Government of the District of Columbia

Department of Insurance, Securities and Banking

Thomas E. Hampton
Commissioner

BEFORE THE INSURANCE COMMISSIONER OF THE DISTRICT OF COLUMBIA

Re: Report on Examination - **National Service Contract Insurance Company Risk Retention Group,** as of December 31, 2006

ORDER

An Examination of **National Service Contract Insurance Company Risk Retention Group,** as of December 31, 2006 has been conducted by the District of Columbia Department of Insurance, Securities and Banking ("the Department").

It is hereby ordered on this 3rd day of November, 2008, that the attached financial condition examination report be adopted and filed as an official record of this Department.

In addition, it is hereby ordered that the Company comply with the recommendations in the attached financial condition examination report.

Pursuant to Section 31-1404(d)(1) of the D.C. Official Code, this Order is considered a final administrative decision and may be appealed pursuant to Section 31-4332 of the D.C. Official Code.

Pursuant to Section 31-1404(d)(1) of the D.C. Official Code, within 30 days of the issuance of the adopted report, the company shall file affidavits executed by each of its directors stating under oath that they have received a copy of the adopted report and related order.

Pursuant to Section 31-1404(e)(1) of the D.C. Official Code, the Department will continue to hold the content of the report as private and confidential information for a period of 10 days from the date of this Order.

Thomas E. Hampton
Commissioner

GOVERNMENT OF THE DISTRICT OF COLUMBIA

DEPARTMENT OF INSURANCE, SECURITIES AND BANKING

Government of the District of Columbia
Department of Insurance, Securities and Banking

REPORT ON EXAMINATION

NATIONAL SERVICE CONTRACT INSURANCE COMPANY RISK RETENTION GROUP

AS OF

DECEMBER 31, 2006

NAIC NUMBER 10234

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Washington, D.C.
May 2, 2008

Honorable Thomas E. Hampton
Commissioner
Department of Insurance, Securities and Banking
Government of the District of Columbia
810 First Street, NE, Suite 701
Washington, D.C. 20002

Dear Sir:

In accordance with Section 31-3931.14 of the District of Columbia Official Code, we have examined the financial condition and activities of

National Service Contract Insurance Company Risk Retention Group

hereinafter referred to as the "Company" or "NSCIC", at the office of its captive manager, located at 45 State Street, Suite #395, Berlin, Vermont 05601.

SCOPE OF EXAMINATION

This full-scope examination, covering the period January 1, 2003 through December 31, 2006, including any material transactions and/or events noted occurring subsequent to December 31, 2006, was conducted by the District of Columbia Department of Insurance, Securities and Banking ("the Department").

Our examination was conducted in accordance with examination procedures established by the Department and procedures recommended by the National Association of Insurance Commissioners ("NAIC") and, accordingly, included such tests of the accounting records and such other examination procedures as we considered necessary in the circumstances.

Our examination included a review of the Company's business policies and practices, management and corporate matters, a verification and evaluation of assets and a determination of the existence of liabilities. In addition, our examination included tests to provide reasonable assurance that the Company was in compliance with applicable laws, rules and regulations. In planning and conducting our examination, we gave consideration to the concepts of materiality and risk, and our examination efforts were directed accordingly.

The Company has been audited annually by an independent public accounting firm. The firm expressed an unqualified opinion on the Company's financial statements for all years under examination. We placed substantial reliance on the audited financial statements for calendar years 2003 through 2005 and, consequently, performed only minimal testing for those periods. We reviewed the working papers prepared by the independent public accounting firm relating to the audit for the year ended December 31, 2006 and directed our efforts, to the extent practical, to those areas not covered by the firm's workpapers.

STATUS OF PRIOR EXAMINATION FINDINGS

The prior examination of the Company was a full scope examination conducted as of December 31, 2002 by the State of Hawaii Department of Commerce and Consumer Affairs Insurance Division. The exam report, dated February 12, 2004, contained three recommendations.

Our examination included a review to determine the current status of the three recommendations in the prior exam report, and determined that the Company had satisfactorily addressed these conditions.

HISTORY

General:

The Company was incorporated in Hawaii on April 4, 1995 as a captive insurance company, and commenced business in the state of Hawaii on April 21, 1995. Effective May 26, 2005, the Company re-domesticated to the District of Columbia, operating as a risk retention group under the captive insurance laws of the District of Columbia.

The Company provides aggregate excess of loss insurance coverage to vehicle service contract providers (also known as administrator obligors and dealer obligors), which are in the business of selling and/or administering automobile, recreational vehicle, motorcycle, marine, and other vehicle-type extended service contracts. Interstate National Dealer Services, Inc. ("INDS"), an administrator obligor, is the majority member/policyholder of the Company.

During March 2006, with approval of the Department, the ownership of INDS' parent, INDS Holdings, Inc., was transferred, pursuant to a Security Purchase Agreement, to Golden Gate Capital Investment Fund II, LP ("Golden Gate"), a San Francisco-based private equity firm in partnership with Eugene Becker, Chairman of INDS. Various Golden Gate equity funds own 95.9 percent of INDS Holdings, Inc., and Mr. Becker owns 4.1 percent. Consequently, Golden Gate became the Company's ultimate controlling parent.

Ownership:

As a risk retention group, the Company is owned by its members/policyholders. As of December 31, 2006, INDS owned 100 percent of the Company's class A common stock, and 99.9 percent (910,651 out of 911,251 shares outstanding) of class B common stock. According to the Company, six other members/policyholders each own one hundred shares each of the Company's class B common stock. However, the Company was unable to document the ownership of these 600 shares. See the "Comments and Recommendations" section of this

Report, under the caption "Ownership Records and Ownership" for further comments regarding this condition.

Pursuant to the Company's Articles of Re-domestication, holders of class A common stock shall be entitled to one vote per share on each matter submitted to a vote at a meeting of shareholders. The holders of class B common stock are not entitled to vote on any matters.

As of December 31, 2006, the Company's capital stock consisted of the following:

	Par value	**Shares Authorized**	**Shares Outstanding**
Class A Common Stock	$.01	10,000,000	2,100,000
Class B Common Stock	$.01	1,000,000	911,251

Dividends and Distributions:

The Company did not declare or pay any dividends during the period under examination.

MANAGEMENT

The following persons were serving as the Company's directors as of December 31, 2006:

Name and State of Residence	Principal Occupation
Eugene Becker Florida	Chairman Interstate National Dealer Services, Inc.
Cindy Luby New York	President Interstate National Dealer Services, Inc.
Shaun Fetherston Georgia	President Consumer Electronics and Alliance Service Contracts Division, Signal Holdings
Michael T. Rogers Florida	President Risk Services, LLC

The following persons were serving as the Company's officers as of December 31, 2006:

Name	Title
Eugene Becker	President
Cindy Luby	Vice President and Secretary
Zvi Sprung	Treasurer
Michael T. Rogers	Assistant Treasurer and Assistant Secretary
Heather Ross	Assistant Secretary

Committees:

As of December 31, 2006, the Company's board of directors had not established any committees.

Conflicts of Interest:

Our review of the conflict of interest statements signed by the Company's directors and officers for the period under examination disclosed no conflicts that would adversely affect the Company. Furthermore, no additional conflicts of interest were identified during our examination.

Corporate Records:

We reviewed the minutes of the meetings of the shareholders and board of directors for the period under examination. Based on our review, it appears that the minutes documented the board's review and approval of the Company's significant transactions and events.

CAPTIVE MANAGER

Risk Services, LLC provides captive management services, including accounting and regulatory services, to the Company.

AFFILIATED PARTIES AND TRANSACTIONS

As indicated in the "Ownership" section of this report, the Company had seven owners as of December 31, 2006. INDS is the majority stockholder and owns 100 percent of the Company's class A common stock, and 99.9 percent of class B common stock.

INDS is 100 percent owned by INDS Holdings, Inc., which is 95.9 percent owned by Golden Gate Capital Investment Fund II, LP, a San Francisco-based private equity firm. The General Partner of Golden Gate Capital Investment Fund II, LP is Golden Gate Capital Management II, LLP, whose managing directors include David Dominik, Jesse Rogers, Prescott Ashe, Ken Diekroeger, and Stefan Kaluzny.

As of December 31, 2006, the Company had one significant related-party agreement in place.

Program Administrator Agreement:

During the period under examination, the Company had a Program Administrator Agreement in place with INDS. Based on the agreement, INDS provides daily management and administrative services, including marketing, underwriting, premium collection and claims handling to the Company. In return, the Company pays INDS $10 per vehicle service contract written. The five-year agreement expires December 31, 2008. In 2006, NSCIC paid fees totaling $755,960 to INDS under this agreement.

The Company reported “Receivables from parent, subsidiaries and affiliates” totaling $4,252,200 as of December 31, 2006. This balance includes the net of various payable balances to and receivable balances from INDS, some of which are up to eight years old with no activity. See the “Comments and Recommendations” section of this Report, under the caption “Accounts and Records” “Intercompany Balance”, for further comments regarding this balance.

FIDELITY BOND AND OTHER INSURANCE

The Company is covered by a Fidelity Bond with limits of $1,000,000, which covers INDS Holdings, Inc. and its subsidiaries. The policy meets the minimum amount of fidelity bond coverage recommended by the NAIC.

