STATE OF MISSOURI

DEPARTMENT OF INSURANCE, FINANCIAL INSTITUTIONS AND PROFESSIONAL REGISTRATION

P.O. Box 690, Jefferson City, Mo. 65102-0690

RE: Examination Report of Cornerstone National Insurance Company as of December 31, 2010

ORDER

After full consideration and review of the report of the financial examination of Cornerstone National Insurance Company for the period ended December 31, 2010, together with any written submissions or rebuttals and any relevant portions of the examiner's workpapers, I, John M. Huff, Director, Missouri Department of Insurance, Financial Institutions and Professional Registration pursuant to section 374.205.3(3)(a), RSMo., adopt such examination report. After my consideration and review of such report, workpapers, and written submissions or rebuttals, I hereby incorporate by reference and deem the following parts of such report to be my findings and conclusions to accompany this order pursuant to section 374.205.3(4), RSMo: summary of significant findings, subsequent events, company history, corporate records, management and control, fidelity bond and other insurance, pension, stock ownership and insurance plans, territory and plan of operations, growth of the company and loss experience, reinsurance, accounts and records, statutory deposits, financial statements, financial statement changes resulting from examination, and comments on financial statement items.

Based on such findings and conclusions, I hereby ORDER, that the report of the Financial Examination of Cornerstone National Insurance Company as of December 31, 2010, be and is hereby ADOPTED as filed and for Cornerstone National Insurance Company to take the following action or actions, which I consider necessary to cure any violation of law, regulation or prior order of the Director revealed by such report: (1) implement, and verify compliance with each item, if any, mentioned in the Comments on Financial Statement Items and/or Summary of Recommendations section of such report; (2) account for its financial condition and affairs in a manner consistent with the Director's findings and conclusions.

So ordered, signed and official seal affixed this 7th day of May, 2012.

John M. Huff, Director
Department of Insurance, Financial Institutions and Professional Registration

REPORT OF THE

ASSOCIATION FINANCIAL EXAMINATION OF

CORNERSTONE NATIONAL INSURANCE COMPANY

AS OF

DECEMBER 31, 2010

STATE OF MISSOURI

DEPARTMENT OF INSURANCE, FINANCIAL INSTITUTIONS AND PROFESSIONAL REGISTRATION

JEFFERSON CITY, MISSOURI

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Columbia, Missouri
February 27, 2012

Honorable Joseph Torti, III, Superintendent
Rhode Island Division of Insurance
Chairman, Financial Condition (E) Committee

Honorable Ted Nickel, Commissioner
Wisconsin Office of the Commissioner of Insurance
Secretary, Midwestern Zone, NAIC

Honorable John M. Huff, Director
Missouri Department of Insurance, Financial Institutions
and Professional Registration
301 West High Street, Room 530
Jefferson City, Missouri 65101

Gentlemen:

In accordance with your financial examination warrant, a full scope association financial examination has been made of the records, affairs and financial condition of

Cornerstone National Insurance Company

hereinafter referred to as such, CNIC, or as the Company. Its administrative office is located at 3100 Falling Leaf Court, Suite 200, Columbia, Missouri, 65201, telephone number (573) 817-2481. This examination began on April 25, 2011, and concluded on the above date.

SCOPE OF EXAMINATION

Period Covered

The prior full scope association financial examination of CNIC was made as of December 31, 2007, and was conducted by examiners from the State of Missouri representing the Midwestern Zone of the National Association of Insurance Commissioners (NAIC), with no other zones participating.

The current full scope association financial examination covered the period from January 1, 2008, through December 31, 2010, and was conducted by examiners from the State of Missouri, representing the Midwestern Zone of the NAIC, with no other zones participating.

This examination also included the material transactions and/or events occurring subsequent to the examination date, which are noted in this report.

Procedures

This examination was conducted in accordance with the NAIC Financial Condition Examiners Handbook, except where practices, procedures and applicable regulations of the Missouri Department of Insurance, Financial Institutions and Professional Registration (DIFP) and statutes of the State of Missouri prevailed. 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 corporate governance, identifying and assessing inherent risks, and evaluating the Company's controls and procedures used to mitigate those risks. An examination also includes assessing the principles used 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.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process. The key activities identified in our examination of CNIC were as follows:

- Investments
- Premiums
- Underwriting
- Claims Handling
- Reserving
- Taxes
- Related Party Transactions
- Reinsurance

The examiners relied upon information supplied by the Company's independent auditor, Williams Keepers, LLP, of Columbia, Missouri, for its audit covering the period from January 1, 2010 through December 31, 2010. Areas in which the testing and results from the CPA workpapers were relied upon in our examination included internal controls, bank confirmations, paid claims data, premiums receivable, unearned premiums, attorney representation letters, fraud assessment, and subsequent events review.

SUMMARY OF SIGNIFICANT FINDINGS

1) A General Agency Agreement between the Company and an affiliate, Cornerstone General Agency, Inc. (CGA) was effective and commenced transactions on May 1, 2010. It was determined in our examination that the level of commissions (at a rate of 17% of written premiums) paid to CGA, pursuant to this Agreement, exceeds the actual direct costs of commissions (at an average rate of 12.6%) that are actually paid by CGA to the independent agents that produce business for CNIC. The high commission rate paid to CGA violates Missouri regulation 20 CSR 200-11.130(3)(A) (Materiality, Fairness and Reasonableness of Certain Affiliated Transactions), which requires that fees and charges paid to affiliates must not exceed the cost basis of the insurer.

CGA also has not delivered increased premium volumes for CNIC that was a key reason for entering into the General Agency Agreement. This is one of several assumptions made in the financial projections provided by management to justify the Agreement that have never materialized.

2) The Company does not maintain or utilize policy level information for the financial reporting of its Program business segment. The Company calculates the applicable asset and liabilities for the Program business from summary reports provided by Managing General Agents (MGAs) and a general agent. Our examination obtained limited policy-by-policy data from the MGAs and general agent that was deficient in order to accurately calculate various assets and liabilities, such as past due uncollected premiums and unearned premiums. A lack of reliable policy information is a significant prospective risk in the event that an MGA or the general agent would become insolvent and cease operations. Losses could occur from write-offs of uncollectible or non-existent premium receivables and overpayment of claims due to the inability to determine accurate policy information.

3) Documentation supporting the reported assets and liabilities for the Program business segment was insufficient and extremely difficult to understand. The lack of clear and easy to follow documentation led to significant delays in the completion of the examination.

4) The claims adjudication process for the Program business segment may not be properly performed by the MGAs and a claims processing administrator. This concern is evidenced by a $1.5 million settlement that occurred in November 2011, which resulted from the disputed denial of a claim by the MGA, THI General Agency, Inc. (THI). Further, the Company does not properly oversee the litigated claims for the Program business. The Company has a large exposure from possible bad faith claims settlement verdicts that could result from a combination of errors in claims adjudication and lack of proper CNIC oversight.

SUBSEQUENT EVENTS

In November 2011, the Company agreed to pay $1.5 million to a claimant as a mediated settlement for a lawsuit originally filed in April 2010. The Company's net retained loss, after application of reinsurance coverages, was $620,000 for this settlement. The underlying accident involved with this lawsuit occurred in February 2010. The related policy was underwritten and the claim was adjudicated by the Company's MGA, THI General Agency, Inc. The underlying policy provided liability coverage up to a limit of only $25,000 per occurrence. The initial claim for the full policy limits of $25,000 was denied by THI.

