Examination Warrant Number 10-PC-145

Report of Examination of

AF&L Insurance Company
Warminster, Pennsylvania

As of December 31, 2010

For Informational Purposes Only

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Harrisburg, Pennsylvania
May 18, 2012

Honorable Stephen J. Johnson, CPA
Deputy Insurance Commissioner
Commonwealth of Pennsylvania
Insurance Department
Harrisburg, Pennsylvania

Dear Sir:

In accordance with instructions contained in Examination Warrant Number 10-PC-145, dated, March 5, 2010, an examination was made of

AF&L Insurance Company, NAIC Code: 35963,

a Pennsylvania domiciled property and casualty stock insurance company, hereinafter referred to as "Company." The examination was conducted at the Company's home office, located at 165 Veterans Way Suite 300, Warminster, Pennsylvania

A report of this examination is hereby respectfully submitted.

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SCOPE OF EXAMINATION

The Company was last examined as of December 31, 2005.

This examination covered the five-year period period from January 1, 2006 through December 31, 2010, and consisted of a general survey of the Company's business practices, management, and operations, and an evaluation of the Company's financial condition as of the latter date. Material subsequent events were also reviewed.

Work programs employed in the performance of this examination were designed to comply with the standards promulgated by the Pennsylvania Insurance Department ("Department") and the National Association of Insurance Commissioners ("NAIC").

The format of this report is consistent with the current practices of the Department and the examination format prescribed by the NAIC. It is limited to a description of the Company, a discussion of financial items that are of specific regulatory concern, and a disclosure of other significant regulatory information.

For each year during the period under examination, the Certified Public Accounting ("CPA") firm of Bee Bergvall & Company provided a ***qualified*** audit opinion on the Company's year-end financial statements based on statutory accounting principles. The CPA expressed uncertainty with the Company's ability to continue as a "Going Concern". Relevant work performed by the CPA firm, during its annual audit of the Company, was reviewed during the examination and incorporated into the examination work papers.

The following company was examined at the same time during the above examination:

Senior American Life Insurance Company ("SALIC") 76759

HISTORY

The Company's prior name, American Fidelity & Liberty Insurance Company, Inc. ("American") was incorporated on August 19, 1987, licensed by the Department on May 16, 1988 and commenced business on May 31, 1988. American's original corporate office was located in Parkesburg, PA.

American filed an amendment to its Articles of Incorporation in 1989, changing its address from Parkesburg to Camp Hill, PA.

On April 19, 1990, American increased its authorized shares from 100,000 to 1,000,000. Par value was not changed at this time.

On May 20, 1991, American again filed a Statement of Change of Registered Office with the Department of State, changing its address from Camp Hill to Coatesville, PA.

On October 18, 1994, American Fidelity & Liberty Insurance Company, Inc. changed its name to American Fidelity & Liberty Insurance Company ("American Company").

On July 3, 1995, American Company changed the number of authorized shares from 1,000,000 to 10,000,000 with no change in par value.

On September 16, 1997, American Company changed its headquarters from Coatesville to Warrington, PA.

On November 1, 2000, American Company changed its name to AF&L Insurance Company ("Company").

On August 7, 2003, the Company requested and thereafter received approval from the Department and the Commonwealth's Department of State to amend its Articles of Incorporation to allow it to adopt all powers and rights to operate as a life and health insurer effective January 1, 2004.

On December 2, 2004, the Company issued a Surplus Note ("Note") to CIVC Partners, the majority owner of the Company's minority owner, Cold Feet, LLC, in exchange for a $1,750,000 investment in the Company. The Note carries an interest rate of 12% and matures December 2, 2034.

On December 2, 2004, the Department approved an application by Cold Feet, LLC to directly acquire for cash, newly issued 1,250,000 shares of the voting common stock of the Company.

The Company stopped writing new business on February 25, 2005 in a mutual agreement with the Department. This action occurred due to its weakened financial position, namely, its negative surplus at the prior year-end that was precipitated by a substantial increase in its claim reserves during the fourth quarter of 2004.

The Company is currently operating under a corrective action plan, which has been updated and filed annually with the Department since March 2, 2006. The corrective action plan allows the department to effectively monitor the Company's run-off operations and status. The plan includes the actions the Company will take to ensure the most effective run off of the Company's obligations. The plan generally includes, at a minimum,

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1. Discontinuation of new business.
2. The reduction in administrative and operating costs.
3. Filing and implementation of rate increases for its Long-Term Care business.

The Department monitors the Company's performance against the plan at pre-established quarterly meetings with the Company.

The Company's Annual Statement filing for the year ended December 31, 2008 triggered a risk-based capital ("RBC") mandatory control level event pursuant to 40 P.S. § 221.1-A. The Company submitted an RBC plan pursuant to this event, part of which sought approval to file its regulatory financial statements on a Property and Casualty blank. On April 1, 2009 the Department approved the RBC Corrective Action Plan filed by the Company. The Company was re-licensed as a Property and Casualty insurer on July 17, 2009 and subsequently filed its regulatory financial statements on a Property and Casualty blank.

On March 22, 2010, the Department approved a Form A filing that gave AF&L Holdings, LLC ultimate control of the Company through its majority ownership of the Company's direct parent, AF&L, Inc. Effective with the acquisition of ultimate control of the Company by AF&L Holdings, LLC, the Note was assigned and transferred to AF&L Holdings, LLC. Immediately following the transfer of the Note, AF&L Holdings, LLC forgave the Note allowing the value of the Note to be recognized as capitalized equity by the Company.

The company is currently authorized to transact those classes of insurance described in the 40 P. S. § 382, Section 202, Subsection (c) Paragraph (2) Accident and Health.

