

**REPORT ON EXAMINATION**  
**OF THE**  
**NIAGARA FIRE INSURANCE COMPANY**  
**AS OF**  
**DECEMBER 31, 2003**

# State of Delaware



## Department of Insurance

Dover, Delaware



I, Matthew Denn, Insurance Commissioner of the State of Delaware, do hereby certify that the attached REPORT ON EXAMINATION, made as of December 31, 2003 of the

### NIAGARA FIRE INSURANCE COMPANY

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

ATTEST BY: *Jennifer L. Miller*

DATE: 30<sup>TH</sup> JUNE, 2005



*In Witness Whereof*, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 30<sup>TH</sup> DAY OF JUNE, 2005.

*Matthew Denn*

*Insurance Commissioner*

*Deputy Insurance Commissioner*

**REPORT ON EXAMINATION**  
OF THE  
**NIAGARA FIRE INSURANCE COMPANY**  
AS OF  
**December 31, 2003**

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.



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MATTHEW DENN  
INSURANCE COMMISSIONER

DATED this 30<sup>TH</sup> day of JUNE, 2005.

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**SALUTATION**

January 31, 2006

Honorable Alfred Gross  
Chairman, Financial Condition (E)  
Committee, NAIC  
State Corporation Commission  
Bureau of Insurance  
Commonwealth of Virginia  
1300 East Main Street  
Richmond, VA 23218

Honorable Walter Bell  
Secretary, Southeast Zone (II), NAIC  
Alabama Department of Insurance  
201 Monroe Street, Suite 1700  
Montgomery, AL 36104

Honorable Matthew Denn  
Commissioner of Insurance  
State of Delaware, Insurance Department  
841 Silver Lake Blvd.  
Dover, DE 19904

Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority No. 04-005, dated February 4, 2004, an Association examination has been made of the affairs, financial condition and management of the:

**NIAGARA FIRE INSURANCE COMPANY**

hereinafter referred to as “Company” or “NFI” or “Niagara” and incorporated under the laws of the State of Delaware as a stock company with its home office located at 1209 Orange Street, Wilmington, Delaware. The examination was conducted at the main administrative office of the Company, located at CNA Plaza, Chicago, IL 60685.

The report of such examination is submitted herewith.

## **SCOPE OF EXAMINATION**

The last examination was conducted as of December 31, 1998. This examination covers the period since that date through December 31, 2003, and consisted of a general review of the Company's business policies and practices, management, any corporate matters incident thereto, a verification and evaluation of assets and determination of liabilities. Transactions subsequent to the latter date were reviewed where deemed necessary.

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

The general procedures of the examination followed the rules established by the Committee on Financial Condition Examiners Handbook of the National Association of Insurance Commissioners ("NAIC") and generally accepted statutory insurance examination standards consistent with the Insurance Laws and Regulations of the State of Delaware. In accordance with the aforementioned Handbook, the consulting firm of INS Services, Inc performed an information systems review.

Niagara was examined as part of a coordinated, multi-state examination. The lead state for the coordinated examination was Illinois, where Continental Casualty Company is domiciled. Thirty-one insurance companies were examined concurrently as part of the coordinated examination.

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

Corporate Records  
Fidelity Bonds and Other Insurance

## **HISTORY**

The Company was originally incorporated on July 31, 1850 under the laws of the State of New York and commenced business the next day. The capital stock was publicly owned until 1929 when The Continental Insurance Company (Continental) and Fidelity Phoenix Fire Insurance Company each acquired 50% ownership. Continental became the sole owner of the Company on June 30, 1959, when Phoenix Fire Insurance Company was merged into Continental.

On February 1, 1974 the group holding company, The Continental Corporation, obtained direct ownership of Niagara by means of a stock dividend from Continental.

On October 18, 1984, The Buckeye Union Insurance Company of Columbus, Ohio (Buckeye Union), a subsidiary of The Continental Corporation, obtained direct ownership of the Company.

In May 1995 CNA Financial Corporation (CNA), a Delaware holding Company with its headquarters in Chicago, Illinois purchased The Continental Corporation and thus obtained control of the daily business affairs of both Buckeye Union and Niagara.

## **CAPITALIZATION**

### **Common Capital Stock**

The Certificate of Incorporation, as amended, provides that the authorized capital stock of the Company shall be 400,000 shares of \$25 par value per share. At December 31, 2003, all 400,000 shares were issued and outstanding. The Company is wholly owned by Buckeye Union, which is owned by Continental Insurance Company.

