REPORT OF EXAMINATION

OF THE

AMERICAN ALTERNATIVE INSURANCE CORPORATION

AS OF

DECEMBER 31, 2005

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

AMERICAN ALTERNATIVE INSURANCE CORPORATION

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

ATTEST BY: ____________________

DATE: 25 JUNE 2007

In Witness Whereof, I HAVE HEREUNTO SET MY HAND AND AFFIXED THE OFFICIAL SEAL OF THIS DEPARTMENT AT THE CITY OF DOVER, THIS 25TH DAY OF JUNE 2007.

____

Insurance Commissioner

REPORT ON EXAMINATION

OF THE

AMERICAN ALTERNATIVE INSURANCE CORPORATION

AS OF

December 31, 2005

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

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

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

MATTHEW DENN
INSURANCE COMMISSIONER

DATED this 25TH Day of JUNE 2007.

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SALUTATION

June 27, 2007

Honorable Alfred Gross
Chairman, Financial Condition (E)
Committee, NAIC
State Corporation Commission
Bureau of Insurance
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Richmond, VA 23218

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Department of Revenue and Regulation
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Honorable Matthew P. Denn
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Dover, Delaware 19904

Commissioners:

In compliance with instructions and pursuant to statutory provisions contained in Certificate of Authority No. 06.005, dated January 26, 2006, an Association examination has been made of the affairs, financial condition and management of the

AMERICAN ALTERNATIVE INSURANCE CORPORATION

hereinafter referred to as "Company" or "AAIC" and incorporated under the laws of the State of Delaware as a stock company with its home office located at 2711 Centerville Road, Suite 400 Wilmington, Delaware 19808. The examination was conducted at the main administrative office of the Company located at 555 College Road East, Princeton, New Jersey 08543.

The report of such examination is submitted herewith.

SCOPE OF EXAMINATION

The last examination was conducted as of December 31, 2002. This examination covers the period since that date through December 31, 2005, and consisted of a general review of the Company's business policies and practices, management, any corporate matters incident thereto, a verification and evaluation of assets and 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.

This examination ran concurrently with the examinations of two Delaware domestic affiliated insurers Munich Reinsurance America, Inc. ("MRAM"- formerly known as American Re-Insurance Company- name was changed on September 5, 2006) and The Princeton Excess and Surplus Lines Insurance Company ("PESLIC").

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

Fidelity Bonds and Other Insurance
Statutory Deposits
Employees' Welfare
All Asset and Liability Items not mentioned

HISTORY

American Alternative Insurance Corporation was incorporated as an insurer in New York on April 26, 1923, under the original name of American Union Insurance Company of New York. The Company's name was changed in 1987 to American Union Reinsurance Company.

On January 1, 1994, American Reinsurance Corporation (name changed on September 5, 2006 to Munich Re America Corporation, "MRAMC") acquired American Union Reinsurance Company from American States Insurance Company, an Indiana domiciled insurer. MRAMC is a Delaware incorporated holding company and the sole owner of American Alternative Insurance Corporation.

On August 13, 1996, MRAMC entered into an Agreement and Plan of Merger with Munchener Ruckversicherungs-Gesellschaft Aktiengesellschaft ("Munich Re Munich" or "MRG," a company organized under the laws of Germany) and Puma Acquisition Corporation, a Delaware corporation and a wholly owned subsidiary of MRG. Pursuant to the terms of the merger agreement, on November 25, 1996, following approval of the merger by MRAMC's stockholders and applicable regulatory authorities, Puma Acquisition Corporation was merged with MRAMC with the latter being the surviving company.

During July 1997, MRAMC and MRG completed the merger of Munich American Reinsurance Company ("MARC"), the U.S. operations of MRG. At that time, the insurance assets and liabilities of the U.S. branch of MRG were also merged into MRAM, an affiliate of AAIC. After the merger, MRG's ownership of MRAMC stood at 91%. The remaining outstanding shares in MRAMC were acquired from Victoria Versicherung AG in 1998 and from Allianz Aktiengesellschaft in 1999, bringing MRG's ownership interest in MRAMC to 100%.

Munich-American Holding Corporation ("MAHC"), a Delaware Holding Company, was organized in September 2000. After regulatory approval, MRG contributed all of the issued and outstanding stock of MRAMC, and therefore its subsidiaries, to MAHC.

No changes in ownership occurred during the current examination period.

CAPITALIZATION

Common Capital Stock

As of December 31, 2005, the Company had issued 3,200 shares of $1,600 par value common capital stock amounting to $5,120,000. All of these shares were issued to MRAMC.

Dividends

There were no stockholder dividends paid during the examination period.

Surplus Paid In

The Company received no surplus paid during the examination period.

Surplus Note

On October 1, 2000, the Company issued a $92,500,000 Promissory Capital Note to MRAM at a 5% annual interest rate. The Note was approved by the Delaware Insurance Department.

All or any part of the principal or interest due pursuant to this Note may be repaid at any time, or from time to time, without penalty, but subject to the prior written approval of the Delaware Insurance Commissioner. In accordance with the 5% annual interest rate, the

Company paid MRAM $4,625,000 in interest during 2005. The interest payment was approved by the Delaware Insurance Department.

