REPORT ON EXAMINATION

OF THE

STARR EXCESS LIABILITY INSURANCE COMPANY LTD

AS OF

DECEMBER 31, 2005

I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of DECEMBER 31, 2005 of the

STARR EXCESS LIABILITY INSURANCE COMPANY, LTD

is a true and correct copy of the document filed with this Department.

ATTEST BY: Antoinette Handy

DATE: 29 JUNE 2007

In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 29TH DAY OF JUNE 2007.

Matthew Denn

Insurance Commissioner

Insurance Commissioner of the State of Delaware

LIBERTY AND INDEPENDENCE

REPORT ON EXAMINATION

OF THE

STARR EXCESS LIABILITY INSURANCE COMPANY, LTD

AS OF

December 31, 2005

The above captioned Report was completed by examiners of the Delaware Insurance Department.

Consideration has duly been given to the comments, conclusions, and recommendations of the examiners regarding the status of the Company as reflected in the Report.

This Report is hereby accepted, adopted, and filed as an official record of this Department.

MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 29TH Day of JUNE 2007.

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SALUTATION

April 11, 2007

Honorable Alfred W. Gross
Chairman, NAIC Financial
Condition Committee
2301 McGee, Suite 800
Kansas City, Missouri 64108-2604

Honorable Matthew Denn
Delaware Department of Insurance
841 Silver Lake Boulevard
Dover, Delaware 19904

Honorable Thomas E. Hampton
Secretary, Northeastern Zone (I), NAIC

Honorable Julie McPeak
Secretary, Southeastern Zone (II), NAIC

Honorable Merle D. Scheiber
Secretary, Midwestern Zone (III), NAIC

Honorable Kent Michie
Secretary, Western Zone (IV), NAIC
Utah Department of Insurance
3110 State Office Building
Salt Lake City. Utah 84114-1201

Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority No. 06.007, dated February 24, 2006, an Association examination has been made of the affairs, financial condition and management of the

STARR EXCESS LIABILITY INSURANCE COMPANY LTD

hereinafter referred to as "Starr Excess", "Company" or "SELIC" and incorporated under the laws of the State of Delaware as a stock company with its home office located at 2711 Centerville Rd, Suite 400, Wilmington, Delaware. The examination was conducted at the main administrative office of the Company, located at 70 Pine Street, New York, NY 10270.

The report of such examination is submitted herewith.

SCOPE OF EXAMINATION

The last examination was conducted as of December 31, 2002. This examination covers the period since that date through December 31, 2005, and consisted of a general review of the Company's business policies and practices, management, any corporate matters incident thereto, a verification and evaluation of assets and a determination of liabilities. Transactions subsequent to the latter date were reviewed where deemed necessary.

The format of this report is designed to explain the procedures employed during the examination and the text will explain changes wherever made. If necessary, comments and recommendations have been made in those areas in need of correction or improvement. In such cases, these matters were thoroughly discussed with responsible officials during the course of the examination.

The general procedures of the examination followed the rules established by the Committee on Financial Condition Examiners Handbook of the National Association of Insurance Commissioners ("NAIC") and generally accepted statutory insurance examination standards consistent with the Insurance Laws and Regulations of the State of Delaware. In accordance with the aforementioned Handbook, the consulting firm of INS Services, Inc performed an information systems review. The 2005 workpapers of the Company's outside audit firm were made available during the examination. These workpapers were extensively reviewed and used wherever possible. In addition, the examiners met regularly with senior managers and supporting staff of the Company's audit firm throughout the planning phase (primarily), and as needed during the field work phase in an effort to best leverage their work, analysis and specific knowledge of critical areas under review.

In addition to items hereinafter incorporated as a part of the written report, the following areas were checked and made part of the work papers of this examination.

Fidelity Bonds and Other Insurance
Statutory Deposits
Employees' Welfare
NAIC Ratios
Legal Actions
All Asset & Liability Items not Mentioned

SELIC operates as a member of American International Group, Inc.'s ("AIG") property and casualty Surplus Lines Pool, a.k.a. the Lexington Pool or Surplus Lines Pool, managed by the Domestic Brokerage Group ("DBG"). Other members of the Surplus Lines Pool are Lexington Insurance Company Ltd ("LIC" or "Lexington"), a Delaware domestic, and Landmark Insurance Company ("LAND" or "Landmark"), a California domestic, both of which were examined concurrently with SELIC.

These concurrent examinations were conducted in accordance with the Association Plan of Examination guidelines established by the NAIC. No other states participated in the examination of SELIC.

In addition to the Surplus Lines Pool examinations and upon consultation with other state insurance regulatory authorities, concurrent and coordinated examinations were also performed on other member insurance companies of AIG's DBG. As a result of these concurrent examinations, participating states wherever possible, collaborated to best coordinate general examination approaches, procedures, staff resources, and shared common results. Other member states participating in the coordinated examination of DBG and non-DBG managed companies were as follows:

Commercial Pool – DBG Managed
National Union Fire Insurance Company of Pittsburgh, Pa (PA)
Birmingham Fire Insurance Company of Pennsylvania (PA) (n/k/a AIG Casualty Company)
The Insurance Company of the State of Pennsylvania (PA)
Granite State Insurance Company (PA)
American International South Insurance Company (PA)
New Hampshire Insurance Company (PA)
American Home Assurance Company (NY)
Commerce and Industry Insurance Company (NY)
AIU Insurance Company (NY)
Illinois National Insurance Co. (IL)

Stand Alone Entities - DBG Managed
American International Specialty Lines Insurance Company (AK)
Audubon Insurance Company (LA)
National Union Fire Insurance Company of Louisiana (LA)

Stand Alone Entities - Non-DBG Managed
AIG Global Trade & Political Risk Insurance Company (NJ)

Refer to the filed examination reports of the participating states for the specific findings and conclusions of their individual legal entity insurance companies. This Report on Examination will address the specific findings and conclusions of SELIC, and by general reference, those of the other Surplus Lines Pool participants, LIC and LAND, the examination reports of which were filed separately.

HISTORY

Starr Excess Liability Insurance Company, Ltd. was incorporated on May 19, 1993 in Bermuda and was a wholly owned subsidiary of Starr Excess Liability Insurance Company Holdings, Ltd. ("SELIC Holdings, Ltd."), also a Bermuda Company. Insurance operations began on June 30, 1993.

The Company was formed to provide large blocks of high-level excess general liability, directors and officers' liability ("D&O") and professional liability ("E&O") capacity to Fortune

1000 and other companies requiring protection against exposures inherent in their business operations. The Company was a joint venture between American International Group ("AIG") and General Re ("Gen Re"), these companies owned 23.9% and 76.1% of SELIC Holdings, Ltd., respectively. On January 29, 1998 AIG purchased the remaining 76.1% of the common stock of SELIC Holdings, Ltd. During 1998, SELIC was re-domiciled from Bermuda to Delaware. Currently the Company is a wholly owned subsidiary of National Union Fire Insurance Company of Pittsburgh, Pa ("NUFIC"), a wholly owned indirect subsidiary of AIG.

In 1998, SELIC established a wholly owned subsidiary, Starr Excess Europe, Limited ("SEE"), in Ireland. During 1998, SEE changed its name to Starr Excess Liability Insurance International Limited ("SELII"); this Company has established a branch London, and a branch in Bermuda.

CAPITALIZATION

Common Capital Stock

The Certificate of Incorporation, as amended, provides that the authorized capital stock of the Company shall be 5,000 shares of $1,000 par value common stock. At December 31, 2005, all shares were issued and outstanding, resulting in total capital stock of $5,000,000.

In 2004, the Company reported a capital contribution of $4,777, which consisted of the unamortized book value of electronic ("EDP") equipment previously under lease by AIG Credit. Although there is no regulation prohibiting the contribution of EDP equipment to a company's surplus, the issue is whether or not a company may take credit for it. In accordance with NAIC *Annual Statement Instructions*, 18 Del.C. §1101(13), 18 Del.C. §526(a), SSAP 4(3)(a), and SSAP 16, the unamortized book value of EDP equipment should be non-admitted for Annual

Statement reporting purposes. Refer to Exception 6/26 in the "Accounts and Records" section of this Report, under the caption "Accounts and Records Findings" for the associated recommendation regarding compliance with NAIC *Annual Statement Instructions* and 18 Del.C. §526(a), which states in part,

> "(a) …The statement filing shall be the annual statement form approved by the National Association of Insurance Commissioners ("NAIC") prepared in accordance with NAIC annual statement requirements and NAIC accounting practices and procedures manual, except, as otherwise prescribed or permitted by this title or by the Commissioner."

Therefore,

> **It is recommended that the Company report EDP equipment in accordance with NAIC *Annual Statement Instructions*, 18 Del.C. §1101(13), SSAP 4(3)(a), and SSAP 16, and non-admit the value of EDP equipment.**
> Exception 1/26

In addition to the above, refer to the "Notes to Financial Statements" section of this Report, under the caption "Gross paid in and contributed surplus" for the associated financial adjustment.

Dividends

The Company paid no stockholder dividends in 2003, 2004 and 2005 to its Parent company.

Reconciliation of Capital and Surplus

The following reconciliation of capital and surplus for the period December 31, 2002 to December 31, 2005, was extracted from the Company's filed Annual Statements and does not reflect examination changes:

Capital and Surplus, December 31, 2002		$472,196,727
Net income	$61,869,969	
Change in net unrealized capital gains or (losses)	7,907,954	
Change in net deferred income tax	16,667,984	
Change in non-admitted assets	(9,025,782)	
Change in provision for reinsurance	325,637	
Aggregate write-ins for gains and losses in surplus		
Federal tax adjustment - prior year	5,288,359	
	$ 83,034,121	
Capital and Surplus, December 31, 2003		$555,230,848
Net income	$14,587,072	
Change in net unrealized capital gains or (losses)	18,244,831	
Change in net deferred income tax	21,950,851	
Change in non-admitted assets	(24,129,251)	
Change in provision for reinsurance	(202,719)	
Surplus adjustment: Paid in	4,777	
Aggregate write-ins for gains and losses in surplus		
Other surplus adjustments	(2,898,127)	
*Correction for error - Restatement	(4,988,348)	
	$22,569,086	
Capital and Surplus, December 31, 2004		$577,799,934
Net income	$80,652,111	
Change in net unrealized capital gains or (losses)	63,041,203	
Change in net deferred income tax	12,585,050	
Change in non-admitted assets	16,458,203	
Change in provision for reinsurance	(15,321,062)	
Aggregate write-ins for gains and losses in surplus		
*Correction for error - Restatement	(21,014,143)	
	$136,401,362	
Capital and Surplus, December 31, 2005		$714,201,296

* As a result of regulatory inquiries into certain transactions, AIG conducted an on-going internal review of its accounting policies, systems, information management and certain transactions from January 2000 to May 2005. Refer to the “Financial Impact Resulting from Remediation” section of this Report for more information related to this matter.

MANAGEMENT AND CONTROL

Stockholders

In accordance with Company bylaws, the annual meeting of the Stockholder shall be held at such time and place as the Board of Directors shall designate. The Board of Directors may, in its sole discretion, determine that the meeting may be held solely by means of remote communication. The Stockholder or Board of Directors may call special meetings for any purpose or purposes when required by the General Corporate Law to do so.

Board of Directors

The Company's amended Certificate of Incorporation provides that all corporate powers of the Company be managed by a Board of Directors. The Company's bylaws stipulate that the Board of Directors shall consist of not less than one (1) member or as may be determined from time to time by action of the stockholders or the Board of Directors. The term of office for all Directors shall be one year. Each Director shall continue to hold office until his term has expired or until his successor has been elected and qualified or until his death or removal or resignation.

At December 31, 2005, the members of the Board of Directors together with their principal business affiliation were as follows:

Name, Residence and Date Elected	Principal Business Affiliation
Kevin H. Kelley (1), Chairman	Senior Vice President, AIG
Merton B. Aidinoff (1)	Retired Partner, Sullivan & Cromwell
Kristian P. Moor (1)	Executive Vice President, AIG
Win J. Neuger (1)	Executive Vice President & CIO, AIG
Ernest T. Patrikis (1)	Senior VP & General Counsel, AIG
Steven J. Bensinger (2)	Executive Vice President & CFO, AIG
Charles H. Dangelo (2)	Vice President, AIG
David L. Herzog (2)	Senior Vice President & Comptroller, AIG
Robert S. Schimek (2)	Senior Vice President & Treasurer, certain AIG subsidiaries including the Company

(1) Elected prior to 2003
(2) First elected in 2005

Committees

In accordance with the Company's bylaws, the Board may designate committees by resolution that set forth the powers and authority of the committee. An Executive Committee of the Board of Directors was designated and was comprised of the following members:

Kevin H. Kelley - Chairman
Steven J. Bensinger
Kristian P. Moor

The bylaws indicate that the Executive Committee will be comprised of the President and such number of other directors, as the Board of Directors deems appropriate. Article IV, Section 1 of the bylaws states that the President may, but need not be a Director. The President of the Company is not a Director, and is not serving on the Executive Committee of the Board, therefore,

It is recommended that the Company comply with its bylaws regarding the role of its President and the Executive Committee.
Exception 2/26

There were no other operating committees appointed by the Board of Directors during the period under review.

Officers

In accordance with the Company's bylaws, the Board of Directors may elect a Chairman of the Board, a President, one or more Vice Presidents, one or more Assistant Vice Presidents, a Secretary, one or more Assistant Secretaries, a Treasurer, one or more Assistant Treasurers, and any other such officers as the Board deems necessary. Only the Chairman is required to be a Director. At December 31, 2005, the Company's principal officers and their respective titles were as follows:

Officer:	Title:
Kevin H. Kelley	Chairman of the Board
Geoffrey J Smith	President
Elizabeth M. Tuck	Secretary
Timothy McAuliffe	Chief Operating Officer, Executive Vice President
Kenneth Gregnoli	Executive Vice President
William Hopkins	Executive Vice President
Robert S. Schimek	Senior Vice President, Treasurer
Kenneth V. Harkins	Senior Vice President, General Counsel
Frank H. Douglas, Jr.	Senior Vice President, Actuary
Andrew P. Archambault	Senior Vice President
Diana J. Cossetti	Senior Vice President
Charles H. Dangelo	Senior Vice President
Neil A. Faulkner	Senior Vice President
Richard T. Pisano	Vice President, Comptroller - DBG
Carl E Chamberlain	Vice President
Agustin Formoso Jr.	Vice President
James J. Rowland	Vice President
Richard Ruggiano	Vice President

In addition to the above officers, additional vice presidents, assistant vice presidents and other assistant officers were also appointed.

Numerous changes in directors and officers occurred during the period under review. As required, proper notification was provided to the Delaware Department of Insurance.

Conflicts of Interest

AIG maintains both a formal written conflict of interest policy and questionnaire, which company officers, directors, and key employees of AIG and its subsidiaries must fill out on an annual basis. Where possible conflicts are disclosed, Company officials scrutinize them further to determine if corrective action is necessary. Conflict of interest questionnaires are not required for principles of managing general underwriters, third party administrators or independently contracted consultants.

Although our review of the conflict of interest questionnaires completed during the examination disclosed no conflicts of interest that appeared to adversely affect the Company, the Company failed to obtain and maintain on-site Conflict of Interest Statements for some officers and directors. Therefore, as also noted in the prior examination,

It is recommended that the Company ensure that procedures requiring the execution of conflict of interest statements for Officers, Directors and key employees be updated yearly in accordance with AIG's Code of Conduct and AIG's Code of Conduct Re-Certification and Questionnaire.

Furthermore,

It is recommended that the Company maintain copies of all completed conflict of interest questionnaires on-site and available for future examination in accordance with NAIC *Annual Statement Instructions* and 18 Del.C. §526(a).
Exception 3/26

Certificate of Incorporation and Bylaws

By resolution of the Board of Directors dated March 15, 2004, the Certificate of Incorporation and bylaws were restated in their entirety. The restated Certificate of Incorporation was filed with the Secretary of State on July 15, 2004 as required, and the restated Certificate and bylaws were provided to the Department of Insurance.

HOLDING COMPANY SYSTEM

The Company is a member of an Insurance Holding Company System. The immediate parent of the Company at December 31, 2005 was National Union Fire Insurance Company of Pittsburgh, Pa (PA), a wholly owned indirect subsidiary of AIG. The Company has one insurance subsidiary, Starr Excess Liability Insurance International Limited (Ireland), of which it had a 100% ownership interest as of December 31, 2005.

The following presentation of the holding company system reflects only the identities and interrelationships between the Company and its parent, affiliates and subsidiary as of December 31, 2005:

Company	Domicile	% own
American International Group, Inc.	Delaware	
National Union Fire Insurance Company of Pittsburgh, Pa	Pennsylvania	100%
Starr Excess Liability Insurance Company Ltd.	Delaware	100%
Starr Excess Liability Insurance International Limited	Ireland	100%
Lexington Insurance Company	Delaware	70%
Japan International Accident & Fire Insurance Company, Ltd.	Japan	50%
AIG Centennial Insurance Company	Pennsylvania	100%
AIG Auto Insurance Company of New Jersey	New Jersey	100%
AIG Preferred Insurance Company	Pennsylvania	100%
AIG Premier Insurance Company	Pennsylvania	100%
AIG Indemnity Insurance Company	Pennsylvania	100%
The Insurance Company of the State of Pennsylvania	Pennsylvania	100%
Lexington Insurance Company	Delaware	20%
Birmingham Fire Insurance Company of Pennsylvania	Pennsylvania	100%
Lexington Insurance Company	Delaware	10%
Landmark Insurance Company	California	100%

AIG, a Delaware corporation, is a holding company which, through its subsidiaries, is engaged in a broad range of insurance and insurance-related activities in the United States and abroad. AIG's primary activities include both General Insurance and Life Insurance & Retirement Services. Other significant activities include Financial Services and Asset Management. As of December 31, 2005, AIG possessed assets totaling $853 billion, shareholder equity of $86.3 billion, and earned net income of $10.5 billion on total reported revenues of $109 billion.

