

REPORT ON EXAMINATION
OF
SOUTHERN FIDELITY INSURANCE
COMPANY, INC.
TALLAHASSEE, FLORIDA

AS OF
DECEMBER 31, 2006

BY THE
OFFICE OF INSURANCE REGULATION

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Tallahassee, Florida

March 18, 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:

**SOUTHERN FIDELITY INSURANCE COMPANY, INC.
2255 KILLEARN CENTER BOULEVARD, SUITE 101
TALLAHASSEE, FLORIDA 32309**

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

SCOPE OF EXAMINATION

This examination covered the period of April 7, 2005 through December 31, 2006. This was a first year examination. This examination commenced, with planning at the Office, on May 6, 2007, to May 10, 2007. The fieldwork commenced on October 4, 2007, and was concluded as of March 18, 2008.

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 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 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.

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 CPA, after verifying the statutory requirements, for the following accounts:

- Other invested assets
- Other expenses
- Taxes, licenses and fees
- Funds held by Company under reinsurance treaties

HISTORY

General

The Company was incorporated under Florida law on March 15, 2005 and commenced business on April 7, 2005 as Southern Fidelity Insurance Company, Inc. The Company was a member of a holding company and the ultimate parent was Southern Fidelity Holding, LLC. The Company was licensed to write Fire, Homeowners multi-peril, Farmowners multi-peril and Mobile Home multi-peril lines of business in Florida. It was formed as a take-out company which also sold policies in the voluntary market. The Company received regulatory approval during 2006 to participate in the Insurance Capital Build-Up Incentive Program. Under this program, the Company received \$25 million in a surplus note with the State Board of Administration of Florida and also received matching funds for \$25 million contributed by investors.

The Company was party to the following three consent orders: Consent Order 79986-05-CO filed February 17, 2005, with the Office regarding the application for the issuance of a certificate of authority, Consent Order 81384-05, filed April 28, 2005, with the Office regarding the proposal to remove selected policies from Citizens Property Insurance Corporation, and Consent Order 87386-06, filed September 1, 2006, with the Office regarding the acquisition of more than 5% of the outstanding units of Southern Fidelity Holding LLC, which owned 100% of the Company.

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

Fire
Farmowners Multi peril
Homeowners multi peril
Commercial multi peril
Mobile Home multi peril

The Company had not written insurance coverage in the lines of business of Farmowners Multi-peril, Commercial Multi-Peril or Mobile Home Multi Peril, within a calendar year and was not in compliance with Section 624.430, Florida Statutes.

The articles of incorporation and the bylaws were not amended during the period covered by this examination.

Capital Stock

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

Number of authorized common capital shares	20,000
Number of shares issued and outstanding	16,000
Total common capital stock	\$1,600,000
Par value per share	\$100

Control of the Company was maintained by its parent, Southern Fidelity Holding LLC, who owned 100% of the stock issued by the Company.

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	15,448,241	9,230,119
Net Underwriting Gain/(Loss)	(638,096)	(2,000,418)
Net Income	233,810	(1,735,327)
Total Assets	81,756,315	20,081,858
Total Liabilities	24,959,083	13,858,899
Surplus As Regards Policyholders	56,797,232	6,222,959

Dividends to Stockholders

The Company did not pay stockholders a dividend in 2006.

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	Principal Occupation
Catherine Mashburn Amos Cumming, Georgia	Manager, Mashburn Farms
William Ronald Cox Bainbridge, Georgia	Consultant, Cox Funeral Home
Tracy Allen Dixon Bainbridge, Georgia	Banker, First National Bank of Decatur
John Adams Dowdy, Jr. Bainbridge, Georgia	CPA, Dowdy & Whittaker, CPA
James Anthony Graganella Tallahassee, Florida	President, Southern Fidelity Insurance Company
Charles Howard Keaton Marietta, Georgia	Retired
Keith Edward Martin Tallahassee, Florida	Treasurer, Southern Fidelity Insurance Company
Ralph Powell, Jr. Bainbridge, Georgia	Insurance Executive, Tim Smith & Associates
Henry Coleman Satterfield, III Tallahassee, Florida	Engineer, City of Tallahassee
Timothy Lee Smith Bainbridge, Georgia	Insurance Executive, Tim Smith & Associates
Byron Hamelin Wells Tallahassee, Florida	Insurance Executive, Southern Fidelity Insurance Company
Charles William Whittaker Bainbridge, Georgia	CPA, Dowdy & Whittaker, CPA

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

Senior Officers

Name	Title
James Anthony Graganella	President & CEO
Keith Edward Martin	Secretary & Treasurer

Following are the principal internal board committees and their members as of December 31, 2006:

Audit Committee

John Adams Dowdy, Jr., Chairman
Tracy Allen Dixon
Henry Coleman Satterfield, III

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.

