

REPORT ON EXAMINATION

OF

CAPACITY INSURANCE COMPANY

COCONUT CREEK, FLORIDA

AS OF

DECEMBER 31, 2003

BY THE

OFFICE OF INSURANCE REGULATION

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Tallahassee, Florida
February 25, 2005

Kevin M. McCarty
Commissioner
Office of Insurance Regulation
State of Florida
Tallahassee, Florida 32399-0326

Dear Sir:

Pursuant to your instructions, in compliance with Section 624.316, Florida Statutes (FS), and in accordance with the practices and procedures promulgated by the National Association of Insurance Commissioners (NAIC), we have conducted an examination as of December 31, 2003, of the financial condition and corporate affairs of:

**CAPACITY INSURANCE COMPANY
3700 COCONUT CREEK PARKWAY, SUITE 200
COCONUT CREEK, FLORIDA 33066-1616**

Hereinafter referred to as the "Company". Such report of examination is herewith respectfully submitted.

SCOPE OF EXAMINATION

This examination covered the period of January 1, 2001 through December 31, 2003. The Company was last examined by representatives of the Florida Office of Insurance Regulation (Office) as of December 31, 2000. This examination commenced, with planning at the Office, on November 29, 2004 to December 3, 2004. The fieldwork commenced on December 6, 2004 and was concluded as of February 25, 2005. The examination included any material transactions and/or events occurring subsequent to the examination date and noted during the course of the examination.

This financial examination was a statutory financial examination conducted in accordance with the Financial Examiners Handbook, Accounting Practices and Procedures Manual and annual statement instructions promulgated by the NAIC as adopted by Rules 69O-137.001(4) and 69O-138.001, Florida Administrative Code (FAC), with due regard to the statutory requirements of the insurance laws and rules of the State of Florida.

In this examination, emphasis was directed to the quality, value and integrity of the statement assets and the determination of liabilities, as those balances affect the financial solvency of the Company.

The examination included a review of the corporate records and other selected records deemed pertinent to the Company's operations and practices. In addition, the NAIC IRIS ratio report, the A.M. Best Report, the Company's independent audit reports and certain work papers prepared by the Company's independent certified public accountant (CPA) were reviewed and utilized where applicable within the scope of this examination.

We valued and/or verified the amounts of the Company's assets and liabilities as reported by the Company in its annual statement as of December 31, 2003. Transactions subsequent to year-end 2003 were reviewed where relevant and deemed significant to the Company's financial condition.

This report of examination is confined to financial statements and comments on matters that involve departures from laws, regulations or rules, or which are deemed to require special explanation or description.

Based on the review of the Company's control environment and the materiality level set for this examination, some reliance was placed on some of the work performed by the Company's CPAs, after verifying the statutory requirements, for the following accounts:

- Agents Balances and Uncollected Premiums
- Unearned Premiums
- Deferred Premiums
- Losses and LAE
- Ceded Reinsurance Premiums Payable

Status of Adverse Findings from Prior Examination

The following is a summary of significant adverse findings contained in the Office's prior examination report as of December 31, 2000, along with resulting action taken by the Company in connection therewith.

Custodian Agreement

The Company's securities were held by two brokers who did not qualify as custodians under Rule 690-143.041, FAC.

Resolution: The Company is now utilizing a custodian, Regions Bank (formerly Union Planters Bank). The Company has entered into a custodial agreement with Regions Bank, and the agreement is in compliance with Rule 69O-143.042, FAC.

Management

The Company did not maintain an audit committee consisting of three or more directors in accordance with Section 624.424(8)(c), FS.

Resolution: The Company is now maintaining an audit committee consisting of three or more directors in accordance with Section 624.424(8)(c), FS.

Affiliated Companies

The Company had an agency agreement with Program Underwriters, Inc., and a claims processing agreement with Equity Adjustment Corporation. The agency agreement did not reflect the current address of the agency. The claims processing agreement did not indicate the current payment structure.