A review of the Annual *Form B* and *Form C* filings made by American International Group, Inc. on behalf of the Company for all years under examination revealed that the Company had complied with the requirements of Delaware Regulation 13.

TERRITORY AND PLAN OF OPERATION

Territory

As of December 31, 2005, the company was licensed to transact multiple lines of insurance business in the State of Delaware. In addition, the Company is an authorized surplus lines carrier in thirty-seven other jurisdictions, including those outside of the U.S. The Company's principal business is writing high excess cat liability coverage. Additionally, business is derived from its participation in an intercompany pooling agreement with two affiliates, LIC and LAND, effective 12/31/98. Refer to "Intercompany Agreements" section of this Report, under the caption "Intercompany Pooling Agreement" for details regarding this pooling agreement. During 2005, under an 85% quota share agreement with its affiliate, Starr Excess Liability Insurance International Limited, the Company assumed $382,227,000 of business principally related to its own direct business. Refer to the "Reinsurance" section of this Report, under the caption "Intercompany Pooling Agreement between LIC, SELIC and LAND" for details regarding this agreement.

Plan of Operation

For the year ending December 31, 2005, approximately sixty percent (59.8%) or $86,037,501 of the Company's direct premium was written in five states: California, 19.2%; New York, 13.4%; New Jersey, 9.8%; Illinois, 8.9%; Texas, 8.5% Direct written premiums of the Company's thirty-three (33) other jurisdictions amounted to approximately 40.2% or

$57,986,303. Refer to the "Accounts and Records" section of this Report, under the caption "Miscoded Direct Written Premiums" for comments regarding exceptions identified in the Company's recording / reporting of direct written premiums.

Starr Excess has maintained its niche as a high-level catastrophic insurer within AIG, primarily in casualty and financial lines. It continues to focus on its core general liability, D&O and E&O product lines. There currently are several initiatives being reviewed that may impact the Company's minimum attachment points and maximum limits for certain lines of business as it is constantly developing new products to satisfy its clients' needs. For example, since the AIG purchase (January 29, 1998), Starr Excess now offers excess liability coverage on a "follow form" basis, whereby the Company's form simply incorporates the terms and conditions of a followed carrier. It also offers an omnibus excess policy, which affords excess umbrella coverage in a single policy, which supplements multiple product lines, such as general liability, D&O and E&O and employment practices liability ("EPL"). Target clients once again principally come from the Fortune 1000 companies, and generally from the industry groups, such as Basic Materials (i.e., chemicals), Energy, Industrials, Technology, Health Care, Transportation, Utilities and Financial Services.

Underwriting is done in the Company's Bermuda branch, and at Starr Excess's office, located in New York, New York.

Business is produced for Starr Excess and its subsidiary, Starr Excess Liability Insurance International Limited, exclusively by brokers, with the world's two largest -- Marsh and AON -- serving as the Company's two largest producers. Since Starr Excess was a Bermuda carrier for most of its existence, the list of brokers who have provided business in the past is small, and essentially include Marsh and AON's Bermuda affiliates, as well as other "large" international brokers (i.e., Sedgwick, Willis Corroon) from Bermuda and elsewhere.

The third party liability coverage provided by Starr Excess applies excess of significant amounts of underlying insurance or specified retentions. For excess general liability, the Company provides limits up to $150 million on a specialized policy known as an "occurrence first reported" form which covers occurrences or claims reported during the policy period, as well as on a follow form (both claims made and occurrence) basis. Minimum attachment points for excess liability coverage start at $25 million for certain classes of business, although the average attachment point for excess liability coverage is just under $200 million. For D&O and E&O, the maximum limit available is $50 million excess of minimum attachment points of $25 million. The average D&O attachment point is approximately $100 million; the average E&O attachment point is approximately $75 million. All D&O and E&O business is written on a claims-made-basis, with policies that follow the terms and conditions of the primary insurer. Since May 1997 Starr Excess has also offered EPL coverage for select classes of business. It offers up to $50 million in capacity excess of a minimum attachment point of $25 million.

<u>Best's Rating</u>

Based on A.M. Best's current opinion of the consolidated financial condition and operating performance of AIG's Surplus Lines Pool, the three pool members were assigned a Best's rating of A+ (Superior) for the year ending 2005.

GROWTH OF THE COMPANY

The following information was extracted from copies of the Company's filed Annual Statements, for each year indicated, and covers the period from the Company's last examination.

Year	Net Admitted Assets	Surplus as Regards to Policyholders	Change in Capital and Surplus	Direct Written Premiums	Premiums	Net Earned Net Income
2005	$2,520,331,288	$714,201,296	23.61%	$144,023,804	$719,928,315	$80,652,111
2004	2,185,663,208	577,799,934	4.06%	120,321,856	670,069,957	14,587,072
2003	1,690,525,175	555,230,848	17.58%	105,102,465	536,635,304	61,869,969
2002	1,436,289,284	472,196,727	14.44%	68,501,045	316,705,108	28,095,387

From its last examination, the Company has nearly doubled in total asset size, principally due to favorable insurance market conditions, leading to advantageous pricing as well as its on-going success in loss control.

As an authorized surplus lines carrier, the Company provides excess and hard to place forms of coverage. The top lines of direct premium written are in the lines of Other Liability-Occurrence, Other Liability-Claims Made, Products Liability-Occurrence and Products Liability-Claims Made. During 2005, Gross Written Premium (GWP), increased slightly by $15.8 million (or 1 .0%) while Net Written Premium (NWP) and Net Earned Premiums (NEP) increased from their 2004 levels by $59.8 million or 8.3% and $49.9 million or 7.4%, respectively. Increase in NWP was largely due to the increase in Company's net retention level and cancellation of its stop-loss treaty. Increase in NEP was driven by the increase in NWP.

During 2005 incurred losses and Loss Adjustment Expense increased by $14.8 million (or 2.6%), while NEP increased by 7.4%. This resulted in a decline to the Company's loss and LAE ratio from 86.7% in 2004 to 82.7% in 2005. The decline in the loss ratio was principally due to the $18.6 million in favorable loss development experienced on prior accident year coverage. The Company's loss ratio includes a charge of $171.0 million for losses associated with Hurricanes Katrina, Rita, and Wilma.

As previously noted, the Company is a member of an intercompany pooling agreement comprised of the Company, LIC and LAND. The Companies cede all direct and assumed business to the lead pool participant, LIC. In turn, the pool participants receive their percentage share of pooled business as follows: Lexington - 80%, Starr Excess - 18%, and Landmark - 2%. Refer to the "Intercompany Agreements" section of this Report, under the caption "Intercompany Pooling Agreement" for details regarding the pooling agreement.

REINSURANCE

The Company had the following reinsurance programs and agreements in effect as of December 31, 2005:

General

The Company assumes all authorized lines of business from affiliates and non-affiliates on a treaty and facultative basis. The largest net aggregate amount insured under any one risk (excluding workers compensation) is limited to $10,987,200. For 2005, the Company reported the following distribution of net premiums written:

Direct Business	$ 144,023,804
Reinsurance Assumed From Affiliates	1,505,446,812
Reinsurance Assumed From Non-Affiliates	2,464,885
Total Direct and Assumed	$1,651,935,501
Reinsurance Ceded to Affiliates	$701,519,490
Reinsurance Ceded to Non-Affiliates	168,027,802
Total Ceded	$869,547,282
Net Premiums Written	$ 782,388,209
Percentage Ceded of Gross	52.64%

Assumed

The Company reported 99.9% of assumed affiliated business of $1,505,446,812 in the following categories:

Intercompany pooling	$1,122,856,000
Starr Excess Liability International	382,227,000
Total	$1,505,083,000

The majority of the Company's non- affiliated assumed business is on a facultative basis.

In 1998, the Company joined with Lexington and Landmark to form a pool (Surplus Lines Pool or Lexington Pool). Lexington assumes 100% of all business written by the Company and Landmark. Lexington retains 80% of the pool and cedes out 18% of pooled business to Starr Excess, and 2% of the pooled business to Landmark. Refer to the "Intercompany Agreement" section of this Report, under the caption "Intercompany Pooling Agreement" for additional details regarding intercompany pooling.

The Company is a member of an AIG internal facility known as the Compulsory Cessions Auxiliary Account ("CCAA"). The CCAA account allows AIG to retain business by ceding selected treaties to affiliated companies. The facility retains additional amounts over the retentions determined by the profit center managers.

For certain new and renewal business, various member companies of AIG cede business to the CCAA program. Some of the business ceded to the CCAA is between different divisions of companies within the same Intercompany Pool. For example, any business written on the paper of members of the Lexington Pool stays within that pool without cession to American Home, which is a member of the Commercial Pool. American Home or Lexington (on behalf of their respective pools) retains 100% of the CCAA's participation.

Prior to the CCAA facility there was the Compulsory Cessions Account ("CCA") facility that performed in the same manner as the CCAA facility. However, with the CCA facility

Lexington, on behalf of the surplus lines pool, would retain 92% of the CCA participation with the 8% balance being retro ceded to Transatlantic Reinsurance Company, which was not for all underwriting years. As of November 30, 2005, the CCA facility was placed in run-off.

The Company is a member of an AIG internal facility known as the Compulsory Cessions Auxiliary Account (CCAA). The CCAA account allows AIG to retain business by ceding selected treaties to affiliated companies. The facility retains additional amounts over the retentions determined by the profit center managers.

For certain new and renewal business, various member companies of AIG, including AIG Europe, AIRCO, AISLIC, AIU, AIUO, ALICO, American Home, Commerce & Industry, Commerce & Industry of Canada, HSBIIC, Illinois National, ISOP, Landmark, Lexington, New Hampshire Insurance, NUFIC, NUFLA, PhilamLife and Starr Excess, cede business to the "CCAA" program. Some of the business ceded to the CCAA is between different divisions of companies within the same intercompany pool. For example, any business written on the paper of members of the Lexington Pool stays within that pool without cession to the American Home Pool. American Home or Lexington (on behalf of the respective pools) retains 100% of the CCAA's participation.

<u>Ceded:</u>

The Company's reinsurance is coordinated and controlled by AIG Global Reinsurance Division. The Company's management located in Boston is responsible for selection of the working and excess treaty reinsurance coverages. When purchased, facultative reinsurance is placed on an individual basis by the applicable underwriter. AIG Global Reinsurance Division ("Reinsurance Services"), in New York, is responsible for placing Catastrophe reinsurance. All reinsurance contracts are centrally filed and maintained electronically by Reinsurance Services. This system is used by the accounting department for the account rendering.

Significant Reinsurance Program details

The following reinsurance programs are presented on a 100% pooling basis. The Company's share is based on its 18% participation percentage as discussed in the "Intercompany Agreement" section of this Report, under the caption "Intercompany Pooling Agreement."

The Company has extensive property reinsurance which is placed through domestic and foreign reinsurers. The program consists of working and excess layers that cover all property business. In addition, Lexington is a named participant (with other AIG domestic insurance subsidiaries) under AIG's "external" property catastrophe program. This excess protection covers all AIG property exposures. The summary details of this program are highlighted below.

Property

Major Working Reinsurance Layers
AIG property quota share coverage, Limit of $10 million, 11.80% of the coverage placed
Property per risk excess of loss coverage, $15 million excess of $10 million
30% Personal lines homeowners property quota share coverage, Limit of $5 million
70% Personal lines umbrella quota share coverage, Limit of $5 million

Property Catastrophe Reinsurance
1st layer property catastrophe coverage, 100% of $150 million in excess of $250 million
2nd layer property catastrophe coverage, 100% of $150 million in excess of $400 million
3rd layer property catastrophe coverage, 100% of $150 million in excess of $550 million
4th layer property catastrophe coverage, 100% of $200 million in excess of $700 million
5th layer property catastrophe coverage, 100% of $250 million in excess of $900 million

Domestic Personal Lines Property
1st layer catastrophe coverage, 100% of $35 million in excess of $25 million
2nd layer catastrophe coverage, 100% of $80 million in excess of $60 million
3rd layer catastrophe coverage, 100% of $100 million in excess of $140 million

Starr Excess- Casualty

Starr Excess participates on a 70% quota share treaty with a limit of $150 million. Additionally, the net is protected by an excess of loss treaty of $55 million in excess of $50 million.

Casualty

Primary Casualty Non-Professional (claims-made basis and claims-incurred basis) coverage, 11% quota share, maximum net $890,000, maximum ceded $110,000.

Employment Practices Liability (claims-made basis and claims-incurred basis) coverage, 40% quota share, maximum net $18,000,000, maximum ceded $10,000,000.

It should be noted that the previously placed (2004 and prior) Corporate Casualty, Casualty Aggregate Stop Loss, and Supplemental Aggregate Stop Loss Agreements, as maintained by AIG, were not renewed for 2005.

<u>Risk Transfer</u>

Treaty placement is in accordance with the AIG Risk Transfer Policy that was adopted October 1, 2005. All assumed and ceded treaties and autofac and obligatory facultative arrangements (excluding captives) must be evaluated by reinsurance services personnel. In the case of a captive, the risk transfer assessment is conducted at the business unit level. If the treaty/certificate contains one or more characteristics or contractual features that are intended to mitigate risk transfer, they are identified on a risk transfer worksheet. The Reinsurance Officer and the Business Unit CFO, or his/her designee must assist in the determination of whether or not an actuarial analysis is required and whether or not there is sufficient risk transfer to allow for reinsurance accounting treatment. Evidence of this analysis and approval by a Reinsurance Officer and the Business Unit CFO, or his/her designee is required. In accordance with SFAS

No. 113 (paragraph 11), a risk transfer analysis is not required if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. If none of the potential loss mitigating features summarized in the risk transfer worksheet is present, risk transfer is deemed to be self evident and the reinsurance transaction qualifies for reinsurance accounting treatment.

When a risk transfer worksheet is required, it must be included in the treaty/certificate file no later than when the treaty/certificate is bound and be available on request. The documentation of the risk transfer worksheet will vary based on circumstances, but the general requirements are outlined in the risk transfer worksheet. The documentation must state the conclusion and the basis thereof, and be sufficient to support the conclusion.

Refer to the “Accounts and Records” section of this Report, under the caption “Reinsurance” for comments and recommendations related to the review of the Company’s reinsurance program. Refer to the “Notes to Financial Statements” section of this Report, under the caption “Provision for Reinsurance” for information regarding certain credits for unauthorized reinsurers. Refer to the “Subsequent Events” section of this Report, under the caption “Reinsurance” for details regarding significant reinsurance transactions subsequent to December 31, 2005.

INTERCOMPANY AGREEMENTS

The Company had the following intercompany agreements and arrangements in effect as of December 31, 2005:

(AIG) Service & Expense Agreement (with amendments)

Effective February 1, 1974, amended December 30, 1998 to include Lexington Insurance Company and Landmark Insurance Company, and subsequently amended January 1, 2002 to include Starr Excess Liability Insurance Company, the companies entered into a Service and Expense Agreement with AIG. AIG has agreed to provide, at cost, services and facilities as required. Services include Law, Investment, EDP, Internal Audit, Actuarial, Claims, Underwriting, Accounting, Tax, and Employee Benefits.

Investment Advisory Agreement between SELIC and AIG Global Investment Corp.

Effective July 29, 1998, the Company retained an affiliate, AIG Global Investment, Corp. ("Manager") to provide investment advisory and investment management services with respect to its portfolio and the assets contained therein. The agreement authorizes the Manager to supervise and direct all investments and to exercise whatever powers the Company may possess with respect to its invested assets. Investment transactions will be in accordance with investment objectives of the Company and subject to restrictions established by the Company in its investment management guidelines provided to the Manager. In accordance with the guidelines, the Manager may buy, sell, exchange, convert and otherwise trade in and engage in investment transactions of any nature whatsoever involving any stocks, bonds, commercial paper, money market instruments and other securities and assets when deemed appropriate and without prior consultation with the Company. Investment management fees are billed quarterly in advance, but payable in arrears 10 days after the end of each billing period, based on a rate of 0.04% of the total assets under management at the end of each calendar quarter. Total investment expenses incurred for 2005 amounted to $855,352.

Tax Allocation Agreement between SELIC and AIG

Effective January 1, 1998, the Company entered into a tax alloaction agreement with AIG. The Company files a consolidated federal income tax return with AIG. The Company's tax liability is calculated based upon its respective share of consolidated taxable income. The agreement further provides that the Company shall receive reimbursement to the extent that its losses and other credits result in a reduction of the current year's consolidated tax liability, not to exceed its liability as if filed on an individual basis.