The Company did not provide Conflict of Interest Statements for the year 2006 as required by the NAIC Financial Condition Examiners Handbook, adopted by Rule 69O-138.001, Florida Administrative Code.

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.

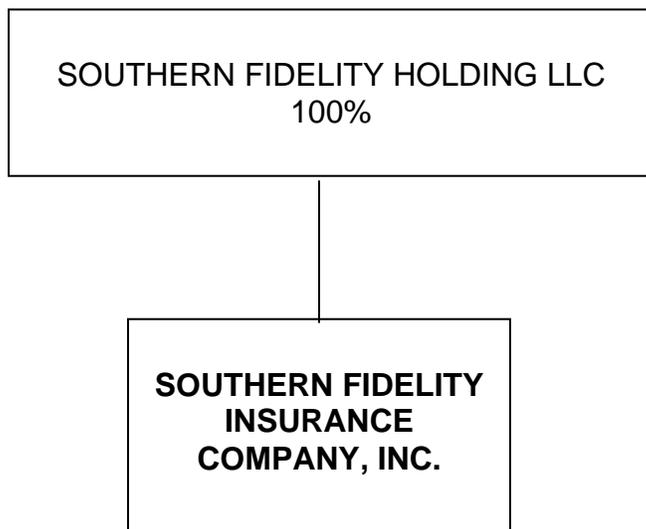
AFFILIATED COMPANIES

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 September 30, 2006, 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.

**SOUTHERN FIDELITY INSURANCE COMPANY, INC.
ORGANIZATIONAL CHART**

DECEMBER 31, 2006



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

Tax Allocation Agreement

The Company, along with its parent, filed a consolidated federal income tax return. On December 31, 2006, the method of allocation between the Company and its parent was based on separate return calculations. Current credit for net losses was provided to the extent that 1) a consolidated liability existed, and 2) the loss of one company was utilized to offset the taxable income of the other company in the consolidated return filing. Any resulting intercompany tax balances were settled in the first quarter of each year.

Managing General Agent Agreement

The managing general agent (MGA) audit report was obtained and no significant findings were noted. The Company had a MGA agreement, in which the MGA provided all marketing for business in Florida.

FIDELITY BOND

The Company maintained fidelity bond coverage up to \$1,000,000 with a deductible of \$150,000, which adequately covered the suggested minimum amount of coverage for the Company as recommended by the NAIC Financial Condition Examiners Handbook.

The Company also maintained Directors and Officers (D&O) and Organization liability insurance coverage with limits of \$2,000,000 in the aggregate and deductible of \$150,000 per claim.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The Company had no pension, stock ownership, or insurance plans as of December 31, 2006.

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 Bank, CD, 4.69%, 3/16/2007	<u>\$ 300,000</u>	<u>\$ 300,000</u>
	TOTAL FLORIDA DEPOSITS	<u>\$ 300,000</u>	<u>\$ 300,000</u>
	TOTAL SPECIAL DEPOSITS	<u>\$ 300,000</u>	<u>\$ 300,000</u>

INSURANCE PRODUCTS

Territory

The Company was authorized to transact insurance in 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.

Assumed

The Company assumed policies from Citizens Property Insurance Corporation as a result of the Company's participation in the Insurance Capital Build-Up Incentive Program by the State Board of Administration of Florida.

Ceded

The Company ceded risk on an excess of loss basis to various authorized and unauthorized reinsurers as listed on Schedule F, Part 3 of the annual statement. The primary authorized reinsurers were QBE Reinsurance Corporation and various Syndicates of Lloyd's. The primary unauthorized reinsurers were Renaissance Reinsurance Ltd., Montpelier Reinsurance Ltd., DaVinci Reinsurance Ltd. and Catlin Insurance Company, Inc. The Company participated in the Florida Hurricane Catastrophe Fund. The reinsurance contracts were reviewed by the Company's appointed actuary and were utilized in determining the ultimate loss opinion. The Company used an intermediary, Benfield, Inc.

