

**STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA**

REPORT ON EXAMINATION

OF

ALFA SPECIALTY INSURANCE CORPORATION

Montgomery, Alabama

AS OF

DECEMBER 31, 2006

Participation:

ALABAMA
Southeastern Zone, NAIC

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AFFIDAVIT

**STATE OF ALABAMA
COUNTY OF MONTGOMERY**

Blase Francis Abreo, being first duly sworn, upon his oath deposes and says:

THAT he is an examiner appointed by the Commissioner of Insurance for the State of Alabama;

THAT an examination was made of the affairs and financial condition of *ALFA SPECIALTY INSURANCE CORPORATION*, for the period of January 1, 2002, through December 31, 2006;

THAT the following 40 pages constitute the report therein to the Commissioner of Insurance of the State of Alabama; and

THAT the statements, exhibits, and data therein contained are true and correct to the best of his knowledge and belief.

Francis Blase Abreo

Blase Francis Abreo, CFE

Subscribed and sworn to before the undersigned authority this 23rd day of May 2008.

Dianne B. Mills

(Signature of Notary Public)

Dianne B. Mills Notary Public

(Print Name)

in and for the State of Alabama

My Commission expires 4-18-2009



BOB RILEY
GOVERNOR

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Montgomery, Alabama
May 23, 2008

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Dear Commissioners and Directors:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, a full scope financial and market conduct examination as of December 31, 2006, has been made of

ALFA SPECIALTY INSURANCE CORPORATION

at its home office at 2108 East South Boulevard, Montgomery, Alabama, 36116. The report of examination is submitted herewith. Where the description "Company" appears herein, without qualification, it will be understood to indicate Alfa Specialty Insurance Corporation.

SCOPE OF EXAMINATION

A full scope financial and market conduct examination was authorized pursuant to the instructions of the Alabama Insurance Commissioner and in accordance with the statutory requirements of the *Alabama Insurance Code* and the regulations and bulletins of the State of Alabama Department of Insurance in accordance with the applicable guidelines and procedures promulgated by the National Association of Insurance Commissioners (NAIC); and in accordance with generally accepted examination standards.

The Company was last examined for the five-year period ended December 31, 2001. A limited scope examination for the period ended December 31, 2004, concluded on June 30, 2005. The current examination covers the intervening period from January 1, 2002, through December 31, 2006, and was conducted by examiners from the Alabama Department of Insurance. Where deemed appropriate, transactions subsequent to December 31, 2006, were reviewed.

The examination included a general review of the Company's operations, administrative practices, and compliance with statutes and regulations. Corporate records were inspected. Income and disbursement items for selected periods were tested. Assets were verified and valued, and all known liabilities were established or estimated as of December 31, 2006. However, the discussion of assets and liabilities contained in this report has been confined to those items which resulted in a change to the financial statements, or which indicated a violation of the *Alabama Insurance Code* and the Insurance Department's rules and regulations, or other insurance laws or rules, or which were deemed by the examiner to require comments and/or recommendations.

The Company copies of the filed Annual Statements for the years 2002 through 2006 were compared with or reconciled to account balances with respect to ledger items.

The market conduct phase of the examination consisted of a review of the Company's territory, plan of operation, complaint handling, marketing and sales, producer licensing, policyholder service, underwriting and rating, claims payments and practices, and compliance with privacy policies and practices.

A signed certificate of representation was obtained during the course of the examination. In this certificate, management attests to having valid title to all assets and to the nonexistence of unrecorded liabilities as of December 31, 2006. A signed letter of representation was also obtained at the conclusion of the examination

whereby management represented that, through the date of this examination report, complete disclosure was made to the examiners regarding asset and liability valuation, the financial position of the Company, and contingent liabilities.

ORGANIZATION AND HISTORY

The Company was incorporated on August 11, 1999, as a wholly-owned subsidiary of Alfa Mutual Insurance Company (AMI). The initial marketing plan for the Company, which is also currently in effect, is the writing of non-standard automobile insurance in Alabama, Georgia, and Mississippi.

The Company's Articles of Incorporation authorized 10,000,000 shares of common stock of a par value of \$.05 per share and 1,000,000 shares of preferred stock of a par value of \$.10 per share. No preferred stock had been issued as of the date of this examination.

The Company's initial capitalization derived from the issue of 10,000,000 shares of its common stock, to AMI, for a price of \$15,000,000, providing \$500,000 of paid up capital and \$14,500,000 of paid in surplus.

On July 23, 2001, the Company's Articles of Incorporation were amended to change the par value of its common stock from \$.05 to \$.10 per share. Subsequent to this action \$500,000 was transferred from paid in surplus to capital. At December 31, 2001, the Company's paid up capital was \$1,000,000, consisting of 10,000,000 shares of common stock with a par value of \$.10. The 2006 Annual Statement indicated the following:

- Net Admitted Assets: \$28,425,060
- Liabilities: \$10,490,803
- Total capital and surplus:
 - Common capital stock: \$1,000,000
 - Gross paid in and contributed surplus: \$24,000,000
 - Unassigned funds (surplus): (\$7,065,743)

The Company is affiliated with seven other property and casualty insurers, which are participants in a reinsurance pooling agreement. The terms of the agreement provide that all direct business of the affiliates will be ceded to AMI. The pooled business is then retroceded according to the percentages provided in the pooling agreement. In 1989, an intercompany reinsurance pooling committee, representing the boards of

1989, an intercompany reinsurance pooling committee, representing the boards of directors of the reinsurance pool participants, was established. This committee is responsible for reviewing and approving any changes to the pooling agreement, to assure that transactions are fair and equitable to all pool participants, and to monitor potential, or actual, conflicts of interest between pool participants. The Company became a participant in the reinsurance pooling agreement in 2001.

In 2004, Alfa Vision Insurance Corporation (AVI) was organized as a wholly-owned subsidiary of Alfa Corporation, an SEC registrant. Alfa Corporation is affiliated with Alfa Mutual Insurance Company, Alfa Mutual Fire Insurance Company, and Alfa Mutual General Insurance Company (collectively, the Mutual Group). The Mutual Group owns 54.8% of Alfa Corporation's common stock, their largest single investment. (See the heading SUBSEQUENT EVENTS for development on Alfa Corporation). AVI commenced business on January 1, 2005, and became a participant in the reinsurance pooling agreement effective January 1, 2005.

During the period covered by the examination, the Company amended the Articles of Incorporation by revoking and replacing Article XIII, which was effective February 24, 2003. No amendments were made to the Company's *By-Laws* during the period under examination.

MANAGEMENT AND CONTROL

Stockholders

The Company is a stock corporation with ultimate control vested in its stockholders. At December 31, 2006, one hundred percent (100%) of the issued and outstanding common stock was owned by Alfa Mutual Insurance Company.

Board of Directors

The Company's *By-Laws* provide that its property and business shall be managed by a Board of Directors consisting of not less than five directors. Directors are elected at the annual meeting of the stockholder and serve until their successors are elected and qualified.

The following directors were elected by the stockholders and were serving at December 31, 2006:

<u>Name and Residence</u>	<u>Principal Occupation</u>
Jerry Allen Newby Athens, Alabama	Chairman of the Board, President and CEO, Alfa Mutual Insurance Company
Russell Riley Wiggins Andalusia, Alabama	Vice President, Southeast Area, Alfa Mutual Insurance Company
Stephen Leonard Dunn Evergreen, Alabama	Treasurer, Alfa Mutual Insurance Company
Curtis Dean Wysner Woodland, Alabama	Vice President, Central Area, Alfa Mutual Insurance Company
Hal Franklin Lee Hartselle, Alabama	Vice President, North Area, Alfa Mutual Insurance Corporation
Jacob Calhoun Harper Camden, Alabama	Vice President, Southwest Area, Alfa Mutual Insurance Company

Officers

According to Article IV of the *By-Laws*, the Company's principal officers shall be a Chairman of the Board, a President, an Executive Vice President, one or more Vice Presidents, a Secretary; a Treasurer and, such other officers as the Board of Directors may determine for such terms, authority and duties as may be determined by the Board of Directors. The Chairman of the Board and President must be members of the Board of Directors. The offices of Chairman of the Board and President may be held by the same person and the offices of Secretary and Treasurer may be held by the same person.

