

REPORT ON EXAMINATION
OF
STAR & SHIELD INSURANCE
EXCHANGE

TALLAHASSEE, FLORIDA

AS OF
DECEMBER 31, 2011

BY THE
OFFICE OF INSURANCE REGULATION

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July 9, 2012

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, 2011, of the financial condition and corporate affairs of:

**STAR & SHIELD INSURANCE EXCHANGE
3717 APALACHEE PARKWAY, SUITE 201
TALLAHASSEE, FLORIDA 32311**

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

SCOPE OF EXAMINATION

This examination covered the period of January 1, 2011 through December 31, 2011. The Reciprocal was last examined by representatives of the Florida Office of Insurance Regulation (Office) as of December 31, 2010. This examination commenced, with planning at the Office, from April 16, 2012 to April 20, 2012. The fieldwork commenced on April 23, 2012, and was concluded as of July 9, 2012.

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.

The Financial Condition Examiners Handbook requires that the examination be planned and performed to evaluate the financial condition and identify prospective risks of the Reciprocal by obtaining information about the Reciprocal including corporate governance, identifying and assessing inherent risks within the Reciprocal, 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.

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

This report of examination is confined to significant adverse findings, a material change in the financial statements or other information of regulatory significance or requiring regulatory action. The report comments on matters that involved departures from laws, regulations or rules, or which were deemed to require special explanation or description.

SUMMARY OF SIGNIFICANT FINDINGS

Current Exam Findings

The material findings or exceptions noted during the examination as of December 31, 2011 were as follows:

Losses and Loss Adjustment Expenses

The examination actuary estimated net loss and loss adjustment expense reserves totaling \$6,529,052, which are \$392,761 greater than the Reciprocal's booked amount of \$6,136,291. Due to the uncertainty related to the insurance lines of business that the Reciprocal writes and its short time in business which did not facilitate historical loss experience factors, the examination actuary concluded that no adjustments should be made in the examination report financial statements.

Prior Examination Findings

There were no material findings or exceptions noted during the examination as of December 31, 2010.

HISTORY

General

The Reciprocal is a domestic insurance exchange, organized in Florida on April 7, 2009, and commenced business on June 29, 2009, as Star & Shield Insurance Exchange. The Reciprocal is an unincorporated aggregation of subscribers governed by the Subscribers Advisory Committee (SAC), which is similar to a Board of Directors. The Reciprocal was initially capitalized through the issuance of a surplus note totaling \$10 million to Star & Shield Holdings LLC, a Delaware LLC (SSH). On December 21, 2010 the Reciprocal entered into another agreement with SSH whereby, the Reciprocal issued another surplus note in the amount of \$2.5 million. An additional surplus note amounting to \$2.5 million was issued during 2011, bringing the total surplus notes issued to \$15 million.

The Reciprocal was managed by its attorney-in-fact, Star & Shield Risk Management LLC (SSRM), in accordance with Section 629.091, Florida Statutes.

The Reciprocal was party to Consent Order 103560-09-CO filed April 07, 2009, regarding the application for the issuance of a Certificate of Authority. As stated in the previous examination report, the Reciprocal complied with Consent Order 103560-09-CO.

The Reciprocal was authorized to transact the following insurance coverage only in Florida on April 7, 2009 and continues to be authorized as of December 31, 2011.

Homeowners multi-peril

Fire

Private passenger auto physical damage

Private passenger auto liability

The Reciprocal voluntarily stopped writing new business in the homeowners' line of business since mid-2011, but renewed existing policies.

Dividends to Stockholders

The Reciprocal is an unincorporated aggregate of subscribers, and, therefore, has no stockholders.

Capital Stock and Capital Contributions

The Reciprocal is an unincorporated aggregate and therefore, has no capital stock. SSRM is controlled by SSH, which is controlled by Flagstone Reassurance Suisse SA (45.02%) and Aon Benfield Holdings Inc., (45.02%), with the balance of members' interest held owned by eight other individuals (9.96%).

Surplus Debentures

The Reciprocal issued surplus notes on April 15, 2009, in the amount of \$10,000,000 to Star & Shield Holdings (SSH). On December 21, 2010, the Reciprocal issued an additional \$2,500,000 in surplus notes in exchange for cash to SSH. During the examination period, the Reciprocal issued surplus notes on June 2, 2011, in the amount of \$2,500,000 again to SSH. The surplus notes have restrictions which require prior approval from the Office prior to any payment of interest or repayment of principal.

