



MISSISSIPPI INSURANCE DEPARTMENT

501 N. WEST STREET, SUITE 1001
WOOLFOLK BUILDING
JACKSON, MISSISSIPPI 39201
www.doi.state.ms.us

MAILING ADDRESS
Post Office Box 79
Jackson, Mississippi 39205-0079
TELEPHONE: (601) 359-3569
FAX: (601) 359-2474
WATS: 1-800-562-2957 (Incoming - USA)

MIKE CHANEY
Commissioner of Insurance
State Fire Marshal

March 6, 2008

CERTIFIED MAIL RETURN RECEIPT REQUESTED

Kristian P. Moor
Chairman of the Board and President
Audubon Indemnity Company
70 Pine Street
New York, NY 10270

RE: Report of Examination as of December 31, 2006

Dear Mr. Moor:

In accordance with Miss. Code Ann. § 83-5-201 et seq. (Rev. 1999), an examination of your Company has been completed. Enclosed herewith is the Order adopting the report and a copy of the final report as adopted.

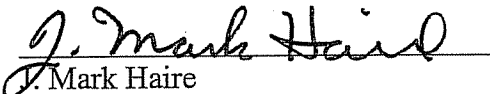
Pursuant to Miss. Code Ann. § 83-5-209(6)(a) (Rev. 1999), the Mississippi Department of Insurance shall continue to hold the content of said report as private and confidential for a period of ten (10) days from the date of the Order. After the expiration of the aforementioned 10-day period, the Department will open the report for public inspection.

If you have any questions or comments, please feel free to contact me.

Sincerely,

MIKE CHANEY
COMMISSIONER OF INSURANCE

BY


J. Mark Haire
Special Assistant Attorney General

MC/JMH/bs
Encls. Order w/exhibit

**BEFORE THE COMMISSIONER OF INSURANCE
OF THE STATE OF MISSISSIPPI**

**IN RE: REPORT OF EXAMINATION OF
 AUDUBON INDEMNITY COMPANY**

CAUSE NO. 08-5706

ORDER

THIS CAUSE came on for consideration before the Commissioner of Insurance of the State of Mississippi ("Commissioner"), or his designated appointee, in the Offices of the Commissioner, 1001 Woolfolk Building, 501 North West Street, 10th Floor, Jackson, Hinds County, Mississippi, pursuant to Miss. Code Ann. § 83-5-201 et seq. (Rev. 1999). The Commissioner, having fully considered and reviewed the Report of Examination together with any submissions or rebuttals and any relevant portions of the examiner's work papers, makes the following findings of fact and conclusions of law, to-wit:

JURISDICTION

I.

That the Commissioner has jurisdiction over this matter pursuant to the provisions of Miss. Code Ann. § 83-5-201 et seq. (Rev. 1999).

II.

That Audubon Indemnity Company is a Mississippi-domiciled company licensed to write Accident & Health; Automobile Physical Damage/Liability; Casualty/Liability; Fidelity; Fire and Allied Lines; Home/Farm Owners; Inland Marine; Plate Glass; Surety; and Workers' Compensation coverages.

FINDINGS OF FACT

III.

That the Commissioner, or his appointee, pursuant to Miss. Code Ann. § 83-5-201 et seq. (Rev. 1999), called for an examination of Audubon Indemnity Company and appointed Dale Miller, Examiner-In-Charge, to conduct said examination.

IV.

That on or about December 3, 2007, the draft Report of Examination concerning Audubon Indemnity Company for the period of January 1, 2004, through December 31, 2006, was submitted to the Department by the Examiner-In-Charge, Dale Miller.

V.

That on or about January 10, 2008, pursuant to Miss. Code Ann. § 83-5-209(2) (Rev. 1999), the Department forwarded to the Company a copy of the draft report and allowed the Company a 15-day period to submit any rebuttal to the draft report. The Department received the Company's response to the draft examination report in a letter on or about January 24, 2008, and in response thereto, minor revisions were made to the draft report.

CONCLUSIONS OF LAW

VI.

The Commissioner, pursuant to Miss. Code Ann. § 83-5-209(3) (Rev. 1999), must consider and review the report along with any submissions or rebuttals and all relevant portions of examiner work papers and enter an Order: (1) adopting the Report of Examination as final or with modifications or corrections; (2) rejecting the Report of Examination with directions to reopen; or (3) calling for an investigatory hearing.

IT IS, THEREFORE, ORDERED, after reviewing the Report of Examination, the Company's rebuttal, and all relevant examiner work papers, that the Report of Examination of Audubon Indemnity Company, attached hereto as Exhibit "A", should be and same is hereby adopted as final.

