



COMMONWEALTH OF MASSACHUSETTS
OFFICE OF CONSUMER AFFAIRS AND BUSINESS REGULATION
DIVISION OF INSURANCE

REPORT OF EXAMINATION OF THE
HOSPITALITY MUTUAL INSURANCE COMPANY

Southborough, Massachusetts

As of December 31, 2016

NAIC GROUP CODE 4724

NAIC COMPANY CODE 13163

EMPLOYER ID NUMBER 04-2901190

HOSPITALITY MUTUAL INSURANCE COMPANY

TABLE OF CONTENTS	<u>Page</u>
Salutation	1
Scope of Examination	2
Summary of Significant Findings of Fact	3
Company History	4
General	4
Management and Control	5
Board of Directors	5
Committees of the Board of Directors	6
Officers	7
Affiliated Companies	7
Organization Chart	7
Transactions and Agreements with Subsidiaries and Affiliates	8
Territory and Plan of Operation	8
Treatment of Policyholders	8
Reinsurance	9
Assumed Reinsurance	9
Ceded Reinsurance	9
Financial Statements	10
Statement of Assets, Liabilities, Surplus and Other Funds	11
Statement of Income, Capital and Surplus	12
Reconciliation of Capital and Surplus	13
Analysis of Changes in Financial Statement Resulting From Examination	14
Comments on Financial Statements Items	14
Subsequent Events	15
Summary of Recommendations	15
Signature Page	22



**COMMONWEALTH OF
MASSACHUSETTS**
Office of Consumer Affairs and Business Regulation
DIVISION OF INSURANCE

1000 Washington Street, Suite 810 • Boston, MA 02118-6200
(617) 521-7794 • Toll free (877) 563-4467
<http://www.mass.gov/doi>

CHARLES D. BAKER
GOVERNOR

KARYN E. POLITO
LIEUTENANT GOVERNOR

JAY ASH
SECRETARY OF HOUSING AND
ECONOMIC DEVELOPMENT

JOHN C. CHAPMAN
UNDERSECRETARY OF CONSUMER AFFAIRS
AND BUSINESS REGULATION

GARY D. ANDERSON
COMMISSIONER OF INSURANCE

May 14, 2018

The Honorable Gary D. Anderson
Commissioner of Insurance
Commonwealth of Massachusetts
Division of Insurance
1000 Washington Street, Suite 810
Boston, MA 02118-6200

Honorable Commissioner:

Pursuant to your instructions and in accordance with Massachusetts General Laws, Chapter 175,
Section 4 an examination has been made of the financial condition and affairs of

HOSPITALITY MUTUAL INSURANCE COMPANY

at its home office located at 106 Southville Road, Southborough, Massachusetts 01772. The
following report thereon is respectfully submitted.

SCOPE OF EXAMINATION

Hospitality Mutual Insurance Company ("Company" or "HMIC") was last examined as of December 31, 2011 by the Massachusetts Division of Insurance ("Division"). The current multi-state examination was also conducted by the Division and covers the five-year period from January 1, 2012 through December 31, 2016, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of this examination.

The examination was conducted in accordance with standards and procedures established by the National Association of Insurance Commissioners ("NAIC") Financial Condition (E) Committee and prescribed by the current NAIC *Financial Condition Examiners Handbook*, the examination standards of the Division and with Massachusetts General Laws. The Handbook requires that we plan and perform the examination to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the Company, including corporate governance, identifying and assessing inherent risks within the Company, and evaluating system controls and procedures used to mitigate those risks.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process. This may include assessing significant estimates made by management and evaluating management's compliance with Statutory Accounting Principles. The examination does not attest to the fair presentation of the financial statements included herein. If, during the course of the examination an adjustment is identified, the impact of such adjustment will be documented separately following the Company's financial statements.

This examination report includes significant findings of fact, as mentioned in the Massachusetts General Laws, Chapter 175, Section 4, and general information about the insurer and its financial condition. There may be other items identified during the examination that, due to their nature (e.g., subjective conclusions, proprietary information, etc.), are not included within the examination report but separately communicated to other regulators and/or the Company.

The Company is audited annually by Crowe Horwath, LLP ("CH"), an independent certified public accounting firm. The firm expressed unqualified opinions on the Company's financial statements for the calendar years 2015 through 2016. The Company was audited in 2012 through 2014 by the independent certified public accounting firm of Saslow, Lufkin & Buggy, LLP, who also expressed unqualified opinions of the Company's financial statements. Effective July 1, 2015, Saslow, Lufkin & Buggy, LLP merged with CH. A review and use of the Certified Public Accountants' work papers was made to the extent deemed appropriate and effective.

Risk & Regulatory Consulting LLC ("RRC") was engaged to perform certain agreed upon procedures, which are in compliance with the NAIC *Financial Condition Examiners' Handbook*. The assistance included a review of information systems and information technology general controls ("ITGC's") and a review of the actuarially determined loss and loss adjustment expense reserves, as well as other significant actuarial estimates.

The examination was conducted in compliance with the coordinated examination framework of the NAIC. The Company's wholly owned subsidiary, Hospitality Insurance Company ("HIC")

Hospitality Mutual Insurance Company

redomesticated to the State of Connecticut on December 21, 2016. As such, the State of Connecticut Department of Insurance coordinated with the Division to conduct its examination of HIC. HMIC and HIC ("Group") are members of an inter-company reinsurance pool. The Connecticut Department relied upon work performed by the Division impacting HIC, including IT and actuarial work performed on the Group's pooled operations. The Connecticut Department also conducted examination work on various key functional activities and risks of the Group which has been relied upon by the Division.

