

REPORT ON EXAMINATION
OF
HILLCREST INSURANCE COMPANY
GAINESVILLE, FLORIDA
AS OF
DECEMBER 31, 2006

BY THE
OFFICE OF INSURANCE REGULATION

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Tallahassee, Florida

May 30, 2008

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, 2006, of the financial condition and corporate affairs of:

**HILLCREST INSURANCE COMPANY
7201 NORTHWEST 11TH PLACE
GAINESVILLE, FLORIDA 32605**

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

SCOPE OF EXAMINATION

This examination covered the period of January 1, 2006 through December 31, 2006. This examination commenced, with planning at the Florida Office of Insurance Regulation (Office), on October 1, 2007, to October 5, 2007. The fieldwork commenced on October 8, 2007, and was concluded as of May 30, 2008.

This was a first year 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 of assets and the determination of liabilities, as those balances affect the financial solvency of the Company as of December 31, 2006. Transactions subsequent to year-end 2006 were reviewed where relevant and deemed significant to the Company's financial condition.

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 reports, 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) and other reports as considered necessary were reviewed and utilized where applicable within the scope of this examination.

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.

HISTORY

General

The Company was incorporated on June 23, 2005, as a stock property and casualty insurance company under the applicable provisions of the Florida Statutes. The Company commenced business on August 25, 2005.

The Company was party to Consent Order 81816-05-CO filed June 8, 2005 with the Office regarding the application for the issuance of a Certificate of Authority. The Company complied with all provisions of this consent order.

The Company was authorized to transact the following insurance coverage in Florida on December 31, 2006:

Homeowners multi peril
Inland marine

Capital Stock

As of December 31, 2006, the Company's capitalization was as follows:

Number of authorized common capital shares	100,000
Number of shares issued and outstanding	100,000
Total common capital stock	\$100,000
Par value per share	\$ 1.00

Control of the Company was maintained by its parent, Hillcrest Holdings, LLC which owned 100% of the stock issued by the Company, which in turn was 96.55% owned by The Vernon Smith Family LLC, a Florida company, and 3.45% by Ernest & Kathy Petrone.

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 statements.

	2006	2005
Premiums Earned	3,914,421	0
Net Underwriting Gain/(Loss)	(2,849,708)	(27,071)
Net Income	(2,298,810)	61,979
Total Assets	14,138,784	7,098,013
Total Liabilities	8,912,084	35,034
Surplus As Regards Policyholders	5,226,700	7,061,979

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, 2006, were:

Directors

Name and Location

Vernon D. Smith
Ft. Pierce, Florida

Ernest A. Petrone

Principal Occupation

Director
Hillcrest Insurance Company

Director

Winter Park, Florida

Hillcrest Insurance Company

Kathy S. Petrone
Winter Park, Florida

Chairwoman
Hillcrest Insurance Company

Karen S. Espling
Melbourne, Florida

Director
Hillcrest Insurance Company

Christopher D. Smith
Vero Beach, Florida

Director
Hillcrest Insurance Company

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

Senior Officers

Name	Title
Ernest A. Petrone	President/CEO
Kathy S. Petrone	Chairman/Treasurer
William J. Thompson	CFO and COO

The Company's board appointed several internal committees in accordance with Section 607.0825, Florida Statutes. Following are the principal internal board committees and their members as of December 31, 2006:

Compensation Committee

Vernon Smith
Kathy Petrone

Audit Committee

Vernon Smith
Christopher Smith
Karen Espling

Investment Committee

Vernon Smith
William J. Thompson
Kathy Petrone

The Company maintained an audit committee, as required by Section 624.424(8), Florida Statutes.

Conflict of Interest Procedure

The Company adopted a policy statement requiring annual disclosure of conflicts of interest in accordance with the NAIC Financial Condition Examiners Handbook.

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 and events 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, and purchases or sales through reinsurance during the period under examination.

Surplus Debentures

The Company did not have any surplus debentures.