IT IS FURTHER ORDERED that a copy of the adopted Report of Examination, accompanied with this Order, shall be served upon the Company by certified mail, postage pre-paid, return receipt requested.

IT IS FURTHER ORDERED that the Mississippi Department of Insurance shall continue to hold the content of this report as private and confidential for a period of ten (10) days from the date of this Order, pursuant to Miss. Code Ann. § 83-5-209(6)(a) (Rev. 1999).

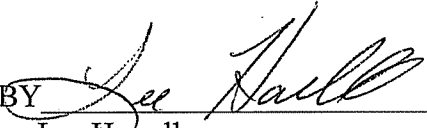
IT IS FURTHER ORDERED, pursuant to Miss. Code Ann. § 83-5-209(4) (Rev. 1999), that within thirty (30) days of the issuance of the adopted report, Audubon Indemnity Company of Mississippi shall file affidavits executed by each of its directors stating under oath that they have received a copy of the adopted report and related orders.

IT IS FURTHER ORDERED that Audubon Indemnity Company take the necessary actions and implement the necessary procedures to ensure that all recommendations contained in the Report of Examination are properly and promptly complied with.

SO ORDERED, this the 6th day of March, 2008.

MIKE CHANEY
COMMISSIONER OF INSURANCE
STATE OF MISSISSIPPI

BY




Lee Harrell
Deputy Commissioner

CERTIFICATE OF MAILING

I hereby certify that a true and correct copy of the above and foregoing Order and a copy of the final Report of Examination, as adopted by the Mississippi Department of Insurance, was sent by certified mail, postage pre-paid, return receipt requested, on this the 6th day of March, 2008, to:

Kristian P. Moor
Chairman of the Board and President
Audubon Indemnity Company
70 Pine Street
New York, NY 10270



J. Mark Haire
Special Assistant Attorney General

J. Mark Haire
Special Assistant Attorney General
Counsel for the Mississippi Department of Insurance
Post Office Box 79
Jackson, MS 39205-0079
(601) 359-3577
Miss. Bar No. 2065



Mississippi Insurance Department

Report of Examination

of

Audubon Indemnity Company

**70 Pine Street
New York, New York 10270**

As of December 31, 2006

**NAIC Company Code 19925
NAIC ETS No. MS029-C28**

AUDUBON INDEMNITY COMPANY
EXAMINATION REPORT TABLE OF CONTENTS
DECEMBER 31, 2006

Examiner Affidavit	1
Salutation	2
Introduction	3
Scope of Examination	3
History of the Company	3
Holding Company Structure	3
Management and Control	5
Corporate Records	6
Fidelity Bonds and Other Insurance	7
Officers', Employees', and Agents' Welfare	7
Reinsurance	7
Accounts and Records	8
Statutory Deposits	10
Financial Statements:	
Introduction	11
Statement of Admitted Assets, Liabilities, Surplus and Other Funds	12
Statement of Income	13
Reconciliation of Capital and Surplus	14
Reconciliation of Examination Changes to Surplus and Other Funds	15
Comments on Financial Statements	16
Market Conduct Activities	17
Compliance with Previous Examination Recommendations	18
Commitments and Contingencies	18
Subsequent Events	18
Comments and Recommendations for Current Examination	19
Acknowledgement	20

EXAMINER'S AFFIDAVIT AS TO STANDARDS AND
PROCEDURES USED IN AN EXAMINATION

State of Mississippi,

County of Hinds,

R. Dale Miller, CFE, CPA, being duly sworn, states as follows:

1. I have authority to represent the State of Mississippi in the examination of Audubon Indemnity Company as of December 31, 2006.
2. The Mississippi Insurance Department is accredited under the National Association of Insurance Commissioners Financial Regulation Accreditation Standards.
3. I have prepared the examination report, and the examination of Audubon Indemnity Company, as of December 31, 2006, was performed in a manner consistent with the standards and procedures required by the National Association of Insurance Commissioners and the Mississippi Insurance Department.

The affiant says nothing further.

R. Dale Miller

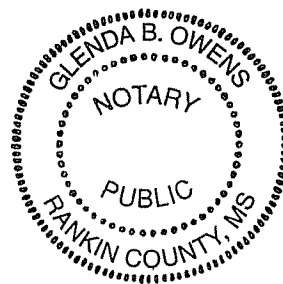
R. Dale Miller, CFE, CPA
Examiner-In-Charge

Subscribed and sworn before me by Dale Miller on January 30, 2008.

