

MARKET CONDUCT EXAMINATION

OF

XL SPECIALTY INSURANCE COMPANY

AS OF

MARCH 31, 2006

I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON MARKET CONDUCT EXAMINATION, made as of MARCH 31, 2006 of the

XL SPECIALTY INSURANCE COMPANY

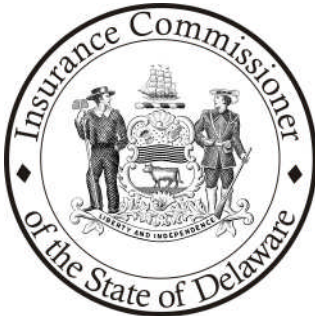
is a true and correct copy of the document filed with this Department.

ATTEST BY: _____

Antoinette Handy

DATE: 23 JULY 2007

In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 23RD DAY OF JULY 2007.



Matthew Denn

Insurance Commissioner

REPORT ON MARKET CONDUCT EXAMINATION
OF THE
XL SPECIALTY INSURANCE COMPANY
AS OF
MARCH 31, 2006

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.

A handwritten signature in black ink, appearing to read "Matt Denn", written over a horizontal line.

MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 23RD day of JULY, 2007.

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SALUTATION

March 4, 2007

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

Dear Commissioner Denn:

In compliance with the instructions contained in Certificate of Examination Authority Number 05.776, and pursuant to statutory provisions including 18 *Del. C.* §318-322, a market conduct examination has been conducted of the affairs and practices of:

XL Specialty Insurance Company

hereinafter referred to as the "Company" or as "XL Specialty." XL Specialty Insurance Company is incorporated under the laws of the State of Delaware. This examination reviewed the operations of XL Specialty. The on-site phase of the examination was conducted at the following locations:

- 1201 North Market Street, Suite 501; Wilmington, DE 19801
- 520 Eagleview Blvd; Exton, Pennsylvania 19341
- 100 Constitution Plaza, 17th Floor; Hartford, CT 06103
- 13777 Ballantyne Corporate Place, Suite 430; Charlotte, NC 28277

The examination is as of March 31, 2006.

Examination work was also conducted off-site and at the offices of the Delaware Department of Insurance, hereinafter referred to as the "Department" or as "DDOI."

The report of examination thereon is respectfully submitted.

SCOPE OF EXAMINATION

The basic business areas that are subject to a Delaware Market Conduct Examination vary depending on the type of insurer. For all insurers these areas include:

- Company Operations/Management
- Complaint Handling
- Marketing and Sales
- Producer Licensing
- Policyholder Service
- Underwriting and Rating
- Claims

Additional areas may be included for an insurer writing property and casualty coverage. Each business area has standards that can be examined and measured, typically utilizing sampling methodologies.

This examination is a Delaware Baseline Market Conduct Examination. It is comprised of two components. The first is a review of the Company's countrywide complaint patterns. This is not a pass/fail test but rather is aimed at determining if there is a detectable pattern to the complaints the Company receives from all sources.

The second component is an analysis of the management of the various business areas subject to a market conduct examination through a review of the written procedures of the Company. This includes an analysis of how the Company communicates its instructions and intentions to its lower echelons; how it measures and monitors the results of those communications; and how it reacts to and modifies its communications based on the resulting findings of its measurement and monitoring activities. The examiners also determine whether this process is dynamic and results in enhanced compliance activities. Because of the predictive value of this form of analysis, focus is then made on those areas where review indicators suggest that the process used by management does not appear to be achieving appropriate levels of statutory and regulatory compliance.

All business areas noted above are addressed, to some extent, by one or more of the procedures reviewed, thus providing a comprehensive view of the Company and its component operations.

This examination report is a report by test rather than a report by exception. This means that all areas tested are described and results indicated. Substantial departure from the norm may result in a supplemental review focused on the area so noted.

HISTORY AND PROFILE

XL Specialty Insurance Company (“XL Specialty” and/or the “Company”) is a Delaware domiciled property and casualty insurer. XL Specialty was originally incorporated under the laws of New Mexico as the International Cargo and Surety Insurance Company on November 14, 1979 and began business in the following month. The Company redomesticated to the State of Illinois in 1989 and changed its name to Intercargo Insurance Company one year later. Effective November 23, 1999, the Company changed its name to its present title. Effective August 16, 2002, the Company redomiciled from the State of Illinois to the State of Delaware. XL Specialty is licensed in 49 states, the District of Columbia, Guam, Puerto Rico and the U. S. Virgin Islands.

Since September 30, 1999, XL Specialty has been a wholly-owned subsidiary of XL Reinsurance America Inc., a New York domiciled insurer (“XLRA”), and a wholly-owned indirect subsidiary of X.L. America, Inc., a Delaware domiciled corporation (“X.L. America”). X.L. America is the ultimate United States parent of XL Specialty and its insurer and non-insurer affiliates, and is an indirect wholly-owned subsidiary of XL Capital Ltd, a Cayman Islands domiciled New York Stock Exchange publicly traded company (“XL Capital”). X.L. America and its affiliates are members of the XL Capital Holding Company System.

Effective June 30, 2003, with the approval of the companies’ domiciles, the holding company structure of X.L. America was restructured. As a result of the realignment, XLRA contributed all of the issued and outstanding shares of Indian Harbor Insurance Company, a North Dakota domiciled insurer (“Indian Harbor”), to XL Specialty, thereby making Indian Harbor a wholly-owned direct subsidiary of XL Specialty.

Effective February 12, 2004, XL Lloyds Insurance Company (“XL Lloyds”) was organized under the Texas Lloyds plan provisions (Chapter 941) of the Texas Insurance Code. The capitalization of XL Lloyds is provided by XL Specialty to the underwriters and is evidenced by trust agreements between underwriters and XL Specialty. The attorney-in-fact of XL Lloyds is XL Management Services, LLC, a Texas limited liability company formed on September 29, 2003, and a wholly-owned subsidiary of XL Specialty. XL Lloyds is also 100% reinsured by XL Specialty pursuant to a quota share reinsurance agreement between the two companies.

XL Specialty offers products in the aerospace, marine, equine, specie, environmental, professional liability, general liability, property, workers compensation, and surety lines. Its business is currently produced by the following divisions: XL Professional, XL Aerospace, XL Design Professional, XL Programs, XL Marine & Offshore Energy, XL Surety, XL US Primary Risk Management, XL Specie, XL Casualty, XL Equine, and XL Environmental.

XL Specialty distributes its insurance products and services through brokers and agents, appointed and licensed as required by the various jurisdictions in which it operates. XL

Specialty accepts business produced by major national brokerage firms, as well as regional and independent producers.

XL Specialty is a member of the XL Reinsurance America Intercompany Pooling Agreement. Under the terms of this Agreement, XL Specialty and the other intercompany member insurers cede 100% of their premiums and liabilities to the pool leader, XLRA. XLRA cedes 75% of the pool business net of specific reinsurance to its affiliate XL Re Ltd. The remaining 25% of the business is redistributed among the pool members ratable to their surplus.

METHODOLOGY

This examination is based on the Standards and Tests for a Market Conduct Examination of a Property and Casualty Insurer found in Chapter VIII of the Delaware Market Conduct Examiners' Handbook. This chapter is derived from applicable Delaware statutes, rules, and regulations as referenced herein and in the *NAIC's Market Conduct Examiners' Handbook*.

The types of review used in this examination fall into three general categories: generic, sample, and electronic.

A "Generic" review is conducted through an analysis of general data gathered by the examiner, or provided by the examinee in response to queries by the examiner.

A "Sample" review is conducted through the direct review of a random sample of files using the sampling methodology described in the Delaware Market Conduct Examiners' Handbook and the *NAIC's Market Conduct Examiners' Handbook*. The sampling techniques used are based on a ninety-five percent (95%) confidence level. This means that there is a ninety-five percent (95%) confidence level that the error percentages shown in the various standards tested are representative of the entire set of records from which it was drawn.

An "Electronic" review is conducted through the use of a computer program or computer routine applied to a download of computer records of the examinee. This type of review typically reviews 100% of the records of a particular type.

The complaints pattern review is conducted using all three methodologies. The various procedures are reviewed using a "Generic" review methodology.

The Introduction to the Review of Procedures section describes the basis for the analysis methodology. Each procedure review is described and the result of the review is provided under the appropriate procedure. Each procedure is supported by 18 *Del. C.* §318(a) and 18 *Del. C.* §508(b). In some cases there is additional specific statutory support, however, these references have not been listed. The reference source for each procedure found in the *NAIC's Market Conduct Examiners' Handbook* (NAIC MCEH Reference) is noted.