PENSION AND INSURANCE PLANS

The Company has no employees and therefore has no employee pension or insurance plans.

STATUTORY DEPOSITS

As of December 31, 2006, the Company did not have a statutory deposit in the District of Columbia and is not required to maintain one. In addition, the Company was not required to maintain statutory deposits with any other jurisdictions.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2006, the Company was licensed in the District of Columbia, and was registered as a risk retention group in all states except Florida and Wisconsin.

During 2006, NSCIC wrote approximately $1.4 million direct premiums in 48 states and the District of Columbia. Approximately 61 percent of the total premiums were written from the following five states: New York (30 percent), Missouri (13 percent), Delaware (7 percent), Pennsylvania (6 percent), and Massachusetts (5 percent). In 2007, the Company discontinued writing business in New York and Missouri.

The Company has no employees. Its member/policyholder, INDS, pursuant to the terms of the aforementioned Program Administrator Agreement, acts as the Company’s program manager and manages the Company’s daily business activities.

During the period under examination, the Company wrote direct business and also assumed reinsurance as follows:

Contractual Liability Insurance:

The Company provides aggregate excess of loss insurance coverage directly to its members ("insureds") who are in the business of selling and/or administering Vehicle Service Contracts ("VSCs"). Coverage provided by the underlying VSCs varies for new and used vehicles with terms ranging from 3 months to 10 years. According to management, the Company did not incur any claims during the period under examination, and has never incurred a claim since its inception in 1995.

According to the Company, during the period under examination, the Company issued aggregate excess of loss insurance policies to INDS, six Dealer Obligators (DOs) (Kite Brothers, LLC; Reliable Motors; A-1 Autoflex; A1 Homes – Natchitodes; Central Autoplex; and Family RV Center), and six Administrator Obligators (AOs) (Auto Services Company; Alternative Financial Acceptance Corporation; Associates Underwriting Limited, LLC; Lloyd Anderson & Co., Inc.; Tracker Marine, LLC; and WPC Associates). The terms "DO" and "AO" can be used differently by different entities in the VSC industry such as the Company. According to the Company, the above six DOs are members and owners of the Company, and market and sell VSCs themselves. The DOs then contract with INDS to administer the VSCs, including maintenance of loss reserve funds (see below for comments regarding the loss reserve funds). The AOs are responsible for administering VSC programs, including premium collection, loss payments, and maintenance of loss reserve funds. The AOs can also directly sell VSCs themselves. INDS and the six DOs are owners of NSCIC, and the six AOs are not currently owners of the Company. INDS is the Company's major policyholder, and generates 99 percent of the Company's direct written premiums. As of December 31, 2006, the six AOs were no longer writing business insured by the Company.

As indicated above in the "Ownership" section of the report, the Company was unable to document the ownership by the six DOs. In addition, the six AOs are not currently owners of the Company, and according to management, have never been owners. Because the six AOs are not currently writing any business, they are not currently required to be owners. However, under the requirements of the Federal Liability Risk Retention Act (LRRA), all insureds must be owners, and therefore, the six AOs should have been owners at one time. See the "Comments and Recommendations" section of this Report, under the caption "Ownership Records and Ownership" for further comments regarding this condition.

INDS (which is itself an AO) and the DOs and the six other AOs sell and administer VSCs. These warranties are offered by vehicle dealers to a buyer upon the sale of vehicle and are optional to the buyer. The cost to the purchasers of the VSCs varies based on the type of vehicle, whether it is new or used, mileage, and various other factors. A portion of the contract cost is retained by the seller (generally the automobile dealer) for commission and administrative expenses, and the remainder is remitted to the DOs and AOs, which then administer the contracts and are liable for payments under the contracts. Claims payments to the purchasers of the automobile extended service contracts are made directly by the insureds and are deducted from the loss reserve fund (see below for comments regarding the loss reserve fund).

From the sale price of each VSC, the Company receives premium income under its aggregate excess of loss policies with the AOs and DOs. Premiums received by the Company on the VSCs average $21-24 per VSC. This is the amount recorded on the Company's Schedule "T" in its Annual and Quarterly Statement filings. During 2006, the Company recorded premiums totaling $1,408,197. Premiums are earned by NSCIC on a prorated basis over the life of each contract.

In addition, from the sale price of each VSC, the AO or DO allocates a pre-determined loss reserve amount to a Loss Reserve Fund ("LRF") for the payment of future VSC claims. NSCIC's liability attaches once the aggregate amount of losses in each program exceeds the respective loss reserve fund deposits. NSCIC's liability is subject to a maximum limit per loss equal to the actual cash value of the covered vehicle and an aggregate limit for each service contract equal to the purchase price of the covered vehicle or $75,000, whichever is less. We noted that the Company's policy with INDS did not specifically define how the loss reserve fund shall be computed and maintained. In addition, the Company's policy with INDS contains no requirements regarding how the LRF is held by INDS (e.g., in a trust or fiduciary account). See the "Comments and Recommendations" section of this Report under the caption "Contractual Liability Insurance Policy Agreements" for further comments regarding these conditions.

As indicated above, the Company's obligation is supposed to attach at the amount of the LRF. However, under the terms of the Company's policies, if the insureds are unable to perform their obligations for any reason, regardless of the amounts in the LRFs or the amounts that are supposed to be in the LRFs, or, in the event the insureds are no longer in business, for whatever reason, the Company will assume the responsibilities of the insureds and will provide directly to the VSC holder all benefits to which the VSC holder is entitled under the terms of the VSC. See Note 1 in the "Notes to Financial Statements" section of this report for additional comments regarding the LRFs, and see the "Comments and Recommendations" section of this report, under the caption "Company Financial Responsibility and Loss Reserve Fund Deficiency", for further comments regarding the Company's financial responsibility under its policies with INDS.

We noted that the Company did not separately account for the written premiums and loss reserve funds associated with business insured for the six DOs, but recorded this business with the premium and loss reserve fund records under its policy with INDS. We also noted that the Company recorded approximately $16,000 returned premium related to the five of the six AOs in 2006, and only one AO had positive written premiums in 2006. The Company indicated no new business under these six AO policies was written after July 2006. However, the Company was unable to provide details regarding these AO policies (e.g., copies of executed policies for some of the AOs, dates of cessation of business under each policy, etc.). See the "Comments and Recommendations" section of this Report under the caption "Accounts and Records" "Policy Records", for further comments regarding these conditions.

The policy issued to INDS covers losses above the total LRFs for all VSCs that INDS has issued and/or administered through various dealers. Approximately 85 producers for INDS have funded their loss reserves in individual Producer Owned Reinsurance Companies ("PORCs"). There are multiple loss funds related to the INDS business; one for each independent AO and each PORC, and one for all other INDS and DO contracts written by NSCIC. INDS has effective security control over the LRFs and such loss funds are dedicated to each PORC, and no excess funds from one PORC can be used to offset deficiencies in another PORC fund.

Loss Reserve Funds of the AO programs are assets of the individual AOs. Any excess funds are therefore not available to offset another AO's fund deficit. Each of the AO and PORC LRFs are secured in trust accounts for the benefit of INDS and NSCIC, and some include LOCs as collateral.

In addition, since 2004 INDS has secured excess contractual liability insurance from Dealers Assurance Company ("DAC"), an insurer domiciled in Ohio. INDS utilizes the DAC policy to cover VSC business administered by INDS when one or more parties in the VSC transaction will not accept the policy provided by a risk retention group (NSCIC). INDS maintains a dedicated loss reserve escrow fund for contracts covered by DAC. INDS is entitled to any resulting profits, which can be used to meet other INDS liabilities. NSCIC has no direct connection to the DAC business.

<u>First Dollar Policy</u>:

As indicated above, the Company has issued contractual liability policies, which provide coverage above the insureds' loss reserve funds, and which do not directly insure the VSCs or the obligations to the purchasers of the VSCs, but provide excess of loss coverage above the insureds' loss reserve funds. However, certain jurisdictions require "first dollar" coverage of the obligations to the purchasers of VSCs. As a result, NSCIC has issued INDS a "first dollar" policy for use in any states requiring such form. However, according to NSCIC, as of December 31, 2006, all states in which it does business have accepted the standard aggregate excess of loss insurance policy filed by the Company in those states and no states had required the Company to use the "first dollar" policy. No premiums were written under the "first dollar" policy in 2006.

Under the Company's first dollar policy, the Company agrees to pay claims to the purchasers of the VSCs, on behalf of INDS, subject to an "Aggregate Deductible", which is defined as the sum of the individual amounts for each vehicle service contract required to be placed in to the loss reserve fund. The Company's financial responsibility under the first dollar policy is similar to its non-first dollar policies, except that the first dollar policies are subject to a deductible and the non-first dollar policies are excess of a self insured retention. The premiums paid to the Company, the obligations of the Company and INDS, and the accounting transactions by and between the Company and INDS with respect to the first dollar policy would be the same as under the non-first dollar policies.

Under terms of the first dollar policy, the presence of the aggregate deductible does not prohibit a holder of a VSC from filing a claim directly with the Company.