Glenda B. Owens
Notary Public

My Commission Expires November 11, 2008

My commission expires _____





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September 30, 2007

Honorable George Dale
Commissioner of Insurance
State Fire Marshal
Mississippi Insurance Department
501 N. West Street
1001 Woolfolk Building (39201)
Post Office Box 79
Jackson, Mississippi 39205-0079

Honorable Alfred W. Gross
Chair, Financial Condition (E) Committee
Commissioner
State Corporation Commission
Bureau of Insurance
Commonwealth of Virginia
Post Office Box 1157
Richmond, Virginia 23218

Honorable Julie McPeak
Executive Director
Secretary, Southeastern Zone
Kentucky Office of Insurance
Post Office Box 517
Frankfort, Kentucky 40602-0517

Dear Sirs and Madam:

Pursuant to the instructions and authorization from the Commissioner of Insurance for the State of Mississippi, and in compliance with statutory provisions, an examination as of December 31, 2006 has been conducted of the affairs and financial condition of:

AUDUBON INDEMNITY COMPANY
(NAIC COMPANY CODE 19925; NAIC-ETS No. MS029-C28)

Statutory Home Office:
506 South President Street
Jackson, Mississippi 39201

Main Administrative Office:
70 Pine Street
New York, New York 10270

The examination was performed at the Mississippi Insurance Department (MID) and at Audubon Indemnity Company's (AIC or Company) Main Administrative Office, and was conducted in accordance with Miss. Code Ann. §83-1-201 et seq., and the report of examination is herewith submitted for your review.

INTRODUCTION

The examination period, for purposes of this report, is defined as January 1, 2004 through December 31, 2006, and the examination date is December 31, 2006. The examination was performed by examiners representing the MID and covered AIC's operations and financial condition through the examination period, including material transactions and/or events that occurred subsequent to the examination date and were noted during the course of the examination. The Company's previous examination was as of December 31, 2003, and the previous report of examination was dated November 10, 2004.

SCOPE OF EXAMINATION

The examination of the Company was a full scope financial examination conducted in a manner consistent with the standards and procedures required by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook, as well as the MID, and included an assessment of the Company's financial condition, its ability to fulfill and manner of fulfillment of its obligations, the nature of its operations, and compliance with applicable laws. A full scope market conduct examination was not performed; however, limited procedures were performed on certain areas of the Company's market conduct.

HISTORY OF THE COMPANY

The Company was organized under the laws of the State of Texas on March 25, 1969, and was licensed in Mississippi on December 1, 1977. In order to effect a redomestication of the Company from Texas to Mississippi, the following transactions were completed:

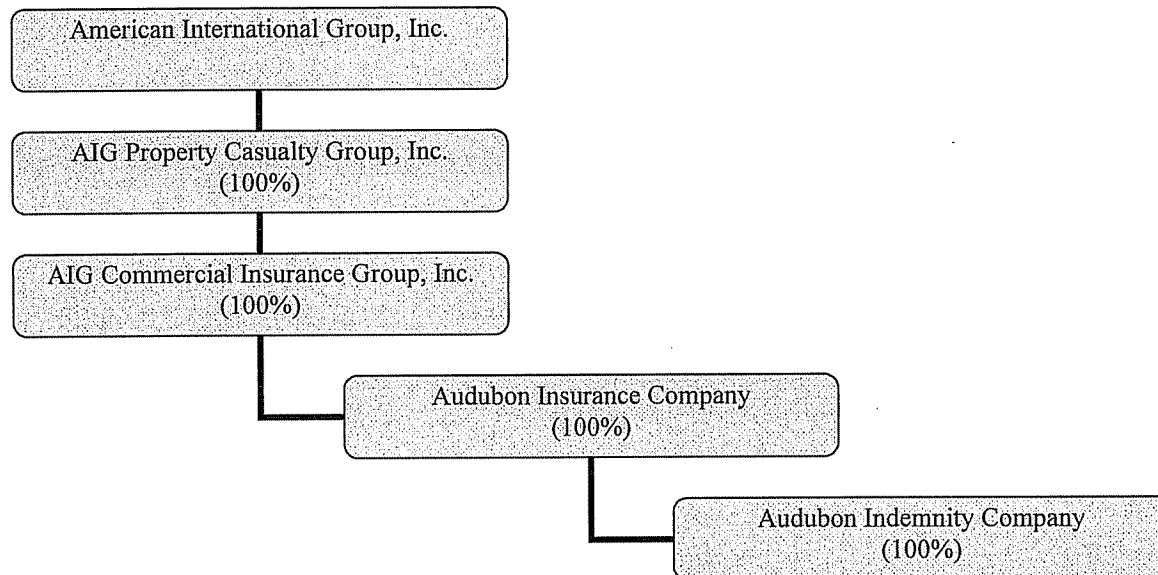
- 1) AIC Insurance Company was organized as a Mississippi company on September 4, 1980;
- 2) AIC Insurance Company was licensed in Mississippi on December 1, 1980;
- 3) Effective December 23, 1980, the Company merged into AIC Insurance Company, the survivor, which changed its name to Audubon Indemnity Company.

