

REPORT ON EXAMINATION

OF

CYPRESS PROPERTY & CASUALTY

INSURANCE COMPANY, INC.

JACKSONVILLE, FLORIDA

AS OF

DECEMBER 31, 2004

BY THE

OFFICE OF INSURANCE REGULATION

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Tallahassee, Florida

December 22, 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, 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:

**CYPRESS PROPERTY & CASUALTY INSURANCE COMPANY
13901 SUTTON PARK DRIVE SOUTH, SUITE 310
JACKSONVILLE, FLORIDA 32224**

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 September 19, 2005, to September 23, 2005. The fieldwork commenced on October 10, 2005, and was concluded as of December 22, 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, with due regard to the statutory requirements of the insurance laws and rules of the State of Florida.

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

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

We valued and/or verified the amounts of the Company's assets and liabilities as reported by the Company in its annual statement as of December 31, 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:

- Reinsurance
- Consideration of Fraud
- Federal Income Taxes

Status of Adverse Findings from Prior Examination

There were no significant adverse findings contained in the Office's prior examination report as of December 31, 2001.

HISTORY

General

The Company was incorporated in Florida on August 26, 1998 and commenced business on December 27, 1998 as Cypress Property & Casualty Insurance Company.

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

Fire	Inland Marine
Homeowners Multi Peril	Other Liability
Allied Lines	

The articles of incorporation and the bylaws were not 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	7,000,000
Number of shares issued and outstanding	700,000
Total common capital stock	\$700,000
Par value per share	\$1.00

Control of the Company was maintained by its parent, Cypress Holdings, Inc. (Parent) who owned 100 percent of the stock issued by the Company, who in turn was 86 percent owned by Cypress Holdings II, Inc. (a Delaware corporation), and 14 percent owned by management and other investors. Cypress Holdings II, Inc. was owned 95 percent by Onex Investment Pools and 5 percent by Cypress Manager, LLC.

Profitability of Company

The following table shows the profitability trend (in dollars) of the Company for the period of examination, as reported in the filed annual statement of the Company.

	2004	2003	2002
Premiums Earned	25,677,446	19,519,798	28,554,579
Net Underwriting Gain/(Loss)	(25,275,125)	174,923	(195,935)
Net Income	(16,181,230)	282,982	2,286,648
Total Assets	64,266,984	40,873,395	38,591,994
Total Liabilities	56,244,053	27,475,093	25,699,119
Surplus As Regards Policyholders	8,022,931	13,398,302	12,892,875

Dividends to Stockholders

No dividends were paid during the period of examination.

Management

The annual shareholder meeting for the election of directors was held in accordance with Sections 607.1601 and 628.231, Florida Statutes. Directors serving as of December 31, 2004, were:

Directors

Name and Location

Allen H. Fishman
Brooklyn, New York

Brook L. Cuddy
New York, New York

Marc T. Wray
United Kingdom

Gary R. Harger
Jacksonville, Florida

Loni G. Lugo
Jacksonville, Florida

Principal Occupation

President & CEO
Independence Community Bank

Principal
JP Morgan/Chase, NA

Consultant
MW Ventures

President & CEO
Cypress P&C Insurance Company

Executive Vice President & Secretary
Cypress P&C Insurance Company

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

Senior Officers

Name	Title
Gary Harger	President, Chief Executive Officer
Loni Lugo	Executive Vice President & Secretary
Michael Whatley	Vice President & Actuary
Robert Gantley	Vice President, Claims
Glenn Lawson	Chief Financial Officer

The Company's board appointed an internal committee in accordance with Section 607.0825, Florida Statutes. Following is the principal internal board committee and members as of December 31, 2004:

Audit Committee

Alan Fishman, Chairman
Brook Cuddy
Marc Wray

Conflict of Interest Procedure

The Company adopted a policy statement requiring annual disclosure of conflicts of interest, in accordance with Section 607.0832, Florida Statutes. 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, Florida Statutes, including the authorization of investments as required by Section 625.304, Florida Statutes.

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

There were no acquisitions, mergers, disposals, dissolutions, purchases nor sales through reinsurance.

Surplus Debentures

The Company issued a \$3 million subordinated surplus note to the Parent on January 4, 1999 for cash, with the approval of the Office. The note had an interest rate of 7% on the unpaid balance and had a fixed maturity date. Interest was paid annually with prior approval of the Office from unassigned surplus of the Company. Principal payments may be made on these notes with prior approval of the Office. The Company paid interest of \$210,000 due at December 31, 2003, after approval by the Office.