Dividends

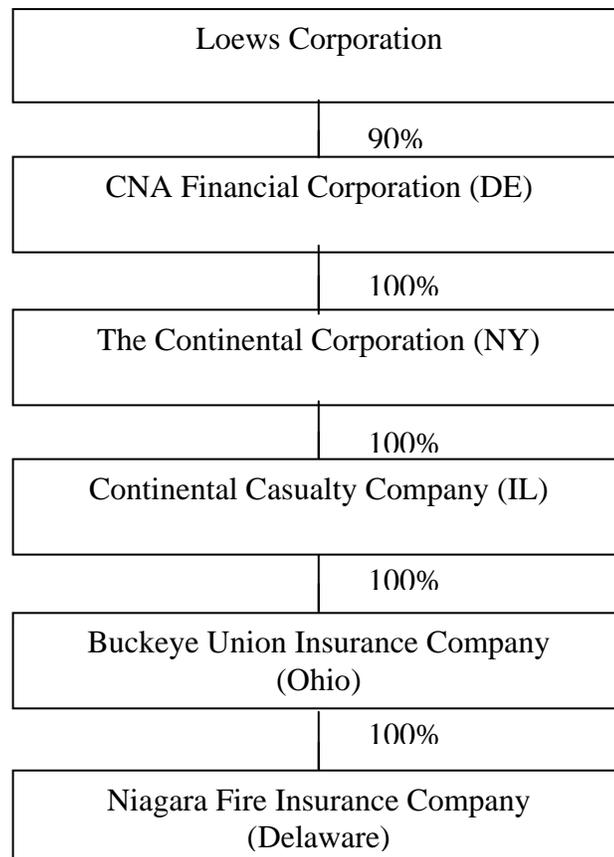
There were no stockholder dividends paid for the period 1999-2003.

In 2003, the Company paid \$20,000,000 to its parent as a return of capital. This transaction was approved by the Delaware Insurance Department.

**MANAGEMENT AND CONTROL**

Holding Company System

Niagara is a member of a complex holding system and is currently wholly owned by Buckeye Union Insurance Company, which is solely owned by Continental Casualty Company. The ultimate parent of the holding company system is Loews Corporation (Loews). Loews is a diversified financial holding company which is publicly traded on the New York Stock Exchange. The following is a partial chart that reflects the principle identities and relationships between the Company, the Parent, and some affiliated insurers.



Niagara Fire Insurance Company

Relationships between other members of the holding company structure can be found in Schedule Y of the 2003 Annual Statement.

At December 31, 2003 Continental Casualty Company (CCC), the intermediary parent of Niagara and the Company's ultimate reinsurer, reported the following:

Assets	\$34,589,154,000
Policyholders Surplus	6,045,822,000
Premiums Earned (2003)	5,929,490,000
Net Income	(1,563,151,000)

Largely due to reserve strengthening, CCC reported an underwriting loss of \$3,344,091,000 for 2003. As noted in the Continental Casualty Company Loss Reserves section of this report, the coordinated multi-state examination noted a deficiency in CCC's total Loss Reserves at December 31, 2003 of 7%.

In compliance with Chapter 50 of the Delaware Insurance Code, the Company filed the appropriate Holding Company Registration Statement with the State of Delaware for each period currently under review.

#### Board of Directors

Pursuant to the By-Laws of the Company, the Board of Directors shall manage the business and affairs of the corporation. The Directors serving at December 31, 2003 were as follows:

Stephen W. Lilienthal	Chairman, Chief Executive Officer & President
Robert V. Deutsch	Executive Vice President & Chief Financial Officer
Jonathan D. Kantor	Executive Vice President, Secretary & General Counsel
Robert L. McGinnis	President & CEO, CNA Life & Group Operations
Thomas Pontarelli	Executive Vice President, Human Resources & Corp. Services

The Articles of Incorporation of Niagara, as amended May 26, 1977, state that the property and daily business affairs are to be managed by a Board of Directors that is elected at the annual shareholder's meeting for one-year terms. The number of persons serving on the Board could vary between three (3) and twelve (12) persons as determined by the By-Laws from time to time.

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Those who serve on the Board must be at least 21 years of age. The By-Laws, as amended December 18, 1992, requires a minimum of seven (7) members to serve on the Board. During the 2001 and 2003 business years, only five (5) Directors served on the Board. Therefore, the Company was not in compliance with its By-Laws for the entire five year period under review. The same problem was disclosed in the previous examination report with a recommendation the Company initiate procedures to remedy this problem. The following recommendation will be made:

**It is again recommended that the Company come into compliance with its own By-Laws and elect the appropriate number of Directors to the Board.**

### Officers

The Officers of the Company listed as of December 31, 2003, were as follows:

Stephen W. Lilienthal	Chairman, Chief Executive Officer & President
Dennis R. Hemme	Vice President & Treasurer
Jonathan D. Kantor	Executive Vice President, Secretary & General Counsel
Robert V. Deutsch	Executive Vice President & Chief Financial Officer
Michael Fusco	Executive Vice President
John P. Golden	Executive Vice President, Chief Information Officer
Dean K. Haring	Executive Vice President, Claims
Robert V. James*	Executive Vice President, U.S. Insurance Operations
James R. Lewis	President & CEO, Property & Casualty Operations
Robert L. McGinnis	President & CEO, CNA Life & Group Operations
Thomas Pontarelli	Executive Vice President, Human Resources & Corp. Services
Peter W. Wilson	Executive Vice President, Global Specialty Operations

\*Resigned effective 1/2/04

The amended By-Laws of Niagara require the election or appointment of a President, a Vice-President, a Secretary, a Treasurer, and a Controller. The By-Laws also allow for the election or appointment of Senior Vice Presidents, Executive Vice-Presidents, and other Officers as may be deemed necessary. All corporate officers are elected for one-year terms.