MANAGEMENT AND CONTROL

Stockholders

In accordance with Article II, Section I of the Company's bylaws, the annual meeting of the stockholders shall be held each year on a date and at a time designated by the Board of Directors. At each annual meeting, directors shall be elected and any other proper business may be transacted. A majority of the stock issued and outstanding and entitled to vote at any meeting of stockholders, in person or represented by proxy, shall constitute a quorum. As previously noted, the Company has only one stockholder.

Board of Directors

In accordance with Article III, Section I of the Company's bylaws, the Board of Directors shall consist of not less than three or more than eleven members. The number of directors shall be fixed or changed from time to time, within the minimum and maximum, by the vote of the stockholders or by the then appointed directors. A majority of the members shall constitute a quorum for the transaction of business at any meeting of the Board of Directors. The directors are elected at the annual meeting of the stockholder and each director serves until the next annual election and until their successors are elected and qualified.

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

Name	**Principal Business Affiliation**
John P. Phelan	Chairman, President and CEO Munich Reinsurance America, Inc.
Albert J. Beer (1)	Executive Vice President Munich Reinsurance America, Inc.
Wolfgang R. Engshuber	Executive Vice President Munich Reinsurance America, Inc.

(1) Albert J. Beer resigned as a director of the Company effective September 1, 2006. Subsequently, Murray Steven Levy and Robin Harriet Willcox, both officers of the Company at December 31, 2005, were elected as members of the Board of Directors.

Committees

The minutes of the meetings of the Board of Directors reveal that the Company maintains a committee known as the Risk Management Committee (RMC). The RMC has significant influence in the underwriting direction of AAIC. The RMC is responsible for determining underwriting authorities and limits. The examination noted that the Board of Directors in accordance with Article III, Section 3 of the bylaws had not appointed this committee, which is made up of members and non-members of the Board of Directors. This concern was presented to the Company during the course of the examination. Subsequently, the Company resolved this concern by officially chartering the RMC as a committee of the Board that reports directly to the Board.

Officers

The Company's bylaws state that the Board of Directors is to appoint or elect the officers of the Corporation.

At December 31, 2005, the principal officers of the Company were as follows:

Name	**Title**
Albert J. Beer (1)	Chairman, President and Chief Executive Officer
Jeffery W. Davis (2)	Senior VP and Chief Actuary
Murray Steven Levy	Senior Vice President and Chief Financial Officer
John W. Rodgers	Senior VP and Chief Claims Officer
Robin Harriet Willcox	Senior VP, General Counsel and Secretary
Bonnie Boccitto	Senior VP
Anthony J. Kuczinski	Senior VP

(1) Albert J. Beer resigned as Chairman, President and Chief Executive Officer effective September 1, 2006. Mr. Beer was replaced by Anthony J. Kuczinski, formerly a Senior VP of AAIC.

(2) Mr. Davis is no longer with the Company.

Conflicts of Interest

The Company maintains a formal written conflict of interest policy, which officers, directors, and all key employees of AAIC must fill out on an annual basis. The Policy Statement on Conflicts of Interest requires the disclosure of possible conflicts of interest on the part of officers, directors and employees whose positions are such that they exercise judgments or make decisions which may be influenced so as to result in a conflict of interest. The review of the conflict of interest questionnaires completed during the examination disclosed no conflicts of interest that appeared to adversely affect the Company.

Bylaws

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

Corporate Records

The Company's corporate records were reviewed for the period under examination. No exceptions were noted in addition to the recommendations previously disclosed in this Report of Examination.

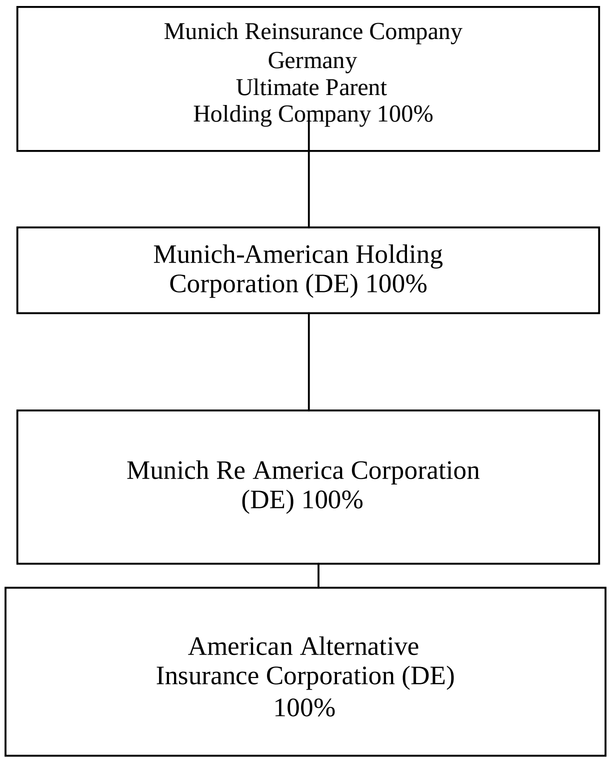
HOLDING COMPANY SYSTEM

The Company is a member of an Insurance Holding Company System as defined under Chapter 50 of the Delaware Insurance Code. The Holding Company filings have been made pursuant to the Insurance Company, Holding Company System Registration provisions of 18 Del.C. §5004. The immediate parent of the Company at December 31, 2005 was MRAMC. AAIC's ultimate parent is MRG, which reported the following financial results as of December 31, 2005. The amounts below, which are in US dollars, were converted from the Euro at the December 31, 2005 conversion rate of 1.259 (rounded):

Assets	$275,000,000,000
Equity	31,000,000,000
Net premiums written (2005)	45,600,000,000
Gain from operations (2005 pre-tax)	5,200,000,000

The following presentation of the holding company system, as of December 31, 2005, reflects only the identities and interrelationships between the Company and its direct parent, its intermediate parent, and its ultimate parent.

