

REPORT ON EXAMINATION
OF
HILLCREST INSURANCE COMPANY
GAINESVILLE, FLORIDA

AS OF
DECEMBER 31, 2007

BY THE
OFFICE OF INSURANCE REGULATION

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Tallahassee, Florida

April 20, 2009

Kevin M. McCarty
Commissioner
Office of Insurance Regulation
State of Florida
Tallahassee, Florida 32399-0326

Dear Mr. McCarty:

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, 2007, of the financial condition and corporate affairs of:

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

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

SCOPE OF EXAMINATION

This examination covered the period from January 1, 2007, through December 31, 2007. The Company was last examined by representatives of the Florida Office of Insurance Regulation (Office) as of December 31, 2006. This examination commenced, with planning at the Office, September 8, 2008 to September 12, 2008. The fieldwork commenced on October 6, 2008, and was concluded as of April 20, 2009.

This 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.

The Financial Condition Examiners Handbook requires that the examination be planned and performed to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the Company including corporate governance, identifying and assessing inherent risks within the Company, and evaluating system controls and procedures used to mitigate those risks. An examination also includes assessing the principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation and management's compliance with Statutory Accounting Principles and annual statement instructions when applicable to domestic state regulations.

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, 2007. Transactions subsequent to December 31, 2007 were reviewed where relevant and deemed significant to the Company's financial condition.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process.

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 involved departures from laws, regulations or rules, or which were 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, 2006, along with resulting action taken by the Company in connection therewith.

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, policies, or what their statuses were 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.

It was recommended 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. 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. These findings were addressed in Consent Order 97-323-08-CO, dated October 28, 2008, and have now been rectified by the Company.

Resolution: Hillcrest Insurance Company agreed and entered into a consent order with the Florida Office of Insurance Regulation on October 22, 2008, which stated that they would make corrections to the purge process and that they would maintain evidence of sequential policy numbers.

Information Technology (IT)

There were four recommendations made to the company as a result of the prior examination IT review. These findings were included in a separate report to the Company, and were as follows:

The Company has taken steps to have these issues corrected. The Company did not require business unit management to periodically review and sign-off on end-user's data and application security permissions. It was recommended 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.

It was also recommended 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

Resolution: The Company now performs quarterly user audits and the appropriate officers of the company sign off on their employee's security access.

- 1) 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 IS has yet to be developed.

This was a repeat issue for THIG, Hillcrest's Managing General Agency. It was recommended 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.

Resolution: Hillcrest Insurance Company now has a Board approved IT security policy which is verified as part of the quarterly user audits.

- 2) The IT Specialist made inquiry as to disaster recovery tests performed since the 2004 year-end IT review. It was recommended 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.

Resolution: Annual disaster recovery tests are now carried out prior to Hurricane season. The last one was carried out in May of 2008, and all critical systems were brought online at the Managing General Agent's Kentucky facility.

The Company received the December 31, 2006 examination report in August, 2008 and, accordingly, was unable to implement the recommendations for the year ended December 31, 2007. These findings were also addressed in Consent Order 97-323-08-CO, dated October 28, 2008, and have now been rectified by the Company.

HISTORY

General

The Company was incorporated in Florida on June 23, 2005, and commenced business on August 25, 2005.

The Company was party to Consent Order 81816-05-CO filed June 5, 2005, and Consent Order 82883-05-CO filed August 25, 2005, regarding the application for the issuance of a Certificate of Authority and related matters. The Company complied with all provisions of these consent orders.

The Company was authorized to transact the following insurance coverage in Florida on December 31, 2007:

- Fire
- Allied lines
- Other liability
- Mobile home multi peril
- Mobile home physical damage
- Homeowner's multi peril
- Inland marine

Subsequent event: On July 25, 2008 the Company removed the following lines of business from its Certificate of Authority: Other liability, Mobile home multi peril and Mobile home physical damage.

The Articles of Incorporation and the Bylaws were not amended during the period covered by this examination.

Capital Stock

As of December 31, 2007, 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 company, Hillcrest Holdings, LLC, which owned 100% of the stock issued by the Company. Hillcrest Holdings, LLC in turn was 96.55% owned by the Vernon Smith Family, LLC, a Florida company, and 3.45% by Ernest and Kathy Petrone.