Examiner "Observations" accompany each procedure. In some cases a "Recommendation" is made. Reference, Observations and Recommendations are reported with the appropriate Standard.

A. COMPANY OPERATIONS/MANAGEMENT

This examination report is not designed to be a pass/fail report, with two exceptions. Those exceptions are the standards that state:

- "The Company is licensed for the lines of business that are being written" and
- "The Company cooperates on a timely basis with examiners performing the examinations."

Standard A 07

NAIC Market Conduct Examiners' Handbook - Chapter XV, §A, Standard 7 & Chapter XVII, §A, Standard 7

The Company is licensed for the lines of business that are being written.

18 Del. C. §318(a), §505(b), §508(b)

The review for this standard is by "generic" methodology. This standard has a direct insurance statutory requirement. This standard is intended to ensure that the Company's operations are in conformance with the Company's Certificate of Authority.

Results: Pass

Observations: The Company is licensed for the lines of business being written.

Recommendations: None

Standard A 09

NAIC Market Conduct Examiners' Handbook - Chapter VIII, §A, Standard 9

The Company cooperates on a timely basis with examiners performing the examinations.

18 Del. C. §318(a), §320(c), §508(b), §520(b)3

Review for this standard is by "generic" methodology. This standard has a direct insurance statutory requirement. This standard is aimed at ensuring the Company is cooperating with the state in the completion of an open and cogent review of the Company's operations. Cooperation with examiners in the conduct of an examination is not only required by statute, it is conducive to completing the examination in a timely fashion and in minimizing cost.

Results: **Pass**

Observations: During the course of the examination XL Insurance Company America was provided with sixty-one (61) Information Requests (IR's) and all responses were provided in a timely manner. The Company's communication with the examiners was responsive. The examiners did not experience any delays during the course of the examination.

Recommendations: None

B. COMPLAINTS/GRIEVANCES

Evaluation of the Standards in this business area is based on the Company's response to various information requests (IR items) and complaint files at the Company. Delaware statute 18 *Del. C.* §2304(17) requires the Company to "...maintain a complete record of all complaints received." The statute also requires that "this record shall indicate the total number of complaints, their classification by line of insurance, the nature of each complaint, the disposition of these complaints and the time it took to process each complaint." Delaware's definition of a complaint is: "...any written communication primarily expressing a grievance."

The Company provided a database with sixty (60) logged complaints for the period of examination. All complaints were reviewed for any patterns of problems relating to coverage. No patterns were noted and all complaints were resolved in a timely manner. The review of the complaint process is noted in Procedure 11.

REVIEW OF PROCEDURES

The management of well-run companies generally has some processes that are similar in structure. These processes generally take the form of written procedures. While these procedures vary in effectiveness from company to company, the absence of them or the ineffective application of them is often reflected in the failure of the various Standards that follow this section. The processes usually include:

- a planning function where direction, policy, objectives and goals are formulated;
- an execution or implementation of the planning function elements;
- a measurement function that considers the results of the planning and execution;
- a reaction function that utilizes the results of measurement to take corrective action or to modify the process to develop more efficient and effective management of its operations.

The absence of written procedures that provide direction for company staff in its various operational areas tends to produce inconsistent application of the intended process. The

same is generally true of the absence of a means to measure the results of the application of procedures and a means to determine that the process is performing as intended.

The reviews in this section are not pass/fail measurements. Rather, they are intended to reflect those management strengths and weaknesses that have a bearing on regulatory compliance issues.

Procedure 01 – Audit (Internal and External)

Observations: The Company has a written audit procedure for internal audits. This procedure is dated January 20, 2003. No conflicts with Delaware’s statutes or regulations are noted.

The Internal Audit Department (IAD) has twenty-four (24) employees. The Internal Audit Department performs, on average, ninety (90) to one hundred (100) audits per year, with each audit taking approximately six (6) to eight (8) weeks. Approximately seventy percent (70%) of audits are conducted in the field with the remaining thirty percent (30%) completed in the office. The Company utilizes contractor auditors to fill resource gaps as needed.

The Internal Audit Department develops an audit plan comprised of three phases, the planning phase, testing phase and the executive summary. The planning phase includes the audit process, control evaluation and risk assessment of key controls. In the testing phase, compliance and substantive tests are conducted and information is loaded in TeamMate[®]. The IAD looks specifically at detail issues that include condition, risk and recommendation. The executive summary phase is the finalization of the report. The report is then issued to Executive Management and the findings are inserted into a follow-up database.

The IAD reports to the Audit Committee of the Board of Directors. Management recommendations to improve the Company’s operations are submitted to the Audit Committee for consideration. IAD conducts an annual enterprise-wide risk assessment. These business risks include all strategic, financial, credit, operational, compliance and technology initiatives. IAD identifies areas of significant risk at a business unit and process level and makes a preliminary assessment of the current effectiveness of management controls.

PricewaterhouseCoopers (PwC) handles the external audits for the Company. PwC audits the consolidated financial statements of the Company. Their audit focuses on the identification of the core business processes utilized by the Company that support or impact the reliability of financial reporting and the assessment of the risks associated with these core business processes.

The IAD and PwC communicate on audits to ensure the audit is performed correctly. The introductory e-mail that IAD sends to the auditees/stakeholders at the pre-planning stage of the audit is also sent to the external auditors. Each region has a designated

liaison at PwC. At the time that the final audit report is issued, a copy is also sent to the PwC designate. When an internal audit of a smaller, remote location is conducted, IAD meets with PwC at the planning stage to determine what specific procedures IAD will perform.

The Company has quarterly meetings to indicate changes to the internal/external audit plans; review internal audits completed in the previous quarter and any key findings expected to relate to the external audit process; and review key findings from PwC's work. The Audit Committee meets six (6) times per year to discuss all of the audits and discuss any problems that have been identified, or any changes that need to occur in a specific business segment. In 2006, the Company stated they intend to develop a peer review process that will involve hiring a firm to review the processes of the internal audit.

Recommendations: None

Procedure 02 – Assertions of Privilege

Observations: The Company does not have a formal written “assertion of privilege” procedure. Privilege is asserted on a case-by-case basis. The Company maintains that a general assertion of privilege would be in conflict with the idea of attorney-client privilege. The Company requires each privilege to be requested. In addition, all privilege assertions must be discussed with the Division Lawyer.

Recommendations: None

Procedure 03 – Company Records, Central Recovery and Backup

Observations: The Company has a written Company Records, Central Recovery and Backup procedure. The procedure is dated September 1, 2005. No conflicts with Delaware's statutes or regulations are noted.

The Company schedules daily incremental backups Monday through Friday and full backups run on Friday. Restores are made when the Company receives a request to restore data or when a quarterly restore test needs to be performed. The Data Center accepts restore requests for a user's Home Directory or Shared Directory via a Help Desk ticket. A Service Request is required for any other type of restore. When a ticket (Service Request or Help Desk) is received, data is not restored over the top of existing data unless instructed to do by a supervisor. The Company employee or supervisor reviews the restore and confirms if the data was properly restored. Upon confirmation that the data is acceptable, the restore request is closed. On a quarterly basis, the operations manager verifies that restores have happened on both AS400 and Windows platforms.

The retention policy for the Company states that all mail, file and application data is kept off-site indefinitely, unless data retention requirements call for destruction of the data.

Recommendations: None

Procedure 04 – Computer Security

Observations: The Company has a written Computer Security Procedure. The procedure is dated November 14, 2003. No conflicts with Delaware statutes or regulations are noted.

All Company employees are required to maintain the confidentiality of customer and Company Group information, ensure that customer and Company Group information is accurate and secure, adhere to all security, electronic communication, and confidentiality policies as mandated by the Company's Capital Compliance Program and Policy Statements located on the Company's website. Employees are required to immediately report any violation of this policy or known security incident to the employees local IT Help Desk or IT Security Officer.

All Users authenticate their identity prior to initiating a computer session or electronically accessing Company Group information. The required means of identification for most systems and applications is a User ID and password. The Users are prohibited from loading unlicensed or unauthorized software onto any Company owned or leased PC, laptop, workstation, or other electronic device. Users may not allow Company Group owned or licensed software or other intellectual property to be copied by others and may not themselves make copies other than those provided for in the relevant licensing agreements. All hardware, software, and IT resources supplied by the Company are the property of the Company and as such may at any time, without prior notice, be subject to audit review.

Users may not connect to any third party (i.e. Internet, Extranet) while connected to Company networks except through Company authorized gateways and are prohibited from connecting personally owned computers, laptops, or other electronic devices to the Company's network without the approval of the IT Department.

