REPORT ON EXAMINATION

OF

CAPITOL PREFERRED INSURANCE COMPANY, INC.

TALLAHASSEE, FLORIDA

AS OF

DECEMBER 31, 2004

BY THE

OFFICE OF INSURANCE REGULATION

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Tallahassee, Florida

July 15, 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, 2004, of the financial condition and corporate affairs of:

CAPITOL PREFERRED INSURANCE COMPANY, INC.
2255 KILLEARN CENTER BLVD., SUITE 101
TALLAHASSEE, FLORIDA 32309

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, 2002 through December 31, 2004. The Company was last examined by representatives of the Florida Office of Insurance Regulation (Office) as of December 31, 2001. This examination commenced, with planning at the Office, on May 16, 2005, to May 20, 2005. The fieldwork commenced on May 23, 2005, and was concluded as of July 15, 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 Condition 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 and the Company's independent audit reports 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, 2004. Transactions subsequent to year-end 2004 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, reliance was placed on work performed by the Company's CPAs, after verifying the statutory requirements, for the following accounts:

Investment Income Due and Accrued
Commission Payable, Contingent Commissions and Other Similar Charges
Other Expenses
Current Federal and Foreign Income Taxes
Amounts Withheld or Retained by Company for Others

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, 2001, along with resulting action taken by the Company in connection therewith.

Management

The annual meeting of shareholders was held at a location other than provided for in the by-laws.

Resolution: On November 7, 2002, the by-laws were amended to allow the President to designate the time and place of the annual meeting of shareholders within or outside the State of Florida.

Conflict of Interest Procedures

The Company failed to obtain conflict of interest statements from all officers and/or directors during 2001.

Resolution: The Company obtained statements prior to completion of fieldwork.

Accounts and Records

The Company failed to include the $25 per policy MGA fee as premium.

Resolution: The Company had been recording the MGA fee as premium in the annual statements since it was addressed in the prior examination.

Bonds

The Company failed to submit documentation and information for a filing of securities with the SVO.

Resolution: The Company provided documentation of compliance for the period covered by this examination.

Ceded Reinsurance Premiums Payable

It was recommended to the Company to correctly report ceded reinsurance premiums payable balances on all future annual and quarterly statement filings in compliance with the NAIC Annual Statement Instructions and the NAIC Accounting Practices and Procedures.

Resolution: The Company is currently in compliance in recording the ceded reinsurance premiums payable on their annual and quarterly statements.

HISTORY

General

The Company was incorporated in Florida on April 9, 1998 and commenced business on May 24, 1998 as Capitol Preferred Insurance Company.

In accordance with Section 624.401(1), FS, the Company was authorized to transact the following insurance coverage in Florida on December 31, 2004:

Fire	Farm Owners Multi Peril
Homeowners Multi Peril	Allied Lines
Mobile Home Multi Peril	Surety
Mobile Home Physical Damage	Bail Bonds

The Company did not write insurance coverage in the allied lines and farm owners lines of business for the period covered by this examination. The license to write farm owners insurance coverage was issued in 2003. Management stated that it intends to write these new product lines in Georgia and possibly in South Carolina.

The Company was formed for the primary purpose of facilitating the depopulation of the Florida Residential Property and Casualty Joint Underwriting Association (JUA). There was no JUA take out bonus received during the period covered by this examination now known as Citizens Property Insurance Corporation (Citizens).

The Company was granted statutory approval to write business in Georgia in 2003 and South Carolina in 2004. The Company concentrated on its expansion to Georgia to allow for a leveling of premium exposure in Florida. The expansion in South Carolina was temporarily suspended as a result of the 2004 Florida hurricane activity.

The articles of incorporation and the bylaws were amended during the period covered by this examination.

Capital Stock

As of December 31, 2004, the Company's capitalization was as follows:

Number of authorized common capital shares	20,000
Number of shares issued and outstanding	15,000
Total common capital stock	$1,500,000
Par value per share	$ 100.00
Number of authorized preferred capital shares	100,000
Number of shares issued and outstanding	0
Total preferred capital stock	$ 0
Par value per share	$ 100.00

Control of the Company was maintained by its parent, Preferred Holding Company, Inc., a State of Florida corporation, who owned 100 percent of the stock issued by the Company, who in turn was 72 percent owned by PATTCO, LLC, a privately held corporation, and 20 percent owned by James A. Graganella, an individual.

In 2004, the Company amended its articles of incorporation for the authorization of 100,000 shares of preferred stock with a $100 par value. This was approved by the Office in October of 2004. In 2003, it amended the articles of incorporation to increase the authorized common shares from 1,000 shares to 20,000 shares. The par value per share was increased from $10 to $100. After the amendment, the board of directors approved a 30 to 1 stock split in November of 2003.

