REPORT ON EXAMINATION

of the

DIRECT INSURANCE COMPANY
1281 MURFREESBORO ROAD
NASHVILLE, TENNESSEE

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Company Examinations

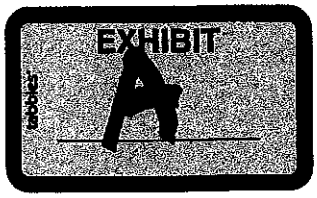
as of

DECEMBER 31, 2010

THE DEPARTMENT OF COMMERCE AND INSURANCE

STATE OF TENNESSEE

NASHVILLE, TENNESSEE



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Nashville, Tennessee
December 20, 2011

The Honorable Joseph Torti, III
Chair, NAIC Financial Condition
(E) Committee
Deputy Director and
Superintendent of Insurance
1511 Pontiac Avenue, Building 69-2
Cranton, Rhode Island 02920

The Honorable Julie M. McPeak
Commissioner of Commerce & Insurance
State of Tennessee
500 James Robertson Parkway
Nashville, Tennessee 37243

The Honorable Sharon B. Clark
Secretary, Southeastern Zone, NAIC
Commissioner of Insurance
P.O. Box 517
Frankfort, Kentucky 40602

Dear Superintendent and Commissioners:

Pursuant to your instructions and in accordance with the Tennessee Insurance Laws, regulations, and resolutions adopted by the National Association of Insurance Commissioners (NAIC), a financial examination and market conduct review has been made concerning the conditions and affairs of the

DIRECT INSURANCE COMPANY
NASHVILLE, TENNESSEE

hereinafter generally referred to as the "Company" and a report thereon is submitted as follows:

INTRODUCTION

This examination was called by the Commissioner of Commerce and Insurance of the State of Tennessee and commenced on May 16, 2011. The examination was conducted under the association plan of the NAIC by duly authorized representatives of the Department of Commerce and Insurance, State of Tennessee (TDCI). The examination of the Company was conducted as part of a coordinated examination with Direct General Insurance Company (Indiana), Direct National Insurance Company (Arkansas), Direct General Life Insurance Company (South Carolina), and Direct General Insurance Company of Louisiana (Louisiana).

SCOPE OF EXAMINATION

This examination covers the period from January 1, 2006 through December 31, 2010, and includes any material transactions and/or events occurring subsequent to the examination date which were noted during the course of examination.

The examination of the financial condition was conducted in accordance with guidelines and procedures contained in the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook. During the course of the examination, assets were verified and valued and liabilities were determined or estimated as of December 31, 2010. The Company's financial condition and its degree of solvency were thereby established. Test checks were made of income and disbursement items for selected periods, and a general review was made of the Company's operations, practices and compliance with statutes and regulations.

All asset and liability items contained in the financial statement of this report were examined and verified with relative emphasis according to their amounts and potential impact on capital and surplus. In addition, the following topics the following items were reviewed made:

Previous Examination Comments
Company History
Growth of Company
Charter and Bylaws
Management and Control
Corporate Records
Holding Company System
Agreements with Parent, Subsidiaries and Affiliates
Fidelity Bond and Other Insurance
Employee Benefits and Pension Plans
Territory and Plan of Operation
Market Conduct Activities
Loss Experience
Reinsurance Agreements
Commitment and Contingent Liabilities
Statutory Deposits
Accounts and Records
Loss Reserves
Subsequent Events
Financial Statements

These will be discussed as follows:

Previous Examination Comments

The previous full scope examination was made as of December 31, 2005. Its corresponding "Order Adopting Examination Report with Directives" instructed the Company to comply with two issues. These issues appear to have been resolved by the Company as of the examination report date. Following is a description of the two issues:

1. Bonds

As of December 31, 2005, the Company held securities in two custodial accounts

at U.S. Bank. One account was set up as a primary, with account number 19-1652, while the second was a sub-account with account number 19-1652A. While the first account had the Company's complete correct name, the sub-account did not have the correct name listed. The Company corrected this error during the course of the examination.

It is recommended that the Company exercise diligence in setting up its custodial accounts and continue to comply with Tenn. Comp. R. & Regs. 0780-1-46 and guidelines set in the *NAIC Financial Condition Examiners Handbook* concerning custodian agreements with banks where they hold securities at all times.

2. Information Systems

It was noted during the review of the Company's Information Systems that the sales offices which produce the Company's business each have multiple desktop computers which do not have any virus protection. These computers connect to the systems at DGC to upload transactions and images. This could expose the corporate systems to infection.

It is suggested that the Company obtain virus protection software for all of its computers that connect to the Company's Information Systems.

COMPANY HISTORY

The Company was originally incorporated on November 8, 1990. The Charter of Incorporation was filed with the Tennessee Secretary of State on April 10, 1991, and the TDCI issued a Certificate of Authority on April 11, 1991, which licensed the Company as a stock property and casualty insurer. The Company commenced business on April 12, 1991, as Direct Insurance Company, Nashville, Tennessee.

