

REPORT ON EXAMINATION
OF
FAIRMONT SPECIALTY INSURANCE COMPANY
AS OF
DECEMBER 31, 2004

I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of December 31, 2004 of the

FAIRMONT SPECIALTY INSURANCE COMPANY

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

ATTEST BY: *Antoinette Handy*

DATE: 23 February 2006



In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 23RD DAY OF FEBRUARY 2006.

Matthew Denn
Insurance Commissioner

REPORT ON EXAMINATION
OF THE
FAIRMONT SPECIALTY INSURANCE COMPANY
AS OF
December 31, 2004

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 23RD Day of FEBRUARY 2006.

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October 28, 2005

Honorable Alfred Gross
Chairman, Financial Condition (E)
Committee, NAIC
State Corporation Commission
Bureau of Insurance
Commonwealth of Virginia
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Commonwealth of Massachusetts
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Honorable Jorge Gomez
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Honorable John Morrison
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Montana Department of Insurance
840 Helena Avenue
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Honorable Matthew Denn, Commissioner
State of Delaware
Department of Insurance
841 Silver Lake Boulevard, Suite 100
Dover, Delaware 19904

Dear Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority 05-009, dated April 25, 2005, an Association examination has been made of the affairs, financial condition and management of

FAIRMONT SPECIALTY INSURANCE COMPANY

hereinafter referred to as the “Company” incorporated under the laws of the State of Delaware as a stock company with its home office located at 1209 Orange Street, Wilmington, Delaware.

The examination was conducted at the main administrative offices of the Company located at 10777 Westheimer Road, Houston, Texas 77042.

The report of examination is respectfully submitted.

SCOPE OF EXAMINATION

The Company was last examined as of December 31, 2001, by representatives of the Delaware Department of Insurance representing the Northeastern Zone of the National Association of Insurance Commissioners (NAIC). This comprehensive financial examination covered the period January 1, 2002, through December 31, 2004, and 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. Transactions subsequent to the latter date were reviewed where deemed necessary.

This report is presented on the exception basis. It is designed to set forth the facts with regard to any material adverse findings disclosed during the examination. 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 cases, these matters were thoroughly discussed with responsible Company officials during the course of the examination.

The general procedure of the examination followed the rules established by the NAIC's Committee on Financial Condition Examiners Handbook, and generally accepted statutory insurance examination standards. The examination was performed by representatives of the Delaware Department of Insurance representing the Northeastern Zone of the NAIC and a representative of the California Department of Insurance representing the Western Zone. No other states participated in the examination.

The examination of the Company is being conducted concurrently with the examinations of two affiliates, Fairmont Premier Insurance Company and Fairmont Insurance Company, both California companies. The Delaware examination team is participating in the examinations of the two California affiliates.

In addition to items hereinafter incorporated as part of the written report, the following were checked and made part of the workpapers of this examination:

Corporate Records
Fidelity Bonds and Other Insurance
Officers', Employees', and Agents' Welfare and Pension Plans
Business in force by States
Legal Actions

HISTORY

The Company was incorporated on April 24, 1980 under the laws of Delaware under the temporary title of Ranger Insurance Company of Delaware to act as the vehicle for the transfer of the corporate domicile of Ranger Insurance Company from Elmsford, New York to Wilmington, Delaware, effective December 31, 1983. The original incorporation date, August 1, 1923, was retained pursuant to Delaware law. The predecessor company was incorporated under the laws of New York and began business on September 1, 1923.

From organization until July 29, 1966, when the name Ranger Insurance Company was adopted, operations were conducted under the title Export Insurance Company. On December 31, 1978, the Company absorbed by merger the Pan American Fire & Casualty Company. In 1986, Ranger's former parent, Anderson Clayton & Co., was acquired by The Quaker Oats Company, Chicago, Illinois. The Company was purchased from the Quaker Oats Company on April 1, 1987 by American Ranger, Inc., a Delaware holding company, owned by David T. Chase family interests and transferred October 6, 1987 to Chase Insurance Holdings Corporation, a newly formed wholly owned subsidiary.

On January 6, 1994, the Company was purchased by Fairfax Financial Holdings, Ltd. (FFHL). The Company is a member of the FFHL holding company, a Canadian holding company system, and a subsidiary of Fairfax, Inc., a Wyoming corporation. Ownership of the

Fairmont Specialty Insurance Company

Company changed on December 4, 2000, from Fairfax, Inc., to TIG Insurance Company, a California company and a subsidiary of Fairfax, Inc.

A corporate restructuring plan was effective January 1, 2004, whereby all of the outstanding shares of the Company were contributed to TIG Premier Insurance Company (TPIC), whose common stock was subsequently distributed to TIG Insurance Group from TIG Insurance Company. TIG Insurance Group then contributed the common stock of TPIC to Fairmont Specialty Group Inc. (FSG). FSG is a subsidiary of Fairfax, Inc., which is a subsidiary of FFHL.

On May 5, 2004, the Secretary's office for the State of Delaware approved the Certificate of Amendment changing the name of Ranger Insurance Company to Fairmont Specialty Insurance Company.

On December 2, 2004, TPIC changed its name to Fairmont Premier Insurance Company.

Capitalization

Common capital stock of the Company totaled \$3,100,000 during the period under examination. Since December 4, 2000, 100% of the Company's 310,000 shares of common capital stock, with a par value of \$10.00 per share, were owned by TIG Insurance Company. As previously noted, a corporate restructuring plan was effective January 1, 2004, whereby all of the outstanding shares of the Company were contributed to TPIC, whose common stock was subsequently distributed to TIG Insurance Group from TIG Insurance Company. TIG Insurance Group then contributed the common stock of TPIC to Fairmont Specialty Group Inc. (FSG). Additionally, all of the shares of FSG are held in the TIG Insurance Group Trust as required by the California Insurance Department to effect the 2002 re-alignment of the TIG Insurance Group.

