

REPORT OF
MARKET CONDUCT EXAMINATION
OF
CLEARWATER INSURANCE COMPANY
AS OF
OCTOBER 1, 2005

I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON MARKET CONDUCT EXAMINATION, made as of OCTOBER 1, 2005 of the

CLEARWATER INSURANCE COMPANY

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

ATTEST BY:

Antoinette Handy

DATE: 20 MARCH 2007

In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 20TH DAY OF MARCH 2007.



Matthew Denn

Insurance Commissioner

REPORT ON MARKET CONDUCT EXAMINATION
OF THE
CLEARWATER INSURANCE COMPANY
AS OF
October 1, 2005

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

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

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

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

MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 20TH day of MARCH, 2007.

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SALUTATION

August 1, 2006

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 Certificates of Examination Authority Number 06.705, and pursuant to statutory provisions including 18 Del. C. §318-322, a market conduct examination has been conducted of the affairs and practices of:

Clearwater Insurance Company

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

- 17 State Street, New York, NY

The examination is as of October 1, 2005.

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

This 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 on insurer. For all insurers, these areas include:

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

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. It 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 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 the 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

Clearwater Insurance Company was incorporated in New York on May 15, 1974 under the name Skandia America Reinsurance Corporation. On May 31, 1996, Skandia (now known as Clearwater Insurance Company) and its subsidiaries were sold to Fairfax Financial Holdings Limited (Fairfax). On October 26, 1999, Clearwater and its solely owned subsidiary, Hudson, were sold in an affiliate transaction to Odyssey America Reinsurance Corporation. In this reorganization, Clearwater ceased writing new reinsurance business but became active as an admitted, primary insurer. On December 4, 2003, Odyssey Reinsurance Corporation changed its name to Clearwater Insurance Company.

Clearwater is part of the Hudson Insurance Group (HIG) that is comprised of four (4) primary property casualty insurance carriers that share an employment force and business plan. Those four (4) companies provide the vehicle for Odyssey Re Holdings Corporation's primary insurance operations. Clearwater's role in the Group is to provide an additional widely licensed admitted carrier for the placement of specialty programs. The Company believes this allows them to respond quickly and directly to the needs of consumers since the program administrators have specific expertise.

The main administrative office is located in New York, NY. The Board of Directors and executive management team consists of individuals who serve in a similar capacity for the other companies in the Group. Hudson has group officers that include a President and Chief Operating Officer, Chief Actuary, Senior Vice President, General Counsel and Corporate Secretary; Senior Vice President and Controller and a Senior Vice President and Chief Compliance Officer. There is also an Executive Vice President of the Programs Division and a Senior Vice President of the Claims Department.

Currently Clearwater has no employees. The Company has entered into inter-company agreements with affiliated companies in which it obtains certain operational services.

There is one specialty program that Clearwater has entered into: non-trucking liability for truckers who are not on company dispatch. The main state for the program is Tennessee, a state where Hudson was not licensed until December of 2005. The program is expected to generate \$22-\$25 million in direct written premium in 2005.

METHODOLOGY

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

Some standards were measured using a single type of review, while others used a combination of all of the types of review. The types of review used in this examination fall into three general categories: generic, sample, and electronic.

A "generic" review indicates that a standard was tested 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 indicates that a standard was tested through direct review of a random sample of files using sampling methodology described in the Delaware Market Conduct Examiners' Handbook and the *NAIC Market Conduct Examiners' Handbook*. For statistical purposes, an error tolerance level of seven percent (7%) was used for claims reviews and a ten percent (10%) tolerance level was used for other types of review. The sampling techniques used are based on a ninety-five percent (95%) confidence level. This means that there is a 95% confidence level that the error percentages shown in the various standards so tested are representative of the entire set of records from which it was drawn. Note that the statistical error tolerance is not indicative of the DDOI's actual tolerance for deliberate error.

An "electronic" review indicates that a standard was tested through use of a computer program or routine applied to a download of computer records of the examinee. This type

of review typically reviews one hundred percent (100%) of the records of a particular type.

Standards are measured using tests designed to adequately determine how the examinee met the standard. The various tests utilized are set forth in the Delaware Market Conduct Examiners' Handbook. Each standard applied is described and the result of testing is provided under the appropriate standard. The standard, its statutory authority, and its source in the *NAIC Market Conduct Examiners' Handbook* are stated and contained within a bold border.

Each Standard is accompanied by a "Comment" describing the purpose or reason for the Standard. The "Result" is indicated and the examiners' "Observations" are noted. In some cases a "Recommendation" is made. Comments, Results, Observations and Recommendations are reported within the appropriate Standard.

A. COMPANY OPERATIONS/MANAGEMENT

This report is designed as a summary of Observations and recommendations. However, the following two standards are evaluated on a pass/fail basis:

- “The Company is licensed for the lines of business that are being written.”
- “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 methodology for this standard is generic. 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 appears to be licensed for the lines of business being written based upon a review of premium schedules and the Company's Delaware Certificate of Authority.

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

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 is cooperating with the state in the completion of an open and cogent review of the Company’s operations. Cooperation with the examiners in the conduct of an examination is not only required by statute, it is conducive to completing the examination in a timely fashion thereby minimizing cost.