At incorporation, the Company was authorized to issue forty thousand (40,000) shares of common capital stock with a par value of one hundred dollars ($100) per share. Eleven thousand (11,000) shares were issued and outstanding at April 10, 1991. From that date through 1994, the Company continued to issue additional shares to various individuals, trusts and business entities until December 2, 1994, when all sixteen thousand, seven hundred ninety-four and one-half (16,794.5) outstanding shares were acquired by "Direct Corporation," which was the name stated on the stock certificate. In 1996, the Company's parent company changed its name from Direct Corporation to Direct General Corporation (DGC). Effective December 31, 1996, the par value of the Company's stock was increased to one hundred fifty dollars ($150) per share. In the December 31, 1997 examination report it was recommended that the name on the stock certificate be amended to reflect the parent's correct name. On March 14, 2000, the aforementioned stock certificate was replaced with a new certificate to reflect the correct corporate name.

The Company writes nonstandard private passenger automobile insurance in Tennessee and Arkansas. As of 2006, the Company ceased writing new business in

Arkansas while continuing to renew existing customers. Affiliated insurance agencies sell the Company's products directly through neighborhood sales offices. The Company's products are available for sale by phone and the internet. In 2007, the Company began writing hail crop and multi-peril crop insurance through NAU Country Insurance Company (NCIC), an unaffiliated company, under a managing general agent contract. This business was ceded 100% to NCIC and was discontinued in 2009.

On December 17, 1998, the Company increased its surplus by $2,000,000 in the form of gross paid in and contributed surplus to $11,823,125.

On March 31, 2007, Elara Holdings, Inc., acquired all of DGC's outstanding stock, the parent of the Company.

GROWTH OF COMPANY

The following exhibit depicts certain aspects of the growth and financial history of the Company for the period subject to this examination according to its annual statements as filed with the Tennessee Department of Commerce and Insurance:

Year	Premiums Earned	Losses Incurred	Assets	Liabilities	Capital & Surplus
2006	$62,555,103	$39,606,026	$83,558,166	$56,224,573	$27,333,593
2007	56,560,597	35,596,373	80,065,843	53,918,130	26,147,713
2008	54,863,454	37,785,122	76,877,739	50,865,575	26,012,164
2009	51,507,910	33,801,946	69,198,300	48,164,129	21,034,171
2010	52,061,027	35,752,732	69,210,104	50,421,529	18,788,575

CHARTER AND BYLAWS

Charter:

The original Charter of the Company was approved by the TDCI and became effective April 10, 1991. An Articles of Amendment was filed with the Secretary of State on December 31, 1996 increasing the authorized stock par value. On April 1, 1997, an Articles of Amendment was filed with the Secretary of State changing the statutory address and registered agent. An amended and restated Charter was filed with the Secretary of State on July 3, 2000. The Charter was again amended and restated effective June 26, 2003 upon being filed with the Secretary of State and having been approved by the TDCI on June 17, 2003.

The Charter provides for the operation of a property and casualty insurance company that is for profit, and establishes its location in Nashville, Tennessee. The Charter in effect at the examination date states that:

> The purpose for which the Corporation is organized is to engage in the business

of a multiple line insurance company, writing and issuing policies of casualty insurance, as defined in section 56-2-201(2) of the Tennessee Code Annotated, and property insurance, as defined in the Tennessee Code Annotated Section 56-2-201(5)(a), in the State of Tennessee and elsewhere, where authorized.

The Company's Charter states the Board of Directors shall have the power to fill any vacancies to the Board until the next annual meeting of the stockholders. The Charter also gives the Board of Directors the power to elect all officers, to discharge officers, with or without cause and such other powers as may be prescribed from time to time in the Corporation's Bylaws.

In addition to the above, the Company's Charter recites other general and specific powers in detail. They are usual in nature and consistent with statute.

Bylaws:

The Company's Bylaws were most recently amended on December 14, 2010. The Bylaws provide for an annual shareholders' meeting at which a Board of Directors is elected. The Bylaws call for the Board of Directors to designate a Chairman of the Board. Officers are elected by the Board annually at the first Board meeting after the annual shareholders meeting. There has been no evidence of the Board of Directors designating a Chairman of the Board in accordance with the Company's Bylaws.

The current Bylaws are such as generally found in corporations of this type and contain no unusual provisions. They provide for the regulation of the business and for the conduct of the affairs of the Company.

MANAGEMENT AND CONTROL

Management of the Company is vested in a Board of Directors which is elected annually by the shareholder. The Board of Directors must consist of no less than two (2) nor more than twelve (12) members, with the exact number to be fixed by the Board of Directors from time to time. Directors serve until the next annual meeting of the shareholders and thereafter, until a successor has been elected.