The shares of FSG will remain in trust through 2004 to support the efficient run-off of TIG Insurance Group.

As of the examination date, 100% of the Company's 310,000 shares of common capital stock, with a par value of \$10.00 per share, were owned by Fairmont Premier Insurance Company (Premier).

A review of capitalization found that the Company could not locate a stock register or stock stub book. Therefore,

It is recommended that the Company maintain a stock register and stock stub book.

On December 31, 2002, the Company received a cash surplus contribution in the amount of \$5,000,000 from its then parent, TIG Insurance Company.

Dividends to Stockholders

During the period under review, the Company paid no dividends to stockholders.

MANAGEMENT AND CONTROL

Management

The elected Directors of the Company at December 31, 2004, were as follows:

<u>Director</u>	<u>Principal Occupation or Other Business Affiliation</u>
Marc James Adee	President, Fairmont Specialty Group, Inc.
David Owen Green	Executive Vice President, Specialty P & C Business Unit, Fairmont Specialty Group, Inc.
Sharlene Joy Husky	Senior Vice President, Human Resources, Fairmont Specialty Group, Inc.
Loyd Ray Godbold	Senior Vice President, Claims, Fairmont Specialty Group, Inc.

The Officers of the Company at December 31, 2004, were as follows:

Marc James Adee	President
Gary Joseph McGeddy	Executive Vice President
Lloyd Fred Chaffin	Executive Vice President
David Owen Green	Executive Vice President
Nicole Bennett Smith	Senior Vice President
Loyd Ray Godbold	Senior Vice President
Chris Throckmorton	Senior Vice President and Chief Actuary
Sharlene Joy Husky	Senior Vice President
Jill Suzanne Everett	Vice President
Richard Joseph Klimaszewski	Vice President
Lindsey Morgan	Vice President and Controller
Paul Mundy	Assistant Vice President and Treasurer
Scott Schickram	Assistant Vice President
Michael Ziemer	Assistant Secretary
Keith Walker	Assistant Secretary
Steven Javinski	Assistant Secretary
Wes Neely	Assistant Secretary
Adeline Haft	Assistant Secretary
Eileen McCollum	Assistant Secretary
Duane Brown	Assistant Secretary

Section 4919 – “Change of directors, officers; notice” of the Delaware Insurance Code (the Code) states that:

“Every domestic stock or mutual insurer shall promptly notify the Commissioner in writing of any change of personnel among its directors or principal officers.”

It was noted through a review of the various annual statement jurat pages as well as the minutes of the Board of Directors' meetings that there were changes in principal officers and directors which had not been reported to the Delaware Insurance Commissioner. These changes should have been reported to the Delaware Insurance Commissioner in accordance with the Code. Therefore,

It is recommended that the Company comply with the provisions of Section 4919 of the Code regarding the proper reporting of changes in the principal officers and directors of the Company.

As previously noted, the sole stockholder in 2002 and 2003 was TIG Insurance Company. The Company could not provide minutes to stockholder meetings in 2002 or 2003. Article I of the Company's by-laws provide for annual meetings of the stockholders. The Company could not provide evidence of annual meetings of the stockholder in 2002 or 2003, contrary to its by-laws and contrary to Section 211(b) of the General Corporation Law of the State of Delaware.

In conjunction with the above, the Company is in violation of Article II Section 2 of its by-laws in 2002 and 2003, which state that the Board of Directors shall be elected at the annual meeting of stockholders. Therefore, the examiners could not verify the directors listed on the jurat page of the Company's Annual Statements for 2002 and 2003.

Article II Section 1 of the Company by-laws states the number of the Board of Directors shall be seven, during which time they only listed four directors. Based on the jurat page of the Annual Statements, the Company was in violation of Article II Section 1 of its by-laws in 2003 and 2004.

Article III of the Company's by-laws state that the Company shall elect an Executive Committee, and Article IV states that the Company shall elect a Finance Committee. The

Company was in violation of Articles III and IV of its by-laws in 2002 and 2004 because they had neither. Therefore,

It is recommended that the Company comply with the provisions of its by-laws and Section 211(b) of the General Corporation Law of the State of Delaware.

Subsequent to the examination date, on August 22, 2005, the Board of Directors held a special meeting and, among other things, elected a Finance Committee and an Executive Committee, in compliance with Company by-laws. In addition, the Board of Directors amended the number of designated directors to be four.

Control

The ultimate controlling person is V. Prem Watsa, Chairman and chief executive officer of FFHL. Watsa has voting control, directly or indirectly, of more than 50 percent of the voting common shares of FFHL.

Conflicts of Interest

Conflict of interest statements were not signed by officers or employees of the Company in 2002 or 2003. As of 2004, the Company had a procedure in place whereby the "Company Policies and Guidelines" are posted on the Human Resources database. Inclusive in this procedure is a Conflicts of Interest Policy. Officers and employees of the Company are asked to sign an Employee Acknowledgment to certify that each has read and understand the Company Policies and Guidelines. It was noted that several of the officers and directors of the Company did not sign Employee Acknowledgments in 2004. Therefore,

It is recommended that the officers and employees of the Company execute conflict of interest statements annually.

HOLDING COMPANY SYSTEM

The Company became a member of the FFHL holding company on January 6, 1994. FFHL is a Canadian financial services holding company that owns property/casualty and life insurance and reinsurance companies along with investment management and insurance claims administration business.