Assumed Reinsurance:

In addition to its contractual liability and first dollar policies, NSCIC assumes reinsurance from Business Alliance Insurance Company ("BAIC"). Under its agreement with BAIC, the Company assumes, on a quota share basis, 100 percent of the liability for losses under Mechanical Breakdown Insurance ("MBI") policies issued by BAIC in the State of California, and produced by INDS' subsidiary, Warranty Direct Insurance Services. The BAIC policy pays the reasonable cost to repair or replace covered parts due to a "failure" of the covered parts up to the actual cash value of the insured vehicle subject to a maximum aggregate limit of the lesser of $75,000 or the retail cost of the vehicle. The policy period runs from inception for a specified term (3 months to 10 years) subject to a mileage limitation.

This agreement was terminated effective January 1, 2007 on a run off basis. The Company is liable for all cessions in force at the time of termination and will continue to administer all policies in-force at the time of the termination until such time that all claims are settled. INDS administers the BAIC policies on behalf of the Company.

The assumed reinsurance premium in 2006 was $2,591,528, which is 100 percent of BAIC's net subject written premium. BAIC received a 12 percent ceding commission allowance which is inclusive of commissions, premiums taxes and California Insurance Guarantee Association fees. Our review disclosed deficiencies in the documentation related to the Company's accounting for the business assumed from BAIC. See the "Comments and Recommendations" section of this Report under the caption "Accounts and Records" "Policy Records", for further comments regarding this condition.

INSURANCE PRODUCTS AND RELATED PRACTICES

This examination was a financial examination, and did not include market conduct procedures. An examination of the market conduct affairs of the Company has never been conducted. A market conduct examination would include detailed reviews of the Company's sales and advertising, agent licensing, timeliness of claims processing, and complaint handling practices and procedures.

The scope of our examination did not include market conduct procedures, including, but not limited to, market conduct procedures in the following areas:

- Policy Forms
- Fair Underwriting Practices
- Advertising and Sales Materials
- Treatment of Policyholders:
    - Claims Processing (Timeliness)
    - Complaints

REINSURANCE

Assumed Reinsurance:

As indicated in the “Territory and Plan of Operation” section of this report, during the period under examination, the Company assumed business from BAIC under a quota share treaty. This quota share treaty was terminated on a run off basis effective January 1, 2007. As of December 31, 2006, the Company recorded the estimated assumed loss liabilities of $4,391,194 as unearned premiums in its balance sheet.

Ceded Reinsurance:

Direct business of the Company is reinsured through an aggregate excess of loss reinsurance agreement between NSCIC and certain members of the Hannover Re Group (rated “A-” by AM Best). The treaty, effective April 1, 2005 to April 1, 2008, has a $2 million aggregate limit, and attaches at 105 percent of the LRFs underlying the business insured by the Company. The treaty was renewed April 1, 2008 with the same terms for another three years. Hannover accounts for this treaty using a deposit accounting basis, which in turn requires the Company to do the same.

The annual ceded reinsurance premium is $110,000. The Company is required, however, to provide a letter of credit equal to the policy limit, and any losses payable under the agreement can be drawn from the LOC as additional premium due. INDS has provided evergreen LOCs in the amount of $2M on behalf of the Company. This finite reinsurance structure is not considered to afford sufficient risk transfer, and accordingly, the Company does not take credit for losses recoverable from the reinsurer on its financial statements. In addition, the independent actuary does not recognize the Hannover contract in its loss reserve analysis.

ACCOUNTS AND RECORDS

During the period of the examination, the primary locations of the Company’s accounting and corporate records were at the office of its captive manager, Risk Services, LLC in Berlin, Vermont, and at the offices of its program manager/majority member, Interstate National Dealer Services, Inc., in Uniondale, New York. We performed our examination fieldwork at the aforementioned offices.

The Company’s general accounting records consisted of an automated general ledger and various subsidiary ledgers. Our review disclosed certain areas of deficiencies in these records, and areas in which controls could be improved. See the “Comments and Recommendations” section of this Report, under the caption “Accounts and Records” for further comments regarding these conditions.

FINANCIAL STATEMENTS

The following financial statements, prepared in accordance with accounting practices generally accepted in the United States ("GAAP") reflect the financial condition of the Company as of December 31, 2006, as determined by this examination:

The accompanying "Notes to Financial Statements" are an integral part of these Financial Statements.

BALANCE SHEET

ASSETS

	Assets December 31, 2006
Bonds	$ 4,860,494
Cash ($2,626,474), cash equivalents ($0) and short-term investments ($2,960,093)	5,586,567
Subtotals, cash and invested assets	$ 10,447,061
Investment income due and accrued	105,300
Premiums and considerations: Uncollected premiums and agents' balances in the course of collection	63,433
Reinsurance: Funds held by or deposited with reinsured companies	3,624,157
Net deferred tax asset	239,442
Receivables from parent, subsidiaries and affiliates	4,252,200
Aggregate write-ins for other than invested assets	637,422
Total	$ 19,369,015

LIABILITIES, SURPLUS AND OTHER FUNDS

	December 31, 2006
Losses (**NOTE 1**)	$ 590,320
Loss adjustment expenses (**NOTE 1**)	0
Other expenses (excluding taxes, licenses and fees)	66,066
Taxes, licenses and fees (excluding federal and foreign income taxes)	29,252
Current federal and foreign income taxes (including $0 on realized capital gains (losses))	249,889
Unearned premiums (after deducting unearned premiums for ceded reinsurance of $0 and including warranty reserves of $0) **(NOTE 2)**	5,143,761
Total liabilities	$ 6,079,288
Common capital stock	30,113
Gross paid in and contributed surplus	4,122,227
Unassigned funds (surplus)	9,137,387
Surplus as regards policyholders	$ 13,289,727
Total	$ 19,369,015

STATEMENT OF INCOME

	2006
UNDERWRITING INCOME Premiums earned	$ 3,166,887
DEDUCTIONS Losses incurred Other underwriting expenses incurred	 859,047 1,841,570
Total underwriting deductions	2,700,617
Net underwriting gain	466,270
INVESTMENT INCOME Net investment income earned Net realized capital gains less capital gains tax of $0	 537,956 25,018
Net investment gain	562,974
Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	1,029,244
Federal and foreign income taxes incurred	249,889
Net income	$ 779,355

CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders, December 31, 2002	$	7,465,599
Net income, 2003		559,149
Change in net deferred income tax		40,302
Change in non-admitted assets		(1,625)
Capital changes: Paid in		2,000,250
Surplus adjustments: Paid in		124,977
Net change in surplus as regards policyholders, 2003		2,723,053
Surplus as regards policyholders, December 31, 2003	$	10,188,652
Net income, 2004		478,839
Change in net deferred income tax		113,684
Change in non-admitted assets		(255,102)
Capital changes: Paid in		290
Surplus adjustments: Paid in		144,804
Net change in surplus as regards policyholders, 2004		482,515
Surplus as regards policyholders, December 31, 2004	$	10,671,167
Net income, 2005		1,151,004
Change in net unrealized capital gains or (losses) less capital gains tax of $0		(86,994)
Change in net deferred income tax		(31,759)
Change in non-admitted assets		278,852
Cumulative effect of changes in accounting principles		506,951
Capital changes: Paid in		109
Capital changes: Transferred to surplus		(1,890,000)
Surplus adjustments: Paid in		54,355
Surplus adjustments: Transferred from capital		1,890,000
Net change in surplus as regards policyholders, 2005		1,872,518
Surplus as regards policyholders, December 31, 2005	$	12,543,685
Net income, 2006		779,355
Change in net unrealized capital gains or (losses) less capital gains tax of $0		(28,551)
Change in net deferred income tax		(4,762)
Capital changes: Transferred to surplus		(189,000)
Surplus adjustments: Transferred from capital		189,000
Net change in surplus as regards policyholders, 2006		746,042
Surplus as regards policyholders, December 31, 2006	$	13,289,727

ANALYSIS OF EXAMINATION CHANGES TO SURPLUS

There were no changes to the Company's surplus as a result of our examination.

COMPARATIVE FINANCIAL POSITION OF THE COMPANY

The comparative annual financial position of the Company since January 1, 2003 is as follows:

	2006	2005	2004	2003
Assets	$ 19,369,015	$ 18,691,986	$ 16,501,585	$ 13,733,807
Liabilities	6,079,288	6,148,301	5,830,418	3,545,155
Capital and surplus	13,289,727	12,543,685	10,671,167	10,188,652
Gross written premium	3,999,725	4,185,171	6,268,676	2,379,325
Net earned premium	3,166,887	3,393,035	3,091,693	1,664,372
Net investment income	562,974	373,620	295,028	161,390
Net income	$ 779,355	$ 1,151,004	$ 478,839	$ 559,149

Note: Amounts in the preceding financial statements for the years ended December 31, 2003, through December 31, 2005 were taken from the Company's Annual Statements as filed with the Department. Amounts for the years ended December 31, 2002 and 2006 are per examination.

