

Des Moines, Iowa
October 6, 2003

HONORABLE ALFRED W. GROSS
Commissioner of Insurance
Commonwealth of Virginia
Chair, Financial Condition (E)
Committee, N.A.I.C.
Richmond, Virginia

HONORABLE SALLY MCCARTY
Commissioner of Insurance
State of Indiana
Secretary, Midwestern Zone, N.A.I.C.
Indianapolis, Indiana

HONORABLE THERESE M. VAUGHAN
Commissioner of Insurance
State of Iowa
Des Moines, Iowa

Commissioners:

In accordance with your respective authorizations and pursuant to Iowa statutory provisions, an Association Examination has been made of the records, affairs and financial condition of the

MERCHANTS BONDING COMPANY (MUTUAL)

DES MOINES, IOWA

AS OF DECEMBER 31, 2002

at the Company's Home Office, 2100 Fleur Drive, Des Moines, Iowa.

INTRODUCTION

The Merchants Bonding Company (Mutual), hereinafter referred to as the "Company", was last examined under the Association Plan by the Iowa Insurance Division as of December 31, 1998. This was the regular comprehensive financial examination of the Company, as granted by authority under Iowa statute 507.2, covering the intervening period from December 31, 1998 to the close of business on December 31, 2002, including any material transactions and/or events occurring and noted subsequent to the examination date. Concurrently with the examination of the Company, the Company's affiliate via interlocking directors, Northern Casualty Company (Mutual), was also examined. The examination reported herein was conducted under the Association Plan by the Iowa Insurance Division, representing the Midwestern Zone.

SCOPE OF EXAMINATION

During the course of the examination, which was conducted in accordance with the procedures recommended by the Financial Condition (E) Committee of the N.A.I.C., a general review and survey was made of the Company's operations and business transactions during the stated period. Accounting methods, internal control procedures, records and other supporting evidences were examined or tested by appropriate method to the extent deemed necessary. The Company's assets were verified and evaluated and the liabilities determined to reflect herein a statement of its financial condition as of December 31, 2002.

In addition, the working papers of the Company's independent auditors were made available for review and copies of those deemed useful to the examination were requested. These workpapers were tested for reliance and have been included as part of the examination work files.

HISTORY

The Company was incorporated in 1933 under the name Merchants Mutual Bonding Company. It commenced business in 1934 writing fidelity and surety bonds and insuring against the loss or damage resulting from burglary or robbery, as then permitted by Iowa statutes. The Articles of Incorporation were amended in 1972 authorizing the Company to write multiple lines of business in accordance with Chapter 515, Section 515.48, Code of Iowa.

The corporate name was officially changed to Merchants Bonding Company (Mutual) on April 18, 1981.

The corporate existence of the Company was renewed for perpetual existence beginning March 30, 1991.

MUTUAL HOLDING COMPANY SYSTEM

The Company is a member of an Insurance Holding Company System as defined by Chapter 521A, Code of Iowa. The Company is affiliated with Northern Casualty Company (Mutual), an Iowa insurance corporation, via interlocking directors. Except for directors' qualifying policies, all of Northern Casualty's business is assumed from the Company through a twelve percent quota share reinsurance arrangement.

At December 31, 1998 the Company held all of the outstanding stock of MBC, Inc., an Iowa corporation that operated as an investment holding company and an insurance agency doing business primarily with its parent company. This corporation was dissolved effective July 15, 1999 with a reported book value of \$453,809 and for consideration of \$898,678.

MANAGEMENT AND CONTROL

MEMBERSHIP

Every person, firm, corporation or association having any insurance or bond in the Company shall be a member thereof during the term that such insurance or bond is in force. A member may have more than one policy or bond, and shall be entitled to vote at regular or special meetings, but no member shall be entitled to more than one vote.

The Articles of Incorporation provide for the annual meeting of the membership to be held at the Home Office and shall be convened between the hours of 10:00 a.m. and 2:00 p.m. on the Saturday that precedes Easter Sunday of each calendar year. Special meetings may be called by three-fifths of the members of the Board of Directors or by a majority of members holding policies or bonds in the Company when such meeting is called.