As previously noted, on January 1, 2004, a corporate restructuring plan was implemented resulting in the ownership of the Company held by Premier, whose common stock was contributed to FSG. FSG, a newly formed holding company organized under the laws of Delaware, was set up to oversee underwriting and management of particular classes of business formerly managed by TIG Insurance Group. FSG is a subsidiary of Fairfax, Inc., which is a subsidiary of FFHL. FSG consists of four insurance companies: Fairmont Premier Insurance Company (Premier), formerly TIG Premier Insurance Company (TPIC), Fairmont Insurance Company (FIC), Fairmont Specialty Insurance Company, formerly Ranger Insurance Company (the Company), and Ranger Lloyds. The ownership of all four companies ultimately remains with FFHL.

Organization Chart

The following organization chart reflects the identities and interrelationships between the Company and parent as of December 31, 2004. Due to the large organizational make up of the group, the chart has been limited to its direct affiliates and subsidiaries:

Fairfax Financial Holdings Limited
Fairfax, Inc.
 TIG Holdings, Inc.
 TIG Insurance Group, Inc.
 Fairmont Specialty Group, Inc.
 Fairmont Premier Insurance Company
 Fairmont Insurance Company
 Fairmont Specialty Insurance Company
 Ranger Insurance Managers, Inc.
 Ranger Insurance Finance Company

Fairmont Specialty Managers Corp.
Ranger Lloyds*
Advent Capital (Holdings) PLC (6.01%)
HWIC Asia Fund

*An incorporated association

Copies of the “Form B Holding Registration Statements” filed with the Delaware Insurance Department, during the period under examination, were reviewed. It appeared that the Company had complied with the provisions of Regulation 1801 of the Code.

MANAGEMENT AND SERVICE AGREEMENTS AND RELATED PARTY TRANSACTIONS

The following agreements were reviewed in prior examinations and remain in effect as of the examination date:

- Assignment of agents' balances from Ranger Lloyds to the Company, effective January 1, 1975.
- Loan Agreement between the Company and Ranger Insurance Managers, Inc. dated November 1, 1987.
- Service Agreement between the Company and Ranger Managers Corp., effective January 1, 1996.
- Service Agreement between the Company and Ranger Insurance Managers, Inc., effective January 1, 1996.
- Service Agreement between The Company and Ranger Insurance Finance Company, effective January 1, 1996.
- Agreement for Allocation and Settlement of Consolidated Federal Income Tax Liability among Fairfax, Inc., and the Company and its wholly owned direct and indirect subsidiaries, Noro, Inc., and Odyssey Reinsurance Corporation and its wholly owned

subsidiary, Hudson Insurance Company, effective December 31, 1996, and amended December 31, 1998.

- Service Agreement between the Company and Odyssey Reinsurance Company of Canada, effective January 1, 1999.
- OASIS Reimbursement Agreement between the Company and Fairfax, Inc., dated January 1, 1999.
- A Claims Service and Management Agreement between the Company and RiverStone Claims Management LLC, effective October 20, 1999.
- An Inter-Company Tax Allocation Agreement between the Company and TIG Holdings, Inc., effective January 1, 2000.
- A Tax Services Agreement between the Company and Fairfax, Inc., effective May 10, 2001.
- An Information Technology Agreement between the Company and Fairfax Information Technology Systems, Inc., effective December 1, 2001.
- The Company has reinsurance brokerage agreements with the following intermediaries: Guy Carpenter & Company, Inc., Benfield Inc., and Towers, Perrin, Forrester and Crosby, Inc.

The following agreements were entered into during the period covered by this examination and are summarized as follows:

- The Company entered into a Stock Purchase Agreement, dated December 31, 2003, with Guild Underwriters Napa, Inc., whereby the Company sold all of its issued and outstanding stock, consisting of 1,000 shares, of Ranger Insurance Services, Inc. for consideration of

\$1,000. The transaction was not material and did not require prior approval by the Department.

- The Company entered into a Service Contract and Expense Sharing Agreement with TIG Insurance Company (TIG), effective July 1, 2002. The Agreement applies to all operating expenses pertaining to shared functions of TIG and the Company and its subsidiaries and affiliates. Pursuant to the Agreement services to be provided by TIG include, but are not limited to finance, human resources, legal, licensing and executive operations. The Agreement provides that expenses will be fairly apportioned and reimbursed by the Company to TIG on an equitable basis, in accordance with statutory accounting practices. This agreement was filed with the Department on September 4, 2002.
- An Investment Agreement among the Company, Hamblin Watsa Investment Counsel Ltd. (HWIC), and Fairfax Financial Holdings Limited (FFHL) was effective January 1, 2003. Pursuant to the Agreement, HWIC manages the investments of the Company in accordance with investment objectives outlined in the Agreement. The Company's investments are held in an account by The Bank of New York, as custodian. All fees are paid by the Company to FFHL and FFHL reimburses HWIC for investment management services. HWIC is a subsidiary of FFHL. The Agreement was approved by the Department by letter dated May 6, 2003.
- A Claims Service and Management Agreement between the Company and nSpire Reinsurance Limited (nSpire) was entered into as of December 31, 2003. The Agreement was made in association with the restructuring of the Company. As part of the restructuring, the Company and nSpire entered into a Loss Portfolio Transfer Agreement pursuant to which nSpire reinsures all of the losses and related loss adjustment expenses of the Company incurred prior to the effective date under the Company's discontinued lines of business. In

addition, the Company entered into a 100% Quota Share Reinsurance Agreement with nSpire, pursuant to which nSpire reinsures all of the net liability of the Company for loss incurred after the effective date under the Company's discontinued lines policies that are in force on the effective date. Under the Loss Portfolio Transfer Agreement and the 100% Quota Share Reinsurance Agreement, nSpire has assumed responsibility for handling claims arising under insurance policies and assumed reinsurance contracts covered by the Loss Portfolio Transfer Agreement and 100% Quota Share Reinsurance Agreement. The Claims Service and Management Agreement provides for nSpire to delegate back to the Company certain claims handling functions. Pursuant to the Agreement, the Company will perform claims and litigation management and related administrative services and be paid a Management Fee. nSpire will pay the Company a Management Fee equal to nSpire's share of the costs, overhead and general expenses incurred by the Company for claims handling services. The Claims Service and Management Agreement was approved by the Department by letter dated December 23, 2003, approving the Form D filing by the Company.

