REPORT ON EXAMINATION

OF

MERCURY INSURANCE COMPANY OF FLORIDA

CLEARWATER, FLORIDA

AS OF

DECEMBER 31, 2003

BY THE

OFFICE OF INSURANCE REGULATION

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Tallahassee, Florida

November 9, 2004

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, 2003, of the financial condition and corporate affairs of:

MERCURY INSURANCE COMPANY OF FLORIDA
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, 2003 through December 31, 2003. The last examination by representatives of the Florida Office of Insurance Regulation (Office) was performed as of December 31, 2002. This examination commenced, with planning at the Office, on June 1, 2004, to June 4, 2004. The fieldwork commenced on June 7, 2004, and was concluded as of November 9, 2004. 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, 2003. Transactions subsequent to year-end 2003 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:

Consideration of Fraud

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, 2002, along with resulting action taken by the Company in connection therewith.

General

The Company did not disclose all payments to its parent, Mercury General Corporation (MGC), under their tax allocation agreement on Schedule Y, Part 2 of the Annual Statement. **The Company is now reporting such.**

The Company's by-laws incorrectly stated the Company is exempt from keeping their records in Florida in accordance with Section 628.281, FS. **The Company amended the by-laws.**

The Company was unable to provide the original stock ledger book. **The Company stated that since the Company only had one shareholder, and that all the authorized shares have been issued, no formal stock ledger book was created. However, the Company maintained a certificate receipt for each stock certificate issued which indicated the date issued, to whom it was issued, the certificate number, and the number of shares issued.**

The Company did not maintain individual officer and director Conflict of Interest Statements. **The Company provided individual Conflict of interest Statements for the 2003 examination.**

The Company had various findings regarding their IT systems. **The Company stated that an IT plan of action was presented 90 days after the report was issued. The 2003 IT Report had several findings repeated as present year findings.**

Management

The Company did not maintain an audit committee. **The Company now has an audit committee.**

The Company did not have a record of election for Treasurer as required in their By-laws. **The Company elected Theodore Stalick as Treasurer of the Company, by board resolution on September 17, 2003.**

Management Agreements

The Company did not pay estimated and final tax payments on schedule per the terms of their tax allocation agreement with Mercury General Corporation. **The Company has complied with the payment schedule specified in the agreement.**

The Company's reinsurer Mercury Casualty Company (MCC) collected and deposited the Company's premiums into their own account. The reinsurance agreement did not authorize MCC to collect and deposit the Company's premiums. MCC was not handling premiums in a fiduciary capacity. **The Company amended the reinsurance treaty to be in compliance.**

Reinsurance

The Company's Quota Share Reinsurance Contract did not qualify for credit or deduction in liabilities from the Annual Statement, because of the following non-compliance issues: SSAP No. 62, Required Terms for Reinsurance Agreements - Paragraph 8(d): The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis, unless there is no activity during the period, and also Paragraph 10 – Reinsurance Contracts Must Include Transfer of Risk: Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims and claims settlement expenses and (b) the timing of the receipt and payment of those cash flows. The contract does not provide enough information regarding specific cash flows to determine timing risk. **The Company amended their reinsurance agreement.**

Cash

The Company did not maintain their cash balance in a Florida bank. **The Company opened bank accounts in the State of Florida, but still had two accounts in an out of state bank on the 2003 Annual Statement. The account with Farmers State Bank, in Minnesota was closed in 2004. The account with Bank of America, in California paid claims and returned premiums. Outstanding checks remain that have not cleared the account as of the report date. Management stated that as soon as all the checks clear the bank, the account will be closed.**

The Company was unable to provide a cash receipts journal for premium deposits. **The Company performed a daily reconciliation using a system report (daily deposit summary) to the bank statement.**

Other Expenses

The Company did not accrue any general office expenses for 2002. **The Company accrued general office expenses in 2003.**

HISTORY

General

The Company was incorporated in Florida on August 27, 2001 and commenced business on January 2, 2002 as Mercury Insurance Company of Florida.