Any software or data received from an external source is treated as suspect and is not installed until it has been scanned for viruses using the Company's standard virus detection software. Any actual or suspected virus related problem is reported to the local Help Desk or IT department. Lost, stolen or damaged Company equipment is reported to the local Help Desk or IT Department. Any equipment other than the individual's laptop or PDA taken off-site must have management authorization prior to removal.

Confidential information is destroyed at the end of its useful life cycle. Paper media is disposed of using paper shredders or secure trash disposal providers. Electronic media is destroyed using secure delete, physical destruction or degaussing processes. The exam team did not review this process and no timeframe was given for when something is no longer "useful".

Recommendations: None

Procedure 05 – Anti-fraud

Observations: The Company has a written Anti-fraud procedure. The procedure is dated June 2003. No conflicts with Delaware’s statutes or regulations are noted.

For the prevention of external fraud, the Company has retained MJM Investigations Inc. (MJM). MJM is a nationwide fraud and insurance investigations company that investigates and evaluates potentially fraudulent acts.

The Company’s prevention of internal fraud is accomplished by both internal and external audit functions and by alerting personnel and agents through instruction, education, and public awareness that alleged acts of impropriety will be investigated and, if warranted, prosecuted. Employees are informed as to what to look for as indicators of internal fraud, encouraged to report acts of suspected impropriety, and instructed how to report any suspected improprieties.

The Special Investigation Unit, (SIU) and/or claims supervisor meets with the claims adjusters annually and has periodic meetings to discuss emerging issues and topics regarding fraud detection, changes to state laws, procedures, and the Company performance in detecting and preventing fraud. Attendance by employees at these meetings is mandatory.

The investigative staff provides a variety of training services and materials for adjusters, underwriters, and management annually, semi-annually, or on an as needed basis. These services include Fraud Awareness Training which focuses on the magnitude of the fraud problem, the types of fraud one might expect to encounter, fraud indicators, the types of cost-effective investigative activity that might be used, case studies illustrating successful investigations, and procedures for how referrals should be made.

The Company’s SIU prepares and distributes a bi-weekly “e-business insurance fraud newsletter” to all personnel that provides current industry information on fraud legislation, prosecutions, fraud schemes and detection methods, outside training opportunities and an educational article addressing an insurance fraud related topic.

XL’s SIU has an Anti-Fraud Plan that explains the process for reporting any fraud activity to the different States and the NAIC. The Fraud Prevention & Detection Procedures were established to prevent insurance fraud, including internal fraud involving employees or company representatives, fraud resulting from misrepresentation on applications for insurance coverage and external claim fraud.

The fraud review and investigations encompasses the review of claims in order to detect evidence of possible insurance fraud and procedures for investigating claims where fraud

is suspected. XL America has a systematic method of reporting fraud to the appropriate law enforcement agencies, fraud bureaus and any designated prosecutor's office. The Company has developed plans and procedures dealing with restitution or other damages through either house counsel, independent counsel or under criminal proceedings.

Pursuant to the NAIC's and/or the Canadian Association of Income Funds (CAIF's) standardized statements of warning, XL is developing insurance claim documents that will include warnings having language substantially similar to the following: *"It is a crime to knowingly provide false, incomplete or misleading information to an insurance company for the purpose of defrauding the company. Penalties include imprisonment, fines and denial of insurance benefit"*.

Recommendations: None

Procedure 06 – Disaster Recovery

Observations: The Company does not have a formal Disaster Recovery Procedure. They are currently in the process of developing such a procedure.

Recommendations: It is recommended the Company develop a formal Disaster Recovery. It is also recommended that the procedure address:

- revision and audit history of the procedure;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

Procedure 07 – Managing General Agent (MGA) Oversight and Control

Observations: The Company has one MGA, MGU, Inc. An agreement provides for oversight of the underwriting manager and provides for the MGA to solicit, underwrite, bind, issue and service policies and collect premiums for the Company. Except for the authority granted to MGU under the agreement, the Company retains absolute management authority and control over the underwriting and issuance of all policies issued under the terms of the Agreement. This includes any disciplinary actions. The Company reserves the right to audit any file, process or individual at such times and frequency as the Company deems it appropriate. MGU must maintain all licenses, registrations, and bonds required by law to write business as an underwriting manager. MGU annually provides the Company a list of agents and brokers soliciting the business on behalf of MGU. MGU is solely responsible for any fines or assessments levied by regulatory organization for actions or omissions of MGU, where MGU has the responsibility or authority to perform. Upon written notice to MGU, the Company may

immediately suspend or amend any or all of MGU's authority under the agreement for such time as the Company may deem necessary.

Recommendations: None

Procedure 08 – Vendor Oversight and Control

Observations: The Company has a written Vendor Oversight and Control Procedure. The procedure is dated January 28, 2004. No conflicts with Delaware's statutes or regulations are noted.

The Company explained that Information Technology (IT) Agreement negotiation involves clarification and mutual agreement on the structure and requirements of the agreement prior to signing. Mutual obligations include responsibilities and authorities, technical and business management approaches, financing, and price. All IT Agreements are reviewed and approved by the appropriate Company Legal organization before execution. The final IT Agreement includes all agreements reached by the specific Company's legal entity including key clauses that define and communicate specific roles and responsibilities. Once a vendor has been selected and the IT Agreement signed, the process of managing the vendor relationship begins.

The Company's IT administration ensures that the vendor's performance meets contractual requirements. The IT Manager who signed the agreement is responsible for IT disputes. Vendor performance is reviewed after each project completion. Vendors are held accountable for their service in accordance with the IT Agreement and can be excluded from future selection if their performance does not meet the required standards.

Vendors are evaluated on technological competence, systems capabilities, geographic coverage, volume capacity, financial viability, accuracy of product/service delivery, completeness of product/service delivery, quality of product/service delivery, timeliness of product/service including problem resolution and record of client satisfaction (both internal and external). The exam team did not review the Vendor's evaluations.

TPA's are also used to handle claims and related issues. The process described above for IT vendors also applies to TPA vendors.

Recommendations: None

Procedure 09 – Customer and Consumer Privacy Protection

Observations: The Company has a written Customer and Consumer Privacy Protection Procedure. The procedure is dated February 5, 2005.

The Company stated they verify and exchange information regarding their customer's credit and financial status only for the purpose of underwriting, policy administration, or risk management, and only with reference and clearinghouse services. The Company also stated they do not collect nor use information about their customers and their business other than the amount of information necessary to administer the Company's business. The Company indicated they train their employees to handle information about their customers, and their business, in a secure and confidential manner and only permit employees authorized to use such information to have access to such information. The Company indicated they also do not disclose information about their customers or their business to any organization outside the Company or to third party service providers unless the Company first discloses to the customer their intent to do so or they are required to do so by law. The Company indicated they do not disclose medical information about their customer, the customer's employees, or any claimants under any policy of insurance, unless the customer provides them with written authorization to do so.

The Company attempts to keep the Company's records regarding the customer and their business complete and accurate, and will advise them on how and where to access their account information (unless prohibited by law), and advises them how to correct errors or make changes to that information, and audits and assess the Company's operations, personnel and third party service providers to assure that the customer's privacy is protected. If the Company becomes aware that an item of personal information may be materially inaccurate, it re-verifies the information and corrects any error(s). Any Company employee violating the Privacy Policy is subject to discipline, up to and including, termination.

Recommendations: None

Procedure 10 – Insurance Information Management

Observations: The Company has a written procedure manual for the management of Insurance Information. The manual is dated March 5, 2004. The Internal Audit Committee reviews and tests this procedure annually and the results are provided to both the Audit Committee and the Board of Directors. A review of the audit reports was not conducted during this examination.

The Company manual provides guidance to employees on which records to maintain, the length of time to maintain these records and under what circumstances these records may or may not be discarded or destroyed. The manual also addresses the proper method for destroying such documents. Business units and service units established Best Practices to implement the corporate policy.

Recommendation: None

Procedure 11 – Complaint Handling

Observations: The Company has a formal written Complaint Handling Procedure. This procedure is clear, readable, organized and available to persons needing access to or affected by the procedure. The procedure is updated at least annually.

The Company maintains a Consumer Complaint Manual, which details the complaint handling process and all complaints are logged into the XL Consumer Complaints Database for tracking and analysis. The Company defines consumer complaints as written communications from policyholders or claimants, which primarily express a grievance.

When the Company receives a complaint, the date is recorded and it is scanned into a PDF file. The complaint is logged into the complaint database, assigned a file number by the system, and a hard copy file is created. An Administrator forwards the complaint to the appropriate contact person for review. Depending on the process that is in place for the particular business unit or program, the contact person either drafts a response or provides the Administrator with information and supporting documentation with which to draft a response. After the response has been sent to the complainant and/or insurance department, an electronic copy of the response is attached to the complaint file record in the database and the file record is closed. The file record may be reopened if follow-up inquiries are received on the complaint matter. If the file record is reopened, a Re-open document record is created by the system under the original file record.

