

REPORT ON EXAMINATION AS TO THE CONDITION OF

HARBOR SPECIALTY INSURANCE COMPANY

TRENTON, NEW JERSEY

AS OF DECEMBER 31, 2008

NAIC GROUP CODE 0517

NAIC COMPANY CODE 21806

FILED

June 22, 2010

Commissioner
Department of Banking & Insurance

TABLE OF CONTENTS

| | <u>Page</u> |
|---|-------------|
| Salutation | 1 |
| Scope of the Examination | 2 |
| Compliance with Prior and 2007 Target Examination Report Recommendations..... | 3 |
| History and Kind of Business | 7 |
| Territory and Plan of Operation..... | 8 |
| Reinsurance..... | 9 |
| Parent, Subsidiaries and Affiliates | 11 |
| Inter-company Agreements..... | 12 |
| Management and Control..... | 13 |
| Continuity of Operations..... | 17 |
| Policy on Conflicts of Interest | 18 |
| Fidelity Bond and Other Insurance Coverages | 18 |
| Accounts and Records..... | 20 |
| Treatment of Policyholders..... | 21 |
| Statutory Deposits..... | 21 |
| | |
| Financial Exhibits: | |
| Statement of Assets, Liabilities, Surplus and Other Funds At December 31, 2008 (Exhibit A)..... | 22 |
| | |
| Underwriting and Investment Exhibit for the four year period ending December 31, 2008 (Exhibit B)..... | 23 |
| | |
| Capital and Surplus for the four year period ending December 31, 2008 (Exhibit C)..... | 24 |
| | |
| Notes to Financial Statements..... | 25 |
| Subsequent Events..... | 25 |
| Conclusion | 26 |

SALUTATION

Honorable Alfred W. Gross
Chairman Financial Condition, (E)
Subcommittee, NAIC
State Corporation Commission
Bureau of Insurance
P.O. Box 1157
Richmond, Virginia 23218

Mary Jo Hudson
Secretary, Midwestern Zone
Director
Ohio Department of Insurance
50 West Town Street
Third Floor, suite 300
Columbus, OH 43215

James J. Donelon
Secretary, Southeastern Zone
Commissioner
Louisiana Dept. of Insurance
1702 N. 3rd Street
P.O. Box 94214
Baton Rouge, Louisiana 70802-9214

Paulette J. Thabault
Secretary, Northeastern Zone
Commissioner
Vermont Insurance Division
Dept. of Banking, Insurance, Securities, and
Health Care Administration
89 Main Street
Montpelier, Vermont 05620-3101

Christina Urias
Secretary, Western Zone
Director
Arizona Department of Insurance
2910 N. 44th Street, suite 210
Phoenix, Arizona 85018-7269

Honorable Tom Considine
Commissioner
New Jersey Department of Banking and
Insurance
State of New Jersey
20 West State Street
Trenton, NJ 08625-0325

June 2, 2010

Commissioners:

In accordance with the plan adopted by the National Association of Insurance Commissioners for association examination of insurance companies, a financial condition examination has been made of:

Harbor Specialty Insurance Company
Princeton, New Jersey
NAIC Group Code 0517 NAIC Company Code 21806

Hereinafter referred to as the "Company".

SCOPE OF THE EXAMINATION

This financial condition examination was called by the Commissioner of Banking and Insurance of the State of New Jersey pursuant to the authority granted by N.J.S.A. 17:23-22. The examination covers the period January 1, 2005 through December 31, 2008.

A separate target exam was conducted in 2007 as a follow up on certain issues on the prior examination.

The examination was conducted at the Company's main administrative office located at 466 Lexington Avenue, New York, New York 10017. The examination was conducted in accordance with the Association Plan of Examination guidelines established by the National Association of Insurance Commissioners.

The examination was conducted in accordance with the 2008 NAIC Financial Condition Examiners Handbook. The Handbook requires that we plan and perform the examination to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the Company including corporate governance, identifying and assessing inherent risks within the Company and evaluating system controls and procedures used to mitigate those risks. An examination also includes assessing the principles and significant estimates made by management, as well as evaluating the overall financial statement presentation, management's compliance with Statutory Accounting Principles and annual statement instructions when applicable to domestic state regulations. All accounts and activities of the Company were considered in accordance with the risk-focused examination process as defined in the 2008 NAIC Financial Condition Examiners Handbook.

In addition, a review or audit was also made of the following items:

- Policy on Conflict of Interest
- Corporate Records
- Fidelity Bond and Other Insurance Coverage's
- History and Kind of Business
- Management and Control
- Continuity of Operations
- Territory and Plan of Operation
- Treatment of Policyholders
- Accounts and Records
- Reinsurance
- Parent, Subsidiaries and Affiliates
- Intercompany Agreements
- Information System Review

Surplus as regards policyholders determined by the examination, at the examination date, consisted of the following:

| | |
|---|-----------------------------|
| Common Capital Stock | \$ 4,100,000 |
| Gross Paid in and Contributed Surplus | 26,250,000 |
| Unassigned Funds | <u>(1,849,103)</u> |
| Surplus as Regards Policyholders | <u>\$ 28,500,897</u> |

The change in assets, liabilities and surplus for the period covered by this examination is detailed below:

| | 12/31/2008 | 12/31/2007 | 12/31/2006 | 12/31/2005 | 12/31/2004* (Per Exam) |
|-------------|-------------------|-------------------|-------------------|-------------------|-----------------------------------|
| Assets | \$131,755,306 | \$144,408,657 | \$182,199,449 | \$197,327,145 | \$263,180,109 |
| Liabilities | \$103,254,409 | \$122,527,135 | \$154,909,599 | \$175,979,063 | \$237,844,431 |
| Surplus | \$ 28,500,897 | \$ 21,881,522 | \$ 27,289,847 | \$ 21,348,082 | \$ 25,335,678 |

**Amounts differ from the financial statements for the year ended Dec. 31, 2004.*

COMPLIANCE WITH PRIOR EXAMINATION REPORT AND 2007 TARGET RECOMMENDATIONS

MANAGEMENT AND CONTROL

It is recommended that the Company comply with its By-laws regarding the required number of Directors.