SUMMARY OF SIGNIFICANT FINDINGS OF FACT

As a result of the previous examination, a management letter was issued to the Company's Board of Directors ("Board") on June 24, 2013. A number of findings and recommendations included in that management letter do not appear to have been addressed by management and/or the risk associated with the findings have not been successfully mitigated. Prior recommendations still considered to be unaddressed include the following:

1. Design and implement appropriate procedures and controls to ensure adequate documentation supporting the rationale for any amounts recorded by management that differ from the actuarial indications, and that all claim data be reconciled back to the Company's financial systems prior to use by the actuary. This process should include data from the claims system which should be protected in "read only" format to prevent any data corruption.
2. Establish a claims report at year-end to provide the appointed actuary an update of claim activity, noting any unusual issues that may not be evident in the claims data.
3. Develop and implement an IT governance approach that provides adequate internal resources to lead the Company's IT function. The approach to IT governance should establish the basics of an IT management function.
4. Develop and implement an approach to periodically assess the Company's IT systems network perimeter.
5. A succession plan for members of the executive leadership team should be developed which includes executable strategies in the event the plan needs to be implemented. We note that the previous response to this recommendation was agreement, however no actions were taken.
6. Implement controls over expenses and the recording of those transactions in the general ledger. Develop and implement expense reporting procedures and guidelines to allow all disbursement of corporate assets to be justified, verified, and properly accounted for.
7. The prior management letter contained numerous recommendations relating to corporate governance. Certain observations and recommendations were acted upon by management and the Board, but there were others that were not addressed. Conflict of interest and board independence concerns were not fully addressed.

Hospitality Mutual Insurance Company

8. The Division recommended that all legal documents and agreements be reviewed and updated to reflect the Company as the party to those documents and agreements. Although management agreed with this recommendation, not all documents and agreements have been updated.

COMPANY HISTORY

General

The Company originated in 1985 with the enactment of Chapter 223 of the Acts of 1985 of the Massachusetts Legislature as the Liquor Liability Joint Underwriting Association of Massachusetts ("LLJUA"). The purpose of the enabling legislation was to guarantee the availability of liquor liability insurance to any person lawfully engaged in serving alcoholic beverages as an incident of business. The LLJUA commenced business on January 1, 1986, and under the enabling legislation, was required to provide liquor liability insurance coverage to all applicants which could not secure such insurance elsewhere. Over the years the enabling legislation was amended in various ways and in 2002, Chapter 211 of the Acts of 2002 formerly repealed section 13 of the enabling acts, which in effect made the LLJUA a permanent organization.

On June 20, 2008, Sections 1 through 12 of Chapter 223 was repealed and Massachusetts General Law Chapter 175 was amended by Section 113W which converted the LLJUA into a mutual insurance company, and all assets and liabilities of the LLJUA were assumed by HMIC. Under this amendment, HMIC may provide any line of liability insurance other than automobile coverage. HMIC is still required to guarantee the continued availability of liquor liability coverage to any licensee or any person lawfully engaged in serving alcoholic beverages in Massachusetts.

In January 2010, the Company received permission from the Division to write property and automobile insurance and in March 2012, the Company's Certificate of Authority was amended to include boiler and machinery coverage.

On February 23, 2011, HMIC acquired all of the issued and outstanding shares of common stock of Eastern Casualty Insurance Company ("Eastern"). Eastern was acquired from the Massachusetts Commissioner of Insurance in his capacity as liquidator of Eastern. At the date of acquisition, Eastern had 25,000 shares of common stock issued and outstanding with a par value of \$0.008 per share. Consideration paid by the Company for Eastern amounted to \$325,000. Simultaneously, the Eastern name was changed to Hospitality Insurance Company. HIC obtained the licenses of Eastern, which include the Commonwealth of Massachusetts and the Commonwealth of Pennsylvania, and the States of Connecticut, New Hampshire, Rhode Island, and Vermont. At the time of acquisition not all licenses were active. HIC commenced operations in October 2011 as a wholly owned subsidiary of HMIC and began writing business in Rhode Island. HIC has since began writing business in Pennsylvania, Connecticut, New Hampshire, Vermont, and North Carolina. The Company has created an intercompany reinsurance pool, whereby it is the lead insurer and 100% of business written by HIC is ceded to the pool and assumed by HMIC.

Hospitality Mutual Insurance Company

MANAGEMENT AND CONTROL

Board of Directors

According to the bylaws, the Company's business shall be managed under the direction of the Board of Directors, who may exercise all powers of the Company, except as otherwise provided by law, the articles of organization or the bylaws. The Directors may from time to time delegate any of their powers to committees, officers, attorneys or agents of the company, subject to such limitations as the articles of organization, bylaws or the Directors may impose.

The Board of Directors was comprised of the following members as of December 31, 2016.