The Company stated they comply with the response times mandated by each state and for those states that do not mandate response time frames, the Company has set a goal to respond to inquiries within fifteen (15) working days. In a general electronic review, no exceptions were noted.

Recommendations: None

Procedure 13 – Advertising, Sales and Marketing

Observations: The Company has a written Advertising, Sales and Marketing procedure. The procedure was revised in August 2005. No conflicts with Delaware's statutes or regulations are noted.

The Company developed a process that includes eight (8) steps to ensure that the Company's senior management is aware and involved in the development of marketing projects and programs, and that legal and regulatory groups are included in the process. The eight (8) steps include: project inception, marketing service center engagement, determination of complexity of project, project entry into the project database, project development, project review and approval, implementation of any necessary revisions and the distribution of any materials. The project is reviewed by a number of persons including; Marketing management, the requesting client, the requesting client's management, Legal counsel (US or International, depending on scope of project), Quality

Control, Technical review, if appropriate, and Regulatory personnel, if appropriate (policy forms, etc.).

All marketing projects are based on a plan and an approved line of budget. The Company assigns the appropriate marketing center based on expertise, logistics, available time and geography. There is a preliminary screening to determine the scope and size of the project and time available to produce the project. For any project expected to require more than four (4) hours of time involvement by Creative or Marketing Coordination staff, an Analysis of Marketing Project form is completed. This form is sent to Marketing management for review and approval before any further work is started. The Senior Marketing management determines which marketing service center will undertake the project. Once the project is approved it is entered into the Marketing project database. The Company's Creative Department develops marketing material based on client input and Company branding standards. The project is then reviewed and approved, revisions are made and copies are distributed.

Recommendations: None

Procedure 14 – Agent Produced Advertising

Observations: The Company does not have a written Agent Produced Advertising Procedure. The Company's marketing and legal personnel review all marketing and advertising material that includes the Company's name or logo.

Recommendations: The Company should develop a formal, written, Agent Produced Advertising Procedure. It is also recommended that the procedure address:

- revision and audit history of the procedure;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

Procedure 15 – Producer Training

Observations: The Company does not have a formal written Producer Training Procedure. The Company does not write business on a direct basis. A number of their employees are licensed and appointed on behalf of their Company but they do not place business with or solicit business on behalf of the company. Since there is no direct written business and they have no "active" producers, a formal training procedure has not been developed. The Company distributes its insurance products and services through managing general agents, brokers and agents. The Company accepts business produced by major national brokerage firms, as well as regional and independent producers. XLIA

distributes its insurance products and services through brokers and agents, appointed and licensed as required by the various jurisdictions in which it operates. The Company accepts business produced by major national brokerage firms, as well as regional and independent producers. The business units work directly with their appointed agents on the products that they write on the Company's behalf.

Recommendations: The Company should develop a formal written Producer Training Procedure to ensure producers writing business with the company are properly trained to solicit the company's products. It is also recommended that the procedure address:

- revision and audit history of the procedure;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

Procedure 20 – Producer Selection, Appointment and Termination

Observations: The Company has a written Producer Selection, Appointment and Termination procedure. The procedure is clear and current. No conflicts with Delaware's statutes or regulations are noted.

The Company's Sales and Marketing (S&M) Department and the business units determine from whom they will accept business. Either S&M or the business unit contacts the Regulatory Services Group's Producer Administration Unit in order to determine whether the producer has an existing appointment with the Company or if an appointment should be requested. The assigned Producer Analyst contacts the producer directly for any additional information required in order to process the appointment. Appointments are made with Kaplan Financial's Appointpak product. Background checks are integrated within Appointpak (GIS is the Company's background check vendor). Every business unit, except the Company's Equine and Design Professional units, treat their producers as brokers. If the state permits brokering, an appointment is not required. The Company requires license information in order to verify that the agency and/or individual holds a valid broker license in the insured's and producer's state of domicile. The Producer Analyst advises S&M or the business unit (depending on who made the appointment request) that either the appointment has been made or that no appointment is required (states that permit brokering). The database is updated with the new producer information.

The Producer Administration Manager secures a listing of all producers. Those producers flagged as not producing business within the past eighteen (18) months are terminated after confirmation that S&M or any business unit has objections. The producer is notified of the termination, the state is notified of the termination (if required), and the database is updated accordingly.

Recommendations: None

Procedure 21 – Producer Defalcation

Observations: The Company has a written Producer Defalcation Procedure. The procedure is dated July 2005.

Producers suspected of fraud or illegal conduct is referred to the Legal Department, Internal Audit, and Regulatory Services. The Legal Department/Regulatory Services handles all required communication with state insurance departments regarding the producer. The Internal Audit Department investigates the allegation of fraud.

Generally, a notice of fraudulent or illegal activity is forwarded to the Producer Administration Unit from the Company's Legal Department. The Company checks their database and the National Insurance Producer Registry's Producer Database (PDB) to determine if there is an appointment for the producer with any of the Companies. If so, the Company advises the Legal Department who requests that the producer's appointment be terminated. The producer's agreement is also terminated. The Legal Department advises all business units and Sales & Marketing as to the particulars of the action taken. If there is no active appointment, the Company provides evidence to the Legal Department that there are no active appointments with any of their Companies. This verification is done via a screen print from the PDB and proof that the producer agreement was cancelled. During the course of this examination, the examiners did not review the PDB system. No problems were noted in the materials provided for review or mentioned during any of the on-site interviews.

Recommendations: None

Procedure 22 – Prevention of the Use of Persons with a Felony Conviction

Observations: The Company has a written procedure addressing the Use of Persons with a Felony Conviction Procedure. The procedure is clear and readable and dated July 2005. No conflicts with Delaware's statutes or regulations are noted.

If an appointment is required, the background check is automatically sent to the Company's background check vendor (GIS) via Appointpak, the tool used to make all appointments. Background checks are performed in all states which require them. The Company uses Kaplan Financial's E-Pal product as their reference tool to determine which states require background checks. The background check criteria are listed below:

Criminal History: Any misdemeanor convictions found at the county level, any felony convictions found at the county level.

Credit History: Bankruptcies and tax liens within one (1) year totaling \$5,000 or more, Bankruptcies and tax liens within seven (7) years totaling \$15,000 or more, Garnishment on earnings within the last five (5) years.

Recommendation: A federal requirement (18 USC §1033) makes it illegal for an individual convicted of a crime involving dishonesty, breach of trust or a violation of the Act to work or continue to work in the business of insurance affecting interstate commerce without receiving written consent from an insurance regulatory official authorized to regulate the insurer. Until such time as consent is given, a person who has committed such a crime is considered a "prohibited person" in the insurance industry. Every prohibited person must be granted written consent to engage in the business of insurance before that person can engage in the business of insurance. The consent must be issued by the appropriate insurance regulatory official and must specify that it is granted for the purpose of 18 U.S.C. § 1033. A "prohibited person" includes but is not limited to, any insurance agency or insurance company employee, agent, solicitor, broker, consultant, third-party administrator, managing general agent, or subcontractor representing an agency or company who engages or participates in the business of insurance as it affects interstate commerce, who has been convicted of any criminal felony involving dishonesty, breach of trust, or a violation of the Act.

The Company responses indicate the Company considers the federal requirement for producers. The Company should develop written procedures to ensure they comply with the provisions of 18 USC §1033 for all Officers, Directors, and employees of the insurance company, agents, brokers, solicitors, managing general agents, claims adjusters, resident licensees, and other persons (e.g.; agents, third-party administrators, independent contractors) who perform substantial insurance-related activities for the Company. It is also recommended that the procedure address:

- revision and audit history of the procedure;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

Procedure 23 – Policyholder Service

Observations: The Company has a written procedure manual for Policyholder Services that is clear and readable. The procedure is accessible to persons subject to its provisions, and training is provided to persons affected by the procedure. No conflicts with Delaware's statutes or regulations are noted.

With limited, significant exceptions, (mid-term cancellation) XL's US Risk Management (USRM) requires that endorsements be pended for processing until the end of the policy. Endorsements are handled at the time of premium audit.

All policies are subject to audit. USRM utilizes a premium audit company to conduct on-site audits of client books and records. USRM just completed its first audit/renewal season. As such, specific procedures are still in development.

The renewal process begins approximately one hundred, twenty (120) days prior to expiration. The Technical Deal Administrator (TDA) prepares a conditional notice of renewal (from Oden) and sends it to the Insured. The underwriter and broker open discussions regarding a renewal strategy.

All three transactions are reviewed/underwritten/invoiced (if appropriate) in a manner similar to new business transactions.