The following officers were elected by the Board of Directors and were serving at December 31, 2006:

<u>Officer</u>	<u>Title</u>
Jerry Allen Newby	Chairman of the Board; President & CEO
Clyde Lee Ellis III	Vice President and Treasurer
Herman Alan Scott	Secretary

The following officers were appointed by the Board of Directors and were serving at December 31, 2006:

Officer	Title
Clyde Lee Ellis III	Executive Vice President, Operations
Herman Tyrone Watts	Executive Vice President, Marketing
Stephen Goddard Rutledge	Senior Vice President, CFO & Chief Investment Officer
Herman Alan Scott	Senior Vice President, and General Counsel
James Rogers Azar	Senior Vice President, Audit & Risk Management
John Thomas Jung	Senior Vice President, CIO
Jerry William Johnson	Senior Vice President, Claims
Thomas Earle Bryant	Senior Vice President, Human Resources
Wyman Worley Cabaniss	Senior Vice President, P & C Underwriting
Jerry Charles Ralph	Senior Vice President, Marketing, North Alabama
William Merit Hardy Jr.	Senior Vice President, Marketing, South Alabama
Carol Lynn Golsan	Senior Vice President, Marketing Services
Alfred Edwin Schellhorn	Vice President, Corporate Development
Ralph Clayton Forsythe	Vice President, Finance & Assistant CFO
David Ray Proctor	Vice President, Taxes
Gordon Thomas Carter	Vice President and Associate General Counsel
Donald Eugene Manis	Vice President, Property & Casualty Actuary
Hudson Clayton Bush Jr.	Vice President, Alfa Agency/ASIC
Darrell Lee McNeal	Vice President, Georgia Marketing
Robert Wyatt Pace	Vice President, Mississippi Marketing
Christine Gnann Cantrell	Vice President, Marketing Communications
Connie Leah Whitecotton	Vice President, Chief Risk & Compliance Officer
Jacob Daniel Black	Vice President, P&C Accounting
Patti Jo Everage	Vice President, Financial Reporting & Planning
Linda Gail Pelt	Vice President, Auto Underwriting
John Delane Hemmings Jr.	Vice President, Investments

Committees

The following committees were appointed by the Board of Directors and were serving at December 31, 2006:

<u>Pooling Committee</u>	<u>Contribution Committee</u>
Jerry Allen Newby	Steve Dunn
Curtis Dean Wysner	Curtis Dean Wysner
Jacob Calhoun Harper	Hal Franklin Lee
	Jacob Calhoun Harper

Conflict of Interest

The Company follows an established procedure for the disclosure of conflicts between the Company's interest and the personal interest of directors and officers. The conflict of interest policy is part of the "Principles of Business Conduct" (Principles) policy, which was effective August 14, 2001. Effective February 4, 2003, the Principles went into major revision, when the Company incorporated the provisions required by the Federal Sarbanes-Oxley Act.

Section 8 of the revised Principles, does not require the employees to sign annual conflict of interest statements. Under the policy, all new employees are required to confirm their compliance with the policy at their hiring. Confirmations are obtained from all existing employees when the policy undergoes significant revision, or whenever circumstances dictate that reconfirmation would be helpful in reinforcing the Company's "tone at the top" message.

The listing that indicated that the officers and directors had read the Principles and electronically acknowledged that they had read the Principles was reviewed. The disclosures made during the period did not appear to represent a conflict of interest. The listing was checked with the names of the officers and directors listed on the Company's Annual Statements under examination. The review indicated that some directors, which were non-employees, had not acknowledged reading the Principles, since it had a significant revision, effective February 4, 2003. Company management indicated that the aforementioned directors had signed the acknowledgement, confirming reading and adhering to the Principles, since its significant revision. However, according to Company management, the signed copies had been misplaced and could not be located.

The Company indicated “Yes” to the GENERAL INTERROGATORIES of the NAIC Annual Statement Instructions, which asks the following question:

“Has the reporting entity an established procedure for disclosure to its board of directors or trustees of any material interest or affiliation on the part of any of its officers, directors, trustees, or responsible employees that is in conflict or likely to conflict with the official duties of such persons?”

As noted above, the Company had an established procedure for the disclosure of conflicts of interest to the Board of Directors; however, the Company could not provide evidence that all directors had signed the conflict of interest statements.

CORPORATE RECORDS

The Articles of Incorporation and *By-Laws*, as amended were inspected and found to provide for the operation of the Company in accordance with usual corporate and applicable statutes and regulations. Minutes of the Annual Membership meetings, Board of Directors and committees from January 1, 2002, through December 31, 2007, recorded by the Company were reviewed. The minutes appeared to be complete with regard to recorded actions taken on matters before the respective bodies for deliberation and action.

HOLDING COMPANY AND AFFILIATES

Holding Company Registration and Reporting

The Company is subject to the *Alabama Insurance Holding Company Regulatory Act*, as defined in ALA. CODE § 27-29-1 (1975). In connection therewith, the Company is registered with the Alabama Department of Insurance as joint registrant of an Insurance Holding Company System. The Company is responsible for holding company registration and periodic filings in accordance with ALA. CODE § 27-29-4 (1975), and ALA. ADMIN. CODE 482-1-055 (1994).

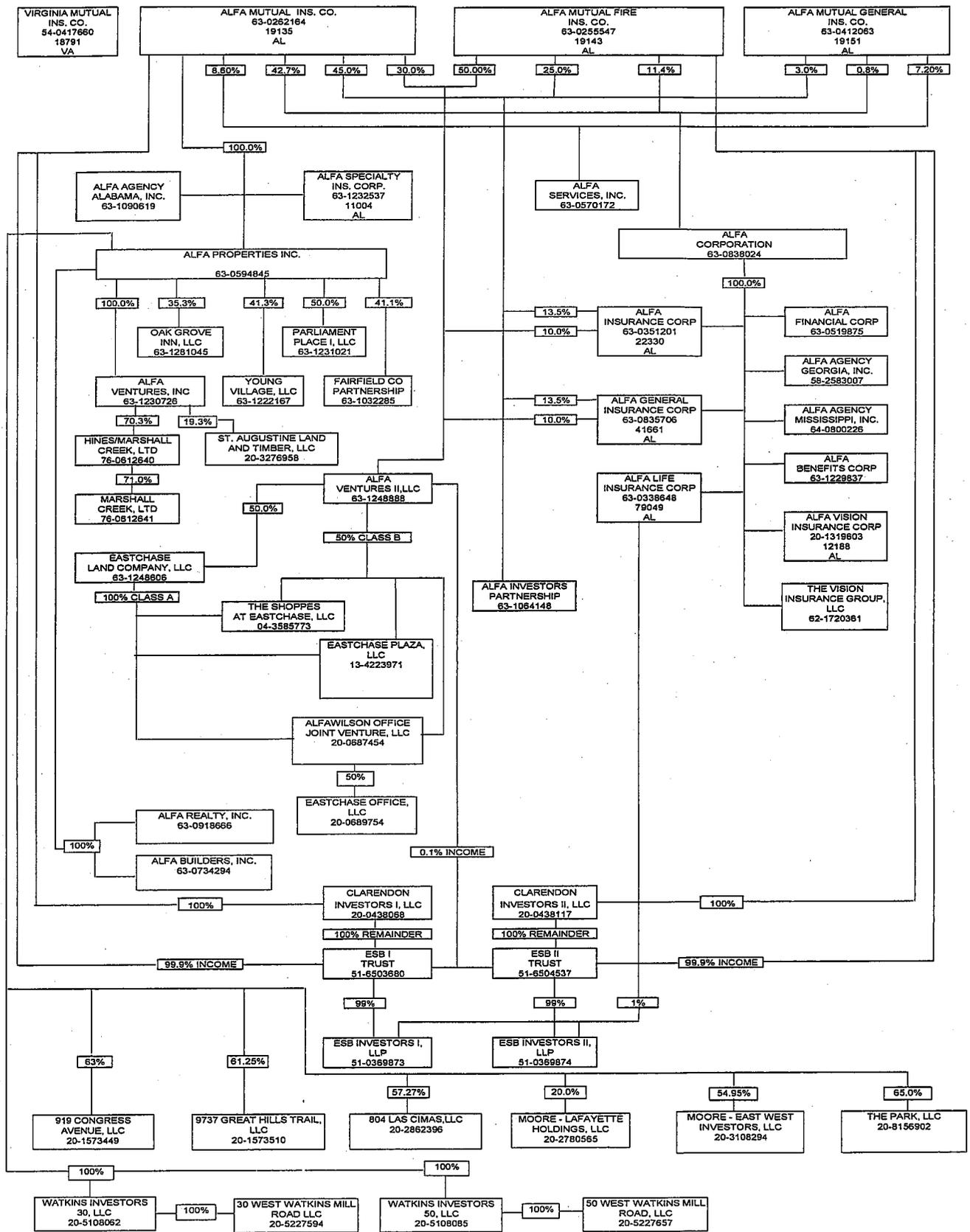
Appropriate filings required under the Holding Company Act were made from time to time by the Company as registrant. The examination did not determine that any required disclosures were excluded from the Company’s filings.