Resolution: The Company updated the agreements to properly reflect the current address of the agency and the payment structure of claims processing.

HISTORY

General

The Company was incorporated in Florida on April 23, 1986 and commenced business on February 16, 1989, under the name Capacity Insurance Company, to operate as a stock

property and casualty insurer in accordance with Section 624.4621, FS. The Company specializes in commercial multi-peril coverage for various low-hazard classes of business.

In accordance with Section 624.401(1), FS, the Company was authorized to transact the following insurance coverage in Florida on December 31, 2003:

Fire	Allied Lines
Commercial Multi-Peril	Burglary and Theft
Inland Marine	Glass
Other Liability	
Commercial Automobile Liability	
Commercial Auto Physical Damage	

The articles of incorporation and the bylaws were not amended during the period covered by this examination.

Capital Stock

As of December 31, 2003, the Company's capitalization was as follows:

Number of authorized common capital shares	750,000
Number of shares issued and outstanding	750,000
Total common capital stock	\$750,000
Par value per share	\$1.00

Profitability of Company

The following table shows the profitability trend of the Company for the period of examination.

	2001	2002	2003
Premiums Earned (\$)	1,328,517	1,747,255	3,136,768
Net Underwriting Gain/(Loss) (\$)	(83,758)	(134,936)	848,218
Net Income (\$)	239,788	123,085	807,221
Total Assets (\$)	7,058,899	8,470,612	9,620,491
Total Liabilities (\$)	3,399,647	4,723,847	4,606,538
Surplus As Regards Policyholders (\$)	3,659,251	3,746,765	5,013,953

Dividends to Stockholders

In accordance with Section 628.371, FS, the Company has not declared or paid dividends to its stockholders during the period covered under this examination.

Management

The annual shareholder meeting for the election of directors was held in accordance with Sections 607.1601 and 628.231, FS. Directors serving as of December 31, 2003, were:

Directors

Name and Location	Principal Occupation
Donna M. Buto Coral Springs, Florida	President
Frances T. Buto Coral Springs, Florida	Secretary & Treasurer
Annette T. Carter Pompano Beach, Florida	Vice President Underwriting
Stephen Buto Coral Springs, Florida	Executive Vice President
Arnold Zisselman Boca Raton, Florida	Senior Vice President/CFO

The Board of Directors in accordance with the Company's bylaws appointed the following senior officers:

Senior Officers

Name	Title
Donna M. Buto	President
Arnold Zisselman	Vice President/CFO
Frances T. Buto	Secretary/Treasurer

Vice Presidents

Name	Title
Stephen Buto	Vice President
Arnold Zisselman	Vice President
Annette T Carter	Vice President
Terry Chiappelli	Vice President
Helen K. Bacon	Vice President

The Company's board appointed several internal committees in accordance with Section 607.0825, FS. Following are the principal internal board committees and their members as of December 31, 2003:

Audit Committee

Steven Buto¹
Annette Carter
Arnold Zisselman

Investment Committee

Donna Buto¹
Arnold Zisselman

¹ Chairman

Conflict of Interest Procedure

The Company adopted a policy statement requiring annual disclosure of conflicts of interest, in accordance with Section 607.0832, FS. No exceptions were noted during this examination period.

Corporate Records

The recorded minutes of the shareholder, Board of Directors, Audit and Investment Committee meetings were reviewed for the period under examination. The recorded minutes of the Board adequately documented its meetings and approval of Company transactions in accordance with Section 607.1601, FS, including the authorization of investments as required by Section 625.304, FS.

There was documentation in the minutes reviewed that the Company's directors reviewed the previous examination report.

Acquisitions, Mergers, Disposals, Dissolutions, and Purchase or Sales Through Reinsurance

As of December 31, 2003, the Company had no acquisitions, mergers, disposals, dissolutions, and purchases or sales through reinsurance.

