REPORT ON LIMITED SCOPE EXAMINATION

OF

GUARANTEE INSURANCE COMPANY

FT. LAUDERDALE, FLORIDA

AS OF

DECEMBER 31, 2013

BY THE

FLORIDA OFFICE OF INSURANCE REGULATION

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Tallahassee, Florida

June 16, 2014

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, Rule 69O-138.005, Florida Administrative Code, and in accordance with the practices and procedures promulgated by the National Association of Insurance Commissioners (NAIC), we have conducted a limited scope examination of the segregated account business as of December 31, 2013, of:

GUARANTEE INSURANCE COMPANY
401 E. LAS OLAS BOULEVARD
FT. LAUDERDALE, FLORIDA 33301

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

SCOPE OF EXAMINATION

This was a limited scope examination of Guarantee Insurance Company ("Company") to the extent and in the manner directed by the Florida Office of Insurance Regulation ("Office"). The Company was last examined by representatives of the Office as of December 31, 2010. To the extent applicable, the limited scope examination was conducted in accordance with the guidance of the National Association of Insurance Commissioners ("NAIC") Financial Condition Examiner's Handbook, the NAIC Accounting Practices and Procedures Manual and the Florida Administrative Code. The limited scope examination differed in many respects from that of a full-scope examination or an audit performed in accordance with generally accepted auditing standards.

The fieldwork commenced on July 22, 2013 and concluded as of June 16, 2014. The limited scope examination included material events occurring subsequent to December 31, 2013 and noted during the course of the examination as they related to the foregoing areas within the limited scope of the examination.

This examination covered a review of the segregated account business as of December 31, 2013 and was conducted by Examination Resources, LLC. The following items were reviewed:

1. Accounting of segregated accounts
2. Loss reserving practices
3. Risk transfer of the segregated accounts
4. Affiliation of the segregated accounts to the Company

HISTORY

General

The Company is a stock property and casualty insurance company wholly owned by Patriot National Insurance Group, Inc. (Patriot National), an insurance holding company. When Patriot National purchased the Company in 2003, it had not written any business since 1987. In late 2010, the holding company structure was reorganized, removing Patriot Risk Management, Inc. (Patriot Risk) and its affiliated service companies to a separate organization structure.

The Company was authorized to transact the following insurance coverage in Florida on December 31, 2010 and continued to be authorized as of December 31, 2013:

Workers' Compensation

ACCOUNTING / RISK TRANSFER

We conducted examination procedures to gain an understanding of the segregated account, or captive business and how it is accounted for in the Company's financial statements.

Guarantee had three types of captive cell reinsurance arrangements:

- Investor captives were owned by insurance brokers and/or outside investors and assumed a 90% quota share of business ceded by the Company. The attachment point was equal to the loss fund and the aggregate limit was 15% over the loss fund.
- Risk retention captives were owned by policyholders of the Company and usually entered into 90% quota share arrangements with the Company. The attachment point was equal to the loss fund and the aggregate limit was set based on the loss pick.
- Agency captive ownership was held exclusively by agents of the Company, and the quota share risk was usually only 25%

Captive cell arrangements typically apply to the first $1,000,000 of a claim, with the remaining amount up to $50,000,000 covered by traditional excess of loss reinsurance. The aggregate limit was 20% over loss fund. All of the captives were domiciled in the Cayman Islands and total premium ceded by the Company to the captives was approximately $92,800,000 as of 2012 and $164,300,000 as of 2013.

Before evaluating the financial strength of the captives, it was necessary to gain an understanding of their legal structure and the applicable laws that govern their operations. In Schedule F – Part 3, the Company reports the captives as Segregated Portfolio Companies (SPC). Pursuant to Part XIV of the Companies Law (applicable Cayman Islands law), an SPC is a single legal entity. Once registered with the Cayman Islands Monetary Authority, an SPC can create and operate one or more segregated portfolios (in some jurisdictions described as a "protected cell") with the benefit of statutory segregation of assets and liabilities between portfolios.

A segregated portfolio does not constitute a legal entity separate from the SPC. A segregated portfolio is an internal account of the SPC to which may be attributed assets and liabilities that are legally separated from the assets and liabilities of the SPC ordinary account, called its "general assets" and also separate from assets and liabilities attributed to the SPC other segregated portfolios.

