

REPORT ON EXAMINATION
OF
MERCURY INDEMNITY COMPANY OF
AMERICA
CLEARWATER, FLORIDA

AS OF
DECEMBER 31, 2004

BY THE
OFFICE OF INSURANCE REGULATION

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Tallahassee, Florida

December 9, 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:

**MERCURY INDEMNITY COMPANY OF AMERICA
1901 ULMERTON ROAD, SIXTH FLOOR
CLEARWATER, FLORIDA 33762-2307**

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, 2004 through December 31, 2004. The Company was last examined by representatives of the Florida Office of Insurance Regulation (Office) as of December 31, 2003. This examination commenced, with planning at the Office, on June 20, 2005, to June 24, 2005. The fieldwork commenced on June 27, 2005, and was concluded as of December 9, 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, 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.

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, 2003, along with resulting action taken by the Company in connection therewith.

Information Technology (IT) Report

The Company had a material finding in their Information Technology Report issued by Dixon Hughes PLLC. The Company's system did not monitor their employees' access to applications when an employee changed job functions or departments within the Company. **Resolution:** The Company stated they were in the process of implementing formalized policies and procedures governing access to programs, data and management oversight to mitigate such deficiency.

Capital Stock

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

Number of authorized common capital shares	2,000,000
Number of shares issued and outstanding	1,200,000
Total common capital stock	\$1,200,000
Par value per share	\$1.00

Control of the Company was maintained by its parent, Mercury General Corporation (MGC), a California corporation, who owned 100 percent of the stock issued by the Company, who in turn was owned by controlling stockholders' George Joseph and Gloria Joseph, who owed 34.5% and 16.8%, respectively. The remaining 48.7% was owned by public stockholders and traded on the New York Stock Exchange.

Subsequent Event

MGC contributed \$7,500,000 to the surplus of the Company on August 11, 2005, and \$5,000,000 on November 4, 2005.

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 of the Company.

	2004	2003	2002
Premiums Earned	39,957,349	1,419,231	0
Net Underwriting Gain/(Loss)	(4,013,772)	(1,002,711)	(10,564)
Net Income	(2,623,386)	(859,118)	50,890
Total Assets	67,189,504	17,580,159	5,085,727
Total Liabilities	52,719,882	5,722,584	11,706
Surplus As Regards Policyholders	14,469,622	11,857,575	5,074,021

Dividends to Stockholders

The Company did not declare or pay dividends to its stockholder in 2004.

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
Bruce Bunner Orlando, FL	Director CFO, Campus Crusade for Christ
George Joseph Los Angeles, CA	Director/Chairman CEO, MGC & Subsidiaries
Donald Patrick Newell Los Angeles, CA	Director Senior VP, The SCPIE Companies
Gabriel Tirador Tustin, CA	Director President/COO, MGC & Subsidiaries
Judith Ann Walters Los Angeles, CA	Director Secretary, MGC & Subsidiaries

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

Senior Officers

Name	Title
Gabriel Tirador	President
Jack Dougherty (a)	Vice President
Judith Ann Walters	Secretary
Theodore Robert Stalick	Vice President & Treasurer

(a) Resigned during 2005.

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

Audit Committee

Nathan Bessin
Donald Patrick Newell
Donald R. Spuehler

Investment Committee

George Joseph
Gabriel Tirador
Christopher Graves
Richard Grayson
Theodore Robert Stalick

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

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

The Company had no acquisitions, mergers, disposals, dissolutions, purchase or sales through reinsurance during the calendar year 2004.

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), FAC. The latest holding company registration statement was filed with the State of Florida on April 25, 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 and other affiliated corporations, filed a consolidated federal income tax return. On December 31, 2004, the method of allocation of tax liability between the companies was based upon calculations on a separate return basis.

Furniture and Equipment Rental Agreement

The Company and Mercury Insurance Company of Florida (MICFL) had a furniture and equipment rental agreement with their affiliate, Mercury Casualty Company (MCC), to pay for the furniture and equipment used at the Florida office.

Management Agreement

The Company had a management agreement with Mercury Insurance Services, LLC (MIS). Pursuant to the agreement, MIS provided underwriting and loss adjustment services to the Company for a management fee based on the actual incurred expenses.