Surplus Debentures

The Company had no surplus debentures for the year ending December 31, 2003.

Subsequent event: The Company added \$1,800,000 in cash on December 22, 2004, in the form of surplus notes.

AFFILIATED COMPANIES

The Company had affiliated companies and was a member of an insurance holding company system as defined by Rule 69O-143.045(3), FAC. The latest holding company registration statement was filed with the State of Florida as required by Section 628.801, FS, and Rule 69O-143.046, FAC.

The following agreements were in force between the Company and its affiliates:

Claims Servicing Agreement

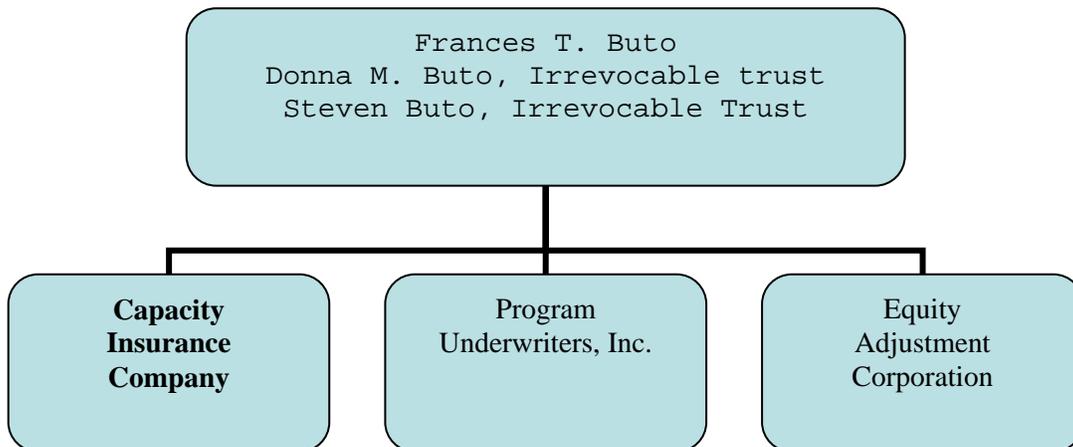
The Company had an agreement with Equity Adjustment Corporation (EAC) to provide claims handling services. The agreement was entered into on January 1, 1990. The agreement stipulated that EAC provide claims processing services on behalf of the Company. The original agreement, allowed for this service, a fee of 2.5% of gross written premiums. In an addendum dated January 1, 1991, the agreement was changed to allow for this service, on a per claim basis based on time spent.

Agency Agreement

The company had an agreement with Program Underwriters Incorporated (PUI) to produce business in which it was paid a commission. The Company agreed to pay PUI 7.5% of the Company's gross written premiums in return for certain administrative services provided by PUI, including but not limited to policy preparation and issuance, data processing services, management consulting services and other financial functions.

A simplified organizational chart as of December 31, 2003, reflecting the holding company system, is shown below. Schedule Y of the Company's 2003 annual statement provided a list of all related companies of the holding company group.

**CAPACITY INSURANCE COMPANY
ORGANIZATIONAL CHART
DECEMBER 31, 2003**



FIDELITY BOND AND OTHER INSURANCE

The Company maintained fidelity bond coverage up to \$500,000 with a deductible of \$1,000, which adequately covered the suggested minimum amount of coverage for the Company as recommended by the NAIC.

PENSION, STOCK OWNERSHIP, AND INSURANCE PLANS

On May 27, 1996, the Company executed a supplemental participation agreement in which it became a participating employer evidencing the adoption of a 401(K) profit sharing plan and trust, sponsored by PUI for Company employees meeting eligibility requirements.