<u>Name of Director</u>	<u>Principal Occupation</u>
E. Thomas McCabe, Jr. *	Chairman of the Board of HMIC Owner, Restaurant Resources
William T. McGrail	Vice-Chairman of the Board of HMIC Chairman, Massachusetts Medical Malpractice Reinsurance Plan
John W. Tympanick **	President and Chief Executive Officer
Peter T. Robertson	Secretary and Clerk to the Board of HMIC Massachusetts Counsel, Property Casualty Insurers Association of America Counsel, Massachusetts Insurance Federation Director, ProSelect National Insurance Company, Inc. Founder, RightFind Technology Company, LLC Founder, RightFind Auto, Inc. Director, ProSelect Insurance Company
James J. Donoghue	Treasurer, Restaurateur, Tweed's Pub Restaurant
Gerald J. Cassidy	Insurance Consultant
James R. Bacon	Woodlands Financial, LLC
Doreen Cusolito	Manager, Project Development, Arbella Insurance Group
Joseph D. Duffy	Consultant, Owner, JDD Insurance Regulatory Services, LLC
Terrence C. Quinn	President, Allen M. Walker & Co., Inc., Independent Insurance Agency
Richard Brewer	Retired

Hospitality Mutual Insurance Company

* Mr. McCabe stepped down as Chairman and was replaced by Mr. McGrail as acting Chairman effective 5/11/2017.

** Mr. Tympanick retired as a member of the Board of Directors and as President and Chief Executive Officer of the Company effective 12/31/2017. Effective 1/1/2018, Mr. Richard E. Welch, Jr. became President and CEO.

Committees of the Board of Directors

The Company's bylaws indicate that the Board may form an audit committee of Directors who are not employees of the Company. The audit committee shall oversee the selection and retention of an independent auditor and shall have responsibility for the content and oversight of the audit program, including review of the effectiveness of the Company's corporate accounting and financial practices, and the adequacy of internal controls. Consistent with the prior examination the Board continued to operate primarily under one standing committee, the Executive and Audit Committee.

Executive / Audit Committee

Per the committee charter, the committee shall consist of the chairperson and vice-chairperson of the Board and three other Directors elected by the Board and others appointed by the Board as necessary. The principal responsibility of the Executive and Audit Committee is to assist the Board in fulfilling its responsibilities to oversee the Company's accounting and financial reporting processes. At least two members of the committee shall have accounting or financial expertise. The committee shall, subject to the direction of the Board have general supervision between regular meetings of the Board over business operations, financial affairs and corporate governance of the Company. The committee shall also have such further powers such as the approving of executive compensation, hiring independent consultants, and perform such other duties as the Board may from time to time prescribe. The committee shall report to the Board all deliberations and decisions made by them between meetings.

The Executive and Audit Committee was comprised of the following members as of December 31, 2016.

<u>Name of Director</u>	<u>Title</u>
E. Thomas McCabe, Jr.	Chairman of the Board
William T. McGrail	Vice-Chairman of the Board
James J. Donoghue	Treasurer
Joseph D. Duffy	
Terrence C. Quinn	

Hospitality Mutual Insurance Company

Officers

Principal Officers of the Company as of December 31 2016 were as follows:

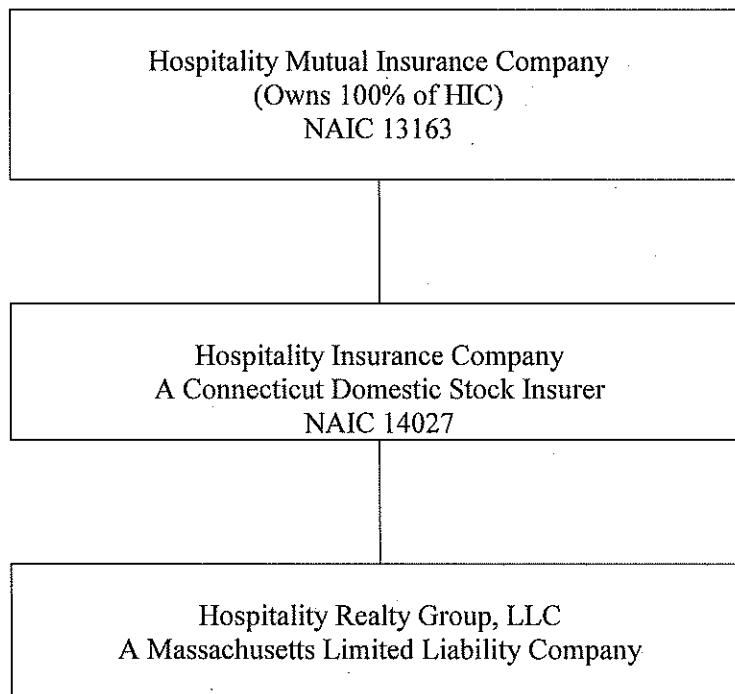
<u>Name of Officer</u>	<u>Title</u>
E. Thomas McCabe, Jr.,	Chairman
William T. McGrail	Vice-Chairman
Peter T. Robertson	Secretary
James J. Donoghue	Treasurer
John W. Tympanick	President and Chief Executive Officer
Eric F. Piurkowski	Vice President and Chief Financial officer
Sandra B. Haley	Senior Vice President
Stephanie M. Connon	Senior Vice President

Affiliated Companies

As stated in the Insurance Holding Company System Form B as filed with the Division, the Company is a member of a holding company system and is subject to the registration requirements of Massachusetts General Laws, Chapter 175, Section 206C, and 211 CMR 7.00. The Company owns 100% of the stock of HIC and is the “ultimate controlling person” of the holding company system.