During this examination, the Company complied with this recommendation.

It is recommended that the appointment of the Director of Internal Audit be documented in the corporate minutes of either the Board of Directors or the Audit Committee thereof. A new Director of Internal Audit was appointed in 2005 and was indicated in corporate records provided by the Company.

The Company has complied with this recommendation.

CONTINUITY OF OPERATIONS

It is again recommended that the disaster plan be fully tested. Before completion of the 2004 examination the Company provided documentation they had performed disaster recovery plan testing subsequent to the examination date.

The Company has complied with this recommendation.

TREATMENT OF POLICYHOLDERS

It is again recommended that the Company communicate to its agencies the requirement to maintain complaint logs, and that it ensures they are being maintained as required by New Jersey Code, NJSA 17:29B-4 (10).

The Company has complied with this recommendation.

ACCOUNTS AND RECORDS

It is again recommended that the Company implement a comprehensive accounting system, with both physical and electronic controls, to collect and monitor claims, premiums, reinsurance and other related accounting data.

The Company has not complied with this recommendation. Additional comments are found under Accounts and Records in this report.

It is again recommended that the Company have consistent claims and premium accounting cut-off dates and limit or eliminate the use of estimates of premium and claims activity.

The Company has complied with this recommendation regarding claims. The Company is no longer writing new business; therefore this recommendation is no longer applicable regarding premiums.

REINSURANCE

It is again recommended that the Company ensure its reinsurance files are maintained with complete signed copies of all reinsurance agreements and such agreements are readily available for review by the examiners.

The Company has complied with this recommendation.

PARENT, SUBSIDIARIES AND AFFILIATES

It is recommended that all affiliated transactions be reported in Schedule Y Part 2 in accordance with NAIC Annual Statement Guidelines.

The Company has complied with this recommendation.

INTER-COMPANY AGREEMENTS

It is recommended that all signatures affixed to any inter-company agreements be accompanied by the date the signature was attached to allow for a determination of when it becomes a binding agreement.

The Company has complied with this recommendation.

BONDS AND STOCKS

It is again recommended that the Company revise their custodial agreement to meet all the requirements and contain the satisfactory safeguards and controls as outlined in the provisions of the NAIC guidelines. Subsequent to the 2004 examination date, the Company complied with this recommendation and currently has a custodial agreement in compliance with the NAIC standards.

The Company has complied with this recommendation.

It is recommended that the Company ensure that the data reported on its Schedule D and Schedule E is reconciled to the amounts reported by their outside investment service provider.

The Company has complied with this recommendation.

It is recommended that the Company ensure that the correct jurisdiction be identified for all securities listed on the Special Deposit Schedule.

The Company has complied with this recommendation.

UNCOLLECTED PREMIUMS AND AGENTS' BALANCES IN THE COURSE OF COLLECTION

It is again recommended that the Company ensure that all provisions of their agency agreements are complied with, specifically, required data files.

The Company is no longer writing new business; therefore this recommendation is no longer applicable.

LOSSES AND LOSS ADJUSTMENT EXPENSES

It is again recommended that the Company establish and maintain a reserve for loss adjustment expenses to cover the ultimate estimated expenses necessary to adjust all unpaid losses irrespective of any agreements other than a valid contract of reinsurance.

The Company has complied with this recommendation.

AGENTS' CREDIT BALANCES

It is recommended that all provisions and components of uncollectible agents' balances be recorded in the "Allowance for Uncollectible" general ledger account, and also be included in the "non-Admitted" column of Page 2 on the Annual Statement.

The Company is no longer writing new business; therefore this recommendation is no longer applicable.

It is recommended that agents' credit balances be reported separately as a liability in accordance with SSAP #5.

The Company is no longer writing new business; therefore this recommendation is no longer applicable.

It is recommended that the Company identify and report deferred premiums based upon the actual balances deferred.

The Company is no longer writing new business; therefore this recommendation is no longer applicable.

LOSSES AND LOSS ADJUSTMENT EXPENSES

It is recommended that the Company establish and maintain adequate reserves to cover both reported and unreported claims.

The Company has complied with this recommendation.

CEDED REINSURANCE PREMIUMS PAYABLE

It is recommended that the Company develop and maintain its reinsurance related records to enable it to respond to and respond promptly to requests for information made by the examiners in future examinations.

The Company has complied with this recommendation.

PROVISION FOR REINSURANCE

It is recommended that the Company properly report its provision for reinsurance.

The Company has complied with this recommendation.

2007 EXAM FINDINGS

It is recommended that the Company review the aging process and result of all manually determined programs for accuracy. It is further recommended that the Company implement automated aging techniques whereby human error is removed from the aging process to the extent possible.

The Company has complied with this recommendation.

It is recommended that the Company include a detailed allocation of the blanket LOC in future MOU quarterly reporting, similar to that included in the December, 2007 reporting package.

The Company has complied with this recommendation.

HISTORY AND KIND OF BUSINESS

The Company was incorporated under the laws of the State of Georgia on July 2, 1981, as First of Georgia Fire and Casualty Insurance Company and commenced business on October 1, 1981. It was acquired by the Clarendon Group on September 8, 1995, and redomiciled to the State of New Jersey on November 9, 1995, at which time it changed its name to Harbor Specialty Insurance Company.

During 1996, the Company became a subsidiary of Clarendon National Insurance Company through a corporate restructuring of the Clarendon Insurance Group.