USRM requires that endorsements be pended for processing until the end of the policy. Endorsements are handled at the time of premium audit.

USRM holds management meetings approximately twice per month. These meetings are informal in structure, and allow for interactive, roundtable discussions. The focus of the meeting is more strategic/overview (rather than tactical or agenda-driven discussions). The Company uses it as an opportunity to promote awareness and level understanding among all groups within USRM and to discuss problems and issues that may be impacting the Company.

Recommendations: None

Procedure 24 – Premium Billing Procedure

Observations: The Company has a premium billing procedure. The procedure is clear and readable. The Company has different procedures for each business unit.

XL U.S. Risk Management underwriter meets with the Director to review the structure and specifics of the bound account. The underwriter provides the account information to Underwriting Services. The TDA completes the Post Deal checklist, listing various administrative and regulatory action items, including the policy instruction sheet and the invoice. Invoices are issued shortly after binding with copies forwarded to Accounting in Exton at the same time they are sent to the broker and Insured. An invoice copy is also sent to credit control. TDA forwards the file's contents to the Policy/Deal Administrator (PAM). The PAM inputs the policy into the Company's computer processing system, completes financial and statistical coding steps, and produces a draft policy for the TDA's review. The policy shows as bound once financial and statistical coding is complete. A print screen of the final premium screens is provided to the underwriter. The underwriter compares the booked premiums to the proposed premiums. There are a small number of policies that cannot be coded due to system issues. In these instances, relevant policy details are summarized on a spreadsheet and sent to Exton Finance for recording in the financial database and the ledger.

XL Marine and Offshore does not issue invoices. Payments are received through broker's monthly statements. The Company is notified of all payments to verify the accuracy of amounts paid against amounts booked. Non-payments of premium and incorrect payments are brought to broker's attention for collection, explanation and resolution.

Cargo policies are written on an agency bill basis. The Company does not bill the premium on new and renewal business until the binder has been received, reviewed and approved by the underwriter. Billing coincides with the month of the effective date of the policy. On adjustable and reporting policies, the technical assistant calculates the earned premium for the period of the report and gives it to the underwriter for approval before the premium is processed. The underwriter determines if an audit is required. If an endorsement is required, the billing coincides with the issuance of the endorsement.

XL Programs' MGA, MGU, provides all financial information and reports, monthly bank statements, and the applicable statistical codes for each binder, policy, or endorsement. In addition, MGU provides the state, line of business, sub-line of business, classification code, rating factors, premium, agent, sub-producer or broker, policy limits, deductible or self-insured retention, effective date, expiration date, insured name and address, transaction code, and other transaction information necessary to enable the Company to comply with its compliance, financial and statutory accounting obligations. Information is provided on a summary or transactional level, as required by the Company, within five (5) days after the end of each calendar month, in the form and with the content required by the Company. MGU ensures that all financial information required by the Company is accurately coded, input, and balanced. MGU supports the Company in identifying and correcting any reconciliation issues which emerge

XL Design Professional policy issuance, coding, commission calculation, billing, etc., are all generated by the data processing systems. Once the policy is set-up in the system, it is available to Finance for agency account information and billing/accounts receivable management. The agent responsible for premium collection completes a direct billing to the insured. The agent is responsible to pay the company on an account current basis, forty-five (45) days from the policy effective date. Once remittance has been received, it is entered into the payment manager system and a monthly reconciliation is conducted.

XL Professional invoices are produced when the policy is bound. An invoice Summary sheet is emailed or faxed along with the binder. Two invoices are mailed directly to the broker of record.

Recommendations: None

Procedure 25 – Correspondence Routing Procedure

Observations: The Company does not have a formal written correspondence routing procedure. Each of the Company's business units has their own correspondence routing processes.

In XL Environmental, incoming mail comes into a central location in their mailroom. If the correspondence has a person's name on it, it is opened, stamped, returned to the envelope and placed in their mail bin for delivery. If the correspondence does not have a person's name on it, it is indexed on the AS400 to identify the appropriate recipient. If no identification is found, the mailroom attempts to phone the sender to gain additional information to determine the intended recipient. If identification attempts fail, a "Return to Sender" letter is attached to the mail and it is submitted back to sender for more information."

XL Aerospace correspondence is sent by brokers via fax, mail, or email to individuals within the Aerospace Division office. Correspondence is routed to the individuals assigned to work on the account within Underwriting, Risk Control, Claims or Finance. Additional details of correspondence routing are encompassed within the Aviation and Space Business Process Documentation Procedures.

XL Equine correspondence is routed through Equine management or underwriters. Management or Underwriters determine how the correspondence should be disseminated if it is not related to their responsibilities or a specific account. Management establishes a correspondence handling procedure when management and underwriting are out of the office.

XL Professional provided the following statements: "USPS mail is picked up by 9:00 a.m. daily and distributed to addressees by 11:00 a.m. Overnight express mail is delivered as soon as received. Outgoing regular mail is deposited daily by 5:00 p.m. Express mail is picked up by 4:30 p.m. daily." XL Design Professional "distributes its products exclusively through 54 independent agents throughout North America, known as the Professional Liability Agency Network ("PLAN Network"). Therefore, the majority of insured correspondence is conducted via this agency network. Most of the correspondence is communicated between the agent and company via the EAP system – application submission, quoting, request to bind, binding confirmation, etc. in addition, the more traditional methods of correspondence are also utilized – phone, fax, mail." XL Professional and XL Design do not have formal written procedure but have processes in place for correspondence routing.

XL Select Professional submissions are sent to the underwriter via fax, mail or email. Upon receipt, the underwriter processes for name clearance and submission set-up. Once the setup information is entered into the WINS system and quote logged, the underwriter then reviews the submission. The current version is dated July 2003.

The Company's XL U.S. Risk Management, XL Marine and Off-Shore Energy, XL Programs, do not have formal written procedures on correspondence routing. Their process is that all correspondence is received in the mailroom, date stamped and distributed to the appropriate person. Unidentifiable mail is researched then forwarded to the appropriate person.

Recommendations: It is recommended that the Company's XL Equine, XL Professional, XL Design, XL U.S. Risk Management, XL Marine and Off-Shore Energy, XL Programs develop a formalized correspondence routing procedure. It is also recommended that the procedure address:

- revision and audit history of the procedure;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

Procedure 26 – Policy Issuance Procedure

Observations: The Company has a written policy issuance procedure. Each business unit also has their own procedure/process. No conflict with Delaware statutes and regulations was noted.

The Company's XL U.S. Risk Management Technical Deal Administrator (TDA) reviews draft policy comparing coverages and endorsements to the coverages and endorsements cited in the proposals, binders, and/or broker's annotated coverage specifications. Once the policy is acceptable, it is forwarded to the underwriter for final review. The underwriter reviews the policy compared to proposals, binders and/or broker's annotated coverage specifications. If acceptable, the underwriter initials the control sheet as evidence of review and returns draft policy to the PAM for release. PAM generates a final policy from WINS and forwards to the TDA. The TDA performs a final review using corrected draft policy. If acceptable, the TDA mails the policy to the broker. The TDA provides material to the PAM, who creates a policy file, labels etc. The PAM then sends policy file to the file room.

The Company's XL Environmental generates a report based on the prior months binding/ mailing activity for all policies. The monthly data is merged with prior month's data to provide a snapshot on progress. All policies not mailed greater than 55 days from the effective date are provided to the unit managers to provide a description of the progress/delay. The responses by the unit managers are combined and submitted to the President for review/response.

XL Aerospace indicated that once a policy is bound, the underwriter or underwriting assistant assigns the account a policy number by handwriting the insured's name and policy period into a Policy Register Log. The underwriter receives/sends the

confirmation of coverage binder and processes as needed. The underwriter then creates an Account Review Sheet for the account and collects all correspondence, analysis and other notes. The account is assigned a folder, it is reviewed and signed off and then it is given back to the underwriting assistant.

XL Marine and Offshore creates a proposed policy in compliance with the binder and forwards to the Technical Assistant for issuance. The Technical Assistant issues the complete policy and cover letter and forwards it to the Underwriter for review. The Underwriter returns the signed policy and cover letter to the Technical Assistant. The Technical Assistant mails the cover letter, original policy, and two policy copies to the broker. The Technical Assistant then files one copy of the policy and cover letter in the policy file. The Technical Assistant returns the policy file to the file room.

The objective of XL Equine Policy issuance procedures is to ensure policies are issued in a complete, compliant and timely manner. Bound Policies are entered into the WINS computer tracking system. Policies are issued in accordance with the terms and conditions of binding captured in the WINS system. Policies are issued and undergo an internal Quality Control process.