Dividends to Stockholders

During the period under examination, the Company did not pay any dividends to its sole stockholder, Alfa Mutual Insurance Company.

Organizational Chart

The following chart presents the identities and interrelationships among all affiliated persons within the Insurance Holding Company System at December 31, 2006.



Transactions and Agreements with Affiliates

Management and Operating Agreement

The following insurers were under the control of Alfa Mutual Insurance Company (AMI) and were parties to a Management and Operating Agreement with AMI: the Company, Alfa Mutual Fire Insurance Company; Alfa Mutual General Insurance Company; Alfa General Insurance Corporation; Alfa Insurance Corporation; Alfa Life Insurance Corporation; and Alfa Vision Insurance Corporation. These companies will be referred to, collectively, as the “affiliates” in the remainder of the discussion of this topic.

The original agreement had been in effect since January 1, 1960, with periodic amendments to modify the terms and to add companies as they became affiliated. Effective January 1, 2001, it was amended and restated “. . . in its entirety in order to clarify and make more certain their relationship to one another.” Also, the term of the agreement was to be five years, through December 31, 2005, then automatically renewed for periods of one year. Effective January 1, 2005, it was amended to include Alfa Vision Insurance Corporation.

Pertinent terms of the agreement include the following:

- The affiliates appoint and engage AMI to take charge of, conduct, operate and manage the business operations of the affiliates, respective to each affiliate’s charter and Board of Directors, and in a proper and prudent fashion. AMI will provide all home office operating service to the affiliates, including accounting, disbursement and payroll services and will serve as a disbursing agent for the payment of all employees and agents of the affiliates.
- AMI agrees to employ, in its own name, all personnel necessary to perform the aforesaid, and reserves all rights and responsibilities of the employer of said personnel. All agents of the affiliates shall be appointed in the name of the respective affiliates and shall work on behalf of the respective affiliates. All personnel and agents of any affiliate employed outside Alabama are the sole responsibility of that affiliate. AMI agrees to indemnify and hold the affiliates harmless against any loss on account of the dishonesty or infidelity of any of AMI’s employees. Also, the affiliates agree to indemnify and hold harmless AMI for liabilities and obligations prior to the effective date of the agreement, failure or negligent failure of the affiliate to perform under the agreement, breach of

warranty by the affiliate and liabilities or obligations of AMI's management or operation of the affiliate.

- AMI agrees that the business of each party to the agreement shall be conducted in the name of the respective party and that the records of each party shall be kept separately. AMI agrees to provide all required records, record-keeping services and data processing necessary to the efficient and economical operation of such business.
- The affiliates agree to reimburse AMI for expenses and additional charges in accordance with schedules which are attached to the agreement. These schedules are subject to periodic amendment. Expense allocations and other charges are determined by time, usage, and related special expense allocation studies conducted by AMI. Expenses entirely attributable to the affiliates such as printing and supplies are purchased and paid for directly by the respective affiliate.
- Arbitration: Disputes not resolved in 30 days are to be submitted for arbitration in the Birmingham, AL office of the American Arbitration Association in accordance with commercial arbitration rules.
- Confidentiality: Each party agrees to keep all Confidential Information strictly confidential.

Numerous expense categories are prorated between affiliates on Schedule A, an attachment to the agreement. Certain other expenses are allocated directly to the affiliates that benefit from expenditures. Agents' commissions are allocated 100% to the affiliate writing the business. Fixed monthly charges are paid by the affiliate for certain other expenses.

Tax Allocation Agreement

The Company entered into a Tax Allocation Agreement between AMI (Parent) and among several affiliates including Alfa Mutual Insurance Corporation, Southern Boulevard Corporation, Alfa Agency Alabama, Inc. and Alfa Ventures, Inc. on January 1, 2004, which applied to the taxable year ending December 31, 2003, and subsequent years until terminated. The agreement was amended and restated effective March 1, 2004, to add affiliates Alfa Builders, Inc. and Alfa Realty, Inc. to the affiliated group. The agreement was amended and restated again on May 22, 2006, to change the tax allocation method to the percentage method pursuant to Treasury Regulation §1.1502-33(d)(3).

The Company and affiliates, parties to the agreement, agree as follows:

- A U.S. consolidated income tax return shall be filed by the Parent for the taxable year ending December 31, 2006, and for each subsequent taxable period in respect of which this agreement is in effect and for which the affiliated group is required or permitted to file a consolidated tax return.
- The agreement stipulates that the tax liability of the group shall be apportioned among the members of the group in accordance with the ratio of that portion of the consolidated taxable income attributable to each member of the group, and that each bears to the consolidated taxable income.
- The parties to the agreement agreed that the consolidated tax liability for each year, determined in accordance with Treasury Regulation §1.1502-2, shall be apportioned among them in accordance with the provisions of Treasury Regulation §1.1502-33(d)(3) (Percentage Method). This percentage method allocates tax liability based upon the absorption of tax attributes, without taking into account the ability of any member to subsequently absorb its own tax attributes.
- Payment of the consolidated tax liability for a taxable period shall include the payment of estimated tax installments due for such taxable period, and each subsidiary shall pay to the Parent its share of each payment within ten days of receiving notice of such payment. Any amounts paid by a subsidiary on account of a separate return or separate estimated tax payments which are credited against the consolidated tax liability of the Affiliated Group, shall be included in determining the payments due from such subsidiary. Any overpayment of estimated tax should be returned to the subsidiary.
- If the consolidated tax liability is adjusted for any taxable period, whether by means of an amended return, claim for refund, or after a tax audit by the IRS, the liability of each member shall be recomputed to give effect to such adjustments, and in the case of a refund, the Parent shall make payment to each member for its share of the refund, within ten days after the refund is received by the Parent. In the case of an increase in tax liability, each member shall pay to the Parent its allocable share of such increased liability within ten days after receiving notice of the liability from the Parent.

- If, during a consolidated return period, the Parent or any subsidiary acquires or organizes another corporation that is required to be included in the consolidated return, then such corporation shall join in and be bound by the agreement. The agreement shall be binding upon and inure to the benefit of any successor, whether by statutory merger, acquisition of assets or otherwise, to any of the parties, to the same extent as if the successor had been an original party to the agreement.

FIDELITY BOND AND OTHER INSURANCE

At December 31, 2006, the Company was named insured under a financial institution bond issued by Fidelity and Deposit Company of Baltimore, Maryland. The single loss limit of the bond met the NAIC suggested minimum requirements for fidelity coverage. The bond provided the following coverages:

- Fidelity
- Forgery or alteration
- Optional
 - Agents # 1
 - Computer systems fraud.