Organization Chart

A summary of ownership of the Company as of December 31, 2016 is illustrated below:



Hospitality Mutual Insurance Company

Transactions and Agreements with Subsidiaries and Affiliates

Inter-Company Services Agreement

The Company has in place an Inter-Company Services Agreement with its wholly owned subsidiary, HIC. The agreement establishes services provided, the responsibilities of each party to the agreement, and the allocation of costs and expenses associated with the operation of, and participation in the Inter-Company Reinsurance Pooling Agreement.

The Inter-Company Services Agreement provides that the Company will make available to HIC all necessary services to assist HIC in the establishment, conduct and management of its business operations, including all necessary services in connection with the underwriting and management of HIC's insurance business. All costs, facilities and resources as outlined in the agreement are allocated between the Company and HIC at their actual cost in accordance with the percentages set forth in the Inter-Company Reinsurance Pooling Agreement. Per the Inter-Company Reinsurance Pooling Agreement, the Company assumes and retains 100% and HIC cedes 100% and retains 0% of business written.

Tax Sharing Agreement

Effective January 1, 2011, the Company established and entered into a tax sharing agreement with its wholly owned subsidiary, HIC, whereby the Group will file a consolidated federal and state income tax return. The intent is to fairly allocate among themselves the federal, state, or local tax liabilities, credits, refunds, benefits, and similar items related to the consolidated tax return.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to write business in the Commonwealth of Massachusetts. The primary line of business is liquor liability coverage and its target market is business establishments in the hospitality industry serving or selling liquor. The Company is mandated to provide liquor liability insurance to any Massachusetts business meeting applicable underwriting guidelines. The Company has expanded its lines of coverage to include property, general liability, assault and battery and excess liability, and boiler and machinery coverage.

With the acquisition of HIC in 2011, the Company also acquired licenses to write business in additional states. HIC currently writes business in Connecticut, New Hampshire, North Carolina, Pennsylvania, Rhode Island, and Vermont. HIC cedes, and HMIC assumes, 100% of all business written by HIC via the Inter-Company Reinsurance Pooling Agreement.

Treatment of Policyholders

The Company has no claim related litigation with policyholders and has not received significant complaints regarding its claims practices. The Company is involved in various litigation matters with claimants primarily arising from its liquor liability business. This litigation is considered to be in the normal course of business.

Hospitality Mutual Insurance Company

REINSURANCE

Assumed Reinsurance

The Company operates under an Inter-Company Reinsurance Pooling Agreement ("Pooling Agreement") with its wholly owned subsidiary, HIC. The Pooling Agreement became effective January 1, 2011. The Company is the lead insurer in the pool and assumes 100% of all net insurance liabilities of HIC. The Company's participation in the pooled accounts is 100% and HIC's ultimate participation in the pooled accounts is 0%.

Ceded Reinsurance

The Company also has a number of reinsurance agreements in place with third party reinsurers. The Company uses the services of reinsurance intermediary (Holborn Corporation) to place the majority of its reinsured business. Reinsurance is placed after pooling and therefore all business written by HIC and ceded to the pool is covered. As of December 31, 2016, the Company had in place excess of loss coverage on liquor liability and general liability policies of \$4,400,000 excess of \$600,000 retention. For excess liability, the Company had in place 95% of \$3,000,000 excess of \$1,000,000 retention. This coverage was placed 50% with Arch Reinsurance Company and 50% with Scor Reinsurance Company.

For property exposure, the Company has in place a 50% quota share treaty applicable to the first \$2,000,000 in coverage. For policies with coverage between \$2,000,000 and \$4,000,000, the cession percentages are on a tiered quota share basis starting at 55% excess of \$2,000,000 until it reaches 75% excess of \$3,300,000 up to \$4,000,000. The contract is subject to a limit of liability of \$4,000,000 on any one occurrence. This coverage is also placed 50% each with Arch Reinsurance Company and Scor Reinsurance Company.

Boiler and Machinery coverage is fully reinsured with Travelers Indemnity Company whereby the entire premium is ceded less a 32% ceding commission.

The Company has facultative coverage in place with Gen Re on a special acceptance basis for policy limits in excess of above.

Hospitality Mutual Insurance Company

FINANCIAL STATEMENTS

The following financial exhibits are based on the statutory financial statements prepared by management and filed by the Company with the Division and present the financial condition of the Company for the period ending December 31, 2016. The financial statements are the responsibility of Company management.

Statement of Assets, Liabilities, Surplus and Other Funds as of December 31, 2016

Statement of Income, Capital and Surplus for the Year Ended December 31, 2016

Reconciliation of Capital and Surplus for Each Year in the Five-Year Period Ended December 31, 2016

Hospitality Mutual Insurance Company

Hospitality Mutual Insurance Company Statement of Assets, Liabilities, Surplus and Other Funds as of December 31, 2016