A review of the supporting documentation for the THI lawsuit showed that an unfavorable jury verdict could have resulted in much higher losses than the mediated settlement amount of $1.5 million. Further, there was exposure to additional litigation against CNIC for bad faith claims settlement practices. The Company's reinsurance agreements only provided coverage up to $4.3 million for a liability claim. Losses in excess of the reinsurance coverage limits were a distinct possibility in this claim that was managed by THI. An unfavorable verdict in the lawsuit plus an unfavorable verdict in a potential bad faith claims settlement lawsuit could have resulted in losses at such a high level that it would have left CNIC in a situation of financial strain.

There are several concerns relating to the THI lawsuit. First, THI and other MGAs may not have the expertise to properly adjudicate claims. Second, any errors made by MGAs in the claims adjudication process will expose CNIC to possible bad faith claims settlement litigation. Third, the Company's reinsurance coverage may be insufficient to protect the Company from another bad faith claim settlement scenario similar to the THI lawsuit. Finally, the most troubling aspect of the lawsuit is that the Company is not properly informed and does not appear to properly review litigated claims involving its Program business segment. Management of CNIC was not aware that the THI litigation existed until two weeks before a jury trial was to commence in November 2011. A lack of thorough oversight of claims litigation is a prospective risk that could have damaging effects upon the Company's financial condition, in the event of future multi-million dollar settlements or jury verdicts.

COMPANY HISTORY

General

The Company was incorporated on March 6, 1997 and commenced business on March 19, 1997. The Company operates as a stock property and casualty insurer under the insurance laws of Chapter 379 RSMo (Insurance Other Than Life).

Capital Stock

As of the examination date, the Company's Articles of Incorporation allowed for the issuance of 23,500 shares of common stock with a par value of $100 per share. As of December 31, 2010, all 23,500 shares were issued and outstanding to Cornerstone Management Partners, Inc. (CMP) for a total capital stock balance of $2,350,000.

Dividends and Capital Contributions

CNIC paid cash dividends to its sole shareholder, CMP, in the following amounts during the examination period: 2008 – $0, 2009 – $900,000, 2010 – $400,000.

Mergers and Acquisitions

None.

CORPORATE RECORDS

The Company's Articles of Incorporation and Bylaws were reviewed. There were no amendments or changes to the Articles of Incorporation or Bylaws during the examination period. However, the Articles of Incorporation were amended in January 2011 to update the section listing the Company's principle place of business. The Bylaws were also amended in March 2011 to prohibit the same officer from simultaneously holding the offices of President and Secretary.

The minutes of the Board of Directors' meetings and the written consents of the sole shareholder (in lieu of meeting) were reviewed for proper approval of corporate transactions. In general, the minutes and written consents appear to properly reflect and approve the Company's major transactions and events for the period under examination.

MANAGEMENT AND CONTROL

Corporate Governance

The management of the Company is vested in a Board of Directors, which is appointed by the sole shareholder. The Company's Bylaws specify that the Board of Directors shall consist of fourteen (14) members, but the Board has the power to change the number of members. The Board approved a resolution to increase the number of directors to fifteen (15), effective May 29, 2009. The Board of Directors appointed and serving, as of December 31, 2010, were as follows:

Name	Address	Principal Occupation and Business Affiliation
Daniel H. Allen	Houston, TX	Senior Vice Pres. and Underwriting Auditor, CMP
Michael G. Burnam	Columbia, MO	Chief Exec. Officer, Storage Mart Partners, LP
D. Scott Forrest	Columbia, MO	Vice President and General Counsel, CMP
James C. French	Columbia, MO	President and Chief Executive Officer, CMP
James E. Godfrey, Jr.	St. Louis, MO	Attorney, Evans & Dixon, LLC
Brian G. Harrison	Columbia, MO	Owner, Harrison Agency, Inc.
R. Alan Hedrick	Dexter, MO	Owner, Country Wide Insurance Agency
Earl P. Holland	Fort Myers, FL	Retired / Investor
Lewis E. Melahn	Mexico, MO	Attorney, Private Practice
Stephen M. Palmer	Frontenac, MO	Physician, Private Practice
Robert A. Rowles	Tipton, MO	President, Insurance Associates America, Inc.
Kirk W. Schmidt	Jefferson City, MO	Vice President and Chief Financial Officer, CMP
Roger W. Thomas	Naples, FL	Retired
Roger D. Walker	Columbia, MO	Senior VP and Chief Operating Officer, CMP
John W. Wooldridge [1]	Columbia, MO	Vice President of Midwest Marketing, CMP

[1] Retired, effective May 20, 2011, and replaced by Michael K. Block

Committees

The Articles of Incorporation and Bylaws do not require any committees, but the Bylaws do allow for the creation of committees, if authorized by a resolution of the Board of Directors. The Company did not have any appointed committees, as of December 31, 2010. However, the parent company, CMP, had committees established throughout the exam period that regularly address and take actions on the business affairs of CNIC.

The CMP committees appointed and serving, as of December 31, 2010, were as follows:

Audit Committee	Executive Compensation Committee	Nominating Committee
James E. Godfrey, Jr. (Chair)	Earl P. Holland (Chair)	Earl P. Holland (Chair)
Michael G. Burnam	Roger W. Thomas	James C. French
Lewis E. Melahn	James E. Godfrey, Jr.	Robert A. Rowles
Stephen M. Palmer		Roger D. Walker

Officers

The officers elected by the Board of Directors and serving as of December 31, 2010, were as follows:

Officer	Position
James C. French	Chief Executive Officer
Kirk W. Schmidt	President, Chief Financial Officer, Treasurer
Roger D. Walker	Senior Vice President and Chief Operating Officer
Daniel H. Allen	Senior Vice President and Underwriting Auditor
John W. Wooldridge	Vice President – Midwest Marketing and Sales, Secretary
D. Scott Forrest	Vice President – Claims, General Counsel, Asst. Secretary
Michael K. Block	Vice President – Underwriting

Holding Company, Subsidiaries and Affiliates

The Company is a member of an Insurance Holding Company System as defined by Section 382.010, RSMo (Definitions). An Insurance Holding Company System Registration Statement was filed by CNIC for each year of the examination period.