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

The Reciprocal had no acquisitions, mergers, disposals, dissolutions, and purchases or sales through reinsurance during the period of this examination.

CORPORATE RECORDS

The recorded minutes of the SAC, and the Audit Committee were reviewed for the period under examination. The recorded minutes of the SAC and the Audit Committee adequately documented its meetings and approval of Reciprocal transactions and events, in compliance with the NAIC Financial Condition Examiners Handbook adopted by Rule 69O-138.001, Florida Administrative Code, including the authorization of investments as required by Section 625.304, Florida Statutes.

Conflict of Interest

The Reciprocal adopted a policy statement requiring annual disclosure of conflicts of interest in accordance with the NAIC Financial Condition Examiners Handbook adopted by Rule 69O-138.001, Florida Administrative Code.

MANAGEMENT AND CONTROL

Management

The SAC members were appointed in accordance with Sections 629.201, Florida Statutes. SAC members serving as of December 31, 2011 were:

Members

Name and Location	Principal Occupation
Allen Davis Durham Tallahassee, Florida	President and CEO
Wallace Lamar McLendon Tallahassee, Florida	US Marshall, Retired

Donald Francis Eslinger
Lake Mary, Florida

Sherriff, Seminole County

Ronald Rufus Parrish
St. Lucie, Florida

Fire Chief, St. Lucie County

The senior officers of SSRM are as follows:

Senior Officers

Name	Title
Allen Davis Durham	President and Chief Executive Officer
John Edwin Hunt Jr.	Executive Chairman
Jaipersad Heerah	Chief Underwriter

The Reciprocal maintained internal committee functions through the SAC with general responsibilities outlined in the Powers of the SAC. The Reciprocal maintained an Audit Committee, in accordance with Section 624.424(8)(c), Florida Statutes. The audit committee was comprised of the following individuals that were also members of the SAC:

Audit Committee

Wallace Lamar McLendon
Donald Francis Eslinger
Ronald Rufus Parrish

Affiliated Companies

In accordance with Section 629.061, Florida Statutes, the Reciprocal was managed by the Attorney-in-Fact, SSRM, pursuant to the terms of an attorney-in-fact agreement between the Reciprocal and SSRM. SSRM was controlled and managed by SSH. SSH was controlled by Flagstone Reassurance Suisse SA (45.02%), and Aon Benfield Global, Inc., (45.02%), with the

balance of members' interest held by eight other individuals (9.96%). Aon Benfield Global, Inc. is a subsidiary of Aon Corporation and Flagstone Reassurance Suisse SA, owned by Flagstone Reinsurance Holdings Ltd.

The Reciprocal 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 dated February 29, 2012, as required by Section 628.801, Florida Statutes, and Rule 69O-143.046, Florida Administrative Code.

An organizational chart as of December 31, 2011, reflecting the holding company system, is shown below. Schedule Y of the Reciprocal's 2011 annual statement provided a list of all related companies of the holding company group.

**STAR & SHIELD INSURANCE EXCHANGE
ORGANIZATIONAL CHART**

DECEMBER 31, 2011



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

Subscribers Agreement and Power of Attorney

The Reciprocal set the Powers of the SAC in a document dated April 14, 2009, in accordance with Section 629.201, Florida Statutes. Each new subscriber signed a Subscriber's Agreement and Power of Attorney which appointed SSRM as the Attorney-In-Fact, which allowed the AIF to conduct the lawful business of the Reciprocal.

Attorney-In-Fact Agreement

The Reciprocal entered into an Attorney-In-Fact agreement with SSRM on April 15, 2009. The agreement provided that SSRM manage the affairs of the Reciprocal to include administrative services, management of daily operations, provision of all personnel for underwriting, claims, marketing, financial, legal, information technology and senior management.

Managing General Agent Agreement

The Reciprocal had a Managing General Agent agreement (MGA) with Star & Shield Services, LLC (SSS). The agreement was entered into as of April 15, 2009, and is effective for a 5 year period which automatically renews for a successive 5 year period unless cancelled within 90 days prior to renewal by either party. In consideration of Underwriting and Marketing services provided to the Reciprocal, SSS will receive 23% of the Net Written Premiums as defined by the following calculation: net written premium less policy fees, inspection fees, billing fees, catastrophe charges, taxing authority surcharges, guarantee association charges and or non-premium assessments or recoupment. Commissions and fees paid under the agreement in 2011 totaled \$4,772,463.