STATUTORY DEPOSITS

The following securities were deposited with the State of Florida as required by Section 624.411, FS, and with various state officials as required or permitted by law:

State	Description	Par Value	Market Value
FL	USTNT, 5.500%, 02/15/2008	<u>\$ 404,424</u>	<u>\$ 441,000</u>
TOTAL FLORIDA DEPOSITS		<u>\$ 404,424</u>	<u>\$ 441,000</u>
TOTAL SPECIAL DEPOSITS		<u>\$ 404,424</u>	<u>\$ 441,000</u>

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operation

The Company was authorized to transact insurance only in the State of Florida, in accordance with Section 624.401(2), FS:

Treatment of Policyholders

The Company had established procedures for handling written complaints in accordance with Section 626.9541(1)(j), FS. The Company maintained a claims procedure manual that

included detailed procedures for handling each type of claim, through their claims servicing company, EAC.

REINSURANCE

The reinsurance agreements reviewed were found to comply with NAIC standards with respect to the standard insolvency clause, arbitration clause, transfer of risk, reporting and settlement information deadlines.

Assumed

The Company assumed no risk from other companies.

Ceded

The Company ceded risk on a quota share basis, casualty excess of loss basis and a property per risk excess of loss basis through Guy Carpenter to a majority of authorized and some unauthorized reinsurers.

Quota Share Contract

The quota share contract, effective May 1, 2003, shared 50% of premiums and losses with the remaining 50% being retained by the Company. The maximum loss paid, in regards to property business, was \$5,000,000 on any one risk, each loss. The maximum loss paid in regards to all risks involved in any one property loss occurrence was \$9,000,000.

Casualty Excess of Loss Contract

The casualty excess of loss contract stipulated the reinsurer's maximum liability of each layer for losses arising out of the acts of terrorism was \$300,000 for the first layer and

\$500,000 for the second layer for such acts commencing during the term of the contract.

Property Per Risk Excess of Loss Contract

The property per risk excess of loss contract stipulated that the reinsurer's limits of liability were \$300,000 each loss and \$900,000 each loss occurrence for the first layer, \$500,000 each loss and \$1,500,000 each loss occurrence for the second layer, and \$2,000,000 and \$4,000,000 for the third and fourth layers.

The reinsurance contracts were reviewed by the Company's appointed actuary and were utilized in determining the ultimate loss opinion.

ACCOUNTS AND RECORDS

An independent CPA audited the Company's statutory basis financial statements annually for the years 2001, 2002 and 2003 in accordance with Section 624.424(8), FS. Supporting work papers were prepared by the CPA as required by Rule 69O-137.002, FAC.

The Company's accounting records were maintained on a computerized system. The Company's balance sheet accounts, with the exception of two accounts, were verified with the line items of the annual statement submitted to the Office.

The Company did not report reinsurance recoverable on paid losses as an asset. Instead it netted these amounts against ceded reinsurance premiums payable. The NAIC Accounting Practices and Procedures Manual, SSAP No. 62, paragraph 19, requires that reinsurance recoverable on paid losses be set up separately as an asset. No reclassification was made due to the immaterial amount involved.

The Company maintained its principal operational offices in Fort Lauderdale (Coconut Creek), Florida, where this examination was conducted.

The Company and non-affiliates had the following agreements:

Custodial Agreement

The Company entered into a custodial agreement with Regions Bank (formerly Union Planters Bank) on April 30, 2002. Regions Bank is a national bank as set forth in the definition of an agent or custodian. The custodial agreement with Regions Bank was in compliance with Rule 69O-143.042, FAC.

Independent Auditor Agreement

The Company engaged DeMeo, Young, McGrath Professional Services Company, for the purpose of auditing and reporting on the balance sheet and statutory financial statement of the Company.

Risk-Based Capital

The Company reported its risk-based capital at an adequate level.

FINANCIAL STATEMENTS PER EXAMINATION

The following pages contain financial statements showing the Company's financial position as of December 31, 2003, and the results of its operations for the year then ended as determined by this examination. Adjustments made as a result of the examination are noted in the section of this report captioned, "Comparative Analysis of Changes in Surplus."