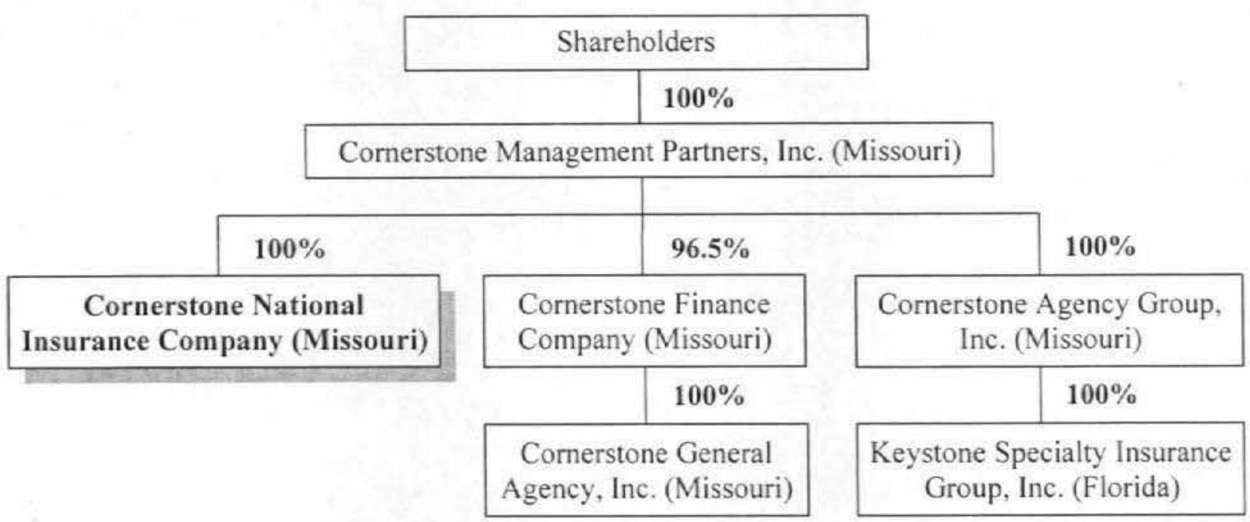
The Company is directly owned 100% by Cornerstone Management Partners, Inc. (CMP), a holding company. CMP is a privately held stock company with approximately 350 common and preferred shareholders. The largest shareholder of CMP is James French, the Chief Executive Officer of CNIC. Mr. French owned 13% of the outstanding stock of CMP, as of December 31, 2010. Collectively, officers and directors of CNIC own approximately 30% of CMP.

CMP has other subsidiaries, which have business operations in or related to the insurance industry. CMP and its subsidiaries are collectively referred to as the Cornerstone Group. CNIC is by far the largest entity in the Cornerstone Group. A description of the business operations of CMP and its subsidiaries are as follows:

- Cornerstone Management Partners, Inc. – Holding company with a primary purpose to manage and support the business operations of CNIC. Employees of CMP perform the day-to-day operational functions of CNIC and its other subsidiaries.
- Cornerstone Finance Company – A commercial lender that issues loans to businesses for the purpose of financing insurance premiums on commercial policies.
- Cornerstone General Agency, Inc. (CGA) – An agency that is responsible for managing the network of independent agents that produce business for CNIC. CGA also writes business for unaffiliated insurers for any risks, such as homeowners insurance and life products, that are not written by CNIC.
- Cornerstone Agency Group, Inc. – A holding company with no operations.
- Keystone Specialty Insurance Group, Inc. (Keystone) – Formerly a managing general agent that marketed and serviced the Company's non-standard auto policies in Florida and Texas. Keystone ceased operations at the end of April 2008 and remains a shell company, as of December 31, 2010.

Organizational Chart

Below is the organizational chart of Cornerstone and its affiliates, as of December 31, 2010.



Intercompany Agreements

The Company's agreements with related parties that were in effect, as of December 31, 2010 and subsequent periods are outlined below.

1. **Type:** Managing General Agency Agreement

   Affiliate: Keystone Specialty Insurance Group, Inc.

   Effective: December 1, 2005

   Terms: Keystone has the authority to issue insurance policies on behalf of CNIC. The authorized business that Keystone may write is private passenger auto liability, auto physical damage, and other related auto coverages in the states of Florida, Missouri, and Texas only. Keystone will collect all premiums for the subject policies. The collected premiums, less the commissions due to Keystone, are to be deposited in premium trust account that will be held by Keystone in a fiduciary capacity on behalf of CNIC. Keystone is also authorized to settle and pay claims. The investment earnings on the funds in the premium trust account will be retained by Keystone. The commissions received by Keystone are 19% of Florida written premiums, 20% of Missouri written premiums, and 22.5% of Texas written premiums.

   This agreement had no activity during the examination period, but has not been terminated. Keystone ceased operations, effective April 30, 2008.

2. **Type:** Tax Allocation Agreement

   Affiliates: Cornerstone Management Partners, Inc., Cornerstone Finance Company, and Keystone Specialty Insurance Group, Inc.

   Effective: October 4, 2006

   Terms: All of the parties to the Agreement will annually file a consolidated federal income tax return commencing with the 2000 tax year. Each entity's share of the consolidated tax liability or refund shall be calculated as the amount that would have been incurred if each entity would have filed a tax return on a stand-alone basis. The settlements of tax payments due to CMP are to be paid within 30 days of the date that each filing is due to the Internal Revenue Service (IRS). Any tax refunds receivable from CMP are due within 30 days of CMP's receipt of the funds from the IRS.

3. **Type:** Cost Allocation Agreement

   Affiliate: Cornerstone Management Partners

   Effective: March 1, 2009

   Terms: CMP will provide various management and administrative services for CNIC, which includes claims processing, underwriting, policyholder services, marketing, accounting, tax reporting, premium rating, legal, human resources, investments, billing and collection, financial reporting, regulatory compliance, strategic planning, data processing, computer support, and office space. CMP will allocate the direct costs for salary and benefits of its employees that provide services to CNIC, based upon a mutually agreed upon methodology. Various other general and administrative expenses incurred by CMP to provide services to CNIC will be allocated with the same percentage used for the allocation of salary and benefits. CNIC will reimburse CMP for the depreciation of its computer hardware and software costs used to provide data processing services. CMP will invoice CNIC on a monthly basis for all direct and allocated costs under the agreement.

4. **Type:** General Agency Agreement

   Affiliate: Cornerstone General Agency, Inc.

   Effective: May 1, 2010

   Terms: CGA will serve as the general agent to supervise and conduct the writing of CNIC's private passenger automobile business. CGA shall have the authority to appoint local agents and solicit applications for insurance in the states of Missouri, Arkansas, Oklahoma, Kansas and Texas. CGA must follow the underwriting guidelines of CNIC. CGA does not have the responsibility to collect premiums and will not process claims. CNIC will pay CGA a monthly commission of 17% of net premiums written.

   A separate Assignment and Assumption Agreement was executed simultaneous with the General Agency Agreement to transfer the rights and obligations under CNIC's existing agent contracts to CGA, effective May 1, 2010.

CNIC also had a Management Agreement with CMP that was effective through February 28, 2009. This agreement allocated costs incurred by CMP to operate the business of CNIC. The Management Agreement was replaced by the Cost Allocation Agreement with CMP, effective March 1, 2009, that is explained above.

General Agency Agreement with CGA

The structure of the Company's commission payments changed upon the implementation of the General Agency Agreement with CGA on May 1, 2010. Previously, CNIC had directly made commission payments to its network of approximately 500 producing independent agencies. CGA was inserted as an intermediary between the Company and the independent agents, as a result of the General Agency Agreement. CGA became directly responsible for commission payments to the independent agents, while CNIC now only pays CGA a flat commission rate of 17% of direct written premiums.

Management provided financial projections for 2010 through 2012 to accompany the Form D filing that was submitted to the Missouri DIFP for the approval of the General Agency Agreement with CGA. These financial projections showed that there was supposed to be little overall financial impact to CNIC in the first 2½ years of the Agreement. The financial projections showed that increased premiums for CNIC would be offset by increased commissions expenses paid to CGA that would essentially have a surplus neutral impact upon CNIC through 2012. The true benefit of the General Agency Agreement was to occur in future years, as management represented that CGA would leverage its arrangements with unaffiliated insurers to create higher premium volumes for CNIC.

There were several assumptions made in the financial projections submitted by the Company that would benefit CNIC as a result of the General Agency Agreement with CGA. However, none of the key assumptions have occurred, as explained below.