Intercompany Pooling Agreement between LIC, SELIC and LAND

Effective December 31, 1998, the Company entered into a pooling agreement with affiliates, LIC and LAND, collectively known as the Surplus Lines Pool or Lexington Pool. Under terms of the agreement, LIC assumes all business written by Starr Excess and Landmark and shares in all expenses in accordance with their participation. LIC's participation is eighty percent (80%). The remaining ceded participation of Starr Excess and Landmark is eighteen percent (18%) and two percent (2 %), respectively. The pooling agreement has been properly filed and approved by the Delaware and California Insurance Departments.

On November 6, 2006, the Company submitted a request to the Delaware Insurance Department amending the Intercompany Pooling Agreement to address a recommendation made in Landmark Insurance Company's Report of Financial Examination as of December 31, 2002. Refer to the "Subsequent Events" section of this Report, under the capion "Intercompany Pooling Agreement – Amendment 1" for details of the proposed amendment.

Capital Maintenance Agreement between SELIC and AIG:

Effective February 27, 2006, the Company entered into a Capital Maintenance Agreement ("CMA") with its ultimate parent, AIG, which supersedes the certain letter agreement, dated October 14, 2005, between AIG and SELIC regarding capital maintenance. The CMA provides that in the event the Company's Total Adjusted Capital falls below 200% of the Company's Authorize Control Level Risk Based Capital ("RBC"), as shown in the Company's 2005 Annual Statement, together with any adjustments or modifications required by the Company's domiciliary regulator, AIG shall, within 30 days of written notice thereof, provide a capital contribution to the Company in an amount that equals the difference between the Company's Total Adjusted Capital and 200% of the Company's Authorized Control Level RBC. In lieu of making any capital contributions, with the prior approval of the Company's domiciliary regulator, AIG may provide a letter of credit naming the Company as beneficiary. The obligations under the CMA terminate without the need for any action twelve (12) months from the date of the CMA effective date, unless extended in writing prior thereto.

Joint Asset Advisory Agreement

Effective August 12, 1998, the Company joined the Joint Asset Advisory agreement with affiliated AIG companies. The Joint Asset Advisory agreement outlines the appointment of AIG Capital as the administrator of the AIG Domestic Fund. The AIG Domestic fund pools all subsidiary funds to maximize investment yields on short-term funds. As of December 31, 2005, this agreement was still in effect; however, it did not govern any funds as this agreement is in the process of being terminated.

EXTERNAL AGREEMENTS

In addition to the above intercompany agreements, the Company had the following external agreements in effect at December 31, 2005:

Custodial Agreement

On April 20, 1998, amended November 9, 1998, and June 2, 2006, the Company entered into a custodial agreement with Mellon Bank for the purpose of safekeeping the Company's invested assets. The agreement provides the necessary safeguards against the negligence or dishonesty of the bank's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction. The agreement provides that in the event of loss, from which the Custodian is obligated to indemnify the Company, the Custodian at the sole discretion of the Company, shall either (i) promptly replace the securities, or (ii) pay the value thereof. Further, the agreement provides that in the event of any loss of rights or privileges in connection with said loss of securities, the Custodian shall promptly replace such loss at the value of such privilege immediately preceding the expiration thereof. Although the custodial agreement contained the majority of clauses recommended to be included in Custodial or Safekeeping Agreements in accordance with the NAIC *Examiner's Handbook*, the agreement does not contain all required clauses, nor stipulate the proper governing state law. Therefore

It is recommended that the Custodial Agreement with Mellon Bank be amended to incorporate all required clauses that must be included in Custodial or Safekeeping Agreements in accordance with the NAIC *Examiners Handbook.* In addition, the laws under which the agreement is governed should be changed to the laws of the state of Delaware.
Exception 4/26

Refer to the "Subsequent Events" section of this Report, under the caption "Custodial Agreement" for modifications that are anticipated to be incorporated into the Custodial Agreement subsequent to June 2, 2006 to address the aforementioned findings.

Program Administtrator ("PA") Agreements

Program Administrators are used by the Company to acquire and handle program business written in the Lexington Profit Center under Divisions 66 (Program Group) and 97 (Health Care Group), as well as business written in Divisions 72 (Marine) and 84 (Risk Management Property). The agreements in effect are of a standard format, defining a PA's basic responsibilities and authority, and defining general and specific clauses protecting the Company. Further, the Company reserves the right to withdraw the PA's power to place any one or more particular programs, policies, or particular lines or classes of insurance at any time for any reason and may decline to accept any particular risk or class of risk. The Company's right to withdraw the PA's power or to decline particular risks or classes of risks may be exercised by the Company at any time, without prior notice to the PA. Either party may terminate the agreement, at any time, by written notice specifying the effective date of the termination, which shall not be less than 60 days thereafter. Additional terms for cancellation are detailed and include: liquidation; bankruptcy; breach of contract; lack or loss of reinsurance purchased by the Company, if reinsurance is an integral part of the business underwritten by the PA; expiration, termination or suspension of the PA's licenses. In addition, each agreement includes separate addenda defining the PA's territory, authorized Lines of Business ("LOB"), and associated LOB commission rates.

Broker Agreements

As noted in the "Territory and Plan of Operation" section of this Report, under the caption "Agency Relations and Third Party Agreements", the Company accepts business mainly from insurance brokers. Broker agreements are of a standard format, defining a Broker's basic responsibilities and authority, which include but are not limited to: rules and regulations regarding the Company's underwriting guidelines; licensing and countersignature requirements; details regarding ownership of expirations; payment of premium taxes; Payment of premiums and premium tax clauses; Right of offset clause; Books and records clause; Binding authority clause; Arbitration clause. Broker agreements may be terminated with 30 days notice by either party, automatically if any public authority revokes, suspends, or declines renewal of the Broker's license, automatically upon the sale, assignment, transfer, merger, bankruptcy, or insolvency of the Broker's insurance business, or immediately upon either party giving written notice to the other of fraud, failure to remit balances, or gross or willful misconduct on the part of the other party.

Third Party Administrator Agreements

Third Party Administrator Agreements ("TPA") include claims administration agreements, as well as other vendor agreements. The agreements in place are of a standard format/form, defining the TPA's basic responsibilities and authority, which includes, but is not limited to: Clause defining the purpose of the agreement; Specific term period of the agreement; Representations and authorities clause; Obligations clause; TPA is not allowed to subcontract services without written notice to the insurer clause; Fiduciary responsibilities clause; Required monthly reports clause; Submission of an audited balance sheet of the TPA and the related audited statements of income, retained earnings and cash flows for such fiscal year; Privacy policy clause; Limitations to the TPA's authority regarding settlement of claims, endorsement of checks, use of trade names, process applications for insurance, withhold monies from the insurer; Indemnification clause; Confidentiality clause; Termination clause; and an Arbitration clause. In addition to standard language, each agreement includes separate addendums defining the Schedule of Coverage, i.e., Claims to be handled by the TPA - updated every 90 days, Claims Handling Guidelines, Summary of document retention policy, and a Funding schedule.

Other Vendor Contracts

In addition to the above non-affiliate contracts, the Company and its affiliates Starr Excess and Landmark have entered into contracts with various independent contractors for the performance of services which include, but are not limited to, providing general strategic advice, strategic planning, business development efforts; providing actuarial services; independent auditing services. These agreements are renewed on an annual basis, based on past performance and the needs of the Company at the renewal date.

Reviews of external agreements disclosed the following comment and recommendation:

- The Company provided the examiner with a listing of third party contracts retained by Legal. From this listing of forty-eight contracts, the examiner haphazardly selected twelve (12) for review. Although the Company made every effort to locate all requested agreements, the Company was unable to locate two. This exception represents a violation of 18 Del.C. §320(c), which states:

"(c) every person being examined, the person's officers, attorneys, employees, agents and representatives, shall make freely available to the Commissioner, or the Commissioner's examiners, the accounts, records, documents, files, information, assets and matters of such person, in the person's possession or control, relating to the subject of the examination and shall facilitate the examination."

For the recommendation associated with the above findings, refer to Exception 5/28 in the "Accounts and Records" section of this Report, under the caption "Accounts and Records Findings."

FINANCIAL IMPACT RESULTING FROM REMEDIATION

As a result of regulatory inquiries into certain transactions, AIG conducted an internal review of information and certain transactions from January 2000 to May 2005. As part of this review, the Company reviewed the statutory accounting treatment for matters identified during the internal review and concluded that certain transactions required adjustment. An agreement was reached with the Delaware Insurance Department for the Company to re-file its 2004 annual statement using the methodology described under SSAP No. 3, specifically as it relates to accounting for correction of errors. In applying this methodology, during 2004, the Company reported the surplus impact (in the amount of $88.9 million) to its January 1, 2004 unassigned surplus as a prior period correction adjustment in changes to unassigned surplus. On December 6, 2005, the Company re-filed its 2004 Annual Statement with the Delaware Insurance Department, which amended the originally reported net income for the year ended December 31, 2004 of $211.9 million to $71.6 million (a decrease of $140.3 million), and amended its originally reported policyholder's surplus of $2.4 billion to $2.2 billion ($200 million surplus decrease).

During 2005, the Company dedicated significant effort to the resolution of the previously identified weakness in internal controls over balance sheet reconciliations. As a result, management concluded that further adjustments, other than those mentioned above, should be made to assets, liabilities, net income, and ultimately to policyholder surplus as reported in the Company's December 31, 2004 refiled Annual Statement. A correction in errors resulted in an after tax statutory charge of $93.4 million (reduction to unassigned surplus). In accordance with SSAP No. 3, the Company reported this surplus impact to its January 1, 2005 unassigned surplus as a prior period correction adjustment to changes in unassigned surplus. AIG's remediation of disclosure controls and procedures are further discussed in the "Accounts and Records" section of this Report, under the caption "Remediation of Material Weaknesses in Internal Controls over Financial Reporting" as well as under the caption "Allowance Provision – FAS 5 – Accounting for Contingencies." Refer to the "Notes to Financial Statements" section of this Report, under the caption "Allowance Provision" for the financial impact resulting from the Company's accounting for contingencies, i.e., FAS 5 Reserve. Additionally, refer to the "Subsequent Events" section of this Report, under the caption "Reconciliation and Remediation" for details of AIG's continued remediation efforts.

ACCOUNTS AND RECORDS

Accounting System and Information/IT Process Flows

All necessary accounting records of the Company are maintained on electronic data processing equipment ("EDP"), made available to the Company under its Service and Expense Agreement with AIG. The general ledger is maintained on a statutory basis with additional accounts used to convert to the accrual basis suitable for Generally Accepted Accounting Principles. AIG's EDP equipment and information technology control environment was tested as part of the examination by INS Services, Inc., and given a control risk assessment of 'Medium'.

As part of this examination and in collaboration with INS Services, Inc., assigned examination staff reviewed the information/accounting and information technology 'process flow' interface of the Company's premium, policy management, and reinsurance cycles as managed in its Boston, MA facilities. As part of the coordinated examinations of AIG's DBG operations (as a whole), discussed under the "Scope of Examination" section of this Report, the review and assessment of information technology and information/accounting process flow was reviewed by INS Services, Inc. and other examiners regarding (in part) loss, investment accounting, and financial reporting cycles of DBG, the results of which were shared with the Surplus Lines Pool examiners. In addition, AIG's DBG 'non-machine' functions were reviewed and assessed by other examiners, the results of which were shared with the Surplus Lines Pool examiners. The testing of 'non-machine' data and transactions regarding the Surplus Lines Pool was performed by the Delaware examiners, without material exception.

Accounts and Records Findings

The following findings, recommendations and comments were noted during the examination and pertain to the Company's overall level of records maintenance and filed Annual Statement:

During the course of the examination, the Company had difficulty in locating original claim records, i.e., missing claim files, as well as complete and original documentation for various other claim files. These exceptions represent noncompliance with 18 Del.C. §320(c). Therefore, as also noted in the prior exam report,

It is again recommended that the Company comply with 18 Del.C. §320(c), and maintain / retain all records necessary for the performance of Delaware's tri-annual examinations.
Exception 5/26

With regard to the filed 2005 Annual Statement, several immaterial presentation discrepancies were noted. These discrepancies related to both financial and non-financial reported information. The exceptions identified represent noncompliance with 18 Del.C. §526(a). Therefore,

It is recommended that the Company complete its annual statement blank in accordance with NAIC *Accounting Practices and Procedures* NAIC *Annual Statement Instructions* and 18 Del.C. §526(a), verifying that all financial and non-financial data is reported accurately, completely, and appropriately.
Exception 6/26

Refer to the "Notes to Financial Statements" section of this Report, under the various balance sheet items for more information related to noted financial discrepancies.

As of December 31, 2005, it was noted that there remained significant reconciliation issues with various G/L accounts that resulted in unidentifiable differences between the G/L and subledger support. This matter was commented on during the last examination, as such,

It is recommended that the Company ensure that sub ledger detail reconciles to the General Ledger, and that any unidentifiable differences are reconciled in a timely manner.
Exception 7/26

Refer to the caption "Remediation of Material Weaknesses in Internal Controls over Financial Reporting" in this section of the Report, for details regarding the Company's material weakness in controls over certain balance sheet reconciliations, and remediation efforts implemented in 2005/2006 to address this material weakness. Additionally, refer to the "Subsequent Events" section of this Report, under the caption "Reconciliation and Remediation" for comments regarding the remediation status of material weaknesses identified as of December 31, 2005.

Independent Accountants

The Company's financial statements are audited each year by the firm of PricewaterhouseCoopers, LLP or "PwC" or "CPA", of New York, NY. The examiners reviewed the audited statutory financial statements for all years under examination. For all years under review, PwC issued an unqualified opinion. For 2004 and 2005, the unqualified opinion was issued notwithstanding the existence of the material weakness in internal controls over balance sheet reconciliations for which the Company has devoted significant efforts to its resolution. Refer to the "Financial Impact Resulting from Remediation" section of this Report, and under the caption "Remediation of Material Weaknesses in Internal Controls over Financial Reporting" in this section for additional comments.

As noted in the "Scope of Examination" section of this Report, the examiners reviewed PwC's 2005 workpapers, and incorporated their work and findings as deemed applicable to the current examination.

Actuarial Opinion

The Company's loss reserves and related actuarial items were reviewed by Robert J. Meyer, FCAS, MAAA, an associate of Milliman Inc., who issued a statement of actuarial opinion, based on the financial information presented by the Company. The opinion stated that the reserves and related actuarial values carried on the balance sheet were fairly stated and met the requirements of the insurance laws of the state of Delaware.

Miscoded Direct Written Premiums

Prompted by inquires regarding the accuracy of reported direct written premiums ("DWP") in Schedule T of the annual statement, an internal review of DWP was performed by DBG Legal Counsel. Upon conclusion of this internal review, it was determined that $2,042,267 of premium was miscoded as Starr Excess direct premium, which should have been coded as Lexington or other legal entity direct premium. As a result of these recording exceptions, the Company's DWP was erroneously overstated as of December 31, 2005, which translated into an inaccurately reported Underwriting and Investment Exhibit, Part 1B, and Schedule T. Refer to the Exception 6/26 in this section of this Report, under the caption "Accounts and Records Findings" regarding compliance with NAIC *Annual Statement Instructions* and 18 Del.C. §526(a).

In addition to the aforementioned miscodes, it was disclosed that various AIG Profit Center were erroneously writing business on inappropriate/unlicensed legal entity paper. As SELIC was indirectly affected by these errors due to its participation in the Intercompany Pooling Agreement with LIC and LAND, refer to the "Subsequent Events" section of this Report, under the caption "Miscoded Direct Written Premiums" for subsequent corrective action taken by AIG to resolve this matter.

Reinsurance

The following comments and findings were noted during the current examination, and pertain to the Company's overall reinsurance program:

- The Company does not currently report assumed reinsurance payable on paid losses and loss adjustment expenses, as a separate liability item on its balance sheet in accordance with NAIC *Annual Statement Instructions* and SSAP 62, paragraph 40, which states in part,

> "Amounts payable by reinsurers on losses shall be classified as unpaid losses. Assumed reinsurance payable on paid losses shall be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business shall be netted with ceded losses on the balance sheet and listed separately by annual statement line of business in the Underwriting and Investment exhibits."