MANAGEMENT AND CONTROL

CAPITALIZATION

As of the examination date, December 31, 2010, the Company's total capitalization was $802,108 , consisting of 3,750,000 capital shares of issued and outstanding common stock with a par value of $1.00 per share amounting to $3,750,000 ; $18,214,365 in gross paid in and contributed surplus; and $(21,162,257) in unassigned funds (surplus).

The Company's minimum capital and minimum surplus requirements for the types of business for which it is licensed, pursuant to 40 P. S. § 386.1, is $750,000 in capital and $375,000 in surplus. The Company has not met all governing capitalization requirements throughout the examination period.

It is recommended that the Company comply with 40 P. S. § 386.1 and increase its surplus to at least the minimum as required by statute.

STOCKHOLDER

The Company is owned by its sole stockholder, AF&L, Inc. There have been no dividends approved or distributed during the examination period.

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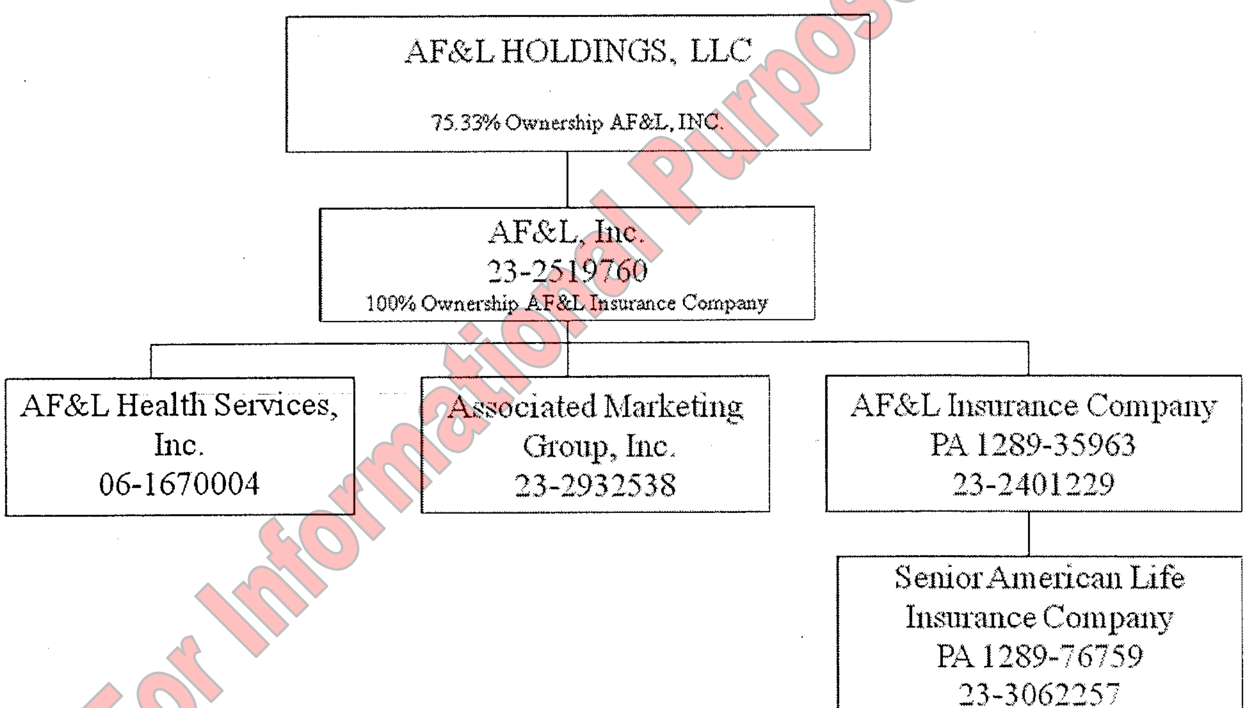
The Company's stock register does not reflect the ownership as noted above. The stock register shows that 1,250,000 shares are still owned by Cold Feet, LLC.

It is recommended, as a good business practice, that the stock register of the Company be updated to reflect the current ownership interests in the Company.

INSURANCE HOLDING COMPANY SYSTEM

The Company meets the requirements for filing an Insurance Holding Company System Registration Statement, in accordance with 40 P.S. §§ 991.1401-991.1413. Pertinent Forms B and C were filed annually along with various amendments as required during the examination period.

The Company's organization structure at the examination date, December 31, 2010, is shown below:



A brief description of the entities in the organization chart above follows:

AF&L Holdings, LLC is named as the ultimate controlling person in the holding company system. AF&L Holdings, LLC was formed on December 23, 2009, and has as it members a non-profit corporation, The Marc Foundation, an affiliate of The ARC of Montgomery, Berks and Bucks Counties ("MARC") (90% interest), and an individual, Mr. Benedict J. Iacovetti (10% interest).

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AF&L, Inc., an insurance holding company, is the corporate parent of Associated Marketing Group, Inc. and sole owner of AF&L Insurance Company.

Associated Marketing Group, Inc., a subsidiary of AF&L, Inc., is a marketing organization in addition to a licensed insurance agency.

AF&L Health Services, Inc. is currently dormant.

AF&L Insurance Company is a Pennsylvania stock property and casualty insurance company, which is currently in runoff. It sold primarily long-term care accident and health policies, including nursing home and home care products, to, mostly, senior citizens. It is the corporate parent of Senior American Life Insurance Company.

Senior American Life Insurance Company, a subsidiary of the Company, is a Pennsylvania stock life and health insurance company and similarly sells primarily long-term care accident and health policies, including nursing home and home care products, to, mostly, senior citizens in markets not serviced by the Company.