1) Commission Rates – As of May 1, 2010, CNIC paid most of its independent agents 15% commissions for new business and 12% for renewal business. Management stated that commissions for independent agents would be increased to 15% for renewals, effective January 1, 2011. This change never occurred and CGA continues to pay 12% renewal commissions to independent agents, while receiving 17% renewal commissions from CNIC.
2) Premium Growth – Management stated that CNIC premiums were projected to increase by $2 million from May 1, 2010 through December 31, 2011 by selling more CNIC auto policies in combination with homeowners policies sold by CGA for an unaffiliated insurer. As of September 2011, virtually no business has been generated for CNIC through CGA's business partnership.
3) Expense Allocations – Management stated that significant cost savings of at least $200,000 per year would be realized by CNIC due to lower allocated payroll and other expenses from the parent, CMP. Expenses that previously had been allocated to CNIC were to be shifted to CGA. An analysis of the allocated expenses from CMP to CNIC during the first eight months (May 2010 to December 2010) of the General Agency Agreement with CGA showed that there were no changes in the percentage of expenses allocated from CMP.

The actual commissions paid by CNIC to CGA, pursuant to the General Agency Agreement, were compared to the commissions paid by CGA to the independent agents. For the first 12 months of the Agreement (May 2010 to April 2011), the Company paid $5.4 million of commissions to CGA. In comparison, CGA only paid commissions of $4.0 million to the independent agents for the same time period. The average commission rate paid by CGA to the independent agents was only 12.6% of the Company's written premiums, which is well below the 17% commission rate paid by CNIC to CGA under the General Agency Agreement.

It was also noted that CGA began paying the parent, CMP, "management and capital fees" of $60,000 per month or $720,000 per year, beginning in May 2010, which coincides with the beginning of the General Agency Agreement between CNIC and CGA. The "management and capital fees" are charged to CGA (but not CNIC) in addition to the monthly expenses that CMP allocates to CNIC, CGA and its other subsidiaries. The commission payments paid by CNIC to CGA appear to be generating sizable profits for CGA, which allows CGA to effectively transfer the profits to the parent, CMP, at a rate of at least $720,000 per year.

Management stated during the examination that the commission rate of 17% that is paid to CGA represents a "market" rate. However, Missouri regulation 20 CSR 200-11.130(3)(A) (Materiality, Fairness and Reasonableness of Certain Affiliated Transactions) states:

> "The charges, fees or other consideration, paid by the registered insurer to an affiliate for a service shall not exceed the direct cost to the registered insurer. "Direct cost" means the expenses and costs to the registered insurer of directly performing substantially the same service for itself."

The 12% commission rate on renewal premiums is clearly the direct cost that has been paid to independent agents by both the Company (prior to May 1, 2010) and CGA (since May 1, 2010). Therefore, the terms of the General Agency Agreement do not meet the cost basis requirements of Missouri regulation 20 CSR 200-11.130(3)(A).

Intercompany Payments

The following table summarizes the payments made during the examination period, between CNIC and its affiliates, pursuant to intercompany agreements and other transactions.

	Agreement /	Net Paid / (Received)		
Affiliate	Transaction	**2008**	**2009**	**2010**
CMP	Management	$5,234,471	$ 768,901	$ 0
CMP	Cost Allocation	0	4,245,058	5,088,092
CMP	Tax Allocation	(a)	(a)	(a)
Keystone Specialty	MGA Agreement	0	0	0
CGA	General Agency	0	0	3,075,392
CGA	Reimbursements (b)	0	0	(1,195,714)
CFC	Sale of Bond	0	0	(250,000)
CMP	Dividends	0	900,000	400,000
TOTAL		$5,234,471	$5,913,959	$7,117,770

(a) No cash settlements, pursuant to the Tax Allocation Agreement, during the examination period. However, CNIC incurred the following tax expenses (benefits), pursuant to the Tax Allocation Agreement: 2008 - ($167,176), 2009 - $514,915, 2010 - $640,139.

(b) CNIC paid agent commissions on behalf of CGA from May 2010 through October 2010 during the transition period for the General Agency Agreement. CGA's reimbursements of these payments were netted with CNIC's payments of commissions to CGA.

FIDELITY BOND AND OTHER INSURANCE

The Company's parent, CMP, has a financial institution bond to cover losses resulting from fraudulent or dishonest acts of an employee. The bond insures all subsidiaries of CMP, including CNIC. The bond has a liability limit of $1,000,000 with a $10,000 deductible, which meets the minimum coverage that is recommended by the NAIC.

The Company is also covered by several other insurance policies of the parent, CMP. These policies include the following: property, general liability, commercial excess and umbrella liability, employment liability, directors and officers liability, insurance services professional liability, and cyber security. Although CNIC is not a named insured on most of these policies, the terms of the policies extend coverage to the subsidiaries of the named insured, CMP.

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

CNIC does not have any direct employees and thus, does not directly incur or accrue any expenses for employee benefits. The employees of the parent, Cornerstone Management Partners, Inc., perform all of the operational and administrative functions of the Company. Most of the CMP employees are located in the Columbia, Missouri home office. At the end of 2010, CMP had 52 total employees. An allocated portion of the payroll and benefit costs of CMP employees are paid by CNIC pursuant to a Cost Allocation Agreement, which is described in the Intercompany Agreements section of this report.

TERRITORY AND PLAN OF OPERATION

Cornerstone National Insurance Company is licensed as a property and casualty insurer by the Missouri DIFP under Chapter 379 RSMo (Insurance Other than Life). The Company is licensed in nineteen (19) states, but only wrote business in twelve states during 2010. The states with the largest written premiums were as follows:

State	2010 Direct Written Premiums	% of Total
Missouri	$14,980,159	15.7%
California	14,485,383	15.2%
Georgia	12,808,883	13.4%
Louisiana	10,241,332	10.7%
Oklahoma	6,844,938	7.2%
All Other	20,189,784	25.4%
Total	$79,550,479	100.0%

The Company's two main lines of business are Private Passenger Auto Liability and Auto Physical Damage, which accounted for 58% and 42% of net written premiums in 2010, respectively. The Company divides its personal auto business into "Core" and "Program" segments. The Company insures standard auto risks in its "core" states of Arkansas, Kansas, Missouri, Oklahoma, and Texas. The Company has "programs" with three managing general agents (MGAs) and one general agent to write non-standard auto business in Arizona, California, Colorado, Georgia, Louisiana and Utah that is mostly ceded.

The Program business administered by the MGAs and general agent accounted for $41.9 million of direct written premium in 2010, as follows:

MGA / General Agent	Effective Date	States	Direct Written Premium 2010	Percent Ceded
Freedom National Insurance Services, Inc.	04/01/2007	California	$12,896,883	90.0% to 100.0%
THI General Agency, Inc.	02/01/2008	Georgia	12,808,883	100.0%
Sun Coast General Insurance Agency, Inc.*	04/01/2008	Arizona, California, Colorado, Utah	11,334,549	87.5%
Lane and Associates, Inc.	10/01/2008	Louisiana	4,825,388	95.0%
Total			$41,865,703	

* Sun Coast General Insurance Agency, Inc. does not perform claims processing and therefore, does not meet the definition of an MGA

CNIC also writes crop insurance in Louisiana and federal flood insurance in several states that is 100% ceded. In 2010, direct written premiums totaled $5.4 million for crop insurance and $0.6 million for flood insurance. The reinsurer for the crop insurance terminated its agreement with the Company, effective January 1, 2011.