Results: Pass

Observations: During the course of the examination the Company was provided with memorandums and exceptions. If a response could not be provided in the requisite time frame set forth by the examiners the Company responded with an expected due date and reason for the delay. The Company’s communication with the examiners was very responsive. The examiners experienced no 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."

Observations: Clearwater received four (4) complaints during the examination period. The examiners reviewed each complaint. Each complaint was claim related and appears to have been handled properly. Based upon the number of complaints no trends were identified.

Recommendation: None

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; and
- 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 for the absence of a means to measure the results of the application of procedures and 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's audit program is organized into two categories -internal and external audits.

Internal Audits. The Company's contracted audit firm conducts regular internal audits of the Company and its affiliates in order to validate the Company's financials and procedures and to provide an unqualified opinion on those topics.

External Audits. The Company considers external audits to be reviews performed on their business partners referred to as program administrators (PA) and third party administrators (TPA). Audits of PA's and TPA's are performed to determine: 1) the adequacy of the financial and operational controls and 2) adherence to underwriting and/or claims management guidelines. External audits are typically performed by Company employees. Audit goals and guidelines are based upon criteria developed by Odyssey Re's internal audit department. The audit criteria are continually reviewed and revised to reflect the changing control environment. Audit reports describe the scope of the audit performed and allow management to utilize the results for future reviews.

Management of audits is under the direction of the Vice President and Director of Internal Audit (DIA). The DIA is responsible for identifying the audit scope, planning

and reviewing the audit schedule, monitoring audit progress and reviewing report findings. External audit results are sent to Company management and to the PA/TPA that was reviewed. Report comments are followed up on until resolution is reached.

Recommendations: None

Procedure 02 – Assertions of Privilege

Observations: The Company does not maintain a written procedure for the Assertion of Privilege (AOP); however, the Company was able to provide a summary of their AOP process. The Company employs a General Counsel (GC) with the decision making authority in matters related to AOP. Arising issues are forwarded to the GC for assessment and proper handling. The GC has additional authority to retain outside counsel to assist in matters when necessary.

The GC maintains the responsibility of handling privileged materials and recording information selected for AOP in a privilege log. The privilege log is designed to contain information related to when information was prepared, the sender and recipient, title and/or subject matter. The log assists in identifying correspondence related to materials the Company deems to be confidential, proprietary or privileged.

The process has not been designed to indefinitely form a database of information, instead it is used as a tracking system while issues are presented and resolved.

Recommendations: None

Procedure 03 – Company Records, Central Recovery and Backup

Observations: The Company maintains a written procedure manual for Company Records, Backup and Recovery Procedures (CRBR). Procedures for the Company are implemented through the parent company Odyssey Re and monitored from a facility in Stamford, CT. The back-up and recovery processes have been developed to be locally managed with assistance from the Stamford facility when required. Back-up and Recovery procedures include the use of the national storage vendor Iron Mountain whose duties include daily pick up and delivery of back-up tapes. Duties related to the preparation of and the requesting of tapes is assigned to the Network Technology group within the Company.

The Company has controls in place to ensure the movement of data both for internal system changes and for off-site storage. Within the CRBR procedures are directives for change control to ensure operating environments remain constant. All tapes for off-site storage are to be logged both outgoing and incoming to ensure proper storage processes. Both change control and data storage require sign-offs prior to being completed.

Review of the back-up and recovery programs for both Program Administrator (PA) and Third Party Administrator (TPA) is part of the Company's external audit process. In the

event a PA or TPA does not have a back-up or recovery procedure in place, Clearwater recommends that one be put in place and follows up to confirm the procedures have been established. In the event a PA/TPA has a system error resulting in a loss of Clearwater data they are to report this information to the Company immediately. System repairs and re-establishing data are the responsibility of the PA/TPA.

Recommendations: None

Procedure 04 – Computer Security

Observations: The Company retains two manuals regarding computer security, one for physical security and the other for computer (server and workstations) security. The physical security manual contains information describing the general controls around physical computer security for initiating / changing and terminating physical access to the computer environment. The computer information security manual presents control of areas surrounding network monitoring, production processing and problem management resolution and tracking. Both manuals are designed to supplement the control information included in the Sarbanes-Oxley Section 404 (SOX 404) documentation.

Control of computer security is measured through a version control listings. The version control provides when changes were made, who made the changes, description of the changes and change date. Testing to ensure compliance with SOX 404 is monitored by the Company's IT department and internal audit department. Results of SOX 404 testing are presented to Company Management.

Audit reports are reviewed during quarterly meetings with senior management. Any deficiencies in the measurement structure are addressed immediately by management for remediation. However, the Company only reviews their security procedures when deemed appropriate by the Management.

Recommendations: It is recommended that the Company develop structured time frames for the review of its Computer Security and include these timeframes in the existing procedures.

Procedure 05 – Anti-Fraud

Observations: The Company has recently contracted with the firm of GAB Robins (GAB) to assist the Company with their anti-fraud efforts. GAB assists the Company in preparing anti-fraud plans, provides anti-fraud training, reviews suspicious claims and prepares annual special investigation reports. The anti-fraud plans developed by GAB have been distributed to all Third Party Administrators (TPA) who handle day to day claim operations, internal claim staff and part of the TPA claim audits.