In 1999, the Company was part of the Clarendon Insurance Group which became a wholly owned subsidiary of Hannover Finance Incorporated, a Delaware corporation. The Company's ultimate parent is Hannover Ruckversicherung AG, hereinafter referred to as "Hannover Re".

On March 7, 2006, Hannover Re announced a fundamental restructuring of its U.S. primary insurance business by transferring, through an indemnity reinsurance agreement, most of the specialty business of the HFI group insurance subsidiaries to Praetorian Insurance Company (PIC) and Redland Insurance Company (Redland).

Effective May 31, 2007 the sale of Praetorian Insurance Group to QBE Insurance Group was closed upon receipt of the required approval from regulators.

The Company and its affiliates focus is to continue to service its in-force book of business and the orderly administration, including prompt claims payment, of its discontinued business. The administration of the in-force book requires the renewal of business in accordance with the state specific forced renewal requirements. The Company is licensed in Delaware, New Jersey and the U.S. Virgin Islands.

Its Certificate of Authority dated May 28, 1996 authorized the Company to transact the business of insurance specified in paragraphs “a”, “b”, “e”, “f”, “i”, “j”, “k”, “l”, “m”, “n”, and “o-1”, “o-2”, and “o-3” of N.J.S.A. 17:17-1.

The capital structure of the Company includes 4,100,000 shares of common stock with a par value of \$1 per share totaling \$4,100,000 of common stock. The Company’s capital also includes \$26,250,000 of gross paid in and contributed surplus and unassigned funds in the amount of (\$1,849,103).

The Company’s current statutory home office is located 196 Princeton Hightstown Road, Building 2, Suite 14A, Princeton Jct., NJ 08550. The examination was conducted at the Company’s New York, New York offices. The registered agent upon whom process may be served is William F. Megna at the Company’s statutory home office.

TERRITORY AND PLAN OF OPERATIONS

The Company ceased writing new business on July 1, 2005. In instances of mandatory renewals the Company has complied with these requirements. The Company entered into fronting arrangements with Praetorian Financial Group on certain programs.

As of December 31, 2008, the Company was in a business run-off mode and renewal of business in accordance with the state specific forced renewal requirements.

The Company’s direct written business currently in runoff is primarily program business which consists of homogeneous books of business dedicated to a well defined market segment. Many of these programs had been recommended to the Company by various reinsurers who desire to participate in the program through quota share treaties.

The Company used reinsurance intermediary brokers to negotiate its reinsurance. These brokers are licensed either in New Jersey or in other accredited states having similar laws to the State of New Jersey.

Prior to starting the run-off process, the Company was actively marketing its insurance products, it primarily employed managing general agents (MGAs), general agents (GAs) and third party administrators (TPAs) to actively manage its various programs. These parties conduct a substantial portion of the administrative work associated with premium and claims processing functions, backup supporting records, and reconciliation to Company bank accounts established for their use.

These firms have contracts with the Company, whereby their responsibilities and authority delineated. Our review determined that the Company was requiring that their MGAs obtain fidelity bond insurance as required under N.J.S.A. 17:22-(2-7).

REINSURANCE

Assumed:

The Company's assumed reinsurance involved only unaffiliated insurers, at December 31, 2008. The Company reported only nominal 2008 assumed known case losses and LAE reserves of \$306,000.

Ceded:

The Company makes extensive use of ceded reinsurance in managing its business. During 2008, the Company ceded \$74 thousand of its direct and assumed premiums written.

The Company's ceded reinsurance arrangements are similar to its affiliates and are described as follows:

Program and Global Reinsurance:

The Company ceded program level business on both a pro rata and excess of loss basis to other reinsurers.

While the Company focuses on managing its discontinued business, there remained forced renewal on some of its property business. Effective June 1, 2006, the Company purchased excess reinsurance to protect its exposure for this business, consistent with its exit strategy; which was subsequently extended through May 31, 2008. The contract was not renewed.

Effective July 1, 2005, the Company transferred, through an indemnity reinsurance agreement, most of the insurance business of the Company to Redland Insurance Company and Praetorian Insurance Company and sold the renewal rights for ongoing business of the Company. Cessions under the indemnity agreement were net of underlying reinsurance on the Company's books for the period July 1, 2005 through December 31, 2005. Effective January 1, 2006 the agreement was amended and cessions were made on a gross basis.

Affiliated Reinsurance:

Effective December 31, 2003, the Company and its affiliates, Clarendon National Insurance Company and Harbor Specialty Insurance Company entered into a Loss Portfolio retroactive ceded reinsurance agreement with affiliate Hannover Re, whereby Hannover Re agrees to assume 100% of the ultimate net liability of certain discontinued programs of business, subject to a loss limitation of \$350 million. The contract further provides to the Company unlimited protection for uncollectible reinsurance, disputed reinsurance and legal expenses associated to the collection of those balances. This agreement was approved by the New Jersey Department of Banking and Insurance. As of December 31, 2004, the inception to date losses and loss adjustment expenses and uncollectible or disputed reinsurance ceded under this contract totaled \$614 million for all three reinsureds.

Effective July 1, 2005, the Company and its affiliates Harbor Specialty Insurance Company and its parent, Clarendon National Insurance Company entered into an Adverse Development Cover reinsurance agreement with Hannover Re. Under the terms of the agreement, the Companies can recover \$295 million of losses in excess of the ultimate net liability on specific programs, as defined in the agreement.