CNIC historically used numerous independent agencies to produce its core standard auto business. Effective April 1, 2010, the Company executed a General Agency Agreement with an affiliate, Cornerstone General Agency, Inc. (CGA), which is now the sole agency for the production of Cornerstone's core standard auto business. This agreement is described in the Intercompany Agreements section of this report. Independent agencies still produce business for Cornerstone, but have agency agreements directly with CGA instead of CNIC.

GROWTH OF COMPANY

The table below shows the Company's premium writings and writing ratios for the most recent four years, which includes the current examination period.

Year	Direct Premiums Written	Net Premiums Written	Change in Net Premiums	Capital and Surplus	Ratio of Net Premiums to Surplus
2007	$55,932,862	$40,998,828	na	$13,038,565	3.14
2008	67,295,524	29,586,085	-27.8%	12,910,385	2.29
2009	88,141,865	30,800,183	4.1%	13,489,147	2.28
2010	79,550,476	33,145,930	7.6%	14,335,016	2.31

The large increases in direct premiums in 2008 and 2009 were attributable to growth in the Program business. Direct written premiums in the states for the Program business increased by nearly $20 million in 2008 and by another $28 million in 2009. These large increases in the Program business more than offset decreases in the direct premiums written in Florida, which declined $8 million in 2008 and another $2 million in 2009, plus a $5 million decrease in direct premiums in Core states in 2009. The Company ceased writing new business in Florida during 2008. The overall decrease in direct written premiums in 2010 was due to the continued run-off of the Florida business and lower writings in several of the Program states.

The changes in net written premiums are mostly attributable to changes in reinsurance. Although, the volume of the Program business increased dramatically in 2008 and 2009, there was little impact on net premiums, since this business is mostly ceded. The $11 million decrease in net written premiums in 2008 was due to higher ceding percentages in a quota share reinsurance agreement for the Core business and the run-off business in Florida. The slight increase in net premiums in 2010 was caused by the elimination of the quota share agreement for the Core business. The net premium to surplus ratio changed very little during the examination period.

LOSS EXPERIENCE

The table below shows the Company's incurred losses and loss ratios for the most recent four years, which includes the current examination period.

Year	Net Premiums Earned	Net Losses and Loss Adjustment Expenses Incurred	Loss Ratio
2007	$39,384,957	$32,599,620	82.8%
2008	35,048,230	29,195,685	83.3%
2009	29,322,571	21,230,996	72.4%
2010	33,084,831	23,703,156	71.6%

The loss ratio in 2008 was higher than normal due to a high frequency of severe storm activity that resulted in hail damage to a large amount of insured automobiles.

REINSURANCE

General

The Company's premium activity on a direct written, assumed and ceded basis, for the period under examination, is detailed below:

	2008	2009	2010
Direct Business	$67,295,524	$88,141,865	$79,550,476
Reinsurance Assumed	0	0	0
Reinsurance Ceded:			
Affiliates	0	0	0
Non-affiliates	(37,709,439)	(57,341,682)	(46,404,546)
Net Premiums Written	$29,586,085	$30,800,183	$33,145,930

Assumed

CNIC did not assume any premiums during the exam period and there are no plans to assume business in the future.

Ceded

The Company's reinsurance program for the Core business involves separate agreements for property and casualty risks. As of December 31, 2010, the Company had a casualty excess of loss agreement to cede 100% of liability losses in excess of a $500,000 retention, subject to a reinsurer limit of $4,000,000 per occurrence. Property risks were reinsured with a property catastrophe agreement that ceded 95% of losses in excess of a $500,000 retention, subject to a reinsurer limit of $1,100,000 per occurrence. There were no changes in the reinsurance program for the Core business in the 2011 treaty year.

The Company has separate quota share reinsurance coverage for each MGA / general agent participating in the Program business. As of December 31, 2010, the ceding percentages for property and liability risks under each Program were as follows: Freedom National Insurance Services, Inc. (Freedom) – 90% (California) to 100% (Arizona and Colorado), THI General Agency, Inc. – 100%, Lane and Associates, Inc. – 95%, and Sun Coast General Agency, Inc. (Sun Coast) – 87.5%. All of the reinsurance agreements for the Program business have no limit of reinsurer liability, except for the reinsurance agreement for the Sun Coast Program, which provides no coverage for losses in excess of a 125% loss ratio.

There were two changes in the Program reinsurance coverages for the 2011 treaty year. The ceding percentage for the Freedom Program was reduced to 90% for all states. The ceding percentage for the THI Program was also reduced to 90% in 2011.

All liability risks in the Program business are also covered by the casualty excess of loss agreement that is described above for the Core business. There is no property catastrophe coverage for the Program business. Management has not deemed catastrophe coverage necessary since a high percentage of the risk in the Program business is already ceded under the quota share agreements.

Below is a summary of the major external reinsurers, based upon 2010 ceded premiums and net reinsurance recoverables, as of December 31, 2010:

Name of Reinsurer	2010 Premiums Ceded	Percent of Ceded Premiums	Net Reins. Recoverable 12/31/2010	Percent of Net Recov.
Dorinco Reinsurance Company	12,964,000	27.9%	12,188,000	31.6%
SCOR Reinsurance Company	11,795,000	25.4%	10,714,000	27.8%
NGM Insurance Company	10,703,000	23.1%	9,493,000	24.6%
Paris Re, S.A.	5,200,000	11.2%	3,978,000	10.3%
All Others	5,743,000	12.4%	2,201,000	5.7%
Total Ceded – Unaffiliated	$46,405,000	100.0%	$38,574,000	100.0%

The significant reinsurers and reinsurance balances in the table above all pertain to the Program business. There were no significant ceded premiums in 2010 or reinsurance recoverables, as of December 31, 2010, associated with the Core business.

The Company is contingently liable for all reinsurance losses ceded to others. This contingent liability would become an actual liability in the event that an assuming reinsurer fails to perform its obligations under the reinsurance agreement.

ACCOUNTS AND RECORDS

General

The Company uses the Policy Tracking System (PTS) software from Information Distribution & Marketing, Inc. (IDMI) for policy management, claims management, and producer management functions. In 2009, some of the accounts receivables functions were transitioned from PTS to a SunGard accounts receivables application. Portfolio Manager software from Accurate Business Systems is used for investment management and reporting. QuickBooks software from Intuit, Inc. is used for financial reporting. All of these software applications are hosted on a Dell PowerEdge server located at an underground facility in Columbia, Missouri. The server, server applications, and data are accessed remotely to the Company's office via an Ethernet connection.

The CPA firm, Williams Keepers, LLC, of Columbia, Missouri issued audited statutory financial statements of the Company for all years in the examination period.

The actuarial opinion regarding the Company's reserves for losses and loss adjustment expenses was issued by Mark A. Doepke, FCAS, MAAA, of Actuarial Advisors, Inc. in Minneapolis, Minnesota, for all years of the examination period.

Policy Information for Program Business

The assets and liabilities reported by CNIC in the 2010 Annual Statement included numerous large balances for the Program business segment that is produced by three MGAs and a general agent. The Company relies upon summary reports from the MGAs and general agent to record balances such as uncollected premiums, unearned premiums, and ceded reinsurance premiums payable. For example, the Company determined uncollected premiums of approximately $11.2 million for the Program business by calculating the difference between the cumulative net written premiums and collected premiums.