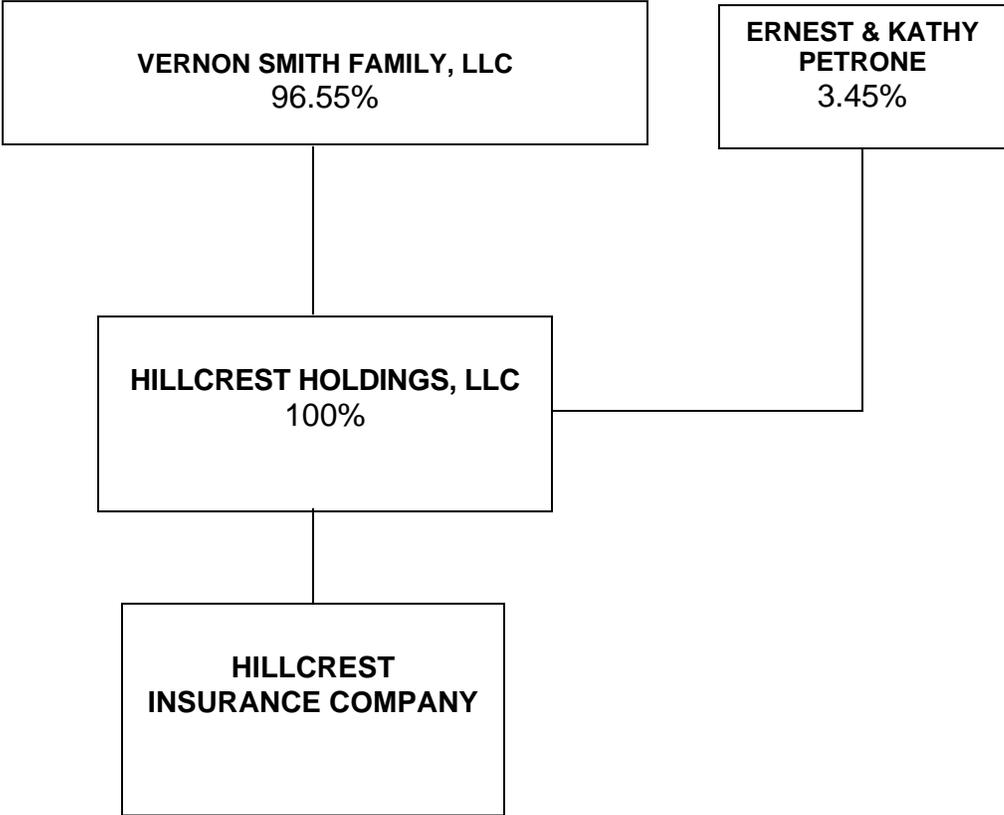
AFFILIATED COMPANIES

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 28, 2007, as required by Section 628.801, Florida Statutes, and Rule 69O-143.046, Florida Administrative Code.

A simplified organizational chart as of December 31, 2006, reflecting the holding company system, is shown below. Schedule Y of the Company's 2006 annual statement provided a list of all related companies of the holding company group.

**HILLCREST INSURANCE COMPANY
ORGANIZATIONAL CHART**

DECEMBER 31, 2006



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

Management Agreement

The Company had a management agreement with its parent, Hillcrest Holdings, LLC. Hillcrest Holdings, LLC provided legal, accounting, reinsurance, auditing, administrative, information technology, and other services as required.

The Company made payments to Hillcrest Holdings, LLC equal to 2% of written premium on new and renewable business monthly.

FIDELITY BOND

The Company maintained fidelity bond coverage at December 31, 2006, up to \$500,000 with a deductible of \$10,000, which adequately covered the suggested minimum amount of coverage for the Company as recommended by the NAIC Financial Condition Examiners Handbook.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The Company did not have pension plans, stock ownership or insurance plans. All services were provided by the Company's parent, Hillcrest Holdings, LLC.