In accordance with Section 624.401(1), FS, the Company was authorized to transact the following insurance coverage in Florida on December 31, 2003:

Auto Physical Damage	Private Passenger Auto Liability
Commercial Automobile Liability	Commercial Auto Physical Damage

The articles and bylaws were amended during the period covered by this examination in response to a prior examination finding.

Capital Stock

As of December 31, 2003, the Company's capitalization was as follows:

Number of authorized common capital shares	1,200,000
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, MGC, which owned 100 percent of the stock issued by the Company. MGC was a publicly traded insurance holding company domiciled in the State of California.

Profitability of Company

The Company reported for 2003 net underwriting loss as ($18,804), net investment gain as $325,006 and net income after taxes as $195,202.

Dividends to Stockholders

The Company did not declare and pay any dividends to its stockholder in 2003.

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, 2003, were:

Directors

Name and Location	Principal Occupation
Bruce Bunner Fairfield, CT	Director Retired President, FSL Group
Gabriel Tirador Tustin, CA	Director President/COO MGC & Subsidiaries
George Joseph Los Angeles, CA	Director/Chairman CEO MGC & Subsidiaries
Judith Ann Walters Oxnard, CA	Director VP/Corp. Sec. MGC & Subsidiaries
Donald Patrick Newell Rancho Sante Fe, CA	Director Senior VP/The SCPIE Cos.

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

Senior Officers

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

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, 2003:

Audit Committee	**Investment Committee**
Nathan Bessin	George Joseph
Donald Patrick Newell	Gabriel Tirador
Donald R. Spuehler	Chris Graves
	Richard Grayson

Conflict of Interest Procedure

The Company had 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 Executive 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.

Documentation did not exist in the minutes that the Company's directors reviewed the previous examination report.

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

The Company had no acquisitions, mergers, disposals, dissolutions, and purchase or sales through reinsurance.

Surplus Debentures

The Company had no 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 September 8, 2003, 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 various affiliated companies filed a consolidated federal income tax return. On December 31, 2003, the method of allocation between the Company and its parent with respect to the income tax due required the Company to pay the parent estimated payments on or before the tenth day prior to the due date, an amount equal to the estimated tax payment that the Company would have had to pay if it had been filing a separate return. The parent and subsidiaries are members of an affiliated group, within the meaning of Section 1504(a) of the Internal Revenue Code. The parties filed the return on a consolidated basis, as required by Section 1502 of the IRS Code.

Cost Sharing Agreement

The Company maintained a cost sharing agreement as follows: Mercury Insurance Company of Florida (MICFL) and Mercury Indemnity Company of America (MIDAM) agreed to pay a monthly rental fee to MCC for the furniture and equipment subject to this agreement. The amount would be equal to the depreciation expense applied by MCC on the furniture and equipment subject to this agreement multiplied by the percentage that the gross written premium amount that the Company bears to the total gross written premium of both MICFL and MIDAM. Each company shall pay the rent monthly to MCC by the twentieth day of each month.

Management Agreement

The Company had a management agreement with Mercury Insurance Services, LLC (MIS). MIS agreed to manage all of the duties that the Company deemed necessary for the complete operation of the Company. Some of the duties in the agreement included issue and underwrite insurance, settle and adjust any and all losses and claims, prepare records, perform all operating functions, and pay operating expenses, including rent, salaries and phone expense.