Therefore, as also note in the two prior examination reports,

> **It is again recommended that the Company report assumed reinsurance payable on paid losses and loss adjustment in compliance with SSAP 62 paragraph 40, NAIC *Annual Statement Instructions*, and 18 Del.C. §526(a).**
> Exception 8/26

- The Company's complex inter-company division based reinsurance program has produced mismatches between intercompany reinsurance amounts reported in affiliated companies' respective Annual Statement Schedule F, Part 1 and Part 3 filings. The individual surplus lines companies also report amounts ceded to themselves as a result of the complex arrangement. No financial adjustment is proposed regarding this item, as the Company had already established a $22,000,000 FAS 5 reserve (Surplus Pool basis) at December 31, 2005. Therefore,

> **It is recommended that the Company accurately report reinsurance balances with affiliates in its Annual Statement Schedule F in accordance with 18 Del.C. §526(a), NAIC *Annual Statement Instructions,* and that all inter-company balances mirror the associated affiliate balances.**
> Exception 9/26

- Based on numerous CPA Summary of Aggregated Deficiencies ("SAD") findings, it was noted that the Company did not have adequate accounting controls related to the processing and recording of reinsurance transactions at December 31, 2005. However, the Company's CPA firm has noted mitigating high level oversight controls. Additionally, the Company has established a FAS 5 reserve for reinsurance accounting issues as a means to mitigate financial impact associated with the aging of account balance reconciliations. Refer to the "Notes to Financial Statements" section of this Report, under the caption "Allowance Provision" for additional FAS 5 reserve adjustments resulting from this finding. Therefore,

It is recommended that the Company correct reinsurance control inadequacies that have been identified during its remediation process, and continue to identify, quantify and correct misstated balances.
Exception 10/26

- The DBG companies, excluding the Surplus Lines Pool companies have voluntarily set up a FAS 5 reserve for disputed reinsurance receivables as of December 31, 2005. In the third quarter of 2006, $23,980,000 was reallocated from the Commercial Lines Pool to the Surplus Lines Pool. An additional amount was reallocated to the Surplus Lines Pool in the fourth quarter of 2006 to bring the reserve total to $31,338,152. Per management, these amounts should have been included in the Surplus Lines Pool company statements as of December 31, 2005. Refer to the "Notes to Financial Statements" section of this Report, under the caption "Allowance Provision" for FAS 5 reserve adjustments resulting from this finding. Therefore,

It is recommended that the Company properly allocate and record all contingent reserves or adjustments associated with the reinsurance contracts in dispute or where collection has not occurred in accordance with the contract terms and/or regulatory requirements, as well as SSAP No. 62, paragraphs 54-56, NAIC *Annual Statement Instructions,* and 18 Del.C. §526(a).
Exception 11/26

- The Surplus Lines Pooled companies established a FAS 5 credit exposure reserve for paid, unpaid and IBNR reinsurance recoverable balances. This reserve was established to reserve for known exposures for those items too small to be specifically identified and for the unpaid and ceded IBNR exposures. During 2006, additional credit risk exposures related to 2005 and prior were identified and further development of the analytical model resulted in the increase of the reinsurance credit reserve related to credit risk. Refer to the "Notes to Financial Statements" section of this Report, under the caption "Allowance Provision" for FAS 5 reserve adjustments resulting from this finding. Therefore,

It is recommended that the Company establish complete and adequate credit exposure FAS 5 reserves for reinsurance recoverable exposures.
Exception 13/26

- The NAIC Annual Statement Instructions for Schedule F - Part 3 allow for the aggregation of reinsurance recoverable balances due from individual reinsurers if both the total premium ceded and the total amounts recoverable, individually, are less than $100,000 and none of the amounts recoverable are over ninety days past due. Per management, total reinsurance recoverable balances of $50,000 or less due any surplus lines pool member are aggregated and 100% of the total recoverable balances are reported on Lexington Insurance Company's Schedule F - Part 3.

"Unaffiliated reinsurers may be aggregated under the designated categories and line numbers to the extent that amounts in both column 6 - Reinsurance premium ceded and column 15 - Total (Recoverable) are individually less than $100,000 and none of the amounts are over 90 days past due. The procedure is applicable to Part 3 only."

Therefore,

It is recommended that the Company report in Schedule F, Part 3, its respective summary of reinsurers with balances less than $100,000 in Schedule F in accordance with NAIC *Annual Statement Instructions* and 18 Del.C. §526(a), rather than booking the aggregate total to LIC.
Exception 14/26

Uncollected Premiums and Agents' Balances

During the review of a sample of policies, one account current and one individual policy were issued subsequent to the receipt of cash. As there was no policy for which to allocate this premium, in the case of the account current sample, it was applied to the producer's account. Per Management, this type of cash is defined as "Stand Alone Cash", a.k.a. Remittance and Items not allocated, and is not unusual. This internal policy of applying Stand Alone Cash to a producer without an underlying policy does not follow SSAP 67, paragraph 9 "Remittances and Items Not Allocated", which states in part,

> "9. Cash receipts cannot always be identified for a specific purpose or, for other reasons, applied to a specific account when received. The reporting entity shall record a liability for these cash receipts when the funds are received. These liability accounts are generally referred to as suspense accounts. Examples include:
>
> a. Premium payments received with the application for policies which have not yet been issued;
> b. Premium payments in an amount different than the amount billed by the reporting entity; and
> c. Unidentified cash receipts."

Therefore,

It is recommended that the Company report cash received but not allocated to a specific policy as "Remittances and items not allocated" in accordance with NAIC *Annual Statement of instructions,* SSAP 67, paragraph 9, and 18 Del.C. 526(a).
Exception 15/26

No financial adjustment has been proposed, as determination of amounts classified as "Stand Alone Cash" was not performed. Refer to the "Notes to Financial Statements" section of this Report, under the caption "Uncollected premiums and agents' balances in course of collection" for financial adjustments that were made with regards to this balance sheet item.

<u>Outstanding Loss Drafts and Escheat</u>

Reconciliation of OLD

The Company utilizes a general ledger ("G/L") account, identified as Outstanding Loss Drafts ("OLD"), as a holding account to reflect issued checks that have not cleared the bank. In addition to outstanding checks, the OLD G/L account has also been used as a "clearing account" by various departments without clearly defined ownership/accountability of balances. Examples of the transactional activity with OLD include: deductibles, deductible buybacks, salvage, loss clearing, reinsurance, and inter-company. The inability to monitor and manage the volume of transactions was compounded by the fact that no-subledger existed.

During the course of the examination, Management provided the examiners with updates regarding the balance sheet line item, Drafts Outstanding, which reflects the balance carried in the Company's OLD G/L account. Although AIG has devoted significant resources to remediate OLD reconciliation issues, there still remains a material weakness within OLD. The primary reason for this weakness is that OLD still contains millions of transactions, related and unrelated to outstanding checks, which remain unreconciled over a number of years.

As noted previously and discussed further under the caption "Remediation of Material Weaknesses in Internal Controls over Financial Reporting," AIG is currently performing a remediation of balance sheet reconciliations, which includes an attempt to reconcile OLD, and to implement a system so that only proper transactions are recorded in this G/L account. The Company provided the examiners with many updates to the process; however, due to the fact that this remediation process is ongoing, the Company could not provide specific underlying detail to support the OLD G/L account balance. Therefore,

It is recommended that the Company reconcile its OLD G/L account, and properly report balances in appropriate balance sheet line items in accordance with NAIC *Annual Statement Instructions*, and 18 Del.C. 526(a).
Exception 16/26

Refer to the "Notes to Financial Statements in this Report" section of this Report, under the caption "Drafts Outstanding" for associated financial adjustments related to Drafts Outstanding. Refer to the "Subsequent Events" section of this Report, under the caption "Outstanding Loss Drafts" for the Company's remediation efforts.

Checks $50 and Under

The Company has written procedures in place for handling outstanding loss checks in excess $50. The procedures call for the Claims Unit Managers to facilitate contact with the payee via phone or mail. If the attempts become futile, the claim is identified as Abandoned Property. It should be noted that due to the elongated time frame from the examiner's initial request to the point of receiving a full and complete outstanding check listings for Lexington, Starr Excess and Landmark from Management, no verification of contacts to the Payee was reviewed by the examiner.

The Company could not provide procedures for the handling of outstanding loss checks $50 and under. Thus, these outstanding loss checks are not tracked, and efforts to contact the Payee via phone or mail are not documented. Therefore,

It is recommended that Management expand its operational guidelines to encompass adequate tracking of outstanding loss checks $50 and under, and facilitate appropriate contact with the Payee via phone or mail.
Exception 17/26

Escheat Review

The results of the review of escheat reports, outstanding checks and other documentation revealed that the Company has a process in place for the tracking and processing of escheatable funds, except as noted with regard to checks $50 and under. A review of escheat reports for the year 2005 indicates the Company filed escheat reports. However, these reports were shown to be inaccurate. Upon review of the year-end 2005 and August 2006 outstanding check lists, there were checks which were issued by the Company that were significantly old (1996 - 2002), but were yet to be escheated to the states as of December 31, 2006.

Based on the review performed, the examiner concluded that while the filed escheat reports indicated escheat of funds to states in a timely manner, the outstanding check listing indicates that there remain outstanding checks, which have yet to be escheated to states. Additionally, Management stated that outstanding checks $50 and under have not been escheated to any state, as there is no process in place to track checks $50 and under. Therefore,

It is recommended that the Company commit resources to provide the following with regards to escheating uncashed checks:

- **Develop written procedures for escheating checks $50 and under, when these are determined escheatable under state time tables;**
- **Undertake procedures to track outstanding checks ($50 and under), and include these checks in the Abandoned Property Reports;**
- **Review its escheat system for proper tracking and reporting of Escheatable funds, as a means to locate checks that have not been or remain unremitted to the appropriate states;**
- **Verify that remittance of all outstanding loss checks from 1996 and prior (over and under $50) have been escheated to the appropriate state. If the applicable state cannot be determined, the escheatable item should be escheated to the Company's state of domicile.**

  Exception 18/26

Remediation of Material Weaknesses in Internal Controls over Financial Reporting

Following receipt of subpoenas from, and commencement of investigations by, various regulatory agencies, in March 2005 AIG's then Chief Executive Officer retired, and the then Chief Financial Officer was terminated. In connection with the preparation of AIG's consolidated financial statements, AIG's current management initiated an internal review of AIG's books and records, which was substantially expanded in mid-March (2005) with the oversight of the Audit Committee of the Board of Directors. Based on its evaluation and the identification of the material weaknesses in internal control over financial reporting and new information about preexisting facts which came to AIG's attention during the course of its internal review, and because of an inability to file AIG's Annual Report on Form 10-K within the statutory time period, AIG's new Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2004, AIG's disclosure controls and procedures were ineffective.

Control deficiencies as of December 31, 2004 were noted in the following areas:

- Control environment
- Controls over the evaluation of risk transfer
- Controls over certain balance sheet reconciliations
- Controls over the accounting for certain derivative transactions
- Controls over income tax accounting

As a result of these review findings, together with the results of investigations conducted by outside counsel at the request of AIG's Audit Committee, and in consultation with AIG's independent registered public accounting firm, AIG restated its audited consolidated financial statements for the years ended December 31, 2003, 2002, 2001 and 2000 and its unaudited condensed consolidated financial statements for the quarters ended March 31, June 30 and September 30, 2004 and 2003 and the quarter ended December 31, 2003 (the First Restatement).

As a result of the aforementioned restatements, AIG's new Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2004, AIG's disclosure controls and procedures were ineffective based on the criteria in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”); these control deficiencies constitute material weaknesses.

Upon identification of these material weaknesses and under the direction of its new CEO and CFO, AIG developed a comprehensive plan to remediate the material weaknesses identified.

On November 9, 2005, AIG announced that it had identified certain additional errors, the preponderance of which was identified during the remediation of the material weaknesses in internal control over financial reporting. Subsequent to this announcement, and in connection with its ongoing remediation efforts, AIG identified certain additional errors principally relating to internal controls over reconciliation of certain balance sheet accounts in the Domestic Brokerage Group. Due to the significance of these additional errors, AIG restated its consolidated financial statements and financial statement schedules for the years ended December 31, 2004, 2003 and 2002, along with 2001 and 2000 for purposes of preparation of the Selected Consolidated Financial Data for 2001 and 2000, and quarterly financial information for 2004 and 2003 and the first three quarters of 2005 (the Second Restatement). This Second Restatement included a refilling of both LIC and SELIC’s 2004 Annual Statements.

As of December 31, 2005, the material weaknesses relating to the control environment, i.e., management changes, and controls over the evaluation of risk transfer, i.e., reclassification of certain reinsurance transactions as deposit accounting, were remediated; however, the material weaknesses relating to 1.) controls over certain balance sheet reconciliations, 2.) controls over the accounting for certain derivative transactions (not applicable to LIC and SELIC), and 3.) controls over income tax accounting, remained as they were not fully remediated. As a result of these remaining material weaknesses in internal control over financial reporting, AIG's Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2005, AIG's disclosure controls and procedures were ineffective.

Throughout 2005 and continuing in 2006, AIG has devoted significant efforts towards remediation of the three (3) remaining material weaknesses, and remediation of AIG's control environment has aided in these efforts. Nonetheless, these material weaknesses were not yet fully remediated as of December 31, 2005. AIG management continues to assign the highest priority to AIG's remediation efforts in these areas, with the goal of remediating these material weaknesses by year-end 2007. However, due to the nature of the remediation process and the need to allow adequate time after implementation to evaluate and test the effectiveness of the controls, management has given no assurance as to the timing of complete achievement of remediation. As part of its remediation efforts, AIG management represents its intention to develop new systems and processes which will allow it to rely on front-end preventative controls, which will be more sustainable over the long term. During the examination, AIG management represented its commitment to making the investments necessary to make these improvements.

AIG has taken specific remediation steps with respect to its three remaining material weaknesses:

- ***Controls over certain balance sheet reconciliations:*** AIG has implemented the following measures to enhance its ability to identify, assess, measure and help to ensure the accuracy of its balance sheet accounts:

    - Adoption and implementation of new corporate guidelines on balance sheet reconciliations;
    - Implementation of new programs to train staff on the requirements of the new guidelines;
    - Enhancement of the oversight of the balance sheet reconciliation function by adding qualified staff and engaging outside resources; and
    - Enhancement of processes for evaluating and monitoring financial statement exposures related to balance sheet reconciliations.

- ***Controls over the accounting for certain derivative transactions:*** AIG has taken the following actions to remediate this material weakness:

    - Enhancement of systems and implementation of new controls over the accounting for derivatives and related assets and liabilities;
    - Implementation of new procedures and controls to ensure technical compliance with the provisions of FAS 133, including specific documentation requirements, prior to application of hedge accounting by AIG subsidiaries; and
    - Establishment of improved oversight, monitoring and supervision of derivative accounting issues in part, through the hiring of additional personnel with expertise in FAS 133.

- ***Controls over income tax accounting:*** AIG has taken the following actions to remediate this material weakness:

    - Implementation of new controls over its accounting for income taxes;
    - Enhancement of its oversight over income tax accounting through hiring of additional qualified staff;
    - Engagement of an outside accounting firm to assist in the analysis of its income tax accounting; and
    - Enhancement of processes for evaluating and monitoring financial statement exposure related to income tax accounting.

Refer to caption “Allowance Provision – FAS 5 – Accounting for Contingencies,” which follows this section, for details regarding the Company’s accounting for contingencies, i.e., FAS 5 Reserve, and details regarding 2006 remediation. Refer to the “Subsequent Events” section of this Report, under the caption "Reconciliation and Remediation" for details and results of AIG's continued remediation efforts subsequent to the examination period.

Allowance Provision – FAS No. 5 - Accounting for Contingencies

In accordance with the ***Financial Accounting Standards No 5 - Accounting for Contingencies*** ("FAS 5"), at year-end 2005, AIG established an allowance provision for identified and potential exposures within DBG's operational areas. The Surplus Lines Pool FAS 5 Allowance Provision at December 31, 2005 was as follows:

Fusion	$ 129,778
Financial Accounting	10,327,791
Premium Receivables	10,535,424
Reinsurance	71,724,680
Total Surplus Pool FAS 5	$92,717,673

2004 and 2005 Remediation

Refer to the "Remediation of Material Weaknesses in Internal Controls over Financial Reporting," previously discussed in this section, for details regarding AIG's 2004 and 2005 remediation.

2006 Remediation

As of December 31, 2006 the material weaknesses relating to the controls over certain balance sheet reconciliations and the controls over the accounting for certain derivative transactions were remediated; however, the material weakness relating to the controls over income tax accounting was not fully remediated. Based on the remaining material weakness in internal control over financial reporting relating to income tax accounting, AIG concluded that, as of December 31, 2006, AIG's disclosure controls and procedures were ineffective.

AIG's outside auditor, PwC, noted in their report as of December 31, 2006, that AIG did not maintain effective internal control over financial reporting as of December 31, 2006 because of the effect of the material weakness relating to controls over income tax accounting. PwC specified that because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. They further defined a material weakness as a control deficiency, or a combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

With respect to the remediated material weaknesses, as of December 31, 2006 AIG disclosed significant deficiencies relating to internal controls over the reconciliation of balance sheet accounts in DBG. The AICPA Statement of Auditing Standards (SAS 60) defines a significant deficiency as a control deficiency that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that they is more than a remote likelihood that a misstatement of the entity's' financial statements that there is more than inconsequential will not be prevented or detected.

Examination Coverage

AIG Management's ongoing remediation efforts during 2005 and 2006 were considered as part of the Delaware Statutory Examination for DBG's key operational segments: Fusion, Premium Collections, Financial Accounting, and Reinsurance.

Fusion

Fusion 2005 Remediation

- As of December 31, 2005, Management recognized a significant deficiency over the Fusion operational area. The deficiency was based on eight control deficiencies or SAD's, and the recording of large changes in exposure reserves. The 2005 year-end DBG FAS 5 reserve included reserves for receivables (both legal and non-legal), historical general ledger clean-up items, and state related regulatory reporting and tax issues associated with loss sensitive business.

- As part of the 2005 significant deficiency remediation process a comprehensive plan covering 1) accounting/controls, 2) technology, 3) organization/production capabilities and 4) process improvement was implemented. Within the framework of the four categories, a collection of 16 projects with both strategic / sustainability aspects and tactical activities were initiated. The majority of these projects were fully implemented as of December 31, 2006.