- A Trust Agreement among the Company, nSpire Reinsurance Limited, and The Bank of New York was entered into as of January 1, 2004. The Trust Agreement was entered into in conjunction with the Loss Portfolio Transfer Agreement and the 100% Quota Share Reinsurance Agreement, collectively referred to as the "Reinsurance Agreements". Pursuant to the Reinsurance Agreements, the Company has ceded certain losses and nSpire has reinsured and agreed to indemnify the Company against such losses in accordance with the terms of the Reinsurance Agreements. The Trust Agreement provides for nSpire to establish a Trust Account at The Bank of New York to hold assets in order to secure payments under or in connection with the Reinsurance Agreements. Assets in the Trust Account are held for the sole use and exclusive benefit of the Company. The Trust Agreement was approved by

the Department by letter dated February 26, 2004, approving the Form D filing by the Company.

- An Inter-Company Reinsurance Pooling Agreement among the Company, Fairmont Insurance Company (FIC), and TIG Premier Insurance Company (Premier) was entered into as of January 1, 2004. Under the Agreement FIC and the Company cede 100% of their net business to Premier, the lead company. Premier then cedes the pooled results, including premiums, losses and certain expenses of all three companies, 13 percent to FIC, 67 percent to the Company, and 20 percent is retained by Premier. The Agreement was approved by the Department by letter dated December 23, 2003, approving the Form D filing by the Company.
- An Administrative Services Agreement was entered into among the Company, FIC, and Premier as of January 1, 2004. This Agreement was entered into in conjunction with the Inter-Company Reinsurance Pooling Agreement. Pursuant to the Administrative Services Agreement, Premier agrees to act as manager for the parties to the Agreement and perform underwriting, claims and litigation management and related administrative services for the business under the Pooling Agreement. The Administrative Services Agreement outlines certain direct expenses for which each party is responsible; including allocable policy and other printed supplies necessary to conduct its business, commissions to producers, taxes, board and bureau assessments, auditing expenses, license fees, legal expenses, investment expenses, and all loss and loss adjustment expenses. Under the Agreement, expenses for services provided by the manager will be allocated, fairly apportioned and reimbursed by and among the parties on an equitable basis, in accordance with statutory accounting practices. The Agreement was approved by the Department by letter dated December 23, 2003, approving the Form D filing by the Company.

- An Expense Sharing Agreement was entered into among the Company, FIC, TIG Insurance Company (TIC), and Premier as of January 1, 2004. The Agreement was entered into in conjunction with the restructuring of the companies. The Expense Sharing Agreement provides each company will make available to the other services and facilities necessary for the conduct of their respective businesses and to allocate the cost of such services and facilities on an equitable basis, in accordance with statutory accounting practices. The Agreement applies to all operating expenses pertaining to shared functions of the parties, and does not apply to losses, allocated loss adjustment expenses, agents' or other commissions, taxes or fees for investment management services. The Agreement provides for all personnel and personnel services of any one or more of the parties, all office space, supplies, business equipment, furniture, fixtures, and all other requirements for the conduct of business of any of the parties may be provided by any one or more of the other parties. The Agreement was approved by the Department by letter dated December 23, 2003, approving the Form D filing by the Company.

TERRITORY AND PLAN OF OPERATION

The Company is a property and casualty insurance company that currently writes primarily commercial multiple peril, other liability, products liability, surety, other commercial auto liability, group accident and health and personal lines. The Company writes in all 50 states and the District of Columbia and specializes in niche markets that require unique underwriting, claims and loss control expertise, such as propane distributors and agri-products. The Company assumes 100% of the business produced by Ranger Lloyds, an affiliate.

The corporate restructure plan, effective January 1, 2004, resulted in change in ownership of the Company, as previously discussed, and the creation of Fairmont Specialty Group (FSG).

As previously noted, FSG consists of four insurance companies: Premier, FIC, the Company and Ranger Lloyds. FSG operates as three distinct business units: 1) bail and specialty property and casualty, based in Houston, TX, focusing on niche business with a concentration on short-tailed casualty programs; 2) accident and health, based in Tinton Falls, NJ, focusing on a variety of specialty coverages; and 3) Hawaii property and casualty, based in Honolulu, Hawaii, focusing on serving the local Hawaii economy by writing personal lines and small commercial business insurance. Each of the three business units have access to write on any of the companies in the group. Planning, budgeting and monitoring of FSG are prepared by management based on the three separate business units. As part of the formation of FSG, significant changes in management occurred.

Premiums for the bail and specialty property/casualty segments have historically been written by the Company, and will continue to be. The niche areas targeted are energy (propane, fuel oil, natural gas and utilities), agriculture (grain elevators, feed mills, fruit and vegetable processing), explosives and bail bonds. The Company's insurance business is operated through independent agents. Business is produced using 81 licensed and appointed agencies and 157 agents that access the Company through Fairmont Specialty Insurance Managers.

The accident and health business under FSG offers employer stop loss, provider excess and medical excess, special risk (student medical, travel, and blanket special risk), and carve-out (dental, vision, and organ transplant). Distribution is primarily through approximately twenty managing general agents (MGAs) and claims are managed using third party administrators (TPAs).

The Hawaii property/casualty business segment under FSG provides personal lines and small commercial coverages strictly within the Hawaiian Islands. Commercial wind exposure is limited and there is no personal lines wind exposure.