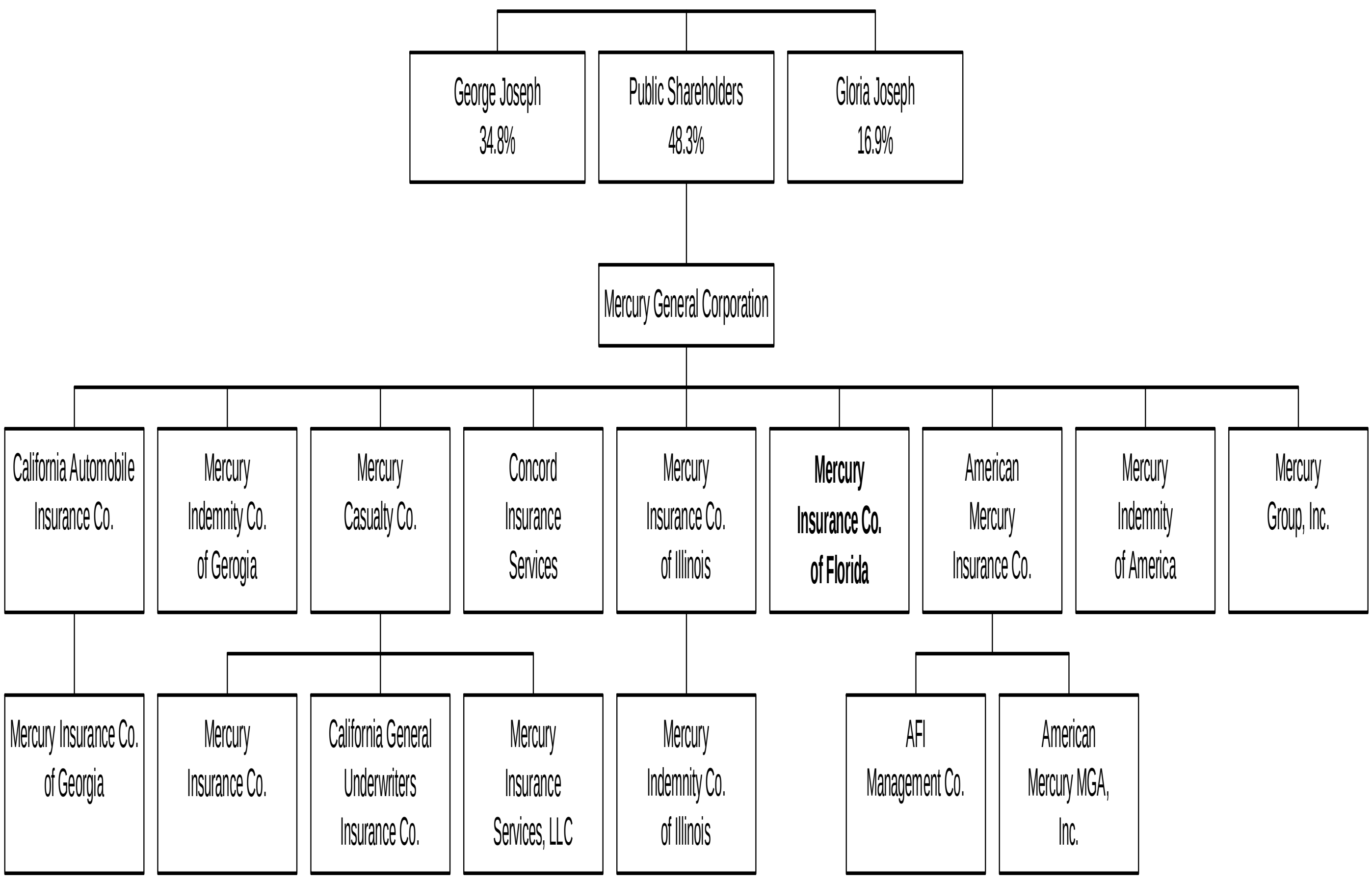
MGA Agreement

The Company maintained 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.

A simplified organizational chart as of December 31, 2003, reflecting the holding company system, is shown below. Schedule Y of the Company's 2003 annual statement provided a list of all related companies of the holding company group.

MERCURY INSURANCE COMPANY OF FLORIDA
ORGANIZATIONAL CHART

DECEMBER 31, 2003



FIDELITY BOND AND OTHER INSURANCE

The Company, along with its parent and a number of affiliates, 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's employees were paid by MIS and reimbursed by the Company. Company management stated that the Company provided no benefits to these employees.