The Company works to measure the effectiveness of this new initiative through quarterly contacts with GAB to determine the number and type of claim referrals GAB receives.

Review of the claim referrals effectiveness is the responsibility of Company claim examiners and the Compliance Department, who report to senior management. In addition, all house claim examiners and TPA adjusters completed initial anti-fraud training as of January 31, 2006. The Company's Program Administrators (PA's) are also taking part in anti-fraud training to heighten PA underwriter's awareness of application fraud. All plans will be enforced through onsite audits to ensure compliance with GAB's plans and procedures.

Clearwater's control and oversight of its TPA's is codified in the claim administration agreement (CAA) with each TPA. The CAA will assist the Company with determining the TPA's GAB compliance.

Recommendations: None

Procedure 06 – Disaster Recovery

Observations: The Company maintains a corporate wide Disaster Recovery (DR) manual developed by the parent company Odyssey Re which includes dedicated sections for the Company's New York City operations. The DR has been developed into five (5) core areas: 1) Definitions, Declarations, Priorities; 2) Responsibilities, Teams, Assessments, and Communications; 3) Implementation, Notification, and Restoration; 4) Department Recovery; and 5) Facility Management.

The Company maintains a process to test the DR function ability at least annually. Currently all testing takes place on a country wide basis. To test specific departments the Company is currently in the process of developing departmentalized testing criteria.

Management exercises control over DR procedures through semi-annual reviews. The Company directs which associates are responsible for maintaining the written procedures. Associates are assisted by attending training sessions on DR planning techniques and testing procedures. Review of measurement results allows the Company to identify possible areas which need improvements.

Recommendations: None

Procedure 07 – MGA Oversight and Control

Observations: The Company does not have a written procedure for MGA Oversight, per se. The Company does have in place a multi-tiered process that includes strict controls over their Program Administrators (PA) who qualify as an MGA. PA's agree to a Program Administration Agreement (PAA) with the Company that contains specific requirements for underwriting. Additionally, a separate agreement is entered into with a third party administrator (TPA) for the claim handling responsibilities. This is the claim administrator agreement (CAA).

The PAA and CAA contain controls which allow the Company to review any and all records deemed important to their business functions. It is expressly stated that all insured related materials are the property of the Company. Reviews of PA activity are conducted monthly through the submissions of bordereaux and by on-site reviews. PA's who qualify as an MGA are reviewed semi-annually to ensure compliance with the provisions set forth in the PAA, CAA, and statutory regulations.

The onsite audit reports include reviews of all business operations. Reports are provided to Company management and the PA's/TPA's. All recommendations are to be followed up on by the PA/TPA with remediation plans to address non-compliance issues related to the PAA, CAA and applicable statutes and regulations. Continued non-compliance by a PA/TPA could result in the termination of a contract.

Recommendations: None

Procedure 08 – Vendor Oversight and Control

Observations: The Company does not maintain a written Vendor Oversight procedure. Once the Company determines a need for a vendor the oversight and review process begins. The process of selecting a vendor for a particular program starts with the senior underwriter responsible for identifying if the services required can be met by a current vendor or if a new vendor should be selected.

In instances where a new vendor is required, the Company identifies vendors who meet the Company's requirements and then seeks a quotation for providing services. The senior underwriter is responsible for reviewing the vendor's qualifications in conjunction with other departments. Once a vendor is reviewed and determined to be qualified for the program's needs, a recommendation is sent to senior management for approval. Once approval is given the legal department is responsible for reviewing and approving any vendor contract.

The Company maintains continuous vendor reviews. The vendors are selected for distinct purposes (form filings, subrogation) and the result of a vendor's performance is immediately reported to management. The Company's business model allows for communication related to vendor performance. Failure of a vendor to meet the Company's expectations can result in the termination of a vendor contract.

Recommendations: None

Procedure 09 – Customer and Consumer Privacy Protection

Observations: The Company's Consumer Privacy Policy procedure is provided to all Program Administrators (PA) and Third Party Administrators (TPA). Once a program is bound a compliance manual is sent explaining the Consumer Privacy Policy and what is

required by the PA and TPA. Included in the information sent to the PA/TPA are copies of a Privacy Policy Notice and the Company's Consumer Privacy Policy Statement.

The Company requires each PA and TPA to provide policyholders and claimants with a copy of Clearwater's Privacy Notice where appropriate. The directive for this requirement is included as part of the Program Administration Agreement and is reviewed when the PA/TPA external audits are performed. Consumer Privacy audits are conducted as part of the annual review performed by the Company. Audits may occur as the Company deems necessary and those PA's who qualify as Managing General Agents are generally reviewed semi-annually.

External audit reports of PA/TPA are reviewed by senior management. Any issues found related to Consumer Privacy protection, during the audit process, are addressed by the PA/TPA with remediation efforts. Future audits will provide evidence of the PA/TPA acknowledgment of the recommendations. Failure to comply with the Company's consumer privacy procedure could lead to possible contract termination.

Recommendations: None

Procedure 10 – Insurance Information Management

Observations: The Company's Information Management procedures are related in part to Procedure 04 (P4) Computer Security and Procedure 09 (P9) Consumer Privacy. P4 contains information related to computer security and logic (physical security) to ensure information remains secure. P9 takes into consideration the privacy efforts in place by the Company. Together P4 and P9 work to ensure the information kept by the Company about an insured remains secure.