In anticipation of the restructure plan, the Company discontinued two books of business; specifically, a public entity and California inter-state trucking book of business.

Beginning January 1, 2004, the Company and FIC cede 100% of their net business to Premier, pursuant to the Inter-Company Reinsurance Pooling Agreement.

As part of the restructure plan, effective January 1, 2004, the Company entered into a Loss Portfolio Transfer Agreement with nSpire Reinsurance Limited (an affiliate), pursuant to which nSpire will reinsure all of the losses and related loss adjustment expenses of the Company incurred prior to the effective date under its discontinued lines of business (the “Specialty Discontinued Lines”).

In addition, effective January 1, 2004, the Company entered into a 100% Quota Share Reinsurance Agreement with nSpire under which nSpire will reinsure all of the net liability of the Company for losses incurred after the effective date under Specialty Discontinued Lines policies that are in force on the effective date and mandatory renewals of such policies.

GROWTH OF THE COMPANY

The following information was obtained from the Company’s filed Annual Statements for the period under examination, with the exception of 2001, which represents the prior examination findings.

<u>Year</u>	<u>Net Admitted Assets</u>	<u>Surplus As Regards Policyholders</u>	<u>Gross Written Premium</u>	<u>Net Income</u>
2004	\$235,722,443	\$86,988,899	\$82,156,549	\$10,941,363
2003	269,704,280	84,039,435	80,283,583	27,832,207
2002	229,325,278	44,936,997	115,292,534	(6,621,392)
2001	204,022,919	33,831,549	96,266,988	(35,152,052)

The Company's assets increased from 2001 to 2003 due primarily to an increase in short term investments. However, assets decreased from 2003 to 2004 in the amount of \$34 million

due mainly to funding of the Loss Portfolio Transfer Agreement and pooling of beginning underwriting reserves.

Surplus as regards policyholders increased from 2001 to 2004 due to several factors. These increases were due to a capital contribution received in the amount of \$5 million, an underwriting profit of approximately \$6 million, and an increase in investment income.

Gross written premiums increased from 2001 to 2002, decreased from 2002 to 2003, and increased from 2003 to 2004. These fluctuations were due to increased pricing and growth with niche programs (increase 2001 to 2002), and corporate restructuring and the discontinuation of two books of business (public entity and California inter-state trucking), which cause a decrease from 2002 to 2003.

The Company reported a net loss in 2002 of \$6.5 million, down from \$35 million in 2001 due to improved combined ratio, specifically the loss ratio, and due to re-underwriting and terminating unprofitable relationships. In 2003 the Company returned to profitability due to the changes mentioned above, and increase in investment income.

REINSURANCE

The following describes the Company's reinsurance program as of December 31, 2004.

As of January 1, 2004, the Company was reorganized and entered into a pooling agreement with two of its California affiliates, Premier and FIC. The agreement provides, among other things, that Premier will be the lead company and that the companies will cede all business to the pool, net of reinsurance. The Company has a 67% participation in the pool and Premier and FIC have 20% and 13% participation, respectively.

The reorganization of the Company required the commutation of several treaties and a loss portfolio transfer to nSpire, an unauthorized affiliate of the Company. The Company entered into a Commutation and Release Agreement with CRC (Bermuda) Reinsurance Limited,

effective June 30, 2003. The Agreement provided for CRC to pay the Company \$18.7 million. Pursuant to the Agreement, the parties commuted all past, present and future obligations and liabilities under the named reinsurance agreements, the Aggregate Reinsurance Agreement (Stop-Loss Treaty) underwriting year 1999 and the Aggregate Reinsurance Agreement (Stop-Loss Treaty) underwriting year 2000.

The Company commuted two existing Aggregate Excess Reinsurance Contracts with CRC covering the 2001 and 2002 accident years. The effective date of the commutations was September 30, 2003. The Company received \$500,000 and \$250,000, respective to the 2001 and 2002 accident years.

The Company entered into a Loss Portfolio Transfer Agreement with nSpire Reinsurance Limited, Ireland, effective January 1, 2004. Pursuant to the Agreement, nSpire reinsures all of the losses and related loss adjustment expenses of the Company incurred prior to the effective date under the Company's discontinued lines of business. The Company paid a reinsurance premium of \$66 million minus all covered loss paid during the period October 1, 2003 through December 31, 2003.

In conjunction with the loss portfolio transfer to nSpire, the Company entered into a 100% Quota Share Reinsurance Agreement with nSpire, effective January 1, 2004. Pursuant to the Agreement, nSpire reinsures all of the net liability of the Company for losses incurred after the effective date under the discontinued lines of business that are in force on the effective date, and mandatory renewals of such policies.

The Company's ongoing business consists of the following lines and sub lines: propane, utilities, agriculture, bail bonds, Markel fronting, explosives, miscellaneous bonds and fuel oil.

Assumed

The Company assumes 100% of the business written by an affiliate, Ranger Lloyds. The business assumed from Ranger Lloyds under the 100% reinsurance agreement, effective February 19, 1968, was primarily commercial multi peril, other liability and product liability.

Ceded

Casualty

For the 2004-2005 treaty years (August 1, 2004 to July 31, 2005) the Company's casualty reinsurance program provided working layer excess of loss reinsurance coverage of \$5 million in excess of \$1 million. Casualty catastrophe reinsurance provided additional coverage of \$20 million in excess of \$1 million, as shown below.