BOARD OF DIRECTORS

Management of the Company is vested in its Board of Directors ("Board"), which was comprised of the following member as of the examination date, December 31, 2010:

Name and Address	**Principal Occupation**
Benedict John Iacovetti. Warminster, PA	President and Chief Executive Officer AF&L Insurance Company

Mr. Iacovetti is currently the sole member of the Board.

It is recommended that the Company, at a minimum, increase its number of Directors to conform to the requirements of 15 Pa. C.S.A. § 3131 and the mandates of its own By-laws, both of which require no less than seven members.

COMMITTEES

The Company did not have any committees of the Board as of the examination date.

Governing law, namely 40 P.S. § 991.14059(c)(3) Standards of transactions between an insurer and an affiliate within a holding company system, states: "not less than one-third of the directors of a domestic insurer and not less than one-third of the members of each committee of the board of directors of any domestic insurer shall be persons who are not officers or employees of such insurer or of any entity controlling, controlled by or under common control with such insurer of any such entity. At least one such person must be included in any quorum for the transaction of business at any meeting of the board of directors or any committee thereof."

Likewise, 40 P.S. § 991.1405(c)(4) Standards of transactions between an insurer and an affiliate within a holding company system, further states: "The Board of Directors who are not officers or employees of the insurer or of any entity controlling, controlled by or under common control with the insurer and who are not beneficial owners of a controlling interest in the voting

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stock of the insurer and who are not beneficial owners of a controlling interest in the voting stock of the insurer or any such entity. The committee or committees shall have the responsibility of recommending the selection of independent certified public accountants, reviewing the insurer's financial condition, the scope and results of the independent audit and any internal audit, nominating committees for director for election by shareholders or policyholders, evaluating the performance of officer deemed to be principal officers of the insurer and recommending to the board of directors the selection and compensation of the principal officers."

It is recommended that the Company reorganize its Board to be compliant with 40 P.S. § 991.1405 (c)(3-4) once it increases its Board membership.

OFFICERS

As of the examination date, December 31, 2010, the following officers were appointed and serving in accordance with the Company's By-laws:

Name	Title
Benedict John Iacovetti	President
Paul John Lukacs	Treasurer
Ernest Iannucci	Vice President

CORPORATE RECORDS

MINUTES

A compliance review of corporate minutes revealed the following:

- The Annual Meetings of the Company's stockholder were not held in compliance with its By-laws.
- The stockholder does not elect directors at such meetings in compliance with the By-laws.
- The stockholder did not ratify the prior year's actions of the officers and directors.
- Due to lack of board members, quorums were not present at all directors' meetings.
- The Company's investment transactions are approved quarterly by the Board.
- All directors attend Board meetings regularly.
- The Company's Board meeting minutes document approval of the reinsurance contracts.

It is recommended that the Company have annual stockholder meetings in compliance with its By-laws.

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ARTICLES OF AGREEMENT

The company amended and restated its Articles of Agreement on July 14, 2009. The following changes were made:

1) Change in the class of insurance for which the Company is authorized to transact business to that described in 40 P.S. § 382, Section 202, Subsection (c) Paragraph (2) Accident and Health.
2) Address of the Company was changed.

BY-LAWS

The Company amended its By-laws on June 11, 2007. The following changes were made:

1) Change in number of directors from nine (9) to seven (7).
2) Name change from American Fidelity and Liberty Insurance Company to AF&L Insurance Company.

FIDELITY BOND

The Company maintains a fidelity bond of $500,000 with a $5,000 deductible. The minimum bond value as computed based on the formula contained in the NAIC Financial Condition Examiners Handbook is $1,000,000. 40 P.S. § 443 requires insurance companies domiciled in Pennsylvania to follow the guidance provided by the NAIC.

It is recommended that the Company increase the limit on its fidelity bond from $500,000 to $1,000,000 in order to comply with 40 P.S. § 443.

SERVICE AND OPERATING AGREEMENTS

The Company is a party to various service and operating agreements with both affiliates and non-affiliates. The examination reviewed the following agreements and found them to be in compliance with the "fair and reasonable" standards of 40 P.S. §991.1405(a) (1), except as noted below.

COST ALLOCATION AGREEMENT

The Company is party to a cost allocation agreement with its subsidiary, SALIC , whereby actual expenses are allocated directly to the incurring entity while selected agreed-upon joint expenses are allocated based upon each entity's respective percentage of total aggregate collected premiums.

TAX ALLOCATION AGREEMENT

The Company is party to a tax allocation agreement with its subsidiary, SALIC. Based on the testing performed by the examination team, the Company does not appear to be operating

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in accordance with the terms of the tax allocation agreement that was provided by the Company to the examination team. According to the Company, the tax allocation agreement was amended; however, the Company could not produce an amended agreement.

It is recommended, that the Company revise its Tax Allocation Agreement so that it reflects the current method of allocation.

REINSURANCE

CEDED

Sun Life of Canada

The Company maintains an Excess of Loss Treaty with Sun Life of Canada, which provides 100% coverage for any lifetime benefit claims in excess of five years, on certain long-term care policies written between January 1, 1998 and March 31, 2000. This treaty does not cover a material portion of the Company's losses.

London Life Reinsurance Company

Effective January 1, 2010 the Company recaptured the business it had reinsured with London Life Reinsurance Company ("LLRC") in which the Company ceded approximately 80% of its inforce business. The reinsurance agreement was commuted and terminated with a net termination amount due the Company from LLRC of $3.0 million. The $3.0 million settlement amount was recorded as a negative paid loss. The December 31, 2009 balance in the funds held by the Company under reinsurance treaties was written off in the Statement of Income. This commutation and termination agreement also had a significant effect on all of the elements that made up the underwriting results.