XL Professional's Policy Issuance Coordinator (PIC) requests the declarations page of the policy from RT/Genius. The PIC then compares the binder data to the declarations page data to ensure that all policy and endorsement details are correct. Endorsements for attachment to the policy are stored in Word files. They are opened in word and formatted with effective date, policy number, insurer name, insured name, and endorsement number. Policies are proofed by the underwriter and delivered to the policy mailer for assembly. Two copies of the policy are sent to the broker with one copy retained for the policy file.

XL Design Professional Agents submit applications electronically via a workflow management system called the Electronic Application Program ("EAP"). The system handles application entry, rating, quoting, binding and endorsements. There is an interface between the "EAP" and the Phoenix system... At the point of binding the contract, all policy information (i.e., agency, insured, commission rate, premium, limits, and rating information) is uploaded into the Phoenix system automatically, creating a policy portfolio for policy issuance. Once the policy is ready for production and reviewed by the Underwriter, an Underwriting Assistant prints the policy and mails it to the insured and agent.

XL Select Professional's underwriting assistant issues all policies through WINS. Three policies are printed, two go to the agent and one is retained for the policy file. The package is then sent to the agent with a letter from the underwriter. The underwriting assistant continues to update the policy as needed.

XL Programs does not issue policies directly. Managing General Agents and Managing General Underwriters issue all of the policies out of the XL Program unit. Those

businesses are responsible for the issuance and maintenance of the policy. XL Program is responsible for the administration of the programs.

Recommendations: None

Procedure 27 – Reinstatement Procedure

Observations: The Company has a written reinstatement procedure. The procedure is clear, readable, organized and available to persons needing access to, or affected by, the procedure. The procedure was adopted in June 16, 2004.

XL Environmental's Bulletin 04-0019 includes information related to cancellation for non-payment of premium, and mentions reinstatements. If a letter of cancellation was sent, a Direct Notice of Cancellation was sent, payment was received prior to AS400 cancellation and the payment was received prior to effective date of cancellation, staff from the accounting area advises USG to reinstate the policy in the computer system.

XL Programs reinstatement procedures are referenced in customized Underwriting Guidelines by Program. The operation and effectiveness procedures are measured through Finance, Compliance and underwriting audits.

XL Fine Arts and Specie unit utilizes the computer system to generate state-approved cancellation notices. In the event that the notice would be rescinded and the policy reinstated, an endorsement is issued and a letter sent to rescind the cancellation notice.

XL Design Professional finance companies or agencies send reinstatement requests directly to the regional underwriting office. The Underwriter receives the notification, approves it and gives it to the Underwriting Assistant for reinstatement processing. Underwriting Assistants then reinstate the policy in the computer system, and a notice of reinstatement is automatically sent out.

XL Professional unit procedures indicate that if premium is received within 30 days after the policy was cancelled in the computer system, the submission is underwritten again. If, after satisfactory underwriting, the risk remains the same, the policy is reinstated.

XL U.S. Risk Management and XL Marine and Off-Shore Energy do not have written procedures for policy reinstatement. XL U.S. Risk Management uses ODEN Terminator and ODEN Online Cancellation, Non-renewal and Conditional Renewal Manuals to terminate policies and reinstate when that information is available.

Aerospace does not provide for policy reinstatements.

These procedures do not appear to conflict with Delaware statutes or regulations. Procedures are provided to all employees as necessary and Internal Audit reviews compliance with the procedures.

Recommendations: None

Procedure 28 – Insured or Member Requested Claim History Procedure

Observations: The Company has a claim history request procedure. The procedure is clear, readable, organized and available to persons needing access to or affected by the procedure. The procedure was adopted in March 10, 2005.

The XL Environmental unit's procedure is as follows:

- loss runs are requested in writing;
- USG verifies whether the requester is the broker of record;
- if of the requestor is verified, a report is generated and sent to via email or by mailing a hard copy;
- if the requestor is not verified, the user reviews the request with the underwriter for guidance. If the requestor cannot be verified, the underwriter can request that the insured sign off before any information is released.

According to the Company, XL Aerospace's business unit requests for claims history go through the Insured's broker to the Aviation or Space Underwriting teams. The underwriting team provides correspondence back to the broker via email or fax. Details of past losses are provided through loss runs or a statement that there have been no claims.

XL's Program unit utilizes Third Party Administrators to provide claim history reports. Measurements of the operation and effectiveness of the written procedures are made by follow-up with the TPAs to ensure completed requests have been submitted to XL.

XL's Fine Arts and Specie has all requests for loss history sent to the Claims Manager who secures a loss run from the computer system.

XL Professional business unit's policy number, Insured Name, Matter/Reference Number and Subject Status (Open/Closed) are provided, upon request, to brokers. The number of reported, open, paid claims, and the paid amounts are provided to the Insured. .

XL Design Professional business units' insurance application includes a requirement for the insured's claims history. The Company requires a 5-year loss history, currently valued, for the Company's review. For renewals, the underwriter accesses an insured's claims activity and generates a loss report 60 days in advance of renewal

XL Select Professional requests come through the agent and are routed to the claims department for handling.

The XL U.S. Risk Management and XL Marine and Off-Shore Energy units do not have a written procedure.

These procedures do not appear to conflict with Delaware statutes or regulations. The procedures are provided to all employees as necessary and the Internal Audit reviews measure compliance with the procedures.

Recommendations: None

Procedure 30 – Premium Determination and Quotation Procedure

Observations: The Company has a written premium determination and quotation procedure. This procedure is clear, readable, organized and available to persons needing access to or affected by the procedure. The procedure was adopted in May 2005.

XL Equine’s premium determination utilizes risk exposure rates, premium increases, changes and yearly authority statements. These documents provide direction and guidance for rating the risk exposure. Underwriting Authority Schedules determine an Underwriter’s ability to quote a particular risk exposure based upon limits of liability, coverage and authority type. Guidelines establish the means to premium development and issuance of a quotation. Quotes are prepared in accordance with the established instructions and Guidelines.”

XL Programs’ premium determination and quotation procedures are contained in the customized Underwriting Guidelines developed by Program. The method used to measure the operation and effectiveness of this tool is Compliance and Underwriting audits. See the Audit section for additional information.

XL Professional’s business unit receives a submission which is then analyzed by the underwriter. Analysis includes assessing the company’s financial condition through a review of financial statements, reviewing recent analyst reports, reviewing recent news and correspondence with the broker or the client. Based upon the analysis performed, the underwriter either rejects the submission or brings it to a round table review. The underwriter supports pricing utilizing a standard rating sheet, which is based on the rating plan filed with and approved by each applicable state.

XL Design Professional’s business unit performs an automatic download of the application details into a standard template called A/E Underwriter Notes. The Underwriter reviews the information included in the insurance application and A/E Underwriter Notes along with any available information. The underwriters perform an initial rating assessment. Based on the rating given during the assessment, the Underwriter decides if the applicant is approved or denied. Once approved, the Underwriter builds a rating schedule to derive a premium amount. The A/E Standard Rate Development Template is loaded into the computer system and a quotation form is created. Once the quotation is created no manual adjustments are allowed.

XL Marine and Off-Shore Energy do not have written procedures.

The procedures do not appear to conflict with Delaware statutes or regulations. The procedures are provided to all employees and are measured through Internal Audit reviews.

Recommendations: None

Procedure 31 – Policyholder Disclosures Procedure

Observations: The Company has a written policyholder disclosure procedure. This procedure is clear, readable, organized and available to persons needing access to or affected by the procedure. The procedure was adopted in May 2005.

The XL Insurance General Practice unit has developed an online resource to produce policies using the appropriate rates, rules and forms. Included in the online resource is a Statutory Policyholder Notice Section, which provides the underwriter and/or policy production team to select the appropriate policyholder notices.

As part of U.S. Risk Management policy issuance process and policy checking, the list of mandatory policyholder disclosure notices is used to confirm that all required documents are made part of the final policies.

XL Environmental binds paperwork and forwards it to the USG department. USG reviews the online resource and prints out the mandatory policyholder disclosures that must be attached to the policy.

XL Aerospace, XL Equine, XL Programs, XL Fine Arts and Specie, XL Professional, XL Select Professional programs use the online resource for this procedure. The method used to measure the operation and effectiveness of this tool is Compliance and Underwriting audits.

XL Design Professional utilizes three types of policyholder disclosures: Fraud Warnings, State Amendatory Endorsements, and State Notices. Each is handled in a different way as follows:

- **Fraud Warnings:** These appear on every application and contain state-specific language.
- **State Amendatory Endorsements:** State-specific endorsements are automatically attached to the policy by the computer system.
- **State Notices:** The Underwriting Assistant is responsible for attachment of state notices to policies as required.

