

REPORT ON EXAMINATION

OF THE

**AMERICAN EMPIRE SURPLUS
LINES INSURANCE COMPANY**

AS OF

DECEMBER 31, 2006

I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of DECEMBER 31, 2006 of the

**AMERICAN EMPIRE SURPLUS LINES
INSURANCE COMPANY**

is a true and correct copy of the document filed with this Department.

ATTEST BY: Antoinette Handy

DATE: 24 JUNE 2008



*In Witness Whereof, I HAVE HEREUNTO SET MY HAND
AND AFFIXED THE OFFICIAL SEAL OF THIS
DEPARTMENT AT THE CITY OF DOVER, THIS
24TH DAY OF JUNE 2008.*

Matthew Denn
Insurance Commissioner

REPORT ON EXAMINATION
OF THE
AMERICAN EMPIRE SURPLUS LINES INSURANCE COMPANY
AS OF
December 31, 2006

The above captioned Report was completed by examiners of the Delaware Insurance Department.

Consideration has duly been given to the comments, conclusions, and recommendations of the examiners regarding the status of the Company as reflected in the Report.

This Report is hereby accepted, adopted, and filed as an official record of this Department.

A handwritten signature in black ink, appearing to read "Matt Denn", written in a cursive style.

MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 24TH Day of JUNE 2008.

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SALUTATION

April 24, 2008

Honorable Alfred W. Gross
Chairman Financial Condition (E) Committee
National Association of Insurance Commissioners
2301 McGee, Suite 800
Kansas City, Missouri 64108-2604

Honorable Matthew Denn
Insurance Commissioner
State of Delaware
Rodney Building
841 Silver Lake Boulevard
Dover, Delaware 19901

Dear Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority #07.032 dated May 5, 2007 an examination has been made of the affairs, financial condition and management of the

AMERICAN EMPIRE SURPLUS LINES INSURANCE COMPANY

Hereinafter referred to as the "Company" or "AESLIC". The examination was conducted at the administrative office of the Company located at 580 Walnut Street, Cincinnati, Ohio 45202.

SCOPE OF EXAMINATION

Representatives of the Delaware Department of Insurance conducted the previous examination as of December 31, 2001. The current examination was conducted utilizing the National Association of Insurance Commissioners (NAIC) Risk Surveillance Methodology and covers the intervening period January 1, 2002 to December 31, 2006.

The “Risk Surveillance” approach, as outlined by the NAIC, seeks to identify residual risk relating to specific operational areas that are determined in part by the evaluation of design effectiveness and operating effectiveness of operating controls. Upon the determination of medium to high residual risk, additional examination procedures are performed to determine the monetary effect upon the Company’s financial statements. Having performed the examination under the “Risk Surveillance” approach, the examiner utilized the work performed by others with primary reliance on work performed by the Company’s external auditors, Ernst & Young LLP, and the Ohio Department of Insurance examination team relating to Investments and Treasury operation, Actuarial loss reserve review, Taxes and Information Technology review.

The examination also consisted of a general survey of the Company’s business policies and practices, management, any corporate matters incident thereto, a verification and evaluation of assets and a determination of liabilities as of December 31, 2006. Transactions subsequent to December 31, 2006 were reviewed where deemed necessary. The format of this report is designed to explain the procedures employed on examination and the text will explain changes wherever made. If necessary, comments and recommendations have been made in those areas in need of correction or improvement. In such matters, these issues were thoroughly discussed with responsible officials during the course of the examination.

The general procedure of the examination followed the rules established by the Committee of Financial Examiners Handbook, NAIC. Statements of Statutory Accounting Principles contained in the NAIC Accounting Practices and Procedures Manual as of March 2007 guided conclusions.

The Company is the lead company in a pooling agreement with its sole subsidiary company. The companies and the pooling percentages as of December 31, 2006 are as follows:

<u>Company</u>	<u>State</u>	<u>%</u>
American Empire Surplus Lines Insurance Company (AESLIC)	(DE)	90%
American Empire Insurance Company (AEIC)	(OH)	<u>10%</u>
Total		<u>100%</u>

In addition to the items included as part of this written report, the following items were reviewed but not commented upon.