Although the Company had several changes in its directors and principal officers during the examination period, not every appointment and resignation was reported in the Board of

Niagara Fire Insurance Company

Director's minutes. Furthermore, the Company did not report every appointment and resignation to the Delaware Insurance Department, as required by 18 Del. C. §4919, which states,

*“Every domestic stock or mutual insurer shall promptly notify the Commissioner in writing of any change of personnel among its directors or principal officers.”*

Therefore, as also noted in the prior examination report, the following recommendation will be made:

**The failure of the management of Niagara to disclose the resignation of key management personnel to the Commissioner of the Delaware Insurance Department constitutes non-compliance with Section 4919 of the Delaware Insurance Code. This is the THIRD examination in succession that the Company has failed to comply with the provisions of Section 4919 of the Delaware Insurance Code.**

**It is recommended that the Company immediately initiate measures to comply with the provisions of Section 4919 of the Delaware Insurance Code regarding the proper reporting of changes in the principal Officers and Directors of the Company.**

#### By-Laws

A review of the Company's By-Laws revealed that no changes were made during the examination period.

#### Corporate Records

The Articles of Incorporation have not changed during the period under review.

### **TERRITORY AND PLAN OF OPERATION**

#### Territory

As of December 31, 2003, Niagara is licensed in all fifty (50) States, and the District of Columbia. It is also licensed to sell insurance in the U.S. Virgin Islands.

#### Plan of Operation

Niagara has traditionally been utilized as a niche insurer by the CNA Group. The Company also participated in the Continental Insurance Company (CIC) reinsurance pool by

Niagara Fire Insurance Company

which most or all of Niagara's business was ceded to the pool. (See the Reinsurance section of this report for detailed information on the Pool.)

In 2000, the CNA Group began writing the Mail Handlers Benefit Plan (MHBP) and placed that business in the Company. The MHBP provided health insurance to approximately one million lives and generated premiums of \$2 billion annually. In the second quarter of 2002, the CNA Group terminated participation in MHBP and the business was transferred to a non-related insurer. The negative premium amounts reported by the Company in 2003 resulted from the unwinding of the MHRB business.

At present, Niagara writes no direct or assumed premiums. As noted in the De-Pooling section of this report, the CNA Group is currently evaluating the functions of many of the insurance companies in the Group.

Agency Relations and Third Party Administrators:

Niagara has no agents of its own nor does it directly contract with independent agents or brokers. CNA refers to certain agents as having Delegated Underwriting Authority, identified as a DUA, whereby these entities have authority to bind the company, but do not handle claims and do not place reinsurance. There are approximately 40 DUA's for Standard Lines and 40 for Global Specialty Lines at the CNA level.

Best's Rating:

Based on Best's current opinion of the consolidated financial condition and operating performance of the members of the CNA Property and Casualty Group, Best has issued an "A" rating for all participants in that group.

**GROWTH OF THE COMPANY**

The following information was extracted from copies of the Company's filed Annual Statements with the Delaware Insurance Department for each year indicated.

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	Admitted Assets	Policyholder Surplus	Gross Written Premium	Net Premiums Written	Underwriting Profit (Losses)	Net Income (Loss)
1999	\$116,421,257	\$67,963,290	\$ 62,709,813	\$16,184,739	\$(2,124,495)	\$2,869,422
2000	107,737,262	72,639,167	731,275,732	19,374,587	(7,584,348)	(1,762,351)
2001	130,385,203	61,299,698	2,266,887,051	55,617,464	(13,595,283)	(9,134,326)
2002	120,557,043	71,792,052	1,183,775,142	33,134,527	(2,984,729)	8,113,664
2003	56,936,002	53,351,052	(7,485,501)	(7,776,970)	-0-	3,992,761

\* Note: Due to de-pooling and 100% quota share agreement with CCC, no premium, or loss balance sheet lines are recognized in 2003.