The Company does not utilize any policy level information in the determination of uncollected premiums, unearned premiums, ceded reinsurance premiums payable, and other balances related to the Program business. The MGAs and general agent either do not provide policy-by-policy information or the policy level information is ignored for reporting purposes. The Company's use of summary data for the financial reporting of the Program business resulted in the failure to determine any uncollected premiums over 90 days past due, as required by paragraph 9.c. of SSAP No. 6 (Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due from Agents and Brokers).

The MGAs and general agent do not appear to be providing policy level data in accordance with their agreements with CNIC. Further, the agreements specify that CNIC may request any policy data that may be necessary to comply with statutory accounting obligations. Management apparently has not requested sufficient policy information and has made no efforts to determine the accuracy of the limited policy data that may be maintained by the MGAs and general agent. The Company performs semi-annual audits of the MGAs and general agent, but the scope of these audits is limited to underwriting and claims handling only.

Our examination requested policy level information for the Program business to determine the accuracy of the amounts reported in the 2010 Annual Statement. The Company was able to obtain limited policy-by-policy information from the MGAs and general agent. However, there were numerous deficiencies or errors in the data that was provided, as follows:

- Freedom National Insurance Services, Inc. (Freedom) – The receivables in the policy-by-policy data did not correspond with summary reports provided to the Company. Policy ending effective dates were inaccurate and policy due dates were not provided.
- THI General Agency, Inc. – No due dates were available to properly age the uncollected premium receivables. Only effective dates and cancellation dates were provided to approximate the past due amounts.
- Suncoast General Insurance Agency, Inc. (Suncoast) – Due dates were incorrect and the policy-by-policy data did not correspond with summary reports provided to the Company.
- Lane and Associates, Inc. (Lane) – Only a listing of policy numbers with the associated premium receivable was provided. Effective dates and due dates were not available.

As a result of the deficiencies in the policy level information for the Program business, our examination was only able to approximate the correct balances for uncollected premiums, unearned premiums, ceded reinsurance premiums payable, and other balances. Several of the reported assets and liabilities for the Program business were inaccurate. For example, it was determined approximately $800,000 of uncollected premiums were over 90 days past due and should have been non-admitted, per SSAP No. 6. However, on a net basis, any errors in the financial reporting for the Program business should theoretically have minimal overall impact on capital and surplus, since most of the Program business is ceded.

There is a significant prospective risk from the lack of reliable policy level information for the Program business, which is tied to the financial condition of the MGAs and general agent. These entities have weak financial conditions, based upon our review of their most recently available financial statements. Further, the Company has a recent history of using MGAs that became bankrupt. In the event that one or more of the current agencies for the Program becomes insolvent and/or abruptly ceases operations, CNIC could encounter a huge administrative problem to take over the policy management with inaccurate or incomplete policy information. This could result in significant losses due to write-offs of uncollectible or non-existent premium receivables and overpayment of claims due to the inability to determine accurate policy information, such as effective periods.

Recordkeeping for Program Business

The Company's recordkeeping for the assets and liabilities attributable to the Program business segment was very difficult to understand. The supporting documentation was poorly organized and included a maze of complicated worksheets. The only method to understand several of the Company's calculations was to review lengthy cell formulas in an attempt to painstakingly recreate the amounts that were reported in the 2010 Annual Statement. There were many instances in which the supporting calculations varied from the actual amounts reported in the general ledger and the Annual Statement. The Company apparently does not perform regular reconciliations for several general ledger balances or reconciling variances are not resolved.

The deficient audit trail made it extremely difficult to examine the Program business amounts reported in the following asset and liability lines: Uncollected Premiums and Agents' Balances, Amounts Recoverable from Reinsurers, Losses, Loss Adjustment Expenses, and Ceded Reinsurance Premiums Payable. As a result of the difficulties encountered, it required much more time to complete our examination than should have been required.

STATUTORY DEPOSITS

Deposits with the State of Missouri

The funds on deposit with the Missouri DIFP as of December 31, 2010, as reflected below, were sufficient to meet the capital deposit requirements for the State of Missouri in accordance with Section 379.098 RSMo (Securities to be Deposited). The funds on deposit were as follows:

Type of Security	Par Value	Fair Value	Book Value
State and Municipal Bonds	$2,060,000	$2,049,119	$2,060,000

Deposits with Other States

The Company also has funds on deposit with other states. Those funds on deposit, as of December 31, 2010, were as follows:

State	Type of Security	Par Value	Fair Value	Book Value
Arkansas	Municipal Bonds	$150,000	$150,695	$148,870
Georgia	Municipal Bonds	35,000	35,162	34,736
Louisiana	Municipal Bonds	20,000	21,461	21,229
Oklahoma	Municipal Bonds	350,000	350,924	348,599
Virginia	Municipal Bonds	250,000	260,263	249,621
Total		$805,000	$818,505	$803,055

FINANCIAL STATEMENTS

The following financial statements, with supporting exhibits, present the financial condition of Cornerstone National I nsurance Company for the period ending December 31, 2010. Any examination adjustments to the amounts reported in the financial statements and/or comments regarding such are made in the "Comments on Financial Statement Items." The failure of any column of numbers to add to its respective total is due to rounding or truncation.

There may have been additional differences found in the course of this examination, which are not shown in the "Comments on Financial Statement Items." These differences were determined to be immaterial concerning their effect on the financial statements, and therefore, were only communicated to the Company and noted in the workpapers for each individual Annual Statement item.

Assets
as of December 31, 2010

	Assets	Non-Admitted Assets	Net Admitted Assets
Bonds	$31,214,481	$ 0	$31,214,481
Common Stocks	1,311,920	0	1,311,920
Cash, Cash Equivalents and Short-Term Investments	3,411,023	0	3,411,023
Other Invested Assets	201,976	0	201,976
Investment Income Due and Accrued	371,612	0	371,612
Uncollected Premiums and Agents' Balances **(Note 1)**	13,368,832	1,171,042	12,197,790
Amounts Recoverable from Reinsurers	5,957,853	0	5,957,853
Other Reinsurance Amounts Receivable	6,282	0	6,282
Federal Income Tax Recoverable	1,111,564	1,111,564	0
Net Deferred Tax Asset	1,177,653	82,560	1,095,093
EDP Equipment and Software	72,685	72,685	0
Aggregate Write-In Assets	943,203	942,226	977
TOTAL ASSETS	**$59,149,084**	**$3,380,077**	**$55,769,007**

Liabilities, Surplus and Other Funds
as of December 31, 2010

Losses	$10,154,938
Loss Adjustment Expenses	5,363,824
Commissions Payable	472,685
Other Expenses	140,252
Taxes, Licenses and Fees	532,149
Unearned Premium	8,712,709
Advance Premium	320,286
Ceded Reinsurance Premiums Payable (**Note 2**)	15,549,559
Funds Held Under Reinsurance Treaties	688,830
Payable to Parent, Subsidiaries and Affiliates	39,206
TOTAL LIABILITIES	**$41,974,438**
Common Capital Stock	2,350,000
Surplus Notes	5,028,658
Gross Paid-In and Contributed Surplus	12,824,342
Unassigned Funds (Surplus)	(6,408,431)
Capital and Surplus	**$13,794,569**
TOTAL LIABILITIES AND SURPLUS	**$55,769,007**