	Per Annual Statement
Assets	
Bonds	\$13,995,081
Preferred stock	903,057
Common stock	31,321,614
Cash, cash equivalents, and short-term investments	11,110,692
	<hr/>
Subtotals, cash and invested assets	57,330,444
Investment income due and accrued	122,088
Premiums and considerations:	
Uncollected premiums and agents' balances in course of collection	2,313,688
Premium and agents balances deferred and not yet due	0
Amounts recoverable from reinsurers	512,804
Current federal income tax recoverable	758,428
Net Deferred tax assets	1,076,452
Receivable from parent, subsidiaries and affiliates	2,046,717
Aggregate write-ins for other than invested assets	126,154
	<hr/>
Total Assets	<u>\$64,286,775</u>
Liabilities	
Losses	\$19,630,794
Loss adjustment expense	8,798,280
Commissions payable, contingent commissions and other similar charges	213,738
Other expenses	302,988
Unearned premiums	8,818,374
Advance premium	15,103
Ceded reinsurance premium payable	293,161
Amounts withheld or retained by company for account of others	0
Aggregate write-ins for liabilities	103,074
	<hr/>
Total Liabilities	38,175,512
Common capital stock	0
Gross paid in and contributed surplus	0
Unassigned funds (surplus)	26,111,263
	<hr/>
Surplus as regards policyholders	26,111,263
	<hr/>
Total liabilities and policyholder surplus	<u>\$64,286,775</u>

Hospitality Mutual Insurance Company

Hospitality Mutual Insurance Company Statement of Income, Capital and Surplus For the Year Ended December 31, 2016

	<u>Per Annual Statement</u>
Underwriting Income	
Premiums earned	\$15,832,437
Deductions	
Losses incurred	11,285,308
Loss adjustment expenses incurred	3,335,763
Other underwriting expenses incurred	6,681,344
Aggregate write-ins for underwriting deductions	0
Total underwriting deductions	<u>21,302,415</u>
Net underwriting gain (loss)	(5,469,978)
Investment Income	
Net investment income earned	890,295
Net realized capital gains or (losses)	<u>511,747</u>
Net investment gain or (loss)	1,402,042
Other Income	
Net gain (loss) from agents' or premium balances charged off	1001
Finance and service charges not included in premiums	295,034
Aggregate write-ins for miscellaneous income	<u>16,500</u>
Total other income	<u>312,535</u>
Net income before dividends to policyholders and before federal income taxes	(3,755,401)
Foreign and federal income taxes incurred	<u>(407,041)</u>
Net income	<u><u>(\$3,348,360)</u></u>
Capital and Surplus Account	
Surplus as regards policyholders, December 31 prior year	28,131,242
Net income	(3,348,360)
Change in net unrealized capital gains or (losses)	876,684
Change in net deferred income tax	808,049
Change in nonadmitted assets	(327,492)
Aggregate write-ins for gains and losses in surplus	<u>(28,860)</u>
Change in surplus	<u><u>(2,019,979)</u></u>
Surplus as regards policyholders, December 31 current year	<u><u>\$26,111,263</u></u>

Hospitality Mutual Insurance Company

Hospitality Mutual Insurance Company Reconciliation of Capital and Surplus For Each Year in the Five Year Period Ended December 31, 2016

	<u>Per Annual Statement</u>				
	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Surplus as regards policyholders, December 31 previous year	<u>\$28,131,242</u>	<u>\$27,612,437</u>	<u>\$27,467,977</u>	<u>\$24,947,821</u>	<u>\$24,168,167</u>
Net income (loss)	(3,348,360)	925,447	(171,177)	741,396	1,180,970
Change in net unrealized capital gains or (losses)	876,684	(434,464)	251,462	651,335	(359,367)
Change in net deferred income taxes	808,049	45,579	34,317	1,357,825	(3,229,881)
Change in nonadmitted assets	(327,492)	20,862	84,494	(220,191)	3,224,352
Aggregate write-ins for gains and losses in surplus	<u>(28,860)</u>	<u>(38,619)</u>	<u>(54,636)</u>	<u>(10,209)</u>	<u>(36,420)</u>
Change in surplus	<u>(2,019,979)</u>	<u>518,805</u>	<u>144,460</u>	<u>2,520,156</u>	<u>779,654</u>
Surplus as regards policyholders, December 31 current year	<u><u>\$26,111,263</u></u>	<u><u>\$28,131,242</u></u>	<u><u>\$27,612,437</u></u>	<u><u>\$27,467,977</u></u>	<u><u>\$24,947,821</u></u>

Hospitality Mutual Insurance Company

ANALYSIS OF CHANGES IN FINANCIAL STATEMENTS RESULTING FROM THE EXAMINATION

There were no changes in the financial statements resulting from the examination.

COMMENTS ON FINANCIAL STATEMENT ITEMS

Risk & Regulatory Consulting, LLC was retained to assist in the analysis of various actuarially determined items in the 2016 Annual Statement. Given the “risk focused” examination approach of the overall examination, RRC’s primary objective was to perform an assessment of reserve risk by performing a qualitative review of the work papers and documentation supporting the estimates of loss and loss adjustment expense liabilities in order to assess the reasonableness of the scope, data used, methodologies and assumptions applied. This review included the analysis prepared by the Company’s appointed actuary from the firm of Milliman, Inc., and review and evaluation of the Company’s reconciliation as of December 31, 2016 of the actuarial data to Schedule P. This evaluation was also intended to consider data integrity and the appropriateness of the data segmentation. RRC also performed a high level evaluation of the Group’s actuarial process for development of pricing indications.

Based on RRC’s analysis and applied examination procedures, RRC determined that the Company’s carried Loss and LAE reserves are approximately \$2.8 million dollars lower than RRC’s central estimate, but still within RRC’s range of reasonable estimates.