Profitability of Company

The following table shows the profitability trend (in dollars) of the Company for the period of examination.

	2002	2003	2004
Premiums Earned	5,854,234	8,510,579	7,415,040
Net Underwriting Gain/(Loss)	(2,041,050)	(40,895)	(9,107,904)
Net Income(Loss)	(1,045,320)	108,743	(8,753,022)
Total Assets	14,367,277	15,980,825	26,517,760
Total Liabilities	9,125,121	10,471,766	21,276,986
Surplus As Regards Policyholders	5,242,156	5,509,059	5,240,774

Dividends to Stockholders

There was no dividend declared or paid to its stockholders during the years covered by 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, 2004, were:

Directors

Name and Location	Principal Occupation
Thomas A. Dieruf Louisville, Kentucky	Vice President PATTCO, LLC

James A. Graganella Tallahassee, Florida	President/CEO Capitol Preferred Insurance Company
Keith E. Martin Tallahassee, Florida	Vice President/CFO Capitol Preferred Insurance Company
James A. Patterson Louisville, Kentucky	President; PATTCO, LLC
James A. Patterson II Louisville, Kentucky	Vice President; PATTCO, LLC

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

Senior Officers

Name	**Title**
James A. Graganella	President
Keith E. Martin	Vice President/Secretary/Treasurer

The Company's Board appointed several internal committees in accordance with Section 607.0825, FS. The following are the principal internal board committees and their members as of December 31, 2004:

Executive Compensation Committee
Thomas A. Dieruf – Chairman
James A. Patterson

Audit Committee
Thomas A. Dieruf – Chairman
James A. Patterson
James A. Patterson, II

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, and certain internal committees 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.

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

There were no acquisitions, mergers, disposals, dissolutions, or purchases or sales through reinsurance during the period covered by this examination.

Surplus Debentures

All surplus debentures were issued in exchange for cash and require payment of interest and principal to be made with the approval of the Office.

As of December 31, 2004, there were $8,800,000 in surplus debentures with interest equal to the prime rate plus 1%; issued to PATTCO, LLC ($4,000,000), Preferred Holding Company, Inc. ($400,000), Preferred Managing Agency ($2,000,000), Robert Fishback ($1,000,000), Van Fishback ($1,000,000), and Allen Baker ($400,000). The maturity of all the notes will be on October 31, 2029. Each of the surplus debentures establish a maximum interest rate of 12 percent.

Subsequent events:

On August 3, 2005, additional surplus debentures totaling $4,800,000, were approved by the Office.

AFFILIATED COMPANIES

The Company 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 on February 21, 2005, as required by Section 628.801, FS, and Rule 69O-143.046, FAC.

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

Tax Allocation Agreement

The Company, along with its parent, filed a consolidated federal income tax return. On December 31, 2004, the method of allocation between the Company and its parent was based upon separate return calculations with current credit for net losses.

MGA Agreement

The Company entered into three Managing General Agency (MGA) agreements with its affiliate Preferred Managing Agency, Inc. (PMA).

The first agreement was effective January 1, 1998, and indicated that PMA shall act as the MGA for the insurance policies issued in the State of Florida, which were mostly fire and homeowners policies. The agreement further indicated that PMA had the authority to handle claims and assist with negotiation of reinsurance; however, PMA may not bind reinsurance. PMA charged a $25 policy fee. Addendum numbers 1 and 2 were executed on May 1, 2001 with an effective date of January 1, 2001 and addendum number 3 was executed on May 10, 2005 with an effective date of January 1, 2001.

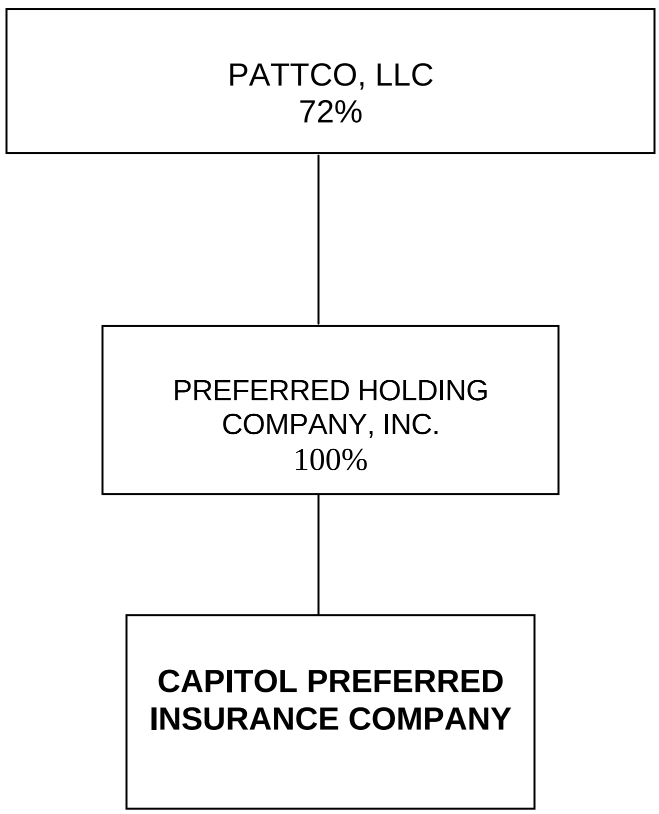
The second agreement, effective June 26, 2000, was substantially the same as the first, except that the second agreement covered bail bond business.