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	Cash	<u>\$ 325,000</u>	<u>\$ 325,000</u>
TOTAL FLORIDA DEPOSITS		<u>\$ 325,000</u>	<u>\$ 325,000</u>

INSURANCE PRODUCTS

Territory

The Company was authorized to transact insurance in the State of Florida.

Treatment of Policyholders

The Company established procedures for handling written complaints in accordance with Section 626.9541(1)(j), Florida Statutes.

The Company maintained a claims procedure manual that included detailed procedures for handling each type of claim in accordance with Section 626.9541(1)(i)3a, Florida Statutes.

REINSURANCE

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

Ceded

The Company ceded risk on a quota share and excess of loss basis to various authorized and unauthorized reinsurers. The largest reinsurers were the Florida Hurricane Catastrophe Fund, Everest Re and Transatlantic Re. All of these companies were authorized.

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

ACCOUNTS AND RECORDS

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

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

An independent CPA audited the Company's statutory basis financial statements for the 2006 year, 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 and non-affiliates had the following agreements:

Managing General Agent Agreement

The Company entered into a managing general agent (MGA) agreement with Tower Hill Insurance Group, Inc. (THIG) dated August 24, 2005. The agreement stated that THIG would act as the MGA for the insurance policies issued in the State of Florida.

Custodial Agreement

The Company had a custodial agreement with U.S. Bank. The agreement complied with Rule 69O-143.042, Florida Administrative Code.

Independent Auditor Agreement

The Company had an agreement with Thomas Howell Ferguson P.A. to perform a statutory annual audit of the Company's financial statements for the 2006 year.

Information Technology

The Company had an information technology (IT) evaluation performed by Highland Clark, LLC. THIG provides IT services to the Company under the MGA agreement. The following issues were noted:

1. The Company does not currently require business unit management to periodically review and sign-off on end-user's data and application security permissions. In the absence of this control, the IT Specialist performed substantive testing of user security levels for the ICS policy and claims payable modules. Defined levels grant specific users varying ability to add, change or delete policies and to manage, pay expenses and generate checks for claim payments. The objective was to determine that access coincided with departmental responsibilities to enforce

segregation of duties. This inspection noted seven users in Information Systems and five users in Claims that could modify policies and create invoices.

2. The IT Specialist noted some progress with the Company's development of IT-related policies, but a formal IT policy that properly defined and segregated the roles and obligations of end-users, business-unit management and information systems (IS) has yet to be developed. Failure to formally acknowledge the business unit's role as data owner and the IS area's role as service provider results in too much authority and accountability being placed on the IS area. This was a repeat issue for THIG.

3. The IT Specialist inquired of the disaster recovery tests performed since the previous 2004 year-end IT review. It was noted that, apart from testing the failover features of the Border Gateway Protocol, no formal restore of ICS or CMS applications has been done on machines at the Kentucky warm site. The IT Specialist discussed this at length with the Chief Information Officer (CIO) and recognized THIG expertise and forethought in designing their wide area network to facilitate easy data and voice switching between the Gainesville, Florida and Kentucky office. However, without an integrated test of the restored applications on Kentucky machines from Gainesville backup tapes, many untested assumptions, from technology to personnel could ultimately prevent a timely and full recovery. This was a repeat issue for THIG.

4. In supporting the IT Specialist with completeness testing as required by the underwriting and claims cycles, the IT Specialist requested an extract of all bound policies and purged quote records. The objective was to determine that, under the quote/policy numbering scheme at THIG, an unbroken sequence of records were maintained for bound policies, cancelled policies and expired quotes. By design, the purge process did not permanently delete records but

merely moved them from a production table to a purge table. With assistance from the data base administrator (DBA) both tables were appended into a single data extract file ordered by policy sequence number with the assumption being that, among the two tables, all records should be accounted for in an unbroken numerical sequence. However, there were 152 records that did not exist in either the production or purge table. Without the detail records, it could not be determined if these were quotes or policies or what their status was when they were apparently deleted.

Additionally, there were 5 policies with the same sequence number, but different effective dates, that existed in the production table and the purge table. It could not be confirmed, but it appeared that these may have been different policies that had been assigned the same number.