Working layer

Company's retention		\$1,000,000
Underlying casualty excess of loss	<u>\$5,000,000</u> xs	1,000,000
Total	<u>\$5,000,000</u>	

Catastrophe

First casualty clash excess of loss treaty	\$ 5,000,000 xs	\$1,000,000
Second casualty clash excess of loss treaty	5,000,000 xs	6,000,000
Third casualty clash excess of loss treaty	<u>10,000,000</u> xs	11,000,000
Total	<u>\$20,000,000</u>	

Property

For the 2004 treaty year (January 1, 2004 to December 31, 2004), the Company's property reinsurance program provided per risk excess of loss reinsurance coverage of \$9 million in excess of \$1 million. Property catastrophe reinsurance provided additional coverage for 95 percent of \$18 million in excess of \$2 million, as shown below.

Per Risk excess of Loss

Company's retention		\$1,000,000
Property underlying per risk excess of loss treaty	\$1,000,000 xs	1,000,000
Property first per risk excess of loss treaty	3,000,000 xs	2,000,000
Property second per risk excess of loss treaty	<u>5,000,000</u> xs	5,000,000
Total		<u>\$9,000,000</u>

Catastrophe (Combined per risk/occurrence)

Company's retention		\$2,000,000
Property per risk/occurrence excess of loss		
Treaty 95% of	<u>\$18,000,000</u> xs	2,000,000
Total 95% of	<u>\$18,000,000</u>	

The Company also purchased facultative reinsurance on an individual risk basis when additional property or casualty insurance was needed or when an account included unusual or extreme exposures.

ACCOUNTS AND RECORDS

The Company utilized various applications to process and account for financial operations. Some of the financially significant applications included the RPS/PMSC system, a mainframe application, utilized for policy administration and claims processing. The Company utilized the RPC system as a data warehouse and earnings function on a mainframe platform. The general ledger and accounts payable system were maintained on the EAS system. Agency accounting was maintained on the OASIS system. Reinsurance was maintained utilizing the FASTER system. The Company also utilized the WINS system for policy administration, claims processing and reinsurance accounting.

The Company's trial balance and adjusting entries were traced to the annual statement, and items were linked from schedule to schedule. It appears that the Company's accounting fairly discloses its financial position.

An assessment of the overall control environment was performed by INS Services, Inc., an internal control specialist team. INS Services, Inc. examined the Company's responses to the Examination Planning Questionnaire Exhibit C, interviewed management, reviewed systems, performed judgmental and statistical samples of Company records evidencing execution of the Company's information systems control environment. As a result of the examination performed by INS Services, Inc., the assessment of the overall control risk related to information systems controls at the Company is high for those policies and procedures that had been in place as of December 31, 2004. In some areas a substantive examination approach was taken in response to the risk rating of high.

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, 2004.

Analysis of Assets
Liabilities, Surplus and Other Funds
Underwriting and Investment Exhibit
Capital and Surplus Account
Analysis of Examination Changes

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

Analysis of Assets
December 31, 2004

	<u>Ledger</u> <u>Assets</u>	<u>Assets Not</u> <u>Admitted</u>	<u>Net Admitted</u> <u>Assets</u>	<u>Notes</u>
Bonds	\$92,677,335	\$0	\$92,677,335	
Common stocks	33,258,962	4,199,514	29,059,448	1
Cash and cash equivalents and short-term				
Investments	56,213,340	0	56,213,340	
Receivable for securities	2,440,452	0	2,440,452	
Aggregate write-ins for invested assets:				
Derivative instruments	1,368,105	0	1,368,105	
Investment income due and accrued	1,420,495	0	1,420,495	
Uncollected premiums and agents' balances				
in course of collection	11,390,006	711,050	10,678,956	
Deferred premiums, agents' balances and				
installments booked but deferred				
and not yet due	6,531,773	0	6,531,773	
Amounts recoverable from reinsurers	4,973,172	0	4,973,172	
Funds held by or deposited with reinsured				
companies	2,633,571	0	2,633,571	
Net deferred tax asset	17,940,571	9,976,253	7,964,318	
Guaranty funds receivable or on deposit	1,350,641	0	1,350,641	
Receivable from parent, subsidiaries, and				
affiliates	8,175,363	0	8,175,363	
Aggregate write-ins for other than invested				
assets:				
Prepays	2,017,326	2,017,326	0	
Recoverables	16,612,700	10,576,739	6,035,961	
Totals	<u>\$259,003,812</u>	<u>\$27,480,882</u>	<u>\$231,522,930</u>	

Liabilities, Surplus and Other Funds
December 31, 2004

		<u>Notes</u>
Losses	\$64,357,193	2
Reinsurance payable on paid loss and loss adjustment expenses	579,474	
Loss adjustment expenses	20,118,840	2
Commissions payable, contingent commissions and other similar charges	2,863,348	
Other expenses	4,248,366	
Taxes, licenses and fees	1,577,224	
Current federal and foreign income taxes	292,031	
Net deferred tax liability	226,668	
Unearned premiums	37,401,148	
Ceded reinsurance premiums payable	7,997,744	
Funds held by company under reinsurance treaties	1,529,068	
Amounts withheld or retained by company for account of others	1,025,480	
Remittances and items not allocated	4,186,876	
Provision for reinsurance	2,330,084	
Total liabilities	<u>\$148,733,544</u>	
Common capital stock	3,100,000	
Gross paid in and contributed surplus	92,709,892	
Unassigned funds (surplus)	<u>(13,020,506)</u>	
Surplus as regards policyholders	<u>\$82,789,386</u>	
Total	<u>\$231,522,930</u>	

Underwriting and Investment Exhibit
Statement of Income
December 31, 2004

UNDERWRITING INCOME

Premiums earned	<u>\$112,991,249</u>
DEDUCTIONS:	
Losses incurred	\$64,373,331
Loss expenses incurred	8,356,246
Other underwriting expenses incurred	<u>40,181,464</u>
Total underwriting deductions	<u>\$112,911,041</u>
Net underwriting gain or (loss)	<u>\$80,208</u>