Following is a reconciliation of capital and surplus for the period under examination:

Policyholder Surplus, December 31, 1998		\$65,550,954
Net income	\$2,869,422	
Net unrealized capital gains or (losses)	(89,946)	
Change in non-admitted assets	(1,583,393)	
Change in provision for reinsurance	297,492	
Change foreign exchange adjustment	918,760	
		<u>2,412,336</u>
Policyholder Surplus, December 31, 1999		\$67,963,290
Net income	(1,762,351)	
Net unrealized capital gains or (losses)	(69,716)	
Change in non-admitted assets	3,615,562	
Change in provision for reinsurance	(158,743)	
Change foreign exchange adjustment	3,051,127	
		<u>4,675,878</u>
Policyholder Surplus, December 31, 2000		\$72,639,167
Net income	(9,134,326)	
Net unrealized capital gains or (losses)	505,927	
Change Net unrealized foreign exchange capital gain	2,478,500	
Change in net deferred income tax	(194,990)	
Change in non-admitted assets	381,236	
Change in provision for reinsurance	(2,485,336)	
Cumulative change in accounting principles	(753,873)	
Aggregate Write-ins	(2,136,607)	
		<u>(11,339,469)</u>
Policyholder Surplus, December 31, 2001		\$61,299,698

Net income	8,113,664	
Net unrealized capital gains or (losses)	(253,725)	
Change in Net Deferred Income Tax	9,732,064	
Change in non-admitted assets	(9,708,163)	
Change in provision for reinsurance	1,682,278	
Change in excess over statutory reserves	926,435	
		<u>10,492,553</u>
Policyholder Surplus, December 31, 2002		\$71,792,251
Net income	3,992,761	
Net unrealized capital gains or (losses)	(6,354,505)	
Change in net deferred income tax	(1,557,427)	
Change in non-admitted assets	2,275,262	
Change in provision for reinsurance	1,992,538	
Aggregate Write-ins	1,210,172	
Surplus Adjustment, Paid-In	(20,000,000)	
		<u>(18,441,199)</u>
Surplus as Regards Policyholders, December 31, 2003		<u>\$53,351,052</u>

### NAIC RATIOS

The NAIC Insurance Regulatory Information System (IRIS) did not designate the Company as requiring regulatory attention based on its Annual Statement filings for any of the five years under examination. In addition, the NAIC Examiner Team did not select for review any of the Annual Statements filed by the Company during the examination period.

The Company's NAIC IRIS Ratio tests were available for all years under review. During the examination period, two (2) IRIS ratios produced "unusual values" as defined by the NAIC Examiner Team in each year under review, as shown in the following table:

Year	Ratio*	Ratio Description	Usual Range of Values Over/Under	Company's Result
2003	3	Change in Net Writings	33 -33	99.0
2003	7	Change in Policyholder Surplus	50 -10	-27.0

Niagara Fire Insurance Company

Following is a brief description of the underlying circumstances, which produced the “unusual values” in the Company’s IRIS Ratios:

Ratio 3 – Change in Net Writings

This ratio measures the consistency of the business written by the Company.

These unusual values noted for 2003 were primarily the result of the loss of a major portion of business. The Mail Handlers Benefit Plan chose not to renew coverage with the Company.

Ratio 7 – Change in Policyholder Surplus

This ratio measures trends in the Company Surplus that may be indicators of future concerns to regulators.

These unusual values noted for 2003 were primarily resulted from the reorganization of the Company through its de-pooling efforts. As previously noted in Capitalization, the Company paid \$20,000,000 to its parent in 2003 as a return of capital.

**DE-POOLING**

During 2002 CNA began the process of streamlining its United States property-casualty insurance entity structure. Towards that purpose, CNA has been conducting research and investigating ways to create a simpler, more efficient organization. By the end of 2005, CNA currently plans to complete the process of reevaluating its business needs to determine an optimum insurance company count. Over the next few years, CNA plans to continue the process of re-domesticating its core U.S. property-casualty insurance companies into a total of four states (down from 14) and to merge redundant companies.

Also during 2002, and in conjunction with the execution of this plan, CNA restructured the Continental Casualty Company group of companies by establishing Continental Casualty Company as the net risk bearer for the group. This was accomplished through the commutation of the former inter-company reinsurance pool agreement and the establishment of individual

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reinsurance contracts and quota share treaties between Continental Casualty Company and each of the former inter-company reinsurance pool members.

CNA also accomplished the same type of restructuring for The Continental Insurance Company group of companies. CNA commuted the Restated Inter-company Pooling Agreement, effective January 1, 2001, replacing it with individual reinsurance contracts and quota share treaties between The Continental Insurance Company and each of the current inter-company reinsurance pool members. These agreements are very similar to the ones used to restructure the former Continental Casualty Company inter-company reinsurance pool, as well as the agreements used in 2001 to de-pool the former members of The Continental Insurance Company inter-company reinsurance pool.

CNA has put in place a reinsurance contract between The Continental Insurance Company and Continental Casualty Company, through which Continental Casualty Company reinsures 100% of the business of The Continental Insurance Company. These actions establish Continental Casualty Company as the net risk bearer of nearly the entire U.S. property-casualty insurance operations of CNA.