Statement of Income
For the Year Ended December 31, 2010

Premium Earned	$33,084,831
DEDUCTIONS:	
Losses Incurred	19,457,802
Loss Adjustment Expenses Incurred	4,245,354
Other Underwriting Expenses Incurred	10,068,348
Total Underwriting Deductions	$33,771,504
Net Underwriting Loss	($ 686,673)
Net Investment Income Earned	1,016,675
Net Realized Capital Gains	6,429
Net Investment Gain	$ 1,023,104
Other Income	1,155,269
Dividends to Policyholders	0
Federal Income Taxes Incurred	640,139
Net Income	$ 851,561
CAPITAL AND SURPLUS ACCOUNT:	
Surplus as Regards Policyholders, December 31, 2009	$13,489,147
Net Income	851,561
Change in Net Unrealized Capital Gains or (Losses)	177,958
Change in Net Deferred Income Tax	142,249
Change in Non-Admitted Assets	74,101
Change in Surplus Notes	84
Surplus Adjustments – Paid In	(400,000)
Aggregate Write-In for Gains and Losses in Surplus	(84)
Examination Changes	(540,447)
Surplus as Regards Policyholders, December 31, 2010	$13,794,569

Comments on Financial Statement Items

Note 1 – Uncollected Premiums and Agents' Balances **$12,197,790**

The balance reported in the Uncollected Premiums line is composed of several components, including premiums receivable from policyholders in the Company's Core business segment and net amounts due from the MGAs and general agent in the Program business segment. The net amounts for the Program business include premiums receivable, commissions payable, claims payable, and premium taxes receivable.

Our examination estimated that $798,869 of the uncollected premiums for the Program business were over 90 days past due and should have been non-admitted, pursuant to paragraph 9.c. of SSAP No. 6. A precise determination of premium receivables over 90 days past due could not be made, due to lack of sufficient policy-by-policy information. Refer to the Accounts and Records section of this report for a complete description of deficiencies in policy data for the Program business.

The other components of the net balances for the Program business, as of December 31, 2010, between the Company and the MGAs and general agent are derivatives of the uncollected premium amounts. Adjustments to commissions payable and premium taxes receivable were necessary to correspond with the estimated amounts over 90 days past due for uncollected premiums. A net examination change of $853,414 was made to collectively non-admit and adjust all of the various balances for the Program business.

Note 2 – Ceded Reinsurance Premiums Payable **$15,549,559**

The reported liabilities in the Ceded Reinsurance Premiums Payable line for the Suncoast and Lane MGA programs are derived from the premium receivables reported in the Uncollected Premiums line. Examination changes were made to non-admit premiums receivables for the Program business, as explained in Note 1 above. Corresponding adjustments were necessary to decrease the liabilities for ceded premiums payable to the reinsurers of the Suncoast and Lane MGA Programs. An examination change of $312,967 was made to decrease the reported liabilities.

It should be noted that the ceded premiums payable for the Freedom and THI Programs are based upon unearned premiums. Therefore, no corresponding adjustments to the Ceded Reinsurance Premiums Payable line were necessary for these two Programs.

Examination Changes

Capital and Surplus Per Company, December 31, 2010:	
Common Capital Stock	$ 2,350,000
Surplus Notes	5,028,658
Gross Paid-In and Contributed Surplus	12,824,342
Unassigned Funds (Surplus)	(5,867,984)
Total Capital and Surplus Per Company	**$14,335,016**
Examination Changes:	
Decrease Uncollected Premiums (**Note 1**)	($ 853,414)
Decrease Ceded Reins. Premiums Payable (**Note 2**)	312,967
Total Examination Changes	**($540,447)**
Capital and Surplus Per Examination, December 31, 2010:	
Common Capital Stock	$ 2,350,000
Surplus Notes	5,028,658
Gross Paid-in and Contributed Surplus	12,824,342
Unassigned Funds (Surplus)	(6,408,431)
Total Capital and Surplus Per Examination	**$13,794,569**

General Comments and/or Recommendations

Claims Adjusting and Litigation Review – Program Business (pages 3-4)

The Company should review the adequacy of the process and procedures performed by its MGAs and claims processing administrator to deny claims for the Program business segment. Any claims that are recommended for denial should be given extra attention to avoid possible bad faith claims settlement litigation. The Company should also require the MGAs and the claims processing administrator to provide monthly status reports on lawsuits or potential lawsuits. CNIC management should thoroughly review the litigation status of claims for the Program business to ensure that proper actions are being taken in the resolution of the lawsuits. Also, the Company should review its reinsurance agreements to assess the need to increase coverage limits for any multi-million dollar jury verdicts that could occur from bad faith claims lawsuits.

General Agency Agreement with CGA (pages 10-11)

It is recommended that the Company immediately terminate or significantly restructure the terms of the General Agency Agreement with CGA. If the Agreement continues, the terms should be amended so that CNIC should only reimburse commissions to CGA on a cost basis, as required by Missouri regulation 20 CSR 200-11.130(3)(A) (Materiality, Fairness and Reasonableness of Certain Affiliated Transactions). In other words, CNIC's commission payments to CGA should equal the commission payments that CGA pays to the independent agents. Any expenses (such as payroll and agent training) incurred by CGA to provide services for CNIC should also be charged on a cost basis. Such amendments to the General Agency Agreement would make the terms equivalent to CNIC's Cost Allocation Agreement with CMP, which also allocates expenses on a cost basis, with no profit margin.

Policy Information for Program Business (pages 17-18)

It is recommended that the Company immediately take actions to obtain reliable policy level information from its MGAs and general agent for the Program business. On a monthly basis, the Company should receive policy-by-policy data with all pertinent attributes, such as beginning and ending effective dates, payment due dates, original premium amounts, premium payments, and uncollected premiums. The Company should investigate the accuracy of the policy-by-policy data obtained from the MGAs and general agent to ensure accuracy of the reported information. Any discrepancies or errors in the data should be addressed and corrected. Further, the Company should begin using policy level information to determine the balances of the various assets and liabilities that are reported for the Program business in future Quarterly and Annual Statements. This would include aging of uncollected premiums to non-admit any amounts over 90 days past due.

Recordkeeping for Program Business (pages 19)

The Company should invest resources to construct clear and understandable supporting workpapers for the Program business amounts reported in the following asset and liability lines: Uncollected Premiums and Agents' Balances, Amounts Recoverable from Reinsurers, Losses, Loss Adjustment Expenses, and Ceded Reinsurance Premiums Payable. The documentation should support both the calculation of the direct and ceded components of each asset and liability. Reconciliations should be performed on at least a quarterly basis to reconcile the amounts from the Company's supporting workpapers to the amounts recorded in the general ledger and Annual Statement. Any unreconciled differences should be written off or otherwise eliminated.

ACKNOWLEDGMENT

The assistance and cooperation extended by the officers and the employees of Cornerstone National Insurance Company during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Shannon Schmoeger, CFE, Steve Koonse, CFE, Scott Rennick, AFE, and Timothy Carroll, examiners for the Missouri DIFP, participated in this examination. Jon Michelson, FCAS, MAAA, of Expert Actuarial Services, LLC, also participated as a consulting actuary.

VERIFICATION

State of Missouri)
)
County of)

I, Tim L. Tunks, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of Cornerstone National Insurance Company its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.

Tim L. Tunks

Tim L. Tunks, CPA, CFE
Examiner-In-Charge
Missouri DIFP

Sworn to and subscribed before me this 12th day of January 2012.

My commission expires: ____________ Sheila M Burgess
Notary Public

SHEILA M. BURGESS
Notary Public - Notary Seal
State of Missouri
Commissioned for Boone County
My Commission Expires: November 02, 2012
Commission Number: 08408885

SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with NAIC procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.