The Fidelity coverage insured the Company against any loss through any dishonest or fraudulent act committed by an employee acting alone or in collusion with others. The dishonest or fraudulent acts must be committed by the employee with the manifest intent to cause the insured to sustain such loss and to obtain financial benefit in the normal course of employment.

In addition to the fidelity bond, Alfa Mutual Insurance Company maintained other insurance policies to protect the Company and its affiliates against hazards to which they may be exposed.

EMPLOYEES' AND AGENTS' WELFARE

The Company had no employees; therefore, it had no formal employees' or agents' welfare program. Its operations were conducted by the personnel of Alfa Mutual Insurance Company, an ultimate parent of the Company, under the terms of a Management and Operating Agreement. The Company's officers, elected and appointed, were also employees of Alfa Mutual Insurance Company. For further

comment, see the caption *Management and Operating Agreement* under the heading HOLDING COMPANY AND AFFILIATES.

Section 1033 of Title 18 of the U.S. CODE

As noted above, the Company's operations were conducted by personnel employed by Alfa Mutual Insurance Company (AMI) under the terms of a Management and Operating Agreement. According to ALA. ADMIN. CODE 482-1-121 (2003), persons who act as or are officers, directors, producers, or employees, including those authorized to act on their behalf are subject to Section 1033 of Title 18 of the U.S. CODE; therefore the Company and those acting on its behalf including Directors, officers, agents, and employees working under the terms of a Management and Operating Agreement are subject to the terms of the aforementioned ALA. ADMIN. CODE.

The Company was asked how it determined if those working on its behalf were not in conflict with Section 1033 of Title 18 of the U.S. CODE, and ALA. ADMIN. CODE 482-1-121 (2003), which prohibits certain persons from participating in the business of insurance.

The Company provided an employment application used during the examination period which asks potential employees about any criminal convictions during the previous ten years and the authorization to obtain consumer and/or investigative consumer reports on the applicant. Company management indicated that the Company does not hire applicants who have been convicted of a felony unless prior authorization has been obtained from the Alabama Department of Insurance in accordance with ALA. ADMIN. CODE 482-1-121 (2003). The Company's "Principles of Business Conduct" (Principles) policy requires that employees report any felony convictions, either personal or about another employee immediately to Human Resources.

Although, the employment applications used during the examination period, asked potential employees about felony convictions within the last ten years, and the Principles policy requires employees to report felony convictions, the Company could not demonstrate that employees who had been with the Company before the Principles went into effect were not in conflict with ALA. ADMIN. CODE 482-1-121 (2003), which states:

"... The Act contains no grandfather provision for persons already transacting the business of insurance. The Act contains no automatic waivers for individuals who may possess a state insurance license. Further, there is no

time limitation on how far back the felony conviction that triggers the prohibited person status may have occurred. . . .”

The Company indicated it had a procedure in place to perform background checks on agents and customer service representatives since 1998, and on its home office employees since 2004. The Company provided evidence that in 2003-2004 its employees electronically certified pursuant to the Company’s Principles policy that they had not been convicted of a felony and would inform management of any changes to their responses. According to the Company, employees hired subsequent to 2004 signed the policy when hired and a copy is maintained in their personnel file.

The Company could not provide evidence that it had a policy in place to ensure those authorized to act on its behalf continue to meet the requirements of Section 1033 of Title 18 of the U.S. CODE, and ALA. ADMIN. CODE 482-1-121 (2003), which states:

“ . . . Insurance companies, as well as persons employing anyone to conduct the business of insurance may be in violation of this statute if they willfully permit participation by a prohibited person, including persons who are already employed or being considered for employment. Failure to initiate a screening process in an attempt to identify prohibited persons in current or prospective employment relationships may be a factor in determining if a violation of this statute has occurred. . . .”

MARKET CONDUCT ACTIVITIES

Territory

At December 31, 2006, the Company was licensed to transact business in the following states:

Alabama

Georgia

Mississippi

Virginia

The Certificates of Authority from the respective jurisdictions were inspected and found to be in effect at December 31, 2006.

Plan of Operation

The Company markets its non-standard automobile products through captive agents. At December 31, 2006, the Company employed 1,016 agents appointed to write its business in Alabama, Georgia, Mississippi, and Virginia. At December 31, 2006, there were 486 licensed agents in Alabama; 83 in Georgia; 76 in Mississippi; and 371 in Virginia.

For the year 2006, direct premiums written for private passenger automobile insurance comprised 100% of the Company's total business, of which 48.90% of its business was written in Alabama, 25.90% was written in Virginia and the remaining 25.20% was split between Georgia and Mississippi.

Policy Forms and Underwriting

All the Company's active policy forms and rates in force at December 31, 2006, were found to have been approved by the Alabama Department of Insurance. Rates were filed independently on the Company's direct business.

For Alabama policyholders only, membership in the Alabama Farmers Federation was a prerequisite to the issuance of a policy with the Company. The Company's policy is to cancel coverage when Federation membership is not renewed, except on those policies involving a real property lien holder.

Compliance with Agents' Licensing Requirements

In order to verify compliance with agents' licensing requirements of the Alabama Department of Insurance (ALDOI), a sample of fifty agents licensed in Alabama was taken from the listing maintained by the Company. The agents' names were compared with the listing maintained on the ALDOI website. No discrepancies were found within the sample.

A sample of 100 policies written by the Alfa P & C companies in the State of Alabama was checked against the ALDOI's licensing records to verify if the agents were appropriately licensed for the P & C companies. No discrepancies were found within the sample.

Advertising and Marketing

The Company's advertising materials were reviewed for the period covered by the examination. The advertisements consisted of signs, billboards, newspaper advertisements and spot advertisements on radio and television.

The Company's web page (www.alfains.com) was reviewed and found to include the following links: Company's background, product lines, claim information, career opportunities, how to locate an agent or the Alabama Farmers Federation, headlines, and Company contact information.

The Company's advertising was planned and coordinated by Integrated Marketing Communication, a subdivision of the Alfa Mutual Insurance Company's marketing division. The cost of advertisement was shared on a proportionate basis with other participating affiliates of the Company and the Alabama Farmers Federation. Company management indicated that the producers are not allowed to create their own advertising and sales material, including internet sites. Producers are required to use Company approved advertising material.

Claims Payments Practices

Paid Claims

A sample of one hundred claims was selected from the 2002 – 2006 closed claim register. The population from which the sample was taken included all of the paid claims from each of the P&C companies being examined. The paid claims sample was reviewed with regards to compliance with policy provisions, timeliness of payments, and adequacy of documentation. Other than the items listed below, no noteworthy discrepancies were found within the sample of paid claims. The examiners determined the following:

- Five files could not be located.
- Two claim payment drafts could not be located.

Since the Company could not provide five files and the two claim payment drafts, the Company did not comply with ALA. CODE § 27-27-29 (a) (1975), which states:

“Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and

systems as are customary or suitable as to the kind, or kinds, of insurance transacted.”

Denied and Closed without Payment Claims

A sample of one hundred claims was selected from a population of 120,941 claims denied during the examination period. The population from which the sample was taken included all of the denied claims from each of the P&C companies being examined. The claims were reviewed to verify compliance with claims payment practices of the Alabama Department of Insurance (ALDOI). The examiners determined the following:

- Two files could not be located.
- Four files did not have denial notifications to the insured, but had a note indicating that the files were closed.
- Two files did not have any correspondence.

Since the two files could not be located and six other files lacked adequate denial correspondence, the Company was not in compliance with ALA. CODE § 27-27-29 (a) (1975), which states:

“Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted.”

Because six of the eight files did not contain documentation regarding the denial notification, the Company was not in compliance with ALA. ADMIN. CODE 482-1-125-.07 (1) (2003), which states:

“... No insurer shall deny a first party claim on the grounds of a specific policy provision, condition or exclusion unless reference to such provision, condition, or exclusion is included in the denial. The denial may be given to the first party claimant in writing, verbally or electronically (e-mail). If verbal, the file should clearly indicate the denial and reasons for the denial. If the denial is in writing or electronic (e-mail), the file should contain a copy of the denial letter or e-mail. . . .”