It was discovered during the P4 review that system testing was only performed when the Company deemed it necessary. The recommendation made in P4 will also be issued under the Information Management section of the report, based upon the Company's reliance on computer security in relation to Information Management.

Recommendations: It is recommended that the Company develop structured time frames for the review of its Computer Security and include these time frames within the existing procedures.

Procedure 11 – Complaint Handling

Observations: The Company maintains a Complaint Handling Procedure which is designed to effectively monitor incoming complaints, route the complaints, and provide the Program Administrators (PA) and Third Party Administrators (TPA) with response timeframes. Upon receipt of a complaint a determination is made as to which department within the Company maintains the ultimate responsibility for resolution. This process is

completed through the assistance of the Compliance Department. This department reviews and logs the complaints and then assists in determining which of the Company's PA/TPA's are responsible based on the line of business in question. After the Company has completed the initial review the complaint is forwarded to the appropriate PA/TPA who then provides a follow-up response on the Company's behalf.

During the complaint review and response procedure applicable statutory guidelines are adhered to and the Company works to provide follow-ups within the time periods required by law. When the Company forwards complaints to the PA/TPAs they are provided a timeframe to respond on the Company's behalf, normally five (5) days prior to any response due date. The PA/TPAs are to forward the Company a copy of the draft response. A majority of the complaints arrive at the Company from a State Insurance Department; however, the Company does receive a few complaints directly from insureds. When complaints are sent directly to the Company from insureds, the Company attempts to provide a response within ten (10) days.

Management has an active roll in the Complaint process. The Director of Compliance for the Company is a Senior Vice President. If a PA/TPA has not provided a complaint response within the specified time period, the VP of Compliance becomes active in the Complaint resolution process. The Company also monitors their PA/TPAs through the use of audits and any deficiencies are noted, reported, remediated and then a follow up review is performed.

Recommendations: None

Procedure 13 – Advertising, Sales and Marketing

Observations: The Company's directives for Advertising, Sales and Marketing are placed through the parent company Odyssey Re (OR). OR maintains procedures for both print and press release policies, which are to be followed by Clearwater. The sales materials generated for Clearwater are designed to increase the Company's profile in a specific insurance program industry.

The decision to initiate advertising is made at the Clearwater level by the chief underwriting officer and president. The Company will contact the Marketing Department of OR, who is responsible for preparing a budget, media plan, and other required analytical tools to reach a target market. After the Marketing Department of OR has placed together a marketing plan the information is forwarded to the Corporate Communications Committee (CCC) for review.

The CCC reviews all marketing materials prior to their release. The CCC is made up of OR's Chief Executive Officer, Chief Financial Officer, General Counsel, Executive Vice President of Communications and Division Chief Operating Officer. All materials are prepared for review on a quarterly basis when the CCC meets. Once sales and marketing materials are approved they are logged by date, publication and print size.

Recommendations: None

Procedure 14 – Agent Produced Advertising

Observations: The corporate directive for procedures related to sales and marketing materials were reviewed as part of Procedure 13. The same procedures apply to agent produced materials and such materials must meet the requirements set forth in Procedure 13. When a program administrator (PA) would like to use the Company name for marketing, the PA must first seek approval from the Company. Part of the Program Administrator Agreement (PAA) states that the PA must seek approval and provides the Company thirty (30) days for material review. The Company's General Counsel provides the final approval or rejection of a PA's request to use the Company's name.

Recommendations: None

Procedure 15 – Producer Training

Observations: The Company does not maintain a written Producer Training procedure. Program Administrators (PA), by contract, provides training to their employees and sub-producers. To determine if a PA's past performance meets expectations Clearwater reviews the following areas: underwriting discipline, historic program results, financial viability and regulatory compliance. The Company's actuaries examine the experience record of the program being submitted, through an analysis of the premium and claim history of the program. After the Company has an understanding of the proposed program, per the Company's review adequate producer training can be identified.

PA's and their sub-producers may only use advertising and sales materials when they are prospecting with the prior written approval of Clearwater (Procedure 14). The Company does not perform any training associated with the developed and approved advertising material. The Company places all training requirements upon the PA/TPA. The examiners noted on review of the PA's contract that there is a provision requiring the PA to provide training that extends to training their sub-producers.

Recommendations: None

Procedure 16 – Replacements

Observations: N/A

Recommendations: N/A

Procedure 17 – Illustrations

Observations: N/A

Recommendations: N/A

Procedure 20 – Producer Selection, Appointment and Termination

Observations: The Company maintains procedures for the Selection, Appointment, and of Termination of Agents. Program Administrators (PA) are initially selected by the Company's underwriting department. The Company may request a Dunn and Bradstreet report of the PA's financial statements, perform background checks and confirmation of references and look for any disciplinary actions by the domiciliary state's Department of Insurance. After reviews have been performed and a new program is bound, the Compliance Department is solely responsible for appointing all producers related to the PA. In the event a sub-producer is acting on the PA's behalf the sub-producer must also be appointed by the Company's Compliance Department. All appointments (where applicable) are processed electronically through the National Insurance Producer Registry (NIPR). In the event a Program is cancelled the Company maintains all appointment records to properly terminate producer records through NIPR (where applicable).