Organizational Chart as of December 31, 2005



In addition to the above, AAIC has two affiliated insurance entities, which are domiciled in the State of Delaware. The affiliates are Munich Reinsurance America, Inc. (MRAM) and The Princeton Excess and Surplus Lines Insurance Company (PESLIC). Examinations of MRAM and PESLIC ran concurrently with the examination of AAIC.

A review of the annual *Form B* and *Form C* filings made by AAIC for all years under examination revealed that the Company had complied with the requirements of Delaware Regulation 13.

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.

Year	Net Admitted Assets	Surplus as Regards Policyholders	Gross Premiums Written	Net Premiums Written	Net Income
2005	$409,029,002	$152,827,821	$569,516,539	$34,804,355	$ 5,519,422
2004	422,576,237	147,871,673	534,265,764	17,249,738	2,970,376
2003	363,481,935	145,484,192	423,534,598	39,068,660	35,930,449
2002	378,968,054	109,677,216	311,303,972	36,253,947	1,216,130

Gross premiums written steadily trended upward over the examination period, mainly as a result of premiums from the Global Aerospace/AAU Aviation pool, as well as a combination of both new business and rate increases on renewal business. The decrease in net premiums written from 2003 to 2004 was partially due to an error reported in the Company's 2003 Annual Statement. The error was corrected in the first quarter 2004 statutory financial statements. The net premiums written increase from 2004 to 2005 is consistent with the gross premiums written increase discussed above.

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

Policyholders' Surplus, December 31, 2002	$109,677,216
Net income	44,420,247
Net unrealized capital gains or (losses)	(103,902)
Change in net deferred income tax	(586,118)
Change in non-admitted assets	(579,622)
Policyholders' Surplus, December 31, 2005	$152,827,821

The above amounts are prior to any examination adjustments.

TERRITORY AND PLAN OF OPERATION

Territory

The Company is currently licensed to write business in all fifty (50) states and the District of Columbia, and is authorized as an acceptable surety by the U.S. Treasury.

The Company's clients are traditional insurance buyers (i.e., commercial corporations) and the alternative market (i.e., risk retention groups, risk purchasing groups, captives, and risk managers of commercial companies).

AAIC primarily markets its products through the use of Managing General Agents (MGA's). During 2005, the seven largest MGAs utilized by the Company (below) produced in excess of $466 million in direct premiums written or 82.9% of total direct premiums written during 2005.

MGA/TPA	Direct Premiums Written
1) Volunteer Fireman’s Insurance Services	$231,432,000
2) Global Aerospace, Inc.	$122,030,000
3) W.H. Greene Associates	$ 49,441,000
4) Charter Partners	$ 29,347,000
5) Woodcrest Services Inc.	$ 15,257,000
6) Housing Insurance Services	$ 10,701,000
7) Universal Insurance Facilities, LTD	$ 7,884,000

The examiners reviewed the applicable MGA agreements, state licenses, audit schedule, and selected audit reports. Proper licensing was noted and the selected audit reports indicated no conflicts with the Company's underwriting guidelines. All of the MGAs above have been granted underwriting and binding authority along with the authority to collect premiums. Further, Volunteer Fireman's Insurance Services, Global Aerospace Inc., Woodcrest Services, Inc. and Housing Insurance Services all have claims adjustment and claims payment authority. None of the MGAs are permitted to bind the Company to ceded reinsurance.

The premiums applicable to Global Aerospace, Inc. were in turn 100% ceded to MRG under an agreement entered into during 2003 by AAIC, MRG and Global Aerospace, Inc. Per the agreement, AAIC acts as the policy issuing company, representing Munich Re of Germany, as a 25% participant in a pool that is managed by Global Aerospace Inc. The pool provides general aviation, airline, products liability, and space & satellite risk coverage to the North American Aviation market.

It should also be noted that a significant portion of the business underwritten by Volunteer Fireman's Insurance Services is retroceded to an unaffiliated entity. These significant retrocessions to both affiliated and unaffiliated entities result in AAIC retaining less than 7% of its gross premiums written (*see* *Reinsurance* *for additional details*).

During 2005 the largest lines of business written by the Company on a direct basis were as follows (including the percentage of total direct premiums written):

Aircraft (all perils)	$127,813,052 (22.7%)
Commercial Multiple Peril	$123,894,805 (22.0%)
Other Liability - Occurrence	$114,784,709 (20.4%)
Commercial Auto Liability	$ 76,283,343 (13.6%)

These four lines of business account for 78.7% of total direct premiums written during 2005. Total direct premiums written during 2005 amounted to $562.6 million.

Plan of Operation

During 2002 the US operations of MRG (hereinafter referred to as MRG-US*) underwent a corporate restructuring. Separate Strategic Business Units (SBU's) were created for the purpose of segregating its major underwriting operations. The five main SBU’s are Direct Treaty, Direct Facultative, Direct Broker, Risk Partners and Healthcare. Most of the business underwritten by AAIC is generated by Risk Partners.