Underwriters and Underwriting Assistants have a regional endorsement listing by state indicating which endorsements are required, including any state-specific notices. This listing is used in the quality review process before a policy is mailed out.

XL Marine and Off-Shore Energy do not have a formal written procedure. They reference the online reference to determine any state-specific policyholder disclosures.

Recommendations: None

Procedure 32 – Underwriting and Selection Procedure

Observations: The Company has a written premium determination and quotation procedure. This procedure is clear, readable, organized and available to persons needing access to or affected by the procedure. The procedure was adopted in October 23, 2003.

XL Environmental business unit's Formal Underwriting Rules and Guidelines exist for each product line offered and are made available to underwriting staff in an online reference area. Adherence with the established underwriting guidelines is controlled through the maintenance of formal underwriting authority statements and compliance is verified through the internal audit procedure. The logic supporting the underwriting and selection procedure is evidenced in a formal Customer Acquisition Document (CAD) that is completed on every bound account and is retained in the underwriting file.

XL Aerospace unit's additional underwriting and selection procedures are contained in the customized Underwriting Guidelines developed by Program. The methods used to measure the operation and effectiveness of this tool includes internal audits, peer reviews and underwriting Audits. The review of these documents showed no exceptions.

XL Equine utilizes authority statements outlining general objectives for the selection of risks. These statements also provide the Underwriter with their individual authority limits and the binding of policies.

XL Programs additional underwriting and selection procedures are contained in the customized Underwriting Guidelines developed by Program. The method used to measure the operation and effectiveness of this tool includes reviewing underwriting audits, reviewing bordereaux, and reviewing large loss files referred to claim department. The review of these documents showed no exceptions.

XL Design Professional business unit performs an automatic download of the application details into a standard template called A/E Underwriter Notes. The Underwriter reviews the information included in the insurance application and A/E Underwriter Notes, and any additional information received. The underwriters perform an initial rating assessment and based on the rating given, the Underwriter decides if the applicant is approved or denied. Once an applicant is approved, the Underwriter builds a rating schedule to derive a premium amount. The AEE Standard Rate Development Template is uploaded into the computer system and a standard quotation form is created. Once the upload is complete and the quotation has been created, there can be no manual adjustments to the quote.

XL Marine and Off-Shore Energy do not have a formal written procedure.

These procedures do not appear to conflict with Delaware statutes or regulations. The procedures are provided to all employees as necessary and are measured through Internal Audit reviews.

Recommendations: None

Procedure 33 – Rate and Form Filing Procedure

Observations: The Company has a written rate and form filing procedure. This procedure is clear, readable, organized and available to persons needing access to or affected by the procedure. The procedure was adopted in July 2005.

The Company provided the Examiner with a State Filings and Compliance Procedure Manual. XL processes submissions to obtain approval of rate, rule and form filings for the Operating Business Units and Program Managers. The company encourages education in the areas of state filing, contract analysis, insurance regulations and insurance operations.

The procedure is provided to all employees and is measured through Internal Audit reviews.

Recommendations: None

Procedure 34 – Termination Procedure

Observations: The Company has a written premium determination and quotation procedure. This procedure is clear, readable, organized and available to persons needing access to or affected by the procedure. The procedure was adopted in November 1, 2005. No conflict with Delaware statutes or regulations was noted.

XL Insurance businesses use the ODEN Policy Terminator to terminate policies. The ODEN On-line product is also used to determine the termination guidelines for each state. The ODEN On-line products are available via the online resource area.

Recommendations: None

Procedure 35 – Underwriting File Documentation Procedure

Observations: The Company has a written underwriting file documentation procedure. This procedure is clear, readable, organized and available to persons needing access to, or affected by, the procedure. The procedure was adopted in October 23, 2003.

XL General Business Practice uses the online resource area to identify the necessary file documentation and processes.

XL Design unit utilizes the A/E Underwriting Notes and the Underwriting Assistant prints insurance applications. An underwriting file is created and is given to the respective Underwriter for review. The Underwriting Assistants ensure that all documents such as the AEE Standard Rate Development Template, quotation, request to bind, binder and final contract are in the underwriting file, along with all other documentation and correspondence.

XL Professional utilizes a quoting worksheet based on the Company's underwriting guidelines. Due diligence documentation includes an examination of financial statements, auditor's opinion, disclosure, press releases and other related data.

XL Programs file documentation procedures are contained in the customized Underwriting Guidelines developed by Program. The method used to measure the operation and effectiveness of this tool is through internal audits.

XL Equine maintains consistency in its file documentation through adherence to the procedures established for the entry of information into the computer system, quote development, quality control and document retention.

XL Marine and Off-Shore Energy underwriting decisions are documented on the Off-Shore Energy Underwriter Notes exhibits.

XL Aerospace Underwriting file documentation procedures are contained within the Business Process Documentation for Aviation and Space. The measurement of the operation and effectiveness is through internal and underwriting audits.

XL Environmental has a formal policy set-up procedure that provides guidance regarding underwriting file documentation. The underwriting and selection procedure is evidenced in a formal Customer Acquisition Document completed on every bound account and is retained in the underwriting file.

XL Fine Arts and Specie does not have a formal written process. Underwriters must properly document the underwriting file to include all support for all rating usage. The procedure does not appear to conflict with Delaware statutes or regulations. The procedure is provided to all employees as necessary and Internal Audit reviews measure the effectiveness of the procedures.

Recommendations: None

Procedure 36 – Underwriter Training

Observations: The Company does not have a written Underwriter Training Procedure. XL Environmental has each Underwriter undergo training when hired. The training process is a collaborative effort involving the line of business the Underwriter is assigned, Human Resources, IT, and Corporate Underwriting.

XL General Business Practice and XL Programs provide on-site training for new employees. XL Insurance offers a tuition reimbursement program to encourage employees to participate in job related courses. The Company provides management training via XL HR developed management training programs such as, Global Development Program, Performance Development Program and Leadership Development Program. Training is part of every manager's goals and objectives and personal development is rated at all performance reviews for all employees at all levels.

Recommendations: It is recommended that the Company formulate, adopt and implement a written Underwriting Training procedure. It is also recommended that the procedure address:

- revision and audit history of the process adopted;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the process addressed by the written procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

Procedure 40 – Staff Training

Observations: The Company does not have a Staff Training Procedure. XL Insurance provides on-site training for their new employees and offers a tuition reimbursement program to encourage employees to participate in job related courses. XL Insurance also provides management training via XL Human Resource developed management training programs such as, Global Development Program, Performance Development Program, and Leadership Development Program.

XLIA stresses underwriting integrity and profitability. This is accomplished by operating in “niche” areas requiring a significant degree of specialized knowledge and by acquiring experienced and successful operators in those niches. Regardless of the area of specialty, the individuals underwriting on behalf of XLIA are seasoned underwriters. Many of the underwriters have come from the actual industries they are now evaluating as underwriters. These underwriters adhere to a core philosophy to only underwrite business that meets the Company's underwriting criteria in accordance with the Company's guidelines.

Similar to the underwriting staff, claims personnel working on the Company's behalf have experience in handling and settling losses and claims in all of the areas engaged. They are knowledgeable to handle all claims related services tailored to the niche business units they serve. In some areas, due to the extremely specialized skills required, XLIA may not have the appropriate internal resource to handle the potential losses of a certain class of business. In those cases, claims specialists are engaged, usually through a Third Party Claims Administration (TPA) agreement.

Recommendations: It is recommended that the Company formulate, adopt and implement a written Staff Training procedure. It is also recommended that the procedure address:

- revision and audit history of the process adopted;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the process addressed by the written procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

Procedure 42 – Adjuster/Claims Adjudicator Training

Observations: XL Insurance does not have a formal written procedure regarding Adjuster Training. XL Insurance provides internal training for the newly hired adjusters. It is the Company's general practice to hire seasoned adjusters with a background adjusting claims similar to those experienced by the Company. XL supports and promotes continued education and on-going training. Claims staff attends various insurance seminars and classes offered around the country. XL Insurance is currently developing a written procedure.

Recommendations: It is recommended that the Company formulate, adopt and implement a written Adjuster/Claims Adjudicator procedure. It is also recommended that the procedure address:

- revision and audit history of the process adopted;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the process addressed by the written procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

Procedure 43 – Claim Handling

Observations: The Company has a written Claim Handling Procedure. The procedure is clear and has been in place for ten (10) years. The Company appoints a Process Improvement Committee annually to review and revise the procedure, which includes

changing any area that might be affected by any recent legal changes. No conflicts with Delaware's statutes or regulations are noted.