<u>Hospitality Mutual Insurance Company</u> (000’s omitted)					
<u>RRC Estimates</u>					(Deficiency) Vs. Indicated
	<u>Low</u>	<u>Indicated</u>	<u>High</u>	<u>Total Carried</u>	
Net Loss & LAE	\$ 28,109	\$ 31,233	\$ 35,918	\$ 28,429	\$ (2,804)
<u>Milliman Estimates</u>					(Deficiency) Vs. Indicated
	<u>Low</u>	<u>Indicated</u>	<u>High</u>	<u>Total Carried</u>	
Net Loss & LAE	\$ 25,583	\$ 28,426	\$ 32,690	\$ 28,429	\$ 3

We note the above is after the inter-company pooling with HIC. As the Company retains 100% of all liabilities of the pool and HIC’s post pooling participation is zero, all net Loss and LAE reserves are carried by HMIC. The above amounts are also net of external reinsurance of approximately \$3,554,000 dollars in loss and LAE ceded to third-party reinsurers.

SUBSEQUENT EVENTS

As noted in Milliman's Statement of Actuarial Opinion for the year ended December 31, 2017, and observed during the examination, the Company experienced significant adverse claim development in 2016. This trend continued in 2017, although to a lesser extent. During 2017, the Company also experienced a higher level of paid losses than expected. Per Milliman's 2017 Actuarial Opinion, this appeared to have "changed key diagnostics in the Company's data," including higher levels of average case reserves. Management asserted that while there was no formal change in the guidance provided to the claims department there was an increasing level of conservatism in case reserves during this period. Part of this increase in case reserves appears to have been supported by higher than expected levels of paid losses in calendar year 2017. However, management believes that the risk factors of its claims have not changed materially, and that case reserves as of year-end 2016 were set more conservatively than in the past. Therefore, in the fourth quarter of 2017, management reduced the case reserves on a number of claims by a total of \$3.4 million dollars. Milliman notes that shifts in average case reserve statistics increase the uncertainty of their estimates.

Milliman's 12/31/17 selected estimate was \$31.5 million, or \$3.1 million greater than 2016. Management, in order to book its year end 2017 reserves for loss and loss adjustment expenses to Milliman's selected estimate, reduced its booked reserves as of 9/30/17 by approximately \$1.2 million dollars.

SUMMARY OF RECOMMENDATIONS

Actuarial Findings and Recommendations:

1. Quarterly Adjustment of IBNR – The Company monitors its paid loss and case reserves on a quarterly basis and uses this analysis to judgmentally adjust IBNR.

It is recommended that the Company formalize and quantify the process of adjusting IBNR on a quarterly basis. Based on emerging loss exposures, it is also recommended that the initial loss ratio for a new accident year be selected using actuarial considerations including recent loss cost history, pricing changes, and loss trend. The assumptions, methodology, and calculations supporting the recorded quarterly IBNR reserve should be thoroughly documented.

2. Lack of Exposure Data – It was noted that the Company's appointed actuary was not provided with true exposure data, despite multiple inquiries and recommendations. As a result, the appointed actuary must use average premium data to estimate rate level changes.

It is recommended that the Company supply the appointed actuary with complete and accurate exposure data.

3. The Company engaged Milliman to perform a pricing analysis for Rhode Island in March 2017. The indicated ultimate loss ratio in Rhode Island is 89% compared to 79% for HIC business in other states and 67% for HMIC. However, no action was taken by the Company to mitigate this

Hospitality Mutual Insurance Company

risk, i.e. increase rates, because the Company determined that the Rhode Island experience is too immature.

It is recommended that the Company closely monitor the experience in Rhode Island and also engage Milliman or another qualified resource to perform pricing analysis for other states.

4. The Company has the ability to monitor schedule rating debits and credits, however there is no evidence that this monitoring is performed on a regular basis.

It is recommended that the Company regularly monitor schedule rating debits and credits, and document the process.

Deficiency over Internal Financial Controls

The Chief Financial Officer has the responsibility to calculate what is deemed to be complex accruals and complex general journal entries. There is no evidence to support the process includes a review of supporting detail used to generate the financial data, or evidence to support any edits or changes made to the financial reports before being presented to the Board. Additionally, we note the Company's independent audit firm does not rely on internal controls for audit purposes, and therefore does not perform any testing over internal financial controls. Based on the lack of evidence to support the assertion that adequate review, and segregation of duties, roles and responsibilities exist, this is considered a deficiency over internal financial controls.

It is recommended that management review all internal controls over financial reporting for effectiveness and implement processes and procedures to assure all controls are being adhered to by all individuals responsible for executing those controls. It is recommended that additional controls be implemented and followed to assure proper segregation of duty is in place and can be supported by appropriate review and sign-off. It is further recommended that the audit scope of the Company's certified public accounting firm include adequate testing over internal financial reporting controls.

Bylaw Changes

The Board of Directors amended Article II and Article VI of the Company's Bylaws effective November 10, 2013. Article II relates to annual and special meetings of the policyholders, the date of the annual meeting, notice of meetings, and what constitutes a quorum at the annual meeting. The substance of the changes made to the Article II of the bylaws included changing the date of the annual policyholders meeting; changing the method of notice of the annual meeting; changing the method by which special meetings can be called and the method of notice of special meetings; and changing the requirement to achieve a quorum at these meetings from ten percent of total members to eight members. The changes made to Article VI of the bylaws alter the way amendments can be made to the bylaws. Based upon the Company's records, it does not appear that its policyholders were given notice of these changes.