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	USTNTS, 5%, 08/15/11	$ 350,000	$ 357,508
TOTAL FLORIDA DEPOSITS		$ 350,000	$ 357,508
Total Special Deposits		$ 350,000	$ 357,508

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operation

The Company was authorized to transact insurance in Florida, in accordance with Section 624.401(2), FS.

Treatment of Policyholders

The Company 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, and transfer of risk, reporting and settlement information deadlines. The Office Actuary reviewed the contract and concluded that there was transfer of risk.

Assumed

The Company did not assume any business.

Ceded

The Company ceded all risk on a quota share basis to MCC. 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 Company's original reinsurance contract was amended to add additional lines of business including Other Liability, Commercial Auto Liability, Commercial Physical Damage and Commercial Multi-Peril.

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

ACCOUNTS AND RECORDS

An independent CPA audited the Company's statutory basis financial statements for the year 2003, 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 was unable to provide adequate office space for the examiner and examination manager in conducting this examination. Management stated that future examiners would be provided with suitable office space, and the Company intends to lease additional office space in the building.

There were lengthy delays in receiving requested information. Only after communicating with executive management in California by telephone and electronic mail, were information requests for data received at the end of the examination.

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.

MGA Agreement

The Company maintained a MGA agreement with MCC entered into on September 1, 2001.

Independent Auditor Agreement

The Company maintained an agreement with an external CPA 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.

Information Technology (IT)

Dixon Hughes PLLC, performed a computer systems evaluation on the Company. Results of the evaluation were noted in the IT report provided to the Company. A summary of significant findings with recommendations were as follows:

1. No validation of access capabilities were performed. The Company is at risk should an individual employee be transferred from one department to another and continue to maintain access to specific applications that were no longer required for the new job function.

2. Management stated that the business managers were responsible for ensuring that access capabilities of their immediate employees were commensurate with their assigned duties.

However, the Company currently does not have a formalized, documented process for managers to perform this responsibility.

FINANCIAL STATEMENTS PER EXAMINATION

The following pages contain financial statements showing the Company's financial position as of December 31, 2003, 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 INSURANCE COMPANY OF FLORIDA
ASSETS

DECEMBER 31, 2003

Classification	Per Company	Examination Adjustments	Per Examination
Bonds	$11,581,850		$11,581,850
Cash:			
Cash equivalents	5,203,973		5,203,973
Short-term investments	2,980,287		2,980,287
Investment income due and accrued	90,258		90,258
Premiums and considerations:			
Uncollected premiums and agents' balances in the course of collection	2,176,300		2,176,300
Reinsurance recoverable	6,084,715		6,084,715
Receivable from PSA	9,955,171		9,955,171
Totals	$38,072,554	$0	$38,072,554

MERCURY INSURANCE COMPANY OF FLORIDA
Liabilities, Surplus and Other Funds

DECEMBER 31, 2003

Liabilities	Per Company	Examination Adjustments	Per Examination
Losses	$0		$0
Commissions payable, contingent commissions and other similar charges	3,678,511		3,678,511
Other expenses	44,650		44,650
Taxes, licenses and fees	732,683		732,683
Current federal and foreign income taxes	14,000		14,000
Net deferred tax liability	42		42
Advance premiums	663,768		663,768
Ceded reinsurance premiums payable	7,982,406		7,982,406
Funds held by company under reinsurance treaties	2,333,805		2,333,805
Drafts outstanding	474,846		474,846
Payable to parent, subsidiaries and affiliates	2,836,233		2,836,233
Total Liabilities	$18,760,944		$18,760,944
Common capital stock	$1,200,000		$1,200,000
Gross paid in and contributed surplus	17,800,000		17,800,000
Unassigned funds (surplus)	311,610		311,610
Surplus as regards policyholders	$19,311,610		$19,311,610
Total liabilities, capital and surplus	$38,072,554	$0	$38,072,554