INVESTMENT INCOME

Net investment income earned	\$4,778,215
Net realized capital gains or (losses)	<u>6,662,742</u>
Net investment gain or (loss)	<u>\$11,440,957</u>

OTHER INCOME

Net gain or (loss) from agents' or premium balances charged off	<u>(490,067)</u>
Total other income	<u>(\$490,067)</u>
Net income before dividends to policyholders and before FIT	<u>\$11,031,098</u>
Net income, after dividends to policyholders but before FIT	<u>\$11,031,098</u>
Federal income tax incurred	89,735
Net income	<u><u>\$10,941,363</u></u>

CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders, December 31, 2003	<u>\$84,039,435</u>
Net income	<u>\$10,941,363</u>
Change in net unrealized capital gains or (losses)	931,708
Change in net unrealized foreign exchange capital gains (loss)	(481,727)
Change in net deferred income tax	(2,272,142)
Change in nonadmitted assets	(11,060,115)
Change in provision for reinsurance	<u>690,862</u>
Change in surplus as regards policyholders for the year	<u>(1,250,051)</u>
Surplus as regards policyholders, December 31, 2004	<u><u>\$82,789,384</u></u>

Analysis of Examination Changes
December 31, 2004

	Company Amount	Examination Amount	Surplus Increase (Decrease)	Total
Capital and Surplus per Company				\$86,988,899
<u>Assets</u>				
Common stocks	\$33,258,962	\$29,059,448	\$(4,199,514)	(\$4,199,514)
Capital and Surplus per Examination				\$82,789,385

NOTES TO THE FINANCIAL STATEMENT

(1) Common Stock \$29,059,448

Common stock in the amount of \$29,059,448 is \$4,199,514 less than the amount reported by the Company in its 2004 Annual Statement. The Company's common stock investment of an affiliate, HWIC Asia Fund, exceeded Delaware investment limitation statutes. The cost of the common stock, purchased December 17, 2003, was in violation of Section 1305(2) and Section 1321(a) of the Code, stipulating a 3% limitation for a foreign investment in a country that is not an SVO 1 jurisdiction. The Company was also in violation of Section 5005(a)(2) of the Code requiring prior approval for this material affiliate investment. Therefore,

It is recommended that the Company comply with Sections 1305(2), 1321(a) and 5005(a)(2) of the Delaware Insurance Code pertaining to investment limitations and reporting of material transactions with affiliates.

Subsequent to the examination date, on May 20, 2005, the Company sold shares of HWIC Asia Fund common stock equivalent to meet compliance with Delaware statutes.

(2) Loss and Loss Adjustment Expenses\$64,357,193

The examination of losses and loss adjustment expenses was conducted by the contract actuary, INS Consultants, Inc. (INS), of Philadelphia, PA, on a group basis for FSG rather than on an individual company basis, due to the Inter-Company Reinsurance Pooling Agreement, entered into January 1, 2004.

The independent review of the FSG book of business by type was conducted on both a net and gross basis for loss and defense and cost containment expense. For adjusting and other expense (A & O), INS reviewed the methodology employed by FSG and accepted its booked A & O reserve. Four reserving methods were used in the analysis of the FSG's loss reserves. They are the paid loss method, the incurred loss method, the paid Bornhuetter-Ferguson method and the incurred Bornhuetter-Ferguson method. The analysis included a review of the Company's Statement of Actuarial Opinion and supporting documentation.

Testing was performed to verify the accuracy and completeness of the underlying data pertaining to losses and loss adjustment expenses. It was ascertained that the data was accurate and complete.

The distribution of reported net loss and loss adjustment expense reserves, totaling \$126.1 million, by line of business is summarized as follows (\$000 omitted):

Other Liability - Occurrence	\$ 34,333
Commercial Auto Liability	31,847
Commercial Multiple Peril	20,019
Workers' Compensation	12,745
All Other	<u>27,140</u>
Total	\$126,084

The INS estimate of gross loss and loss adjustment expense reserve was \$12.3 million higher than FSG's booked gross loss and loss adjustment expense reserves of \$236.7 million. This \$12.3 million difference represents 5.2 percent of the Annual Statement gross reserves. The

INS estimate of net loss and loss adjustment expense reserves was \$176,000 higher than FSG's booked net loss and loss adjustment expense reserves of \$126.1 million. The \$176,000 difference represents 0.1 percent of the Annual Statement net reserves, and was considered not material. The FSG net loss and loss adjustment expense reserves as of December 31, 2004 were accepted as adequate.

Subsequent to the examination date, in March 2005, FSG increased gross loss reserves associated with discontinued programs by approximately \$14 million. These reserves were subsequently ceded in accordance with the provisions of the loss portfolio transfer with nSpire and had no impact to FSG net reserves.

The actuarial analysis of losses and loss expense reserves resulted in the following recommendation:

It is recommended that FSG document the accident and health loss and defense and cost containment incurred but not reported reserve procedure in order to facilitate verification of this liability in the future.

COMPLIANCE WITH PRIOR REPORT

The Company's compliance with prior examination recommendations was reviewed for each account in the current examination for which there was prior examination recommendations. The Company complied with all prior examination recommendations with the exception of the valuation of the Company's affiliated stock, Fairmont Specialty Insurance Finance Company, formerly Ranger Insurance Finance Company (RIFCO), which was overstated by an amount that was below tolerable error. This overstatement represented a portion of the notes receivable per the RIFCO balance sheet as of December 31, 2004. A detailed review concluded that one of the notes was not supported by admissible collateral. Per Section 1101 of the Delaware Insurance Code, it is general practice that a downstream subsidiary cannot do anything not permitted directly by the insurance company. Therefore, any loan to

agents that is not collateralized by an admissible asset would be not admitted for examination report purposes. Due to the amount being below tolerable error, no adjustment was made to this report. Therefore,

It is again recommended that the Company comply with Section 1101 of the Delaware Insurance Code when determining value of its common stock such that a downstream subsidiary cannot do anything that an insurer cannot do in compliance with statutory practice.