On September 30, 2004, after prior approval by the Office, the Company issued a \$2 million subordinated surplus note to its Parent for cash. The note had an interest rate of 6.75% on the unpaid balance and had no fixed maturity date. Interest was paid annually from unassigned surplus with prior approval of the Office. Principal payments may be made on these notes with prior approval of the Office.

The Company did not pay any interest on either of these notes at December 31, 2004.

In the fourth quarter of 2004, the Parent contributed an additional \$8.6 million to the Paid in surplus of the Company.

AFFILIATED COMPANIES

The Company was a member of an insurance holding company system as defined by Rule 69O-143.045(3), Florida Administrative Code. The latest holding company registration statement was filed with the state of Florida on February 25, 2005, as required by Section 628.801, Florida Statutes, and Rule 69O-143.046, Florida Administrative Code.

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 in compliance with the appropriate Internal Revenue Service regulations. On December 31, 2004, the method of allocation was determined using a spreadsheet to estimate the amount of tax liability or tax refund due. Each company would pay no more tax liability and receive no less tax refund than each of the companies would have if they had been filing separate federal income tax returns.

Cost Sharing Agreement

The Company incurred and paid regular overhead expenses throughout the year. Some of the expenses were attributable to affiliated companies. The agreement required the affiliates to pay a reasonable allocation of the identifiable overhead costs paid by the Company. The affiliates agreed to remit payment for allocated charges on a monthly basis.