FINANCIAL STATEMENTS PER EXAMINATION

The following pages contain financial statements showing the Company's financial position as of December 31, 2006, 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."

HILLCREST INSURANCE COMPANY
Assets

DECEMBER 31, 2006

	Per Company	Examination Adjustments	Per Examination
Bonds	\$7,544,626		\$7,544,626
Cash	3,637,747		3,637,747
Investment income due and accrued	120,847		120,847
Uncollected premium	2,340,048		2,340,048
Reinsurance recoverable	4,745		4,745
Federal and foreign income tax	27,240		27,240
Net deferred tax asset	463,531		463,531
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Totals	\$14,138,784	\$0	\$14,138,784
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HILLCREST INSURANCE COMPANY
Liabilities, Surplus and Other Funds

DECEMBER 31, 2006

		Adjustments	Examination
Losses	\$533,259		\$533,259
Loss adjustment expenses	181,077		181,077
Other expenses	8,466		8,466
Taxes, licenses and fees	81,738		81,738
Unearned premium	3,504,688		3,504,688
Ceded reinsurance premiums payable	4,525,228		4,525,228
Drafts outstanding	23,910		23,910
Payable to parent, subsidiaries and affiliates	53,718		53,718
Total Liabilities	<u>\$8,912,084</u>	<u>\$0</u>	<u>\$8,912,084</u>
Common capital stock	\$100,000		\$100,000
Gross paid in and contributed surplus	6,900,000		6,900,000
Unassigned funds (surplus)	<u>(1,773,300)</u>		<u>(1,773,300)</u>
Surplus as regards policyholders	<u>\$5,226,700</u>		<u>\$5,226,700</u>
Total liabilities, surplus and other funds	<u>\$14,138,784</u>	<u>\$0</u>	<u>\$14,138,784</u>

HILLCREST INSURANCE COMPANY
Statement of Income

DECEMBER 31, 2006

Underwriting Income		
Premiums earned		\$3,914,421
	Deductions:	
Losses incurred		1,603,818
Loss expenses incurred		238,202
Other underwriting expenses incurred		4,922,109
Aggregate write-ins for underwriting deductions		0
Total underwriting deductions		<u>\$6,764,129</u>
Net underwriting gain or (loss)		(\$2,849,708)
Investment Income		
Net investment income earned		\$526,774
Net realized capital gains or (losses)		(8)
Net investment gain or (loss)		<u>\$526,766</u>
Other Income		
Net gain or (loss) from agents' or premium balances charged off		\$0
Total other income		<u>\$0</u>
Net income before dividends to policyholders and before federal & foreign income taxes		(\$2,322,942)
Dividends to policyholders		0
Net Income, after dividends to policyholders, but before federal & foreign income taxes		(\$2,322,942)
Federal & foreign income taxes		(24,132)
Net Income		<u>(\$2,298,810)</u>
Capital and Surplus Account		
Surplus as regards policyholders, December 31 prior year		\$7,061,979
Net Income		(\$2,298,810)
Net unrealized capital gains or losses		0
Change in non-admitted assets		(291,121)
Change in net deferred income tax		754,652
Examination Adjustment		
Change in surplus as regards policyholders for the year		<u>(\$1,835,279)</u>
Surplus as regards policyholders, December 31 current year		<u><u>\$5,226,700</u></u>

COMMENTS ON FINANCIAL STATEMENTS

Liabilities

Losses and Loss Adjustment Expenses

\$714,336

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, 2006, made a reasonable provision for all unpaid loss and loss expense obligations of the Company under the terms of its policies and agreements.

The Office contracted with Kufera Consulting, Inc., an independent actuary, to perform the actuarial review. The independent actuary reviewed work papers provided by the Company and was in concurrence with this opinion.

Capital and Surplus

The amount reported by the Company of \$5,226,700, exceeds the minimum of \$4,000,000 required by Section 624.408, Florida Statutes.