HOLDING COMPANY STRUCTURE

Organizational Structure

The Company was a member of an insurance holding company system, as defined in Miss. Code Ann. §83-6-1. The Company filed Holding Company Registration Statements with the MID in accordance with Miss. Code Ann. §§ 83-6-5 and 83-6-9. The statements and applicable amendments that were filed during the examination period were reviewed and it appeared that any changes and/or material transactions between the Company and its affiliates were reported. The Company was a wholly owned subsidiary of Audubon

Insurance Company and the ultimate controlling parent was American International Group, Inc. (AIG). The following chart depicts the Company's direct line of ownership at December 31, 2006.



Related Party Transactions

Tax Allocation Agreement: The Company entered into a tax allocation agreement with its ultimate parent company, AIG, for taxable years beginning January 1, 1982, whereby it was agreed that the Company's federal income tax returns would be filed on a consolidated basis with AIG and its domestic subsidiaries. Pursuant to the terms of this agreement, AIG agreed to prepare and file the consolidated return; not to charge the Company a greater portion of the consolidated tax liability than would have been paid by the Company if it had filed individually; and to reimburse the Company for any tax benefit arising from the use of any investment credits, foreign tax credits, net operating losses and/or capital losses of the Company.

Service Recovery Agreement: Effective February 10, 1993, the Company entered into an agreement with American International Recovery, Inc. (AI Recovery) whereby AI Recovery provided subrogation, liability deductible recovery and salvage activities. Under the terms of this agreement, the Company paid \$10,074, \$32,262 and \$88,272 for years 2006, 2005, and 2004, respectively.

Investment Management Agreement: Effective January 1, 1991, the Company entered into an agreement with AIG Global Investors, Inc. (AIG Global) whereby AIG Global agreed to serve as the Company's investment manager, subject to the direction of the Company's

Board of Directors. The amounts paid by the Company under the terms of this agreement totaled \$9,874 in 2006, \$11,198 in 2005 and \$8,037 in 2004.

Service and Expense Agreement: Effective January 15, 2003, the Company became a party to an existing agreement with AIG through which AIG and its subsidiaries provided various services, at cost, to the Company. The services provided under the terms of this agreement, as amended, included advertising, accounting, actuarial, legal, data processing and claims adjustment. As a part of this agreement the Company paid AIG Domestic Claims fees totaling \$2,687,784 during 2006.

MANAGEMENT AND CONTROL

Stockholders

The Company is a Mississippi domestic stock insurance company whose stock, at December 31, 2006, was wholly owned by Audubon Insurance Company and the ultimate controlling parent was AIG. No dividends were paid by the Company during the examination period.

Board of Directors

The Articles of Association and Bylaws vest the management and control of the Company's business affairs with the Board of Directors (Board). The members of the duly elected Board, along with their place of residence and principal occupation as of the examination date, follows:

Name and Place of Residence

Mr. Charles H. Dangelo
Manasquan, NJ

Mr. Neil A. Faulkner
Hockessin, DE

Mr. David N. Fields
New York, NY

Mr. David L. Herzog
St. Albans, MO

Mr. Kristian P. Moor
Farifield, CT

Mr. Win J. Neuger
New York NY

Mr. Robert S. Schimek
Newtown, PA

Principal Occupation

Vice President, Senior Reinsurance Officer
AIG

Operations Officer for Global Operations
and Systems Division, AIG

President of Risk Finance Profit Center
AIG

Senior Vice President & Comptroller
AIG

Executive Vice President
AIG

Executive Vice President and Chief
Investment Officer, AIG

Senior Vice President and Chief Financial
Officer for Domestic Brokerage Group, AIG

Officers

The following officers were duly elected by the Board and held the following offices as of December 31, 2006:

<u>Name</u>	<u>Title</u>
Mr. Kristian P. Moor	Chairman of the Board, President
Mr. Charles H. Dangelo	Senior Vice President
Mr. Frank H. Douglas, Jr.	Senior Vice President and Actuary
Mr. Kenneth V. Harkins	Senior Vice President and General Counsel
Mr. Robert P. Hubbard	Senior Vice President
Mr. William P. Kane, Jr.	Senior Vice President
Mr. Charles R. Schader	Senior Vice President
Mr. Robert S. Schimek	Senior Vice President and Treasurer
Mr. Claude J. Broussard, Jr.	Vice President
Mr. Carl E. Chamberlain	Vice President
Mr. Agustin Formoso, Jr.	Vice President
Mr. Andrew R. Holland	Vice President
Mr. Gary E. Muoio	Vice President
Mr. Richard T. Pisano	Vice President and Comptroller
Mr. James C. Roberts	Vice President
Mr. James J. Rowland	Vice President and Assistant Comptroller
Mr. Richard Ruggiano	Vice President
Mr. Ronald J. Topping	Vice President and Assistant Comptroller
Ms. Elizabeth M. Tuck	Secretary

Committees

As of the examination date, the Company had an Executive Committee of the Board and the following Board members served on this committee:

Mr. Charles H. Dangelo
Mr. David L. Herzog
Mr. Kristian P. Moor

Conflict of Interest

The Company had formal procedures whereby disclosure was made to the Board of any material interest or affiliation on the part of any officer or director that is, or would likely be, a conflict with their official duties. These procedures were reviewed and no conflicts or exceptions to the Company's policies were noted.

CORPORATE RECORDS

The minutes of the meetings of the Stockholders and Board, prepared during the period under examination, were reviewed and appeared to be complete with regard to the matters brought up at the meetings for deliberation, which included the approval and support of the Company's transactions and events, as well as the review of its audit, actuarial and

examination reports. It was noted, however, that the Company's Bylaws did not specifically prohibit the offices of president and treasurer from being held by the same person and this appeared to be in conflict with Miss. Code Ann. §83-19-15. This was discussed with the Company and an amendment to the Company's Bylaws correcting this situation was subsequently submitted to the MID.

FIDELITY BONDS AND OTHER INSURANCE

As a subsidiary of AIG, the Company participated in a comprehensive insurance program, whereby AIG maintained a financial institution bond containing a primary layer and four excess layers, with single loss coverage of \$145 million and aggregate coverage being \$285 million, which exceeded the minimum fidelity coverage recommended by the NAIC.

OFFICERS', EMPLOYEES', AND AGENTS' WELFARE

The Company did not have any direct employees but instead, pursuant to a service and expense agreement, received management services from its affiliates and its ultimate parent company, AIG.

REINSURANCE

During this examination period, the Company was party to the following reinsurance relationships and agreements:

- Quota Share Agreement with Audubon Insurance Company
Effective January 1, 1986, the Company entered into a quota share agreement whereby it ceded 100% of its net retained liability on property and casualty business.
- Quota Share Agreement with American International Insurance Company
The Company became a party to this agreement effective January 1, 2005, whereby it ceded 100% of the Private Client Group business written by AIG Marketing, Inc.
- In addition to the above, the Company had reinsured business with non-affiliates, which included property and casualty excess of loss treaties; as well as a casualty clash treaty and catastrophe excess of loss treaties. In each of these treaties, the Company ceded excess risk and retained specific amounts per treaty, which in turn were 100% ceded under the quota share treaty with Audubon Insurance Company. The Company did not place any new business with non-affiliated reinsurers during this examination period. Further, the Company was a servicing carrier for the Mississippi Residential Property Insurance Underwriting Association (MRPIUA); all business

written through this program was 100% reinsured by the Association. The Company ceased writing for MRPIUA effective March 1, 2007.

As a result of the treaties noted above, the Company had no retained liability, whether direct or assumed, on losses or loss adjustment expenses. The reinsured amounts at December 31, 2006 were as follows:

<u>Reinsurance ceded</u>	
Reinsurance premiums ceded	\$7,610,443
Reinsurance recoverable on paid losses and LAE	11,130,306
Reserve credits taken	28,258,000
Unearned premium ceded	3,511,475
<u>Reinsurance assumed</u>	
Premiums assumed	\$(20,000)
Assumed losses and LAE payable	175,054
Assumed reserves for losses and LAE reported	734,027
Assumed unearned premium	541

ACCOUNTS AND RECORDS

The Company maintained its accounting and policy maintenance records through the utilization of a mainframe computer running IBM Z/OS operating system. The mainframe environment worked in conjunction with the Company's client-server environment which utilized UNIX Solaris 8 operating system. The annual audits were conducted by the certified public accounting firm of PricewaterhouseCoopers, LLP (PWC).