Profitability of Company

The following table shows the profitability trend (in dollars) of the Company for the period of operation, as reported in the filed annual statements.

| | 2007 | 2006 | 2005 |
|----------------------------------|-------------|-------------|-------------|
| Premiums Earned | 13,939,075 | 3,914,421 | 0 |
| Net Underwriting Gain/(Loss) | 341,190 | (2,849,708) | (27,701) |
| Net Income (Loss) | 1,080,150 | (2,298,810) | 61,979 |
| Total Assets | 19,641,418 | 14,138,784 | 7,098,013 |
| Total Liabilities | 11,352,027 | 8,912,084 | 36,034 |
| Surplus As Regards Policyholders | 8,289,391 | 5,226,700 | 7,061,979 |

Dividends to Stockholders

In accordance with Section 628.371, Florida Statutes, the Company did not declare nor pay a dividend to its stockholder in 2007.

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, 2007, were:

Directors

| Name and Location | Principal Occupation |
|---|---|
| Vernon D. Smith Ft. Pierce, Florida | Chief Executive Officer Riverside Bank of Central Florida |
| Ernest A. Petrone Winter Park, Florida | President and Chief Executive Officer Hillcrest Insurance Company |
| Kathy S. Petrone Winter Park, Florida | Chairwoman & Treasurer Hillcrest Insurance Company |
| Karen S. Espling Melbourne, Florida | Secretary Carlton Jewelers |
| Christopher D. Smith Vero Beach, Florida | President Horizon Tree Farms |
| William J. Thompson Tallahassee, Florida | Chief Financial Officer, COO and Secretary 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 and Chief Executive Officer |
| Kathy S. Petrone | Chairwoman and Treasurer |
| William J. Thompson | Chief Financial Officer, COO & Secretary |

The Company's Board appointed several internal committees in accordance with Section 607.0825, Florida Statutes. Following were the principal internal board committees and their members as of December 31, 2007:

Compensation Committee

Vernon Smith¹
Kathy Petrone

Audit Committee

Vernon Smith¹
Christopher Smith
Karen Espling

Investment Committee

Vernon Smith¹
William Thompson
Kathy Petrone
Ernest Petrone

¹ Chairman

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, purchases or sales through reinsurance during 2007.

Surplus Debenture

The Company issued a surplus debenture in the amount of \$2 million on February 2, 2007 to its parent, Hillcrest Holdings, LLC. The debenture beared an interest rate of 11.25%, with interest to be paid quarterly. The payment of interest and the repayment of any principal are dependent upon the prior approval of the Office.

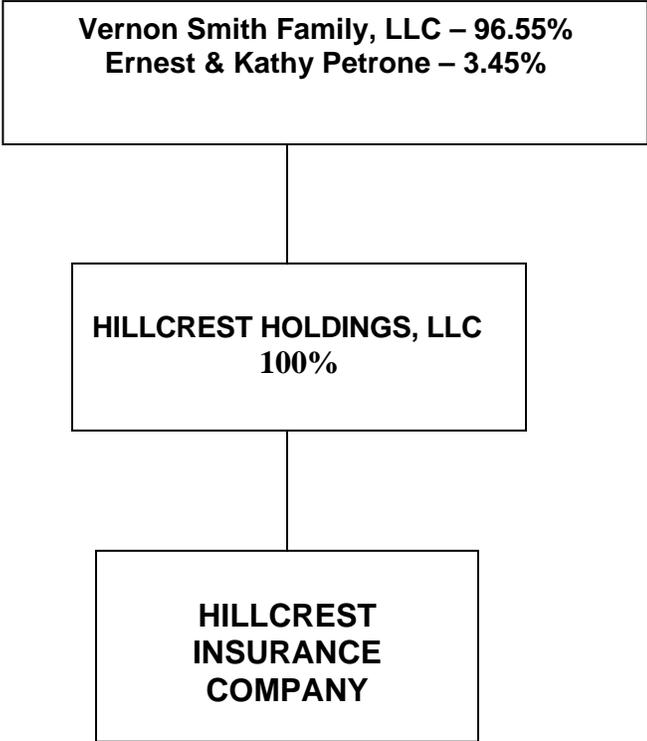
AFFILIATED COMPANIES

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 26, 2008, as required by Section 628.801, Florida Statutes, and Rule 69O-143.046, Florida Administrative Code.