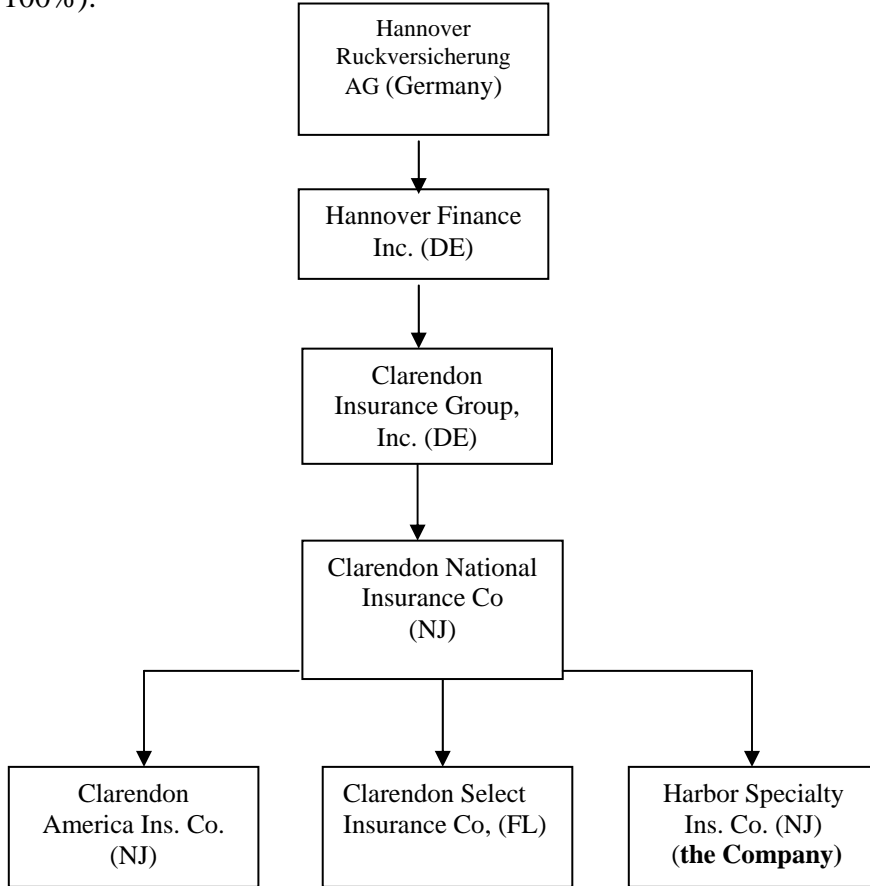
The Company has filed a form D with the New Jersey Department of Banking and Insurance seeking approval to commute the Loss Portfolio Agreement. Under the terms of the commutation Hannover Re will pay to Clarendon approximately \$245,946,678 which represents the sum of (i) the discounted value calculated on the \$252,946,678 in outstanding reserves commuted, and (ii) a risk charge for the reserves that are re-assumed.

Simultaneously the ADC will be amended to include unlimited protection for failed reinsurance, disputed reinsurance, and any other contingencies for which the uncapped coverage of the LPT would have responded for both the Raydon and Cromwell programs including a payment for the enhanced coverage provided by this amendment. The cost to the Company for this amendment is \$5,000,000.

PARENT, SUBSIDIARIES AND AFFILIATES

The Company is a member of an insurance company holding system as defined in N.J.S.A. 17:27A-1 et seq. Accordingly, the Company has registered with the State of New Jersey under the registration it filed as required under N.J.S.A. 17:27A-3.

A chart of the holding company system, as it relates to the Company follows (all ownership is 100%):



INTER-COMPANY AGREEMENTS

Federal Income Tax Allocation and Settlement Policy Agreement:

The Company is party to a Federal Income Tax Allocation and Settlement Policy Agreement dated January 1, 2003. This agreement was made between the Company's parent, Hannover Finance Incorporated and its subsidiaries.

The provisions of this agreement call for each subsidiary to calculate the amount of federal income tax it would be required to pay as a stand alone company. All applicable rates of the federal income tax laws are required to be applied by each subsidiary in preparing their individual returns.

A consolidated return consisting of all of the subsidiaries in the Clarendon Insurance Group is prepared by the Company and submitted to Hannover Finance Incorporated for inclusion in its consolidated federal income tax filing as required under this agreement.

The specific settlement terms of this agreement call for each subsidiary to pay the annual settlement of their tax assessment on or before the prescribed due date of the consolidated income tax return. In the event that the Hannover Finance Corporation owes the subsidiary an overpaid amount, that corporation is required to remit that overpayment to the subsidiary on or before the due date of the consolidated federal tax return.

Expense Allocation Agreement:

The Company is party to an expense allocation agreement that provides provisions to allocate certain expenses to various affiliated companies. The agreement calls for the Company to provide services as the participating companies may request including, but not limited to: accounting, underwriting, actuarial, consulting, claims and other administration services.

Within thirty days after the end of each quarter end, in return for these services, the Company must furnish a report to the other parties to this agreement, estimating each of the entities expenses. The entities shall remit payment to the Company within fifteen days of the receipt of this report. Within forty-five days after the end of each calendar quarter, the Company must make a final determination of each of the participant's expense allocation. These entities must make payments to the Company within ten days after receipt of the final determination.

The agreement shall be negotiated every three years and may be terminated at any time by mutual agreement of the parties involved with not less than sixty days notice to the other participants.

Claims Administration Agreement:

The Company is a party to a Claims Administration Agreement dated, January 1, 1999 with North American Risk Services, Inc. which remained in effect until NARS was sold in 2008.

Investment Agreement:

The Company is party to an Investment Management Agreement with Ampega-Gerling effective January 1, 2004 until December 31, 2008. The agreement covers managing, investing, realizing and reinvesting all or any part of the portfolio under the terms of the agreement and the Company's investment guidelines. A new agreement was submitted to the NJDOBI subsequent to the exam for its approval.