One plus the number of members on the Board shall constitute a quorum for the transaction of business at an annual or special meeting but a lesser number may adjourn from time-to-time.

BOARD OF DIRECTORS

The Articles of Incorporation provide that the affairs and business of the Company shall be managed by a Board of Directors consisting of at least five nor more than seven directors. The Board of Directors shall be divided into five classes. The election of directors shall be by ballot at each annual meeting. Directors of the class whose terms expire shall be elected for a term of five years and in such number as shall be determined at such meeting.

The Articles also provide that regular meetings of the Board of Directors shall be held quarterly with the meeting held immediately following the annual meeting of the membership designated as the annual meeting of the Board of Directors. Special meetings of the Board may be called by the President or by any three members of the Board of Directors upon written notice.

Elected and qualified members serving as directors at December 31, 2002 were as follows:

<u>Name</u>	<u>Principal Business Affiliation</u>	<u>Term Expires</u>
Lawrence B. Taylor Des Moines, Iowa	President and Chairman Merchants Bonding Company (Mutual)	2003
Janet Taylor Des Moines, Iowa	Not Employed	2004
William W. Warner, Jr. Milton, Florida	Director and Secretary Merchants Bonding Company (Mutual)	2004
Melissa A. Warner Des Moines, Iowa	Director and Secretary/Treasurer Northern Casualty Company (Mutual)	2005
William N. Taylor Englewood, Colorado	Major Account Manager Cisco Systems	2006
Jeffrey W. Taylor Cary, North Carolina	Director of Marketing Nortel Networks	2007
Lloyd B. Taylor Des Moines, Iowa	Retired Vice President Cargill Inc.	2007

Each of the Board members is a member of the Board of Directors of Northern Casualty Company (Mutual). All directors are related family members.

Directors receive \$2,000 per meeting, whether attended or not. The Company shares the cost of directors' incurred travel expenses with Northern Casualty Company (Mutual).

EXECUTIVE COMMITTEE

The Bylaws require that the Board of Directors shall annually appoint an Executive Committee of at least three directors and/or officers. The President shall be a member ex-officio of this committee. This committee shall assist the Board of Directors in the management of the affairs of the Company and shall discharge other duties as delegated to it by resolution of the Board of Directors. Members serving on this committee were:

<u>Name</u>	<u>Office</u>
Lawrence B. Taylor	President and Chairman
William W. Warner, Jr.	Secretary
Wefel W. Warner	Chairman of the Board (Emeritus)
Stanley P. McCormack	Executive Vice President
Mike P. Foster	Executive Vice President
Edwin L. DeKock	Treasurer

OTHER COMMITTEES

The Board of Directors may also establish other committees from time-to-time to discharge such duties as the Board of Directors shall establish. Other committees established were:

<u>Compensation Committee</u>	<u>Advisory</u>
Lawrence B. Taylor	Wefel W. Warner
Melissa A. Warner	Denine Taylor
Wefel W. Warner	

OFFICERS

The Articles prescribe that the Board of Directors annually elects a President, a Vice President, a Secretary, a Treasurer and such other officers as may be necessary for the conduct of business. The offices of the Treasurer and Vice President may be combined with any other office at the discretion of the Board of Directors.

Duly elected officers serving at December 31, 2002 were:

<u>Name</u>	<u>Title</u>
Wefel W. Warner	Chairman of the Board (Emeritus)
Lawrence B. Taylor	Chairman of the Board and President
Stanley P. McCormack	Executive Vice President - Claims
Mike P. Foster	Executive Vice President - Underwriting
Edwin L. DeKock	Treasurer
William W. Warner, Jr.	Secretary
Karl Williamson	Vice President
Rob Freel	Assistant Vice President
Curt Hartter	Assistant Vice President
Audrey Williams	Assistant Vice President
Kim Wells	Assistant Vice President
Jacki Kragel	Assistant Secretary

The salaries of officers are shown in Exhibit "A".