Mark A. Nance
Mark A. Nance, CPA, CFE
Audit Manager
Missouri DIFP

CORNERSTONE
GROUP

Frederick G. Heese
Missouri Department of Insurance
301 W. High Street, Room 530
P.O. Box 690
Jefferson City, MO 65102-0690

Mr. Heese:

Please accept this letter as our official response to our December 31, 2010 examination report. We wish to have this letter included with the public document.

Claim Adjusting and Litigation Review

We do conduct reviews of our MGA's claim handing policy and procedures and have now started focusing more on litigated files during our reviews. We believe the MGA's generally have competent staff although we did have one MGA who made some bad decisions and allowed their outside attorneys to drive their decision making process. We have been thoroughly involved with that situation and would appear they have made appropriate changes.

We also have raised our excess of loss reinsurance beginning April 1, 2012 to $4.5 million excess of $500,000 from the previous coverage of $3.5 million excess of $500,000. We believe that should be adequate coverage.

General Agency Agreement

The agreement was based on what was believed to be fair market value for the services, as it was observed that the standard commission in the automobile market was 15% for new business and 15% for renewal, and then an additional 2% was added to cover bonus commissions and other costs that were shifted to CGA. We also have an agency agreement with a Texas company that produces for us where we pay them 17.5% for both new and renewal business. The rationale for approval was discussed with the Chief Financial Examiner before ever filing the agreement and he acknowledged that market rate should be appropriate but said staff would have to review the agreement. He also said that the Department would be "solely concerned with what Cornerstone pays". When the agreement was submitted for review there were no inquiries made about whether the compensation paid to CGA would be based upon their cost basis, and the agreement was approved.

The projections provided were done so at the request of the Department and were made in good faith, but the underlying premise behind the agreement was fair market value for the services which is what we were told would be appropriate. The exam report was critical of the projections; however, it should be noted that the examination report was misleading on several of its conclusions. First, the rate paid to the agents is much higher than the 12.6% noted in the report. There was also a substantial amount of other cost savings for CNI based upon changing the expense allocations and also CGA picking up promotional, advertising, and agency appointment costs. The examination also concluded that "virtually no business has been generated" by this partnership and we don't think there is enough information to make that conclusion. The Department cannot form this conclusion without knowing how much business would have been produced without this agreement. We believe the agreement has been positive for production to CNI.

In regard to the conclusion about the agreement needing to be at cost basis, we are aware of many agreements in place with Missouri domestics and affiliates that are based upon percentages of premiums, percentage of assets, or fixed fees. We have discussed this with Department staff and they were not able to adequately explain why those agreements are allowed but it has now been concluded that ours should be on a cost basis. We are confused why our agreement would be treated differently. The cost standard suggested does not seem to be applied uniformly and there are some agreements that allow companies to be run at a very high cost structure through affiliated fees. Our current expense ratio is at a reasonable level.

We believe the terms of the agreement are "fair and reasonable" but are willing to amend or restructure the agreement, and have attempted to discuss this with the Department. We do not believe cost basis is appropriate for an Agency Agreement, and it does not appear the cost standard is consistently applied. We would respectfully request that we not be treated unfairly on this issue because we are a small company. Our current surplus adequately supports our company and we also believe we have very redundant reserves.

Policy Information for Program Business

Although we acknowledge the need to obtain detailed aging reports to age uncollected premiums over 90 days, we do not feel collecting detailed policy level information about the program business will help us with the accounting process or oversight of the MGA business without administering the business ourselves. We do get summary level information from all MGA's for our monthly accounting and do check that data for reasonableness and consistency. Some of the MGA's send us more detailed information about policies, claims, and collected premiums however reviewing information to the detail level would not seem to accomplish anything unless the summary level data looked unusual or we had reason to believe there were errors. We do acknowledge that conducting a run-off would be difficult without the knowledge and cooperation of the MGA, however collecting detailed data would not solve that problem.

In regard to over 90 day aging that was the bulk of the examination changes, we would also like to add at the end of 2011 we were able to obtain aging reports to our satisfaction from all MGA's and the net balance over 90 days was only $60,200. In past statements we had measured the 90 days from when the MGA owed us the money, since many of them are responsible to us for uncollected. We felt that was a better way to measure the risk of uncollectible however we will do at the policyholder level in the future.

Recordkeeping for Program Business

We do have a reconciliation process in place or sufficient detail to substantiate all the balances mentioned. The reconciliations are done at least quarterly, (sometimes we are not completely caught up at the end of the first quarter), and if material adjustments are necessary they are made. Unfortunately when the examination team reviewed these reconciliations they were not willing to make any effort to understand how our accounting and reconciliation process worked, instead they were apparently looking at an audit program and trying to perform the exact step that was noted on that guidance. Our reconciliations and ledger are maintained on an MGA level basis, and the examination team insisted everything be done reinsurer by reinsurer which made the entire review more confusing. We also have detailed workpapers that would tie our ledger totals into the appropriate Schedule F lines. We do acknowledge that some of the reinsurer by reinsurer allocations in Schedule F were somewhat inaccurate; however the numbers balance out in total and can be supported. Our independent auditors review our processes every year and have not found any material difference during their reviews. We will consider the need to also perform reconciliations at the reinsurer level however we do not believe that helps our overall accounting or helps us in making sure all balances are appropriately settled, since settlement with reinsurers are made through our reinsurance broker and are made on a specific item basis and not in total. We do maintain spreadsheets that track outstanding settlements with reinsurers however we do not keep running totals by reinsurer and especially not by individual annual statement line items since all settlements are made on a net basis.

We believe the Department's write-up in the report is misleading and implies we could not reconcile major account balances. This is absolutely not true. We are disappointed based upon the extreme amount of time on the examination and the amount charged to the company that the Department could not reach a more accurate conclusion and would ask the examination report be modified.

On a general note, we also think it is relevant to mention that we will be reducing our business produced through the MGA's during 2012 and will be exiting some relationships as well, and may be completely out of that segment during 2013. The run-off of policy and claims will still be occurring and will obviously take awhile. This is relevant because if our long-term strategy was to continue these relationships we may have been in a better position to add more processes or resources behind tracking, reporting and monitoring those relationships but given this planned contraction we do not believe expending additional resources would be cost effective.

We also think it is important to point out that as of December 31, 2011 we have approximately $3.25 million of LAE reserves on our books that is required only on a statutory basis and is essentially a default reserve in case the MGA's or TPA's default on their obligations to handle claims for which they have already been substantially paid. We believe it is unlikely that all of our MGA's and TPA's will default on their entire claim handling responsibility. We also have another $1.3 million of IBNR loss reserves and have also set up an allowance for doubtful accounts of approximately $870,000. Although the examination seems to mention prospective risks of the MGA business it does not seem to acknowledge that much of the overall risk to the financial statements is mitigated through the reserving requirements. The reserve levels mentioned above were not to that level as of December 31, 2010 but we did have substantial reserves at 12/31/2010 and they have now been strengthened to the levels mentioned as of December 31, 2011.

We appreciate the opportunity to respond and hope that the Department will modify its report and conclusions to more accurately reflect the situation and uniformly apply its standards to us as it has done with other companies.

Sincerely,

Kirk Schmidt

Kirk Schmidt, CPA, CFE
President and CFO
Cornerstone National Insurance Company