MANAGEMENT AND CONTROL

On February 25, 1999, the Company became a wholly owned subsidiary of Hannover Finance Incorporated, due to its acquisition of all of the issued and outstanding stock of Lion Holding Incorporated. The Company's ultimate parent is Hannover Re which owns 100% of Hannover Finance Inc.

Shareholders

The By-laws provide for an annual meeting of the shareholders at a time and place to be designated by the Board of Directors. This meeting shall be for election of Directors and for the completion of any other business concerned with the Corporation.

The By-laws also state that special meetings, of the shareholders, may be called by the Chairman of the Board, the President, the Secretary, the Board of Directors or by the holders of at least one-half of all of the outstanding shares of stock of the Company.

A quorum at all shareholder meetings shall be majority of the outstanding shares of the Corporation represented either in person or by proxy. In the absence of a quorum, a majority of the represented shares may adjourn the meeting without further notice.

Directors

The affairs of the Corporation are managed by its Board of Directors. The number of Directors shall be fixed from time to time by resolution of the Board of Directors or the shareholders. Each Director holds office until the next annual shareholders meeting or until his successor shall have been elected and qualified. Directors may be removed with or without cause as provided by law. A successor Director shall be elected to replace the removed Director by a plurality of the votes cast by a quorum of the Board present at the meeting to remove the Director in question.

The regular meeting of the Board shall be held immediately following and at the same place as the annual shareholders meeting. The Board may provide, by resolution, the time and place for additional meetings without notice other than the resolution. Special meetings of the Board may be called by the Chairman of the Board, the Vice Chairman of the Board, the President or the Secretary at the request of a majority of the Board of Directors.

A majority of the number of Directors shall constitute a quorum at all meetings of the Board providing that, in the absence of a quorum, a majority of the Directors that are present can adjourn the meeting which shall be rescheduled with at least twenty-four hours notice.

A review was made of the Board minutes for the period of the examination. It was determined that Board minutes adequately support all major Company decisions.

At December 31, 2008, the Board of Directors was comprised of the following members:

| <u>Name and Address of Director</u> | <u>Principal Occupation</u> |
|---|------------------------------------|
| Patrick Fee 2045 Church Street Wauwatosa, WI 53213 | President and CEO |
| Anders Larsson 6 Marion Road Westport, Ct 06880 | COO and CFO |
| Robert Redpath 166 Georgetown Road Weston, CT 06883 | General Counsel and SVP |

The By-laws state that the Board may, by resolution, designate one or more committees each consisting of one or more of the Directors of the Corporation. As of the examination, the Board had established the following Committees:

| <u>Committee</u> | <u>Members</u> |
|-------------------------|--|
| Audit Committee | Dr. Elke Koenig (Chairwoman) William Kelty III Patrick Fee |
| Compensation Committee | Wilhelm Zeller (Chairman) William Kelty III Patrick Fee |
| Investment Committee | Dr. Elke Koenig (Chairwoman) Patrick Fee Anders Larsson Matt Mascia |

Litigation Committee

William Kelty III
Elke Koenig
Patrick Fee
Dr. Michael Pickel
Robert Redpath

In 2009 William Zeller was replaced by Dr. Michael Pickel as Chairman of the Board of Directors and Chairman of the Compensation Committee. In 2009, Elke Koenig was replaced by Roland Vogel as a member of the Board of Directors and the Chairman of the Audit Committee and Investment Committee.

The Underwriting Committee and Actuarial Committee were dissolved in 2006. The Litigation Committee was dissolved in 2008.

Though the Company is not in compliance with N.J.S.A. 17:27A-4d (3)(4) whereby at least one third of its directors must be outside members and not associated with the Company, its ultimate parent does meet the requirements of New Jersey Statutes regarding the make-up of its Board of Directors.

Article V of the By-laws dictates the corporate officers, their powers and duties. Under this article, the officers, of the Company shall be the following:

Chairman of the Board
Vice Chairman of the Board
President
Vice Presidents
Secretary
Treasurer

The duties of the above listed officers, as stated in the by-laws are as follows:

Chairman of the Board – shall be the Chief Executive Officer of the Company and subject only to the Board of Directors, shall have general authority over the property and business affairs of the Company. The Chairman shall preside at all meetings of stockholders and of the Board of Directors. In the event of the absence or disability of the President, the Chairman of the Board shall discharge all of the duties of the President.

Vice Chairman of the Board – shall exercise all powers of the Chairman of the Board in his absence or disability. At the direction of the Chairman, he shall preside at meetings of the Board of Directors and of the stockholders.

President – shall be the Chief Operating Officer of the Company and subject only to the Chairman of the Board and to the Board of Directors. He shall direct the everyday business of the Company. The President shall have such specific duties as may be assigned by the Chairman of the Board and the Board of Directors. During the absence

or disability of the Chairman and the Vice Chairman, he shall exercise all powers of the Chairman. In the event of the absence of the Chairman and the Vice Chairman, the President shall preside at meetings of the Board of Directors and of the Shareholders. In the absence of the Chairman of the Board, the Vice Chairman and the President, the Board of Directors may direct a Vice President or some other person to be the acting Chief Executive Officer and Acting Chief Operating Officer to perform all duties prescribed for the Chairman of the Board and the President.

Vice Presidents – The Board of Directors shall elect one or more Vice Presidents to serve in such capacities as shall be directed by the Chairman, the Vice Chairman, the President or the Directors.

Secretary – shall have custody of the seal of the Company which he or Assistant Secretary may affix to any corporate documents on which it is required. The Secretary shall perform all duties incidental to that office and such other duties as may be assigned to him by the Chairman of the Board, the Vice Chairman of the Board, the President or the Board of Directors. In the absence of the Secretary, any Assistant Secretary may perform the duties of the Secretary.