ASSUMED

The Company assumed on a coinsurance basis in 2003, a block of long-term care business written by Mid-West National Life of Tennessee as well as MEGA Life and Health Insurance Company. Reserves on these blocks are not material.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2010 the Company is licensed in the following jurisdictions: Arkansas, Delaware, Georgia, Idaho, Illinois, Indiana, Kansas, Kentucky, Maryland, Missouri, Montana, Nebraska, Nevada, North Dakota, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Texas, Utah, Virginia, and West Virginia. The Company also has business that was written in other states that it is not currently licensed, as the Company subsequently lost its license in those states after the business was written. States where this has occurred that have

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written premiums greater than $1.0 million include: Florida, Ohio, and Tennessee. In February of 2005, the Company ceased writing new business and is currently in runoff.

The Company's major line of business is Long Term Care ("LTC"). This business, which represents over 97% of the Company's in force premiums includes comprehensive LTC, which provides coverage for nursing home, assisted living facility and care at home; facility only LTC, which only provides coverage for nursing home and assisted living facility stays and stand-alone home health care, which only provides coverage for care at home. LTC and home health care policies provide coverage of varying periods from one year up to a lifetime and for varying daily benefit amounts. Stand-alone home health care represents about 13% of its business mix, while LTC insurance embodies 84%. Hospital Indemnity, providing recuperative care benefits, and other products constitute 2% and 1% of the balance, respectively.

Florida represents approximately 18.9% of the Company's in force premium. The Company has experienced adverse experience on its Florida LTC business. The Company continues to seek rate relief from Florida as well as other jurisdictions where the company has seen adverse experience related to its LTC business.

As stated above, the company has premium in various states, the states with the most written premium include: Florida (18.9%), Pennsylvania (14.3%), Texas (11.8%) and Ohio (7.5%).

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SIGNIFICANT OPERATING RATIOS AND TRENDS

The underwriting ratios summarized below are on an earned/incurred basis, and encompass the five-year period period covered by this examination.

	Amount	Percentage
Premiums earned	$ 218,127,914	100.0 %
Losses incurred	$ 237,109,191	108.7 %
Loss expenses incurred	4,648,929	2.1 %
Other underwriting expenses incurred	57,720,958	26.5 %
Aggregate write-ins for underwriting deductions	(27,077,958)	(12.4)%
Net underwriting gain or (loss)	(54,273,206)	(24.9)%
Totals	$ 218,127,914	100.0 %

The Company reported the following net underwriting, investment and other gains or losses during the period under examination:

	2010	2009	2008	2007	2006
Admitted assets	$ 177,930,730	$ 173,561,092	$ 168,665,236	$ 162,812,975	$ 154,594,206
Liabilities	$ 177,128,622	$ 172,638,292	$ 168,237,415	$ 161,214,417	$ 151,138,496
Surplus as regards policyholders	$ 802,108	$ 922,800	$ 427,821	$ 1,598,558	$ 3,455,710
Gross premium written	$ 35,076,608	$ 39,954,522	$ 44,560,920	$ 48,433,570	$ 54,041,171
Net premium written	$ 212,825,359	$ (3,922,019)	$ 2,837,769	$ 3,933,436	$ 5,620,357
Underwriting gain/(loss)	$ (12,598,255)	$ (14,718,016)	$ (8,922,979)	$ (9,314,963)	$ (8,718,993)
Investment gain/(loss)	$ 13,752,476	$ 15,391,779	$ 8,644,864	$ 7,885,390	$ 7,209,616
Other gain/(loss)	$ 11,271	$ 23,967	$ 100,958	$ 70,127	$ 90,121
Net income	$ 1,158,425	$ 697,730	$ (177,157)	$ (1,359,446)	$ (1,419,256)

It is noted that the Company has seen a significant decrease in gross and net premium, however, that is to be expected due to the Company's current run-off status. The commutation of the reinsurance treaty with LLRC had a significant effect on net written premium for 2010.

ACCOUNTS AND RECORDS

The Company maintains its accounts and records on an in-house computer system. This includes its general ledger, cash receipts, and cash disbursements, which are all automated using a VAI General Ledger package. Claims processing and billing functions are performed on software provided by Milliman, USA. All hard copies of policies and/or other documentation are scanned into the Company's systems using Image Right software.

PENDING LITIGATION

CLAIMS LITIGATION

The Company is party to various lawsuits, in the normal course of business, relative to benefits provided under its issued insurance policies. Management believes the outcome of these matters would not have a material adverse effect on the Company's results of operation, liquidity or financial position; however, this examination concludes that any deviation from the anticipated results of these lawsuits would have a material effect on these metrics given the Company's surplus position.

BUSINESS PRACTICES LITIGATION

The Company is also involved in two lawsuits filed against it involving non-payment of commissions allegedly owed to insurance agents of the Company as follows:

- The Company has been a defendant in a case filed against it by Buck Capital Management Corporation ("Buck") in 2004. A verdict has been awarded to Buck and an appeal of the verdict was filed by the Company but the appeal was lost in the Pennsylvania Superior Court. A petition for permission to appeal to the Pennsylvania Supreme Court was recently filed by the Company. The Company has accrued a provision within its financial statements that represents the awarded amount in this case.
- The Company is also a defendant in a similar lawsuit filed against it by The National Agency Development, Inc. and Carefree Insurance Management. The lawsuit involves insurance agents of the Company who sold insurance policies to the public beginning in or about 1997. Plaintiffs have asserted claims based on breach of contract and quantum merit to recover the commissions allegedly owed. Discovery phase is almost complete and the Company is vigorously defending this lawsuit.

Management believes the outcome of these matters would not have a material adverse effect on the Company's results of operation, liquidity or financial position; however, this

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examination concludes that any deviation from the anticipated results of these lawsuits would have a material effect on these metrics given the Company's surplus position.