CONFLICT OF INTEREST

The Company has an established procedure for annual disclosure to its Board of Directors of any material interest or affiliation of its officers or directors which is in conflict with their duties. The disclosures were found to be signed annually by directors and officers with no material conflicts noted.

CORPORATE RECORDS

The Articles of Incorporation were not amended during the examination period. The Bylaws were amended at the directors meeting held November 16, 2002. The amendment outlined the duties of the Secretary and the makeup of the Executive Committee.

The minutes of the policyholders, Board of Directors and Executive Committee were read and noted. The examination report as of December 31, 1994 was accepted at the Board of Directors meeting held November 24, 1999. The examination report as of December 31, 1998 was accepted at the Board of Directors meeting held April 22, 2000.

FIDELITY BONDS AND OTHER INSURANCE

A \$3,000,000 fidelity bond that meets the N.A.I.C. recommended minimum amount covers the Company and named affiliates. Other coverages in place appear to adequately protect the interests of the Company. All policies are written with companies authorized to write in Iowa.

EMPLOYEE WELFARE

Full-time eligible employees are provided group health/medical and dental coverage on a contributory basis. Group life insurance benefits and group long-term disability insurance is provided on a non-contributory basis. Employees may participate in a retirement 401(k) savings plan. The Company will match employee contributions by fifty percent up to two percent of their annual salary.

REINSURANCE

Surplus Share

The Company automatically cedes to the Company's affiliate, Northern Casualty Company (Mutual), twelve (12) percent of all contract surety bonds between \$1 and \$100,000. The maximum amount of risk that is ceded on any one contract bond is \$12,000 and in event of a claim, Northern Casualty's liability will not exceed \$20,000 on any one account, notwithstanding the number of bonds which are involved. The Company receives a 42.5 percent direct ceding commission on net premiums written. In addition to the direct commission the Company receives a contingent commission of forty percent of the net underwriting profit.

The Company has a surplus share treaty with three authorized reinsurers for the automatic cession of 100 percent of the Company's surety bonds above its net retention. The Company's net retention is determined according to the amount of the bond, with the reinsurer accepting the excess. The Company's cession levels in effect at December 31, 2002 were as follows:

<u>Bond Amount</u>	<u>Percent Ceded</u>
\$ 1 - \$ 199,999	0%
200,000 - 499,999	50
500,000 - 7,500,000	80

Excess of Loss

The Company has an excess of loss treaty whereby the reinsurer shall be liable for an amount not to exceed \$2,000,000 ultimate net loss, any one loss, any one Principal in excess of the Company's retention of \$500,000. The aggregate limit of liability for losses discovered during any one agreement year is \$3,000,000 all Principals, all losses.

COMMITMENTS AND CONTINGENT LIABILITIES

An executive compensation agreement provides for death benefits, an annuity to be paid to the surviving spouse and monthly disability payments upon termination due to any disability. No funds will be set aside to pay such amounts and the Company's obligations to pay such amounts shall be treated as a general asset of the Company subject to the claims of creditors. The Company reserves the right to terminate or suspend annuity payments in the event that the continued viability of the operations of the Company is or may be threatened for any reason.

The Company has in place employment agreements with executive officers. The agreements stipulate the gross salary and bonus compensation.

An executive bonus plan that provides for an additional bonus that shall be applied as premium on a life insurance policy is also available to select executive officers.

STATUTORY DEPOSIT

The statement value of special deposits held in trust, which are not held for the protection of all policyholders of the Company, are as follows:

Arkansas	\$408,815
Georgia	35,000
Michigan	440,432
New Mexico	100,500
North Carolina	100,090
South Carolina	352,232
Virginia	399,711

The statement value of special deposits held in trust for the protection of all policyholders is \$2,080,345 as of December 31, 2002.