ACCOUNTS AND RECORDS

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

An independent CPA audited the Company's statutory basis financial statements annually for the years 2005 and 2006, 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 were verified with the line items of the annual statement submitted to the Office.

The Company and non-affiliates had the following agreements:

Custodial Agreement

The Company had a custodial agreement with SunTrust Bank effective June 27, 2005 which was not authorized by the Board of Directors as required by Rule 69O-143.042(1)(2), Florida Administrative Code. The custodial agreement was amended on November 15, 2007 and it did not contain all of the required provisions of Rule 69O-143.042(2),(d)(e)(h) and (i) Florida Administrative Code as follows:

- (d) Custodied securities shall be held subject to the instructions of the insurance company and shall be withdrawable upon the demand of the insurance company.
- (e) The custodian shall arrange for execution of transactions in custodied securities in accordance with the insurance company's instructions and shall not exercise discretionary authority to effect transactions in custodied securities except in such limited or special circumstances as the insurance company may authorize.
- (h) The custodian and its agents shall be required to send to the insurance company all reports which they receive from a clearing corporation or the Federal Reserve book-entry system.

- (i) The custodian shall maintain records sufficient to determine and verify information relating to custodied securities.

Subsequent event

The custodial agreement was amended on August 10, 2006. However the amendment was not authorized by the President, the Chief Financial Officer, or the Board of Directors of the Company to comply with Rule 69O-143.042,(4)(a), Florida Administrative Code..

Independent Auditor Agreement

The Company had an agreement with Thomas, Howell, Ferguson, PA to perform an audit of its statutory financial statements for the years 2005 and 2006.

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."

SOUTHERN FIDELITY INSURANCE COMPANY, INC.
Assets

DECEMBER 31, 2006

	Per Company	Examination Adjustments	Per Examination
Bonds	\$39,002,523		\$39,002,523
Cash:	40,181,485		40,181,485
Agents' Balances:			
Uncollected premium	285,763		285,763
Deferred premium	287,684		287,684
Reinsurance recoverable	156,315		156,315
Interest and dividend income due & accrued	456,321		456,321
Current federal and foreign income tax recoverable and interest thereon	308,411		308,411
Net deferred tax asset	801,964		801,964
Aggregate write-in for other than invested assets	275,849		275,849
Totals	\$81,756,315	\$0	\$81,756,315

SOUTHERN FIDELITY INSURANCE COMPANY, INC.
Liabilities, Surplus and Other Funds

DECEMBER 31, 2006

	Per Company	Examination Adjustments	Per Examination
Losses	\$3,627,446		\$3,627,446
Loss adjustment expenses	346,773		346,773
Commissions payable	286,298		286,298
Other expenses	42,541		42,541
Taxes, licenses and fees	328,380		328,380
Unearned premium	10,482,102		10,482,102
Advance premium	1,861,658		1,861,658
Ceded reinsurance premiums payable	7,029,563		7,029,563
Funds held under reinsurance treaties	57,427		57,427
Amounts withheld	15,094		15,094
Aggregate write-ins for liabilities	881,801		881,801
Total Liabilities	\$24,959,083	\$0	\$24,959,083
Common capital stock	\$1,600,000		\$1,600,000
Surplus notes	25,000,000		25,000,000
Gross paid in and contributed surplus	30,900,000		30,900,000
Unassigned funds (surplus)	(702,768)		(702,768)
Surplus as regards policyholders	\$56,797,232		56,797,232
Total liabilities, surplus and other funds	\$81,756,315	\$0	\$81,756,315

SOUTHERN FIDELITY INSURANCE COMPANY, INC.
Statement of Income

DECEMBER 31, 2006

Underwriting Income

Premiums earned	\$15,448,241
Deductions:	
Losses incurred	6,809,295
Loss expenses incurred	1,462,613
Other underwriting expenses incurred	7,814,429
Aggregate write-ins for underwriting deductions	0
Total underwriting deductions	<u>\$16,086,337</u>
Net underwriting gain or (loss)	(\$638,096)

Investment Income

Net investment income earned	\$1,298,850
Net realized capital gains or (losses)	0
Net investment gain or (loss)	<u>\$1,298,850</u>