- Corporate Records
- Fidelity Bond and Other Insurance
- Statutory Deposits
- Employees Welfare
- Legal Actions Pending Settlement
- Business in-force by state
- All Asset and Liability items not commented upon

HISTORY

The Company was originally incorporated under the laws of the State of Delaware on July 15, 1977, under the name of Great American Surplus Lines Insurance Company. The Certificate of Incorporation was amended on December 10, 1986 to change the name of the Company to American Empire Surplus Lines Insurance Company. The registered office of the Company is located at 1209 Orange Street, Wilmington, Delaware 19801. The Company is a member of a holding company system and is wholly owned by Great American Holding, Inc. The ultimate parent is American Financial Group, Inc. (AFG or the Group) a publicly traded

company controlled by the Lindner family. Additional comments are included under the caption “Insurance Holding Company System”.

CAPITALIZATION

The Certificate of Incorporation authorizes 10,000 shares of common stock with no par value. On July 18, 1977, the Great American Insurance Company acquired all 10,000 shares for \$2,500,000. The sole shareholder made the following contributions to the common capital stock and gross paid in and contributed surplus during the period under examination.

<u>Year</u>	<u>Common Capital Stock</u>	<u>Gross Paid In and Contributed Surplus</u>
2001 Balance	\$4,100,000	\$74,899,995
2002 Activity		(20,000,000) *
2006 Activity		<u>184,008</u>
2006 Balance	<u>\$4,100,000</u>	<u>\$55,084,003</u>

* Return of Capital Distribution

DIVIDENDS

The Company has paid the following amounts in dividends for the period under review.

<u>Year</u>	<u>Dividends</u>
2002	-0-
2003	-0-
2004	60,000,000
2005	40,000,000
2006	32,000,000

All dividends had the proper notification and or approval.

MANAGEMENT AND CONTROL

The Company’s Certificate of Incorporation provides for the Company to be managed by a Board of Directors. Article II, Section 8 of the bylaws states that the Board of Directors shall

consist of not fewer than four (4) members nor more than twelve (12). All Directors shall be elected annually. The following directors were duly elected and serving as of May 01, 2006:

<u>Director</u>	<u>Principal Occupation</u>
Gary J. Gruber	Senior Vice President Great American Insurance Company
Karen Holley Horrell	Senior Vice President Executive Counsel & Secretary Great American Insurance Company
Keith A. Jensen	Senior Vice President & Chief Financial Officer American Financial Group, Inc.
Donald D. Larson	Executive Vice President Great American Insurance Company
Robert A. Nelson	President AESLIC

In accordance with Article V, Section 1 of the Company's bylaws, the officers of the Company shall consist of a Chairman of the Board, a President, one or more Vice Presidents, a Treasurer, one or more Secretaries, and such other Assistant Vice Presidents, Assistant Treasurers, or other officers as from time to time, may appear to the Board of Directors necessary or desirable for the conduct of the affairs of the corporation. The same person may hold any two offices, except that any person holding office as Secretary shall not hold the office of Chairman of the Board or President. At the Annual Meeting of the Board of Directors the following officers were elected:

<u>Officer</u>	<u>Position</u>
Gary J. Gruber	Chairman
Robert A. Nelson	President
Chester A. Nalepa	Senior Vice President
Frederick J. Woebse	Senior Vice President
T. Matthew Held	Vice President and Treasurer

Committees

The Company's bylaws provide for a Finance Committee and an Executive Committee whose members are to be appointed by the Board of Directors. The following members were duly appointed and serving as of December 31, 2006:

Executive Committee

Gary J. Gruber
Keith A. Jensen
Donald D. Larson
Robert A. Nelson

Finance Committee

Gary J. Gruber
Keith A. Jensen
Donald D. Larson

The Group has an established procedure for disclosure of any conflict of interest on the part of its directors and officers. A sample of the statements filed by directors and officers was reviewed to determine compliance with the procedure. No discrepancies were noted.