Fusion 2006 Remediation

- Significant progress in addressing control deficiencies was accomplished in 2006. The initial remediation plan was executed and planned results materialized. Management's assessment of the remediated contributing items indicated that the stated deficiency no longer qualified as significant, considering the current control environment and substantive findings on interim financial statements.

Fusion 2007 Remediation

- Management's plan for 2007 identified certain control objectives that had not been fully met during the 2006 remediation of significant deficiencies identified in 2005. These control deficiencies were identified by Fusion Management, either through management control testing or overall evaluation of processes, as new control deficiencies / SAD's.

- The new control deficiencies were identified due to 1) additional functional areas brought into scope, 2) increase in the overall number of key controls and testing, 3) management's view of improvement needs in certain areas which require continued focus, and 4) areas where, although controls are in place, there are either exceptions noted or the recommended testing guidelines cannot be followed due to insufficient testing cycles.
- Management noted that although control deficiencies were identified, all of them are being addressed, and currently present minimal financial impact.

Fusion FAS 5 Reserve Assessment

Examiners considered the above remediation in conjunction with the fourth quarter 2006 ("4Q06") FAS 5 reserve for the Fusion DBG Operational Area. A reserve increase of $10,557,131 was noted in the FAS 5 Reserve for Fusion between fourth quarter 2005 ("4Q05") and 4Q06 as follows (on a pooled basis):

4Q05 FAS 5	($ 129,778)	Beginning Balance
2006 Charge-Offs	1	
2006 Reserve Change	(10,577,131)	
4Q06 FAS 5	($10,706,908)	Ending Balance

The reserve increase ($10.6 million) is attributable to litigation with the State of Texas relating to a surplus lines tax case in the Texas Supreme Court. Although the case is under appeal, the $10.6 million estimate was established for 1996-2006 years and is an estimate of a settlement with Texas. Lexington has prevailed on a summary judgment in the trial court but lost on a subsequent appeal.

Financial Accounting

Financial Accounting 2005 Remediation

As of December 31, 2004, Management identified a Material Weakness in DBG's controls over Balance Sheet Reconciliations, as reconciliations were not completed in a timely manner and/or reconciling items were not resolved. During 2005, management developed and implemented a remediation plan driven by three critical success factors; i) complete and successful testing of reconciliations, ii) performing a reasonable evaluation of exposure, and iii) developing a plan for sustainability of controls.

In their December 31, 2005 “Reconciliation Status Report” AIG management identified a total of 3,266 general ledger accounts that needed to be reviewed as part of their remediation efforts to correct the deficiencies. These general ledger accounts were broken down into “Problem” and “Non-Problem” accounts, and the reconciliation of each was identified as “in-progress” or “not yet started”. For completed reconciliations, accounts were distinguished between “Completed with no Significant Exposure” and “Completed with Exposure”.

In establishing the December 31, 2005 Financial Accounting FAS 5 Exposure, AIG Management considered:

- The aging of account balances (causes and action plans);
- Unreconciled differences;
- Substantiation of balances for validity;
- Unsubstantiated account balances after being researched;
- Any known issues regardless of balance aging.

A significant deficiency was recognized by AIG over DBG’s Balance Sheet Reconciliations as of December 31, 2005. The deficiency was based on eight control deficiencies and the recording of large changes in exposure reserves.

Financial Accounting 2006 Remediation

During 2006, management continued to implement the remediation plan, building on the initiatives in 2005. In April 2006 management issued a formal corporate wide policy for the reconciliation of balance sheet accounts. Management's assessment of the 2006 deficiencies noted that there were 42 control deficiencies relating to reconciliations across AIG entities that were reported. Of these, only <u>one</u> resulted in significant adjustment to the Surplus Lines Pool in 2006:

- A $330 million adjustment recorded at DBG for exposure related to DBG's OLD accounts. DBG management indicated that they fully reconciled OLD for all four quarters of 2006 (note that 2005 and prior periods were not included as part of this OLD reconciliation). They further indicate that their reconciliations have validated the accuracy of the original modeled exposure, for which a $225 million FAS 5 reserve was recorded in 3Q06, with an additional $105 million recorded in 4Q06. Based on AIG's FAS 5 analysis, the resulting FAS 5 adjustment for OLD that Management booked to the Surplus Pool at 4Q06, and carried to the 2006 Statutory Annual Statement was a $33 million debit decrease to the FAS 5 with a resulting Surplus benefit. For Statutory Examination purposes, this FAS 5 adjustment has been disallowed, due to the fact that DBG management could not support the debit balance with underlying details.

Financial Accounting 2007 Activity

With respect to 2007 activity, management concluded that while the material weakness in controls over balance sheet reconciliations had been remediated, a significant deficiency will remain. Remediation of this significant deficiency will require the following:

1. Continue enterprise-wide monitoring and tracking of reconciliations and exposure analysis for DBG and Non-DBG entities. A key to this will be the addition of a Corporate Oversight position to ensure:

   - On-going enterprise-wide compliance with the Accounting Policy for Balance Sheet Reconciliations
   - Quarterly tracking of reconciliation status and exposure analysis across all AIG units
   - Evaluation and review of Self Assessments
   - Monitor and ensure sustainability of remediation steps implemented
   - Act as a point of contact for reconciliation-related issues/inquiries

2. DBG-specific activates related to tracking reconciliations and exposure analysis, including:

   - Continue quarterly self assessments
   - Continue quarterly exposure analysis across all Businesses
   - Evaluate and resolve any SAD's arising from the 2006 Audit
   - Leverage technology to increase automation of the reconciliation process
   - Organization of an OLD/Loss Reporting Unit to finalize a sustained reconciliation process

3. Non-DBG specific activities related to tracking of reconciliations and exposure analysis will include the following, ultimately to be coordinated via the Corporate Oversight position:

   - Continued monitoring of the adoption of the Accounting Policy by non-DBG units. The approach will focus on Policy compliance, including:
     - Inventory and ownership of reconciliations
     - Robust exposure analysis
     - Implementation of a self-assessment process
   - Recommendations and observations from the 3Q06 review to be distributed to each entity. Individual results meetings will be set up with each segment CFO
   - 4Q06 Review will focus on evaluation of Self Assessment programs, with the objective of:
     - Improving current compliance scores for Non-DBG Businesses
     - Leveraging lessons learned/best practices
   - Summary of Internal Audit Department's Risk Assessment Matrix will be distributed to each entity

- Resolution of current period intercompany balances monitored by Corporate Intercompany Unit
- Assist specific segments in the development of "Reconciliation Roadmaps" and implementation of Self Assessment process

Financial Accounting FAS 5 Reserve Assessment

AIG management's remediation efforts during 2006 resulted in changes to the Financial Accounting FAS 5 reserves established as of December 31, 2005. A reserve decrease of $70,123,771 was noted in the FAS 5 Reserve for Financial Accounting between 4Q05 and 4Q06 as follows (on a pooled basis):

4Q05 FAS 5	($10,327,790)	Beginning Balance
2006 Charge-Offs	(59,406,207)	
2006 Reserve Change	70,123,771	
4Q06 FAS 5	$ 389,774	Ending Balance - surplus benefit

Although the 4Q06 ending FAS 5 reserve had a $389,774 debit balance (surplus benefit), management concluded the following,

> *"Due to the complexity of DBG's business lines and control deficiencies identified during 2006, a Significant Deficiency (more than a remote possibility of a misstatement that will not be prevented or detected, that is more than inconsequential but less than material) remains."*

Despite the above "surplus benefit", refer to the "Notes to Financial Statements" section in this Report, under the caption "Allowance Provision" for the financial impact as a result of reflecting reserve changes, and remediation of Summary of Unadjusted Deficiencies during 2006 that applied to 2005 and prior balances, totaling $1,962,557 on a pooled basis, related to Financial Accounting.

Premium Collections

Premium Collections Remediation

Management indicated that it does not have a year-end 2006 assessment and remediation summary memo regarding DBG Premium Collections as there were no reportable significant deficiencies for DBG Premium Collections as of December 31, 2006.

Per review of AIG management's exposure analysis presented to PwC for the 4th Quarter of 2006, Examiners noted a reserve increase of $29,554,285 in the Premium Collections FAS 5 Reserve between 4th Quarter 2005 and 4th Quarter 2006 as follows (on a pooled basis):

4Q05 FAS 5	($10,535,424)	Beginning Balance
2006 Charge-Offs	1,127,253	
2006 Reserve Change	(29,554,285)	
4Q06 FAS 5	($38,962,456)	Ending Balance

It is noted that the 4th Quarter 2005 FAS 5 reserves of $10,535,424 was fully used by AIG Management to reduce the Over 90 Day penalty in Uncollected Premiums for year-end 2005. Although Management did not report a significant deficiency in this area, based on the net year-end 2006 remaining FAS 5 exposure of $28,427,032, it appears that exposure does exist within DBG Premium Collections.

Premium Collections FAS 5 Reserve Assessment

Based on DBG management's Premium Collections FAS 5 presentation to PwC for 4th Quarter 2006, it was noted that the 2006 FAS 5 reserve increase stemmed from the following (in millions):

$2.0	PeopleSoft Ledger Validation - Reconciliation of general ledger accounts.
29.0	ART Subledger Validation - Debit Receivables, Credit Suspense, Run-offs.
143.9	Peoplesoft Subledger Validation - Potential charge offs of future receivables.
20.7	Guaranteed Cost (Legal) - Non loss sensitive business legal collections.
12.4	RSO Provision - Taxes paid to states but not yet collected from brokers/insureds.
$208.0	Total DBG 4Q06 Premium Collections FAS 5 Exposure.

Out of the $208 million total DBG Premium Collections FAS 5, $29.6 million was allocated to the Surplus Lines Pool, of which $20.4 million was applicable to 2005 and prior balances (on a pooled basis).

Refer to the "Notes to Financial Statements" section of this Report, under the caption "Allowance Provision" for the financial impact as a result of the above financial adjustments in 2006 that applied to 2005 and prior balances, totaling $20.4 million on a pooled basis, related to Premium Collections.

Reinsurance

Reinsurance 2005 Remediation

In 2005, AIG management identified a significant deficiency for DBG Reinsurance Operations in conjunction with Loss Sensitive Business, i.e., Fusion, and concluded that it,

> *"…had not maintained effective controls over the monitoring of the completeness, accuracy and reporting (internal and external) of certain reinsurance transactions in a timely manner."*

Sarbanes-Oxley testing performed during 2005 by both management and PwC identified numerous internal control deficiencies. In the aggregate, AIG management concluded that the individual deficiencies, when taken with those noted in the Fusion (loss sensitive) processes, constituted a significant deficiency.

Reinsurance 2006 Remediation

During 2006, Management initiated the implementation of a comprehensive remediation plan to identify and address the root causes of the SAD's that contributed to the 2005 significant deficiency. The plan objectives were to:

1. Establish, document, and test key controls for reinsurance processes to ensure they are operating effectively and are sustainable;
2. Establish, document, and test key controls over the reconciliations and exposure for Intra / Inter-company reinsurance transactions;

3. Establish, document, and test key controls over captive reinsurance and conduct exposure analysis;
4. Establish, document, and test key controls for the quarterly estimates of collateral requirements and the annual compilation of Schedule F;
5. Implement a formal process for non-machine transactions;
6. Document reinsurance process interdependencies (e.g., Actuarial, Claims);
7. Develop organizational structure, and increase resources at DBG Reinsurance Accounting.

AIG management's conclusion at December 31, 2006 stated,

"…based upon inquiry, observation and testing, Management has concluded that there was, in the aggregate, a Significant Deficiency in the design and operational effectiveness of internal controls in this area during year end December 31, 2006."

The critical considerations underlying management's conclusion were summarized as follows:

- Many transaction-level internal controls suffer from design deficiencies, insofar as many of these controls are not rigorous or frequent enough to fully achieve transaction-level control objectives;
- In certain circumstances where these controls are appropriately designed, inquiry, observation and testing have revealed them to be operating inconsistently. Many of these controls have not been completely documented or tested at December 31, 2006;
- There is significant reliance on less frequent DBG-level controls, which are primarily "detective" in nature and often occur late in the financial reporting process;
- These DBG-level controls are manual in nature and heavily dependent upon the experience and expertise of the personnel responsible for executing these controls;
- There are several layers of these DBG-level manual, detective controls which are performed by a cross-section of Management, both within DBG Reinsurance Accounting and in other DBG areas;

- During 2006, these DBG-level controls successfully identified numerous potential financial reporting issues (most of which were insignificant in relation to the overall AIG quantitative materiality threshold) that were successfully investigated and addressed prior to the issuance of any periodic external financial reporting;
- Management is not aware of any qualitative considerations, alleged or factual, suggesting any potentially material financial reporting issue(s);
- DBG Reinsurance Accounting completed several significant projects during 2006 designed to validate financial reporting data.

Despite the aforementioned design and operational deficiencies for transaction-level controls, and based upon both the DBG-level controls, which were "in place" and operational for the entire year, including reinsurance projects completed during 2006, Management believed that the financial reporting data produced by DBG Reinsurance Accounting was materially correct for the interim and annual periods ended December 31, 2006.

Reinsurance FAS 5 Reserve Assessment

Per review of AIG management's reinsurance reserve analysis, Examiners noted a reserve increase of $23,300,000 in the Reinsurance FAS 5 Reserve between 4Q05 and 4Q06 as follows (on a pooled basis):

4Q05 FAS 5	($71,724,682)	Beginning Balance
2006 Charge-Offs	9,500,000	
2006 Change in Reserve	(23,300,000)	
4Q06 FAS 5	($85,524,682)	Ending Balance

Refer to the "Notes to Financial Statements" section of this Report, under the caption "Allowance Provision" for the financial impact as a result of the above financial adjustments in 2006 that applied to 2005 and prior balances, totaling $63,372,068 on a pooled basis, related to Reinsurance.

Permitted Practices

The Delaware Insurance Department has not adopted any of the prescribed or permitted accounting practices that differ from those found in NAIC SAP. However, the Department has permitted the Company to utilize the Independent audit of the Company's Parent (the combined upstream holding company) to support the requirement for audited U.S. GAAP equity of the investments in non insurance and foreign insurance entities, i.e., departure from SSAP 88, paragraph 8. As of December 31, 2005, the aggregate value of equity investments to which this permitted practice applies amounted to $209,460,000.

Refer to the "Subsequent Events" section of this Report, under the caption "Permitted Practice Requests" for information regarding permitted practice requests applicable to the 2006 Annual Statement.

FINANCIAL STATEMENTS

The following pages contain a statement of assets, liabilities, surplus and other funds as of December 31, 2005, as determined by this examination, along with supporting exhibits as detailed below:

Analysis of Assets, December 31, 2005

Statement of Liabilities, Surplus and Other Funds, December 31, 2005

Underwriting and Investment Exhibit, Statement of Income, December 31, 2005

Capital and Surplus Account, Statement of Income, December 31, 2005

Schedule of Examination Adjustments

Analysis of Assets
As of December 31, 2005

	Assets	Non-admitted Assets	Net Admitted Assets	Notes
Bonds	$1,941,392,795		$1,941,392,795	
Stocks:				
Preferred stocks	25,497,500		25,497,500	
Common stocks	209,460,091		209,460,091	
Cash and short-term investments	33,703,977		33,703,977	1
Other invested assets	40,034,689		40,034,689	
Receivable for securities	657,909		657,909	2
Investment income due and accrued	25,614,364		25,614,364	3
Premiums and considerations:				
Uncollected premiums and agents' balances in course of collection	71,865,610	$5,002,944	66,862,666	4
Deferred premiums, agents' balances and installments booked but deferred and not yet due	5,374,124		5,374,124	
Reinsurance:				
Amounts recoverable from reinsures	85,785,111		85,785,111	
Funds held by or deposited with reinsured co.'s	8,511		8,511	
Net deferred tax asset	95,701,833	39,661,472	56,040,361	5
Guarantee funds receivable or on deposit	29		29	
Electronic data processing equipment	66,532	66,532	0	18
Receivable from parent, subsidiaries and affiliates	32,897,027		32,897,027	6
Aggregate write-ins for other than invested assets				
Loss clearing	2,062,468		2,062,468	7
Loss funds on deposit	1,068,942		1,068,942	
Accrued recoverables	498,780		498,780	
Retroactive reinsurance recoverables	170,644		170,644	
Other assets	5,161,874	8,388	5,153,486	8
Allowance provision	(34,025,591)		(34,025,591)	9
Other assets – NA	239,909	239,909	0	
Total Assets	$2,543,237,128	$44,979,245	$2,498,257,883	

Statement of Liabilities, Surplus and Other Funds
As of December 31, 2005

		Notes
Losses	$1,087,598,200	10
Loss adjustment expenses	141,431,547	10
Contingent commissions	(1,076,724)	11
Taxes, licenses and fees	399,117	
Current federal and foreign income taxes	5,591,568	12
Unearned premiums	439,707,877	
Ceded reinsurance premiums payable	84,375,029	13
Funds held under reinsurance treaties	4,408,513	
Provision for reinsurance	29,546,070	14
Drafts outstanding	0	15
Payable to parent, subsidiary and affiliates	12,643,112	
Aggregate write-ins for liabilities		
Other liabilities	965,224	16
Deferred commission	2,481,323	17
Deposit accounting liability	385,596	
Retroactive reinsurance recoverable	(898,383)	
Retroactive reinsurance payable	(563,111)	
Total Liabilities	$1,806,994,958	
Aggregate write-ins for special surplus funds		
Special surplus fund	687,405	
Common capital stock	5,000,000	
Gross paid-in and contributed surplus	194,500,000	18
Unassigned funds (surplus)	491,075,520	
Surplus as regards policyholders	$691,262,925	
Total liabilities	$2,498,257,883	