A simplified organizational chart as of December 31, 2007, reflecting the holding company system, is shown below. Schedule Y of the Company's 2007 annual statement provided a list of all related companies of the holding company group.

**HILLCREST INSURANCE COMPANY
ORGANIZATIONAL CHART**

DECEMBER 31, 2007



The following agreement was in effect between the Company and its affiliate:

Management Agreement

The Company entered into a management services agreement with the Company's parent, Hillcrest Holdings, LLC. The agreement provided for the provision of legal, accounting, reinsurance, auditing, administrative, information technology and other such services, as required. The Company made payments to Hillcrest Holdings, LLC under this agreement of 2% of written premiums on new and renewal business, monthly.

FIDELITY BOND AND OTHER INSURANCE

The Company maintained fidelity bond coverage up to \$500,000 with a deductible of \$10,000, in accordance with the suggested minimum amount of coverage recommended by the NAIC Financial Condition Handbook. The Company also maintained general liability coverage to a limit of \$1 million with a \$1,000 deductible and a Directors and Officers (D & O) liability policy with a limit of \$1 million and with a \$25,000 self insured retention.

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>\$ 325,101</u> |
| TOTAL FLORIDA DEPOSITS | | <u>\$ 325,000</u> | <u>\$ 325,101</u> |
| TOTAL SPECIAL DEPOSITS | | <u>\$325,000</u> | <u>\$ 325,101</u> |

INSURANCE PRODUCTS

Territory

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

Treatment of Policyholders

The Company had 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(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 did not assume any reinsurance risks during 2007.

Ceded

The Company ceded risks on an excess of loss basis to various authorized and unauthorized non-affiliated reinsurers. It also ceded a substantial volume of business to the Florida Hurricane Catastrophe Fund. The Company did not cede any risks on a quota share basis during the examination period.

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

An independent CPA audited the Company's statutory basis financial statements annually for the years 2006 and 2007, 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 US Bank. The agreement complied with Rule 69O-143.042, Florida Administrative Code.

General Agency Agreement

The Company had a general agency agreement with Tower Hill Insurance Group, Inc. The agreement provided for the management and direct oversight of the production of business for the underwriting and policy administrative functions. Additionally, the general agent was to facilitate the payment of premiums and provide various other accounting, reporting and administrative functions.

Claims Services Agreement

The Company had a claims services agreement with Tower Hill Claims Services, Inc. The agreement provided for the management, adjustment, payment request and other various claims administrative duties, as required.

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.

Information Technology Report

Brandon Thomas, HISP, MCM of Huff Thomas & Company performed a computer systems evaluation on the Company. Results of the evaluation were in a report provided to the company.

FINANCIAL STATEMENTS PER EXAMINATION

The following pages contain financial statements showing the Company's financial position as of December 31, 2007, and the results of its operations for the year then ended as determined by this examination.

HILLCREST INSURANCE COMPANY
Assets

DECEMBER 31, 2007

| | Per Company | Examination Adjustments | Per Examination |
|--|---------------------|------------------------------------|------------------------|
| Bonds | \$14,628,263 | | \$14,628,263 |
| Cash | 2,020,426 | | 2,020,426 |
| Agents' Balances: | | | |
| Uncollected premium | 1,881,493 | | 1,881,493 |
| Investment income due and accrued | 210,420 | | 210,420 |
| Net deferred tax asset | 472,072 | | 472,072 |
| Aggregate write-in for other than invested assets | <u>428,744</u> | | <u>428,744</u> |
| Totals | <u>\$19,641,418</u> | | <u>\$19,641,418</u> |

