$0</u></u>	<u><u>\$50,715,636</u></u>

PEMCO 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, prior year	\$ 59,689,318	\$ 58,850,846	\$ 58,786,720	\$ 62,357,367	\$ 63,193,764
Net income	(5,497,586)	5,311,481	7,135,755	3,201,979	2,509,621
Change in net unrealized capital gains or (losses)	(2,771,319)	(190,357)	83,471	(823,150)	335,626
Change in net deferred income tax	233,842	(282,652)	(1,763,542)	325,171	336,556
Change in nonadmitted assets	(706,619)	0	267,388	(243,263)	(18,200)
Cumulative effects of changes in accounting principles	0	0	0	168,616	0
Dividends to stockholders	0	(4,000,000)	(5,800,000)	(6,200,000)	(4,000,000)
Aggregate write-ins for gains and losses in surplus	(232,000)	0	141,054	0	0
Change in surplus as regards policyholders for the year	(8,973,682)	838,472	64,126	(3,570,647)	(836,397)
Capital and Surplus, December 31, current year	\$ 50,715,636	\$ 59,689,318	\$ 58,850,846	\$ 58,786,720	\$ 62,357,367

NOTES TO THE FINANCIAL STATEMENTS

None

ACKNOWLEDGMENT

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

In addition to the undersigned, Michael V. Jordan, CPA, CFE, MHP; 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; Roy Olson, FSA, MAAA, Life Actuary; 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,



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

AFFIDAVIT

STATE OF WASHINGTON

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COUNTY OF KING

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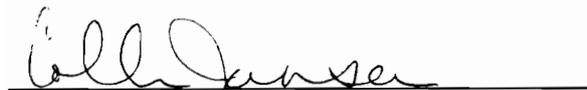
Susan Campbell, CPA, FLMI, CFE, ARA, being duly sworn, deposes and says that the foregoing report subscribed by her is true to the best of her knowledge and belief.

She attests that the examination of PEMCO 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
Reinsurance Specialist
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