A comparative analysis of changes in surplus is shown below.

**HILLCREST INSURANCE COMPANY
COMPARATIVE ANALYSIS OF CHANGES IN SURPLUS
DECEMBER 31, 2006**

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 December 31, 2006, per Annual Statement	\$5,226,700
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	<u>PER COMPANY</u>	<u>PER EXAM</u>	<u>INCREASE (DECREASE) IN SURPLUS</u>
ASSETS:			
No adjustments needed			\$0
LIABILITIES:			
No adjustments needed			\$0
Net Change in Surplus:			0
Surplus as Regards Policyholders December 31, 2006, Per Examination			\$5,226,700

SUMMARY OF FINDINGS

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, 2006.

Information Technology (IT)

Controls Testing

1. The Company does not currently require business unit management to periodically review and sign-off on end-user's data and application security permissions. **We recommend that as soon as practical, and at least every year thereafter, all Company department managers should review all functional access by their personnel and sign-off as to the appropriateness of that access based on job responsibilities.**

We also recommend that the Company should carefully limit Information Systems (IS) user's access to any production systems. Additionally, care should be taken such that no user has capability to create a policy and create and pay a claim against a policy. Failure to limit IS user's access to any production systems and failure to limit non-IS user access between policy, claims and accounting functions creates an opportunity for fraud and also places these users in a position of undue culpability.

2. The IT Specialist noted some progress with the Company's development of IT-related policies, but a formal IT policy that properly defines and segregates the roles and obligations of end-users, business-unit management and Information Systems (IS) has yet to be developed.

This was a repeat issue for THIG. **We recommend that the Company should develop, and the board approve, an IT Security Policy that outlines the roles and responsibilities of information services, end-users, business unit management and security administration. Development of this policy will be a key requirement to enforcing compliance with the above recommendation for end-user security access reviews.**

3. The IT Specialist made inquiry as to disaster recovery tests performed since the 2004 year-end IT review. **We recommend that Company budget time and resources to complete a formal test of the restoration capabilities of all critical technology and facilities components of their disaster recovery plan, based on an unplanned physical disaster and inaccessibility of the Gainesville data center.**

For non-technical components, we recommend a documented walk-through be performed to validate assumptions about the availability of staff, vendor support and supplies. Both the formal test and walkthroughs should be completed at least every eighteen months or after significant organizational or technical changes at the Company.

Claims Testing

By design, the Company's purge process did not permanently delete records but merely moved them from a production table to a purge table. However, there were 152 records that did not exist in either the production or purge table. Without the detail records, it could not be determined if these were quotes or policies or what their statuses was when they were apparently deleted.

Additionally, there were 5 policies with the same sequence number, but different effective dates, that existed in the production table and the purge table. It could not be confirmed, but it appeared that these may have been different policies that had been assigned the same number.

We recommend that the Company further investigate these issues and make corrections to the purge process to ensure that all data records can be accounted for going forward, for the failure to maintain evidence of sequential policy numbers compromises the audit trail capabilities of the system and could limit the company's ability to provide evidence that it is in compliance with Section 626.561, Florida Statutes.

CONCLUSION

The insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Hillcrest Insurance Company** as of December 31, 2006, consistent with the insurance laws of the State of Florida.

Per examination findings, the Company's Surplus as regards policyholders was \$5,226,700, in compliance with Section 624.408, Florida Statutes.

In addition to the undersigned, Michael Hampton, CPA, CFE, Financial Examiner/Analyst Supervisor, Kethessa Carpenter, CPA, Financial Examiner/Analyst Supervisor, and Miriam Bleakley, Financial Examiner/Analyst II, Stephen Feliu, Financial Examiner/Analyst II participated in the examination. We also recognize the participation of Kay Kufera, FCAS, MAAA of Kufera Consulting, Inc., and Tracy Gates, CPA, CISA, of Highland Clark, LLC.

Respectfully submitted,

James D. Collins
Reinsurance/Financial Specialist
Florida Office of Insurance Regulation