NOTES TO FINANCIAL STATEMENTS

NOTE 1 – Loss and Loss Adjustment Expense Reserves:

The Company reported "Losses" and "Loss adjustment expenses" reserves totaling $590,320 and $0, respectively. According to the Company, these reserves are associated with the Company's excess of loss contractual liability business and represent both loss and loss adjustment expense reserves. These reserves are equal to 20 percent of the earned premiums for the preceding two calendar years on the excess of loss contractual liability business and represent management's best estimate of the amounts necessary to pay all claims and related expenses that have been incurred under these policies, but are still unpaid as of December 31, 2006.

As previously indicated in this report, the Company provides aggregate excess of loss insurance coverage to vehicle service contract providers which are in the business of selling and/or administering vehicle extended service contracts. The Company's policies provide coverage to its insureds for amounts in excess of the LRFs established and maintained by each insured. The Company's financial responsibility triggers only upon exhaustion of the LRFs. However, under the terms of the policies, if the insureds are unable to perform their obligations for any reasons, the Company will assume the responsibilities of the insureds. Therefore, if the insureds do not maintain adequate LRFs, or otherwise do not perform their obligations for any reason, the Company's liabilities could be significantly greater than the carried loss reserves as of December 31, 2006. See the "Comments and Recommendations" section of this Report, under the caption "Company Financial Responsibility and Loss Reserve Fund Deficiency" for further comments regarding this condition.

The methodologies utilized by the Company to compute reserves, and the adequacy of the loss and loss adjustment expenses reserves as of December 31, 2006, were reviewed as part of our examination. As part of our review, we relied on the Company's independent actuary, who concluded that the Company's reserves appeared to be sufficient. In addition, as part of our review of the Company's reserves, we engaged an independent actuary to review the methods employed, assumptions relied upon, and conclusions reached by the Company's independent actuary. The independent actuary utilized in our examination concluded that the methodologies and assumptions utilized by the Company's independent actuary to compute these reserves, and the adequacy of the reserves as of December 31, 2006, were reasonable and adequate.

During our examination, as part of our review of the adequacy of the Company's reserves, we also reviewed the LRFs established and maintained by the Company's insureds. As part of this review, we relied on the work, performed on behalf of INDS, of an independent actuary, who concluded that as of December 31, 2006, INDS' ultimate losses on its vehicle service contracts totaled $64.8 million. The actuary also indicated that as of December 31, 2006, INDS had assets totaling approximately $59.1 million in its LRF accounts and was also entitled to undistributed estimated profits of $6.8 million held by INDS in the loss reserve escrow fund related to DAC. Therefore, the actuary concluded the Company had assets totaling $65.9 million ($59.1 million plus $6.8 million) available in the LRFs to cover the obligations totaling $64.8 million. The independent actuary engaged as part of our examination reviewed the methods employed, assumptions relied upon, and conclusions reached by the independent actuary regarding INDS' LRFs. The independent actuary utilized in our examination concluded that the methodologies and assumptions utilized by the Company's independent actuary to compute the estimate of the ultimate losses to be incurred by INDS were reasonable, but disagreed with the conclusion that INDS had adequate assets in the LRFs to cover future estimated liabilities. The actuary also disagreed with the Company's independent actuary that the undistributed estimated profits of $6.8 million held by INDS in the loss reserve escrow fund related to DAC could be used by the Company to fund other LRF obligations. As a result, we estimate a projected deficiency of approximately $30 million in the loss reserve funds of INDS.

Because there has been no triggering event (e.g., exhaustion of the loss reserve funds), or claim made or obligation asserted against the Company, no adjustment has been made to the Company's financial statements as a result of our examination. However, the deficiency in the INDS LRFs and the potential future exposure to the Company must be addressed by the Company going forward. See the "Comments and Recommendations" section of this Report, under the caption "Company Financial Responsibility and Loss Reserve Fund Deficiency" for further comments regarding this condition, and for further details regarding the projected deficiency of approximately $30 million.

NOTE 2 – Unearned Premium Reserves:

As December 31, 2006, the Company reported "Unearned premiums" totaling $5,143,761. $4,391,194 of this amount represents the actuarially estimated ultimate future liabilities associated with the Company's business assumed from BAIC under a quota share treaty. The remaining $752,567 is the unearned premium related to the Company's contractual liability policies.

The methodologies utilized by the Company to compute the ultimate future liabilities of $4,391,194 associated with the BAIC business, and the adequacy of the reserves as of December 31, 2006, were reviewed as part of our examination. As part of our review, we relied on the Company's independent actuary, who concluded that the Company's reserves appeared to be sufficient. In addition, as part of our review of the Company's reserves, we engaged an independent actuary to review the methods employed, assumptions relied upon, and conclusions reached by the Company's independent actuary. The independent actuary utilized in our examination concluded that the methodologies and assumptions utilized by the Company's independent actuary to compute these reserves, and the adequacy of the reserves as of December 31, 2006, were reasonable and adequate.

COMMENTS AND RECOMMENDATIONS

Ownership Records and Ownership:

1. As indicated in the "Ownership" section of this report, as of December 31, 2006 the Company has seven owners. However, the Company was unable to provide records documenting the ownership of the Company among INDS and the other six owners. The Company did not issue stock certificates or keep a formal stock ledger as required by the Company's bylaws. **We recommend that the Company comply with its bylaws and issue stock certificates and maintain a stock ledger in accordance with its bylaws.**

2. As indicated in the "Territory and Plan of Operation" section of this report, the Company has insured six AOs during the examination period that are not currently owners of the Company, and according to management, have never been owners. Because the six AOs are not currently writing any business, they are not required to currently be owners. However, under the requirements of the Federal Liability Risk Retention Act (LRRA), all insureds must be owners. Therefore, these six AOs should have been owners at the time they were insured by the Company and were writing business. **We recommend that the Company maintain full compliance at all times with the Federal LRRA, and ensure that in the future, all insureds are owners.**

Accounts and Records:

Intercompany Balance:

The Company reported "Receivables from parent, subsidiaries and affiliates" totaling $4,252,200 as of December 31, 2006. This balance includes the net of various payable balances to and receivable balances from INDS, some of which are up to eight years old with no activity. A portion of this balance includes $24,000 in dividends payable for which the Company was unable to provide any supporting detail. **We recommend that the Company review and evaluate all components of this account to determine whether amounts are valid receivables or payables and to determine a current balance of this account. Any amounts that are not valid should be adjusted and any write-offs or adjustments should be reviewed and approved by management. This review and approval should be documented and maintained for verification during the next financial examination.**

Policy Records:

1. As indicated in the "Territory and Plan of Operation" section of this report, during the period under examination, the Company issued aggregate excess of loss insurance policies to INDS, six DOs, and six AOs. However, we noted that the Company did not separately account for the written premiums and loss reserve funds associated with business insured for the six DOs, but recorded this business with the premium and loss reserve fund records under its policy with INDS. According to management, the business

insured from the six DOs was a very small portion of the Company's business and the Company chose not to keep separate records for these policies. We also noted that the Company recorded approximately $16,000 returned premium related to the five of the six AOs in 2006, and only one AO had positive written premiums in 2006. The Company indicated no new business under these six AO policies was written after July 2006. However, the Company was unable to provide details regarding these AO policies (e.g., copies of executed policies for some of the AOs, dates of cessation of business under each policy, etc.). As a result of these conditions, the Company may be unable to accurately track and account for certain of its business written. **Accordingly, we recommend that the Company maintain separate records for each of its policies. These records should include documentation of the termination dates of policies.**

2. Our review disclosed deficiencies in the documentation related to the Company's accounting for the business assumed from BAIC. Specifically, the Company did not maintain documentation supporting totals reported in its Annual Statement related to the BAIC business. During our examination, the Company was able to re-create documentation to support the BAIC numbers, however, this information should be routinely maintained, and should be readily available for verification. **We recommend that the Company maintain documentation supporting all of the amounts reported in its Annual and Quarterly Statements, and that this documentation be readily available for future financial examinations.**

<u>Contractual Liability Insurance Policy Agreements</u>:

1. As previously noted in this report, the Company's policies provide insurance for amounts in excess of the LRFs held by the insureds. Most of the Company's policies include provisions regarding the calculation of the LRF. However, the Company's policy with INDS, which produces the majority of the Company's business, does not contain any specific methodology regarding how the LRF should be calculated (e.g., required deposits into the LRF for each VSC, allowable deductions from the LRF, etc.). As a result, the Company's actual attachment point under this policy is not clearly defined or known. **We recommend that the Company amend its policy with INDS to specifically define how the required LRF balance shall be computed.**

2. Under terms of the Company's policy with INDS, there are no requirements regarding how the LRF is to be held by INDS (e.g., in a trust or fiduciary account). As a result, there is a lack of assurance that INDS's assets backing its loss reserve fund will be adequately protected, and will be fully available in the future to pay obligations of the LRF. **We recommend that the Company amend its policy with INDS to require that the INDS LRF be maintained in an independent fiduciary or trust account for the benefit of the Company. This account shall be established by November 30, 2008, pursuant to a fiduciary or trust agreement approved by the Commissioner, with a fiduciary or trustee acceptable to the Commissioner.**

3. The Company's policies require the AOs to replenish, at the Company's request, any LRFs that had not been properly funded. During our examination, we noted a number LRFs that were under funded, however, the Company had not made any request to the AOs to replenish the LRFs. Failure of the Company to ensure all LRFs are fully funded could adversely impact the future financial condition of the Company. **We recommend that the Company ensure that all LRFs have been funded in accordance with their respective loss reserve schedules and request additional funding as necessary and as provided for in the policies.**

Company Financial Responsibility and Loss Reserve Fund Deficiency:

As previously noted in this report, the Company's policies provide coverage to the insureds for amounts in excess of the insureds' LRFs, and the Company's financial responsibility triggers upon exhaustion of the LRFs. However, also under the terms of the Company's policies, if the insureds are unable to perform their obligations for any reason, regardless of the amounts in the LRFs or the amounts that are supposed to be in the LRFs, or, in the event the insureds are no longer in business, for whatever reason, the Company will assume the responsibilities of the insureds and will provide directly to the VSC holder all benefits to which the VSC holder is entitled under the terms of the VSC. In addition, as previously indicated, the LRFs are not held by the Company, but by the insureds.