The General Agent shall be entitled to charge and retain installment fees, as provided by Section 627.901, Florida Statutes, and a per policy MGA fee of \$25.

Service Agreement

The Reciprocal entered into a service agreement with Aon Corporation on April 21, 2009. The agreement is for a 5 year period and includes the following services to be provided by Aon: Corporation Catastrophe Modeling, Actuarial and Risk Analysis, Market Analysis, Portfolio Analysis, Financial Analysis. In exchange for the service noted above, the Reciprocal agreed to compensation of \$400,000 annually, according to the Reciprocal, but Aon Corporation waived all fees due since its inception.

FIDELITY BOND AND OTHER INSURANCE

The Reciprocal maintained fidelity bond coverage up to \$300,000 with a deductible of \$25,000, which adequately covered the suggested minimum as recommended by the NAIC. The Reciprocal was named as insured in a rider in the fidelity bond. The fidelity bond coverage contained the provisions as required by Florida statues and provided comprehensive coverage; including extortion threats to persons and property, computer systems fraud, voice initiated transfer fraud, and telefacsimile initiated transfer fraud.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

The Reciprocal had no employees and therefore had no pension, stock ownership, or insurance plans.

TERRITORY AND PLAN OF OPERATIONS

The Reciprocal was authorized to transact insurance only in the State of Florida at December 31, 2011.

Treatment of Policyholders

The Reciprocal established procedures for handling written complaints in accordance with Section 626.9541(1) (j), Florida Statutes.

RECIPROCAL GROWTH

The Reciprocal experienced net losses since inception of \$1,923,367, \$3,721,552 and \$2,489,304 in 2009, 2010 and 2011, respectively. The losses are primarily due to higher than industry average loss ratios and substantial other underwriting expenses associated with marketing. Since the Reciprocal has been in operations for less than three years, the substantial other underwriting expenses are expected during the growth phase of its operations. The Reciprocal's surplus is supported by contributions in the form of funding from surplus notes issued to SSH. These surplus notes enabled the Reciprocal to fund ongoing operational deficits.

Profitability of Reciprocal

The table on the following page shows the profitability/loss trend of the Reciprocal for the period of examination, as reported in the filed annual statement.

	2011	2010	2009
Premiums Earned	15,739,350	5,565,022	(938,485)
Net Underwriting Gain/(Loss)	(2,680,651)	(3,789,208)	(1,931,262)
Net Income	(2,489,304)	(3,721,552)	(1,923,367)
Total Assets	18,885,624	14,190,942	8,855,128
Total Liabilities	11,698,947	7,099,331	881,820
Surplus As Regards Policyholders	7,186,677	7,091,613	7,973,309

LOSS EXPERIENCE

During the current examination period, the Reciprocal reported adverse development of \$845,000 on the results recorded as of the previous year end 2010. The adverse development is 11.9% of surplus recorded as of December 31, 2010. The ratio of losses and loss adjustment expenses incurred to premiums earned for 2011 was 113.6% and 82.6% for 2010.

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.

REINSURANCE

Assumed

The Reciprocal had no assumed business at December 31, 2011.

Ceded

The Reciprocal ceded risk on a quota share and excess of loss basis to various third party reinsurers. Under quota share agreements the Reciprocal ceded up to 30% of homeowners written premium related to the agreement and losses up to \$2,000,000 per catastrophe occurrence, and the lesser of \$5,000,000 or 150% of the Reciprocal's earned premium less catastrophe costs in the contract year in the aggregate.

Also effective June 1, 2011, the Reciprocal purchased Florida Catastrophe Fund (FHCF) reinsurance and property excess of loss reinsurance for catastrophic events. The Reciprocal purchased a related reinstatement premium protection contract for the excess of loss reinsurance effective June 1, 2011. All reinsurance agreements other than the FHCF are handled through Aon Benfield, the Reciprocal's designated reinsurance intermediary.

The reinsurance contracts were reviewed by the Reciprocal's appointed actuary and were utilized in determining the ultimate loss opinion.