The Company places the responsibility of servicing the insurance transactions with the PA. As part of the agreement between the Company and the PA's, the PA must maintain specific Errors and Omission (E&O) coverage. The E&O coverage is part of the Program Administrator Agreement (PAA). On site reviews are used to determine compliance with the E&O coverage requirement. A review of underwriting files will assist the Company in determining if producers are properly licensed, appointed and insured during the solicitation of Company's programs.

Initially the appointment process was directed by a senior underwriter. As the number of programs increased the responsibilities were redirected to the Compliance Department. This allows the Company greater control to properly appointment producers and centralizes producer records.

Recommendations: None

Procedure 21 – Producer Defalcation

Observations: The Company does not maintain a written procedure for Producer Defalcation Procedure. However, within the Program Administrator Agreement (PAA) there is a clause related to the misapplication of premium dollars by the Program Administrator (PA), which states that the PA shall not misapply, misdirect, or misappropriate any funds or the Company may cancel the PA's contract.

Review of premium transactions occur through monthly bordereaux reviews and during the annual PA onsite audits. During the review process if it becomes apparent a PA is misallocating funds the Company maintains the rights within the PAA to force the PA to cease and desist all actions related to the Company. Further actions by management to

control Producer Defalcation have been developed which allow for premium amounts to be made payable only to Clearwater.

Recommendations: None

Procedure 22 – Prevention of Use of Persons with Felony Conviction

Observations: The Company does maintain a written procedure for the Prevention of Use of Person with Felony Convictions in selling insurance. The process developed by the parent company's Human Resources department is based on two approaches, first with new hires and secondly, controls through program administrators. The processes for both are similar in terms of the end result but the program review contains a more thorough investigation process.

All new hires are asked about prior felony convictions. The Company does not now or has not had any employees who have been convicted of a felony. The Company relies upon background checks to confirm the employee's attestation. Background checks are also used when interviewing new program administrators (PA). The Company maintains a due diligent process to review multiple items, including, but not limited to, on site visits, claim and external audits, licensing, financial records, credit reports and references.

After the Company performs due diligence, it places most of the control into the agreements the Company signs with the PA's. According to the contract the PA is required to abide by all regulatory statutes.

Recommendations: None

Procedure 23 – Policyholder Service

Observations: The Company's procedures for Policyholder Service are contained within the Program Administration Agreement (PAA). Within the PAA are the actions a Program Administrator (PA) should perform during the application and issuing processes. According to the PAA, the PA's are to issue policies within twenty (20) days of binding coverage or within shorter time periods based upon individual state specific statutes.

The Company monitors the Policyholder Service process through its annual PA audit process. Any irregularities are noted and reported to the Company President, Chief Underwriting Officer as well as the Underwriter responsible for the program. The PA must provide a response to the audit report for any irregularities noted.

The internal audits detail the Company's ability to monitor, test, report, and form recommendations related to policyholder service with the expectation of the PA to correct any issues.

Recommendations: None

Procedure 24 – Premium Billing

Observations: The Company does not have a written Premium Billing procedure directing their Program Administrators (PA) on day to day premium billings. The Company does have a process to receive net premiums collected from their PA's. The Program Administrator Agreement (PAA) provides details on premium collection, stating that the PA is responsible for collecting funds and remitting them to the Company. These premiums are to be deposited into a "Premium Collection Account" on the 15th and 30th of each month. The deposits should reconcile with bordereaux submitted by the PA.

The Company places the responsibility to collect past due amounts with the PA. The PA is to notify the Company before any additional actions become necessary to collect funds. In the event a PA misses their scheduled account deposit due date the Company's accounting department is alerted. Follow-ups continue until PA premiums are submitted. In the event of persistent past due premium deposits, the Company maintains the right to cancel the PA agreement for failing to follow the PAA.

Management review of PA premium audits has detailed past premium billing issues which resulted in the PA's insolvency. The Company took the necessary steps to determine proper premium, and obtained the use of a premium collection vendor to assist in collecting past due amounts from the insured.

Recommendations: None

Procedure 25 – Correspondence Routing

Observations: The Company provided a summary of their procedure for Correspondence Routing. All mail is directed to the Company's New York City office, where the office's receptionist receives, sorts and distributes all incoming mail. Any mail sent to the Company which requires the attention of a Program Administrator (PA) or Third Party Administrator (TPA) is gathered and forward via the USPS. Additionally, any mail identified as urgent, e.g., a claim report, is faxed to the appropriate recipient for immediate review.

Correspondence files are set up for each underwriting program. Each file contains general correspondence relating to that particular program, information related to reinsurance, filings, and PA agreements. When electronic mail is received the emails are printed and added to the correspondence folders.

Company management is aware of time sensitive correspondence. The Claim Department, along with the General Counsel, tracks information related to claim litigation. Additional controls are in place when correspondence associated with an Insurance Department complaint is received by the Company. It becomes the responsibility of the Company's Compliance Manager to review the information and respond as described in the complaint process (See Procedure 11 above).

Recommendations: None

Procedure 26 – Policy Issuance

Observations: The Company's standard within their Policy Issuance procedure is to issue policies within a twenty (20) day time period. The procedure is provided to all Program Administrators (PA) and is contained within all Program Administrator Agreements (PAA).