Underwriting and Investment Exhibit - Statement of Income
As of December 31, 2005

UNDERWRITING INCOME

Premiums earned	$719,928,315

DEDUCTIONS

Losses incurred	$521,165,620
Loss expenses incurred	74,407,370
Other underwriting expenses incurred	108,767,071
Total underwriting deductions	$704,340,061
Net underwriting gain or (loss)	$15,588,254

INVESTMENT INCOME

Net investment income earned	$83,703,274
Net realized capital gains or (losses)	9,241,939
Net investment gain or (loss)	$92,945,213

OTHER INCOME

Net gain or (loss) from agents' or premium balances charged off	$(1,078,237)
Aggregate write-ins for miscellaneous income	360,398
Total other income	($717,839)
Net income before dividends to policyholders and before federal income taxes	$107,815,628
Dividends to policyholders	0
Net income after dividends to policyholder but before federal income taxes	$107,815,628
Federal and foreign income taxes incurred	27,163,517
Net income	$80,652,111

Capital and Surplus Account – Statement of Income
As of December 31, 2005

Surplus as regards policyholders, December 31, 2004	$577,799,934

GAINS AND (LOSSES) IN SURPLUS

Net income	$80,652,111
Net unrealized capital gains or (losses)	63,041,203
Change in net deferred income tax	12,585,050
Change in non-admitted assets	16,458,203
Change in provision for reinsurance	(15,321,062)
Surplus adjustments: Paid-in (See Note 17 in Notes to Financial Statements)	(4,777)
Aggregate write-ins for gains and losses in surplus	
Correction of Error – Adjustments	(21,014,143)
Change in surplus as regards policyholders for the year	$136,396,585
Adjustment to surplus as a result of December 31, 2005 Examination	(22,933,594)
Surplus as regards policyholder, December 31, 2005	$691,262,925

SCHEDULE OF EXAMINATION ADJUSTMENTS

Description	Per Examination	Per Company	Examination Increase (Decrease)	Notes
Assets:				
Cash and short-term investments	$33,703,977	$33,767,672	($63,695)	1
Receivable for securities	657,909	675,658	(17,749)	2
Investment income due and accrued	25,614,364	25,604,801	9,563	3
Uncollected premiums and agents' balances	66,862,666	74,659,200	(7,796,534)	4
Net deferred tax asset	56,040,361	57,426,361	(1,386,000)	5
Electronic data processing equipment	0	0	0	18
Receivable from parent, subsidiaries and affiliates	32,897,027	32,897,027	0	6
Aggregate write-ins for other than invested assets:				
Loss clearing	2,062,468	2,665,234	(602,766)	7
Other assets	5,153,486	33,300	5,120,186	8
Allowance provision	(34,025,591)	(16,689,181)	(17,336,410)	9
Totals	$188,966,667	$211,040,072	($22,073,405)	
Liabilities and Surplus:				
Losses	$1,087,598,200	$1,087,598,200	$0	10
Loss adjustment expenses	141,431,547	141,431,547	0	10
Contingent commissions	(1,076,724)	(633,409)	(443,315)	11
Current federal and foreign income taxes	5,591,568	7,168,617	(1,577,049)	12
Ceded reinsurance premiums payable	84,375,029	84,296,369	78,660	13
Provision for reinsurance	29,546,070	18,760,142	10,785,928	14
Drafts outstanding	0	611,071	(611,071)	15
Aggregate write-ins for liabilities:				
Other liabilities	965,224	6,067,532	(5,102,308)	16
Deferred commissions	2,481,323	4,747,202	(2,265,879)	17
Gross paid-in and contributed surplus	194,500,000	194,504,777	(4,777)	18
Unassigned Funds (Surplus)	491,075,520	514,009,114	(22,933,594)	
Totals	$2,036,487,757	$2,058,561,162	($22,073,405)	

NOTES TO FINANCIAL STATEMENTS

Assets

(1) Cash and Short-term Investments: $33,703,977

The above-captioned amount is $63,695 less than that reported by the Company in its 2005 Annual Statement, as a result of reclassifying the balance for issued and outstanding checks at December 31, 2005, which were reported in error as Drafts Outstanding. Note that the aforementioned adjustment does not take into consideration wire transfers, as by their very nature, wire transfers impact cash upon issuance. Accordingly, the Company's bank account reconciliations reflected wire transfer transactions within the reported Annual Statement cash balance as of December 31, 2005. Refer to the caption "Aggregate Write-ins for Other than Invested Assets: Loss Clearing" in this section of this Report, and under the caption "Drafts Outstanding" in this section of this Report for additional comments, and the recommendation regarding this reclassification. Refer to the "Accounts and Records" section of this Report, under the caption "Outstanding Loss Drafts and Escheat" for comments regarding the Outstanding Loss Drafts G/L account.

(2) Receivable for Securities: $657,909

The above-captioned amount is $17,749 less than that reported by the Company in its 2005 Annual Statement, as a result of reclassifying balances to appropriate balance sheet accounts, and then non-admitting some of these balances in accordance with NAIC *Accounting Practices and Procedures*, and SSAP 21, paragraphs 7, 8 and 9, which state;

> "7. …A receivable due from the broker is established in instances when a security has been sold, but the proceeds from the sale have not yet been received…the receivable for securities is an admitted asset to the extent it conforms to the requirements of this statement.

8. An evaluation shall be made in accordance with SSAP No. 5, to determine if there is impairment. If, in accordance with SSAP No. 5, it is probable the balance or any portion thereof is uncollectible, any such deemed uncollectible receivable shall be written off and charged against income in the period the determination is made. If it is reasonably possible, but not probable, the balance or any portion thereof is uncollectible and is therefore not written off, the disclosure requirements outlined in SSAP No. 5 shall be followed.

9. Receivables for securities not received within 15 days from the settlement date shall be non-admitted and shall be classified as 'Other than invested assets.'"

Based on SSAP 21, paragraphs 7, 8 and 9, the balance reported by the Company under "Receivable for securities" was partially reclassified as follows:

<u>Examination Balances in Annual Statement:</u>	
Reclass to Aggregate write-ins for liabilities - Other Liabilities	($202)
Reclass to Investment income due and accrued	9,563
Reclass to Aggregate write-ins for other than invested assets – Other assets	<u>8,388</u>*****
	$ 17,749
Remaining Receivable for Securities – Exam Balance	<u>657,909</u>
2005 Receivable for securities Annual Statement balance	$675,658

*outstanding more than 15 days, non-admitted per SSAP 21, paragraph 9

Therefore,

It is recommended that the Company ensure balances classified as Receivables/Payables for Securities are classified in accordance with NAIC *Annual Statement Instructions* and SSAP 21.
Exception 19/26

Further, as the above finding likewise represents a violation of 18 <u>Del.C.</u> §526(a), refer to Exception 6/26 in the "Accounts and Records" section of this Report, under the caption "Accounts and Records Findings" regarding the Company's compliance with NAIC *Accounting Practices and Procedures* and 18 <u>Del.C.</u> §526(a).

(3) <u>Investment Income Due and Accrued:</u> <u>$25,614,364</u>

The above-captioned amount is $9,563 greater than that reported by the Company in its 2005 Annual Statement, as a result of reclassifying balances reported in error as Payables for

Securities. Refer to the caption "Payable for Securities" in this section of this Report for findings and recommendations regarding this reclassification.

(4) Uncollected Premiums and Agents' Balances in Course of Collection: $66,862,666

The above-captioned amount is $7,796,534 less than that reported by the Company in its 2005 Annual Statement, as a result of:

(1) Increasing the non-admitted 90 day penalty by $2,676,348 based on documentation provided by the Company supporting this adjustment; the Company is in non-compliance with 18 Del.C. 1101(5), which states in part,

> "(5) Premiums in the course of collection…not more than 3 months past due, less commissions payable thereon…"

Additionally, comments noted by the Company's outside auditor affirmed that the Company was not aging balances in accordance with SSAP 6, paragraph 9(c), which states in part,

> "i. If amounts are both payable to and receivable from an agent on the same underlying policy, and the contractual agreements between the agent and the reporting entity permit offsetting, the nonadmitted portion of amounts due from that agent shall not be greater than the net balance due, by agent;"

Rather, the Company is aging balances on a producer level, not on an individual policy level. The aforementioned adjustment takes into consideration the Company's FAS 5 reserve for $20.4 million (pooled basis) established in 2006 for the Over 90 penalty that applied to 2005 and prior balances. Refer to the "Accounts and Records" section of this Report, under the caption "Allowance Provision – FAS 5 – Accounting for Contingencies: Premium Collection" for associated details.

(2) Reclassification of $5,120,186 from Agents' Balances to "Aggregate write-ins for other than invested assets - Other assets". Account 11511770 contains Cash Loss

Advance ("CLA") transactions, which are not premiums or agent balances in the course of collection. Per Reinsurance Accounting, these are prepayments of losses that were subsequently settled in January 2006. This reclassification has zero surplus impact.

Therefore,

It is recommended that the Company properly age agents' balances and determine the Over 90 non-admitted portion in accordance with 18 Del.C. §1101 (5) and SSAP 6, paragraph 9, but in particular ensuring that the Over 90 is calculated in compliance with SSAP 6, paragraph 9(c). Netting of debits and credits between agents and between unrelated policies is not allowed in accordance with SSAP 6.
Exception 20/26

Additionally,

It is recommended that the Company report amounts unrelated to agents' balances, i.e., Cash Loss Advances ("CLA"), in accordance with NAIC *Annual Statement Instructions*, 18 Del.C. §526(a) and SSAP 6, verifying that all financial and non-financial data is reported accurately, completely, and appropriately.
Exception 21/26

(5) Net Deferred Tax Asset: $56,040,361

The above-captioned amount is $1,386,000 less than that reported by the Company in its 2005 Annual Statement, as a result of aggregating various adjustments resulting from the external CPA's review of the statutory provisions for federal income tax. The adjustment is based on the Company's pre-tax statutory income/loss, corresponding tax balance sheet amounts, and financial statement footnote disclosures. Their review was limited to the tax provision calculations, and supporting tax workpapers for the period ended December 31, 2005, as prepared by the AIG DBG staff.

(6) <u>Receivable from Parent, Subsidiary and Affiliates:</u> <u>$32,897,027</u>

The above-captioned amount, which is the same as that reported by the Company in its Annual Statement, has been accepted for purposes of this report. Although the Company's December 31, 2005 balance has been accepted for examination purposes, the following comments are noted with regards to the settlement of intercompany balances.

Based on a review of a sample of intercompany balances, it appears that the Company has not been properly settling these balances in accordance with the terms of Article IV of the Inter-company Pooling Agreement, or Paragraph 5 of the (AIG) Service and Expense Agreement. Refer to the "Intercompany Agreement" section of this Report for details regarding the aforementioned agreements. As a result, some intercompany balances have remained on the pooled company books in excess of 1 year. Although AIG/DBG has taken steps to account for contingencies by establishing a FAS 5 reserve for those balances in excess of 1.5 years as a part of AIG's remediation efforts, a reserve was not established for all balances in excess of 1.5 years. Rather, during 2006 the Company began the process of clearing old outstanding intercompany balances. As part of its remediation process, in fourth quarter, 2006, DBG began the process of clearing stale intercompany balances. It is anticipated that this action will result in a more accurately stated intercompany receivable/payable balance for the three surplus lines companies for year-end 2006 and going forward. Therefore,

It is recommended that the Company ensure compliance with settlement terms of the Inter-company Pooling Agreement and (AIG) Service and Expense Agreement, by settling intercompany balances in accordance with the respective agreements.
Exception 22/26

(7) Aggregate Write-ins for Other than Invested Assets – Loss Clearing: $2,062,468

The above-captioned amount is $602,766 less than that reported by the Company in its 2005 Annual Statement, as a result of reclassifying to Loss Clearing the net balance per examination for Drafts Outstanding, which consists of the following:

- A debit balance for $8,305, representing the outstanding checks issued subsequent to the G/L cutoff date, i.e., December 23, 2005.
- A credit balance for $611,071, representing the balance reported as Drafts Outstanding in the Company's 2005 Annual Statement.

Per management, the balance reported as Drafts Outstanding at December 31, 2005 represents losses clearing as the Company does not issue drafts. Refer to the caption "Cash and Short-term Investments" and under the caption "Drafts Outstanding," both in this section of this Report, for additional detail regarding the above adjustments, and the reclassification of issued and outstanding checks as of December 31, 2005 from Drafts Outstanding.

(8) Aggregate Write-ins for Other than Invested Assets – Other Assets: $5,153,486

The above-captioned amount is $5,120,186 greater than that reported by the Company in its 2005 Annual Statement, as a result of:

- Reclassifying $8,388 reported in error as Receivables for Securities, and then non-admitting this balance in accordance with SSAP 21, paragraphs 7, 8 and 9. Refer to the caption "Receivable for Securities" in this section of this Report for findings and recommendations regarding this reclassification.
- Reclassification of $5,120,186 from Agents' Balances. Account 11511770 contains CLA transactions, which are not premiums or agent balances in the course of collection. Per

Reinsurance Accounting, these are prepayments of losses that were subsequently settled in January 2006. Refer to the caption "Uncollected Premiums and Agents' Balances in Course of Collection" in this section of this Report for findings and recommendations regarding this reclassification.

(9) Allowance Provision: ($34,025,591)

The above-captioned amount is $17,336,410 greater than that reported by the Company in its 2005 Annual Statement, as a result of adjusting for changes to the Company's FAS 5 reserve in 2006 related to 2005 and prior Annual Statement balances.

Surplus Pool (in dollars)	**12/31/2005 Held Reserves**	**2006 Net Change**	**2006 Charge-Offs**	**12/31/2006 Held Reserves**	**SELIC FAS 5 Increase for 2005 & Prior Bal***
Reinsurance Accounting	($12,910,443)	($4,194,000)	$1,710,000	($15,394,443)	($11,406,972)
DBG Fusion	(23,360)	(1,903,884)	0	(1,927,243)	(1,903,883)
Premium Collections	(1,896,376)	(5,319,771)	202,906	(7,013,242)	(3,672,294)
Financial Accounting	(1,859,002)	12,622,279	(10,693,117)	70,159	(353,260)
Total	**($16,689,181)**	**$1,204,624**	**($8,780,212)**	**($24,264,769)**	**(17,336,410)**

*Amounts reported in the column "SELIC FAS 5 Increase for 2005 & Prior Bal" reflect the Company's 18% pooled share of the Surplus Lines Pool FAS 5 reserve increase in 2006 for 2005 and prior balances.

Refer to Exceptions 9/26, 10/26, 11/26, and 13/26 in the "Accounts and Records" section of this Report, under the caption "Reinsurance" for findings and comments of a non-financial nature regarding the FAS 5 reserve (above) associated with Reinsurance Accounting. Refer to the "Accounts and Records" section of this Report, under the caption "Allowance Provision –

FAS No. 5 – Accounting for Contingencies" for underlying details regarding the above adjustments to the Allowance Provision.

Liabilities

(10) Losses: $1,087,598,200

Loss Adjustment Expenses: $141,431,547

The above-captioned amount, which is the same as that reported by the Company in its Annual Statement, has been accepted for purposes of this report.

The Delaware Insurance Department retained the services of INS Consultants, Inc. to conduct an independent review of the Surplus Lines Pool ("Pool") loss and loss adjustment expense reserves as of December 31, 2005. The Consulting Actuary's analysis was performed on both a gross and a net basis; however, this analysis does not address the collectibility of reinsurance recoverables. Should any of the Pool's reinsurers fail to fulfill obligations as stated in their contracts, a contingent liability would need to be established.

The conclusions set forth in the Consulting Actuary's report are based on information provided by the Pool, including the 2005 Annual Statements, the Pool's own December 31, 2005 actuarial reserve analysis, and the December 31, 2005 analysis prepared and certified by Milliman, Inc. A specific review to verify the accuracy of the data provided to the Consulting Actuary was completed via sampling by the examination staff. The sampling results indicated that the underlying data was reasonable. The Consulting Actuary also reviewed the Pool's exhibit which balances the year-end 2005 data to Schedule P, on an all-lines total basis. The exhibit showed that the year-end amounts were closely reconciled to the Schedule P amounts.

The actuarial staff at Lexington provided the Consulting Actuary with the Pool's December 31, 2005 loss & loss adjustment expense reserve workpapers. The Consulting

Actuary also received the 2005 Statements of Actuarial Opinion for the three pooled companies, which were prepared by Robert J. Meyer, FCAS, MAAA, of Milliman, Inc., as well as Milliman's supporting documentation for their reserve selections.