* = MRG-US consists of AAIC, MRAM and PESLIC.

MRG-US corporate philosophy is that risks underwritten by MRG-US should have risk adequate premium, meaning that the appropriate premium for a given risk does not fluctuate simply because the reinsurance market is hard or soft. The Company appears to have applied this underwriting discipline over the past few years, and management has stated that this philosophy will continue in the years to come. MRG-US is willing to restrain its underwriting when the market becomes soft and in the event that premiums are significantly lower than what the Company has determined are adequate for the risks being underwritten.

MRG-US has appointed a Chief Risk Officer and heightened its awareness of risks assumed as a whole. With regards to underwriting risk management, the Company has centralized the direction of underwriting guidelines. The Chief Risk Officer is closely aligned with the Integrated Risk Management Division of MRG in Germany. MRG-US intends to continue to integrate itself into MRG's operations. The companies that make up MRG-US continue to operate as separate legal US entities, all domiciled in the State of Delaware.

The Company's underwriting goals and limitations are developed, reviewed and approved at MRG-US, but are subsequently reviewed by MRG. MRG has an international or group wide business plan of which MRG-US is a significant part.

A.M. Best Rating:

Based on A.M. Best's current opinion of the consolidated financial condition and operating performance of the Company, AAIC was assigned an A.M. Best rating of A (Excellent) for the year ending 2005. Subsequent to the examination date, this rating was reaffirmed in December 2006. A.M. Best noted that the rating reflects the Company's solid returns and substantial improvement in risk adjusted capitalization. Further, A.M. Best noted that AAIC continues to make progress with regards to improvements in its operational and risk management controls.

REINSURANCE

For 2005, AAIC reported the following distribution of premiums:

Direct	$562,567,831
Assumed from non-affiliates	6,948,708
Ceded to affiliates	(359,231,028)
Ceded to non-affiliates	(175,481,156)
Total Net Premiums Written	$34,804,355

Assumed

AAIC's assumed reinsurance is limited to participations in pools and associations. As a direct writer of workers' compensation insurance and auto insurance, the Company is required to participate in various state-operated or sponsored plans or reinsurance facilities. For 2005, AAIC participated in several involuntary pools or associations with total premiums amounting to

$7,032,000. AAIC also participates in three syndicates on voluntary basis, however the Company's involvement in any one syndicate is minimal.

Ceded

AAIC writes a significant amount of business with the express purpose of ceding all or part of the loss exposure to designated reinsurers. These programs are referred to as Specific Reinsurance business and two programs dominated the Company's cessions in 2005:

- In 2003, AAIC became the designated entity within the Munich Re group that writes, on a direct basis, a portion of the business produced by Global Aerospace Underwriting Managers and Associated Aviation Underwriters relating to the Global Aerospace Underwriters Pool. The Company's direct writings are 100% ceded to the ultimate parent, Munich Reinsurance Germany (MRG). Cessions to MRG for the Aerospace program in 2005 were $122,205,000.

- AAIC uses Managing General Agents (MGA) to produce business. The largest MGA producing business for the Company is Volunteer Firemen's Insurance Services (VFIS). The Company cedes 80% of the business produced by VFIS on a quota share basis to GIG Reinsurance Company, Ltd., an affiliate of VFIS. The loss cessions to GIG Reinsurance Company, Ltd. are limited to $800,000 each occurrence. AAIC also cedes business produced by another MGA, Glatfelter Underwriting Services, (GUS) to GIG Reinsurance. These cessions are 20% of the business produced by GUS, with a maximum loss cession of $250,000 per occurrence. Total premiums ceded to GIG Reinsurance in 2005 were $138,126,000.

Corporate Ceded Reinsurance Structure

All of AAIC's business, less the Specific Reinsurance, is ceded to an affiliate of the Company, Munich Reinsurance America, under the following program:

For property casualty business:

Excess of Loss	$40 million of coverage excess of a retention of $10 million per loss.
Quota Share	90% of most lines of business
Accident Year Stop Loss	100% cession in excess of an 102% loss ratio

The ceded program with MRAM remained basically unchanged during the examination period, except that several lines or classes of business were "carved out" and ceded on a 100% basis to MRAM. The lines/classes of business were: Engineering, all business produced by the Global Risk Division of the MRAM Risk Partners Strategic Business Unit, and all business written by the MRAM's Healthcare Unit. In addition, during the examination period, the ceded commission allowed AAIC was reduced from 30% to 24.5%.

Total premium ceded by AAIC to MRAM in 2005 was $237,008,000. Because MRAM has provided the corporate ceded reinsurance program to AAIC for many examination periods, the loss recoveries are significant. At December 31, 2005, AAIC reported total paid and unpaid reinsurance recoveries from MRAM of $852,810,000.

Bad Debt Provision

As of year end 2005, AAIC accrued $72,878,006 for the Bad Debt Provision. A small portion of the Provision, $165,482 is used to offset premiums receivable. The remaining $72,712,524 is dedicated to reinsurance, with $58,299,715 being utilized to offset receivables from the insolvent Reliance Insurance Company (RIC). At December 31, 2005, AAIC wrote down paid reinsurance recoverables of $38,798,721 from RIC. The remaining $19,500,994 is accrued as a liability on the 2005 Annual Statement to offset the unpaid reinsurance recoverables from RIC.