MORTGAGE FORECLOSURE ACTION

On February 21, 2008, the Company commenced a mortgage foreclosure action against Windmill Real Estate Holdings, L.P. ("Windmill"). The mortgage relates to the Company's former headquarters at 1800 Street Road, Warrington, PA. Windmill believes that the suit has no merit as Windmill contends that the Company should be held liable for Windmill's judgment against AF&L, Inc. as Windmill views the Company and its immediate parent company, AF&L, Inc. as "alter egos" of each other (see "Promissory Note of AF&L, Inc. below) and believes that the promissory note judgment against AF&L, Inc. offsets any amounts due the Company under the mortgage. The parties have exchanged preliminary filings and objections. The Company has been vigorously contesting this case and believes it will have a favorable outcome; however, this examination concludes that any unfavorable outcome of this lawsuit would have a material effect on the Company's results of operation, liquidity and financial position given the Company's surplus position.

PROMISSORY NOTE OF AF&L, INC.

On December 5, 2007, Windmill commenced an action against AF&L, Inc. to collect on a promissory note entered into on October 6, 2004. On March 5, 2008 a default judgment was entered against AF&L, Inc., the Company's immediate parent. AF&L, Inc's only significant asset is its stock ownership of the Company. Windmill is now seeking to enforce this judgment against AF&L, Inc. and, in an effort to identify and locate assets of AF&L, Inc., Windmill deposed Benedict J. Iacovetti, the President of AF&L, Inc. on September 14, 2011.

The Company has been vigorously contesting this case and believes it will have a favorable outcome, however; this examination concludes that any unfavorable outcome of this lawsuit would have a material effect on the Company's results of operation, liquidity and financial position given the Company's surplus position.

FINANCIAL STATEMENTS

The financial condition of the Company, as of December 31, 2010, and the results of its operations for the five-year period period under examination, are reflected in the following statements:

Comparative Statement of Assets, Liabilities, Surplus and Other Funds;
Comparative Statement of Income;
Comparative Statement of Capital and Surplus; and
Comparative Statement of Cash Flow.

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Comparative Statement of Assets, Liabilities, Surplus and Other Funds As of December 31,

	2010	2009	2008	2007	2006
Bonds	$ 166,338,851	$ 165,071,061	$ 153,961,467	$ 152,655,552	$ 143,419,448
Common stocks	1,944,284	3,149,134	4,108,961	4,571,318	5,107,221
Mortgage loans on real estate	1,600,833	1,600,834	867,500	1,402,500	1,402,500
Cash, cash equivalents, and short term investments	5,456,267	1,455,130	7,459,682	1,651,957	1,557,556
Receivable for securities	0	9,707	0	0	0
Subtotals, cash and invested assets	175,340,235	171,285,866	166,397,610	160,281,327	151,486,725
Investment income due and accrued	2,137,326	1,961,650	1,935,419	2,243,197	2,135,395
Premiums and agents' balances due	63,631	16,181	19,015	20,859	23,190
Other amounts receivable under reinsurance contracts	204,030	139,013	123,521	115,667	31,881
Electronic data processing equipment and software	44,158	11,702	18,585	40,858	107,523
Receivable from parent, subsidiaries and affiliates	33,060	43,973	56,086	0	634,990
Aggregate write-ins for other than invested assets	108,290	102,707	115,000	111,067	174,502
Total	$ 177,930,730	$ 173,561,092	$ 168,665,236	$ 162,812,975	$ 154,594,206
Losses	$ 66,531,393	$ 13,090,933	$ 14,375,398	$ 14,231,939	$ 14,175,303
Loss adjustment expenses	1,543,062	1,627,117	1,991,146	2,078,338	2,211,156
Commissions payable, contingent commissions and other similar charges	897,080	952,680	893,168	1,368,267	725,641
Other expenses	750,556	699,956	634,235	540,815	838,641
Taxes, licenses and fees	166,587	169,537	122,495	135,198	168,613
Current federal and foreign income taxes	7,066	0	0	0	0
Unearned premiums	5,919,560	1,570,197	1,880,084	2,140,704	2,431,477
Funds held by company under reinsurance treaties	0	129,185,710	121,625,046	115,163,594	106,915,331
Amounts withheld or retained by company for account of others	64,914	41,407	34,615	25,861	52,308
Remittances and items not allocated	0	0	(1,355)	52	3,639
Drafts outstanding	1,613,992	1,643,351	2,302,203	1,417,650	1,606,721
Payable to parent, subsidiaries and affiliates	0	0	33,269	84,930	0
Aggregate write-ins for liabilities	99,634,412	23,657,404	24,347,111	24,027,069	22,009,666
Total liabilities	177,128,622	172,638,292	168,237,415	161,214,417	151,138,496
Common capital stock	3,750,000	3,750,000	3,750,000	3,750,000	3,750,000
Surplus notes	0	1,750,000	1,750,000	1,750,000	1,750,000
Gross paid in and contributed surplus	18,214,365	18,214,365	18,214,365	18,214,365	18,214,365
Unassigned funds (surplus)	(21,162,257)	(22,791,565)	(23,286,544)	(22,115,807)	(20,258,655)
Surplus as regards policyholders	802,108	922,800	427,821	1,598,558	3,455,710
Totals	$ 177,930,730	$ 173,561,092	$ 168,665,236	$ 162,812,975	$ 154,594,206

Note: For calendar year 2008 and earlier, the Company filed its Annual Statement on a Life & Health blank. For 2009 and after, the Company was re-licensed as a property and casualty company and therefore filed its Annual Statement on a Property & Casualty blank, with the prior approval of the Department. All financial statements and financial schedules in this report are shown on a Property & Casualty blank basis, with the years 2008 and earlier converted to this basis in order to more fairly present information on a comparative basis.