Pursuant to M.G.L. c. 156B, §17, via M.G.L. c. 175, § 49 and M.G.L. c. 156B, § 13, a Company's by-laws, if authorized to do so by its articles of organization, may provide that the directors may

Hospitality Mutual Insurance Company

make, amend or repeal the by-laws in whole or in part, except with respect to any provision thereof which by law, the articles of organization or the by-laws requires action by the stockholders. HMIC's Articles of Organization and by-laws permit the directors to amend the by-laws in whole or in part. However, when a Company's by-laws are amended by the directors, notice of the substance of the changes must be given to all stockholders no later than the time of giving notice of the next subsequent meeting of the stockholders. See M.G.L. c. 156B, §17. Further, any by-law adopted by the directors may be amended or ultimately repealed by the stockholders. See *id.* As noted above, HMIC does not appear to have provided notice of the substance of the 2013 amendments to the Company's by-laws to its policyholders following the amendments adoption by the Company's Directors. As a result, the policyholders of the Company were not able to exercise their right to amend or repeal the adopted changes. M.G.L. c. 156B, §17.

It is recommended that the Board of Directors provide proper notice to all policyholders of the 2013 changes to the Company's by-laws and hold a policyholder vote on such changes in accordance with the M.G.L. Chapter 156B, §17.

Annual Meeting Notice Provisions

HMIC provides notice of the annual meetings to policyholders via the last page of the policy jacket. The policy jacket containing the date, time and location of the annual meeting is provided in the initial policy jacket. The initial policy, containing notice of the annual meeting, is sent to the policyholders' agent. The notice does not include and information about the purpose or content of the meeting. Upon policy renewal, a new jacket containing the annual meeting notice is not sent out.

It is recommended that HMIC provide meaningful annual notice to the policyholders of all meetings.

Premium and Claim System Data

The Company's premium and claim system provides management with the ability to generate numerous management reports used to present various financial data and results. The reporting mechanism used by the system generates reports in open excel file format. This data format can be a useful management tool, however it allows the data to be manipulated, which can create "source documentation" that may not reconcile to the actual "source". In addition, certain data is available to multiple individuals across functional lines, including the financial reporting area. This allows financial data to potentially be reported that does not reconcile to the actual data source.

It is recommended that management work with its system vendor to build system safeguards to prevent unauthorized system access across functional operating lines. Additionally, the Company should implement controls over system data being used for financial reporting to assure the data being used is reconciled to actual system generated data and not data downloaded in open excel format, which can lead to data corruption.

Hospitality Mutual Insurance Company

Underwriting and Rating Findings and Recommendations

During our review of the Company's underwriting process and premium development, we noted several exceptions relating to rating and premium calculations and system errors resulting in incorrect pricing.

1. On numerous occasions we could not manually replicate the rating process for liquor liability policies. We could not always verify information used by the underwriter to apply rating discounts or individual risk premium modifications.

It is recommended that all information used to rate and issue policies be verified and documentation supporting underwriting and pricing decisions be retained in the underwriting file. This file should be reviewed when policies are renewed to assure proper and accurate rating for each renewal.

2. While researching pricing issues, we discovered the premium system does not re-rate the entire policy if any of the underwriting data is changed. If the underwriter makes a change that effects the premium, the entire policy must be re-rated from the beginning of the rating process or the resulting premium calculation is inaccurate. The way policies are priced and the order in which premium debits and credits are applied is sequential, yet changing one set of characteristics does not cause the policy to be recalculated correctly. This system design was not previously known by the underwriting department. The system was upgraded to provide a warning notice to the user alerting them that a policy change was made, however it is still incumbent upon the user to re-rate the policy

It is recommended that the system be upgraded and modified to not only alert the user that changes are being made, but system 'edits' should be programmed to prevent policies from being incorrectly priced when underwriting characteristics are changed

3. Consistent with above, we also detected that once a policy is issued, the system will allow a policy to be changed with respect to policy limits and re-priced, however the system will not automatically change the declaration page. In the policy we identified, the insured requested lower policy limits to generate a lower premium, which was calculated, yet the policy was still issued with the higher limits.

It is recommended that the system be upgraded and modified to prevent policy changes from being made without changing all corresponding aspects of the policy. The system should not be able to issue policy declaration pages that do not correspond to the actual risks being insured.

4. We discovered during our rating test work that the system had imbedded in its rating algorithm the incorrect Loss Free Discount factor for policies issued in Vermont. The factor in the system was 40% while the filed rates for this discount was 20%. This was thought to be an isolated incident, and the system was corrected. We went on to discover this was not isolated to our sampled policy, but was in-fact effecting all Vermont policies where the Loss Free Discount was applied. We additionally learned that even though the factor was corrected in the rating system, the correction would only impact new policies issued, while policies with this discount

Hospitality Mutual Insurance Company

that were renewed were still receiving the incorrect additional discount. It was finally determined that unless the underwriter manually changed the rating upon policy renewal, the incorrect rating factor would remain embedded in the rating of all policies originally impacted by this error.

It is recommended that all system rates be tested and verified to identify any other inaccuracies that may be imbedded in the system. It is further recommended that the system be upgraded and modified to force each policy to be completely re-rated at renewal to assure all rating characteristics are current and applicable.