The Company's management indicated that some of the cessions reported in Schedule F – Part 3 are to SPC (which the Company refers to as the "Core") and some are to segregated portfolios. Segregated portfolios can be identified in Schedule F by the notation "SPC." For example, Ancora RE is the Core and Ancora RE SPC 102 is one of its segregated portfolios.

To assess the solvency of the captives, audited financial statements were requested for each SPC and related segregated portfolio reported in Schedule F – Part 3. Some of the audited financial statements were not available; however, for those provided none of the captives reported liquid assets beyond their respective funds withheld or other collateral balances reported in the Company's Schedule F – Part 5. With respect to the financial statements that were not available, the Company has indicated that these captives do not have material assets beyond their respective funds withheld collateral reported in its Schedule F – Part 5.

The captives' inability to settle ceded losses in a timely manner due to a lack of liquid assets are illustrated by negative funds withheld balances reported in the Company's Schedule F – Part 5. The Company has confirmed that negative funds withheld balances occur principally because cumulative ceded losses exceed the cumulative ceded collected premiums (funds withheld). The Company has also confirmed that no ceded loss payments have been made by the captives beyond those settled directly to the applicable captive's funds withheld account.

Collateralization of Reinsured Obligations

Collateral in support of reinsurance credit taken as of December 31, 2012 for cessions to the captives consisted of the following:

1. Funds withheld	$20,599,000
2. LOC	5,040,000
3. Ceded balances payable	28,959,000
4. Misc. balances	
a. Cross-collateralized funds withheld	21,495,451
b. Unearned ceding commission liability	6,794,011
c. Captive bank accounts	1,689,026
Total Reinsurance Collateral	$84,576,488

Funds Held

As provided in the sampled reinsurance contracts, the primary collateral for the reinsured obligations are funds withheld. The total funds withheld for the captives reported in Schedule F were $20,599,000. Included in this aggregate balance are negative balances of $14,200,000. Negative balances accrue when ceded losses exceed ceded premium and therefore represent reinsurance recoverable on paid losses.

Negative balances are reflective of balances due to the Company (reinsurance recoverable) that must be properly reported as such at the financial statement reporting date in order to determine the required provision for reinsurance for each reinsurance counterparty. The negative funds withheld balances of $14,200,000 have been reclassified to reinsurance recoverable to reflect the nature of the balance and to recalculate the provision for reinsurance liability. Additionally a corresponding adjustment in the amount of $14,200,000 has been made to the liability for funds held by company under reinsurance treaties.

Cross Collateralized Funds Withheld

As of December 31, 2012, the miscellaneous balance of $33,708,000 that was reported in Schedule F – Part 5, included $21,495,451 of cross-collateralized funds withheld. These cross collateralization arrangements were instituted for the captives that, according to the Company, wished to reinsure simultaneously both the Company and Ullico Casualty (Ullico) policies administered by Patriot Underwriters.

This collateral was maintained in Patriot Underwriters' account purportedly for the benefit of both the Company and Ullico. As such, this collateral in support of the captives' obligations to the Company was commingled with the collateral supporting obligations to Ullico. Information was not available to determine if the aggregate collateral held pursuant to the cross collateralization agreements is sufficient to support obligations owed by the captives to both the Company and Ullico. It should be noted that Ullico was placed in liquidation by the Delaware Department of Insurance on May 30, 2013.

Section 624.610(4), Florida Statutes, require funds withheld to be subject to withdrawal solely by and under the exclusive control of the ceding insurer. The examiners did not find that the funds held pursuant to the cross collateralization agreements met either of these conditions. As such, these assets should not be allowed as acceptable collateral for the captives' liability to the Company and therefore have been removed from Column 12 of Schedule F – Part 5.

Captive Bank Accounts

As of December 31, 2012, the Company reported $1,689,026 of cash collateral, controlled by various captives and deposited in accounts located in the Cayman Islands, in Column 12 of Schedule F – Part 5. The Company believes the guaranty instruments provided by the captive owners provide sufficiently effective legal means (between U.S. parties and under U.S. law) to allow withdrawal of the funds to their benefit “solely by” their demand. The Company has also indicated that they have requested these captives to move these funds to a bank located in the United States.

Even if the funds are moved to the United States, the necessity to access them through the enforcement of a financial guaranty inherently indicates they are not under the exclusive control of the Company as required by Section 624.610(4), Florida Statutes. As such, the entire balance has been removed from Column 12 in Schedule F – Part 5.