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Comparative Statement of Income
For the Year Ended December 31,

Underwriting Income	2010	2009	2008	2007	2006
Premiums earned	$ 208,463,029	$ (3,651,617)	$ 3,098,390	$ 4,224,209	$ 5,993,903
Deductions:					
Losses incurred	201,273,015	8,353,325	9,508,527	9,044,076	8,930,248
Loss expenses incurred	771,551	542,574	942,285	1,035,437	1,357,082
Other underwriting expenses incurred	51,921,636	1,074,712	1,076,882	1,571,887	2,075,841
Aggregate write-ins for underwriting deductions	(32,904,918)	1,095,788	493,675	1,887,772	2,349,725
Total underwriting deductions	221,061,284	11,066,399	12,021,369	13,539,172	14,712,896
Net underwriting gain or (loss)	(12,598,255)	(14,718,016)	(8,922,979)	(9,314,963)	(8,718,993)
Investment Income					
Net investment income earned	10,145,459	9,955,990	8,877,269	7,943,912	7,209,617
Net realized capital gains or (losses)	3,607,017	5,435,789	(232,405)	(58,522)	(1)
Net investment gain or (loss)	13,752,476	15,391,779	8,644,864	7,885,390	7,209,616
Other Income					
Net gain or (loss) from agents' or premium balances charged off	2,646	2,638	2,908	0	0
Aggregate write-ins for miscellaneous income	8,625	21,329	98,050	70,127	90,121
Total other income	11,271	23,967	100,958	70,127	90,121
Net income before dividends to policyholders and before federal and foreign income taxes	1,165,491	697,730	(177,157)	(1,359,446)	(1,419,256)
Federal and foreign income taxes incurred	7,066	0	0	0	0
Net income	$ 1,158,425	$ 697,730	$ (177,157)	$ (1,359,446)	$ (1,419,256)

Note: For calendar year 2008 and earlier, the Company filed its Annual Statement on a Life & Health blank. For 2009 and after, the Company was re-licensed as a property and casualty company and therefore filed its Annual Statement on a Property & Casualty blank, with the prior approval of the Department. All financial statements and financial schedules in this report are shown on a Property & Casualty blank basis, with the years 2008 and earlier converted to this basis in order to more fairly present information on a comparative basis.

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Comparative Statement of Capital and Surplus
For the Year Ended December 31,

	2010	2009	2008	2007	2006
Surplus as regards policyholders,					
December 31, previous year	$ 922,800	$ 427,821	$ 1,598,558	$ 3,455,710	$ 4,407,846
Net income	1,158,425	697,730	(177,157)	(1,359,446)	(1,419,256)
Net unrealized capital gains or (losses)	(1,139,543)	(1,051,477)	(997,357)	(535,906)	(231,957)
Change in nonadmitted assets	(139,574)	(69,497)	(105,621)	107,616	823,808
Cumulative effect of changes in accounting principles	0	918,223	109,398	(69,416)	(124,731)
Change in surplus as regards policyholder for the year	(120,692)	494,979	(1,170,737)	(1,857,152)	(952,136)
Surplus as regards policyholders,					
December 31, current year	$ 802,108	$ 922,800	$ 427,821	$ 1,598,558	$ 3,455,710

Note: For calendar year 2008 and earlier, the Company filed its Annual Statement on a Life & Health blank. For 2009 and after, the Company was re-licensed as a property and casualty company and therefore filed its Annual Statement on a Property & Casualty blank, with the prior approval of the Department. All financial statements and financial schedules in this report are shown on a Property & Casualty blank basis, with the years 2008 and earlier converted to this basis in order to more fairly present information on a comparative basis.

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Comparative Statement of Cash Flow
For the Year Ended December 31,

	2010	2009	2008	2007	2006
Cash from Operations					
Premiums collected net of reinsurance	$ 212,770,246	$ (3,958,670)	$ 2,839,613	$ 3,935,767	$ 5,625,941
Net investment income	9,565,598	9,145,719	9,213,269	8,186,642	7,394,483
Miscellaneous income	11,271	23,967	6,705,116	8,701,538	11,535,538
Total income	222,347,115	5,211,016	18,757,998	20,823,947	24,555,962
Benefit and loss related payments	147,897,572	9,653,282	9,372,923	9,071,225	8,306,512
Commissions, expenses paid and aggregate write-ins for deductions	22,769,541	2,914,251	8,696,005	11,115,839	15,780,093
Federal and foreign income taxes paid (recovered)	0	0	0	0	(351,328)
Total deductions	170,667,113	12,567,533	18,068,928	20,187,064	23,735,277
Net cash from operations	51,680,002	(7,356,517)	689,070	636,883	820,685
Cash from Investments					
Proceeds from investments sold, matured or repaid:					
Bonds	58,570,129	75,366,063	61,449,980	13,254,314	18,165,131
Stocks	21,400	19,803	0	0	0
Miscellaneous proceeds	9,707	0	0	0	20,712
Total investment proceeds	58,601,236	75,385,866	61,449,980	13,254,314	18,185,843
Cost of investments acquired (long-term only):					
Bonds	55,922,036	80,468,053	63,169,341	22,783,596	33,521,642
Stocks	14,253	14,280	0	0	0
Mortgage loans	0	733,334	0	0	0
Miscellaneous applications	0	9,707	0	0	0
Total investments acquired	55,936,289	81,225,374	63,169,341	22,783,596	33,521,642
Net cash from investments	2,664,947	(5,839,508)	(1,719,361)	(9,529,282)	(15,335,799)
Cash from Financing and Miscellaneous Services					
Other cash provided (applied):					
Other cash provided or (applied)	(50,343,812)	7,191,473	6,838,016	8,986,800	12,409,478
Net cash from financing and miscellaneous sources	(50,343,812)	7,191,473	6,838,016	8,986,800	12,409,478
Reconciliation of cash and short-term investments:					
Net change in cash and short-term investments	4,001,137	(6,004,552)	5,807,725	94,401	(2,105,636)
Cash and short-term investments:					
Beginning of the year	1,455,130	7,459,682	1,651,957	1,557,556	3,663,192
End of the year	$ 5,456,267	$ 1,455,130	$ 7,459,682	$ 1,651,957	$ 1,557,556

Note: For calendar year 2008 and earlier, the Company filed its Annual Statement on a Life & Health blank. For 2009 and after, the Company was re-licensed as a property and casualty company and therefore filed its Annual Statement on a Property & Casualty blank, with the prior approval of the Department. All financial statements and financial schedules in this report are shown on a Property & Casualty blank basis, with the years 2008 and earlier converted to this basis in order to more fairly present information on a comparative basis.