In March 2005, following the receipt of subpoenas and commencement of investigations by various regulatory agencies, AIG's previous Chief Executive Officer retired and the previous Chief Financial Officer resigned. AIG's current management, along with its independent auditors, initiated a comprehensive review of AIG and its subsidiaries' books and records. Based upon this review, management concluded that AIG's disclosure controls and procedures were ineffective. Control deficiencies were noted in the following areas:

- Control environment
- Controls over the evaluation of risk transfer
- Controls over certain balance sheet reconciliations
- Controls over accounting for certain derivative transactions
- Controls over income tax accounting
- Controls over reinsurance transactions

Throughout 2005 and 2006, AIG devoted significant efforts towards the remediation of the control deficiencies listed above. However, in conjunction with its 2006 audit report, AIG's independent auditors issued a letter regarding material weaknesses and significant

deficiencies in AIG and its subsidiaries' internal control structure. The material weaknesses noted within the 2006 letter included the following:

- Accounting for Income Tax: Noted progress was made in the plan to remediate the material weakness with respect to the accounting for income tax. However, effective controls were not maintained over the determination and reporting of certain components of the provision for income tax and the related deferred income tax balances.
- Controls over Reinsurance transactions: Noted progress was made in the plan to remediate the material weakness with respect to reinsurance. However material weaknesses remained over the monitoring, accuracy, completeness, and reporting of certain reinsurance transactions.

Additionally, the following significant deficiencies related to internal controls were noted during the audit of AIG and its subsidiaries: Balance Sheet Reconciliations, Logical Security, Financial Close Process and Agency Integration.

Management continues to assign the highest priority to the remediation of AIG's internal control systems with the goal of completing the remediation efforts by year-end 2007. As disclosed in AIG's 2006 10-K filing, due to the nature of the remediation process, there is no assurance that a complete remediation, including the testing and implementation of new control processes, will be completed within that time frame.

In connection with the control deficiencies and remediation processes discussed above, the Company set up an allowance provision for identified and potential exposures within certain operational areas in accordance with Financial Accounting Standards No. 5 – Accounting for Contingencies (FAS 5). As of the examination date the total FAS 5 allowance totaled approximately \$2.6 million.

During the course of the examination numerous issues related to the lack of timely balance sheet account reconciliations and other internal control weaknesses discussed above were encountered by the examiners. These issues required the examiners to implement alternate procedures in order to ascertain the reliability of the information provided which increased the time necessary to perform the examination. It is recommended that the Company and AIG continue remediation efforts in order to implement the internal controls necessary to ensure the completion of timely account reconciliations and applicable journal entries needed to reflect appropriate reporting period balances.

STATUTORY DEPOSITS

The Company's statutory deposits with the State of Mississippi complied with Miss. Code Ann. §83-15-5(2). The following chart displays the Company's deposits at December 31, 2006.

Description of Security	State Deposited	Book Value	Fair Value
Bond	Arkansas	\$199,236	\$214,006
Bond	Louisiana	199,236	214,006
Bond	Mississippi	1,270,853	1,376,337
Bond	New Mexico	298,854	321,009
Bond	South Carolina	401,777	398,736

FINANCIAL STATEMENTS

The following financial statements, as determined by the examination, consist of a Statement of Admitted Assets, Liabilities, Surplus and Other Funds at December 31, 2006, a Statement of Income for year ended December 31, 2006, a Reconciliation of Capital and Surplus for examination period ended December 31, 2006, and a Reconciliation of Examination Changes to Surplus and Other Funds for Year Ended December 31, 2006.

AUDUBON INDEMNITY COMPANY
STATEMENT OF ADMITTED ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS
DECEMBER 31, 2006

Admitted Assets

Bonds	\$9,139,764
Cash and short-term investments	15,876,797
Investment income due and accrued	167,249
Uncollected premiums	72,722
Amounts recoverable from reinsurers	11,130,306
Federal income tax recoverable	236,049
Net deferred tax asset	244,793
Receivable from parent, subsidiaries and affiliates	1,071,022
Outstanding loss drafts	1,664,781
Salvage and subrogation recoverable	<u>130,833</u>
Total Admitted Assets	<u>\$39,734,316</u>

Liabilities, Surplus and Other Funds

Reinsurance payable on paid losses and LAE	\$175,054
Taxes, licenses and fees due or accrued	465,495
Ceded reinsurance premiums payable	47,980
Funds held by company under reinsurance contracts	3,069,043
Provision for reinsurance	4,362,569
Payable to parent, subsidiaries and affiliates	123,424
Deferred fair plan fee income	293,180
Allowance for doubtful accounts	2,590,399
Escheat funds	<u>1,151</u>
Total Liabilities	<u>11,128,295</u>
Common capital stock	2,000,000
Gross paid in and contributed surplus	2,800,000
Unassigned funds	<u>23,806,021</u>
Total Surplus as Regards Policyholders	<u>28,606,021</u>
Total Liabilities, Surplus and Other Funds	<u>\$39,734,316</u>