Provision for Reinsurance

As a result of the collateral adjustments described above, the provision for reinsurance liability has been increased by $30,197,000. As a result of the collateral adjustments, Patriot Risk contributed $28,250,000 to the Company in exchange for a surplus note.

Financial Condition of Captive Reinsurers

As discussed above, the examiners determined that the captive reinsurers do not have liquid assets beyond the funds withheld by the Company and have minimal capital (or in some cases no capital) which raises substantial doubt as to whether they can pay losses that exceed their respective funds withheld by the Company. Given the financial condition of the captives, it is evident that the business ceded to the captive reinsurers is predominately supported only by the adequacy of the Company’s gross premium and its own capital. While the examiners concluded that based on customary risk transfer analysis reinsurance accounting is appropriate and funds withheld by Company is acceptable collateral for reinsurance credit, the Company’s surplus is exposed to further deterioration if ceded losses to individual captive reinsurers exceed related funds withheld balances.

LOSS RESERVING PRACTICES

The opining actuary used generally reasonable methods in the actuarial analysis conducted as of December 31, 2012. However, in our opinion, the actuary gave excessive weight in his selection process to methods that did not consider adverse development during the second half of 2012, and did not give sufficient consideration to industry or other indications of potential tail development.

As part of the examination, we reviewed the Company's 2012 Annual Statement. During this review, issues were noted regarding the information displayed in Schedule P:

1. Part 3D showed that cumulative paid net losses and DCC decreased from 2011 to 2012 for several accident years. While it is possible that recoveries could have been received to result in this decrease, we cannot conclude whether this is the case or whether the amounts have been reported in error.

2. Part 5D showed a large increase in closed and reported claims from 2011 to 2012 for several accident years. For some accident years, the claim counts at year-end 2012 are exactly double the counts at year-end 2011. For most other accident years, the claim counts are almost, but not exactly, double. It seems unlikely that claim counts would increase in this manner from one year to the next and we could not determine how this information was developed exactly.

CAYMAN ISLANDS SEGREGATED PORTFOLIO COMPANIES

The Company and Patriot National engage in certain activities on behalf of the captives and the examiners have concluded that they have certain delegated authority from the captives. Such activities and authority are as follows:

- The Company/Patriot National obtains executed Segregated Portfolio Participation Agreements from their clients/insureds on behalf of the Cores.
- Pursuant to the "Agreement for Captive Insurance Program", the insured must execute the Participation Agreement within 90 days. If the insured fails to do so, Patriot National reserves the right to terminate immediately the captive component of the insured's Insurance Program.

- Patriot National establishes and collects the initial Captive Management Fee. Subsequent to the segregated portfolio's formation, the Company collects the Captive Management Fee as part of its ceding commission.
- The Company develops financial projections that are included in the cells' business plans, which are filed with the Cayman Islands Monetary Authority.

SUMMARY OF FINDINGS

During this review, issues were noted regarding the information displayed in Schedule P. **We recommend the opining actuary make selections in future analyses that more reasonably consider industry or other indications of tail development beyond the point where Company data are statistically credible. We also recommend that the actuary produce reserve estimates in the future that are on the same basis as the Company's booked reserves, so that any comparison between such reserves can be more meaningful.**

CONCLUSION

The insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Guarantee Insurance Company** as of December 31, 2013, consistent with the insurance laws of the State of Florida.

In addition to the undersigned, Rachelle Gowins, CFE, MCM, Examiner-In-Charge, Cecilee Diamond-Houdek, CFE, MCM, CPA, AIFA and Don Roof, CFE Participating Examiners, Bryan Fuller, CPCU, ARe, AIE, MCM and Robert Kasinow, CFE, ARe, MCM, Reinsurance Specialists, of Examination Resources, LLC participated in the examination. In addition, Brent Sallay, FCAS, MAAA, Glenn Taylor, ACA, MAAA and Robert Stoddart, ASA, MAAA, consulting actuaries, of Taylor-Walker & Associates, Inc., and Jonathan Frisard, CPA, Financial Examiner/Analyst Supervisor, of the Office also participated in the examination.

Respectfully submitted,

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Robin Brown, CFE
Chief Examiner
Florida Office of Insurance Regulation