Company management’s response concerning two of the missing files:

[While we make every effort to retain all claim files, we do acknowledge that one of the two files has not been located at this time. We are continuing to locate this file. One of the two files, with a closed date of 2/26/2002, falls outside the required retention period as required by ALA. ADMIN. CODE §482-1-125-.04 (a), which states:

“This data must be available for all open and closed files for the current year and the five (5) preceding years, in order to permit reconstruction of the insurer’s activities relative to each claim.”]

Company management response concerning the six files with missing correspondence:

[Alfa’s claim Management has reviewed six of the eight files and found no evidence that these claims were denied on the grounds of a specific policy provision, condition or exclusion. Also, the Company’s Best Practices Manual states, “The claim file needs to be documented in such a fashion that the reasoning behind a denial can be clearly understood by other claims professional.”]

The previous examination had also recommended that the Company comply with ALA. CODE § 27-27-29 (a) (1975), and keep complete and accurate records of its claims transactions.

Policyholders’ Complaints

The Company’s complaint register was reviewed in order to verify if all written complaints were logged on the register. Company management indicated that complaints from insurance departments and written complaints received at the home office that allege violation of state or federal laws or of any regulations, directives, or bulletins of the insurance departments are logged on the register. There was one register for the seven Alfa P&C Companies combined, which included: 1) The Company, 2) Alfa Mutual Insurance Company, 3) Alfa Mutual Fire Insurance Company, 4) Alfa Mutual General Insurance Company, 5) Alfa Insurance Corporation, 6) Alfa General Insurance Corporation, and 7) Alfa Vision Insurance Corporation.

During the period covered by the examination, 233 complaints were logged on the register against the Alfa P & C companies. The complaint register did not specify which company was the subject of the complaint. Fifty complaint files were

requested to determine if the files contained adequate documentation. The examiners determined that the Alfa P & C companies maintained adequate documentation.

The Alabama Department of Insurance adopted the NAIC Market Regulation Handbook, effective May 7, 2007, via ALA. ADMIN. CODE 482-1-097-.07 (2007). According to the handbook, a regulated entity should include, but not be limited, to the following information in the complaint register:

- Line of business
- Function (underwriting, marketing and sales, claims, policyholder services or miscellaneous);
- Reason for complaint (underwriting, application, cancellation, rescission, nonrenewal).

The handbook also requires that the regulated entity record all written communication expressing a grievance in the regulated entity's complaint register.

Privacy Policies and Practices

The Company's policy is that non-public information involving underwriting, marketing, claims handling and fraud prevention is not shared with anyone outside the Company except for that sharing allowed by the exceptions in the Gramm-Leach-Bliley Act. The insured receives a Privacy Notice at the point-of-sale, and the Company sends a Privacy Notice to the insured on an annual basis. The Company complied with the privacy requirements of ALA. ADMIN. CODE 482-1-122 (2001).

SPECIAL DEPOSITS

In order to comply with the statutory requirements for doing business in the various jurisdictions, in which it was licensed, the Company had the following securities on deposit with state authorities at December 31, 2006.

State	Book Value	Fair Value
Alabama	\$225,680	\$245,399
Georgia	36,824	41,605
Virginia	526,063	594,355
Total	\$788,567	\$881,359

FINANCIAL CONDITION/GROWTH OF THE COMPANY

The following table sets forth the significant items indicating the growth and financial condition of the Company for the period under review:

<u>Year</u>	<u>Gross Premiums</u> <u>Written</u>	<u>Admitted</u> <u>Assets</u>	<u>Liabilities</u>	<u>Policyholders'</u> <u>Surplus</u>
2001*	\$21,361,367	\$18,628,669	\$4,733,895	\$13,894,774
2002	26,632,006	19,539,775	5,608,605	13,931,170
2003	31,635,168	19,823,904	6,220,726	13,603,178
2004	31,928,631	18,943,900	8,639,495	10,304,405
2005	33,272,283	25,307,931	9,400,236	15,907,695
2006*	39,351,981	28,425,060	10,490,803	17,934,257

*Per examination.

Amounts for the remaining years were obtained from Company copies of filed Annual Statements.

REINSURANCE

Intercompany Reinsurance Pooling Agreement

This agreement was originally effective August 1, 1987, between the Company and its affiliates: Alfa Mutual Insurance Company (AMI); Alfa Mutual Fire Insurance Company (AMF); Alfa Mutual General Insurance Company (AMG); Alfa General Insurance Corporation (AGI) and Alfa Insurance Corporation (AIC). The Company was added to the pool in 2001. Alfa Vision Insurance Corporation (AVI) was added to the pool in 2005. These participants in the pooling agreement will be referred to as "the affiliates" for the remainder of this discussion. This reinsurance pooling agreement was filed with the Alabama Department of Insurance on July 29, 1987, and was subsequently approved. Pertinent terms of the agreement are as follows:

Initially, the affiliates ceded 100% of their book of business, then in force, to Alfa Mutual Insurance Company (AMI) and paid AMI their proportionate share of the net unearned premium less commissions at the provisional rate of 20%.

Currently, the affiliates cede 100% of the net liabilities for net premiums written to AMI; AMI retains or retrocedes the pooled business in accordance with the following percentages:

Company	Effective January 1, 2001	Effective January 1, 2005
AMI	18	18
AMF	13	13
AMG	3	3
ASI	1	1
AIC	32.5	30
AGI	32.5	30
AVI	<u>N/A</u>	<u>5</u>
TOTAL	<u>100</u>	<u>100</u>

The following percentages are shown below for the Coinsurance Allocations for Catastrophe Losses and Related Expenses for the related years:

Effective January 1, 2002			Effective January 1, 2003		
Cumulative Calendar Year Catastrophe Losses and Related Expenses (Million)	Coinsurance Allocation		Cumulative Calendar Year Catastrophe Losses and Related Expenses (Million)	Coinsurance Allocation	
	AGI AIC	AMI, AMF AMG, ASI		AGI AIC	AMI, AMF AMG, ASI
11.6	65%	35%	12.125	65%	35%
19	0%	100%	19	0%	100%
32	0%	100%	32	0%	100%
43	0%	100%	43	0%	100%
77	0%	100%	77	0%	100%
146	0%	100%	146	0%	100%
198	0%	100%	198	0%	100%
289+	16%	84%	301.5 +	18%	82%

- Cumulative calendar year catastrophe losses and related expenses are in millions.
- AIC and AGI to be allocated equally.
- AMI, AMF, AMG, and ASI to be allocated according to this group's relative pool percentages in effect.
- Catastrophe losses are to be accumulated during each annual calendar period.
- AMI, AMF, AMG, ASI, AIC and AGI to be allocated according to this group's relative surplus.

Effective January 1, 2004		
Cumulative Calendar Year Catastrophe Losses and Related Expenses (Million)	Coinsurance Allocation	
	AGI AIC	AMI, AMF AMG, ASI
Less than or = 14.2	65%	35%
Between 14.2 - 352	0%	100%
Greater than or = 352	18%	82%

- AIC and AGI to be allocated equally.
- AMI, AMF, AMG, and ASI to be allocated according to this group's relative pool percentages in effect.
- Catastrophe losses are to be accumulated during each annual calendar period.
- AMI, AMF, AMG, ASI, AIC, and AGI to be allocated according to this group's relative surplus.