The third agreement, effective October 11, 2001, was substantially the same as the first, except that the third agreement covered surety business.

A simplified organizational chart as of December 31, 2004, reflecting the holding company system, is shown below. Schedule Y of the Company's 2004 annual statement provided a list of all related companies of the holding company group.

CAPITOL PREFERRED INSURANCE COMPANY
ORGANIZATIONAL CHART

DECEMBER 31, 2004



FIDELITY BOND AND OTHER INSURANCE

The Company maintained fidelity bond coverage up to $350,000 with a deductible of $10,000, which did not adequately cover the suggested minimum amount of coverage for the Company as recommended by the NAIC. Effective July 20, 2005, the coverage was increased to $400,000.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The Company provided medical coverage and life insurance policies to its employees. There were no pension or stock ownership plans; however, the employees were able to contribute to a 401(K) retirement plan. The Company matched up to a maximum of 4% of employee compensation.

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	CD, 3.21%, 08/06/05	$ 300,000	$ 300,000
TOTAL FLORIDA DEPOSITS		$ 300,000	$ 300,000
GA	Treasury M/M Funds	$ 100,063	$ 100,063
SC	US Treasury, 2.25%, 04/30/06	255,000	255,000
TOTAL OTHER DEPOSITS		$ 355,063	$ 355,063
TOTAL SPECIAL DEPOSITS		$ 655,063	$ 655,063

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory

The Company was authorized to transact insurance in the following states, in accordance with Section 624.401(2), FS:

Florida	Georgia	South Carolina

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.

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 did not assume any insurance business during the period covered by this examination.

Ceded

The Company entered into a 50 percent quota share agreement for all losses, except those relating to catastrophic events, net of other reinsurance coverage which were subject to an aggregate limitation of 87.5 percent of ceded earned premium. The primary reinsurer, Everest Reinsurance Company, was an authorized reinsurer, and there were several unauthorized reinsurers. The unauthorized reinsurers were Arch Reinsurance LTD, Axis Reinsurance, Axis Specialty LTD, DaVinci Reinsurance LTD, Montpelier Reinsurance, IPC RE LTD, PX Re Reinsurance LTD, Renaissance Reinsurance LTD, and XL Re LTD who secured their reinsurance balances as unauthorized reinsurers or the Company set up a provision for reinsurance liability.

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 Certified Public Accountant (CPA) audited the Company's statutory basis financial statements annually for the years 2002, 2003 and 2004, 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 one account, were verified with the line items of the annual statement submitted to the Office.

The Company maintained its principal operational offices in Tallahassee, Florida, where this examination was conducted.

The Company and non-affiliates had the following agreements:

Custodial Agreement

The Company utilized the investment and custodial services of SunTrust Bank. The safekeeping agreement between the Company and SunTrust Bank provided the proper safeguards and controls indemnifying the Company as required by Rule 69O-143.042, FAC.

Independent Auditor Agreement

The Company maintained an agreement with Chilton & Medley of Louisville, Kentucky to perform the audit of the financial statements in accordance with Section 624.424 (8) (a), FS.

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, 2004, 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."

CAPITOL PREFERRED INSURANCE COMPANY, INC.
Assets

DECEMBER 31, 2004

Classification	Per Company	Examination Adjustments	Per Examination
Bonds	$5,844,205		$5,844,205
Cash and short-term investments	14,987,797		14,987,797
Agents' balances:			
Uncollected premium	267,314		267,314
Reinsurance recoverable	3,735,160		3,735,160
Net deferred tax asset	503,381		503,381
Interest and dividend income due & accrued	70,219		70,219
Aggregate write-in for other than invested assets	1,109,684		1,109,684
Totals	$26,517,760	$0	$26,517,760