INTERCOMPANY AGREEMENTS

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

Consolidated Income Tax Allocation Agreement

The Company is a participant in a consolidated federal income tax return with MAHC and all of its subsidiaries, including two Delaware domestic insurance affiliates, MRAM and PESLIC. This arrangement is based upon a written tax allocation agreement dated December 31, 2005. This agreement amended and restated the previous agreement effective December 31, 2000. The agreement was approved by the Delaware Insurance Department.

Under this agreement, income tax expenses are computed on a separate company basis as if each affiliate was filing a separate tax return. Intercompany balances are settled on a quarterly basis. The terms of this agreement appear to be fair and equitable.

General Service and Administrative Agreements

On January 1, 1994, the Company entered into an administrative services agreement with MRAM for the performance of such management services as corporate finance, investment strategy, communications, public relations policies, actuarial, audit, executive, legal, personnel, benefits and benefit plans, accounting, tax and other financial services. Costs and expenses are allocated and payable each quarter. The agreement was approved by the Delaware Insurance Department and was not amended during the current examination period. The terms of this agreement appear to be fair and equitable.

Investment Management Agreement

The Company is a party to an Investment Management Agreement with MEAG New York Corporation (MEAG-NY), an affiliated company. The agreement, which was effective August 1, 2001 and most recently amended on March 12, 2003, has been approved by the Delaware Insurance Department. The agreement provides that MEAG-NY is to manage the investment and reinvestment of the Company’s invested assets held by State Street Bank, the Company’s most significant custodian.

MEAG-NY is required to adhere to strict investment guidelines, which are attached to the agreement and amended periodically whenever the Company amends its investment policy. The Company retains the sole authority to modify the investment guidelines. MEAG-NY is not permitted to trade assets that are designated by the Company as regulatory or trust deposits.

MEAG-NY does not act as custodian and does not physically hold any of the Company’s invested assets. Regular reviews of the performance and actions of MEAG-NY are performed and the terms of the agreement appear to be fair and equitable.

The Company is party to several additional intercompany investment management agreements all with affiliated advisors. The terms of these agreements are similar in nature to the agreement discussed above.

EXTERNAL AGREEMENTS

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

Custodial Agreements

The Company has entered into several custodial agreements. The purpose of the agreements is for the safekeeping of the Company's invested assets. The NAIC's indemnification clause has been included in the agreements. The indemnification clause states that the custodian is obligated to indemnify the insurance company for any loss of securities of the insurance company in the bank or trust company's custody occasioned by the negligence or dishonesty of the bank or trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction. In the event that there is a loss of the securities for which the bank or trust company is obligated to indemnify the insurance company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be replaced.

Investment Accounting Services Agreement

The Company entered into an Investment Accounting Services Agreement (IASA) effective June 1, 2000 with BlackRock Financial Management, Inc. (BlackRock). Per the IASA, BlackRock performs AAIC's investment accounting transaction entry along with asset reconciliations, income and dividend projections, foreign exchange calculations and review of all investment results. Further, BlackRock performs the monthly closing process and provides AAIC with a transaction journal and transaction ledger along with a Client Holding Report showing AAIC's investment portfolio sorted by CUSIP number and by investment classification.

The Client Holding Report contains most investment information necessary for the Company to complete its financial statements.

BlackRock provides AAIC with a SAS 70 Report annually and AAIC has the right to audit the BlackRock operations. The terms of the agreement appear to be fair and equitable.

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.

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 three 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, several IRIS ratios produced "unusual values" as defined by the NAIC Examiner Team in each year under review. The following chart highlights the unusual values in the last year of the examination.

Year	Ratio*	Ratio Description	Usual Range of Values Over/Under		Company's Result
2005	3	Change in Net Writings	33	-33	102.0
2005	6	Investment Yield	6.5	3	2.6
2005	9	Liabilities to Liquid Assets	105	-	106.0

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 change in net premiums written from one calendar year to the next.

The unusual value was caused by an error in reporting in 2003 that was corrected in 2004.

Ratio 6 – Investment Yield

This ratio measures the Company's return on its invested assets.

The unusual value was caused by lower overall market interest rates on the invested assets retained by the Company.

Ratio 9 – Liabilities to Liquid Assets

This ratio measures the comparison between assets that can be quickly liquidated, for the purpose of settling liabilities, to the Company's stated liabilities.

The unusual value is the result of the exclusion of MGA Imprest Loss Funds and Cash Loss Payments in Advance from liquid assets, along with the inclusion in liabilities of the "Additional Provision for Uncollectible Reinsurance". The MGAs retain these funds, as such the Company must exclude them from liquid assets for the purposes of this ratio. The Company produced an unusual value for this ratio in every year of this examination period and in every year of the prior examination period. The reason for the unusual value is consistent through the years. Also, the ratio improved significantly from 2002 to 2005.

ACCOUNTS AND RECORDS

Accounting System

All necessary accounting records of the Company are maintained on electronic data processing equipment, which is also shared by the Company's Delaware insurance affiliates, MRAM and PESLIC. The general ledger is maintained on a statutory basis with additional accounts used to convert to the accrual basis suitable for Generally Accepted Accounting Principles. The Company's database was tested as part of Delaware examination procedures.