Treasurer – Shall be the custodian of the funds and securities of the Company. He shall perform all duties incidental to the office of the Treasurer as well as any other duties which may be assigned to him by the Chairman of the Board, the Vice Chairman of the Board, the President or the Board of Directors. In the absence of the Treasurer, the President or any Assistant Treasurer may perform the duties of the Treasurer.

As of December 31, 2008, the officers of the Company were as follows:

| <u>Name</u> | <u>Title</u> |
|----------------------|-------------------------------|
| Patrick Fee | President & CEO |
| Robert Redpath | Secretary and General Counsel |
| Anders Folke Larsson | Chief Operating Officer |
| Matthew Mascia | Treasurer |

A review of the minutes of the Board of Directors indicated that the Board approved major company actions.

CONTINUITY OF OPERATIONS

The Company stores its paper files, with Iron Mountain throughout its six locations in NJ and also in a lease warehouse in Orlando, Florida located at 6831 Edgewater Commerce Parkway.

Its backup tapes and other important IT information is stored at:

Iron Mountain
Offsite Data Protection
203 Moonachie Road
Moonachie, NJ 07074

Also, at that same location, its computer systems weekly backups are stored. All required systems are real time replicated to a hot site hosted in Equinix in New Jersey.

The Company has in place a disaster recovery plan. This plan includes the appointment of a recovery executive committee, headed by the President and managed by the Chief Administrative Officer, who have overall responsibility for the implementation of the plan.

If the Company were to lose the use of its primary office or its computer facility, the hot site will provide access via internet from any location for key computer systems. From this location, the Company will have key personnel and team leaders from all of its major business areas, work in restoring the Company's ability to operate as a viable entity.

The plan is comprehensive and appears to cover most disasters that might harm the Company's ability to act as a viable operation.

As of the examination date, the Company tests its hot site location yearly.

The continuity of management is provided for in the Company's By-laws which state, under the section dealing with the duties of officers, the Chairman of the Board shall be the Chief Executive Officer of the Company and shall have general authority over the general management of the corporation. The By-laws also state that the President shall be the Chief Operating Officer of the Company. In the case of the disability or absence of either the Chairman of the Board or of the President, the duties of the unavailable officer shall be assumed by the remaining one. If both the above officers should be unavailable to serve, the Board of Directors may select a Senior Vice President or some other party to act instead.

POLICY ON CONFLICTS OF INTEREST

The Company has adopted a conflict of interest policy. This policy states that all directors, officers and employees should conduct business in the spirit of the law, and to refrain from any illegal, dishonest and unethical conduct. If a situation arises which makes it difficult to determine a proper course of action, the matter should be discussed with immediate supervisors or the Human Resource Department.

Transactions with outside firms must be conducted and controlled by the executive level of the Clarendon Insurance Group. Business dealings with outside firms should not result in unusual gains for those firms. Unusual gains refers to bribes, product bonuses, special fringe benefits, unusual price breaks and other windfalls designed to ultimately benefit either the employee, the employer or both. Promotional plans that could be interpreted to involve unusual gain require specific executive level approval.

This policy is comprehensive and helps the Company to seek out any potential conflicts and decide on a course of action regarding the same.

FIDELITY BOND AND OTHER INSURANCE COVERAGES

The Company’s bonding and all other insurance coverage are part of the overall insurance program administered by Hanover Finance, Inc., for itself and its network of subsidiaries. The types of coverage for the Company are summarized as follows:

Fidelity Coverage – a fidelity bond with an aggregate amount of liability of \$15,000,000 was in force at the date of our examination. This fidelity bond included blanket coverage of Hanover Finance, Inc., and its related subsidiaries. Based on the consolidated audited financial statements of the Hanover Finance, the suggested minimum amount of fidelity insurance was calculated using NAIC guidelines. It was determined that the coverage in force was in compliance with the NAIC prescribed amounts.

Other Insurance Coverage’s:

Property and General Liability

(Provided by the Travelers Indemnity Company of America Limits)

| | |
|--|-------------|
| Personal Property..... | \$1,040,000 |
| Business income with extra expense waiting period 72 hours..... | \$1,200,000 |
| Electronic data processing..... | \$ 500,000 |
| Valuable Papers..... | \$ 500,000 |

Business Automobile

Provided by the Travelers Property & Casualty Company of America for \$1 million per occurrence.

Workers Compensation

Provided by the Travelers Indemnity Company of America for \$1 million each accident, \$1 million policy limit and \$1 million each employee.

Umbrella Liability

Provided by the Travelers Property & Casualty Company of America for \$10 million each occurrence, \$10 million aggregate.

Excess Follow Form Liability

Provided by The American Insurance Company for \$50 million, \$50 aggregate.

Fiduciary Liability

Provided by the St. Paul Mercury Insurance Company for \$5 million each policy period.

Financial Institution Bond

Provided by the St. Paul Fire and Marine for \$10 million with a \$250,000 deductible.

Financial Institution Computer Crime

Provided by the St. Paul Fire and Marine 50/50 Co-Surety with Federal Insurance Company for \$10 million with a \$250,000 deductible.

Cyber Security Crime Policy

Provide by the Federal Insurance Company for \$1 million, \$ 250,000 deductible.

Cyber Security Liability Policy

Provided by the Federal Insurance Company for \$1 million, \$150,000 deductible.

Professional Liability

Provided by the Columbia Casualty Insurance Company for \$10 per loss/ aggregate, retention \$ 1.5 million.

Excess Professional Liability

Provided by the Illinois Union Insurance Company for \$10m million per loss/ aggregate.

Group Travel Insurance

Provided by the Federal Insurance Company for \$5 million per accident / aggregate limit.

Employment Practices Liability

Provided by the Federal Insurance Company for \$ 5 million each loss / aggregate \$ 5 million.

Punitive Damages Insurance Policy

Provided by the Chubb Atlantic Indemnity Insurance Company for \$5 million each claim, \$5 million aggregate.