AGREEMENTS

Bonds and stocks of the Company are held under agreements with the Bank of New York and National City Bank of Cleveland, Ohio.

The Company and its sole subsidiary, American Empire Insurance Company (AEIC), participate in an inter-company pooling agreement. The effect of the pooling is to transfer all net insurance liabilities to the Company, which in turn cedes the specified percentages of net underwriting results to AEIC.

The Company and American Empire Underwriters, Inc. (AEUI) are parties to a Managing General Agency Agreement effective January 1, 2001. AEUI is a wholly owned downstream subsidiary located in Houston, Texas. All employees of AEUI are employees of the Company.

The Company is also a party to an agreement with American Money Management Corporation of Cincinnati, Ohio, an affiliate, which (subject to the direction and approval of the Finance Committee) provides management and accounting services related to investments on an incurred cost and expense basis.

Services also are provided between the Company and affiliates through a General Services Agreement with both insurance and non-insurance affiliates; the costs of such services are allocated on the basis of usage.

The Company also participates in an inter-company tax allocation agreement with American Financial Group, Inc. effective December 31, 2005.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to transact business only in the State of Delaware in accordance with Certificate of Authority No. 2353-P dated February 25, 1987. The Company operates on an approved surplus lines basis in all states other than Delaware. The Company is an excess and surplus lines carrier dealing exclusively with wholesale type licensed brokers. Commercial excess and surplus lines coverages are marketed through surplus lines brokers known as "Wholesalers". Wholesalers must be licensed in their own states if doing business with a non-admitted company.

The Company primarily acts as a safety valve for the industry, responding to fluctuations in the pricing of standard lines companies. AESLIC will write most of its business in times when the market is characterized as "hard", when standard companies are adhering to strict underwriting practices and pricing. In a soft market, when standard companies underwriting practices and pricing are not as strict, AESLIC will not compete for the business. Underwriting

responsibilities are divided among five profit centers headed up by underwriting officers each of who have been with the Company in excess of fifteen years.

The Company maintains an inter-company pooling agreement with its sole subsidiary, American Empire Insurance Company (AEIC). AEIC is an Ohio domiciled company licensed in 46 states.

AEIC is a licensed company and was utilized to assume casualty facultative reinsurance produced by reinsurance intermediaries from 1989 to 2003. AEIC ceased assuming reinsurance since 2003 as a result of its decision not to collateralize reinsurance obligations.

AEIC has a wholly owned managing general agent operating in the state of Texas.

REINSURANCE

Pooling

The Company is the majority participant of an inter-company pooling arrangement with its wholly owned subsidiary, American Empire Insurance Company. The business applied to the pooling arrangement is net of ceded reinsurance. Therefore, after the cessions to the third party reinsurers, the agreement allows specific business produced by the participants (including expenses and liabilities incurred pursuant thereto, except investment expenses and federal income taxes) to be ceded 100% to the Company. The business and related expenses are then pooled together with other specific business the Company produces. The Company then cedes the applicable pooled percentages back to the participants. The companies and the pooling percentages are as follows:

American Empire Surplus Lines Insurance Company (AESLIC) (DE)	90%
American Empire Insurance Company (AEIC) (OH)	<u>10%</u>
Total	<u>100%</u>

Ceded

Property

Property reinsurance is comprised of two separate layers of per risk excess treaties. The Company retains the first \$150,000 of each loss, while the treaties provide excess coverage of \$2,850,000 excess of \$150,000. Two separate property surplus share treaties affording a \$2,500,000 limit and a \$1,000,000 limit are also utilized. The Company retains 5.5% and 16.6% of the respective surplus share agreements. Two property pro-rata contracts supplement the basic property reinsurance program. Catastrophe treaties are in force for \$18 million excess of \$2 million net. Additional catastrophe coverage is provided under the parent group property catastrophe reinsurance program that provides limits of \$110 million excess of \$10 million for all perils. Each participating company's retention under this program varies dependent upon their contribution to the parent group's total loss.