## **REINSURANCE**

Prior to January 1, 2001, the Company was a member of the Continental Insurance Company (CIC) reinsurance pool under an amended and restated Inter-company Pooling Agreement. In the last quarter of 2000, the Company submitted a Form D filing to the Delaware Department of Insurance, requesting regulatory approval for a revised pool structure. As proposed, the new structure would remove seven companies from the pool, and reinsure 100% of their in-force insurance liabilities with CIC, including Niagara. The Delaware Department approved the cancellation, commutation, and release to the amended Inter-company Pooling Agreement.

During the fourth quarter of 2002, the CIC reinsurance pool structure was replaced with a separate 100% quota share reinsurance agreement effective January 1, 2003, between CIC and each of its former pool participants, including the Company, whereby CIC assumes, as an intermediate step, the net underwriting activity previously reflected in the CIC pool. As the final step, CIC now cedes this net underwriting activity to the Continental Casualty Company (CCC) under the 100% quota share reinsurance agreement between CCC and CIC.

The following three reinsurance agreements were implemented in order to accomplish the first step in the consolidation of the net risks of the CIC pool into CIC, prior to transacting external reinsurance, and to the ultimate cession to CCC:

- The commutation of the current CIC pool agreement effective January 1, 2001.
- A 100% retroactive reinsurance agreement between CIC and each former CIC pool participant covering all direct in-force business as of December 31, 2002.
- Prospective 100% quota share reinsurance agreement between CIC and each former CIC pool participant effective January 1, 2003. The Company received approval from Delaware in order to execute and implement these reinsurance agreements.

As a result of this transaction, all balances assumed and ceded under the then CIC pool agreement was reversed and the transaction reflecting the execution of the new quota share reinsurance agreement was recorded retroactive to January 1, 2003. Under the new quota share reinsurance agreement, the former CIC pool participants will cede all in-force business, including outstanding loss reserves, and prospective underwriting activity to CIC, prior to external reinsurance, and prior to ultimately ceding its net reinsurance risks to CCC.

During the coordinated multi-state exam, the following exception was noted and has been carried to this report.

*“Many of CCC's transactions with affiliates are related to quota share reinsurance agreements. It is the Company's policy to include quota share*

*transactions within the inter-company accounts. This handling prevents the appropriate tracking of reinsurance amounts and therefore prevents proper presentation of the Annual Statement, Schedule F-Part 1, Columns 6 and 10 concerning reinsurance transactions conducted with affiliated entities.*

*Also, there are reinsurance-related receivables and payables reported as receivable or payable to Parent, Subsidiary, and Affiliates. SSAP 62, paragraph 26 of the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions for Property-Casualty Insurance Companies instructs companies to report reinsurance-related receivable/payables on Annual Statement line items specifically for reinsurance. DE Insurance Code requires companies to prepare their Annual Statements in accordance with NAIC Annual Statement Instructions.”*

The following recommendation is made:

**It is recommended that the Company comply with SSAP 62, paragraph 26 by completing its Annual Statement in accordance with Annual Statement Instructions and Accounting Practices and Procedures adopted by the NAIC.**

#### **CONTINENTAL CASUALTY COMPANY LOSS RESERVES**

As of December 31, 2003, the Company appropriately reported no net loss and loss adjustment expense reserves. As previously mentioned, the Company reinsures 100% of its business under quota share treaties with its ultimate insurance parent, CCC.

The examination of the Company was conducted concurrently with the multi-state examinations of the CNA group of companies. The Illinois Division of Insurance contracted with Towers, Perrin, Tillinghast (Tillinghast), independent actuaries, to provide an estimate of the CCC and CIC loss and loss adjustment expense reserves for core lines, as well as, asbestos, pollution and mass torts (APMT) reserves. In various reports and correspondence, Tillinghast uses the term CNA to refer to the combined reserve positions of CCC and CIC.

In a letter of opinion addressed to the Illinois Division of Insurance, Tillinghast advised that CNA's net loss and loss adjustment expense reserve for the segments reviewed, fall below Tillinghast's point estimates in total, but fall within a range of reasonable estimates. As such, no

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financial adjustment was made to CCC or CIC regarding loss and loss adjustment expense reserves. However, it should be noted that actual future losses and or loss adjustment expenses may show adverse development within the range, which could significantly impact the Company's financials. If APMT reserves were to develop to the high end of the range, the deficiency would have substantial impact on the surplus position of the Company. To note, Tillinghast's point estimates for the relevant business reviewed, exceed CNA's carried reserves, as of December 31, 2003, by approximately 18% of CNA's consolidated policyholders' surplus.

### **INTERCOMPANY AGREEMENTS**

The Company had the following inter-company agreements and arrangements in effect as of December 31, 2003:

#### **Consolidated Income Tax Allocation Agreement**

The Company participates in an inter-company tax allocation agreement (effective May 11, 1995) with Loews. The agreement allows for Niagara to file federal income taxes on a consolidated basis through Loews.