CAPACITY INSURANCE COMPANY
Assets

DECEMBER 31, 2003

Classification	Per Company	Examination Adjustments	Per Examination
Bonds	\$7,017,689		\$7,017,689
Cash:			
On hand	1,274,674		1,274,674
Investment income due and accrued	92,322		92,322
Agents' Balances:			
Uncollected premium	437,796		437,796
Deferred premium	588,021		588,021
Net deferred tax asset	204,927		204,927
Aggregate write-in for other than invested assets	5,062		5,062
Totals	\$9,620,491		\$9,620,491

CAPACITY INSURANCE COMPANY
Liabilities, Surplus and Other Funds

DECEMBER 31, 2003

Liabilities	Per Company	Examination Adjustments	Per Examination
Losses	\$1,510,416		\$1,510,416
Loss adjustment expenses	248,525		248,525
Other expenses	21,980		21,980
Taxes, licenses and fees	92,029		92,029
Current federal and foreign income taxes	194,613		194,613
Unearned premium	2,123,642		2,123,642
Ceded reinsurance premiums payable	409,274		409,274
Funds held by Company	3,775		3,775
Amounts withheld	<u>2,284</u>		<u>2,284</u>
Total Liabilities	\$4,606,538		\$4,606,538
Common capital stock	\$750,000		\$750,000
Gross paid in and contributed surplus	2,063,800		2,063,800
Unassigned funds (surplus)	<u>2,200,153</u>		<u>2,200,153</u>
Surplus as regards policyholders	<u>\$5,013,953</u>		<u>\$5,013,953</u>
Total liabilities, capital and surplus	<u><u>\$9,620,491</u></u>		<u><u>\$9,620,491</u></u>

COMPANY INSURANCE COMPANY
Statement of Income

DECEMBER 31, 2003

Underwriting Income

Premiums earned	\$3,136,768
DEDUCTIONS:	
Losses incurred	651,255
Loss expenses incurred	335,754
Other underwriting expenses incurred	1,301,541
Total underwriting deductions	\$2,288,550
Net underwriting gain or (loss)	\$848,218

Investment Income

Net investment income earned	\$210,643
Net investment gain or (loss)	\$210,643

Other Income

Net gain or (loss) from agents' or premium balances charged off	(\$54)
Total other income	(\$54)
Net income before dividends to policyholders and before federal & foreign income taxes	\$1,058,807
Dividends to policyholders	
Net Income, after dividends to policyholders, but before federal & foreign income taxes	\$1,058,807
Federal & foreign income taxes	251,586
Net Income	\$807,221

Capital and Surplus Account

Surplus as regards policyholders, December 31 prior year	\$3,746,765
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Gains and (Losses) in Surplus

Net Income	\$807,221
Net unrealized capital gains or losses	
Change in net deferred tax income	(25,691)
Change in non-admitted assets	(21,342)
Change in provision for reinsurance	22,000
Surplus adjustments: Paid in	485,000
Change in surplus as regards policyholders for the year	1,267,188
Surplus as regards policyholders, December 31 current year	\$5,013,953

COMMENTS ON FINANCIAL STATEMENTS

Assets

Taxes \$194,613

The Company, in presenting its 2003 income taxes, did not disclose the proper federal income tax liability and allocation for this expense in their 2003 annual statement. The stated liability in the 2003 annual statement totaled \$194,613, while the actual expense, as reported in the Company's 2003 federal income tax return, was \$284,033. The under accrued amount of \$89,500 was below this examination's materiality, so no adjustment was made in this account. The Company's CPA firm believed the difference to be the result of timing of premiums received.

Liabilities

Losses and Loss Adjustment Expenses \$1,758,941

An outside actuarial firm appointed by the Board of Directors, rendered an opinion that the amounts carried in the balance sheet as of December 31, 2003, make a reasonable provision for all unpaid loss and loss expense obligations of the Company under the terms of its policies and agreements.