TERRITORY AND PLAN OF OPERATION

The Company specializes in writing all major classes of surety bonds, including contract surety; bid, performance and payment bonds; licenses and permit bonds; court/judicial and various classes of commercial surety. Business is produced through approximately 2,300 independent agencies. All policies are issued on a non-assessable basis and rates are developed based on the Company's own loss experience.

The Company is authorized to write business in the following jurisdictions:

Alabama	Kentucky	Oklahoma
*Alaska	Louisiana	Oregon
Arizona	Maryland	Pennsylvania
Arkansas	Michigan	South Carolina
California	Minnesota	South Dakota
Colorado	Mississippi	Tennessee
Delaware	Missouri	Texas
District of Columbia	Montana	Utah
Florida	Nebraska	Virginia
Georgia	Nevada	Washington
Idaho	*New Jersey	West Virginia
Illinois	New Mexico	Wisconsin
Indiana	North Carolina	Wyoming
Iowa	North Dakota	
Kansas	Ohio	

*States entered into during the examination period.

GROWTH OF COMPANY

The following historical data, taken from the office copies of the Company's filed annual statements for the years indicated, reflects the progressive surplus growth of the Company:

<u>Year</u>	<u>Admitted Assets</u>	<u>Surplus as Regards Policyholders</u>	<u>Net Premiums Earned</u>	<u>Net Losses Incurred</u>	<u>Investment Income Earned</u>
1998	\$37,298,481	\$23,281,641	\$15,624,398	\$1,528,168	\$1,483,900
1999	39,585,612	25,989,112	16,019,015	718,366	1,537,575
2000	43,437,294	28,968,861	15,990,154	1,174,317	1,702,834
2001	44,743,284	30,161,377	17,169,623	2,854,608	1,813,615
2002	45,121,932	31,473,719	18,240,181	2,142,832	1,679,553

ACCOUNTS AND RECORDS

Office copies of the filed annual statements for the years under review were found to be in agreement with or reconciled to the general ledger balances of assets, liabilities, and income and disbursements.

Based on a review of the information system, it is recommended that the Company create a Disaster Recovery Plan specific for the Information Technology department.

The Company failed to disclose the Reinsurance Assumed and Ceded table for a) return of commission which would have been due if all reinsurance were canceled, and b) accrual of additional or return commissions predicated on loss experience from profit sharing arrangements: in accordance with the Statements of Statutory Accounting Principles - Chapter 62.70.

SUBSEQUENT EVENT

At the Board of Directors meeting held November 16, 2002, the Company organized and capitalized a wholly owned subsidiary, Nations Bonding Company, a Texas domiciled surety insurer. The Company transferred \$2,500,000 in exchange for 100,000 shares of \$10 par value common stock. Initial fully paid common capital stock is \$1,000,000 and paid in and contributed surplus is \$1,500,000. Nations Bonding Company was incorporated effective April 15, 2003. The Company also entered into a Management Services Agreement and Reinsurance Agreement with Nations Bonding Company.

ASSETS

	<u>Ledger</u>	Not <u>Admitted</u>	<u>Admitted</u>
Bonds	\$28,761,447	\$	\$28,761,447
Preferred stocks	1,067,614		1,067,614
Common stocks	4,668,591		4,668,591
Real estate: properties occupied by the Company	1,208,076		1,208,076
Real estate: properties held for income	216,623		216,623
Cash and short-term investments	6,085,551	2,425,862	3,659,689
Agents' balances in course of collection	2,920,447	409,520	2,510,927
Reinsurance recoverable on loss and lae payments	147,326		147,326
EDP equipment and software	27,665		27,665
Interest and dividend income due and accrued	428,112		428,112
Other assets nonadmitted	104,986	104,986	
401(k) - Non-vested portion	17,990	17,990	
Statutory provision 515.35(4)(n)(1)	<u> </u>	<u>(2,237,164)</u>	<u>2,237,164</u>
 Total assets	 <u>\$45,654,428</u>	 <u>\$ 721,194</u>	 <u>\$44,933,234</u>