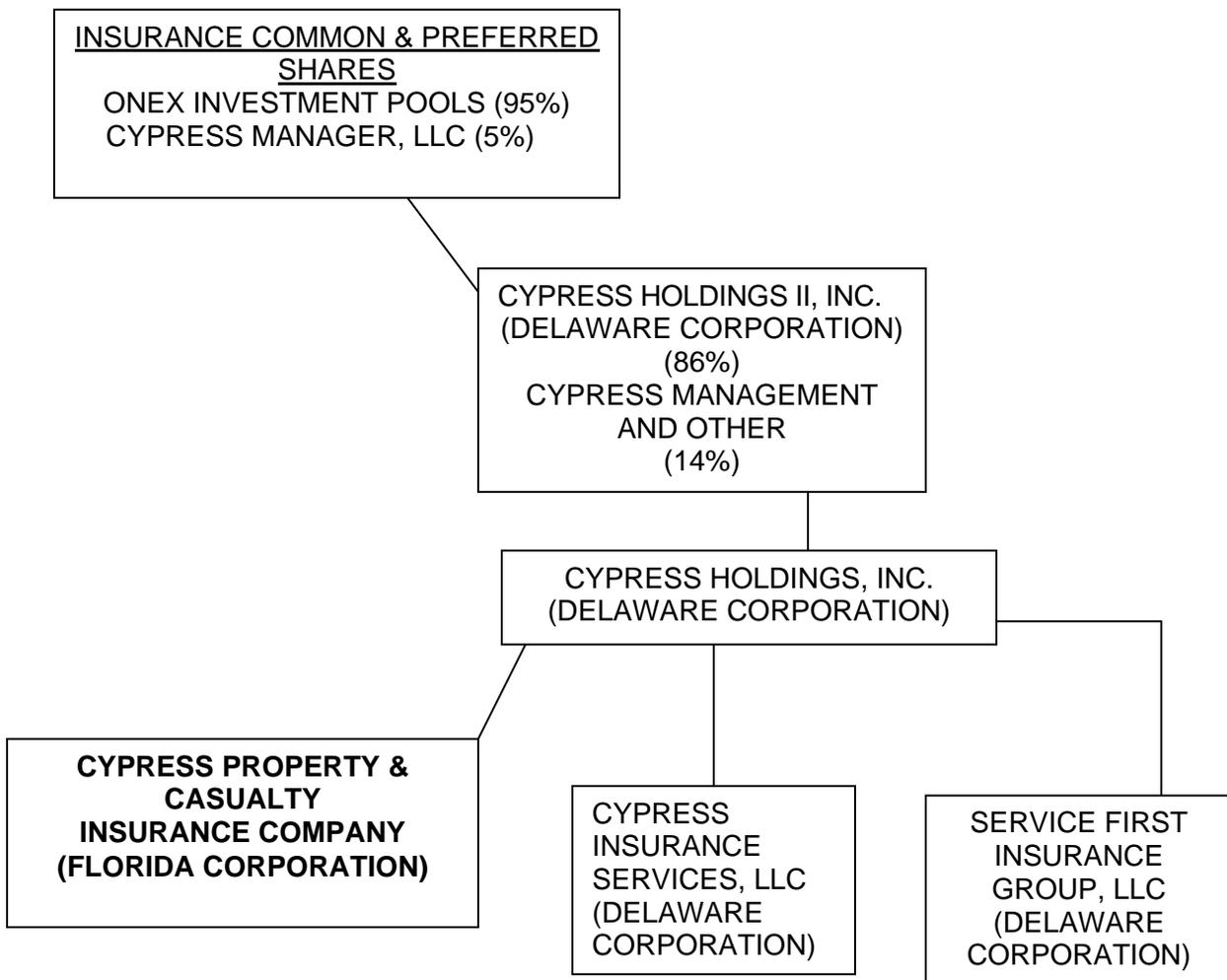
Managing General Agency Agreement

The Company entered into an agency agreement with Cypress Insurance Services, LLC (agent), on December 23, 1999. The agent agreed to provide certain agent and agency related services and other services as deemed appropriate in connection with operations. Services rendered by the agent included marketing the Company's products through independent agents and brokers, soliciting, receiving and transmitting applications for homeowners' insurance to the Company, and assisting and supporting the Company in maintaining the acquired business.

An 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.

**CYPRESS PROPERTY & CASUALTY INSURANCE COMPANY, INC.
ORGANIZATIONAL CHART**

DECEMBER 31, 2004



FIDELITY BOND AND OTHER INSURANCE

The Company maintained fidelity bond coverage up to \$1,000,000 with a deductible of \$50,000, which adequately covered the suggested minimum amount of coverage for the Company as recommended by the NAIC. The Company also carried general liability up to \$2,000,000, automobile insurance up to \$1,000,000, commercial umbrella up to \$5,000,000, personal property up to \$150,000 and professional liability up to \$1,000,000.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The Company did not have any pension, stock ownership and insurance plans during the period of this examination.

STATUTORY DEPOSITS

The following securities were deposited with the State of Florida as required by Section 624.411, Florida Statutes:

State	Description	Par Value	Market Value
FL	Wachovia CD, 0.82 %, 01/25/05	<u>\$ 300,000</u>	<u>\$ 300,000</u>
TOTAL SPECIAL DEPOSITS		<u>\$ 300,000</u>	<u>\$ 300,000</u>

INSURANCE PRODUCTS AND RELATED PRACTICES

Reliance was placed on the latest market conduct examination by the Office to determine accuracy of premium computation, policy construction, claims handling procedures and use of filed rates and forms. The exceptions noted in the issued report did not affect the solvency of the Company.

Territory

The Company was authorized to transact insurance only in Florida.

Treatment of Policyholders

The Company established procedures for handling written complaints as required by Section 626.9541(1) (j), Florida Statutes.

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 risk during the period of this examination.

Ceded

The Company ceded risk on a quota share basis, excess of loss basis and property catastrophe premium protection coverage basis to several reinsurers, through an intermediary. The Company also purchased reinsurance from the Florida Hurricane Catastrophe Fund. The Company maintained adequate catastrophe reinsurance as required in the consent order with the Office.

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

ACCOUNTS AND RECORDS

An independent CPA audited the Company's statutory basis financial statements annually for the years 2002, 2003 and 2004, in accordance with Section 624.424(8), Florida Statutes. Supporting work papers were prepared by the CPA as required by Rule 69O-137.002, Florida Administrative Code.

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

The Company failed to comply with SSAP No. 10, paragraph 10 – Deferred tax assets. The Company subsequently corrected this exception in the June 2005 quarterly statement. The correction increased Net deferred tax assets by \$495,038 and the Ceded reinsurance premiums payable account increased by \$4,170,221. These increases were due to a timing issue from purchasing layers of reinsurance with separate contracts and also the inability to accelerate hurricane premiums revenue to match the revenue with the cost. The acceleration of recognized reinsurance premium expense caused surplus to fall below the minimum amount required in Section 624.408, Florida Statutes. Surplus as regards policyholders reported in the December 31, 2004 filed annual statement was \$8,022,931. The Surplus as regards policyholders as a result of this examination was \$4,347,748, as of December 31, 2004.

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

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

Custodial Agreement

The Company entered into a custodial agreement with Wachovia Bank, NA on February 2, 2004. The agreement met the requirements of Rule 69O-143.042, Florida Administrative Code.