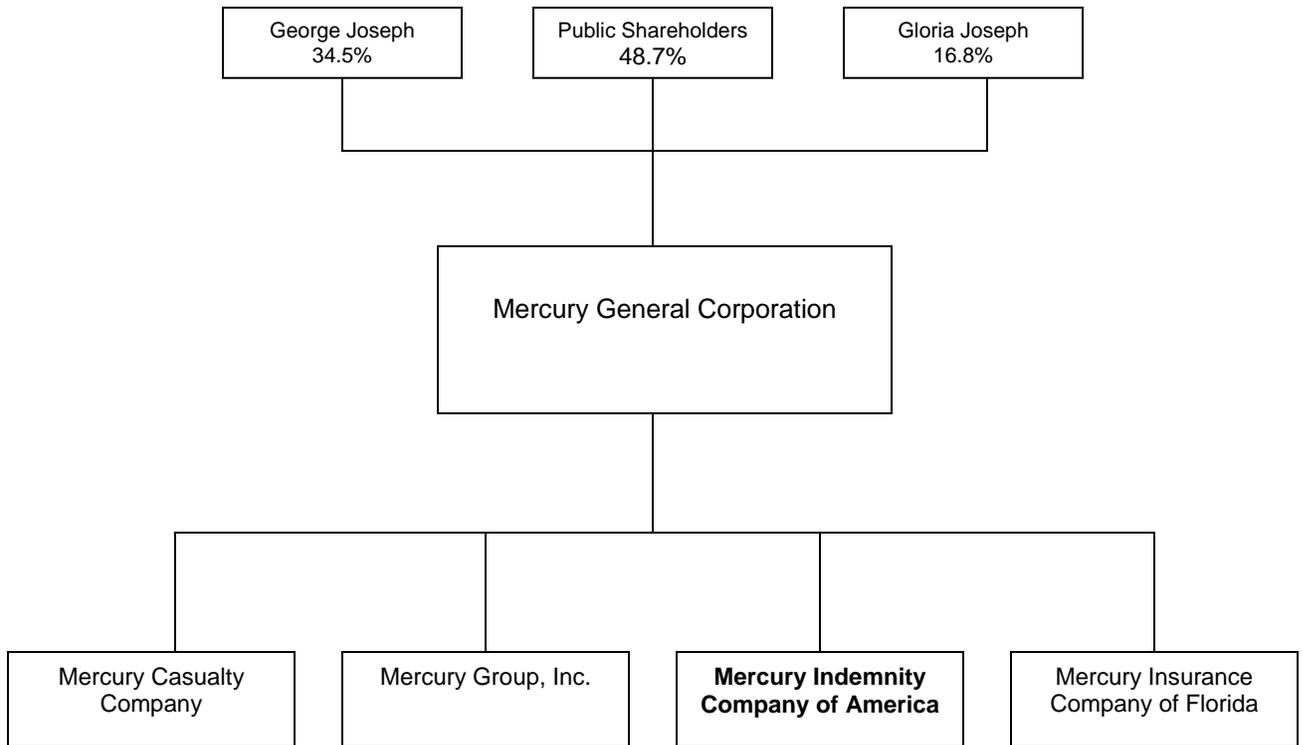
MGA Agreement

The Company had a managing general agency (MGA) agreement with Mercury Group, Inc. (MGI). The agreement stated the MGA's duties and responsibilities would include, but are not limited to marketing and sales, underwriting, premium auditing, premium recovery, invoicing and receipts processing, claims administration, safety and loss prevention and policy issuance.

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.

**MERCURY INDEMNITY COMPANY OF AMERICA
ORGANIZATIONAL CHART**

DECEMBER 31, 2004



FIDELITY BOND AND OTHER INSURANCE

The Company maintained fidelity bond coverage up to \$3,000,000 with a deductible of \$100,000, which adequately covered the suggested minimum amount of coverage for the Company as recommended by the NAIC.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The Company did not have any employees.

STATUTORY DEPOSITS

The following security was deposited with the State of Florida as required by Section 624.411, FS:

State	Description	Par Value	Market Value
FL	USTN, 5.0%, 08/15/11	<u>\$ 350,000</u>	<u>\$ 372,600</u>
	TOTAL FLORIDA DEPOSITS	<u>\$ 350,000</u>	<u>\$ 372,600</u>
	TOTAL SPECIAL DEPOSITS	<u>\$ 350,000</u>	<u>\$ 372,600</u>

INSURANCE PRODUCTS AND RELATED PRACTICES

The Company was licensed as a property and casualty insurer in the states of Florida and New Jersey. Private passenger automobile liability and physical damage account for 100% of the direct written premium. Business was produced by agents who were independent contractors selected and appointed by the Company. In 2004, the Company wrote direct premium of \$109,386,881 in the State of New Jersey.

Territory

The Company was authorized to transact insurance in the following states:

Florida
New Jersey

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.

This report does not include any issues or findings that may result from an ongoing market conduct examination.

REINSURANCE

The reinsurance agreements reviewed, as of December 31, 2004, 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 risk during calendar year 2004.

Ceded

The Company ceded risk on a quota share basis to MCC, an affiliate. The Company ceded 100 percent of the ultimate net loss arising out of each occurrence for all private passenger automobile and automobile physical damage business written by the Company.

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 year 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 were verified with the line items of the annual statement submitted to the Office.

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

The Company and non-affiliates had the following agreements:

Custodial Agreement

The Company maintained a custodial agreement with the Bank of New York Trust Company. The agreement was in compliance with Rule 69O-143.042(1), FAC.

Independent Auditor Agreement

The Company maintained an agreement with KPMG LLP to perform the annual audit, in compliance with Section 624.424(8), 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."