The twenty (20) day procedure was developed after audits found the PA's missing the prior timeframe of thirty (30) days. Failure to issue policies within thirty (30) days could result in regulatory violations in many of the Company's current markets. In 2003 the Company developed a new PAA which included the twenty (20) day policy issuance timeframe.

The Company was able to determine the ineffectiveness of the prior procedure through the use of the audits performed on their PA's. The audits are performed at least on an annual basis, and PA's who qualify as a Managing General Agent (MGA) according to Delaware's statutes are reviewed semi-annually. The audit procedures enable the Company to identify PA's having difficulty meeting the terms of the PAA. Continued deficiencies can result in the PA no longer writing new business until corrective actions occur and the possibility of the PAA being terminated.

Recommendations: None

Procedure 27 – Reinstatement

Observations: The Company does not maintain a written Reinstatement Procedure. Reinstatements are handled by their Program Administrators (PA) without direction from the Company. As part of the annual PA audit process the Company tests policies that have been reinstated to determine if they have been handled timely.

Recommendations: It is recommended that the Company develop detailed reinstatement procedures, provide these procedures to all PA's and MGA's, and monitor the procedures once implemented.

Procedure 28 – Insured or Member Requested Claim History

Observations: The Company does not maintain a written procedure on how to handle “Requests for Claim History” related information. The Company does have a process in place where the Company will identify incoming information requests and forward the information to the proper Third Party Administer (TPA). When the Company enters into a claims agreement with a TPA, it is stipulated that the TPA respond in a timely manner to any request.

After the request is sent to the TPA the Company is no longer involved unless a second request for identical information is submitted. At that point the Company will follow up with the TPA to ensure the original request has been fulfilled. The Company logs when requests are sent to a TPA, however, the Company is not copied on responses and does not include a response timeframe for insured requested claim histories.

Recommendations: It is recommended that when the Company notifies a Third Party Administrator (TPA) of a request for a claim history that they include a timeframe for responding, that the Company is copied on the information provided, and that the Company track response times to ensure claim history requests are properly handled.

Procedure 30 – Premium Determination and Quotation

Observations: The Company does not maintain a written Premium and Quotation procedure for each of their programs due to their business model. The Company uses a system that involves a referral process for large premium items, monitoring of underwriting pricing restrictions and software for quoting some of its products. All programs are unique and final decisions for specific underwriting requirements are agreed upon between a Program Administrator (PA) and the Company.

The Company performs underwriting audits at least yearly to ensure the program requirements are being maintained by the PA’s. Part of the review process includes testing the accuracy of premium quotes. Underwriting guidelines provided to the PA provide for proper premium and quoting upon receipt of an application.

Recommendations: None

Procedure 31 – Policyholder Disclosures

Observations: The Company’s procedure for Policyholder Disclosures is delegated to their Program Administrators (PA). Through the Program Administrator Agreement (PAA) the PA is responsible for ensuring all disclosures are included when a policy is ready for delivery.

During the program development process, the potential forms and disclosures are reviewed for consideration. Once the program nears completion, all necessary forms are

prepared and filed for approval by the various State Insurance Departments. Additional reviews are performed to ensure the proper disclosures are selected. Once the Company is prepared to market their program, the PA's are provided complete policy samples including all approved forms and disclosures.

As part of the external audit process of the operational functions of the PA, testing is performed to ensure all disclosures are included when policies are delivered. The PA must adhere to the terms and conditions set forth within the PAA or the relationship with the Company could be terminated.

Recommendations: None

Procedure 32 – Underwriting and Selection

Observations: The Company does not maintain a rigid set of Underwriting and Selection procedures as a requirement during the program development process. Each program the Company develops is unique and part of the program development process is forming underwriting and selection guides. The Company works with the Program Administrator (PA) to determine the requirements, limits, and documentation to properly underwrite a new risk. Once all determinations have been made, the Company presents the PA with the underwriting guide for the particular market and line of business.

Based on the Company's business model, it becomes imperative for the Company to monitor the decisions made by each PA. On a monthly basis the PA's submit bordereaux for each program they are administering. Each bordereaux is then reviewed by underwriting and accounting upon receipt to determine if corrective actions are required. The underwriting guide submitted to the PA includes a clause which allows the Company to perform underwriting audits whenever it deems it necessary. Additionally, the Company performs at least annual external and underwriting audits of their PA's.

The agreements, set forth between the Company and the PA, (PAA) allow the Company leverage in managing their business with a PA. Failure to comply with the PAA allows the Company to force the PA to cease writing new business and/or face the possibility of contract termination.

Recommendations: None

Procedure 33 – Rate and Form Filing

Observations: The Senior Underwriter (SU) is responsible for Rate and Form Filings when developing a new program. This process is based upon the experience of the Company's underwriters and does not contain a written procedure. Before rates and forms are filed the SU will work with the actuarial and corporate legal departments.

The SU and underwriting staff review prior filings to determine if a new filing is necessary. If a new filing is required, the actuarial department reviews past results and works with the Underwriting Department to determine pricing levels to produce underwriting profits. After the rates have been determined, forms are developed and reviewed by the legal department. After the rates and forms have been determined, the Company uses a vendor to assist in the submission of the rates and forms for approval.