LIABILITIES, SURPLUS AND OTHER FUNDS

Losses		\$ 2,111,211
Loss adjustment expenses		1,436,122
Other expenses		740,791
Taxes, licenses and fees		387,628
Federal income taxes		218,763
Unearned premiums		7,616,648
Dividends declared and unpaid - policyholders		1,127,096
Ceded reinsurance premiums payable		(651,996)
Amounts withheld for account of others		<u>661,950</u>
 Total liabilities		 \$13,648,213
 Surplus as regards policyholders		 <u>31,285,021</u>
 Total liabilities and surplus		 <u>\$44,933,234</u>

UNDERWRITING AND INVESTMENT EXHIBIT

STATEMENT OF INCOME

Underwriting Income

Premiums earned \$18,240,181

Deductions

Losses incurred \$ 2,142,832
Loss expenses incurred 1,314,621
Other underwriting expenses incurred 12,736,342
Total underwriting deductions 16,193,795

Net underwriting gain (loss) \$ 2,046,386

Investment Income

Net investment income earned \$ 1,679,553
Net realized capital gains (losses) (172,726)
Net investment income 1,506,827

Other Income

Net gain or (loss) from agents' balances charged off \$ (1,670)
Aggregate write-ins for miscellaneous income 24,995
Total other income 23,325

Net income before dividends to policyholders and Federal income taxes \$ 3,576,538

Dividends to policyholders 450,319

Net income after dividends to policyholders and before Federal income taxes \$ 3,126,219

Federal and foreign income taxes incurred 1,002,829

Net income \$ 2,123,390

CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders, December 31, 2001 \$30,161,377

Gains and (Losses) in Surplus

Net income \$ 2,123,390
Net unrealized capital gains or (losses) (3,645,248)
Change in net deferred income tax 346,353
Change in nonadmitted assets 59,710
Change in 401(k) - non-vested portion 2,275
Statutory provision 515.35(4)(n)(1) 2,237,164

Change in surplus as regards policyholders for the year \$ 1,123,644

Surplus as regards policyholders, December 31, 2002 \$31,285,021

CASH FLOW

Cash from Operations

Premiums collected net of reinsurance	\$17,180,611	
Loss and loss adjustment expenses paid	3,459,498	
Underwriting expenses paid	<u>12,849,306</u>	
Cash from underwriting		\$ 871,807
Net investment income		1,893,425
Other income:		
Agents' balances charged off	\$ (1,670)	
Net amount withheld or retained for account of others	7,477	
Aggregate write-ins for miscellaneous items	<u>24,995</u>	
Total other income		30,802
Dividends to policyholders		279,297
Federal income taxes (paid) recovered		<u>(512,829)</u>
Net cash from operations		<u>\$2,003,908</u>

Cash from Investments

Proceeds from investments sold, matured or repaid:		
Bonds	\$ 9,012,000	
Stocks	<u>239,304</u>	
Total investment proceeds		\$9,251,304
Cost of investments acquired (long-term only):		
Bonds	\$ 7,883,669	
Stocks	1,313,253	
Real estate	<u>59,341</u>	
Total investments acquired		<u>9,256,263</u>
Net cash from investments		<u>\$ (4,959)</u>

Cash from Financing and Miscellaneous Sources

Cash provided:		
Other cash provided	\$ 197,603	
Net cash from financing and miscellaneous sources		<u>\$ 197,603</u>

Reconciliation of Cash and Short-Term Investments

Net change in cash and short-term investments		\$2,196,552
Cash and short-term investments:		
Beginning of year		<u>3,888,999</u>
End of year		<u>\$6,085,551</u>