5. The Company provides three basic rating tiers for liquor liability policies that have built-in rating discounts. The modified tier allows for a 15% discounted base rate. One characteristic necessary to be considered for this modified tier rating is the requirement that all employees must have alcohol server training. The preferred rating tier extends an additional 15% discount off the base rate based on an additional set of standards that must be met, however, the requirement that employees be trained in alcohol service is not in place to qualify for this preferred rating tier.

It is recommended that the Company increase the requirements for the preferred rating tier to include the alcohol server training requirement, which would be consistent with one of the basic requirements to be eligible for the modified rating tier and discount.

6. All liquor liability policies are subject to annual audits. Based on the results of the audit, the policyholder may be entitled to a return of premium or be charged additional premium. The source of an increase or decrease in exposure is based on total liquor sales. The audit process is based on self-reporting by the insured and a manual calculation by the company. During our test work we observed the audit process to be somewhat subjective, as data used in the calculations was not all inclusive. We learned the audit process is more of a reasonableness test using limited, unaudited data and a +/- 10% tolerance.

If the result of an audit generates a deviation greater than 10%, the Company will recalculate the premium based on the new liquor sales volume and either bill the additional premium to the insured or issue a premium refund. In the event the policyholder does not return or complete the audit process, the Company will apply a 5% surcharge to the renewal premium if the policy is renewed. This surcharge is not disclosed in the policy or included in the various rate filings.

Our testing results identified various exceptions including inconsistency in the application of the surcharge, recalculation of the future premium based on audit results, adjustment of an applied surcharge when the audit provision is complied with, and a communication disconnect between the department processing the audits and the underwriting department.

It is recommended that the entire premium audit process be thoroughly reviewed and revised to accurately achieve the objective of the audit process. It is also recommended that the audit function be managed and controlled by the underwriting department as the fundamental impact of the audit process is intended to impact past and future premiums. It is also recommended that the potential penalty for non-compliance with the audit requirement of the policy be disclosed to the insured and management should determine if this surcharge is required to be filed with the various state regulators in which the Company is licensed.

Hospitality Mutual Insurance Company

Vendor Management

The Company utilizes the services of numerous third-party vendors across multiple functional areas of the organization. The Company does not have in place a vendor management process to assure vendors are held to performance standards if any are in place in the contracts; are challenged from the standpoint of an open bidding process; or periodically evaluated to assess if the agreement in place serves the needs of or is in the best interest of the Company. This condition was also noted by the IT examination consultants as it specifically relates to IT services, all of which the Company is reliant upon third-party vendors.

It is recommended the Company develop and implement a formal vendor management program and review all third-party arrangements to assure the requirements of each agreement are being fulfilled as intended and required under the agreements. Management should engage in a formal procurement process to identify the needs of the Company and secure the best third-party vendors available to facilitate those needs.

Third-Party Relationships

1. The Company continues to have a long standing affiliation with the Massachusetts Medical Malpractice Reinsurance Plan ("MMMRP"). This relationship includes informal affiliations aimed at generating savings by negotiating contracts with various vendors for similar services. This includes contracting for IT software and maintenance used by both entities. There does not appear to be a formal agreement between the Company and MMMRP governing these relationships.

It is recommended that all arrangements with MMMRP be reviewed and that all transactions and agreements with MMMRP be conducted at arms-length.

2. The Company has number of agreements with third party vendors that do not appear to be in compliance with the requirements of the NAIC Examiners Handbook.

It is recommended that the Company's Custodial Agreement with First State Trust Company as well as its Investment Consulting Services Agreement with Prime Buchholz LLC be amended to fully comply with the NAIC Examiner Handbook requirements.

Employee Bonus Compensation

The Company has in place a corporate wide Employee Bonus Compensation Plan ("EBCP"). In reviewing the plan and distributions during the examination period, we noted variances and adjustments to the benchmarks of certain criteria used to measure performance and calculate bonus awards. There is no evidence to support that any change to the EBCP was ever presented to and / or approved by the Compensation Committee, which was charged with creating the plan originally. The presence of these discrepancies and the absence of documentation supporting how the criteria was established and eventually measured indicate a control weakness over the bonus program.

Hospitality Mutual Insurance Company

It is recommended that steps be taken to create a plan that not only establishes clear performance targets that justify the bonus award, but also which data is to be used to measure actual performance against established targets. It is further recommended that the calculation of the bonus be formally reviewed and approved by the Compensation Committee.

Escheat or Abandoned Property Policy

The Company does not have an established escheat policy and does not follow the NAIC's Annual Statement Instructions regarding outstanding checks.

It is recommended that the Company review the requirements of M.G.L. Chapter 200A, including the guidance and definition relating to the "dormancy period" and implement appropriate policies and procedures to comply with the requirements of the statute.

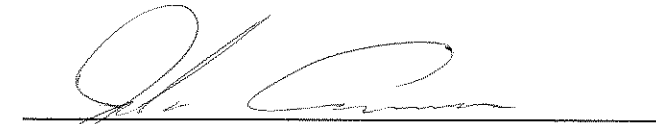
Hospitality Mutual Insurance Company

SIGNATURE PAGE

Acknowledgement is made of the cooperation and courtesies extended by the officers and employees of the Company during the examination.

The assistance rendered by the following Division examiner who participated in this examination is hereby acknowledged.

Steven Tsimtsos, CFE, Financial Examiner II



John M. Curran, CFE

Supervising Examiner and Examiner-in-Charge

Commonwealth of Massachusetts

Division of Insurance