**AUDUBON INDEMNITY COMPANY
STATEMENT OF INCOME
FOR YEAR ENDED DECEMBER 31, 2006**

INCOME:

Net service fee income	\$246,831
Net investment income earned	1,238,552
Net realized capital gains	2,590
Other income	<u>16,094</u>

Total Income 1,504,067

DEDUCTIONS:

Loss from agents' or premium balances charged off 4,188,225

Net loss before federal income taxes (2,684,158)

Federal income taxes (1,175,431)

Net loss \$ (1,508,727)

**AUDUBON INDEMNITY COMPANY
RECONCILIATION OF CAPITAL AND SURPLUS
FOR EXAMINATION PERIOD ENDED DECEMBER 31, 2006**

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Surplus as regards policyholders, beginning of year	\$33,283,710	\$37,148,268	\$28,496,969
Net income (loss)	1,283,074	690,834	(1,508,727)
Change in unrealized capital gains (losses)	(3,922)	5,816	0
Change in net deferred income tax	0	(292,273)	(561,188)
Change in non-admitted assets	0	(1,084,971)	1,084,732
Change in provision for reinsurance	2,586,472	(6,244,030)	2,202,456
Prior year corrections	(1,066)	(1,726,675)	0
Examination adjustments	<u>0</u>	<u>0</u>	<u>(1,108,221)</u>
Surplus as regards policyholders, end of year	<u>\$37,148,268</u>	<u>\$28,496,969</u>	<u>\$28,606,021*</u>

*The Company's surplus and other funds, as determined by the examination, was in compliance with Miss. Code Ann. §83-19-31.

AUDUBON INDEMNITY COMPANY
RECONCILIATION OF EXAMINATION CHANGES TO SURPLUS AND OTHER FUNDS
FOR YEAR ENDED DECEMBER 31, 2006

<u>ASSETS</u>	<u>BALANCE PER ANNUAL STATEMENT</u>	<u>BALANCE PER EXAMINATION</u>	<u>INCREASE (DECREASE) IN SURPLUS</u>
Cash and short term investments	\$15,896,903	\$15,876,797	\$(20,106)
Federal income tax	1,603,554	236,049	(1,367,505)
Net deferred tax asset	0	244,793	244,793
 <u>LIABILITIES</u>			
Net deferred tax liability	106,456	0	106,456
Payable to PSA	103,827	123,424	(19,597)
Allowance for doubtful accounts	2,538,137	2,590,399	<u>(52,262)</u>
Total adjustments to surplus			(1,108,221)
Surplus as regards policyholders, per annual statement			<u>29,714,242</u>
Surplus as regards policyholders, per examination			<u>\$ 28,606,021</u>

COMMENTS ON FINANCIAL STATEMENTS

Bonds **\$9,139,764**

The above captioned amount is the same as the amount reported by the Company in the filed annual statement. It was noted during the review of bonds that the Company's safekeeping agreement with Mellon bank did not conform to the requirements established by the NAIC. Subsequent to the examination date, a revised safekeeping agreement was submitted by the Company and approved by the MID.

Cash and Short-Term Investments **\$15,876,797**

The above captioned amount is \$20,106 less than that amount reported by the Company in the filed annual statement. This examination adjustment was necessary in order to adjust the Company's cash to its proper balance as of the examination date.

Federal Income Tax Recoverable **\$236,049**

The above captioned amount is \$1,367,505 less than the amount reported by the Company in the filed annual statement. This examination adjustment was due to the Company incorrectly reporting the amount recoverable for its 2006 federal income taxes.

Net Deferred Tax Asset **\$244,793**

The above captioned amount is \$244,793 more than the amount reported by the Company in the filed annual statement. This examination adjustment was necessary in order to adjust the Company's reported net deferred tax component to its correct calculated balance as of the examination date.

Net Deferred Tax Liability **\$0**

The above captioned amount is \$106,456 less than the amount reported by the Company in the filed annual statement. See the above explanation for the Net Deferred Tax Asset examination adjustment.

Payable to Parent, Subsidiaries and Affiliates **\$123,424**

The above captioned amount is \$19,597 more than the amount reported by the Company in the filed annual statement. This examination adjustment was necessary in order to increase this payable to its appropriate balance as of the examination date.

Allowance for Doubtful Accounts **\$2,590,399**

The above captioned amount is \$52,262 more than the amount reported by the Company in the filed annual statement. This examination adjustment relates to changes in the calculation of the Company's FAS 5 reserve relating to its allowance for outstanding loss drafts. See the Accounts and Records write-up (Page 8) for additional information regarding the Company's FAS 5 reserve.