The Consulting Actuary review consisted of analyzing the Pool's reserve data by business segment on both a gross and a net basis. The Consulting Actuary utilized the configuration of data that the Pool's actuaries reviewed to prepare independent projections of loss and loss adjustment expense reserves for many of the segments. The Consulting Actuary reviewed segments that represent 77% of the total carried IBNR reserve. The Consulting Actuary analyzed the same segments that Milliman reviewed, plus some additional segments.

Based on work performed, the Consulting Actuary found the Pool's carried December 31, 2005 net and gross loss and loss adjustment expense reserves to be reasonably stated, and as such, no financial adjustment was required for examination purposes.

In Milliman's Statements of Actuarial Opinion, there are appropriate comments concerning the existence of major risk factors that may expose the Pool's ultimate payments to material adverse deviation relative to carried reserves at December 31, 2005. Risk factors mentioned are the long-tailed nature of the business, and the tendency toward low frequency and high severity claim characteristics.

(11) Contingent Commissions: ($1,076,724)

The above-captioned amount is $443,315 greater than that reported by the Company in its 2005 Annual Statement, as a result of increasing the contra-liability for a debit note issued to the benefit of the Surplus Lines Pool for contingent commissions payable associated with the AIG

Property Quota Share Treaty (no. 4397) covering the period January 1, 2001 to December 31, 2001.

(12) Current Federal and Foreign Taxes Payable: $5,591,568

The above-captioned amount is $1,577,049 less than that reported by the Company in its 2005 Annual Statement, as a result of aggregating various adjustments resulting from the external CPA's review of the statutory provisions for federal income tax, and the examiner's review of AIG's consolidated income tax workpapers. The adjustment is based on the Company's pre-tax statutory income/loss, corresponding tax balance sheet amounts, and financial statement footnote disclosures. The CPA's review was limited to the tax provision calculations, and supporting tax workpapers for the period ended December 31, 2005, as prepared by the AIG DBG staff.

(13) Ceded Reinsurance Premiums Payable: $84,375,029

The above-captioned amount is $78,660 greater than that reported by the Company in its 2005 Annual Statement, as a result of adjusting for accrued profit and sliding scale commissions.

Currently, the Company's systems do not have the ability to populate its reinsurance accounting system with non-standard features in its reinsurance contracts. As a result, PwC noted that the Company did not properly accrue for profit and sliding scale commissions in four of its ceded reinsurance contracts. Therefore,

It is recommended that the Company properly accrue for all profit and sliding scale commission that may be contained in the Company's executed reinsurance contracts.
Exception 23/26

(14) Provision for Reinsurance: $29,546,070

The above-captioned amount is $10,785,928 greater than that reported by the Company in its 2005 Annual Statement, based on a review of the authorized status of reinsurers listed in the Company's 2005 Annual Statement Schedule F. The review identified fifty-five reinsurers (including Hannover Ruckversicherungs) reported in the SELIC Schedule F detail as authorized, which were not listed in the State of domicile's authorized insurer listing. Therefore,

> **It is recommended that the Company categorize the authorized and unauthorized reinsurance in accordance with the authorized reinsurer listings of the Delaware Insurance Department. Any changes in the security mechanisms that support the Delaware rating should also be considered in the assignment of the authorized status.**
> Exception 24/26

With regards to the above finding, the Company has acknowledged that Hannover Ruckversicherungs AG should have been treated as unauthorized in 2005, and have done so as of December 31, 2006. Refer to the "Subsequent Events" section of this Report, under the caption "Hannover Ruckversicherungs AG" for additional comments regarding collateral measures taken with regards to Hannover Ruckversicherungs.

(15) Drafts outstanding: $0

The above-captioned amount is $611,071 less than that reported by the Company in its 2005 Annual Statement, as a result of:

- Reclassifying the balance for issued and outstanding checks totaling $63,695 that were reported in error in the Outstanding Loss Drafts G/L account to Cash. Note that this adjustment does not take into consideration wire transfers, as by their very nature, wire transfers impact cash upon issuance. Accordingly, the Company's bank account reconciliations reflected wire transfer transactions within the reported Annual Statement cash balance as of December 31, 2005.

- Reclassification of the resulting net examination balance in Drafts Outstanding totaling $602,766 to Loss Clearing, as per management, the reported balance actually represents losses' clearing since the Company does not issue drafts.

The aforementioned adjustments to Drafts Outstanding resulted from the Company providing documentation subsequent to the examination exit conference, which occurred April 11, 2007, to support their contention regarding loss payments issued, but not booked subsequent to the G/L cutoff date of December 23, 2005. As noted in the "Accounts and Records" section of this Report, under the caption "Outstanding Loss Drafts and Escheat: Reconciliation of OLD," the balance reported as Drafts Outstanding, which represents the balance reported in the Company's OLD G/L account, is used as a clearing account by various departments, in addition to being a repository for outstanding checks and issued wire transfers. As these "other" clearing transactions were known by management to be unreconciled as of December 31, 2005, they were not taken into consideration as part of the examiner's review of OLD / Drafts Outstanding. Accordingly, the unreconciled liabilities and adjustments are not concluded on, nor included as part of the above adjustments due to the unreconciled nature of the OLD G/L account at December 31, 2005.

Refer to the caption "Cash and Short-term Investments" and the caption "Aggregate Write-ins for Other than Invested Assets: Loss Clearing," both in this section of this Report, for the financial adjustments as a result of the reclassification of issued and outstanding checks. Refer to the "Accounts and Records" section of this Report, under the caption "Outstanding Loss Drafts and Escheat" for comments regarding the Outstanding Loss Drafts G/L account.

The Company has not issued drafts for many years; however, the Company has consistently utilized the 'Drafts Issued Method' when reporting issued and outstanding checks. Accordingly, the manner in which the Company has been reporting outstanding checks is not in compliance with NAIC *Annual Statement Instructions* and SSAP 2, paragraph 7, which states in part,

> "7. Drafts and checks have different legal characteristics. A check is payable on demand, whereas a draft must be approved for payment by the reporting entity before it is honored by the bank…Outstanding checks are accounted for as a reduction of cash."

Therefore,

> **It is recommended that the Company report issued, but uncashed checks, as well as other liabilities and assets, which do not meet the definition of Drafts Outstanding, in appropriate balance sheet line items in accordance with NAIC *Annual Statement Instructions*, SSAP 2, and 18 Del.C. 526(a).**
> Exception 25/26

While the Company has reclassed out of Drafts Outstanding some asset and liability balances to appropriate balance sheet accounts in its 2006 Annual Statement, the Company continues to reflect an annual statement liability for Drafts Outstanding. When this was brought to management's attention, it was indicated that the 2007 financial statements would reflect proper reclassifications out of the Drafts Outstanding liability, and that the stated liability would in future filings be reported as zero. Refer to the "Subsequent Events" section of this Report, under the caption "Outstanding Loss Drafts" for comments regarding continued remediation of the Outstanding Loss Drafts G/L account, and the Annual Statement line item Drafts Outstanding.

(16) <u>Aggregate write-ins for liabilities – Other Liabilities:</u> <u>$965,224</u>

The above-captioned amount is $5,102,308 less than that reported by the Company in its 2005 Annual Statement, as a result of:

(1) Remediation efforts during 2006 related to balance sheet reconciliations, which resulted in the determination that $5,102,510 of other liabilities (consisting of balances reported in G/L accounts 40900000 and 40900998), were invalid as of December 31. 2005, and;

(2) Reclassification of ($202) from "Payable for securities" to "Other Liabilities" in accordance with NAIC *Accounting Practices and Procedures*, and SSAP 21, paragraphs 7, 8 and 9, as noted previously under the caption "Payable for securities."

Therefore,

It is recommended that the Company implement policies, procedures and controls to ensure timely reconciliation, and accurate reporting of financial information.
Exception 26/26

Further, as the above finding likewise represents a violation of 18 <u>Del.C.</u> §526(a), refer to Exception 6/26 in the "Accounts and Records" section of this Report, under the caption "Accounts and Records Findings" regarding the Company's compliance with NAIC *Accounting Practices and Procedures* and 18 <u>Del.C.</u> §526(a).

(17) <u>Aggregate Write-ins for liabilities – Deferred commission:</u> <u>$2,481,323</u>

The above-captioned amount is $2,265,879 less than that reported by the Company in its 2005 Annual Statement, as a result of reversing an accrual amount that is supposed to be reversed quarterly by management. It was noted that the accrual in question was subsequently reversed in the first quarter of 2006. Refer to Exception 6/26 in the "Accounts and Records" section of this Report, under the caption "Accounts and Records Findings", regarding the accuracy of reported financial and non-financial data.

(18) Gross paid in and contributed surplus: $194,500,000

The Gross paid in and contributed surplus amount is $4,777, less than that reported by the Company in its 2005 Annual Statement, as a result of reclassifying the capital contribution of unamortized book value of electronic data equipment previously under lease by AIG Credit to EDP and then non-admitting the entire EDP balance. Additional information regarding this transaction is included in the "Capitalization" section of this Report, under the caption "Common Capital Stock."

COMPLIANCE WITH PRIOR REPORT RECOMMENDATIONS

A review was performed of appropriate balance sheet and forepart files to verify corrective action had been taken with regard to prior examination report comments and recommendations.

Management and Control

Conflict of Interest

Prior Exam Comment: It is again recommended that the Company ensure that procedures requiring the execution of conflict of interest statements for Officers and Directors be updated yearly.

Current Exam Finding: A review of current conflict of interest procedures and documentation noted that although the Company is currently in substantial compliance with its conflict of interest procedures, management was still unable to locate conflict of interest statements for some officers and directors. Based on this finding, the Company has not complied with the prior examination report comment. Refer to the "Management and Control" section of this Report, under the caption "Conflicts of Interest" for the associated finding and recommendation.

Reinsurance:

Reinsurance Recoverables on Loss and LAE

Prior Exam Comment: It is recommended that the Company ensure prompt and timely settlement of balances pursuant to the terms of its agreements.

Current Exam Finding: The stop loss treaties for which the previous exam recommendation was noted, are in run off and the settlements have been made on a timely basis per Management. This assertion was not tested however, since the companies CPA firm has identified intercompany reinsurance reconciliation and settlement issues. These issues have resulted in a FAS 5 reserve. Refer to the "Notes to Financial Statements" section of this Report, under the caption "Allowance Provision" for details regarding the Company's December 31, 2005 FAS 5 reserve.

Reinsurance Payable on Paid Loss and LAE

Prior Exam Comment: As it was recommended in prior examinations, it is again recommended that the Company should follow Annual Statement Instructions for the reporting of reinsurance payable in paid loss and loss adjustment expenses in order to company with NAIC practices and procedures as required by Section 526(a) of the Delaware Insurance Code.

Current Exam Finding: This recommendation was made in previous examination reports as of December 31, 1999 and December 31, 1996. The Company's EDP systems are unable to segregate this information. Based on work performed, this recommendation is still applicable as of December 31, 2005. Refer to Exception 8/26 noted in the "Accounts and Records" section of this Report, under the caption "Reinsurance" for the associated finding and recommendation regarding compliance with SSAP 62 Paragraph 40, NAIC *Annual Statement Instructions*, and 18 Del.C. §526(a).

Receivable/Payable from/to Parent, Subsidiaries and Affiliates

Prior Exam Comment: It is recommended that the Company comply with SSAP No. 64 in order to comply with NAIC *Practices and Procedures* as required by 18 Del.C. §526(a).

Current Exam Finding: A review of Receivables/Payables from/to Parent, Subsidiaries and Affiliates noted that although the Company continued to net debit and credit balances, current netting was primarily limited to intercompany pooled balances. Netting of other non-intercompany pooled balances appears to be performed in compliance with SSAP 64 and NAIC *Practices and Procedures* as required by 18 Del.C. §526(a). The Company has substantially complied with this recommendation.

Accounts and Records:

General Ledger Detail

Prior Exam Comment: It is recommended that the Company ensure general ledger detail on a gross and ceded basis agree to Annual Statement presentation.

Current Exam Finding: The G/L detail agrees to the annual statement presentation for reinsurance related items; however, there are still significant reconciliation issues with certain G/L accounts that resulted in unidentifiable differences between the G/L and subledger support. Technically this recommendation is addressed; however, a recommendation in the Accounts and

Records section has been made regarding subledger reconciliation issues. Refer to Exception 7/26 in the "Accounts and Records" section of this Report, under the caption "Accounts and Records Findings" for the associated finding and recommendation.

Timely Response to Examination Requests

Prior Exam Comment: It is recommended that the Company ensure timely responses to examination requests for information.

Current Exam Finding: During the course of the current examination, the Company could not produce certain records requested by the examination team. This finding was likewise noted during the prior examination. Refer to Exception 5/26 in the "Accounts and Records" section of this Report, under the caption "Accounts and Records Findings" for the associated for the associated finding and recommendation regarding compliance with 18 Del.C. §320(c).

SUMMARY OF RECOMMENDATIONS

1. It is recommended that the Company report EDP equipment in accordance with NAIC *Annual Statement Instructions*, 18 Del.C. §1101(13), SSAP 4(3)(a), and SSAP 16. (See Capitalization: Common Capital Stock, page 6 ; Notes to Financial Statements: Gross Paid in and Contributed Surplus, page 79)

2. It is recommended that the Company comply with its bylaws regarding the role of its President and the Executive Committee. (See Management and Control: Committees, page 9)

3. It is recommended that the Company ensure that procedures requiring the execution of conflict of interest statements for Officers, Directors and key employees be updated yearly in accordance with AIG's Code of Conduct and AIG's Code of Conduct Re-Certification and Questionnaire. Furthermore, it is recommended that the Company maintain copies of all completed conflict of interest questionnaires on-site and available for future examination in accordance with NAIC Annual Statement Instructions and 18 Del.C. §526(a). (See Management and Control: Conflict of Interest, page 11; Compliance with Prior Report Recommendations: Management and Control, page 80)

4. It is recommended that the Custodial Agreement with Mellon Bank be amended to incorporate required clauses which must be included in Custodial or Safekeeping Agreements in accordance with the NAIC *Examiners Handbook*. In addition, the laws under which the agreement is governed should be changed to the laws of the state of Delaware. (See External Agreements: Custodial Agreement, page 26)

5. It is again recommended that the Company comply with 18 Del.C. §320(c), and maintain / retain all records necessary for the performance of Delaware's tri-annual examinations. (See External Agreements: Other Vendor Contracts, page 30; Accounts and Records: Accounts and Records Findings, page 32; Compliance with Prior Report Recommendations: Timely Response to Examination Requests, page 82)

6. It is recommended that the Company complete its annual statement blank in accordance with NAIC Annual Statement Instructions and 18 Del.C. §526(a), verifying that all financial and non-financial data is reported accurately, completely, and appropriately. (See Capitalization: Common Capital Stock, page 6; Accounts and Records: Accounts and Records Findings, page 33; Accounts and Records: Miscoded Direct Written Premiums, page 35; Notes to Financial Statements – Receivable for securities, page 66; Notes to Financial Statements – Aggregate write-ins for liabilities - Other Liabilities, page 78; Notes to Financial Statements – Aggregate Write-ins: Deferred Commissions, page 79)

7. It is recommended that the Company ensure that subledger detail reconciles to the General Ledger, and that any unidentifiable differences are reconciled in a timely manner. (See Accounts and Records: Accounts and Records Findings, page 33; Compliance with Prior Report Recommendations: General Ledger Detail, page 82)

8. It is again recommended that the Company report assumed reinsurance payable on paid losses and loss adjustment in compliance with SSAP 62 paragraph 40, NAIC *Annual Statement Instructions*, and 18 Del.C. §526(a). (See Accounts and Records: Reinsurance, page 36; Compliance with Prior Report Recommendations: Reinsurance Payable on Paid Loss and LAE, page 81)

9. It is recommended that the Company accurately report reinsurance balances with affiliates in its Annual Statement Schedule F in accordance with 18 Del.C. §526(a), NAIC *Annual Statement Instructions*, and that all inter-company balances mirror the associated affiliate balances. (See Accounts and Records: Reinsurance, page 36)

10. It is recommended that the Company correct reinsurance control inadequacies that have been identified during its remediation process, and continue to identify, quantify and correct misstated balances. (See Accounts and Records: Reinsurance, page 37)

11. It is recommended that the Company properly allocate and record all contingent reserves or adjustments associated with the reinsurance contracts in dispute or where collection has not occurred in accordance with the contract terms and/or regulatory requirements, as well as SSAP No. 62, paragraphs 54-56, NAIC *Annual Statement Instructions*, and 18 Del.C. §526(a). (See Accounts and Records: Reinsurance, page 37)

12. It is recommended that the Company establish complete and adequate credit exposure FAS 5 reserves for reinsurance recoverable exposures. (See Accounts and Records: Reinsurance, page 38)

13. It is recommended that the Company report in Schedule F, Part 3, its respective summary of reinsurers with balances less than $100,000 in Schedule F in accordance with NAIC *Annual Statement Instructions* and 18 Del.C. §526(a), rather than booking the aggregate total to LIC. (See Accounts and Records: Reinsurance, page 38)

14. It is recommended that the Company report cash received but not allocated to a specific policy as "Remittances and items not allocated" in accordance with NAIC *Annual Statement of instructions*, SSAP 67, paragraph 9, and 18 Del.C. 526(a). (See Accounts and Records: Uncollected Premiums and Agents' Balances, page 39)

15. It is recommended that the Company reconcile its OLD G/L account, and properly report balances in appropriate balance sheet line items in accordance with NAIC *Annual Statement Instructions*, and 18 Del.C. 526(a). (See Accounts and Records: Outstanding Loss Drafts and Escheat: Reconciliation of OLD, page 41)

16. It is recommended that Management expand its operational guidelines to encompass adequate tracking of outstanding loss checks $50 and under, and facilitate appropriate contact with the Payee via phone or mail. (See Accounts and Records: Outstanding Loss Drafts: Checks $50 and Under, page 41)

17. It is recommended that the Company commit resources to provide the following with regards to escheating uncashed checks:

    - Develop written procedures for escheating checks $50 and under, when these are determined escheatable under state time tables;
    - Undertake procedures to track outstanding checks ($50 and under), and include these checks in the Abandoned Property Reports;
    - Review its escheat system for proper tracking and reporting of Escheatable funds, as a means to locate checks that have not been or remain unremitted to the appropriate states;
    - Verify that remittance of all outstanding loss checks from 1996 and prior (over and under $50) have been escheated to the appropriate state. If the applicable state cannot be determined, the escheatable item should be escheated to the Company's state of domicile.