Kidnap & Ransom Insurance Policy

Provided by the Liberty Insurance Underwriters, Inc. for \$ 10 million each loss ,max benefit to any one person of \$100,000.

ACCOUNTS AND RECORDS

Investment transaction data is provided by Ampega-Gerling to the Company in accordance with the terms of an investment services agreement. The company enters the data into the SunGard Investment accounting system. The data from SunGard is transported to the Oracle General Ledger, as well as the Freedom Annual Statement system.

Policy and claims detailed transactions are also primarily administered through contracts executed with third party vendors, as described under the “Territory and Plan of Operation” section of this report. The Company obtains applicable information on a monthly basis through a variety of means such as reports and electronic media. This information is downloaded or entered, as applicable, into excel spreadsheets that in turn flow into other spreadsheets and eventually the data is uploaded, on a quarterly, into Oracle. The Company utilizes an early cut-off of 2 months for the recording of its premium/claim data, primarily due to its reliance on third party administrators/managers and the timing of the receipt of this data, and also due to the timing necessary to be able to report Company data upstream to its parent in Germany. The Company uses estimates of underwriting accounts for two month each quarter which is reversed the following quarter.

During KPMG’s review of the Company a significant deficiency was noted relating to the Company’s extensive use of spreadsheets. “These spreadsheets are utilized to accumulate or calculate certain gross and ceded revenue, losses, expenses, asset and liability balances. The spreadsheets are utilized to account for transactions entered into by the Company’s managing general agents and processed by the program accounting group. Due to the extensive use of spreadsheets the Company is not able to design and implement sufficient controls over access, program development and program changes controls over these spreadsheet.”

In response to this concern, the Company is implementing two accounting systems. One system will handle direct data loads, direct calculations, statutory reporting, general ledger posting and management reports. The other system performs cession calculations, reinsurance billings, reinsurance reporting and Schedule F reporting. It was noted that KPMG expressed the same concerns related to spreadsheets during their 2009 audit.

TREATMENT OF POLICYHOLDERS

N.J.S.A. 17:29-4 (10) requires the maintenance of a complete record of all complaints received by the Company since the date of the prior examination. The Company informed the examiners that the complaint logs are maintained at their various agency offices and monitored by Company personnel.

STATUTORY DEPOSITS

The following is a list of deposits as of December 31, 2008 for the states that require the Company to maintain a deposit for the benefit of all policyholders or the policyholders of the particular state.

The securities held are either US Treasury Notes or a specific security and are in the following amounts and for the indicated states:

| <u>State</u> | <u>Statement Value</u> |
|---------------------|-------------------------------|
| California | \$ 49,898,343 |
| Florida | 113,321 |
| Georgia | 84,978 |
| Louisiana | 124,586 |
| Missouri | 261,922 |
| New Jersey | 1,190,798 |
| North Carolina | 442,801 |
| Ohio | 49,981 |
| South Carolina | 124,953 |
| Tennessee | 90,517 |
| Virginia | 550,403 |
| | |
| Total | <u>\$52,932,603</u> |

The New Jersey deposit was held for the protection of all policyholders while the other deposits were held for the protection of the policyholders in the named jurisdictions.

**Comparative Statement of Assets,
Liabilities, Surplus and Other Funds at
December 31, 2008**

Exhibit A

| | <u>Balance per Examination</u> | <u>Balance per Company</u> | <u>Note</u> |
|---|------------------------------------|--------------------------------|-------------|
| <u>Assets:</u> | | | |
| Bonds | 56,156,120 | 56,156,120 | |
| Cash, Cash Equivalents & short term investments | 69,128,382 | 69,128,382 | |
| Investment income due and accrued | 650,355 | 650,355 | |
| Amounts recoverable from reinsurers | 1,976,426 | 1,976,426 | |
| Funds held by or deposited with reinsured companies | 566 | 566 | |
| Receivable from parent, subsidiaries and affiliates | 3,175,587 | 3,175,587 | |
| Aggregate write-ins for other than invested assets-equities & deposits in pools | <u>667,870</u> | <u>667,870</u> | |
| Total Admitted Assets | \$131,755,306 | \$131,755,306 | |
| <u>Liabilities:</u> | | | |
| Losses | 8,558,076 | 8,558,076 | 1 |
| Loss adjustment expenses | 3,546,018 | 3,546,018 | 1 |
| Commission payable, contingent commissions & other similar charges | 348,387 | 348,387 | |
| Other expenses | 334,799 | 334,799 | |
| Current federal and foreign income taxes | 199,522 | 199,522 | |
| Ceded reinsurance premiums payable | 12,003 | 12,003 | |
| Funds held by company under reinsurance treaties | 87,823,879 | 87,823,879 | |
| Amounts withheld or retained by Company for account of others | 97,743 | 97,743 | |
| Provision for reinsurance | 829,910 | 829,910 | |
| Payable to parent, subsidiaries and affiliates | 1,053,405 | 1,053,405 | |
| Aggregate write ins for liabilities | <u>450,667</u> | <u>450,667</u> | |
| Total Liabilities | \$103,254,409 | \$103,254,409 | |
| <u>Capital and Surplus:</u> | | | |
| Common capital stock | 4,100,000 | 4,100,000 | |
| Gross paid in and contributed surplus | 26,250,000 | 26,250,000 | |
| Unassigned funds | <u>(1,849,103)</u> | <u>(1,849,103)</u> | |
| Surplus as regards policyholders | <u>\$28,500,897</u> | <u>\$28,500,897</u> | |
| Total Liabilities and Surplus and Other Funds | \$131,755,306 | \$131,755,306 | |