Other Income

Net gain or (loss) from agents' or premium balances charged off	(\$1,475)
Finance and service charges not included in premiums	16,120
Aggregate write-ins for miscellaneous income	0
Total other income	<u>\$14,645</u>
Net income before dividends to policyholders and before federal & foreign income taxes	\$675,399
Dividends to policyholders	0
Net Income, after dividends to policyholders, but before federal & foreign income taxes	<u>\$675,399</u>
Federal & foreign income taxes	<u>441,589</u>
Net Income	\$233,810

Capital and Surplus Account

Surplus as regards policyholders, December 31 prior year	\$6,222,959
Net Income	\$233,810
Net unrealized capital gains or losses	0
Change in non-admitted assets	(3,123)
Change in net deferred income tax	343,586
Change in Surplus Notes	25,000,000
Capital adjustments: Paid-in	100,000
Surplus Adjustments: Paid-in	24,900,000
Examination Adjustment	0
Change in surplus as regards policyholders for the year	<u>\$50,574,273</u>
Surplus as regards policyholders, December 31 current year	<u><u>\$56,797,232</u></u>

COMMENTS ON FINANCIAL STATEMENTS

Liabilities

Losses and Loss Adjustment Expenses	<u>\$3,974,219</u>
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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, make a reasonable provision for all unpaid loss and loss expense obligations of the Company under the terms of its policies and agreements.

Actuarial Review

The Office contracted with an independent actuary Charles C. Emma, FCAS, MAAA, to perform an actuarial review. The independent actuary reported that the recorded reserves of December 31, 2006 made reasonable provisions for the Gross and Net unpaid loss and Loss adjustment expenses.

Capital and Surplus

The amount reported by the Company of \$56,797,232, exceeded the minimum amount of \$4,000,000 required by Section 624.408, Florida Statutes.

A comparative analysis of changes in surplus is shown below.

**SOUTHERN FIDELITY INSURANCE COMPANY, INC.
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	\$56,797,232
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	<u>PER COMPANY</u>	<u>PER EXAM</u>	<u>INCREASE (DECREASE) IN SURPLUS</u>
ASSETS:			
No adjustments			
LIABILITIES:			
No adjustments			
Net Change in Surplus:			0
Surplus as Regards Policyholders December 31, 2006, per Examination			\$56,797,232

SUMMARY OF FINDINGS

Current examination comments and corrective action

The following is a brief summary of items of interest and corrective actions to be taken by the Company with regards to this examination.

Lines of Business

The Company had not written insurance coverage in the lines of business of Farmowners Multi-peril, Commercial Multi-Peril, or Mobile Home Multi Peril, in a calendar year and was not in compliance with Section 624.430, Florida Statutes. **We recommend that the Company submit a request to the Office to have these lines of business removed from their Certificate of Authority to comply with Section 624.430, Florida Statutes.**

Conflict of Interest Procedure

The Company did not provide Conflict of Interest Statements for the year 2006 as required by the NAIC Financial Condition Examiners Handbook, adopted by Rule 69O-138.001, Florida Administrative Code. **We recommend that the Board of Directors have each board member and officer execute a conflict of interest statement annually to comply with the NAIC Financial Condition Examiners Handbook.**

Accounts and Records

The original custodial agreement with SunTrust Bank executed in 2005, was not authorized by the Board.

1. The Custodial Agreement with SunTrust Bank did not include all of the required provisions the of Rule 69O-143.042(2), (d)(e)(h) and (i) Florida Administrative Code. Refer to the Custodial Agreement section of this report for details

On August 10, 2006 the custodial agreement was amended. However, the amendment to the Custodial Agreement was not authorized by the President, the Chief Financial Officer, or the Board of Directors of the Company. **We recommend that the Company comply with Rule 69O-143.042, (4) (a), Florida Administrative Code which requires agreements shall be in writing and shall be authorized by a resolution of the Board of Directors of the insurance Company or of an authorized committee thereof.**

CONCLUSION

The insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Southern Fidelity Insurance Company, Inc.** 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 \$56,797,232, in compliance with Section 624.408, Florida Statutes.

In addition to the undersigned, Michael F. Hampton, CPA, CFE, DAFBA, CFE, CPM, Financial Examiner/Analyst Supervisor, and James Collins, Reinsurance/Financial Specialist, participated in the examination. We also recognize the participation of Charles C. Emma, FCAS, MAAA of Pinnacle Actuarial Resources, Inc.

Respectfully submitted,

Mike Young, Examiner in Charge
Financial Examiner/Analyst II
Florida Office of Insurance Regulation