Independent Accountants

The Company's financial statements are audited each year by the firm of KPMG, LLP or "CPA", of New York, NY. The examiners reviewed the audited statutory financial statements for all years under review and noted that the CPA issued an unqualified opinion each year. The workpapers applicable to the CPA's 2005 audit were obtained and reviewed by the examination and utilized to the extent possible.

Information Systems

INS Services, Inc. reviewed the Company's responses to the Evaluation of Controls in Information Systems Questionnaire (Exhibit C) and performed tests of the systems. From its analysis INS Services, Inc. concluded that:

- the Company's responses to Exhibit C present fairly, in all material respects, the aspects of the Company's policies and procedures that may be relevant to their internal control structure,
- the control structure policies and procedures were suitably designed to achieve the control objectives implicit in the questionnaire, if those polices and procedures were complied with, and
- such policies and procedures have been placed in operation as of December 31, 2005.

FINANCIAL STATEMENTS

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

Analysis of Assets, December 31, 2005

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

Statement of Income, December 31, 2005

Capital and Surplus Account, December 31, 2005

Schedule of Examination Adjustments

Analysis of Assets

As of December 31, 2005

	Assets	Non-admitted Assets	Net Admitted Assets	Notes
Bonds	$167,082,165		$167,082,165	1
Cash (including cash equivalents and short-term investments	34,328,754		34,328,754	
Receivables for securities	136,147		136,147	
Subtotals, cash and invested assets	**$201,547,066**		**$201,547,066**	
Investment income due and accrued	1,617,134		1,617,134	
Premiums and considerations				
Uncollected premiums in the course of collection	46,479,636	$1,075,711	45,403,925	
Deferred premiums and installments not yet due	40,226,159		40,226,159	
Reinsurance				
Amounts recoverable from reinsurers	40,078,688		40,078,688	
Funds held by or deposited with reinsured companies	1,342,054		1,342,054	
Current federal income tax recoverable	9,473,311		9,473,311	3
Net deferred tax asset	4,624,073	2,797,863	1,826,210	
Guaranty funds receivable or on deposit	1,616,506		1,616,506	
EDP Equipment	8,817		8,817	
Furniture and equipment	3,546	3,546	-	
Receivable from affiliates	14,818		14,818	
Aggregate write-ins for other than invested assets				
Deposit asset	44,224,487		44,224,487	
Imprest Loss Funds/Cash Loss Payments in Advance	18,793,946		18,793,946	
Commissions Receivable	8,094,590		8,094,590	
Overflow write-ins	143,941		143,941	
Total Assets	**$418,288,772**	**$3,877,120**	**$414,411,652**	

Statement of Liabilities, Surplus and Other Funds

As of December 31, 2005

		Notes
Losses	$61,967,917	2
Reinsurance payable on paid losses and LAE	2,387,364	
Loss adjustment expenses	10,414,231	2
Other expenses	832,401	
Taxes, licenses and fees	6,018,121	
Current federal income taxes payable	719,126	
Unearned premiums	12,824,770	
Ceded reinsurance premiums payable	93,757,339	4
Funds held by Company under reinsurance treaties	32,589,758	4
Amounts withheld by Company for the account of others	6,524,712	
Payable to affiliates	7,862,594	
Aggregate write-ins for liabilities		
Deposit liability	16,180,854	
Additional provision for reinsurance write-off	19,500,994	
Total Liabilities	**$271,580,181**	
Common capital stock	5,120,000	
Surplus notes	92,500,000	
Gross paid in and contributed surplus	8,611,387	
Unassigned funds (surplus)	36,600,084	
Surplus as regards policyholders	**$142,831,471**	
Total Liabilities, Surplus and Other Funds	**$414,411,652**	

Underwriting and Investment Exhibit

Statement of Income

As of December 31, 2005

UNDERWRITING INCOME	
Premiums earned	$30,640,623
DEDUCTIONS	
Losses incurred	24,069,333
Loss expenses incurred	10,488,420
Other underwriting expenses incurred	(1,198,688)
Total underwriting deductions	$33,359,065
Net underwriting gain or (loss)	($2,718,442)
INVESTMENT INCOME	
Net investment income earned	5,411,239
Net realized capital gains or (losses)	(424,153)
Net investment gain or (loss)	$4,987,086
OTHER INCOME	
Net gain or (loss) from agents' or premium balances charged off	(1,331,874)
Aggregate write-ins for miscellaneous income	(6,841,662)
Total other income	($8,173,536)
Net income before dividends to policyholders and before federal income taxes	($5,904,892)
Dividends to policyholders	0
Net income after dividends to policyholders but before federal income taxes	($5,904,892)
Federal income taxes incurred	(1,427,964)
Net income	($4,476,928)

CAPITAL AND SURPLUS ACCOUNT	
Surplus as regards policyholders, December 31, 2004	$147,871,673
Net income	($4,476,928)
Change in net unrealized capital gains or (losses)	(193,902)
Change in net deferred income tax	555,462
Change in non-admitted assets	(924,834)
Change in surplus as regards policyholders for the year	($5,040,202)
Surplus as regards policyholders, December 31, 2005	$142,831,471