#### **Expense Allocation Agreement**

As of the year-end 2003, the daily business affairs and financial records of the Company are handled and maintained by employees of CCC pursuant to an expense allocation agreement. The agreement, between CCC and other affiliated insurers, including Niagara, provides for employees of CCC to perform certain marketing, administrative, investment and other incidental functions and for the use of all necessary equipment and other such facilities of CNA. In return CCC receives a periodic service fee.

During the coordinated multi-state exam, the following exception was noted and has been carried to this report.

*“A review was performed of the CNA Inter-company Expense Agreement. Based on this review, it was determined that the agreement (in place as of December 31, 2003) does not serve as an adequate guideline for the allocation of expenses among the companies nor is it a useful tool for regulators in understanding the allocations made by the companies and determining the fairness of its terms.”*

The following recommendation is made:

**It is recommended that the CNA Inter-company Expense Agreement be rewritten to more clearly define the specific services provided, the specific providers of the identified services, the specific recipients of the services, and reimbursement/payment terms under the agreement to meet the provisions set forth under DE law.**

### **EXTERNAL AGREEMENTS**

In addition to the above inter-company agreements, the Company had the following external agreements in effect at December 31, 2003:

#### **Custodial Agreement**

The examiner acquired the Domestic Custody Agreement between the Company and Chase Manhattan Bank. The original agreement was dated November 26, 1996.

From language reviewed in this agreement, the custodian is charged to maintain a separate accounting of all assets held for the benefit of the Company. These funds are not to be commingled for the investment purposes of any other assets held by the custodian.

Furthermore, the custodians are obligated to indemnify the Company for loss of securities due to negligence, robbery, and damage by the custodians. In the event of such losses, the custodians are responsible to replace the value of the securities.

#### **Securities Lending Agreement**

The Company has in place a securities lending agreement with the aforementioned investment custodian. The agreement goes into some detail as to authority granted to the custodian to engage in the lending of the Company's securities and the credit needed by borrowers to enter into agreements with the custodian. Further discussion is made into the

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collateral held by the custodian, and the types of transactions for the collateral account. The agreement also grants indemnification to the Company, and holds harmless from loss of securities and any legal expenses in enforcing this indemnification.

This agreement is substantiated further in that it is an integral part of CNA's written investment plan.

### **LEGAL ACTIONS**

The Company is a party to various litigation and claims common to its business. Management believes that the outcome of such matters will not have a material adverse impact on the financial position or results of operations of the Company. In accordance with NAIC *Annual Statement Instructions*, the Company has made adequate disclosure of its material contingent liabilities where required.

### **ACCOUNTS AND RECORDS**

#### **Accounting System**

Niagara utilizes automated systems to maintain and account for most transactions. The PeopleSoft General Ledger, Query and Archive Warehouse constitute the Company's official book of record for financial reporting. The General Ledger consists of various ledgers that contain specific types of information required to support GAAP, STAT, SEC and Internal Management Reporting.

The internal auditors perform regular reviews of accounts and records of the Company and may recommend changes in Company procedures. An independent certified public accounting firm conducts an ongoing audit of operations with interim recommendations to management and an annual certified report to the Board of Directors.

#### **Independent Accountants**

The Company's financial statements are audited each year by the firm of Deloitte and Touche, LLP or "D&T", of Chicago, IL. The examiners reviewed the audited statutory financial

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statements for all years under review and noted that D&T issued an unqualified opinion each year.

### Actuarial Opinion

The Company's loss reserves and related actuarial items were reviewed by Ronald J. Swanstrom, FCAS, MAAA, the Senior Vice-President, who issued a statement of actuarial opinion, based on the financial information presented by the Company. The opinion stated that the reserves and related actuarial values carried on the balance sheet are fairly stated and met the requirements of the insurance laws of the state of Delaware.

See Reinsurance section above for more information regarding the cession of 100% of Niagara's Balance Sheet risk.

### Information Systems Control Review

During the course of the coordinated multi-state examination of the CNA companies, the Illinois Insurance Department's Information System audit specialist reviewed the Company's information systems with respect to the following:

- a) the presence of an Information System audit function
- b) Data Center and Local Area Network (LAN) security and control
- c) Contingency planning for recovery of Information Systems

During the examination of Niagara as of December 31, 2003, INS Services, Inc (INS) was engaged to participate on behalf of the state insurance regulators. As part of that effort, INS did an extensive review of the CNA Information Systems area. These workpapers, together with recommendations for resolving deficiencies, were made available to the state examiners at the conclusion of the INS audit. INS identified deficiencies in the control environment, formulated recommendations to improve the controls and passed that information to management, which responded to each recommendation within an agreed timeframe. All conclusions by the financial

examination staff with respect to the Company's information systems general control environment are the result of that review.

Regarding an Information Systems audit function, the examiners requested evidence from the Company in the form of annual reviews of general controls within the data processing environment, specific controls within application systems together with evidence of written communication between the audit staff and management. Audits should be performed on a regular basis, recommendations issued to management, and management should respond in timely fashion. Evidence obtained by INS indicates that the Company's public accounting firm, Deloitte & Touché, LLP together with the CNA internal audit staff, performs this function on an annual basis.