Management's reviews of prospective programs are continuous during the planning stages. The Chief Underwriting Officer and/or the President of the Company may decline further program development based upon reviewing underwriting and actuarial reports. In the event a form filing is not approved, the Company will work to resubmit a filing. However, the program may be cancelled if the Company is unable to obtain the proposed rate.

Recommendations: None

Procedure 34 – Policy Termination

Observations: Clearwater does not currently maintain written procedures regarding individual Policy Termination. Individual policy terminations are the responsibility of the Program Administrator (PA), as specified in Clearwater's Program Administration Agreement (PAA). The Company is notified of terminations as part of a monthly bordereaux review. Clearwater does maintain the right to cancel or non-renew any policy it deems necessary. The PAA requires the PA to process terminations and cancellations in full compliance with applicable state laws. The Company does maintain a reference manual related to terminations and state regulations.

Individual termination cases (outside of bordereaux) are presented by the PA to the senior underwriter responsible for the particular program. The senior underwriter consults, if necessary, with the Compliance Department to determine the appropriate cancellation/non-renewal/termination requirements. Each termination case presented to Clearwater is reviewed on an individual basis. The Company's termination standard requires resolution by using state regulations as the standard. In the event the policy language differs from state specific citations, the wording most applicable to the specific situation is used.

Recommendations: None

Procedure 35 – Underwriting File Documentation

Observations: The Company's Underwriting File Documentation procedure is built into each program the Company develops. The Company works with a Program Administrator (PA) to develop the program and determine the necessary information required to properly underwrite a policy file. All required information is listed within an underwriting guide provided to the PA.

The underwriting guide allows both the PA and Company to fully understand requirements placed on each underwriting file. The Company performs underwriting audits at least annually to ensure compliance with Company standards. In addition to on-site audits, monthly reports are submitted to, and reviewed by, the Company to control underwriting variances.

Management uses monthly reports and on-site audits to determine if a PA is meeting the Company's underwriting file documentation standards. In the event a PA is operating outside the scope of their Program Administrator Agreement (PAA) the Company has the ability to either require the PA to cease issuing policies until they come into compliance or have the contract cancelled for failure to abide by the PAA.

Recommendations: None

Procedure 36 – Underwriting Training

Observations: The Company does not maintain a written Underwriting Training procedure. All training comes via “on the job.” The Company does have a general new employee training (see Procedure 40) process. Specifically for underwriting, the Company has a college training program where the trainees are placed and rotated amongst the different underwriting departments within the Company. Trainees are placed into one of the four (4) underwriting arenas as an associate underwriter under the direction of a head underwriter.

Continual “on the job” training takes place with senior and head underwriters working with associate underwriters, reviewing their work and making recommendations. With additional experience the underwriter's responsibility and authority levels are expanded.

Recommendations: None

Procedure 40 – Staff Training

Observations: The Company's Employee Training procedure is directed by the parent company Odyssey Re. The training regimens are separated into sections to include the training and use of college trainees (see procedure 36), new hires and management focused training. As an introduction to the insurance industry, the Company offers classes on reinsurance to all employees. Part of the parent company's role is to ascertain from the Company the types of educational programs which will assist in employee development.

The Company uses the employee's annual appraisal to review any corporate training recommendations that have been made. The training programs might not be directly related to insurance; however, the programs are developed to provide skills to assist employees in other facets related to their work duties.

Management reviews employee recommendations on the training provided to determine the effectiveness of the programs. Management provides incentives and tuition reimbursements for employees who continue to enhance their job training skills by earning professional designations.

Recommendations: None

Procedure 42 – Adjuster Training

Observations: The Company does not maintain a written Claims Adjustor Training manual. The responsibility for claim adjusting is placed with the Third Party Administrator (TPA) performing the claim function for the Company. Based upon the Company's business model of using a TPA, the Company researches to ensure the TPA has the experience to adjust claims for the appropriate line of business. The Company and the TPA enter into a Claims Administrative Agreement (CAA) which provides the details of the functions the TPA must agree to and adhere to at all times.

The CAA allows the Company to audit the performance of the TPA when the Company deems it necessary. On-site audits are performed at least annually to review the TPA's claim functions. Additional controls are established for losses above a pre-determined amount that are to be referred back to the Company for approval. Insight into day to day operations of claims history and the adjudication process are monitored monthly through loss reports provided to the Company by the TPA.

Company management uses a mix of the on-site audits, claim referrals and monthly reports to determine if the adjustor function in use by the TPA is performing as intended. Failure to conform to the CAA allows the Company to either require the TPA to correct any improper practice immediately or to terminate the contract with the TPA.

Recommendations: None

Procedure 43 – Claim Handling

Observations: The Company maintains a written Claim Handling Procedure which is in part separated between the Company's claim guideline and the Claims Administrator Agreement (CAA). The CAA is the agreement between the Company and the Third Party Administrator (TPA) responsible for claim adjudication. With both the claim guideline and the CAA, the Company is able to express both internally, and to the TPA, the Company's standards and philosophy for proper claim handling.

The Company is able to determine if a TPA remains compliant with the Company's claim handling procedures through the use of on-site audits. The Company performs on-site TPA audits at least annually and retains the right to perform additional reviews as deemed necessary. The audit reports are provided to Company senior management and to the TPA for review.