RECOMMENDATIONS

1. Capitalization - It is recommended that the Company maintain a stock register and stock stub book. (p. 5)
2. Management and Control - It is recommended that the Company comply with the provisions of Section 4919 of the Delaware Insurance Code regarding proper reporting of changes in principal officers and directors of the Company. (p. 7)
3. Management and Control – It is recommended that the Company comply with the provisions of its by-laws and Section 211(b) of the General Corporation Law of the State of Delaware. (p. 8)
4. Conflicts of Interest – It is recommended that the officers and employees of the Company execute conflict of interest statements annually. (p. 8)
5. Common Stock - It is recommended that the Company comply with Sections 1305(2), 1321(a) and 5005(a)(2) of the Delaware Insurance Code pertaining to investment limitations and reporting of material transactions with affiliates. (p. 26)
6. Loss and Loss Adjustment Expenses – It is recommended that FSG document the accident and health loss and defense and cost containment incurred but not reported reserve procedure in order to facilitate verification of the liability in the future. (p. 28)

7. Compliance with Prior Report – It is again recommended that the Company comply with Section 1101 of the Delaware Insurance Code when determining value of its common stock such that a downstream subsidiary cannot do anything that an insurer cannot do in compliance with statutory practice. (p. 29)

CONCLUSION

As a result of this examination, the financial condition of the Company, as of December 31, 2004, was determined to be as follows:

Admitted Assets	<u>\$231,522,930</u>
Liabilities	\$148,733,544
Capital and Surplus	<u>82,789,386</u>
Total	<u>\$231,522,930</u>

Since the last examination as of December 31, 2001, total assets have increased \$27,500,011. Liabilities have decreased \$21,457,826, and capital and surplus have increased \$48,957,837 in the same period.

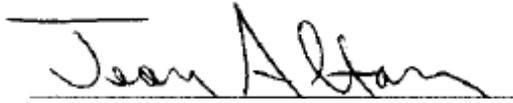
ACKNOWLEDGMENT

The assistance rendered by the officers and employees of the Company during the course of the examination are hereby acknowledged.

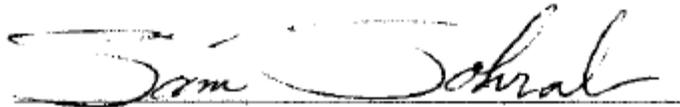
In addition to the undersigned, Giles W. Larkin, CFE, Joseph M. Funkhouser, Jonathan C. Landry, CFE, Don Hollier, CFE, James R. Robinson, CPA, James Boswell, CCP, and Paul Berkebile, CFSA participated in the examination. Sam Sohrab, CFE, participated in the examination representing the Western Zone of the NAIC. Dave Macesic, ACAS, MAAA, and

Fairmont Specialty Insurance Company

Frank Podrebarac, FSA, MAAA, INS Consultants, Inc. completed the actuarial portion of this examination.



Jean Alton, CFE
Examiner-In-Charge
Department of Insurance
State of Delaware
Northeastern Zone, NAIC



Sam Sohrab, CFE
Senior Insurance Examiner
Department of Insurance
State of California
Western Zone, NAIC

SUBSEQUENT EVENTS

The minutes of the meetings of the stockholder and board of directors held to date in 2005 were reviewed. It was noted that on August 22, 2005, the board of directors elected a Finance Committee and Executive Committee, in accordance with Company by-laws. Noted changes to management were the resignation of Eileen McCollum as secretary and her appointment as assistant secretary, election of Sharlene Husky as senior vice president and secretary, election of Gus Aivaliotis as vice president of corporate underwriting and appointment of Darrin Faas as assistant treasurer.

On January 3, 2005, Ranger Insurance Managers, Inc. changed its name to Fairmont Specialty Insurance Managers, Inc. On the same date, Ranger Insurance Finance Company changed its name to Fairmont Specialty Insurance Finance Company.

A review of A.M. Best's News for BestWire Services, dated June 27, 2005, noted that FFHL stated one of its subsidiaries received a subpoena from federal investigators looking into the possible misuse of nontraditional insurance products. It was reported that a Fairmont Specialty Group subsidiary was subpoenaed by the U.S. Securities and Exchange Commission, which is seeking information regarding any nontraditional insurance arrangement Fairmont may have entered into with Berkshire Hathaway Inc.'s General Reinsurance Corp. The Company received a subpoena on June 20, 2005. The subpoena requested, among other things, that the Company produce all documents for the period January 1, 1995 through the present concerning all non-traditional product transactions entered into by FSG with Gen Re. The Company responded on July 21, 2005, by sending a copy of Gen Re treaty No. 8129 representing a stop loss agreement and treaty No. 8130 representing a deposit agreement, along with a cover letter requesting confidential and nonpublic treatment of all documents subject to the subpoena under the federal Freedom of Information Act.

On June 7, 2005, a \$7.5 million letter of credit (LOC) was issued by Wells Fargo Bank on behalf of the Company, with the beneficiary as Liberty Mutual Insurance Company (Liberty). The LOC was required to collateralize a surety bond (appeals bond) issued by Liberty on behalf of the Company for an ongoing claims matter. As collateral for the LOC, Wells Fargo Bank required the Company to deposit in excess of \$8,333,333 in assets in a separate account and grant Wells Fargo Bank a security interest in said account. The account was established at the Bank of New York and, as of September 30, 2005, had a balance of \$8,573,125. The LOC is scheduled to expire on June 7, 2006. Management asserted that since the length of the appeals process on this particular claim is unknown, the Company may have to renew this LOC for another year.