Effective January 1, 2005			Effective January 1, 2006		
Cumulative Calendar Year Catastrophe Losses and Related Expenses (Million)	Coinsurance Allocation		Cumulative Calendar Year Catastrophe Losses and Related Expenses (Million)	Coinsurance Allocation	
	AGI, AVI AIC	AMI, AMF AMG, ASI		AGI AVI AIC	AMI, AMF AMG, ASI
Less than or = 17.9	65%	35%	Less than or = 21.2	65%	35%
Between 17.9 – 443.7	0%	100%	Between 21.2 – 525.5	0%	100%
Greater than or = 443.7	19%	81%	Greater than or = 525.5	21%	79%

- AMI, AMF, AMG, ASI, AIC, AGI, and AVI to be allocated according to this group's relative pool percentages in effect.
- Catastrophe losses are to be accumulated during each annual calendar period.
- AMI, AMF, AMG, ASI, AIC, AGI and AVI to be allocated according to this group's relative surplus as reported in the preceding year-end annual statement.
- Effective January 1, 2006 - Coinsurance Allocation of AMI to include any coinsurance allocation for ASI, (AMI's wholly owned subsidiary).

Reinsurance Assumed

The Company did not assume reinsurance, except through the intercompany reinsurance pool, during the examination period.

Reinsurance Ceded

The Company did not cede reinsurance, except through the intercompany reinsurance pool, during the examination period.

ACCOUNTS AND RECORDS

The Company's principal accounting records were maintained on electronic data processing equipment. Management and record-keeping functions were performed by the personnel of Alfa Mutual Insurance Company (AMI) under the terms of a Management and Operating Agreement. For further discussion of the aforesaid agreement, see the caption *Management and Operating Agreement* under the heading HOLDING COMPANY AND AFFILIATES.

The examiners reviewed the accounts and records maintained by the Company for its cash disbursements of \$25.00 or more. The review indicated the Company's documentation for intercompany balance transfers was not in compliance with ALA. CODE § 27-27-30 (1975). The Company provided copies of the cancelled checks, and vouchers which included the amount of transfer, the payor, and payee. The documentation did not include a description of the consideration for the payment, a description of the services provided, itemization of the expenditures, or a receipt. The documentation is required by ALA. CODE § 27-27-30 (1975), which states:

“(a) No insurer shall make any disbursement of \$25.00 or more unless evidenced by a voucher or other document correctly describing the consideration for the payment and support by a check or receipt endorsed or signed by, or on behalf of, the person receiving the money.

(b) If the disbursement is for services and reimbursement, the voucher or other document, or some other writing referred to therein, shall describe the services and itemize the expenditures. . . .”

Internal Accounting Records

The Company's internal controls and information systems are those of AMI, since the Company is operated by the personnel of AMI, in accordance with the aforementioned Management and Operating Agreement. Said internal controls and information systems were reviewed during the concurrent examination of

AMI. They were evaluated by observation, interviewing AMI personnel, and reviewing the NAIC Internal Controls and Information Systems Questionnaires and Examiner Planning Questionnaire completed by AMI. AMI's internal controls and information systems controls appeared to be sufficient to safeguard the Company's assets and to generate adequate records of its business. The Company's accounting systems and documentation of its transactions were deemed adequate.

External Audit and Actuarial

The Company and its affiliates were audited annually, on a statutory basis. In 2006, the Company and its affiliates were audited by the certified public accounting (CPA) firm of PriceWaterhouseCoopers (PwC), Birmingham, AL; and annually in 2002-2005 by KPMG, Birmingham, AL. The audit reports and workpapers of the external auditors were obtained and utilized as deemed appropriate.

The reserve calculations for the years 2002 - 2005 were certified by Mr. Scott Weinstein, FCAS, MAAA of KPMG, LLC. The reserve calculation for year-end 2006 was certified by Mr. Anthony Kellner, FCAS, MAAA of PwC.

Record Retention Policy

The Company's Record Retention Policy stated that the Company maintains its records as required by law and as long as the records were useful to the Company. Company management also indicated that each department within the Company is responsible for developing a record retention schedule that meets the specific needs of the department. The examination determined that the Company's record retention policy did not contain specific language as to the actual length or time the records are to be retained in accordance with ALA. ADMIN. CODE 482-1-118-.03 (1999), which states:

“Every insurer, which term shall include every domestic insurer . . . or any other legal entity regulated by the Insurance Code and licensed to do business in this state shall maintain its books, records, documents and other business records in order that the insurer's financial condition may be readily ascertained by the Department of Insurance, taking into consideration other record retention requirements. All records must be maintained for not less than five (5) years.”

Disaster Recovery Plan

The NAIC Information System Questionnaire (ISQ) assisted the examiners in determining the strengths and weaknesses within the Company's IS Department. Based on a review of the ISQ responses and supporting documentation, it was determined the business continuity plan describes senior management's roles and responsibilities associated with the declaration of an emergency and implementation of the disaster recovery and business continuity plans.

The Company provided a copy of its Disaster Recovery Plan and documentation supporting its testing. The Company's ISQ responses, Disaster Recovery Plan and supporting documentation were reviewed and it was determined the Company has an adequate and up-to-date plan in place. The plan is reviewed quarterly, and tested annually at an alternate site.

Consideration of Fraud

The examiners utilized the procedures recommended in the NAIC Financial Condition Examiners Handbook in Exhibit M – Consideration of Fraud. The CPA documentation on the fraud risk factors was reviewed and procedures were included during the examination to test the risk factors identified during the planning stages of the examination. Company management was interviewed; management showed an understanding of the fraud risk factors in the Company and has taken action over the years to mitigate the risk.

FINANCIAL STATEMENTS

The Financial Statements included in this report were prepared based on the Company's records, and the valuations and determinations made during the examination for the year ended December 31, 2006. Amounts shown in the comparative statements for the years 2002, 2003, 2004, and 2005, were compiled from Company copies of filed Annual Statements. The statements are presented in the following order:

Statement of Assets, Liabilities, Surplus	29 and 30
Summary of Operations	31
Capital and Surplus	32

THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN THIS REPORT ARE AN INTEGRAL PART THEREOF.

ALFA SPECIALTY INSURANCE CORPORATION
STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS

For the Year Ended December 31, 2006

	Assets	Non- admitted Assets	Net Admitted Assets
Assets			
Bonds	\$7,044,865	\$ 0	\$7,044,865
Cash, cash equivalents, and short-term investments (Note 1)	17,237,868	0	17,237,868
Receivables for securities	63,430	0	63,430
Subtotals, cash and invested assets	\$24,346,163	\$ 0	\$24,346,163
Investment income due and accrued	66,560	0	66,560
Premiums and considerations:			
Uncollected premiums and agents' balances in the course of collection (Note 2)	581,512	1,866	579,646
Deferred premiums, agents' balances and installments booked but deferred and not yet due (Note 2)	1,103,425	387	1,103,038
Reinsurance:			
Amounts recoverable from reinsurers	1,566,083	0	1,566,083
Current federal and foreign income tax recoverable and interest thereon	128,526	0	128,526
Net deferred tax asset	600,876	428,007	172,869
Guaranty funds receivable or on deposit	202	0	202
Electronic data processing equipment and software	310,592	310,592	0
Receivables from parent, subsidiaries and affiliates	461,973	0	461,973
Health care and other amounts receivable	3,569	3,569	0
Aggregate write-ins for other than invested assets	19,640	19,640	0
TOTAL ASSETS	\$29,189,121	\$764,061	\$28,425,060

**THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN
THIS REPORT ARE AN INTEGRAL PART THEREOF.**

ALFA SPECIALTY INSURANCE CORPORATION
STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS

For the Year Ended December 31, 2006

Liabilities:	
Losses	\$2,397,168
Reinsurance payable on paid losses and loss adjustment expenses	442,968
Loss adjustment expenses	420,414
Other expenses (excluding taxes, licenses, and fees)	259,818
Taxes, licenses, and fees (excluding federal and foreign income taxes)	247,711
Unearned premiums	3,076,227
Advance premium	540,471
Ceded reinsurance premiums payable (net of ceding commissions)	1,350,988
Amounts withheld or retained by the Company for the account of others	11,677
Remittances and items not allocated	134,805
Drafts outstanding	1,166,522
Payable to parent, subsidiaries, and affiliates	442,034
Total Liabilities	<u>\$10,490,803</u>
Capital and Surplus:	
Common capital stock	1,000,000
Gross paid in and contributed surplus	24,000,000
Unassigned funds	<u>(7,065,743)</u>
Surplus as Regards Policyholders	<u>\$17,934,257</u>
TOTAL	<u>\$28,425,060</u>

**THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN
THIS REPORT ARE AN INTEGRAL PART THEREOF.**

ALFA SPECIALTY INSURANCE CORPORATION
SUMMARY OF OPERATIONS

For the Years Ended December 31, 2006, 2005, 2004, 2003 and 2002

	2006	2005	2004	2003	2002
Underwriting Income					
Premiums earned	\$9,292,997	\$7,985,530	\$7,153,992	\$6,637,623	\$6,272,157
Losses incurred	5,306,512	10,645,359	8,785,274	6,022,870	5,023,800
Loss expenses incurred	433,391	476,156	341,599	308,533	310,301
Other underwriting expenses Incurred	2,691,310	2,372,060	1,847,276	1,879,375	1,722,867
Aggregate write-ins for underwriting deductions	(28)	(3,253)	(11,242)	6,068	(18,788)
Total underwriting deductions	<u>\$8,431,185</u>	<u>\$13,490,322</u>	<u>\$10,962,907</u>	<u>\$8,216,846</u>	<u>\$7,038,180</u>
Net underwriting gain / (loss)	861,812	(5,504,792)	(3,808,915)	(1,579,223)	(766,023)
Investment Income					
Net investment income earned	1,219,897	432,815	416,708	511,194	658,935
Net realized capital gains / (loss)	0	135,776	229,742	239,454	63,874
Net investment gain / (loss)	1,219,897	568,591	646,450	750,648	722,809
Other Income					
Net gain / (loss) from agents' or premium balances charged off	(20,517)	(3,690)	(3,665)	0	0
Finance and service charges not included in premiums	218,132	155,468	94,111	91,033	86,891
Aggregate write-ins for miscellaneous income	26	(16)	160	16	7
Total other income	197,641	151,762	90,606	91,049	86,898
Net income after dividends to policyholders, after capital gains tax and before all federal and foreign income tax	2,279,350	(4,784,439)	(3,071,859)	(737,526)	43,684
Federal and foreign income taxes Incurred	555,172	(289,397)	(123,708)	(81,860)	109,702
Net Income	\$1,724,178	\$(4,495,042)	\$(2,948,151)	\$(655,666)	\$(66,018)

**THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN
THIS REPORT ARE AN INTEGRAL PART THEREOF.**

**ALFA SPECIALTY INSURANCE CORPORATION
CAPITAL AND SURPLUS ACCOUNT**

For the Years Ended December 31, 2006, 2005, 2004, 2003 and 2002

	2006	2005	2004	2003	2002
Surplus as regards policyholders, December 31 prior year	<u>\$15,907,695</u>	<u>\$10,304,405</u>	<u>\$13,603,178</u>	<u>\$13,931,170</u>	<u>\$13,894,774</u>
Net income	\$1,724,178	\$(4,495,042)	\$(2,948,151)	\$(655,666)	\$(66,018)
Change in net deferred income tax	24,526	(61,577)	149,096	447,882	40,949
Change in non-admitted assets	204,186	376,196	(499,718)	(120,208)	18,951
Cumulative effect of changes in accounting principles	0	0	0	0	42,514
Surplus adjustments: Paid in	0	10,000,000	0	0	0
Aggregate write-ins for gains and losses in surplus	<u>73,672</u>	<u>(216,287)</u>	<u>0</u>	<u>0</u>	<u>0</u>
Change in surplus as regards policyholders for the year	<u>\$2,026,562</u>	<u>\$5,603,290</u>	<u>\$(3,298,773)</u>	<u>\$(327,992)</u>	<u>\$36,396</u>
Surplus as regards policyholders, December 31 current year	<u>\$17,934,257</u>	<u>\$15,907,695</u>	<u>\$10,304,405</u>	<u>\$13,603,178</u>	<u>\$13,931,170</u>

**THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN
THIS REPORT ARE AN INTEGRAL PART THEREOF.**

NOTES TO FINANCIAL STATEMENTS

Note 1 - Cash, cash equivalents and short-term investments

\$17,237,868

The captioned amount is the same as reported by the Company in its 2006 Annual Statement.

The examiners reviewed the Company's bank account statements for the month of January 2007, to identify checks dated before December 31, 2006, were appropriately recorded on the outstanding check listing. The examiners determined that twenty checks for an aggregate total of \$751, dated December 30, 2006, were not recorded in December 2006. The Company should have recorded the check transactions under *Cash, cash equivalents and short-term investments* in accordance with the guidance provided by the NAIC Annual Statement Instructions, which state:

“Include: All cash, including petty cash, other undeposited funds, and certificates of deposit in banks or other similar financial institutions with maturity dates of one year or less . . . in accordance with SSAP No. 2, Cash, Drafts, and Short-term Investments.”

SSAP No. 2, paragraphs 5 – 7, of the NAIC Accounting Practices and Procedures Manual, states:

“If a reporting entity has multiple cash accounts, the net of all accounts shall be reported jointly. Cash accounts with positive balances shall not be reported separately from cash accounts with negative balances. If in the aggregate, the reporting entity has a net negative cash balance, it shall be reported as a negative asset and shall not be recorded as a liability. . . . Outstanding checks are accounted for as a reduction of cash.”

Note 2 – Uncollected Premiums and agents' balances in the course of collection

\$ 579,646

Deferred premiums, agents' balances and installments booked but deferred and not yet due

\$ 1,103,038

The captioned \$579,646 is the same as reported by the Company in its 2006 Annual Statement, but \$64,712 less than that determined by the examination. The captioned \$1,103,038 is the same as reported by the Company in its 2006 annual Statement, but \$64,712 more than that determined by the examination.

The examination determined that the Company recorded certain premiums due under *Deferred premiums, agents' balances and installments booked but deferred and not yet due*. Premiums due are recorded under *Uncollected premiums and agents' balances in the course of collection*, in accordance with the guidance provided by the NAIC Annual Statement Instructions, which state:

“Line 13.1 – Uncollected premiums and Agents’ Balances in Course of Collection.

Include: Direct and group billed uncollected premiums. Amounts collected but not yet remitted to home office.”

CONTINGENT LIABILITIES AND PENDING LITIGATION

The examination for contingent liabilities and pending litigation included review of the Company’s Annual Statement disclosures, minutes of the corporate governing bodies, pending claims, and the usual examination of the accounts for unrecorded items. No material unreported contingencies were noted and all litigation pending against the Company, at December 31, 2006, appeared to be within the ordinary course of its business.

The Company’s Chief Executive Officer and its Chief Financial Officer executed a letter of representation, attesting to the non-existence of unreported liabilities and contingencies as of December 31, 2006.

COMPLIANCE WITH PREVIOUS RECOMMENDATIONS

A review was conducted during the current examination with regards to the Company’s compliance with recommendations made in the previous examination report. This review indicated that the Company had satisfactorily complied with the recommendations contained in the immediately preceding Report on Examination with the exception of the item listed below.

Claims Payment and Practices

The previous examination had noted that the Company did not provide five claims files out of forty-seven files taken from the closed and closed without payment listing, and recommended that the Company comply with ALA. CODE § 27-27-29 (a) (1975), which states:

“Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted.”

The Company did not comply with the recommendation made in the prior Report on Examination. See the caption Claims Payments Practices under the heading MARKET CONDUCT ACTIVITIES.

COMMENTS AND RECOMMENDATIONS

Conflict of Interest – Page 7

It is recommended that the Company maintain evidence of its conflict of interest statements signed by each officer, director and other key personnel as required by the Company’s “Principles of Business Conduct” policy and the GENERAL INTERROGATORIES of the NAIC Annual Statement Instructions.