CAPITOL PREFERRED INSURANCE COMPANY, INC.
Liabilities, Surplus and Other Funds

DECEMBER 31, 2004

Liabilities	Per Company	Examination Adjustments	Per Examination
Losses	$2,902,336	$6,844,000	9,746,336
Loss adjustment expenses	291,930		291,930
Commissions payable, contingent commission and others	89,757		89,757
Other expenses	38,000		38,000
Taxes, licenses and fees	157,903		157,903
Current federal and foreign income taxes	120,000		120,000
Unearned premium	7,017,305		7,017,305
Advance premiums	1,025,805		1,025,805
Ceded reinsurance premiums payable	2,274,528		2,274,528
Funds held under reinsurance treaties	5,707,943		5,707,943
Amounts withheld or retained by company for others	17,533		17,533
Provision for reinsurance	421,000		421,000
Aggregate write-ins for liabilities	1,212,946		$1,212,946
Total Liabilities	$21,276,986	6,844,000	$28,120,986
Capital and Surplus			
Common capital stock	$1,500,000		$1,500,000
Surplus notes	8,800,000		8,800,000
Gross paid in and contributed surplus	4,000,000		4,000,000
Unassigned funds (surplus)	(9,059,226)	(6,844,000)	(15,903,226)
Surplus as regards policyholders	$5,240,774		($1,603,226)
Total liabilities, capital and surplus	$26,517,760	$0	$26,517,760

CAPITOL PREFERRED INSURANCE COMPANY, INC.
Statement of Income

DECEMBER 31, 2004

Underwriting Income	
Premiums earned	$7,415,040
DEDUCTIONS:	
Losses incurred	12,232,294
Loss expenses incurred	893,144
Other underwriting expenses incurred	3,397,506
Total underwriting deductions	$16,522,944
Net underwriting gain or (loss)	($9,107,904)
Investment Income	
Net investment income earned	$348,965
Other Income	
Net gain or (loss) from agents' or premium balances charged off	($11,791)
Finance and service charges not included in premiums	17,709
Total other income	$5,918
Net income before dividends to policyholders and before federal & foreign income taxes	($8,753,021)
Net Income, after dividends to policyholders, but before federal & foreign income taxes	($8,753,021)
Net Income	($8,753,021)
Capital and Surplus Account	
Surplus as regards policyholders, December 31 prior year	$5,509,059
Gains and (Losses) in Surplus	
Net Income	($8,753,021)
Change in net deferred tax asset	111,245
Change in non-admitted assets	(5,509)
Change in provision for reinsurance	(421,000)
Examination adjustment	(6,844,000)
Change in surplus notes	8,800,000
Change in surplus as regards policyholders for the year	(7,112,285)
Surplus as regards policyholders, December 31 current year	(1,603,226)

COMMENTS ON FINANCIAL STATEMENTS

Liabilities

Losses and Loss Adjustment Expenses **$10,038,266**

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, 2004, 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 determined that the reserves were deficient $6,844,000, related to development of loss reserves from the 2004 hurricanes in Florida. The Company has recognized this development and has issued $4,800,000 in surplus debentures in 2005.

CAPITOL PREFERRED INSURANCE COMPANY, INC.
COMPARATIVE ANALYSIS OF CHANGES IN SURPLUS

DECEMBER 31, 2004

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, 2004, Annual Statement				$5,240,774
	PER COMPANY	PER EXAM	INCREASE (DECREASE) IN SURPLUS	
ASSETS:	No adjustment needed			
LIABILITIES:				
Losses	2,902,336	9,746,336	(6,844,000)	
Net Change in Surplus:				(6,844,000)
Surplus as Regards Policyholders December 31, 2004, Per Examination				(1,603,226)

SUMMARY OF FINDINGS

Compliance with previous directives

The Company has taken the necessary actions to comply with the comments made in the 2001 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, 2004.

General

The Company has not written insurance coverage in the allied lines and farm owners lines of business during the period covered by this examination. **It is recommended that the Company comply with Section 624.430, FS, and submit a request to the Office that these lines of insurance be removed from its certificate of authority or submit a plan to write these lines of business to the Office for review and approval, within 90 days after this report is issued.**

CONCLUSION

The customary insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Capitol Preferred Insurance Company, Inc.** as of December 31, 2004, consistent with the insurance laws of the State of Florida.

Per examination findings, the Company's surplus as regards policyholders was (1,603,226), which was not in compliance with Section 624.408, FS. Surplus debentures totaling $4,800,000 were issued in 2005 to address the surplus deficiency.

In addition to the undersigned, John C. Berry, Financial Examiner/Analyst Supervisor, David Schleit, Financial Examiner/Analyst II, Owen A. Anderson, Financial Examiner/Analyst II and Joe Boor, FCAS, Office Actuary, participated in the examination.

Respectfully submitted,

____
Joel V. Bengo
Financial Examiner/Analyst II
Florida Office of Insurance Regulation