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SUMMARY OF EXAMINATION CHANGES

There were no examination changes to the preceding financial statements as filed with regulatory authorities over the review period.

NOTES TO FINANCIAL STATEMENTS

ASSETS

INVESTMENTS

As of December 31, 2010, the Company's invested assets were distributed as follows:

	Amount	Percentage
Bonds	$ 166,338,851	94.9 %
Common stocks	1,944,284	1.1 %
Mortgage loans on real estate	1,600,833	0.9 %
Cash	2,326,764	1.3 %
Short-term investments	3,129,503	1.8 %
Totals	$ 175,340,235	100.0 %

The Company's bond and short-term investment portfolio had the following quality and maturity profiles:

NAIC Designation	Amount	Percentage
1 - highest quality	$ 148,878,105	87.9 %
2 - high quality	19,506,387	11.5 %
3 - medium quality	1,083,862	0.6 %
Totals	$ 169,468,354	100.0 %

Years to Maturity	Amount	Percentage
1 year or less	$ 3,508,685	2.1 %
2 to 5 years	936,290	0.6 %
6 to 10 years	33,489,721	19.7 %
11 to 20 years	25,851,736	15.3 %
over 20 years	105,681,922	62.3 %
Totals	$ 169,468,354	100.0 %

The Company has a written investment policy as required by 40 P.S. § 653b (b). However, the Company could not provide documentation that the investment policy was reviewed and approved on an annual basis by the Board. The Company, at December 31, 2010, was following its investment policy.

It is recommended that the Company maintain documentation that its investment policy is reviewed and approved annually by the Board in compliance with 40 P.S. § 653b (b).

The Company currently does not have an Other Than Temporary Impairment policy.

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It is recommended that the Company develop and implement a formal Other Than Temporary Impairment policy and make it part of its investment policy.

The Company's custodial agreement with Comerica Bank is not in compliance with 31 Pa. Code § 148a.3.

It is recommended that the Company amend its Custodial Agreement to comply with 31 Pa. Code § 148a.3. The Company also maintains an investment in its subsidiary, SALIC. It currently values this investment using the equity method, which is compliant with NAIC valuation standards. As of December 31, 2010, the Company reported the value of its subsidiary at $1,944,284, which was 1% of admitted assets. The Company maintains service and operating agreements with this subsidiary as noted on page 7.

LIABILITIES

LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

The Company establishes reserves for future policy benefits to reflect the impact of level renewal premiums and the increasing risks of claims losses as policyholders' age. The Company also establishes policy and contract claims reserves to reflect the liability for incurred claims, both reported and unreported.

Gross active life reserves reported by the Company as of December 31, 2010 total $105,894,898 and include $5,929,815 in unearned premium reserves and $99,965,083 in contract reserves. These gross reserves were reduced by reinsurance ceded of $340,926 for a net active life reserve provision of $99,634,412. These items were reported in the Company's December 31, 2010 annual statement as follows:

• Page 3, line 9 – Unearned Premiums (net)	$ 5,919,560
• Page 3, line 25 – Aggregate Write-ins for Liabilities	$99,634,412

The gross reserve for Accident and Health contract claims in the amount of $70,459,453 was similarly reduced by a reinsurance claim reserve credit of $3,928,060 for a net claim reserve of $66,531,393, which was reported on the Company's December 31, 2010 annual statement on page 3, line 1 - Losses.

The Company also reported $1,543,062 of loss adjustment expense reserves on the Company's December 31, 2010 annual statement (page 3, line 3 - Loss Adjustment Expenses).

The Company's appointed actuary, Glenn A. Tobleman, FCAS, FSA, MAAA of Lewis & Ellis, Inc., provided an opinion on the Company's reported reserves as of December 31, 2010, which stated that the amounts carried:

1. "Meet the requirements of the insurance laws of Pennsylvania.
2. Are consistent with those computed in accordance with accepted actuarial standards and principles.

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3. Make a reasonable provision, in the aggregate, for all unpaid loss and loss adjustment expense obligations under the terms of its contracts and agreements."

The examination utilized the services of the Department's life actuary to verify the adequacy of the Company's loss and loss adjustment expense reserves. This analysis was performed in accordance with the valuation procedures developed by the Department. During the testing the Department's life actuary noted that assumptions, methods, and approaches with regards to the Company's loss and loss adjustment expense reserves have changed since the last examination. As a result of this testing, it was determined that the Company's reported loss reserves as of December 31, 2010 were deficient by $10,700,000. However, no adjustment is being made to the Company's loss reserves in this examination report due to the fact that the Company had unrealized capital gains relating to its investment portfolio reported on its books as of December 31, 2011 that exceeded the amount of the loss reserve deficiency by about 165%. These unrealized capital gains amounted to $17,655,283 as of December 31, 2011. Also, since the Company is in run off, the Department closely monitors the Company throughout the year and has regularly scheduled quarterly meetings with Company management, which gives the Department the ability to evaluate the Company's continued solvency at any point in time.