    (See Accounts and Records: Outstanding Loss Drafts and Escheat: Escheat Review, page 42)

18. It is recommended that the Company ensure balances classified as Receivables/Payables for Securities are classified in accordance with NAIC Annual Statement Instructions and SSAP 21. (Notes to Financial Statements: Receivable for Securities, page 66; Notes to Financial Statements: Aggregate Write-ins for Other than Invested Assets – Other Assets, page 70)

19. It is recommended that the Company properly age agents' balances and determined the Over 90 non-admitted portion in accordance with 18 Del.C. §1101 (5) and SSAP 6, paragraph 9, but in particular ensuring that the Over 90 is calculated in compliance with SSAP 6, paragraph 9(c). Netting of debits and credits between agents and between unrelated policies is not allowed in accordance with SSAP 6. (Notes to Financial Statements: Uncollected Premiums and Agents' Balances in Course of Collection, page 68; Notes to Financial Statements: Aggregate Write-ins for Other than Invested Assets – Other Assets, page 70)

20. It is recommended that the Company report amounts unrelated to agents' balances, i.e., Cash Loss Advances (CLA), in accordance with NAIC Annual Statement Instructions, 18 Del.C. §526(a) and SSAP 6, verifying that all financial and non-financial data is reported accurately, completely, and appropriately. (Notes to Financial Statements: Uncollected Premiums and Agents' Balances in Course of Collection, page 68)

21. It is recommended that the Company ensure compliance with settlement terms of the Inter-company Pooling Agreement and (AIG) Service and Expense Agreement, by settling intercompany balances in accordance with the respective agreements. (See Notes to Financial Statements: Receivable from Parent, Subsidiary and Affiliates, page 69)

22. It is recommended that the Company properly accrue for all profit and sliding scale commission that may be contained in the Company's executed reinsurance contracts. (See Notes to Financial Statements: Ceded Reinsurance Premiums Payable, page 74)

23. It is recommended that the Company categorize the authorized and unauthorized reinsurance in accordance with the authorized reinsurer listings of the Delaware Insurance Department. Any changes in the security mechanisms that support the Delaware rating should also be considered in the assignment of the authorized status. (See Notes to Financial Statements: Provision for reinsurance, page 75)

24. It is recommended that the Company reported issued, but uncashed checks, as well as other liabilities and assets, which do not meet the definition of Drafts Outstanding, in appropriate balance sheet line items in accordance with NAIC *Annual Statement Instructions*, SSAP 2, and 18 Del.C. 526(a). (See Notes to Financial Statements: Drafts Outstanding, page 77)

25. It is recommended that the Company implement policies, procedures and controls to ensure timely reconciliation, and accurate reporting of financial information. (See Notes to Financial Statements: Aggregate write-ins for liabilities – Other liabilities, page 78)

CONCLUSION

The following schedule shows the results of this examination and the results of the prior examination with changes between the examination periods:

Description	December 31, 2002	December 31, 2005	Increase Decrease
Assets	$1,800,501,359	$2,498,257,883	$697,756,524
Liabilities	1,350,762,152	1,806,994,958	456,232,806
Aggregate write-ins for special surplus funds	0	687,405	687,405
Common Capital Stock	5,000,000	5,000,000	0
Gross Paid In and Contributed Surplus	194,500,000	194,500,000	0
Unassigned Funds (Surplus)	250,239,207	491,075,520	240,836,313
Total Surplus as Regards Policyholders	449,739,207	691,262,925	241,523,718
Totals	$1,800,501,359	$2,498,257,883	$697,756,524

The assistance of Delaware's consulting actuarial firm, INS Consultants, Inc. and its Information Technology consulting firm, INS Services, Inc. is acknowledged. In addition, the assistance and cooperation of examiners representing the states of Alaska, California, Colorado, Pennsylvania, Illinois, Louisiana, New Jersey, and New York in the AIG DBG coordinated examinations, as well as the Company's outside audit firm, PwC, the Company's consulting actuary, Milliman, Inc., and the Company's management and staff was appreciated and is acknowledged.

Respectfully submitted,

Keith E. Misenheimer, CFE
Examiner-In-Charge
State of Delaware
Northeastern Zone, NAIC

SUBSEQUENT EVENTS

Inter-Company Pooling Agreement – Amendment 1

On November 6, 2006, a Holding Company Form D request from the Company was submitted to the Delaware Insurance Department to amend the Intercompany Pooling Agreement to address a recommendation made in the Landmark Insurance Company Report of Financial Examination as of December 31, 2002. Ceded reinsurance has historically been shown in each pool member's Annual Statement Schedule F as cessions by each member of the intercompany pool in proportion to its respective pooling percentage, notwithstanding that some reinsurance agreements show only Lexington, the lead member of the pool, as the ceding company. This practice however, was not supported by the language of the original agreement. Lexington and Starr Excess intend to document treaty cessions by each pool member on a going forward basis. The proposed amendment addresses in force reinsurance agreements, future facultative placements, and the treatment of any collateral provided in connection therewith.

The proposed amendment to Article IV of the Inter-Company Pooling Agreement is as follows:

> "All reinsurance, other than that provided by the pooling effected hereunder, that is placed by Lexington or any other Pool Member shall be deemed to be placed on behalf of all Pool Members assuming liability hereunder, and each such Pool Member shall participate in such reinsurance in proportion to its fixed percentage of participation in the pool. Any security given by the reinsurers for such reinsurance shall be for the benefit of each Pool Member in proportion to its fixed percentage of participation in the pool."

On November 16, 2006, the Delaware Insurance Department approved the proposed amendment to the Inter-Company Pooling Agreement.

Custodial Agreement

As previously noted, on June 2, 2006, the Company issued a first amendment to the amended and restated Custodial Agreement with Mellon Bank N.A., incorporating language as required by Delaware Statutes, and the NAIC *Examiner's Handbook*. Although this first amendment addressed the bulk of the required clauses missing from the November 9, 1998 amended Custodial Agreement, there remained additional required language that had not been incorporated. Consequently, in October of 2006, the Company provided the examiners with a proposed final amendment to the Custodial Agreement to address all required statutory and NAIC *Examiner Handbook* custodial agreement language. The purpose of this final amendment is to develop a custodial agreement that will not only be accepted by Mellon Bank, but also be accepted by other state insurance departments to become AIG's universally accepted custodial agreement format for DBG insurance entities. As of March 31, 2007, the agreement has been accepted by the Delaware Insurance Department, and is in the process of being executed by the Company and Mellon.

Reconciliation and Remediation

The reconciliation and remediation efforts are continuing into 2006 and 2007 on DBG entity general ledger accounts. This significant effort by management to reconcile and remediate G/L accounts reflects the magnitude of the material weaknesses noted by its outside auditor, PwC. AIG management, in its efforts to mitigate any risk of material misstatement of its financial statements for the DBG companies established a FAS 5 reserve for certain business segments/profit centers since they affect the entire DBG P&C group of companies. The total FAS 5 reserve set up in 2005 was $1.8 billion of which $92.7 million was allocated to the Surplus Lines Pool. As of December 31, 2006 the DBG companies reported a FAS 5 reserve of

$1.620 billion. This amount reflects the effects of increases to and write offs of the prior year's FAS 5 reserve, even though the FAS 5 reserve was actually increased in 2006. The total FAS 5 reserve allocated to the Surplus Lines Pool in 2006 was $134,826,689. Refer to the "Accounts and Records" section of this Report, under the captions "Remediation of Material Weaknesses in Internal Controls over Financial Reporting," and "Allowance Provision – FAS No. 5 - Accounting for Contingencies" for details regarding remediation of material weaknesses in internal controls and the Company's established FAS 5 reserve.

Outstanding Loss Drafts

Management surmised a contra liability for the Surplus Lines Pool of $33,164,902 for the OLD G/L account / Drafts Outstanding balance sheet account at December 31, 2006. Management attributed this negative liability to 2005 and prior year balances, which can not be supported. For exam reporting purposes, the unsupported FAS 5 reserve balance (receivable of $33,164,902, resulting in a favorable surplus gain) has not been admitted for exam reporting purposes at December 31, 2005, due the lack of underlying support documentation for which this FAS 5 reserve was established.

It was noted to Management, that in its 2006 Annual Statement, liabilities continued to be inappropriately misclassified as Outstanding Loss Drafts. The Company does not issue drafts, only checks and wire transfers. Management acknowledged that these liabilities will be reclassified and appropriately stated beginning with the 2007 quarterly financial statements.

It should be noted that management concluded that it had fully reconciled the Outstanding Loss Drafts GL account for 2006 on a legal entity basis; however, management did not reconcile this account for 2005 and prior years.

Miscoded Direct Written Premiums

Prompted by inquiries made by Delaware and other state Insurance Departments, it was determined that various AIG Profit Centers were erroneously writing business on inappropriate/unlicensed legal entity paper. As a result, some Companies possess a considerable number of unlicensed, but in-force policies. Realizing the seriousness of this issue, AIG began a significant effort in mid-2006 to implement controls to address this underwriting compliance issue. It is anticipated that by mid-March 2007, programming controls will be implemented, which will only allow policies to be written in a particular state on appropriate/admitted legal entity paper. However, one caveat was noted. As the profit centers have determined that customer service issues would arise from “reissuing” unlicensed, but currently in-force polices, no corrective action will be taken with regards to these in-force polices. Rather, the new underwriting controls will accommodate these policies by setting dates after which renewal of currently in-force policies (and new policies) will not be permitted.

Permitted Practice Requests

On January 30, 2007, DBG requested two, year-end 2006, permitted practices from the states of Delaware, New York, and Pennsylvania, one of which represented a continuation of the year-end 2005 permitted practice request regarding departure from SSAP 88, paragraph 8, previously acknowledged (but not adopted) by the Delaware Insurance Department on May 1, 2006. Refer to the “Accounts and Records” section of this Report, under the caption “Permitted Practices” for information regarding the 2005 permitted practices. Although the Delaware Insurance Department has not adopted any of the prescribed or permitted practice requests, the Department has permitted the Company to utilize the Independent audit of the Company’s Parent (the combined upstream holding company) to support the requirement for audited U.S. GAAP equity of the investments in non insurance and foreign insurance entities, i.e., departure from SSAP 88, paragraph 8.

Additionally, the Department has also permitted the Company to utilize audited financial statements prepared on a basis of accounting other than U.S. GAAP to value investments in joint ventures, limited partnerships and hedge funds, i.e., departure from SSAP 48.

Direct Policies- Risk Transfer Policy

The 2006 Annual Statement “Notes to Financial Statements” comments on the accounting policy for certain direct policies that do not transfer risk. Those comments are as follows:

> “Premium contracts have generally been accounted for as insurance in accordance with SSAP No. 53, entitled Property Casualty Contracts – Premiums (SSAP 53). Direct insurance transactions for which there was insufficient risk transfer have been accounted for using deposit accounting, unless (i) the policy was issued in respect of the insured’s requirement for evidence of coverage pursuant to applicable statues (insurance statues or otherwise), contractual terms or normal business practices, (ii) in respect of an excess insurer’s requirement for an underlying primary insurance policy in lieu of self insurance, or (iii) in compliance with filed forms, rates, and/or rating plans.”

A letter agreement between Delaware and other Domiciliary Insurance Departments allows this accounting practice but is under continued discussion and possible review by the National Association of Insurance Commissioner Statutory Accounting Practices and Procedures Working Group.

Reinsurance

Subsequent to the examination date, the following transactions occurred related to the Company’s reinsurance program:

On January 19, 2006 a Holding Company Form D request from the Company was granted by the Department to increase the Parental Letter of Credit for ceded unauthorized reinsurers from its 2005 level of $300 million to a 2006 level of $460 million. The distribution over the three surplus lines pool companies follows the pooling percentages.

On January 19, 2006 a Holding Company Form D request from the Company was granted by the Department to enter into a reinsurance agreement between each of the surplus lines companies (insured) and National Union Fire Insurance Company of Pittsburgh, Pennsylvania (reinsurer) effective January 1, 2006. The contract is titled the "Domestic Property Catastrophe Excess of Loss Agreement". The coverage is for various property lines, with retentions limits are as follows:

Layer	Retention	Limit
First	$ 750 million	$ 53 million
Second	$ 805 million	$592 million
Third	$1,395 million	$205 million

On January 19, 2006 a Holding Company Form D request from the Company was granted by the Department to enter into a reinsurance agreement between each of the surplus lines companies (insured) and subscribing reinsurers (CCAA) including Transatlantic Reinsurance Company (Reinsurers). The contract is titled "Casualty Quota Share Reinsurance Contract." The coverage is a 30% quota share on a net liability limit of $150 million.

On August 24, 2006 Lexington Insurance Company informed the Department that a non-affiliate special purpose Bermuda reinsurer (limited-life class 3 Bermuda reinsurer or sidecar) had been formed named Concord Re Ltd, with a total capitalization of up to $750 million. Concord Re Ltd will enter into a collateralized quota share reinsurance treaty with its sole cendant Lexington Insurance Company, reinsuring the Surplus Lines Pool's domestic commercial property business, with cessions up to as much as 20% pro-rata share. As of

December 31, 2006, the surplus pool companies reported ceded premium of $118.3 million (LIC - $94.7, SELIC - $21.3, LAND - $2.3).

Hannover Ruckversicherungs AG

Subsequent to December 31, 2005, Hannover Ruckversicherungs AG provided the Lexington Pool with full security based on a 3Q06 collateral call. Additionally, at year-end 2006, the Schedule F's of the Lexington Pool companies reflected no unsecured obligations from Hannover. (In fact, such companies were over funded by $33M.). Unlike year-end 2004 and 2005, Hannover is now reflected as an unauthorized reinsurer.

Investigations and Settlements

In 2006, Management indicated that AIG (Parent) was involved in investigations by Federal and State jurisdictions. In the 2006 Annual Statement "Notes to the Financial Statement", management disclosed the following:

> "Effective February 9, 2006 AIG reached a resolution of claims and matters under investigation with the United States Department of Justice ("DOJ"), the United States Securities and Exchange Commission ("SEC"), the Office of the Attorney General of the State of New York ("NYAG") and the New York Insurance Department ("NYDOI"). The settlements resolved outstanding litigation and allegations by such agencies against AIG in connection with the accounting, financial reporting and insurance brokerage practices of AIG and its subsidiaries, as well as claims relating to the underpayment of certain workers compensation premium taxes and other assessment s. As a result of these settlements, AIG recorded an after tax charge of $1,150,000,000 in the fourth quarter of 2005, and made payments or placed in escrow approximately $1,640,000,000 including (i) $375,000,000 into a fund under the supervision of the NYAG and NYDOI to be available principally to pay certain AIG insurance company subsidiary policyholders who purchased excess casualty policies through Marsh & McLennan Companies, Inc. and in connection with the underpayment of certain workers compensation premium taxes and other assessments.
>
> Various state regulatory agencies are reviewing certain other transactions and practices of AIG and its subsidiaries, including the Company in connection with certain industry wide and other inquiries including, but not limited to, insurance brokerage practices relating to contingent commissions and the liability of certain AIG subsidiaries, including the Company, for taxes, assessments and surcharges relating to the underreporting or misreporting of workers compensation premium"

Management also noted that in August 2006, the NAIC formed a Settlement Review Working Group to review the Workers Compensation Residual Market Assessment Portion of the settlement between AIG, NYAG and the NYDOI.

AIG Settlement with C. V. Starr & Co.

The regular meeting of the Board of Directors' minutes held December 12, 2006 reflected approval of a confidential settlement agreement between AIG and C. V. Starr & Co. Parties to the agreement included AIG, and various insurance company subsidiaries, including but not limited to ASLIC, LIC, LAND, and SELIC (collectively the "AIG Companies"), and C. V. Starr & Co., Inc., and its insurance agency subsidiaries (collectively the "Starr Agency Parties").

The settlement provided for a global resolution of multiple disputes arising out of the historic business relationships between the AIG Companies, and the Starr Agency Parties under which the Starr Agency Parties served as managing general agents for various AIG Companies. The agency relationships were dissolved in 2006, which resulted in disputes concerning the rights to insurance business generated through the agencies, and certain trademarks and business names associated therewith.