Casualty

Casualty reinsurance is comprised of a quota share treaty for the first \$500,000 with the company retaining 79% net. The company has a casualty excess agreement for \$5,500,000 excess the quota share of \$500,000 with the Company retaining 29.6% of the net liabilities arising under the policies.

INSURANCE HOLDING COMPANY SYSTEM

The Company is a member of a holding company system and is currently wholly owned by Great American Holding, Inc. The ultimate parent of the holding company system is American Financial Group, Inc., a diversified financial holding company. An organizational chart identifying the ultimate controlling person and key affiliated companies is displayed below.

American Empire Surplus Lines Insurance Company

American Financial Group, Inc.

American Money Management Corporation

APU Holding Company

American Premier Underwriters, Inc.

GAI Insurance Company, Ltd. (Bermuda)

Premier Lease & Loan Services Insurance Agency, Inc.

Republic Indemnity Company of America

Republic Indemnity Company of California

Great American Holding, Inc.

American Empire Surplus Lines Insurance Company

American Empire Insurance Company

Great American International Insurance Limited (Ireland)

Mid-Continent Casualty Company

Mid-Continent Insurance Company

Oklahoma Surety Company

Great American Insurance Company

Brothers Property Corporation

Crescent Centre Apartments

Eden Park Insurance Brokers, Inc.

El Aguila Compania de Seguros, S.A. de C.V. (Mexico)

FCIA Management Company, Inc.

GAI Warranty Company

GAI Warranty Company of Florida

Global Premier Finance Company

Great American Alliance Insurance Company

Great American Assurance Company

Great American Contemporary Insurance Company

Great American Custom Insurance Services Massachusetts, Inc.

Great American E & S Insurance Company

Great American Fidelity Insurance Company

Great American Insurance Company of New York

Great American Lloyd's Insurance Company

Great American Management Services, Inc.

Great American Protection Insurance Company

Great American Security Insurance Company

Great American Spirit Insurance Company

National Interstate Corporation

Hudson Indemnity, Ltd. (Cayman Islands)

National Interstate Insurance Company

National Interstate Insurance Company of Hawaii, Inc.

Triumphe Casualty Company

Penn Central U.K. Limited (United Kingdom)

Insurance (GB) Limited (United Kingdom)

PLLS Canada Insurance Brokers, Inc.

Professional Risk Brokers, Inc.

Professional Risk Brokers of Connecticut, Inc.

Worldwide Casualty Insurance Company
Great American Financial Resources, Inc.
AAG Holding Company, Inc.
Great American Life Insurance Company
Annuity Investors Life Insurance Company
Consolidated Financial Corporation
Great American Life Insurance Company of New York
Loyal American Holding Corporation
Loyal American Life Insurance Company
American Retirement Life Insurance Co.
Great American Life Assurance Company
Manhattan National Life Insurance Company
Old West Annuity & Life Insurance Company
United Teachers Associates, Ltd.
United Teachers Associates Insurance Company
Ceres Group, Inc.
Central Reserve Life Insurance Company
Provident American Life & Health Insurance Company
United Benefit Life Insurance Company
Continental General Corporation
Great American Advisors, Inc.
One East Fourth, Inc.

Effective December 31, 2004, 100% of the common stock of the Company was conveyed to American Financial Group, Inc. (AFG) as a dividend, which was subsequently contributed to Great American Holding, Inc.

The Company is an indirect 100% owned subsidiary of AFG. AFG, through its subsidiaries, is engaged primarily in special and multi-line property and casualty insurance business and in the sale of annuities, life and supplemental health insurance products. AFG's common stock is listed and traded on the New York Stock Exchange.