The Office actuary reviewed work papers provided by the Company and was in concurrence with this opinion.

CAPACITY INSURANCE COMPANY
Comparative Analysis of Changes in Surplus

DECEMBER 31, 2003

The following is a reconciliation of surplus as regards policyholders between that reported by the Company and as determined by the examination.

Surplus as Regards Policyholders per December 31, 2003, Annual Statement	\$5,013,953
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	<u>PER</u> <u>COMPANY</u>	<u>PER</u> <u>EXAM</u>	INCREASE (DECREASE) <u>IN SURPLUS</u>
ASSETS:			
No adjustment needed.			
LIABILITIES:			
No adjustment needed.			
Net Change in Surplus:			0
Surplus as Regards Policyholders December 31, 2003, Per Examination			\$5,013,953

SUMMARY OF FINDINGS

Compliance with previous directives

The Company has taken the necessary actions to comply with the comments made in the 2000 examination report issued by the Office.

Current examination comments and corrective action

The following is a brief summary of items of interest and corrective action to be taken by the Company regarding findings in the examination as of December 31, 2003.

Reinsurance

The Company did not report reinsurance recoverable on paid losses as an asset. Instead, the Company netted these amounts against ceded reinsurance premiums payable. The NAIC Accounting Practices and Procedures Manual, SSAP No. 62, paragraph 19, requires that reinsurance recoverable on paid losses be set up separately as an asset.

It is recommended that the Company comply with SSAP No. 62, paragraph 19 and set up paid losses as reinsurance recoverable in future filings.

Taxes

The Company, in presenting its 2003 income taxes, failed to disclose the proper federal income tax liability and allocation for this expense in their 2003 annual statement. **It is recommended that for all future filings the Company better estimate their federal income tax liability.**

Information Technology (IT) Evaluation

The IT evaluation indicated that the Company's IT controls were of acceptable standards except for contingency planning. Some key elements of an adequate recovery plan existed and have been tested. The Company needs to develop a plan to assign and communicate responsibilities as well as identify a comprehensive list of tasks to be performed in the case of an emergency. **It is recommended that the Company develop a business contingency plan which should contain those activities required to continue normal business functions during a temporary loss of facilities or equipment; and such plan should be provided to the Office within 180 days of the issuance of this report.**

SUBSEQUENT EVENTS

The Company's underwriting loss position deteriorated considerably after the four hurricanes in August and September, 2004. As of September 30, 2004, the Company's surplus position had been reduced to \$4,004,876, only marginally above the minimum required surplus level.

The Company incurred 95 claims as a result of hurricane **Charley**, for a net retention of \$500,000, 32 claims as a result of hurricane **Frances**, for a net retention of \$445,446 and 20 claims as a result of hurricane **Jeanne**, for a net retention of \$346,106. No claims were incurred as a result of hurricane **Ivan**. The total incurred losses of all three hurricanes were \$5,073,395. After reinsurance recoveries of \$ 3,771,842, the net loss to the Company was \$1,301,552.

In recognition of the deteriorated surplus position, the Company increased cash by \$1.8 million on December 22, 2004, in the form of surplus notes.

CONCLUSION

The customary insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **CAPACITY INSURANCE COMPANY** as of December 31, 2003, consistent with the insurance laws of the State of Florida.

Per examination findings, the Company's surplus as regards policyholders was \$5,013,953, which was in compliance with Section 624.408, FS.

In addition to the undersigned, John Berry, Financial Examiner/Analyst Supervisor, Jay Ambler, Financial Examiner/Analyst I, David Schleit, Financial Examiner/Analyst II, Joe Boor, FCAS, Office Actuary, and Computer Aid, Inc. participated in the examination.

Respectfully submitted,

Owen A. Anderson
Financial Examiner/Analyst II
Florida Office of Insurance Regulation