As indicated previously in this Report, the Company's independent actuary estimated the INDS LRFs future liabilities at $64.8 million, as follows:

Direct liabilities	$ 63,674,000
PORC deficiencies	897,124
AO deficiency	243,029
Total INDS future liabilities (excludes VSCs covered by DAC)	$ 64,814,153

The independent actuary utilized in our examination concluded that the methodologies and assumptions utilized by the Company's independent actuary to compute the estimate of total INDS future liabilities were reasonable, and the estimate was reasonable.

During the examination, we performed procedures to verify the investments and other assets backing the LRFs. As indicated in NOTE 1 in the "Notes to Financial Statements" section of this report, according to the Company and to its actuary, the investments and other assets backing the LRFs totaled approximately $65.9 million as of December 31, 2006, consisting of cash and investments totaling approximately $25.5 million, receivables totaling approximately $18.6 million related to VSCs, a note receivable totaling $20 million from INDS Holdings, Inc., deferred tax assets totaling approximately $6.7 million, undistributed estimated profits of $6.8 million held by INDS in the loss reserve escrow fund related to DAC, and miscellaneous funds totaling approximately $600,000. These amounts total approximately $78.2 million, and after offset of other INDS liabilities totaling approximately $12.3 million unrelated to the LRFs, the net assets available to the LRFs total approximately $65.9 million.

However, based on our examination, we do not agree that this full amount of $65.9 million is readily available to cover liabilities in the LRFs. Although certain amounts comprising the $65.9 million could be considered "assets" under applicable accounting rules, some amounts are not considered liquid, or available to meet current obligations of the LRFs. Specifically, the note receivable totaling $20 million from INDS Holdings, Inc. is of no value as INDS Holdings, Inc. does not have the means to repay the note from its own assets and equity as of December 31, 2006. In addition, INDS' deferred tax assets totaling approximately $6.7 million are not liquid and future realization is uncertain. Of the estimated profits of $6.8 million related to DAC, approximately $2.9 million was realized subsequent to December 31, 2006, but realization of the remaining $3.9 million is uncertain as of the date of this report. Finally, based on our review, the miscellaneous funds totaling approximately $600,000 had been double counted. As a result, we estimate the assets available to the LRFs total $34.7 million ($65.9 million-$20 million-$6.7 million-$3.9 million-$600,000), not $65.9 million as indicated by the Company. As a result, we estimate a deficiency of approximately $30.1 million ($34.7 million available less $64.8 million obligations) in the LRFs. As a result of this condition, the Company is exposed to a potentially significant adverse financial impact.

We recommend the following:

1. **Because the Company does not own, and does not report as part of its assets, the assets of the LRFs, the Company shall amend its policies to clarify that the Company's financial responsibility is not triggered until losses equal the amount of assets that should be in the LRFs, regardless of the actual amount, type, or quality of assets available to satisfy obligations of the LRFs, and regardless of the insureds' abilities to otherwise perform their obligations. Or,**

2. **If the Company remains liable for the full amount of the LRFs, the Company shall immediately record a contingency reserve for the amount of the deficiency of approximately $30.1 million. By January 15, and July 15 of each year, the Company shall submit to the Commissioner a summary of the assets backing the LRFs. Any amount of the LRFs not backed by assets acceptable to the Commissioner shall be recognized by the Company in the immediately preceding financial statements (e.g., December 31 and June 30) as a contingency reserve.**

CONCLUSION

Our examination disclosed that as of December 31, 2006 the Company had:

Admitted Assets	$	19,369,015
Liabilities and Reserves		6,079,288
Common Capital Stock		30,113
Gross paid in and contributed surplus		4,122,227
Unassigned Funds (Surplus)		9,137,387
Total Surplus		13,289,727
Total Liabilities, Capital and Surplus	$	19,369,015

Based on our examination, except as noted, the accompanying balance sheet properly presents the financial position of the Company at December 31, 2006, and the accompanying statement of income properly presents the results of operations for the period then ended.

Chapter 39 ("CAPTIVE INSURANCE COMPANIES") of Title 31 ("Insurance and Securities") of the D.C. Official Code specifies the level of capital and surplus required for the Company. We concluded that the Company's capital and surplus funds exceeded the minimum requirements during the period under examination.

SIGNATURES

In addition to the undersigned, the following examiners representing the District of Columbia Department of Insurance, Securities and Banking participated in certain phases of this examination:

Christina M. Bonney, Collins Consulting, Inc.
John G. Gantz, Collins Consulting, Inc.

The actuarial portion of this examination was completed by N. Terry Godbold, ACAS, MAAA, FCA, President & Senior Actuary, Godbold, Malpere & Co.

Respectfully submitted,

Pamela C. Woodroffe

Pamela C. Woodroffe
Examiner-In-Charge
Collins Consulting, Inc.

Under the Supervision of,

Xiangchun Li

Xiangchun (Jessie) Li, CFE
Supervising Examiner
District of Columbia, Department of Insurance,
Securities and Banking

Government of the District of Columbia
Department of Insurance, Securities and Banking

Thomas E. Hampton
Commissioner

September 10, 2008

Eugene Becker
President
National Service Contract Insurance Company Risk Retention Group
C/o Risk Services, LLC
2233 Wisconsin Avenue, N.W.
Suite 310
Washington, DC 20007

Dear Mr. Becker:

Pursuant to the provisions of Section 31-1404 of the D.C. Official Code, enclosed is a draft copy of the Report on Examination ("Report") of the affairs and financial condition of **National Service Contract Insurance Company Risk Retention Group**, as of December 31, 2006.

Please submit, to my attention, a written response calling attention to any errors or omissions in the draft Report. In addition, the Company's response shall include responses to each of the recommendations included in the "Comments and Recommendations" section of this Report. These responses should indicate the Company's agreement or disagreement with each recommendation, as well as a summary of the corrective measures which will be taken by the Company for each recommendation. If the Company disagrees with any of these recommendations, the response shall indicate the reason(s) for the disagreement, as well as an explanation of alternative measures to be taken by the Company to address the condition which lead to the recommendation.

The response must be in writing and shall be furnished to this Department within **thirty (30) days from the date of this letter (October 10, 2008).** In addition to a hard-copy response, please also furnish the response electronically via e-mail to me, in a Microsoft "Word" format, to sean.o'donnell@dc.gov.

Sincerely,

P. Sean O'Donnell

P. Sean O'Donnell
Director of Financial Examination,
Risk Finance Bureau

Enclosure

NATIONAL SERVICE CONTRACT INSURANCE COMPANY
RISK RETENTION GROUP, INC.
607 14TH Street, N.W., Suite 900
Washington, D.C. 20005

<u>VIA E-MAIL & U.S. MAIL</u>
E-mail: sean.o'donnell@dc.gov

October 8, 2008

P. Sean O'Donnell
Director of Financial Examination
Risk Finance Bureau
Department of Insurance, Securities and Banking
1400 L Street, N.W., Suite 400
Washington, D.C. 20005

Re: National Service Contract Insurance Company Risk Retention Group, Inc.
NAIC Company Code: 10234; FEIN: 99-0319305

Dear Mr. O'Donnell:

The following responses are submitted with respect to the comments and recommendations contained in the Report on Examination of the Company for the period January 1, 2003 through December 31, 2006 forwarded by the Risk Finance Bureau on September 10, 2008:

<u>Ownership Records and Ownership</u>

1. *As indicated in the "Ownership" section of this report, as of December 31, 2006 the Company has seven owners. However, the Company was unable to provide records documenting the ownership of the Company among INDS and the other six owners. The Company did not issue stock certificates or keep a formal stock ledger as required by the Company's bylaws.* ***We recommend that the Company comply with its bylaws and issue stock certificates and maintain a stock ledger in accordance with its bylaws.***

   <u>Company Response</u>
   The company's bylaws provide that stock may be uncertificated and the Company's board of directors has passed a resolution permitting this practice. The Company will formalize its stock ledger to ensure compliance with its bylaws.