Independent Auditor Agreement

The Company had an agreement with PriceWaterhouseCoopers, LLP to audit the statutory financial statements.

Risk-Based Capital

The Company's risk-based capital was not at the required level for 2004. Subsequent to the examination date, the Company submitted a risk-based capital plan to the Office and at that time was considered to be at an adequate level. During 2004, hurricanes in Florida caused significant damage to insured property. The losses depleted layers of reinsurance protection and accelerated the amortization of associated reinsurance premiums. The losses and expenses caused 2004 capital and surplus ratios to fall and the Company did not meet the Risk-Based Capital mandatory action level required for the year ended 2004.

Subsequent Event

The Company submitted a corrective action plan that was approved by the Office.

Information Technology (IT) Report

Highland Clark, LLC performed a IT evaluation on the Company. The evaluation discovered that agents collected and transmitted personal information, including social security numbers of insurance applicants, over the public internet in clear text to the Peak 10 data center. The data was formatted into a PDF document and transmitted un-encrypted to the CSC data center. Unencrypted data could be compromised during transmission. Weak controls over this information could provide a basis for a policyholder to claim a violation of privacy since the Company was not taking reasonable precautions to protect the data. The evaluation recommended the Company implement Secure Socket Layer (SSL) encryption for the rating application web page data and additionally recommended that file transfer protocol (FTP) transmission of PDF policy applications occur over a dedicated line or utilize an encryption feature to protect the data from unauthorized viewing.

Subsequent Event

Management immediately began resolving the findings discovered in the IT examination, and SSL technology was implemented on June 3, 2005. The Company provided verification of the implementation.

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."

CYPRESS PROPERTY & CASUALTY INSURANCE COMPANY
Assets

DECEMBER 31, 2004

Classification	Per Company	Examination Adjustments	Per Examination
Bonds	\$20,824,844		\$20,824,844
Cash:			
On hand	29,893,208		29,893,208
Short-term investments	2,271		2,271
Receivable for securities	7,229		7,229
Agents' balances:			
Uncollected premium	2,407,981		2,407,981
Reinsurance recoverable	2,365,270		2,365,270
Federal and foreign income tax recoverable	6,965,367		6,965,367
Net deferred tax asset	1,602,484	495,038	2,097,522
Interest and dividend income due & accrued	155,469		155,469
Aggregate write-in for other than invested assets	42,861		42,861
Totals	\$64,266,984	\$495,038	\$64,762,022

CYPRESS PROPERTY & CASUALTY INSURANCE COMPANY
Liabilities, Surplus and Other Funds

DECEMBER 31, 2004

Liabilities	Per Company	Examination Adjustments	Per Examination
Losses	\$6,907,820		\$6,907,820
Loss adjustment expenses	530,452		530,452
Other expenses	635,226		635,226
Taxes, licenses and fees	294,615		294,615
Unearned premium	19,669,956		19,669,956
Advance premiums	1,550,147		1,550,147
Ceded reinsurance premiums payable	5,515,189	\$4,170,221	9,685,410
Funds held under reinsurance treaties	19,308,701		19,308,701
Remittances and items not allocated	488,354		488,354
Provision for reinsurance	816		816
Payable to parent, subsidiaries and affiliates	280,850		280,850
Aggregate write-ins for liabilities	1,061,927		1,061,927
Total Liabilities	\$56,244,053	\$4,170,221	\$60,414,274
Common capital stock	\$700,000		\$700,000
Surplus notes	5,000,000		5,000,000
Gross paid in and contributed surplus	14,897,228		14,897,228
Unassigned funds (surplus)	(12,574,297)	(3,675,183)	(16,249,480)
Surplus as regards policyholders	\$8,022,931	(\$3,675,183)	\$4,347,748
Total liabilities, capital and surplus	\$64,266,984	\$495,038	\$64,762,022

CYPRESS PROPERTY & CASUALTY INSURANCE COMPANY
Statement of Income

DECEMBER 31, 2004

Underwriting Income

Premiums earned	\$25,677,446
DEDUCTIONS:	
Losses incurred	36,654,731
Loss expenses incurred	1,304,590
Other underwriting expenses incurred	12,993,250
Aggregate write-ins for underwriting deductions	0
Total underwriting deductions	<u>\$50,952,571</u>
Net underwriting gain or (loss)	(\$25,275,125)