SUBSEQUENT EVENTS

MOST RECENT FINANCIAL STATEMENT HIGHLIGHTS

The Company reported the following in its December 31, 2011 financial statements: total assets of $176,373,545, total liabilities of $176,305,950, surplus of $67,595, and a net income of $1,371,643. None of these figures were verified as part of this examination and are included for information purposes only.

Also of note, the Company's subsidiary, SALIC, reflected on its December 31, 2011 annual statement filed with the Department a negative surplus of $577,000. SALIC was previously held on the Company's financial statements under the statutory equity method. However, due to the negative surplus shown on SALIC's December 31, 2011 annual statement; the Company's valuation of SALIC as of December 31, 2011 is $0.

The Company's independent CPA firm provided a ***qualified*** audit opinion on the Company's December 31, 2011 financial statements based on statutory accounting principles. The CPA firm continued to express uncertainty with the Company's ability to continue as a "Going Concern" as it had done throughout the period under examination.

RECOMMENDATIONS

PRIOR EXAMINATION

The prior examination report contained the following recommendations:

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1. It is recommended that the Company at a minimum, increase its number of Directors to conform to the requirements of 15 Pa. C.S.A. § 3131 and preferably comply with the mandates of its own By-laws.

   The Company has not complied with this recommendation. This recommendation will be reiterated for the current examination.

2. It is recommended that the Company implement a Conflict of Interest policy and evaluate its efficacy periodically.

   The Company has complied with this recommendation.

3. It is recommended that the Company reorganize its Board of Directors to be compliant with 40 P.S. § 991.1405 (c)(3).

   The Company has not complied with this recommendation. This recommendation will be reiterated for the current examination.

4. It is recommended that the Company document its committee meetings, including a record of members in attendance, a description of deliberations and proceedings, and recommendations made to the Board as contemplated by governing Pennsylvania Business Corporation Law, i.e. (15 Pa. C.S. § 1508 (a) in order that compliance with 40 P. S. § 991.1405(c)(4) can be evidenced.

   The Company currently maintains no committees; therefore this recommendation is not applicable to the Company during this examination period.

5. It is recommended that the Board of Directors review and approve all investment activity at least quarterly and approve an Investment Plan at least yearly.

   The Company has complied with this recommendation.

6. It is recommended that the Company revise and update its By-laws to reflect its current name in addition to listing and inserting the expected responsibilities of its Committees.

   The Company has complied with this recommendation.

7. It is recommended that the Company expedite its efforts to cure the current regulatory non-compliance provisions of it securities custodial agreement and forward the revised compliant agreement to the Department as hastily as possible.

   The Company had complied with the original recommendation, however the revised custodial agreement was also found to not be in compliance. A new recommendation will be made in the current examination.

CURRENT EXAMINATION

As a result of the current examination, the following recommendations are being made:

1. It is recommended that the Company comply with 40 P. S. § 386.1 and increase its surplus to at least the minimum as required by statute. (See, "Management and Control - Capitalization", Page 3).

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2. It is recommended, as a good business practice, that the stock register of the Company be updated to reflect the current ownership interests in the Company. (See, "Management and Control - Stockholder", Page 4).
3. It is recommended that the Company, at a minimum, increase its number of Directors to conform to the requirements of 15 Pa. C.S.A. § 3131 and the mandates of its own By-laws, both of which require no less than seven members. (See, "Management and Control - Board of Directors", Page 5).
4. It is recommended that the Company reorganize its Board to be compliant with 40 P.S. § 991.1405 (c)(3-4) once it increases its Board membership. (See "Management and Control - Committees", Page 6).
5. It is recommended that the Company have annual stockholder meetings in compliance with its By-laws. (See, "Corporate Records – Minutes", Page 6).
6. It is recommended that the Company increase the limit on its fidelity bond from $500,000 to $1,000,000 in order to comply with Pennsylvania Insurance Company Law 40 P.S. § 443. (See, "Corporate Records – Fidelity Bond", Page 7).
7. It is recommended, that the Company revise its Tax Allocation Agreement so that it reflects the current method of allocation. (See, "Service and Operating Agreements – Tax Allocation Agreement", Page 8).
8. It is recommended that the Company maintain documentation that its investment policy is reviewed and approved annually by the Board in compliance with 40 P.S. § 653b (b). (See, "Notes to Financial Statements - Investments", Page 16).
9. It is recommended that the Company develop and implement a formal Other Than Temporary Impairment policy and make it part of its investment policy. (See, "Notes to Financial Statements - Investments", Page 17).
10. It is recommended that the Company amend its Custodial Agreement to comply with 31 Pa. Code § 148a.3. (See, "Notes to Financial Statements - Investments", Page 17).

CONCLUSION

As a result of this examination, the financial condition of AF&L Insurance Company, as of December 31, 2010, was determined to be as follows:

	Amount	Percentage
Admitted assets	$ 177,930,730	100.0 %
Liabilities	$ 177,128,622	99.5 %
Surplus as regards policyholders	802,108	0.5 %
Total liabilities and surplus	$ 177,930,730	100.0 %

Since the previous examination, made as of December 31, 2005, the Company's assets increased by $36,609,415, its liabilities increased by $40,215,152, and its surplus decreased by $3,605,737.

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This examination was conducted by Keith D. Wandel Jr., AES, CFE and Matthew C. Milford, CFE,with the la tter in charge.

Respectfully,

Annette B. Szady

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Director, Bureau of Financial Examinations

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Examiner-in-Charge

The CFE designation has been conferred by an organization not affiliated with the federal or any state government. However the CFE designation is the only designation recognized by the NAIC for the purposes of directing statutory Association examinations of insurance companies.

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