MARKET CONDUCT ACTIVITIES

A full market conduct examination, in accordance with the NAIC's Market Conduct Handbook, was not performed; however, particular areas of the Company's market conduct were examined in connection with the financial examination, and no significant exceptions were noted. The particular areas reviewed are as follows:

Complaint Handling

The majority of the complaints filed with the MID against the Company related to Hurricane Katrina claims. A sample of complaint files were reviewed and no policyholder abuse or undesirable patterns were noted.

Marketing and Sales

The Company, during the period under examination, acted as a servicing carrier for MRPIUA. Additionally the Company wrote renewal homeowners policies for AIG's Private Client Group.

Producer Licensing

The Company's main source of business was as a servicing carrier of MRPIUA and thus agents were not utilized by the Company.

Underwriting and Rating

The Company had appropriate licensure to issue its products, and the applicable policy forms were submitted to the MID.

Claims

A representative sampling of claims paid by the Company, for the period under examination, were selected and reviewed. No policyholder abuse or undesirable patterns were noted during the course of this review.

Territory and Plan of Operation

The Company was licensed to issue property and casualty business in the State of Mississippi and was an eligible surplus lines insurer in eleven states. During the examination period, the Company's new business offerings were primarily limited to policies written as a servicing carrier for the Mississippi Residential Property Insurance Underwriting Association (MRPIUA).

Privacy

The Company had a privacy policy in place for the protection of its policyholders, and this policy appeared to be in compliance with applicable laws and standards.

COMPLIANCE WITH PREVIOUS EXAMINATION RECOMMENDATIONS

1. It was noted in the previous examination report that the Company's custodial agreements did not meet the requirements as set forth by the NAIC.

Corrective Action: This situation also applied to the current examination as the Company's custodial agreement with Mellon Bank did not conform to the NAIC's requirements. However, subsequent to the examination date, a revised safekeeping agreement was submitted by the Company and approved by the MID.

2. It was recommended in the previous examination report that the Company maintain all documents relating to its affairs pursuant to Miss Code Ann. § 83-5-207(2).

Corrective Action: As discussed within the Accounts and Records write-up (Page 8), in some instances during this examination the Company was unable to provide properly reconciled support for the reporting period balances. The Company and AIG continue remediation efforts in order to implement the necessary internal controls to prevent this situation in the future.

COMMITMENTS AND CONTINGENCIES

At December 31, 2006, the Company was involved as a defendant in various litigation matters. Although the outcome of such legal actions cannot be predicted, in the opinion of management and its legal representatives, the resolution of any currently pending or threatened actions should not have a material adverse effect on the surplus position of the Company.

SUBSEQUENT EVENTS

In February 2007, the Company entered into a Capital Maintenance Agreement (CMA) with AIG. The CMA provides that in the event that the Company's total adjusted capital falls below 200% of the Company's authorized control level Risked Based Capital (RBC), as reported in the 2006 filed annual statement, AIG will provide a capital contribution to the Company in an amount equal to the difference between the Company's total adjusted capital and 200% of the Company's authorized control level RBC. In lieu of making any such capital contribution, upon the approval of the MID, AIG may provide a letter of credit naming the Company as beneficiary. This current CMA supersedes and replaces similar agreements in place during 2005 and 2006 relating to the Company's 2004 and 2005 surplus positions, respectively.

The Company's servicing agreement with MRPIUA terminated effective March 1, 2007. Policies in force and written through the Company will remain on Company paper until renewal or cancellation. As of the report date, management is uncertain of the future business plan for the Company.

COMMENTS AND RECOMMENDATIONS FOR CURRENT EXAMINATION

1. Accounts and Records: It was recommended that the Company continue remediation efforts in order to implement the necessary internal controls to ensure the completion of timely account reconciliations and applicable journal entries to reflect appropriate reporting period balances. (Page 8)


ACKNOWLEDGEMENT

In addition to the undersigned, the examiners representing the Mississippi Insurance Department who participated in the examination of the Company are listed below.

Manager:	Mr. Joseph R. May, CFE, CPA, CMA, CIE
Assisting Examiner:	Mrs. Kimberly Strong, CFE
Examination Actuary:	Mr. Matthew Merlino, FCAS, MAAA, FCA
Automation:	Mr. J. Scott Joyner, CISA, AES, CGAP

The courteous cooperation extended by the Company and its affiliates is hereby acknowledged and appreciated.

Respectfully,


R. Dale Miller, CFE, CPA
Examiner-In-Charge