ACCOUNTS AND RECORDS

The Reciprocal maintained its principal operational offices in Tallahassee, Florida.

An independent CPA firm audited the Reciprocal's statutory basis financial statements annually for the years 2009, 2010, and 2011 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 Reciprocal's accounting records were maintained on a computerized system.

The Reciprocal and non-affiliates had the following agreements:

Custodial Agreement

The Reciprocal maintained a custodial agreement with First Tennessee Bank National Association entered into on April 15, 2009. The agreement was in compliance with Rule 69O-143.042, Florida Administrative Code.

Independent Auditor Agreement

The Reciprocal contracted with an independent CPA firm, to perform the annual audit of its financial statements as required by Rule 69O-137.002 (7) (c), Florida Administrative Code.

Claims Servicing Agreement

The Reciprocal entered into a claims servicing agreement with North American Risk Management (NARS) effective March 01, 2009. The agreement is in-force until canceled by either party. NARS is contracted to process claims for the Reciprocal and had contractually set authority limits. This agreement was approved by the Office.

INFORMATION TECHNOLOGY REPORT

Paul Berkebile, CISA, CFSA, CRISC, and Claude B. Granese, CPA, IT specialists, both from INS Services, Inc. performed an evaluation of the information technology and computer systems of the Reciprocal. Results of the evaluation were contained in the Information Technology Report provided to the Reciprocal.

STATUTORY DEPOSITS

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

STATE	Description	Par Value	Market Value
Florida	Cash Deposit	\$300,000	\$300,000
TOTAL FLORIDA DEPOSITS		\$300,000	\$300,000
TOTAL SPECIAL DEPOSITS		<u>\$300,000</u>	<u>\$300,000</u>

FINANCIAL STATEMENTS PER EXAMINATION

The following pages contain financial statements showing the Reciprocal's financial position as of December 31, 2011, 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."

STAR & SHIELD INSURANCE EXCHANGE
Assets

DECEMBER 31, 2011

Classification	Per Company	Examination Adjustments	Per Examination
Bonds	\$ 10,691,035		\$ 10,691,035
Cash and short-term investments	5,151,753		5,151,753
Investment income due & accrued	57,179		57,179
Premiums and considerations:			
Uncollected premiums and agents' balances in course of collection	115,595		115,595
Deferred premiums, agents' balances and installments booked but deferred and not yet due	2,506,346		2,506,346
Net Deferred Tax Asset	363,690		363,690
Receivables from parent, subsidiaries & affiliates	25		25
Totals	<u>\$ 18,885,623</u>	<u>\$ -</u>	<u>\$ 18,885,623</u>

STAR & SHIELD INSURANCE EXCHANGE
Liabilities, Surplus and Other Funds

DECEMBER 31, 2011

Liabilities	Per Company	Examination Adjustments	Per Examination
Losses	\$ 5,478,959		\$ 5,478,959
Loss adjustment expenses	657,332		657,332
Other expenses	29,575		29,575
Taxes, licenses and fees	187,309		187,309
Unearned premiums	4,306,241		4,306,241
Advance premium	31,366		31,366
Ceded reinsurance premiums payable	635,807		635,807
Payable to parent, subsidiaries and affiliates	372,357		372,357
Total liabilities	<u>\$ 11,698,947</u>		<u>\$ 11,698,947</u>
Surplus Notes	15,000,000		15,000,000
Unassigned funds (surplus)	(7,813,323)		(7,813,323)
Surplus as regards policyholders	<u>\$ 7,186,677</u>	<u>\$ -</u>	<u>\$ 7,186,677</u>
Total liabilities, capital and surplus	<u>\$ 18,885,624</u>	<u>\$ -</u>	<u>\$ 18,885,624</u>

STAR & SHIELD INSURANCE EXCHANGE
Statement of Income

DECEMBER 31, 2011

Underwriting Income

Premiums earned	\$ 15,739,350
DEDUCTIONS:	
Losses incurred	11,965,759
Loss adjustment expenses incurred	1,032,432
Other underwriting expenses incurred	5,421,810
Total underwriting deductions	<u>\$ 18,420,000</u>
 Net underwriting gain or (loss)	 \$ (2,680,651)