2. *As indicated in the "Territory and Plan of Operation" section of this report, the Company has insured six AOs during the examination period that are not currently owners of the Company, and according to management, have never been owners. Because the six AOs are not currently writing any business, they are not required to currently be owners. However, under the requirements of the Federal Liability Risk Retention Act (LRRA), all insureds must be owners. Therefore, these six AOs should have been owners at the time they were insured by the Company and were writing business.* ***We recommend that the Company maintain full compliance at all times with the Federal LRRA, and ensure that in the future, all insureds are owners.***

Company Response
The Company disagrees that separate insurance policies should have been issued to these six AOs. The AO's in question were insured under insurance policies issued to INDS. However as noted these arrangements no longer exist and the Company will ensure that all insureds are owners to maintain full compliance with the Federal LRRA.

Accounts and Records:

Intercompany Balance:

The Company reported "Receivables from parent, subsidiaries and affiliates" totaling $4,252,200 as of December 31, 2006. This balance includes the net of various payable balances to and receivable balances from INDS, some of which are up to eight years old with no activity. A portion of this balance includes $24,000 in dividends payable for which the Company was unable to provide any supporting detail. ***We recommend that the Company review and evaluate all components of this account to determine whether amounts are valid receivables or payables and to determine a current balance of this account. Any amounts that are not valid should be adjusted and any write-offs or adjustments should be reviewed and approved by management. This review and approval should be documented and maintained for verification during the next financial examination.***

Company Response
The Company will conduct a full review of the balances and will adjust or write off any uncollectible amounts. The review will be documented and approved by management.

Policy Records:

1. *As indicated in the "Territory and Plan of Operation" section of this report, during the period under examination, the Company issued aggregate excess of loss insurance policies to INDS, six DOs, and six AOs. However, we noted that the Company did not separately account for the written premiums and loss reserve funds associated with business insured for the six DOs, but recorded this business with the premium and loss reserve fund records under its policy with INDS. According to management, the business insured from the six DOs was a very small portion of the Company's business and the Company chose not to keep separate records for these policies. We also noted that the Company recorded approximately $16,000 returned premium related to the five of the six AOs in 2006, and only one AO had positive written premiums in 2006. The Company indicated no new business under these six AO policies was written after July 2006. However, the Company was unable to provide details regarding these AO policies (e.g., copies of executed policies for some of the AOs, dates of cessation of business under each policy, etc.). As a result of these conditions, the Company may be unable to accurately track and account for certain of its business written.* ***Accordingly, we recommend that the Company maintain separate records for each of its policies. These records should include documentation of the termination dates of policies.***

   Company Response
   The Company will in future ensure that it maintains separate records for all policies issued.

2. *Our review disclosed deficiencies in the documentation related to the Company's accounting for the business assumed from BAIC. Specifically, the Company did not*

maintain documentation supporting totals reported in its Annual Statement related to the BAIC business. During our examination, the Company was able to re-create documentation to support the BAIC numbers, however, this information should be routinely maintained, and should be readily available for verification. ***We recommend that the Company maintain documentation supporting all of the amounts reported in its Annual and Quarterly Statements, and that this documentation be readily available for future financial examinations.***

Company Response
The Company will in future ensure that complete documentation is maintained to support the business assumed from BAIC.

Contractual Liability Insurance Policy Agreements:

1. *As previously noted in this report, the Company's policies provide insurance for amounts in excess of the LRFs held by the insureds. Most of the Company's policies include provisions regarding the calculation of the LRF. However, the Company's policy with INDS, which produces the majority of the Company's business, does not contain any specific methodology regarding how the LRF should be calculated (e.g., required deposits into the LRF for each VSC, allowable deductions from the LRF, etc.). As a result, the Company's actual attachment point under this policy is not clearly defined or known.* ***We recommend that the Company amend its policy with INDS to specifically define how the required LRF balance shall be computed.***

   Company Response
   The company's insurance policy issued to INDS as filed in Section 16 of its redomestication application for admission approved by the Department contains the following language:

   " *The SELF INSURED RETENTION of this policy is that sum equal to the total of the individual amounts (Amounts), as set forth on Schedule A, for each VEHICLE SERVICE CONTRACT sold and/or entered into by the SELLING DEALER for the policy period plus investment income earned on such Amounts. The Company shall hold the Amounts and the investment income thereon in a loss reserve fund. Amounts and investment income for more than one policy year may be held in the same loss reserve fund but the Company shall maintain separate records of transactions for each policy year. The POLICYHOLDER may withdraw funds from the loss reserve fund for the purpose of payment of claims.*

   These Amounts may be changed from time to time by the COMPANY or its authorized representative by providing a copy of the changes or a copy of the then current Amounts to the POLICYHOLDER; provided, however, that the changes shall apply only to VEHICLE SERVICE CONTRACTS sold and/or entered into after the effective date of the change and the individual Amounts and/or the amount of the SELF INSURED RETENTION determined therefrom for VEHICLE SERVICE CONTRACTS sold and/or entered into prior to the effective date of the change shall not be affected thereby.

   Satisfaction of the SELF INSURED RETENTION shall occur when LOSSES for COSTS REASONABLY INCURRED in discharging the CONTRACTUAL OBLIGATION with respect to SERVICE CONTRACT HOLDER CLAIMS arising from the VEHICLE SERVICE CONTRACTS involved, properly and timely reported as required herein, equal the SELF INSURED RETENTION.

Failure to maintain full funding of the loss reserve fund based on Schedule A or amounts charged from time to time by the Company, will not invalidate this insurance. However this insurance will apply as if the loss reserve fund is fully funded, including investment income thereon."

Schedule A outlines the funding requirement of the loss reserve fund deposits. The Company will ensure that any future Schedule A rate changes are added as an endorsement to the Company's insurance policies.

2. *Under terms of the Company's policy with INDS, there are no requirements regarding how the LRF is to be held by INDS (e.g., in a trust or fiduciary account). As a result, there is a lack of assurance that INDS's assets backing its loss reserve fund will be adequately protected, and will be fully available in the future to pay obligations of the LRF.* ***We recommend that the Company amend its policy with INDS to require that the INDS LRF be maintained in an independent fiduciary or trust account for the benefit of the Company. This account shall be established by November 30, 2008, pursuant to a fiduciary or trust agreement approved by the Commissioner, with a fiduciary or trustee acceptable to the Commissioner.***

   Company Response
   NSCIC's approved business plan as filed with its redomestication application for admission submitted to the Department clearly states in the Summary and Overview section that:

   "It is anticipated that all claims will be paid from the LRF, which is comprised of various assets held by INDS".

   In the same section in a summary of the business plan the application states:

   "INDS holds such loss reserve funds in many different assets, all owned or controlled by INDS".

   The examination recommendation would require INDS, an entity not subject to Department regulation, to completely change its method of operations that have been in place since the formation of NSC over 14 years ago. These operating procedures have never resulted in a paid or reported loss to NSC.

   Where the Company issued an aggregate excess of loss policy whereby the Company's coverage attaches excess of a self insured retention of INDS there is, as noted, no requirement for INDS to establish a separate security trust for the benefit of NSCIC as the policy form does not require it and the Company has exposure only excess of the underlying retention.

   However where the Company issues a first dollar or high deductible insurance policy to INDS the Company will in future establish segregated loss reserve fiduciary accounts on the balance sheet of INDS as collateral for the deductible.

3. *The Company's policies require the AOs to replenish, at the Company's request, any LRFs that had not been properly funded. During our examination, we noted a number LRFs that were under funded, however, the Company had not made any request to the AOs to replenish the LRFs. Failure of the Company to ensure all LRFs are fully funded could adversely impact*

the future financial condition of the Company. ***We recommend that the Company ensure that all LRFs have been funded in accordance with their respective loss reserve schedules and request additional funding as necessary and as provided for in the policies.***

Company Response
As noted above the Company's Aggregate Excess of Loss Policy contains the following language in Section 5:

> *"Failure to maintain full funding of the loss reserve fund based on Schedule A or amounts charged from time to time by the Company, will not invalidate this insurance. However this insurance will apply as if the loss reserve fund is fully funded, including investment income thereon."*

This language protects the Company from any underfunding of the LRFs. However the Company will review its internal procedures to monitor future funding of the LRFs to ensure funding is in accordance with the policy rate schedules.

Company Financial Responsibility and Loss Reserve Fund Deficiency:

As previously noted in this report, the Company's policies provide coverage to the insureds for amounts in excess of the insureds' LRFs, and the Company's financial responsibility triggers upon exhaustion of the LRFs. However, also under the terms of the Company's policies, if the insureds are unable to perform their obligations for any reason, regardless of the amounts in the LRFs or the amounts that are supposed to be in the LRFs, or, in the event the insureds are no longer in business, for whatever reason, the Company will assume the responsibilities of the insureds and will provide directly to the VSC holder all benefits to which the VSC holder is entitled under the terms of the VSC. In addition, as previously indicated, the LRFs are not held by the Company, but by the insureds.

As indicated previously in this Report, the Company's independent actuary estimated the INDS LRFs future liabilities at $64.8 million, as follows:

Direct liabilities	*$ 63,674,000*
PORC deficiencies	*897,124*
AO deficiency	*243,029*
Total INDS future liabilities (excludes VSCs covered by DAC)	*$ 64,814,153*

The independent actuary utilized in our examination concluded that the methodologies and assumptions utilized by the Company's independent actuary to compute the estimate of total INDS future liabilities were reasonable, and the estimate was reasonable.