UNDERWRITING AND INVESTMENT EXHIBIT
FOUR-YEAR PERIOD ENDING DECEMBER 31, 2002

STATEMENT OF INCOME

<u>Underwriting Income</u>		
Premiums earned		\$67,418,973
<u>Deductions</u>		
Losses incurred	\$ 6,890,123	
Loss expenses incurred	3,548,820	
Other underwriting expenses incurred	<u>48,081,291</u>	
Total underwriting deductions		<u>58,520,234</u>
Net underwriting gain (loss)		\$ 8,898,739
<u>Investment Income</u>		
Net investment income earned	\$ 6,733,577	
Net realized capital gains (losses)	<u>230,178</u>	
Net investment income		6,963,755
<u>Other Income</u>		
Net gain or (loss) from agents' balances charged off	\$ (31,861)	
Aggregate write-ins for miscellaneous income	<u>79,891</u>	
Total other income		<u>48,030</u>
Net income before dividends to policyholders and Federal income taxes		\$15,910,524
Dividends to policyholders		<u>1,504,615</u>
Net income after dividends to policyholders and before Federal income taxes		\$14,405,909
Federal and foreign income taxes incurred		<u>4,885,113</u>
Net income		<u>\$ 9,520,796</u>

CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders, December 31, 1998		<u>\$23,281,641</u>
<u>Gains and (Losses) in Surplus</u>		
Net income		\$ 9,520,796
Net unrealized capital gains or (losses)		(4,105,792)
Change in excess of statutory reserves over statement reserves		(41,970)
Change in net deferred income tax		544,185
Change in nonadmitted assets		(163,539)
Cumulative effect of changes in accounting principles		10,261
Change in 401(k) - non-vested portion		2,275
Statutory provision 515.35(4)(n)(1)		<u>2,237,164</u>
Change in surplus as regards policyholders for the period		<u>\$ 8,003,380</u>
Surplus as regards policyholders, December 31, 2002		<u>\$31,285,021</u>

STATEMENT OF SURPLUS DIFFERENCES

	<u>Per Company</u>	<u>Per Exam</u>	<u>Surplus Increase (Decrease)</u>
<u>Assets</u>			
Cash and short-term investments	\$6,085,551	\$3,659,689	\$(2,425,862)
Statutory provision 515.35(4)(n)(1)		2,237,164	<u>2,237,164</u>
Net change in surplus per examination			\$ (188,698)
Surplus as regards policyholders, per Company			<u>31,473,719</u>
Surplus as regards policyholders, per examination			<u>\$31,285,021</u>

COMMENTS

Cash and short-term investments \$3,659,689

The Company held money market securities, reported as short-term investments, in excess of the amount allowed under Iowa Insurance Code 515.35(4)(f)(2).

Statutory provision 515.35(4)(n)(1) \$2,237,164

The amount of \$2,237,164 has been allowed as an admitted asset under Iowa Insurance Code 515.35(4)(n)(1).

CONCLUSION

The cooperation and assistance extended by the officers and employees of the Company during the course of this examination is hereby acknowledged.

In addition to the undersigned, Joseph W. Detrick, AFE, CPA, Marvin R. Minor and Melissa R. Johnson, examiners for the Iowa Insurance Division, participated in the examination and preparation of this report.

A review of losses and related items was performed under the direction of Ramona Lee, ACAS, Actuarial Administrator for the Iowa Insurance Division.

Respectfully submitted,

VIRGINIA R. WEST, CFE
Examiner-in-charge
Insurance Division
State of Iowa

EXHIBIT "A"

The salaries, including bonuses, of the Company's elected and appointed officers for the year ended December 31, 2002 were as follows

<u>Name</u>	<u>Title</u>	<u>Remuneration</u>
Wefel W. Warner	Chairman of the Board (Emeritus)	\$282,400
Lawrence B. Taylor	Chairman of the Board & President	178,000
Stanley P. McCormack	Executive Vice President	216,000
Mike P. Foster	Executive Vice President	158,400
Edwin L. DeKock	Treasurer	124,000
William W. Warner, Jr.	Secretary	12,000
Karl Williamson	Vice President	119,200
Rob Freel	Assistant Vice President	72,350
Curt Hartter	Assistant Vice President	96,200
Audrey Williams	Assistant Vice President	93,800
Kim Wells	Assistant Vice President	78,400
Jacki Kragel	Assistant Secretary	97,600