GROWTH OF THE COMPANY

The following information was extracted from office copies of the Company's filed annual statements for each year indicated:

<u>Year</u>	<u>Admitted Assets</u>	<u>Surplus as Regards Policyholders</u>	<u>Net Premiums Written</u>	<u>Net Income</u>
2002	\$362,839,024	\$137,734,704	\$103,581,465	\$29,616,708
2003	472,995,316	186,450,055	145,308,000	46,787,231
2004	482,628,572	180,678,515	133,055,787	51,457,307
2005	493,214,408	186,659,398	111,361,130	43,833,354
2006	495,241,407	208,704,585	103,678,493	52,931,726

The Company's business fluctuates with the pricing of the standard market. Premium volume will increase in a hard market when standard companies adhere to strict underwriting and pricing rules. In a market where standard companies are expanding market share by compromising underwriting and pricing rules, the Company's premium volume will decline. The Company's admitted assets and surplus have increased \$207,297,887 and \$80,374,042 respectively during the period under review. While profits have increased, there have also been significant dividends paid during the years under review. Dividends paid were \$60,000,000, \$40,000,000, and \$32,000,000 in 2004, 2005 and 2006 respectively. The loss ratio has decreased from a high of 57.6% in 2002 to a low of 28.6% in 2006.

ACCOUNTS AND RECORDS

All necessary accounting records of the Company are maintained on electronic data processing equipment. The general ledger is maintained on a statutory basis with additional accounts used to convert to the accrual basis suitable for General Accepted Accounting Principles.

FINANCIAL STATEMENTS

The following statements show the assets, liabilities, surplus and other funds of the Company, as determined by this examination, as of December 31, 2006:

Assets
 Liabilities, Surplus and Other Funds
 Statement of Income
 Capital and Surplus Account

It should be noted that the various schedules and exhibits may not add to the totals shown due to rounding.

	Assets December 31, 2006		
	<u>Assets</u>	Nonadmitted <u>Assets</u>	Net Admitted <u>Assets</u>
Bonds	\$379,960,227	\$ -0-	\$379,960,227
Stocks			
Preferred	12,357,070	-0-	12,357,070
Common	41,327,475	-0-	41,327,475
Cash	20,493,297	-0-	20,493,297
Other Invested Assets	23,461	-0-	23,461
Premiums and agents balances in course of collection	18,406,325	954,903	17,451,422
Reinsurance recoverable on loss and loss adjustment expense payments	9,852,616	-0-	9,852,616
Federal and foreign income tax recoverable and interest thereon	19,138,555	10,536,423	8,602,132
Other amounts recoverable under reinsurance contracts	181,858	-0-	181,858
Interest, dividends and real estate income due and accrued	4,101,099	-0-	4,101,099
Receivable from parent, subsidiaries and affiliates	189,031	-0-	189,031
Other assets nonadmitted	1,832,886	1,832,886	-0-
Aggregate write-ins for other than invested assets	701,719	-0-	701,719
TOTALS	<u><u>\$508,565,619</u></u>	<u><u>\$13,324,212</u></u>	<u><u>\$495,241,407</u></u>

**Liabilities, Surplus and Other Funds
December 31, 2006**

		Notes
Losses	\$170,541,897	1
Reinsurance payable on paid losses and loss adjustment expenses	(33,721)	
Loss adjustment expenses	42,130,933	
Commission payable, contingent commission and other similar charges	3,368,266	
Other expenses (excluding taxes licenses and fees)	4,026,973	
Taxes, licenses and fees (excluding federal and foreign income taxes)	311,735	
Current federal and foreign income taxes	1,861,010	
Unearned Premiums	48,089,364	
Ceded reinsurance balances payable	15,266,627	
Funds held by company under reinsurance treaties	2,044	
Provision for reinsurance	843,659	
Payable to parent, subsidiaries and affiliates	28,867	
Aggregate write-ins for liabilities	99,167	
Total Liabilities	<u>\$286,536,822</u>	
Common capital stock	\$4,100,000	
Gross paid in and contributed surplus	55,084,003	
Unassigned funds	<u>149,520,582</u>	
Surplus as regards policyholders	<u>\$208,704,585</u>	
TOTALS	<u>\$495,241,407</u>	