Investment Income

Net investment income earned	\$970,148
Net realized capital gains or (losses)	83,380
Net investment gain or (loss)	<u>\$1,053,528</u>

Other Income

Total other income	\$0
Net income before dividends to policyholders and before federal & foreign income taxes	(\$24,221,597)
Dividends to policyholders	0
Net Income, after dividends to policyholders, but before federal & foreign income taxes	<u>(\$24,221,597)</u>
Federal & foreign income taxes	<u>(8,040,367)</u>
Net Income	(\$16,181,230)

Capital and Surplus Account

Surplus as regards policyholders, December 31 prior year	\$13,398,302
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Gains and (Losses) in Surplus

Net Income	(\$16,181,230)
Change in net deferred income tax	283,539
Change in non-admitted assets	(74,093)
Change in provision for reinsurance	(816)
Change in surplus notes	2,000,000
Surplus adjustments: Paid in	8,597,228
Examination Adjustment	3,675,183
Change in surplus as regards policyholders for the year	<u>(\$1,700,189)</u>
Surplus as regards policyholders, December 31 current year	<u><u>\$4,347,748</u></u>

COMMENTS ON FINANCIAL STATEMENTS

Assets

Net deferred tax asset \$2,097,522

Total admitted assets increased by \$495,038 to this amount due to acceleration of recognized reinsurance premium expense of \$4,170,221.

Liabilities

Losses and loss adjustment expenses \$7,438,272

The Company's Actuary 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 was in concurrence with this opinion.

Ceded reinsurance premium payable \$9,685,410

The Ceded reinsurance premium payable increased by \$4,170,221 due to a timing issue brought about by the Company using the customary industry practice of purchasing individual layers of reinsurance with separate contracts and the inability to accelerate the hurricane premium revenue in the January to May timeframe to match the revenue with the associated cost.

**CYPRESS PROPERTY & CASUALTY INSURANCE COMPANY
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	\$8,022,931
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	<u>PER COMPANY</u>	<u>PER EXAM</u>	<u>INCREASE (DECREASE) IN SURPLUS</u>
ASSETS:			
Net deferred tax asset	\$1,602,484	\$2,097,522	\$495,038
LIABILITIES:			
Ceded reinsurance premiums payable	\$5,515,189	9,685,410	<u>(4,170,221)</u>
 Net Change in Surplus:			 <u>(\$3,675,183)</u>
 Surplus as regards policyholders December 31, 2004, Per Examination			 <u><u>\$4,347,748</u></u>

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

Net Deferred Tax

The Company failed to comply with SSAP No. 10, paragraph 10 – Deferred tax assets. The correction to the December 31, 2004 annual statement increased Net deferred tax assets by \$495,038 and increased the Ceded reinsurance premiums payable account by \$4,170,121, due to the acceleration of recognized reinsurance premium expense. The acceleration of expense caused surplus to fall below the minimum amount required in Section 624.408, Florida Statutes.

We recommend that the Company comply with SSAP 10, paragraph 10. We recommend the Company maintain the Surplus as regards policyholders at the amount required by Section 624.408, Florida Statutes.

Information Technology Report

Agents collected and transmitted unencrypted personal applicant information over the public internet to the CSC data center. **We recommend the Company implement SSL encryption for data sent over the internet. We additionally recommend FTP transmission of public document format (PDF) policy applications occur over a dedicated line or utilize encryption features.**

Subsequent Events

The four hurricanes that impacted the State of Florida in 2004 caused significant property damage. The associated losses exhausted various layers of reinsurance protection and accelerated the amortization of the associated reinsurance premiums.

The unaudited amount of Surplus as regards policyholders reported by the Company in the December 31, 2005 filed annual statement was \$8,149,994

CONCLUSION

The customary insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Cypress Property & Casualty Insurance Company** 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 \$4,347,748, which was below the amount required for compliance with Section 624.408, Florida Statutes, based on acceleration of reinsurance premium expense resulting from significant hurricane expenses of 2004. The unaudited surplus as regards policyholders as of December 31, 2005 was \$8,149,994.

In addition to the undersigned, Michael F. Hampton, CPA, CFE, DABFA, CFE, CPM, Financial Examiner/Analyst Supervisor, Joe Boor, FCAS, Office Actuary, and Tracy Gates, CISA, CPA of Highland Clark, LLC participated in the examination.

Respectfully submitted,

Jerry T. Golden
Financial Examiner/Analyst II
Florida Office of Insurance Regulation