Management reviews the audit reports and requests follow up information from the TPA if recommendations are made and/or requirements are not being adhered to as required in the CAA. Failure of the TPA to abide by the CAA could result in a contract termination.

Recommendations: None

Procedure 44 – Internal Claim Audit

Observations: The Company maintains a written Internal Claim Handling procedure as part of their claims handling guideline. The basis behind the internal claim handling procedures is to ensure the TPA is handling claims as directed by the Company through the Claims Administration Agreement (CAA).

Claim files are reviewed by the Company on an annual basis, or as the Company deems warranted for CAA compliance. The file selection process for on-site reviews is based upon prior reviews/recommendations and is selected from the monthly bordereaux submitted to the Company. The Company works to maintain a rapport with the TPA to ensure best practices are being followed and to eliminate any potential claim processing problems.

The Company's management has developed due diligence procedures which must be followed by the TPA. The Company maintains expectations for consistency in file set up which assists the on-site reviews, and is to be performed in a thorough and timely manner.

Recommendations: None

Procedure 45 – Claim File Documentation

Observations: The Company's procedure on Claim File Documentation is contained in the Claim Administrator Agreement (CAA). The CAA is an agreement between the Company and the Third Party Administrators (TPA) that performs the claim adjudication process for the Company. The Company selects the TPA based upon prior experience and industry recommendations. The CAA contains information related to expenses in defense costs, subrogation, and litigation. However, the CAA does not provide details of the necessary types of information required for the prompt review of a claim file or efficient review, analysis and adjudication.

Recommendations: It is recommended that as part of the TPA program development process, the Company include a list of the information required to promptly and effectively adjudicate a claim.

Procedure 46 – Subrogation and Deductible Reimbursement

Observations: The Company maintains a Subrogation and Deductible Reimbursement procedure as part of the Claims Administration Agreement (CAA). The CAA directs the TPA to pursue all reasonable possibilities of subrogation and the recovery of deductibles from third parties.

Claim files are reviewed for potential subrogation by the TPA. The files where potential subrogation exists are then selected for further review. Depending on the line of business subrogation requests are either handled in house by the TPA or by a subrogation vendor selected by the Company. Additional reviews are performed on open claims to determine if subrogation is a viable option.

The claim audits performed by the Company assist in determining if additional subrogation cases exist. Any additional subrogation cases are flagged for review and follow up.

Recommendations: None

Procedure 47 – Reserve Establishment

Observations: The Company maintains a Reserve Establishment Procedure as part of its claim handling guidelines reviewed as part of Procedure 43. Contained within the Claims Administration Agreement (CAA) between the Company and Third Party Administrators (TPA) handling the claims is the Company's philosophy on reserves. The established reserve should reflect a value based upon the adjuster's current knowledge, jurisdictional influences and experience in handling similar cases.

The Company maintains expectations on the reserve process through proper claim file documentation. Reserve assessments are summarized or refer to prior claim information if applicable. The CAA requires initial reserves to be established within thirty (30) days of claim receipt and reviewed at least every ninety (90) days thereafter. The Company is able to determine when initial reserves are set and notified of reserve changes from monthly bordereaux reports submitted by the TPA's.

The Company's management maintains active roles in the reserve establishment procedure. Each TPA has reserve authority levels within the CAA and any reserve established above a TPA's authority requires Company approval. Audits of TPA's ensure claim files are being properly documented to support reserve establishments and changes.

Recommendations: None

SUMMARY

Clearwater Insurance Company is incorporated under the laws of the State of Delaware to provide property and casualty insurance.

The examination was a baseline market conduct examination in which reviews of the procedures affecting the following business areas were conducted: Company Operations/Management; Complaint Handling; Marketing/Sales; Producer Licensing; Policyholder Service; Underwriting and Rating; and, Claims. The review of written procedures included analysis of the controls used by the Company to manage its operations.

Recommendations have been made to address the areas of concern noted during the examination:

- Planned Computer Security reviews
- Controls regarding Requested Claim History
- Written Claim Documentation procedures

These areas are summarized below.

LIST OF RECOMMENDATIONS

Procedure 04 - Computer Security

It is recommended that the Company develop structured time frames for the review of its Computer Security and include them in the existing procedures.

Procedure 10 - Information Management

It is recommended that the Company develop structured time frames for the review of its Computer Security and include them in the existing procedures.

Procedure 27 – Reinstatement

It is recommended that the Company develop detailed reinstatement procedures, provide the procedures to all PA's and MGA's and monitor the procedures once implemented.

Procedure 28 - Insured Requested Claims History

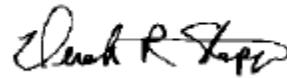
It is recommended that when the Company notifies a Third Party Administrator (TPA) of a request for a claim history that they include a timeframe for responding, that the Company is copied on the information provided, and that the Company track response timeframes to ensure claim history requests are properly handled.

Procedure 45 - Claim Documentation

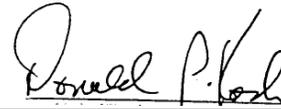
It is recommended that the Company, as part of the program development process, include a listing of the information required to promptly and effectively adjudicate a claim.

CONCLUSION

The examination was conducted by Donald P. Koch, Derek R. Stepp, and James R. Koch and is respectfully submitted,



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