**Underwriting and Investment Exhibit
for the four year period ending
December 31, 2008**

Exhibit B

| | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> |
|--|------------------------|---------------------|-----------------------|--------------------|
| <u>Underwriting Income</u> | | | | |
| Premiums earned | \$11,438,492 | \$(1,411,429) | \$(1,715,947) | \$(81,916) |
| Deductions: | | | | |
| Losses incurred | 8,418,923 | (13,228,796) | (2,860,013) | (2,924,253) |
| Loss expenses incurred | 4,503,318 | 50,065,969 | 1,290,516 | 976,728 |
| Other underwriting expenses incurred | 14,474,198 | (3,637,627) | 6,459,966 | 576,681 |
| Total underwriting deductions | <u>27,396,439</u> | <u>(11,800,454)</u> | <u>4,890,469</u> | <u>(1,370,844)</u> |
| Net underwriting gain or loss | <u>(15,957,947)</u> | <u>10,389,025</u> | <u>(6,606,416)</u> | <u>1,288,928</u> |
| <u>Investment income</u> | | | | |
| Net investment income earned | 3,240,372 | (519,228) | (768,121) | 3,320,018 |
| Net realized capital gains or losses | 595,918 | (22,870) | 0 | 1,268,746 |
| Net investment gain or loss | <u>3,836,290</u> | <u>(542,098)</u> | <u>(768,121)</u> | <u>4,588,764</u> |
| <u>Other income</u> | | | | |
| Net gain or loss from agents' or premium balances charged off | (445,840) | 607,352 | 306,148 | (129,768) |
| Aggregate write-ins for miscellaneous income | 0 | 0 | 0 | 0 |
| Total other income | <u>(445,840)</u> | <u>607,352</u> | <u>306,148</u> | <u>(129,768)</u> |
| Net income before dividends to policyholders and before federal and foreign income taxes | (12,567,497) | 10,454,279 | (7,068,389) | 5,747,924 |
| Less: Federal & foreign income taxes incurred | 0 | 0 | 0 | 23,463 |
| Net income | <u>\$ (12,567,497)</u> | <u>\$10,454,279</u> | <u>\$ (7,068,389)</u> | <u>\$5,724,461</u> |

CAPITAL AND SURPLUS
For the four year period ending
December 31, 2008

Exhibit C

| | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> |
|---|----------------------------|----------------------------|----------------------------|----------------------------|
| <u>Gains and losses in surplus:</u> | | | | |
| Net income or (loss) | \$(12,567,497) | \$10,454,279 | \$(7,068,389) | \$5,724,461 |
| Change in net deferred income tax | 4,798,221 | (3,143,952) | 2,391,882 | (2,585,105) |
| Change in non-admitted assets | (4,378,473) | 216,857 | (2,292,943) | 3,605,389 |
| Change in provision for reinsurance | (529,697) | (1,585,417) | 1,561,124 | (275,920) |
| Aggregate write-ins for gains and Losses in surplus | <u>0</u> | <u>0</u> | <u>0</u> | <u>150,550</u> |
| Change in Surplus as regards to Policyholders for the year | (12,677,445) | 5,941,767 | (5,408,327) | 6,619,375 |
| Surplus, December 31 previous year | <u>34,025,528</u> | <u>21,348,082</u> | <u>27,289,949</u> | <u>21,881,522</u> |
| Surplus, December 31 current year | <u><u>\$21,348,082</u></u> | <u><u>\$27,289,849</u></u> | <u><u>\$21,881,522</u></u> | <u><u>\$28,500,897</u></u> |

NOTES TO FINANCIAL STATEMENTS

Note 1: Losses and Loss Adjustment Expense

The Company reported a liability for losses and loss adjustment expenses in the amount of \$8,558,076 and \$3,546,018 respectively. These reserve amounts were evaluated by the actuarial firm of Oliver, Wyman. The review indicated that the gross and net reserve amounts established by the Company were found to be adequate.

Loss and Loss Adjustment Expense Reserves-Statement by New Jersey Department of Banking and Insurance Actuary

I, Boris Privman, FCAS, MAAA, Managing Property and Casualty Actuary for the New Jersey Department of Banking and Insurance, have reviewed the actuarial analysis performed by Oliver Wyman for reported loss and loss adjustment expense reserves for the Harbor Specialty Insurance Company. Based upon this review the Company's booked gross and net loss reserves should be accepted without adjustments.

Actuarial findings as stated above and in this examination report are the sole responsibility of the New Jersey Department of Banking and Insurance's Property and Casualty Actuarial Unit of the Office of Solvency Regulation.

/S/

Boris Privman, FCAS, MAAA

SUBSEQUENT EVENTS

In its December 31, 2009 annual statement the Company reported prior period adjustments which totaled \$159,079. A summary of these adjustments follows:

| <u>Description</u> | <u>Income Statement Effect</u> | <u>Balance Sheet Effect</u> | <u>Liabilities</u> | <u>Period Booked</u> | <u>SSAP 3 Amount</u> |
|---|--|---------------------------------|--------------------|--------------------------|--------------------------|
| Correction of under accrual of the Company's severance and retention policy obligations due to calculation error. The balance represents the allocation from Clarendon National | 159,079 | 159,079 | (159,079) | 4Q09 | (159,079) |
| Total Adjustments to unassigned funds | 159,079 | 159,079 | (159,079) | | (159,079) |

CONCLUSION

I, Nancy Lee Chice, do solemnly swear that the foregoing report of examination is hereby presented to be a full and true statement of the condition and affairs of the Harbor Specialty Insurance Company as of December 31, 2008, to the best of my knowledge and belief.

Respectfully submitted,

/S/
Nancy Lee Chice, CFE
Examiner-In-Charge

State of New York
County of New York

Subscribed and sworn to before me.
On this 27th day of May 2010.

/S/
Megin P. Blake
Notary Public of New York