Section 1033 of Title 18 of the U.S. CODE – Page 15

It is recommended that the Company create a policy that ensures those authorized to act on its behalf continue to meet the requirements of Section 1033 of Title 18 of the U.S. CODE, and ALA. ADMIN. CODE 482-1-121 (2003), which states:

“... Insurance companies, as well as persons employing anyone to conduct the business of insurance may be in violation of this statute if they willfully permit participation by a prohibited person, including persons who are already employed or being considered for employment. Failure to initiate a screening process in an attempt to identify prohibited persons in current or prospective employment relationships may be a factor in determining if a violation of this statute has occurred. . . .”

Claims Payments Practices – Page 18

It is recommended that the Company maintain complete records on closed claims, including the five missing files, in accordance with ALA. CODE § 27-27-29 (a) (1975), which states:

“Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted.”

It is recommended that the Company maintain complete records of the denied and closed without payment claims, including the missing files, in accordance with ALA. CODE § 27-27-29 (a) (1975), which states:

“Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted.”

It is recommended that the Company maintain adequate records of the denied and closed without payment claims and retain copies of the denial letter in each file, including the six files determined to lack adequate documentation, as required by ALA. ADMIN. CODE 482-1-125-.07 (1) (2003), which states:

“... No insurer shall deny a first party claim on the grounds of a specific policy provision, condition or exclusion unless reference to such provision, condition, or exclusion is included in the denial. The denial may be given to the first party claimant in writing, verbally or electronically (e-mail). If verbal, the file should clearly indicate the denial and reasons for the denial. If the denial is in writing or electronic (e-mail), the file should contain a copy of the denial letter or e-mail. . . .”

Policyholders' Complaints – Page 20

It is recommended that the Company record all written communication primarily expressing a grievance in the company's complaint register. The recommendation is effective May 7, 2007, when the Alabama Department of Insurance adopted the NAIC Market Regulation Handbook.

It is recommended that the company log the function and reasons for complaints in its complaint register. The recommendation is effective May 7, 2007, when the Alabama Department of Insurance adopted the NAIC Market Regulation Handbook

Accounts and Records – Page 25

It is recommended that the Company maintain the required supporting documentation for all disbursements exceeding \$25.00, including intercompany balance transfers, in accordance with ALA. CODE § 27-27-30 (1975), which states:

“(a) No insurer shall make any disbursement of \$25.00 or more unless evidenced by a voucher or other document correctly describing the consideration for the payment and support by a check or receipt endorsed or signed by, or on behalf of, the person receiving the money.

(b) If the disbursement is for services and reimbursement, the voucher or other document, or some other writing referred to therein, shall describe the services and itemize the expenditures. . . .”

Record Retention Policy – Page 26

It is recommended that the Company’s record retention policy indicate that all records should be maintained for no less than five years in accordance with ALA. ADMIN. CODE 482-1-118-.03 (1999), which states:

“Every insurer, which term shall include every domestic insurer . . . or any other legal entity regulated by the Insurance Code and licensed to do business in this state shall maintain its books, records, documents and other business records in order that the insurer’s financial condition may be readily ascertained by the Department of Insurance, taking into consideration other record retention requirements. All records must be maintained for not less than five (5) years.”

Cash and short-term investments - Page 33

It is recommended that the Company record all transactions in the appropriate accounting period in accordance with the guidance provided by the NAIC Annual Statement Instructions, which state:

“Include: All cash, including petty cash, other undeposited funds, and certificates of deposit in banks or other similar financial institutions with maturity dates of one year or less . . . in accordance with SSAP No. 2, Cash, Drafts, and Short-term Investments.”

SSAP No. 2, paragraphs 5 – 7, of the NAIC Accounting Practices and Procedures Manual, which states:

“If a reporting entity has multiple cash accounts, the net of all accounts shall be reported jointly. Cash accounts with positive balances shall not be reported separately from cash accounts with negative balances. If in the aggregate, the reporting entity has a net negative cash balance, it shall be reported as a negative asset and shall not be recorded as a liability. . . . Outstanding checks are accounted for as a reduction of cash.”

Uncollected premiums and agents’ balances in the course of collection – Page 33

Deferred Premiums, agents’ balances and installments booked but deferred and not yet due – Page 33

It is recommended that the Company record all due and uncollected premiums in *Uncollected premiums and agents’ balances in the course of collection* in accordance with the guidance provided by the NAIC Annual Statement Instructions, which state:

“Line 13.1 – Uncollected premiums and agents’ balances in course of Collection.

Include: Direct and group billed uncollected premiums. Amounts collected but not yet remitted to home office.”

SUBSEQUENT EVENTS

The review of events subsequent to December 31, 2006, and up to the date of this report included: review of the March 31, 2007, June 30, 2007, and September 30, 2007, Quarterly Statements; 2) review of the December 31, 2007 Annual Statement; and 3) general review of the cash disbursements/receipts transactions that might potentially have a material impact on the Company’s continued operations and/or financial conditions. In addition, the examiners inquired of management regarding any significant subsequent events. There were no significant subsequent events other than those discussed below.

Privatization of Alfa Corporation

On April 15, 2008, Alfa Mutual Insurance Company (AMI) and Alfa Mutual Fire Insurance Company (AMF) completed a merger transaction (the Merger) in which

they acquired the shares of Alfa Corporation (AC) not previously owned by them. As a result of the transaction, AC became a wholly owned subsidiary of AMI (65%) and AMF (35%). Each share of common stock of AC (other than shares owned by AMI, AMF, AC, and its wholly owned subsidiaries, and holders of shares subject to certain company awards) was cancelled and converted into the right to receive \$22.00 in cash, without interest.

Also, as a result of the Merger, AC's common stock ceased to trade on the Nasdaq Global Select Market as of the close of trading on April 15, 2008, and the registration of AC's common stock under the Securities Exchange Act of 1934, as amended, was terminated.

Contingencies

Subsequent to the end of the second quarter 2007, and following the initial announcement of the proposed Merger, certain purported class action lawsuits were brought on behalf of the public stockholders of AC in the Delaware Court of Chancery and in the Circuit Court of Montgomery County, Alabama. On April 14, 2008, the Circuit Court of Montgomery County, Alabama, formally approved the settlement reached by the parties to the aforementioned class action lawsuits.

In addition, on November 9, 2007, a policyholder of AMI filed a purported class action against AMI in the Circuit Court of Macon County, Alabama, also relating to the Merger. The policyholder subsequently elected to dismiss the class action claims. Also, on November 21, 2007, certain policyholders of AMI, AMF, and AMG filed a purported class action and derivative action against AMI, AMF, AMG, AC, and certain of their officers and directors in the Circuit Court of Walker County, Alabama. On February 23, 2008, counsel for the parties in the Walker County action entered into a Memorandum of Understanding to settle such action, subject to approval of the court. On March 4, 2008, the Walker County court conditionally approved the settlement and set a final approval hearing for May 28, 2008.

Pooling Agreement

On January 1, 2007, the pooling agreement was amended to add Alfa Alliance Insurance Corporation (AAI). Effective April 16, 2008, the pooling agreement was amended to change the pool participation percentages.

CONCLUSION

In concluding this Report on Examination, as of December 31, 2006, of *ALFA SPECIALTY INSURANCE CORPORATION*, acknowledgment is hereby made of the courtesy and cooperation extended by all persons representing the Company during the course of the examination.

The customary examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed to the extent appropriate in connection with the verification and valuation of assets and the determination of liabilities set forth in this report.

In addition to the undersigned, Charles Turner, Toni Bean, Jennifer Haskell, Mora Perkins, Theo Goodin, Jerry Hyche, Examiners, Frank Fricks, CFE, AIE, with Insurance Logic and Matthew Merlino, FCAS, MAAA, FCA and Suejeudi Buehler, FCAS, MAAA, Consulting Actuarial Examiners, both with Merlino & Associates, Inc.; all representing the Alabama Department of Insurance, participated in this examination of Alfa Specialty Insurance Corporation.

Respectfully submitted,

Francis Blase Abreo

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Examiner-in-Charge
State of Alabama
Department of Insurance