HILLCREST INSURANCE COMPANY
Liabilities, Surplus and Other Funds

DECEMBER 31, 2007

| | Per Company | Examination Adjustments | Per Examination |
|--|----------------------------|----------------------------|----------------------------|
| Losses | \$1,922,334 | | \$1,922,334 |
| Loss adjustment expenses | 440,653 | | 440,653 |
| Other expenses | 89,079 | | 89,079 |
| Taxes, licenses and fees | 176,156 | | 176,156 |
| Unearned premiums | 6,446,017 | | 6,446,017 |
| Current federal income taxes | 151,212 | | 151,212 |
| Ceded reinsurance payable | 2,005,324 | | 2,005,324 |
| Proivision for reinsurance | 26,000 | | 26,000 |
| Payable to parent, subsidiaries and affiliates | 26,401 | | 26,401 |
| Aggregate write-ins for liabilities | <u>68,851</u> | | <u>68,851</u> |
| Total Liabilities | <u>11,352,027</u> | | <u>11,352,027</u> |
| | | | |
| Common capital stock | 100,000 | | 100,000 |
| Surplus notes | 2,000,000 | | 2,000,000 |
| Gross paid in and contributed surplus | 6,900,000 | | 6,900,000 |
| Unassigned funds (surplus) | <u>(710,609)</u> | | <u>(710,609)</u> |
| Surplus as regards policyholders | <u>8,289,391</u> | | <u>\$8,289,391</u> |
| Total liabilities, surplus and other funds | <u><u>\$19,641,418</u></u> | | <u><u>\$19,641,418</u></u> |

HILLCREST INSURANCE COMPANY
Statement of Income

DECEMBER 31, 2007

Underwriting Income

| | | |
|--------------------------------------|--------------------|--------------|
| Premiums earned | | \$13,939,075 |
| | Deductions: | |
| Losses incurred | | 4,411,932 |
| Loss expenses incurred | | 490,524 |
| Other underwriting expenses incurred | | 8,695,429 |
| Total underwriting deductions | | 13,597,885 |
| Net underwriting gain | | 341,190 |

Investment Income

| | | |
|------------------------------|--|---------|
| Net investment income earned | | 874,667 |
| Net realized capital gains | | 19,311 |
| Net investment gain | | 893,978 |

| | | |
|--|--|--------------|
| Net Income before federal income taxes | | 1,235,168 |
| Federal income taxes | | (155,018) |
| Net Income | | \$ 1,080,150 |

Capital and Surplus Account

| | | |
|--|--|-------------|
| Surplus as regards policyholders, December 31 prior year | | \$5,226,700 |
| Net Income | | 1,080,150 |
| Change in non-admitted assets | | 267,274 |
| Change in provision for reinsurance | | (26,000) |
| Change in net deferred income tax | | (258,733) |
| Surplus notes paid in | | 2,000,000 |
| Change in surplus as regards policyholders for the year | | 3,062,691 |
| Surplus as regards policyholders, December 31 current year | | \$8,289,391 |

COMMENTS ON FINANCIAL STATEMENTS

Liabilities

Losses and Loss Adjustment Expenses \$2,362,987

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, 2007, made a reasonable provision for all unpaid loss and loss expense obligations of the Company under the terms of its policies and agreements.

The consulting actuary, R. Michael Lamb, FCAS, MAAA of R. Michael Lamb, LLC reviewed work papers provided by the Company and was in concurrence with this opinion.

Capital and Surplus

The surplus amount reported by the Company of \$8,289,391, exceeded 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, 2007

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, 2007, per Annual Statement | \$8,289,391 |
|---|-------------|

| | <u>PER COMPANY</u> | <u>PER EXAM</u> | <u>INCREASE (DECREASE) IN SURPLUS</u> |
|--|------------------------|---------------------|---|
| ASSETS: | | | |
| No adjustments | | | |
| LIABILITIES: | | | |
| No adjustments | | | |
| Net Change in Surplus: | | | - |
| Surplus as Regards Policyholders December 31, 2007, Per Examination | | | \$8,289,391 |

SUMMARY OF FINDINGS

Compliance with previous directives

The Company has taken the necessary actions to comply with the comments made in the 2006 examination report issued by the Office.

Current examination comments and corrective action

There were not any items of interest or corrective actions to be taken by the Company regarding findings in the examination as of December 31, 2007.

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, 2007, consistent with the insurance laws of the State of Florida.

Per examination findings, the Company's Surplus as regards policyholders was \$8,289,391, in compliance with Section 624.408, Florida Statutes.

In addition to the undersigned, Angela Searls, CPA, Insurance Examiner, Huff Thomas & Company, David Schleit, CPA, CFE, Insurance Examiner, Huff Thomas & Company, Brandon Thomas, HISP, MCM, Information Technology Specialist, Huff Thomas & Company, Maurice Fuller, Financial Examiner/Analyst II, Florida Office of Insurance Regulation and R. Michael Lamb, FCAS, MAAA, Actuary, R. Michael Lamb, LLC, participated in the examination.

Respectfully submitted,

Kethessa Carpenter, CPA
Financial Examiner/Analyst Supervisor
Florida Office of Insurance Regulation