Investment Income

Net investment income earned	\$ 172,031
Net realized capital gains or (losses)	19,316
Net investment gain or (loss)	<u>\$ 191,347</u>

Other Income

Net gain or (loss) from agents' or premium balances charged off	\$ -
Finance and service charges not included in premiums	-
Aggregate write-ins for miscellaneous income	-
Total other income	<u>\$ -</u>

Net income before dividends to policyholders and before federal & foreign income taxes	\$ (2,489,304)
Dividends to policyholders	<u>0</u>
Net Income, after dividends to policyholders, but before federal & foreign income taxes	\$ (2,489,304)
Federal & foreign income taxes	<u>-</u>
 Net Income	 \$ (2,489,304)

Capital and Surplus Account

Surplus as regards policyholders, December 31 prior year	<u>\$ 7,091,613</u>
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Gains and (Losses) in Surplus

Net Income	\$ (2,489,304)
Net unrealized capital gains or losses	
Change in net deferred income taxes	875,220
Change in non-admitted assets	(790,851)
Change in surplus notes	2,500,000
Change in surplus as regards policyholders for the year	<u>\$ 95,065</u>
 Surplus as regards policyholders, December 31 current year	 <u><u>\$ 7,186,677</u></u>

A comparative analysis of changes in surplus is shown below.

**STAR & SHIELD INSURANCE EXCHANGE
Comparative Analysis of Changes in Surplus**

DECEMBER 31, 2011

Surplus as Regards Policyholders as of December 31, 2011 per Annual Statement				\$ 7,186,677
	Per Company	Per Examination	Increase (Decrease) in Surplus	
Assets				
No Adjustment				
Liabilities				
No adjustment				
Net Change in Surplus				
Surplus as Regards Policyholders as of December 31, 2011 per Examination				\$ 7,186,677

COMMENTS ON FINANCIAL STATEMENTS

Liabilities

Losses and Loss Adjustment Expenses \$6,136,291

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, 2011, make a reasonable provision for all unpaid loss and loss expense obligations of the Reciprocal under the terms of its policies and agreements. INS Consultants, Inc. (INS) was retained by the Florida Office of Insurance Regulation to conduct an independent review of the Reciprocal's loss and loss adjustment expense (LAE) reserves as of December 31, 2011, in conjunction with the financial examination.

The INS actuary reviewed the loss and loss adjustment expense work papers provided by the Reciprocal's outside actuarial firm and was in concurrence with their opinion. INS provided an overall summary of their estimates of net reserves compared to Reciprocal reserves and the resulting differences. INS estimated net loss and loss adjustment expense reserves totaling \$6,529,052, which are \$392,761 higher than the Reciprocal's booked amount of \$6,136,291. Due to the uncertainty related to the insurance lines of business that the Reciprocal writes and its short time in business which does not facilitate historical loss experience factors, the examination actuary concluded that no adjustments should be made in the examination report financial statements.

Capital and Surplus

The amount reported by the Company of \$7,186,677, exceeded the minimum of \$5,000,000 required by Section 624.408, Florida Statutes.

SUMMARY OF RECOMMENDATIONS

Losses and Loss Adjustment Expenses

We recommended the Reciprocal continuously review its loss reserves and analyze its historical data to develop and report its loss and loss adjustment expenses in its statutory financial statements.

CONCLUSION

The insurance examination practices and procedures as promulgated by the NAIC have been followed in ascertaining the financial condition of **Star & Shield Insurance Exchange** as of December 31, 2011, consistent with the insurance laws of the State of Florida.

Per examination findings, the Reciprocal's surplus as regards policyholders was \$7,186,667 which exceeded the minimum of \$5,000,000 required by Section 624.408, Florida Statutes.

In addition to the undersigned, Tracy D. Gates CISA, CPA (North Carolina) Principal Highland Clark, LLC, Hails W. Taylor, CFE, Senior Insurance Examiner, INS Regulatory Insurance Services, Inc., and Maurice Fuller, Office of Insurance Regulation participated in the examination. We also recognize Michael W. Morro , ACAS, MAAA and Robert W. Gardner, FCAS, MAAA, actuaries from INS Consultants, Inc. along with Paul Berkebile, CISA, CFSA, CRISC and Claude B. Granese, CPA, IT specialists from INS Services, Inc. for participation in the examination.

Respectfully submitted,

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