During the examination, we performed procedures to verify the investments and other assets backing the LRFs. As indicated in NOTE 1 in the "Notes to Financial Statements" section of this report, according to the Company and to its actuary, the investments and other assets backing the LRFs totaled approximately $65.9 million as of December 31, 2006, consisting of cash and investments totaling approximately $25.5 million, receivables totaling approximately $18.6 million related to VSCs, a note receivable totaling $20 million from INDS Holdings, Inc., deferred tax assets totaling approximately $6.7 million, undistributed estimated profits of $6.8 million held by INDS in the loss reserve escrow fund related to DAC, and miscellaneous funds *totaling approximately $600,000. These amounts total approximately $78.2 million, and after offset of other INDS liabilities totaling approximately $12.3 million unrelated to the LRFs, the net assets available to the LRFs total approximately $65.9 million.*

However, based on our examination, we do not agree that this full amount of $65.9 million is readily available to cover liabilities in the LRFs. Although certain amounts comprising the $65.9 million could be considered "assets" under applicable accounting rules, some amounts are not considered liquid, or available to meet current obligations of the LRFs. Specifically, the note receivable totaling $20 million from INDS Holdings, Inc. is of no value as INDS Holdings, Inc. does not have the means to repay the note from its own assets and equity as of December 31, 2006. In addition, INDS' deferred tax assets totaling approximately $6.7 million are not liquid and future realization is uncertain. Of the estimated profits of $6.8 million related to DAC, approximately $2.9 million was realized subsequent to December 31, 2006, but realization of the remaining $3.9 million is uncertain as of the date of this report. Finally, based on our review, the miscellaneous funds totaling approximately $600,000 had been double counted. As a result, we estimate the assets available to the LRFs total $34.7 million ($65.9 million-$20 million-$6.7 million-$3.9 million-$600,000), not $65.9 million as indicated by the Company. As a result, we estimate a deficiency of approximately $30.1 million ($34.7 million available less $64.8 million obligations) in the LRFs. As a result of this condition, the Company is exposed to a potentially significant adverse financial impact.

We recommend the following:

1. ***Because the Company does not own, and does not report as part of its assets, the assets of the LRFs, the Company shall amend its policies to clarify that the Company's financial responsibility is not triggered until losses equal the amount of assets that should be in the LRFs, regardless of the actual amount, type, or quality of assets available to satisfy obligations of the LRFs, and regardless of the insureds' abilities to otherwise perform their obligations.***

Or,

2. ***If the Company remains liable for the full amount of the LRFs, the Company shall immediately record a contingency reserve for the amount of the deficiency of approximately $30.1 million. By January 15, and July 15 of each year, the Company shall submit to the Commissioner a summary of the assets backing the LRFs. Any amount of the LRFs not backed by assets acceptable to the Commissioner shall be recognized by the Company in the immediately preceding financial statements (e.g., December 31 and June 30) as a contingency reserve.***

Company Response

With respect to recommendation #1 above, the Company disagrees with the examination finding that there is a projected LRF deficiency of $30.1m. We agree the examination finding that *"Although certain amounts comprising the $65.9 million could be considered "assets" under applicable accounting rules, some amounts are not considered liquid, or available to meet current obligations of the LRFs"* is correct; however, INDS as an AO is not subject to the regulation of the Department and statutory accounting principles. The liquidity of the Company's LRF assets is being compared with actuarial estimates of future liabilities which will consist of future claim payments over a large number of years. The Company will make amendments to its note receivable from INDS Holdings to ensure it is a liquid asset if and when needed to fund losses.

However as noted above the following language in already included in Section 5 of the Company's insurance policies:

> *"Failure to maintain full funding of the loss reserve fund based on Schedule A or amounts charged from time to time by the Company, will not invalidate this insurance. However this insurance will apply as if the loss reserve fund is fully funded, including investment income thereon."*

The Company will further endorse its insurance policies to add that that the Company's financial responsibility is not triggered until losses equal the amount of assets that should be in the LRFs, regardless of the actual amount, type, or quality of assets available to satisfy obligations of the LRFs, and regardless of the insureds' abilities to otherwise perform their obligations.

To the extent that such language conflicts with any state mandated endorsements the Company shall if required cease writing business in such states.

With respect to recommendation #2 above, although not applicable due to the Company's response as to recommendation #1 in the section immediately above, the Company notes that its financial statements are prepared using Generally Accepted Accounting Principles ("GAAP") as required by District of Columbia regulation. There is no provision under GAAP for the establishment of a "Contingency Reserve" that we are aware of except FASB 5. Any calculated deficiency in the LRF caused by anything other than the payment of claims is a credit risk of the AO and is not a liability of the risk retention group. The Company and its independent CPA audit firm annually review compliance with FASB pronouncements and have determined that no contingency reserve under FASB is applicable.

Thank you. Should you have any questions, please don't hesitate to contact me.

Sincerely,

Michael T. Rogers
President
Risk Services, LLC
As Managers for
National Service Contract Insurance Company
Risk Retention Group, Inc.

MTR/hr

Government of the District of Columbia
Department of Insurance, Securities and Banking

Thomas E. Hampton
Commissioner

November 3, 2008

Eugene Becker
President
National Service Contract Insurance Company Risk Retention Group
C/o Risk Services, LLC
2233 Wisconsin Avenue, N.W.
Suite 310
Washington, DC 20007

Dear Mr. Becker:

We are in receipt of a response dated October 8, 2008, from Michael T. Rogers, President of Risk Services, LLC, as Managers for National Service Contract Insurance Company Risk Retention Group ("NSCIC" or "Company"), which addresses the corrective actions taken or to be taken by NSCIC to comply with the recommendations made in the Report on Examination as of December 31, 2006. The response adequately addresses the recommendations made in the Report, except for the following:

Ownership Records and Ownership:

1. **We recommended that the Company comply with its bylaws and issue stock certificates and maintain a stock ledger in accordance with its bylaws.**

   Company Response:

   The response indicates that the Company's bylaws provide that stock may be uncertificated and the Company's board of directors has passed a resolution permitting this practice. The Company will formalize its stock ledger to ensure compliance with its bylaws.

   Department Response:

   By November 17, 2008, please provide to the Department of Insurance, Securities and Banking ("Department") a copy of this board resolution.

2. **We recommended that the Company maintain full compliance at all times with the Federal LRRA, and ensure that in the future, all insureds are owners.**

Company Response:

The response indicates that the Company disagrees that separate insurance policies should have been issued to these six AOs. The AO's in question were insured under insurance policies issued to INDS. However as noted these arrangements no longer exist and the Company will ensure that all insureds are owners to maintain full compliance with the Federal LRRA.

Department Response:

Please note that during the examination we were provided excerpts from the insurance policies between NSCIC and three of the six AOs. Our understanding is that these policyholders/insureds were never owners of the Company, as required by the LRRA.

Contractual Liability Insurance Policy Agreements:

1. **We recommended that the Company amend its policy with INDS to specifically define how the required LRF balance shall be computed.**

Company Response:

The response indicates that the company's insurance policy issued to INDS as filed in Section 16 of its redomestication application for admission approved by the Department contains the following language:

"*The SELF INSURED RETENTION of this policy is that sum equal to the total of the individual amounts (Amounts), as set forth on Schedule A, for each VEHICLE SERVICE CONTRACT sold and/or entered into by the SELLING DEALER for the policy period plus investment income earned on such Amounts. The Company shall hold the Amounts and the investment income thereon in a loss reserve fund. Amounts and investment income for more than one policy year may be held in the same loss reserve fund but the Company shall maintain separate records of transactions for each policy year. The POLICYHOLDER may withdraw funds from the loss reserve fund for the purpose of payment of claims.*

These Amounts may be changed from time to time by the COMPANY or its authorized representative by providing a copy of the changes or a copy of the then current Amounts to the POLICYHOLDER; provided, however, that the changes shall apply only to VEHICLE SERVICE CONTRACTS sold and/or entered into after the effective date of the change and the individual Amounts and/or the amount of the SELF INSURED RETENTION determined therefrom for VEHICLE SERVICE CONTRACTS sold and/or entered into prior to the effective date of the change shall not be affected thereby.

Satisfaction of the SELF INSURED RETENTION shall occur when LOSSES for COSTS REASONABLY INCURRED in discharging the CONTRACTUAL OBLIGATION with respect to SERVICE CONTRACT HOLDER CLAIMS arising from the VEHICLE SERVICE CONTRACTS involved, properly and timely reported as required herein, equal the SELF INSURED RETENTION.

*Failure to maintain full funding of the loss reserve fund based on Schedule A or amounts charged from time to time by the Company, will not invalidate this insurance. However this insurance will apply as if the loss reserve fund is fully funded, including investment income there*on."

Schedule A outlines the funding requirement of the loss reserve fund deposits. The Company will ensure that any future Schedule A rate changes are added as an endorsement to the Company's insurance policies.

Department Response:

The Department maintains on file a complete copy of the Company's redomestication application for admission approved by the Department. Section 16 in the Department's copy does not contain the above-referenced insurance policy issued to INDS. More specifically, section 16 includes copies of policies executed while the Company was a Hawaii domestic. These policies do not include the above-referenced language cited by Mr. Rogers in the Company's response. Policies substantially similar to these were provided to the examiners during the examination in response to requests for all policies currently in use by the Company.