## **FINANCIAL STATEMENTS**

The following pages contain a statement of assets, liabilities, surplus and other funds as of December 31, 2003, as determined by this examination, along with supporting exhibits as detailed below:

- Analysis of Assets, December 31, 2003
- Statement of Liabilities, Surplus and Other Funds, December 31, 2003
- Underwriting and Investment Exhibit, December 31, 2003
- Schedule of Examination Adjustments

It should be noted that the various schedules and exhibits may not sum to the totals shown due to rounding.

**Analysis of Assets**  
**As of December 31, 2003**

	Ledger <u>Assets</u>	Non-admitted <u>Assets</u>	Net Admitted <u>Assets</u>
Bonds	\$ 47,521,914		\$47,521,914
Cash and short-term investments	8,441,776		8,441,776
Investment Income Due and Accrued	398,958		398,958
Net Deferred Tax Asset	<u>9,587,475</u>	<u>9,014,122</u>	<u>573,353</u>
Total Assets	<u>\$65,950,124</u>	<u>\$9,014,122</u>	<u>\$56,936,002</u>

**Statement of Liabilities, Surplus and Other Funds**  
**As of December 31, 2003**

Losses	\$ 0
Reinsurance payable on paid losses	0
Loss adjustment expenses	0
Contingent commissions	0
Other expenses	0
Taxes, licenses and fees	0
Payable to Parent, Subsidiaries and Affiliates	1,457,669
Payable for Securities	<u>2,127,280</u>
Total Liabilities	<u>\$3,584,949</u>
Common capital stock	\$10,000,000
Gross paid-in and contributed surplus	45,827,198
Unassigned funds (surplus)	<u>(2,476,145)</u>
Surplus as regards policyholders	<u>\$53,351,053</u>
Total liabilities	<u>\$ 56,936,002</u>

**Underwriting and Investment Exhibit - Statement of Income  
Year Ended December 31, 2003**

**UNDERWRITING INCOME**

Premiums earned \$ 0

**DEDUCTIONS**

Losses incurred \$ 0  
 Loss expenses incurred 0  
 Other underwriting expenses incurred 0  
 Total underwriting deductions \$ 0  
 Net underwriting gain or (loss) \$ 0

**INVESTMENT INCOME**

Net investment income earned \$ 3,215,655  
 Net realized capital gains or (losses) 777,107  
 Net investment gain or (loss) \$3,992,761

**OTHER INCOME**

Net gain or (loss) from agents' or premium balances charged off \$ 0  
 Aggregate write-ins for miscellaneous income 0  
 Total other income 0  
 Net income before dividends to policyholders and before federal income taxes \$ 3,992,761  
 Dividends to policyholders 0  
 Net income after dividends to policyholder but before federal income taxes \$ 3,992,761  
 Federal and foreign income taxes incurred 0  
 Net income \$ 3,992,761

**CAPITAL AND SURPLUS ACCOUNT**

Surplus as regards policyholders, December 31, 2002 \$ 71,792,250

**GAINS AND (LOSSES) IN SURPLUS**

Net income \$ 3,992,761  
 Change in net unrealized capital gains or (losses) 211,962  
 Change in net unrealized foreign exchange gains or (losses) (6,566,467)  
 Change in net deferred income tax (1,557,427)  
 Change in non-admitted assets 2,275,262  
 Change in provision for reinsurance 1,992,538  
 Surplus Adjustment – Paid-in (20,000,000)  
 Aggregate Write-ins for gains and (losses) in Surplus 1,210,172  
  
 Change in surplus as regards policyholders for the year \$ (18,441,198)  
  
 Adjustment to surplus as a result of 12/31/03 Examination 0  
  
 Surplus as regards policyholder, December 31, 2003 \$ 53,351,052

**SCHEDULE OF EXAMINATION ADJUSTMENTS**

<u>Description</u>	<u>Per Examination</u>	<u>Per Company</u>	<u>Surplus Increase (Decrease)</u>
Assets:	\$56,936,002	\$56,936,002	0
Adjusted Admitted Assets	<u>\$56,936,002</u>	<u>\$56,936,002</u>	<u>0</u>
Liabilities and Surplus:	\$56,936,002	\$56,936,002	0
Adjusted Liabilities and Surplus	<u>\$56,936,002</u>	<u>\$56,936,002</u>	<u>0</u>

There were no Surplus Adjustments per the examination.

**MARKET CONDUCT ACTIVITIES**

Sales and Advertising

A review was made of the Company's sales and advertising materials for its core lines of business. It appears from this review that the Company is in compliance with 18 Del.C. §2304, and does not appear to be using deceptive or misleading sales and advertising practices.

Underwriting and Rating

A review of the forms and endorsements filed during the period under examination revealed that the Company appears to be in compliance with Title 18 Del.C. §2712.