Schedule of Examination Adjustments

Description	Per Examination	Per Company	Surplus Increase (Decrease)
Current federal income tax recoverable	$9,473,311	$4,090,661	$5,382,650
Ceded reinsurance premiums payable	93,757,339	95,862,325	2,104,986
Funds held by Company under reinsurance treaties	32,589,758	30,484,772	(2,104,986)
Losses	61,967,917	48,994,917	(12,973,000)
LAE	10,414,231	8,008,231	(2,406,000)
Net adjustment to policyholders' surplus			($9,996,350)

NOTES TO FINANCIAL STATEMENTS

(1) Bonds: $167,082,165

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

An evaluation of the Company's bond portfolio noted that 98.9% of the portfolio consists of bonds with an NAIC rating of 1 or 2. With the exception of bonds held for statutory purposes, investments are primarily held by State Street Bank under a custodial agreement. Refer to the section "External Agreements" of this Report of Examination, under the caption "Custodial Agreement" for additional comments regarding this custodial agreement.

A review of corporate records indicated that the Board of Directors has approved the Company's bond investment transactions made during the examination period in accordance with 18 Del.C. §1304.

(2) Losses	$ 61,967,917
Loss Adjustment Expenses	$ 10,414,231

The above-captioned amount for Losses is $12,973,000 higher than the amount reported by the Company. The amount reported for Loss Adjustment Expenses is $2,406,000 higher than the amount reported by the Company.

The balance reported by the Company was comprised of the following:

Losses

Reported Losses (Case)	
Direct	$ 356,735,124
Reinsurance Assumed	15,954,365
Reinsurance Ceded	(356,296,333)
Net Reported Losses	$ 16,393,156
Incurred But Not Reported (IBNR)	
Direct	$ 605,316,265
Reinsurance Assumed	30,452,459
Reinsurance Ceded	(603,166,963)
Net IBNR	$ 32,601,761
Net Losses Unpaid	$ 48,994,917

Loss Adjustment Expenses (LAE)	
Allocated LAE	$ 1,409,607
Unallocated LAE	6,598,624
Total LAE	$ 8,008,231

The examination retained the firm of INS Consultants, Inc. (INS or Consulting Actuary) to review the Company's stated reserves. The Consulting Actuary was provided with the Company's statement of actuarial opinion and an actuarial report as the supporting documentation of the actuarial opinion with loss and loss adjustment expense reserves evaluated as of December 31, 2005. In addition, INS was provided with other reports, schedules, exhibits and relevant information as requested.

The Consulting Actuary's review of loss and ALAE (allocated loss adjustment expenses) reserves consisted of separately analyzing the property and casualty Company's book of business on a gross and net basis. In addition, for unallocated loss adjustment expense (ULAE), the Consulting Actuary reviewed the methodology employed by the Company's actuaries. Though INS accepted the methodology and factor selections utilized by the Company's actuaries, they noted Adjusting and Other ("A&O") LAE estimates that exceeded the Company's A&O estimates to a relatively large extent. INS' held A&O reserve was $2,406,000 more than the Company's held A&O reserve.

In conjunction with the actuarial review, the examination team was tasked with performing a data validity test. Based on the examination team's review, it was ascertained that the data was accurate and complete.

A review of the 2006 Annual Statement indicated that the Company experienced a net one year incurred loss development of $12,973,000 which is 23% higher than the December 31, 2005 carried net reserves for Losses and ALAE. As such, the examiners have increased the reserve for Losses and decreased Policyholders' Surplus by $12,973,000. Further, the $2,406,000 adjustment pertaining to ULAE/A&O reserves noted above has also been made to the financial statements of this Report. See Note 3 (below) for information regarding the tax effect of these adjustments.

(3) <u>Current Federal Income Taxes Recoverable</u> <u>$ 9,473,311</u>

The above-captioned amount is $5,382,650 more than the amount reported in the Company's Annual Statement. The difference is the tax benefit AAIC receives as a result of the Loss and LAE adjustments include in Note 2 (above). The examination used the same 35% tax rate utilized by the Company in preparing its federal income tax returns.

(4) Funds Held By Company Under Reinsurance Treaties	$32,589,758
(4) Ceded Reinsurance Premiums Payable	$93,757,339

The above-captioned amounts are different amounts than what was reported by the Company in its Annual Statement for each item. Funds Held By Company Under Reinsurance Treaties was understated by $2,104,986, while Ceded Reinsurance Premiums Payable was overstated by the same amount. The differences are the result of reclassifications between the two accounts. Neither of the reclassifications, which are explained below, resulted in a net change to policyholders' surplus.

At year end 2005, the Company reported the amount of $18,465,000 for Funds Held By Company Under Reinsurance Treaties for a liability to an affiliate, MRAM. A review of the account indicated that the $18,465,000 was deferred ceded premiums payable due to MRAM in 2006. The NAIC Annual Statement instructions state that deferred ceded reinsurance premiums payable should be reported in the liability line item Ceded Reinsurance Premiums Payable. As such;

It is recommended that the Company comply with the NAIC Annual Statement instructions and report all deferred ceded premiums payable in the annual statement liability line item Ceded Reinsurance Premiums Payable.