MERCURY INSURANCE COMPANY OF FLORIDA
Statement of Income

DECEMBER 31, 2003

Underwriting Income	
Premiums earned	$0
DEDUCTIONS:	
Losses incurred	0
Loss expenses incurred	0
Other underwriting expenses incurred	18,804
Aggregate write-ins for underwriting deductions	0
Total underwriting deductions	$18,804
Net underwriting gain or (loss)	($18,804)
Investment Income	
Net investment income earned	$325,006
Net realized capital gains or (losses)	0
Net investment gain or (loss)	$325,006
Other Income	
Net gain or (loss) from agents' or premium balances charged off	
Finance and service charges not included in premiums	0
Aggregate write-ins for miscellaneous income	
Total other income	$0
Net income before dividends to policyholders and before federal & foreign income taxes	$306,202
Dividends to policyholders	0
Net Income, after dividends to policyholders, but before federal & foreign income taxes	$306,202
Federal & foreign income taxes	111,000
Net Income	$195,202
Capital and Surplus Account	
Surplus as regards policyholders, December 31 prior year	$15,116,450
Gains and (Losses) in Surplus	
Net Income	$195,202
Net unrealized capital gains or losses	0
Change in net deferred income tax	(42)
Surplus adjustments: Paid in	4,000,000
Aggregate write-ins for gains and losses in surplus	0
Examination Adjustment	0
Change in surplus as regards policyholders for the year	$4,195,160
Surplus as regards policyholders, December 31 current year	$19,311,610

COMMENTS ON FINANCIAL STATEMENTS

Assets

Cash $5,203,973

The Company did not maintain all of its assets in Florida. The Company maintained cash in a California bank, Bank of America, in the amount of $183,553 and also in a Minnesota bank, Farmers State Bank, in the amount of $21,001, in violation of Section 628.271(2), FS. No adjustments to cash were made due to materiality. The account in Minnesota was closed in 2004. The account in California will be closed after all outstanding checks have cleared the bank, according to Company management.

Liabilities

Losses and Loss Adjustment Expenses **$0**

The Company ceded 100% of all business written by the Company. There were no net reserves held by the Company.

MERCURY INSURANCE COMPANY OF FLORIDA
Comparative Analysis of Changes in Surplus

DECEMBER 31, 2003

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, 2003, Annual Statement				$19,311,610
	PER COMPANY	PER EXAM	INCREASE (DECREASE) IN SURPLUS	
ASSETS:				
No Adjustments			$0	
LIABILITIES:				
No Adjustments			$0	
Net Change in Surplus:				0
Surplus as Regards Policyholders December 31, 2003, Per Examination				$19,311,610

SUMMARY OF FINDINGS

Compliance with previous directives

The Company has taken the necessary actions to comply with the comments made in the 2002 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, 2003.

The Company had various findings (see the Information Technology caption of this report) noted in the IT Report produced by Dixon Hughes. **It is recommended that the Company present a plan of action to correct the deficiencies in their systems and to provide documentation of compliance to the Office within 90 days after the report is issued.**

Cash

The Company had two bank accounts located out of State. This is in violation of Section 628.271, FS. The Company does not qualify for an exemption under Section 628.281, FS. **It is recommended the Company comply with Section 628.272(2), FS, and maintain its assets in the State of Florida.**

SUBSEQUENT EVENTS

There were no subsequent events to report.

CONCLUSION

The customary insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Mercury Insurance Company of Florida** as of December 31, 2003, consistent with the insurance laws of the State of Florida.

Per examination findings, the Company's surplus as regards policyholders was $19,311,610, which was in compliance with Section 624.408, FS.

In addition to the undersigned, John Berry, Financial Examiner/Analyst Supervisor, and Joe Boor, ACAS, Office Actuary, participated in the examination.

Respectfully submitted,

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