Agents Licensing

Based on our scope of agents' license testing, the Company appears to be in compliance with Regulation 36 of the Delaware Insurance Regulations.

Complaint Handling

The Company maintains a complaint log as required by 18 Del.C. §2304(17). A review of registered complaints from 1999 to 2003 did not indicate a pattern of complaints. Further, there did not appear to be any trends in states where the Company markets insurance products.

Claims Practices

Based upon the procedures performed, it appears that the Company's claims practices are performed in accordance with Delaware Insurance Laws and Regulations.

**COMPLIANCE WITH PRIOR REPORT RECOMMENDATIONS**

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

**Management and Control**

*Board of Directors*

1. Prior Exam Comment: It is again recommended that the current management of Niagara initiate corrective measures in the near future to make sure that the number of Directors elected to the Board complies with the requirement stipulated in the Company By-Laws and the Articles of Incorporation.

Current Exam Finding: The Company still is not in compliance with its own By-Laws. As noted, in the Management and Control section of this report, it is again recommended that the Company come into compliance with its own By-Laws and elect the appropriate number of Directors to the Board.

2. Prior Exam Comment: It is again recommended that the current management of Niagara initiate measures in the near future to ensure compliance with Section 4919 of the Delaware Insurance Code pertaining to notification to the Insurance Commissioner of any changes to key management personnel. The Delaware Insurance Department was not notified about the resignation and replacement of several key employees throughout the period under review.

Current Exam Finding: A review of all changes to officers and directors of the corporation during the examination period had not been reported to the Delaware Insurance Department in accordance with 18 Del.C. §4919. Accordingly, the prior report recommendation remains open as of December 31, 2003.

### **Holding Company Registration**

3. Prior Exam Comment: It is recommended that the current management of Niagara initiate measures in the near future to ensure compliance with Sections 5004(b)(3)(c) and 5004(d) of the Delaware Insurance Code pertaining to the disclosure of material affiliated company transactions not in the ordinary course of business to the Delaware Insurance Department. A material inter-company refinancing of mortgage debt occurred in 1998 which Niagara did not disclose in the 1990 Form “B” filing.

Current Exam Finding: It appears that the Company has properly filed its Form B with the Delaware Insurance Department. Furthermore, it appears that all necessary disclosures have been made in regards to affiliated transactions.

### **Access to Records for Review**

4. Prior Exam Comment: It is again recommended that the current management of Niagara initiate measures in the near future to ensure compliance with Section 320(c) of the Delaware Insurance Code pertaining to the Examiners having free access to the Company records without restrictive constraints encountered during the current examination.

Current Exam Finding: It is of the opinion of the Examiner-in-Charge that the management of the company has made a concerted effort to better facilitate the Examiners access to Company records and personnel.

5. Prior Exam Comment: Again it is recommended the current management of Niagara implement measures in the near future to ensure that examination report recommendations are complied with.

Current Exam Finding: For the first two prior recommendations above, it appears that the Company has made no effort to comply with the recommendations of the exam reports.

### **SUMMARY OF RECOMMENDATIONS**

1. It is again recommended that the Company come into compliance with its own By-Laws and elect the appropriate number of Directors to the Board. (See Management and Control, page 6)
2. The failure of the management of Niagara to disclose the resignation of key management personnel to the Commissioner of the Delaware Insurance Department constitutes non-compliance with Section 4919 of the Delaware Insurance Code. This is the THIRD examination in succession that the Company has failed to comply with the provisions of Section 4919 of the Delaware Insurance Code.

It is recommended that the Company immediately initiate measures to comply with the provisions of Section 4919 of the Delaware Insurance Code regarding the proper reporting of changes in the principal Officers and Directors of the Company (See Management and Control, page 7)

3. It is recommended that the Company comply with SSAP 6s, paragraph 26 by completing its Annual Statement in accordance with Annual Statement Instructions and Accounting Practices and Procedures adopted by the NAIC. (See Reinsurance, page 14)
4. It is recommended that the CNA Inter-Company Expense Agreement be rewritten to more clearly define the specific services provided, the specific providers of the identified services, the specific recipients of the services, and reimbursement/payment terms under the agreement to meet the provisions set forth under Delaware law. (See Inter-Company Agreement, page 16)

**CONCLUSION**

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

<b><u>Description</u></b>	<b><u>December 31, 1999</u></b>	<b><u>December 31, 2003</u></b>	<b><u>Increase/(Decrease)</u></b>
Assets	116,421,257	56,936,002	(59,485,255) *
Liabilities	48,457,967	3,584,949	(44,873,018) *
Capital and Surplus	67,963,290	53,351,052	(14,612,238) *

\* Changes largely due to De-pooling of former CCC and CIC groups. See de-pooling section for more explanation

Respectfully submitted,



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Craig P. Jackson, CFE  
Examiner-In-Charge  
State of Delaware  
Northeastern Zone, NAIC