MERCURY INDEMNITY COMPANY OF AMERICA
Assets

DECEMBER 31, 2004

Classification	Per Company	Examination Adjustments	Per Examination
Bonds	\$26,578,292		\$26,578,292
Cash:			
On deposit	209,926		209,926
Short-term investments	53,320,155		53,320,155
Interest and dividend income due & accrued	169,592		169,592
Reinsurance Recoverable	(16,128,639)		(16,128,639)
Current federal income tax recoverable and interest thereon	2,446,000		2,446,000
Net deferred tax asset	594,178		594,178
Totals	\$67,189,504		\$67,189,504

MERCURY INDEMNITY COMPANY OF AMERICA
Liabilities, Surplus and Other Funds

DECEMBER 31, 2004

Liabilities	Per Company	Examination Adjustments	Per Examination
Losses and loss adjustment expenses	\$0		\$0
Commissions payable & contingent commissions	4,766,300		\$4,766,300
Other expenses	218,773		218,773
Taxes, licenses and fees	2,344,472		2,344,472
Advance premium	10,577,080		10,577,080
Ceded reinsurance premiums payable	22,515,111		22,515,111
Funds held by company under reinsurance treaties	6,318,649		6,318,649
Payable to parent, subsidiaries and affiliates	1,754,519		1,754,519
Payable for securities	<u>4,224,978</u>		<u>4,224,978</u>
Total Liabilities	\$52,719,882		\$52,719,882
Common capital stock	\$1,200,000		\$1,200,000
Gross paid in and contributed surplus	16,300,000		16,300,000
Unassigned funds (surplus)	<u>(3,030,378)</u>		<u>(3,030,378)</u>
Surplus as regards policyholders	<u>\$14,469,622</u>		<u>\$14,469,622</u>
Total liabilities, capital and surplus	<u><u>\$67,189,504</u></u>		<u><u>\$67,189,504</u></u>

MERCURY INDEMNITY COMPANY OF AMERICA
Statement of Income

DECEMBER 31, 2004

Underwriting Income

Premiums earned	\$39,957,349
DEDUCTIONS:	
Losses incurred	21,779,939
Loss expenses incurred	5,587,707
Other underwriting expenses incurred	16,603,475
Aggregate write-ins for underwriting deductions	0
Total underwriting deductions	<u>\$43,971,121</u>
Net underwriting gain or (loss)	(\$4,013,772)

Investment Income

Net investment income earned	\$653,231
Net realized capital gains or (losses)	
Net investment gain or (loss)	<u>\$653,231</u>

Other Income

Net gain or (loss) from agents' or premium balances charged off	(\$6,845)
Finance and service charges not included in premiums	0
Aggregate write-ins for miscellaneous income	0
Total other income	<u>(\$6,845)</u>
Net income before dividends to policyholders and before federal & foreign income taxes	(\$3,367,386)
Dividends to policyholders	0
Net Income, after dividends to policyholders, but before federal & foreign income taxes	(\$3,367,386)
Federal & foreign income taxes	<u>(744,000)</u>
Net Income	(\$2,623,386)

Capital and Surplus Account

Surplus as regards policyholders, December 31 prior year	\$11,857,575
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Gains and (Losses) in Surplus

Net Income	(\$2,623,386)
Change in net deferred income tax	434,377
Change in non-admitted assets	(198,944)
Surplus adjustments: Paid in	5,000,000
Examination Adjustment	0
Change in surplus as regards policyholders for the year	<u>\$2,612,047</u>
Surplus as regards policyholders, December 31 current year	<u><u>\$14,469,622</u></u>

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COMMENTS ON FINANCIAL STATEMENTS

Liabilities

Losses and Loss Adjustment Expenses \$0

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

**MERCURY INDEMNITY COMPANY OF AMERICA
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	\$14,469,622
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	<u>PER COMPANY</u>	<u>PER EXAM</u>	<u>INCREASE (DECREASE) IN SURPLUS</u>
ASSETS:			
No adjustments needed.			
LIABILITIES:			
No adjustments needed.			
Net Change in Surplus:			<u>0</u>
Surplus as Regards Policyholders December 31, 2004, Per Examination			<u><u>\$14,469,622</u></u>

SUMMARY OF FINDINGS

Compliance with previous directives

The Company has taken the necessary actions to comply with the comments made in the 2003 examination report issued by the Office.

Current examination comments and corrective action

There are no items of interest or corrective active to be taken by the Company for the examination as of December 31, 2004.

CONCLUSION

The customary insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Mercury Indemnity Company of America** 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 \$14,469,622, which was in compliance with Section 624.408, FS.

In addition to the undersigned, Michael Hampton, CFE, CPA, DABFA, CFE, CPM, Financial Examiner/Analyst Supervisor, David Schleit, Financial Examiner/Analyst II, Joel Bengo, Financial Examiner/Analyst II, Jay Amber, Financial Examiner/Analyst II and Joe Boor, FCAS, Actuary, participated in the examination.

Respectfully submitted,

Donna Letterio, CFE, CPA, MS
Financial Specialist
Florida Office of Insurance Regulation