AAIC reported Ceded Reinsurance Premiums Payable of $20,569,986 to an affiliate, Princeton Eagle West (PEW). A review of the liability indicates that AAIC is permanently holding these funds as security for recoverables under several treaties with PEW. Since the $20,569,986 will not be physically paid to PEW, it is inappropriate to report this amount as Ceded Reinsurance Premiums Payable. As such;

It is recommended that AAIC report amounts held for security under treaties with affiliate Princeton Eagle West as Funds Held By Company Under Reinsurance Treaties.

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. Based on that review, it has been determined that the Company has complied with the prior examination report comments and recommendations.

SUMMARY OF RECOMMENDATIONS

1. It is recommended that the Company comply with the NAIC Annual Statement instructions and report all deferred ceded premiums payable in the annual statement liability line item Ceded Reinsurance Premiums Payable (Notes to Financial Statements). (p.30)

2. It is recommended that AAIC report amounts held for security under treaties with affiliate Princeton Eagle West (PEW) as Funds Held By Company Under Reinsurance Treaties. (p.31)

SUMMARY COMMENTS

1. Territory and Plan of Operation: Business Written Through MGAs

The majority of the Company's business is produced through the use of Managing General Agents (MGAs). During 2005, the seven largest MGAs utilized by the Company produced in excess of $466 million in direct premiums written or 82.9% of total direct premiums written during 2005.

2. Territory and Plan of Operation: Corporate Restructuring and Change in Underwriting Approach

During 2002 the US operations of MRG (MRG-US) underwent corporate restructuring. Separate Strategic Business Units (SBU's) were created for the purpose of segregating its major underwriting operations. The five main SBU's are Direct Treaty, Direct Facultative, Direct Broker, Risk Partners and Healthcare. The business underwritten by AAIC is mainly generated by the Risk Partners SBU. NOTE: MRG-US consists of AAIC, MRAM and PESLIC- U.S. based insurance affiliates of MRG.

MRG-US has become more conservative during the examination period in terms of the business being solicited and underwritten. The corporate philosophy is that risks underwritten by MRG-US should have risk adequate premium, meaning that the appropriate premium for a given risk does not fluctuate simply because the reinsurance market is hard or soft. MRG-US is willing to restrain its underwriting when the market becomes soft and in the event premiums are significantly lower than what MRG-US has determined are adequate for the risks being underwritten.

3. Ceded Reinsurance: Significant Reinsurance Protection

AAIC maintains a significant amount of ceded reinsurance coverage, retaining only $34,804,355 or 6.1% of gross premiums written in 2005. Significant reinsurance coverage is provided from both affiliates and non-affiliates. Specifically with regards to affiliated coverage, MRAM provides AAIC with excess of loss, net aggregate quota share and accident year stop loss coverages leaving AAIC with minimal net retained risk.

4. Notes to Financial Statements: 2006 Loss Development and Resulting Tax Effect

A review of the 2006 Annual Statement indicated that the Company experienced a net one year incurred loss development of $12,973,000 which is 23% higher than the December 31, 2005 carried net reserves for Losses and ALAE. As such, the examiners have increased Losses and decreased 2005 Policyholders' Surplus by $12,973,000. Further, INS Consultants (the examination's consulting actuaries) calculated a ULAE/A&O reserve that exceeded AAIC's ULAE/A&O estimate to a relatively large extent. INS' held ULAE/A&O reserve was $2,406,000 more than the Company's held ULAE/A&O reserve. The net adjustment to Policyholders' Surplus as Regards Policyholders amounted to ($9,996,350), which is the Loss and LAE adjustments noted above, less the tax benefit related to the Loss and LAE adjustments. The resulting increase in current income tax recoverables amounted to $5,382,650.

CONCLUSION

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

Description	December 31 2002	December 31, 2005	Increase
Assets	$378,968,054	$414,411,652	$35,443,598
Liabilities	$269,290,838	$271,580,181	$2,289,343
Surplus as Regards Policyholders	$109,677,216	$142,831,471	$33,154,255

In addition to the undersigned, Albert Piccoli, CFE, Joe Rome, CFE, Paul Ellis, CPA, CFE, John P. White, Jim Russo, CFE, and Legh Cathey, CFE participated in the examination. James J. Blair, Jr., CPA, CFE served as the examination supervisor. The assistance of Gene Thompson, ACAS, MAAA of the actuarial consulting firm, INS Consultants, Inc. is acknowledged along with the information systems consulting firm of INS Services, Inc.

Respectfully submitted,

Gregg S. Bealuk

Gregg S. Bealuk, CFE
Examiner-In-Charge
State of Delaware
Northeastern Zone, NAIC

SUBSEQUENT EVENTS

2006 Loss Development

A review of the 2006 Annual Statement indicated that the Company experienced a net one year incurred loss development of $12,973,000 which is 23% higher than the December 31, 2005 carried net reserves for Losses and ALAE. As such, the examiners have increased Losses and decreased 2005 Policyholders' Surplus by $12,973,000. Further, INS Consultants (the examination's consulting actuaries) calculated a ULAE/A&O reserve that exceeded AAIC's ULAE/A&O estimate to a relatively large extent. INS' held ULAE/A&O reserve was $2,406,000 more than the Company's held ULAE/A&O reserve. The net adjustment to Policyholders' Surplus as Regards Policyholders amounted to ($9,996,350), which is the Loss and LAE adjustments noted above, less the tax benefit related to the Loss and LAE adjustments. The resulting increase in current income tax recoverables amounted to $5,382,650.