All Company claims are handled at the Company's Exton, PA office. The Company receives approximately 4,000 claims per year. Of the open claims, seventy percent (70%) are automobile liability, twenty-five percent (25%) are general liability and the remaining five percent (5%) are divided among Property, Inland Marine and Marine. The Company has eleven (11) in-house adjusters that handle claims, and rely on independent adjusters across the United States. The Company receives the majority of claims via facsimile, with other claims received through mail, telephone and email.

Upon receipt of a claim, the supervisor reviews the claim, assigns an approximate reserve and an adjuster. The claim is given to the claim transfer center to be logged into the computer system, a file is created and a claim number assigned. The file is given to the adjuster to be worked. Normally, this process is completed within the same business day.

The supervisor uses his/her discretion as to which adjuster will work each claim, depending on the adjuster's experience. The Company's environmental consultants are involved with the remediation of all claims involving hazardous materials, spills, etc.

Once the adjuster receives the claim, they must contact the insured within twenty-four (24) hours and begin the investigation process. Each adjuster is assigned a maximum reserve and, before any claim is paid, a supervisor reviews the claim. A ledger is produced each day including all payments sent to the Accounting Department. Clean claims are paid within one day, and can be mailed out that same day, depending on the urgency.

Each quarter, the Company randomly selects and reviews five (5) claims per adjuster. The Company's Global Audit Company also conducts an annual review by selecting claims at random to review in detail. No results from the audit were requested or provided by the Company for review.

Recommendations: None

Procedure 44 – Internal Claim Audit

Observations: The Company has a written Internal Claim Audit Procedure. The procedure is updated annually or as needed. No conflicts with Delaware's statutes or regulations are noted.

Each quarter, the Company selects five (5) claims per adjuster to review. The Company's Global Audit Company also conducts an annual review by selecting claims at random to review in detail. Each claim unit is audited on a two year cycle to measure compliance with claims standards and requirements. Any claim units receiving a Needs Improvement rating will have a follow-up review within one (1) year. An annual review

of the risk factors impacting the business is considered and, if management deems it necessary, a unit may be reviewed again in less than two (2) years.

The techniques used during an audit include a sample review of claims against standards (complaint compliance, internal and external), interviews of claims and non-claims personnel, process analysis and a review of management reporting and customer service requirements.

An annual reconciliation is performed across the entire claims network to verify that the claim files and the key data fields in the claim systems match.

Areas audited include claim office operations, TPA/Vendor's qualifications and performance, and other claim functions reporting to the Global Claims Executive (GCE).

Recommendations: None

Procedure 45 – Claim File Documentation

Observations: The Company has a written Claim File Documentation Procedure. The procedure has been in place for ten (10) years. The Company appoints a Process Improvement Committee annually to review and revise the procedure, which includes changing any area that might be affected by any recent legal changes. Please refer to the observations in Procedure 43, Claim Handling, for more information on claim file documentation. No conflicts with Delaware's statutes or regulations were noted.

Recommendations: None

Procedure 46 – Subrogation and Deductible Reimbursement

Observations: The Company does not have a written Subrogation and Deductible Reimbursement Procedure. The Company uses a Special Distribution Channel Movements Report that identifies all proceedings (reserve amendments, payments reducing reserves). The Claims Manager reviews the report on a weekly basis.

Recommendations: It is recommended that the Company formalize, adopt, and implement a written procedure for the Subrogation and Deductible Reimbursement Process. It is also recommended that the procedure address:

- revision and audit history of the process adopted;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the process addressed by the written procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

Procedure 47 – Reserve Establishment

Observations: The Company does not have a written Reserve Establishment Procedure however; they do have a process in place.

The Company reserves are posted into the individual case reserves account (unpaid losses) which is reduced when the actual payments have been executed. Each payment in the computer system generates a posting in both the claims account and the respective claims expenses account. The computer system indicates whether a payment is a regular claims settlement or a loss adjustment expense. Once an appropriate level of Senior Claims Management and claim payments approves reserves are authorized in the computer system, the process is supervised by the Central and Local Finance Department.

Recommendations: It is recommended that the Company develop a formal written Reserve Establishment Procedure. It is also recommended that the procedure address:

- revision and audit history of the process adopted;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the process addressed by the written procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

SUMMARY

XL Specialty Insurance Company (XL Specialty) is a Property and Casualty Company domiciled in Delaware.

The examination was a limited scope market conduct examination of the following business areas: Company Operations/Management, Complaint Handling, Marketing and Sales, Producer Licensing, Policyholder Service, Underwriting and Rating, and Claims.

The most significant issue noted during the course of the examination is that the company needs to formalize a written procedure for the following issues:

- Disaster Recovery (P-6)
- Agent Produced Advertising (P-14)
- Producer Training (P-15)
- Prevention of the Use of Persons with a Felony Conviction (P-22)
- Correspondence Routing (P-25)
- Underwriter Training (P-36)
- Staff Training (P-40)
- Adjuster Training (P-42)
- Subrogation and Deductible Reimbursement (P-46)
- Reserve Establishment (P-47)

Recommendations have been made to address the areas of concern noted during the examination. These are summarized below.

LIST OF RECOMMENDATIONS

As noted above, the Company needs to formalize several different procedures. The following is a listing of those procedures.

Recommendation P-06, Disaster Recovery Procedure

It is recommended the Company develop a formal Disaster Recovery Procedure that includes the Company's processes in the event of a disaster, and the recovery process

Recommendation P-14, Agent Produced Advertising Procedure

The Company should develop a formal written Agent Produced Advertising Procedure.

Recommendation P-15, Producer Training Procedure

The Company should develop a formal written Producer Training Procedure.

Recommendation P-25, Correspondence Routing Procedure

It is recommended that the Company develop a formal correspondence routing procedure.

Recommendation P-36, Underwriter Training Procedure

It is recommended that the Company formulate, adopt and implement a written Underwriter Training procedure.

Recommendation P-40, Staff Training Procedure

It is recommended that the Company formulate, adopt and implement a written Staff Training procedure.

Recommendation P-42, Adjuster Training Procedure

It is recommended that the Company formulate, adopt and implement a written Adjuster Training procedure.

Recommendation P-46, Subrogation and Deductible Reimbursement Procedure

It is recommended that the Company formalize and adopt a complete procedure for the Subrogation and Deductible Reimbursement Process.

Recommendation P-47, Reserve Establishment Procedure

It is recommended that the Company develop a formal written Reserve Establishment Procedure.

In each of the above recommendations, it is noted a formal written procedure is necessary. When developing each of those separate processes, the company needs to ensure that the following issues are addressed in each procedure:

- revision and audit history of the procedure;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

In addition to those noted above, the examination also proposed the following recommendation. While similar to the above, it involved additional issues, and is therefore listed separately.

Recommendation P-22, Prevention of the Use of Persons with a Felony Conviction

A federal requirement (18 USC §1033) makes it illegal for an individual convicted of a crime involving dishonesty, breach of trust or a violation of the Act to work or continue to work in the business of insurance affecting interstate commerce without receiving written consent from an insurance regulatory official authorized to regulate the insurer. Until such time as consent is given, a person who has committed such a crime is considered a "prohibited person" in the insurance industry. Every prohibited person must be granted written consent to engage in the business of insurance before that person can engage in the business of insurance. The consent must be issued by the appropriate insurance regulatory official and must specify that it is granted for the purpose of 18

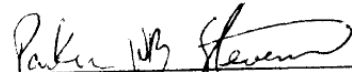
U.S.C. § 1033. A "prohibited person" includes but is not limited to, any insurance agency or insurance company employee, agent, solicitor, broker, consultant, third-party administrator, managing general agent, or subcontractor representing an agency or company who engages or participates in the business of insurance as it affects interstate commerce, who has been convicted of any criminal felony involving dishonesty, breach of trust, or a violation of the Act.

The Company responses indicate the Company considers the federal requirement for producers. The Company should develop written procedures to ensure they comply with the provisions of 18 USC §1033 for all Officers, Directors, and employees of the insurance company, agents, brokers, solicitors, managing general agents, claims adjusters, resident licensees, and other persons (e.g.; agents, third-party administrators, independent contractors) who perform substantial insurance-related activities for the Company. It is also recommended that the procedure address:

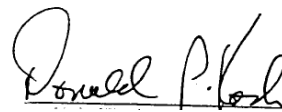
- revision and audit history of the procedure;
- adequate training for persons affected by the procedure;
- management exercise of oversight and control of the procedure;
- formulation and use of measurement structures to assure the Company that the procedure is working as intended;
- utilization of the measurement structures to revise the procedure when indicated

CONCLUSION

The examination was conducted by Donald P. Koch, Parker W.B. Stevens, Susanna Stevens, and Candace Reese and is respectfully submitted,



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