We do note that additional "sample" policies were also included in section 16 of the Company's application. These "sample" policies do contain the above-referenced language cited by Mr. Rogers. However, these policies are unexecuted, and contain no reference to INDS. In addition, executed copies of these documents were never provided to the examiners in response to requests for all policies currently in use by the Company.

By November 17, 2008, please provide to the Department the following:

a. **A copy of the fully executed insurance policy, including Exhibit A, issued to INDS as filed in Section 16 of its redomestication application for admission, as referred to in the October 8, 2008, from Michael T. Rogers.**
b. **Complete, fully executed copies (including all exhibits, endorsements, addendums, and any other documents that are part of the policy) of all policies issued to INDS by the Company and in force as of December 31, 2007.**

c. **Complete, fully executed copies (including all exhibits, endorsements, addendums, and any other documents that are part of the policy) of all policies issued to INDS by the Company and in force as of October 31, 2008.**

Contractual Liability Insurance Policy Agreements (continued):

2. **We recommended that the Company amend its policy with INDS to require that the INDS LRF be maintained in an independent fiduciary or trust account for the benefit of the Company. This account shall be established by November 30, 2008, pursuant to a fiduciary or trust agreement approved by the Commissioner, with a fiduciary or trustee acceptable to the Commissioner.**

Company Response:

The response indicates that NSCIC's approved business plan as filed with its redomestication application for admission submitted to the Department clearly states in the Summary and Overview section that:

"It is anticipated that all claims will be paid from the LRF, which is comprised of various assets held by INDS".

In the same section in a summary of the business plan the application states:

"INDS holds such loss reserve funds in many different assets, all owned or controlled by INDS".

The examination recommendation would require INDS, an entity not subject to Department regulation, to completely change its method of operations that have been in place since the formation of NSC over 14 years ago. These operating procedures have never resulted in a paid or reported loss to NSC.

Where the Company issued an aggregate excess of loss policy whereby the Company's coverage attaches excess of a self insured retention of INDS there is, as noted, no requirement for INDS to establish a separate security trust for the benefit of NSCIC as the policy form does not require it and the Company has exposure only excess of the underlying retention.

However where the Company issues a first dollar or high deductible insurance policy to INDS the Company will in future establish segregated loss reserve fiduciary accounts on the balance sheet of INDS as collateral for the deductible.

Department Response:

Please note that the Commissioner's recommendation relates to the policy form issued by NSCIC to INDS. As indicated in the examination report, the Company shall amend its policy with INDS to require that the INDS LRF be

maintained in an independent fiduciary or trust account for the benefit of the Company. This account shall be established by November 30, 2008, pursuant to a fiduciary or trust agreement approved by the Commissioner, with a fiduciary or trustee acceptable to the Commissioner.

Contractual Liability Insurance Policy Agreements (continued):

3. **We recommended that the Company ensure that all LRFs have been funded in accordance with their respective loss reserve schedules and request additional funding as necessary and as provided for in the policies.**

Company Response:

The response indicates that the Company's Aggregate Excess of Loss Policy contains the following language in Section 5:

*"Failure to maintain full funding of the loss reserve fund based on Schedule A or amounts charged from time to time by the Company, will not invalidate this insurance. However this insurance will apply as if the loss reserve fund is fully funded, including investment income there*on."

This language protects the Company from any under funding of the LRFs. However the Company will review its internal procedures to monitor future funding of the LRFs to ensure funding is in accordance with the policy rate schedules.

We disagree that the Company is protected from under funding of the LRFs as the Company's policies also provide that if the insureds are unable to perform their obligations for any reason, regardless of the amounts in the LRFs or the amounts that are supposed to be in the LRFs, or, in the event the insureds are no longer in business, for whatever reason, the Company will assume the responsibilities of the insureds and will provide directly to the VSC holder all benefits to which the VSC holder is entitled under the terms of the VSC.

Company Financial Responsibility and Loss Reserve Fund Deficiency:

We recommended the following:

1. **Because the Company does not own, and does not report as part of its assets, the assets of the LRFs, the Company shall amend its policies to clarify that the Company's financial responsibility is not triggered until losses equal the amount of assets that should be in the LRFs, regardless of the actual amount, type, or quality of assets available to satisfy obligations of the LRFs, and regardless of the insureds' abilities to otherwise perform their obligations. Or,**

2. **If the Company remains liable for the full amount of the LRFs, the Company shall immediately record a contingency reserve for the amount of the deficiency of approximately $30.1 million. By January 15, and July 15 of each year, the Company shall submit to the Commissioner a summary of the assets backing the LRFs. Any amount of the LRFs not backed by assets acceptable to the Commissioner shall be recognized by the Company in the immediately preceding financial statements (e.g., December 31 and June 30) as a contingency reserve.**

<u>Company Response:</u>

The response indicates that with respect to recommendation #1 above, the Company disagrees with the examination finding that there is a projected LRF deficiency of $30.1m. We agree the examination finding that *"Although certain amounts comprising the $65.9 million could be considered "assets" under applicable accounting rules, some amounts are not considered liquid, or available to meet current obligations of the LRFs"* is correct; however, INDS as an AO is not subject to the regulation of the Department and statutory accounting principles. The liquidity of the Company's LRF assets is being compared with actuarial estimates of future liabilities which will consist of future claim payments over a large number of years. The Company will make amendments to its note receivable from INDS Holdings to ensure it is a liquid asset if and when needed to fund losses.

However as noted above the following language in already included in Section 5 of the Company's insurance policies:

*"Failure to maintain full funding of the loss reserve fund based on Schedule A or amounts charged from time to time by the Company, will not invalidate this insurance. However this insurance will apply as if the loss reserve fund is fully funded, including investment income there*on."

The Company will further endorse its insurance policies to add that that the Company's financial responsibility is not triggered until losses equal the amount of assets that should be in the LRFs, regardless of the actual amount, type, or quality of assets available to satisfy obligations of the LRFs, and regardless of the insureds' abilities to otherwise perform their obligations.

To the extent that such language conflicts with any state mandated endorsements the Company shall if required cease writing business in such states.

With respect to recommendation #2 above, although not applicable due to the Company's response as to recommendation #1 in the section immediately above, the Company notes that its financial statements are prepared using Generally Accepted

Accounting Principles ("GAAP") as required by District of Columbia regulation. There is no provision under GAAP for the establishment of a "Contingency Reserve" that we are aware of except FASB 5. Any calculated deficiency in the LRF caused by anything other than the payment of claims is a credit risk of the AO and is not a liability of the risk retention group. The Company and its independent CPA audit firm annually review compliance with FASB pronouncements and have determined that no contingency reserve under FASB is applicable.

Department Response:

Please note that with respect to the response above to recommendation #1, NSCIC has agreed, as a condition of licensing by the Department, to facilitate a certain level of monitoring by the Department of INDS, including the submission of annual audited financial statements of INDS. However, neither NSCIC, nor INDS are required to conform to statutory accounting principles.

In addition, as previously indicated above, the Company is not protected from under funding of the LRFs, or shortfalls caused by any other reasons, as the Company's policies also provide that if the insureds are unable to perform their obligations for any reason, regardless of the amounts in the LRFs or the amounts that are supposed to be in the LRFs, or, in the event the insureds are no longer in business, for whatever reason, the Company will assume the responsibilities of the insureds and will provide directly to the VSC holder all benefits to which the VSC holder is entitled under the terms of the VSC.

By November 30, 2008, please send to the Department the above-mentioned endorsements to the Company's insurance policies to add that that the Company's financial responsibility is not triggered until losses equal the amount of assets that should be in the LRFs, regardless of the actual amount, type, or quality of assets available to satisfy obligations of the LRFs, and regardless of the insureds' abilities to otherwise perform their obligations. In addition, please promptly inform the Department of any states which will not accept these endorsements, and inform the Department of the Company's plans in those states (e.g., withdrawal of Company's registration; or other plans). If the Company's plans are other than the withdrawal of the Company's registration, please specify exactly what these plans are.

In addition, to the extent deemed necessary, we have made changes previously suggested by Heather Ross, Vice President, and Director of Regulatory Compliance, Risk Services, LLC.

The adopted Report (which includes a copy of this letter), and the Order evidencing such adoption are enclosed. Pursuant to Section 31-1404(e)(1) of the D.C. Official Code, the adopted Report will be held private and confidential for a period of 10 days from the date of the Order evidencing such adoption. After this 10 day period has passed, the Report will be publicly available, and will be forwarded electronically to each Commissioner whose name is set forth on Page 1 of the Report, as well as to the National Association of Insurance Commissioners, and to each state in which the Company is registered.

Pursuant to Section 31-1404(d)(1) of the D.C. Official Code, within 30 days of the date of the above-mentioned Order, affidavits executed by each Company director stating under oath that he or she has received a copy of the adopted examination Report and related Order shall be filed with this Department. Please send these affidavits to my attention at the Department.

Please contact me at 202-442-7785 if you have any questions.

Sincerely,

P. Sean O'Donnell

P. Sean O'Donnell
Director of Financial Examination
Risk Finance Bureau

Enclosures