**Underwriting and Investment Exhibit
Statement of Income
December 31, 2006**

Underwriting income

Premiums earned	<u>\$106,506,796</u>
DEDUCTIONS	
Losses incurred	\$30,480,713
Loss expenses incurred	10,085,496
Other underwriting expenses incurred	<u>15,747,554</u>
Total underwriting deductions	<u>\$56,313,763</u>
Net underwriting gain	<u>\$50,193,033</u>

Investment income

Net investment income earned	\$25,428,685
Net realized capital gains (Losses)	<u>238,887</u>
Net investment gain (loss)	<u>\$25,667,573</u>

Other income

Net gain (loss) from agents balances charged off	\$11,171
Aggregate write-ins for miscellaneous income	<u>(7,017)</u>
Total other income	<u>\$4,155</u>
Net income before dividends to policyholders and federal income taxes	\$75,864,760
Dividends to policyholders	<u>-0-</u>
Net income, after dividends to policyholders but before federal and foreign income taxes	\$75,864,760
Federal and foreign income taxes	<u>22,933,034</u>
Net income	<u>\$52,931,726</u>

Capital and Surplus Account

2006

Surplus as regards policyholders, December 31, prior year	<u>\$186,659,398</u>
Net income	52,931,726
Net unrealized capital gains or (losses)	1,601,848
Change in deferred income taxes	(460,907)
Change in non-admitted assets	(178,492)
Change in provision for reinsurance	(32,996)
Surplus paid in adjustment	184,008
Dividends to stockholders	<u>(32,000,000)</u>
Change in surplus regards policyholders for the year	<u>\$22,045,187</u>
Surplus as regards policyholders, December 31, current year	<u>\$208,704,585</u>

SCHEDULE OF EXAMINATION CHANGES

There were no adjustments made to the financial statements of this report.

NOTES TO FINANCIAL STATEMENTS

1) <u>Losses</u>	<u>\$170,541,897</u>
<u>Loss Adjustment Expenses</u>	<u>\$ 42,130,933</u>

The Delaware Department of Insurance additionally engaged INS Consultants, consulting actuaries, to review the underlying data utilized by the Ohio actuary. This review of the underlying data, performed by the INS actuary, noted no exceptions.

CONCLUSION

As a result of this examination, the financial condition as of December 31, 2006 is as follows:

	<u>2001</u>	<u>2006</u>	<u>Difference</u>
Admitted Assets	<u>\$ 287,943,520</u>	<u>\$ 495,241,407</u>	<u>\$207,297,887</u>
Liabilities	<u>\$ 159,612,977</u>	<u>\$ 286,536,822</u>	<u>\$126,923,845</u>
Surplus as regards policyholders	<u>128,330,543</u>	<u>208,704,585</u>	<u>80,374,042</u>
Totals Liability and Surplus	<u>\$ 287,943,520</u>	<u>\$ 495,241,407</u>	<u>\$207,297,887</u>

ACKNOWLEDGMENT

Appreciation is extended for the assistance of the Company's officers and employees during the course of this examination. Appreciation is also extended to the examination team members of the Ohio Department of Insurance whose examination work was relied upon for specific Company operational areas reviewed.



Paul E. Ellis, CFE
Examiner-In-Charge
State of Delaware

SUBSEQUENT EVENTS

On August 20, 2007 the Board of Directors adopted, via unanimous written consent, the following resolutions: **(1)** The Company declares an extraordinary dividend of \$67 million payable on or after the earlier of September 20, 2007 or approval by the Delaware Department of Insurance. **(2)** The Company Treasurer is instructed to charge the dividend amount against the Company's unassigned funds. **(3)** That the proper officers of the Company are authorized, empowered and directed to take any and all such actions to fully effectuate the foregoing resolutions.