The following persons were serving as members of the Board of Directors at December 31, 2010:

Name	Principal Occupation
Carey D. Benson	Chief Executive Officer and President
Scott J. Bojczuk	Executive Vice President, General Counsel, and Secretary
John T. Hagely	Executive Vice President and Chief Financial Officer

The Bylaws state that the Board of Directors will elect officers of the Company which must include a Chairman of the Board, a Chief Executive Officer, a President and a Secretary. The corporation may also have one or more Vice-Presidents, a Treasurer, one or more assistant Secretaries, one or more assistant Treasurers, and such other

officers as the Board of Directors shall from time to time deem necessary. Any two or more offices may be held by the same person, except the offices of President and Secretary. Also, the Board of Directors shall designate either the Chairman of the Board or the President to be the Chief Executive Officer of the corporation. In accordance with the Company's Bylaws, the Board of Directors should designate a Chairman of the Board and duly record such action in the minutes of the meeting.
The following officers were duly elected and were serving at December 31, 2010:

Name	**Title**
Carey D. Benson	President and Chief Executive Officer
Scott J. Bojczuk	Executive Vice President, General Counsel, and Secretary
John T. Hagely	Executive Vice President and Chief Financial Officer
Paul F. DiFrancesco	Executive Vice President - Operations
John F. Campbell, Jr.	Executive Vice President – Product Management
John G. Walters	Senior Vice President and CIO
David J. Newman	Senior Vice President - Finance
Thomas A. Kaschalk	Senior Vice President - Claims
Kimberly W. Nowell	Senior Vice President – Human Resources
Jobie G. Williams	Vice President and Treasurer
Kyle G. Morse	Vice President and Corporate Controller
Marc E. DiGiacomo	Vice President - Product Management
Brian T. Hanrahan	Vice President – Actuarial Group
Timothy G. Thomas	Vice President – Insurance Operations
Josh L. Jarrett	Vice President – Product Management
Amy M. Sanford	Vice President and Assistant Secretary
Constance A. Collins	Assistant Secretary
Jonathan R. Dowell	Assistant Secretary
Ronna F. Rupelt	Assistant Secretary

The Bylaws allow the Directors to create one or more committees which may consist of a single member. The Bylaws state that all committees so created shall have such powers as the Board of Directors may delegate to such committee.

Investment transactions for the period under review were approved by the Board of Directors from quarterly reports of aggregate investment transactions.

The Company has no employees. Personnel and services are provided by the Company's affiliates, primarily Direct Administration, Inc. and Direct Adjusting Company, Inc., in accordance with an Intercompany Cost Allocation Agreement.

Pecuniary Interest:

The Company's parent, DGC, has a written policy on Business Conduct and Code of Ethics. According to this policy, directors, officers and certain employees are required to complete a Policy on Business Conduct Annual Questionnaire. This questionnaire is used for all entities within the holding company system and persons required to complete the certificate sign only one form regardless of the number of positions held

throughout the group of companies. According to the policy, potential conflicts of interests, as discovered or reported, are submitted through complete disclosure of facts to the General Counsel. If the General Counsel determines a conflict exists, the transaction or situation should be submitted to an ad hoc committee of one or more senior officers designated by the Chief Executive Officer. Dependent upon level of severity, recommended resolutions of potential conflicts must be approved by the Chairman of the Audit Committee, or upon recommendation of the Chairman, by the Board of Directors of the Company.

The questionnaires completed by management during the period under examination were reviewed and no exceptions were noted.

Control:

At December 31, 2010, one hundred percent (100%) of the outstanding shares of the Company were owned by DGC. DGC in turn is wholly owned by Elara Holdings, Inc., a Delaware corporation. During the examination period, dividends were paid to DGC as follows:

Year	Amount
2006	$3,950,000
2007	4,300,000
2008	2,879,615
2009	7,500,000
2010	2,100,000

CORPORATE RECORDS

The minutes of the meetings of the Shareholders and Board of Directors were reviewed for the period under examination. They were found to be complete as to necessary detail and appear to properly reflect the actions of the respective bodies.

AGREEMENTS WITH PARENT, SUBSIDIARIES AND AFFILIATES

The Company is a member of an insurance holding company system, as defined by Tenn. Code Ann. § 56-11-101, et seq. "Insurance Company Holding Act of 1986". The Company files a Holding Company Registration Statement annually as required by Tenn. Code Ann. § 56-11-105. The required Forms B and C were filed by the Company April 27, 2010.

The Company is a subsidiary of DGC, which owns 100% of the Company's stock. DGC in turn is 100% owned by Elara Holdings, Inc. An organizational chart is attached at the end of this report.

Intercompany Cost Allocation Agreement:

On May 22, 2000 the TDCI approved the Intercompany Cost Allocation Agreement (Agreement) between the Company and its parent, DGC, and affiliated companies whereby the entities share the costs of certain administrative, personnel, legal, accounting, tax, information systems, strategic planning, and other shared services. Essentially, DGC, Direct Administration, Inc. (DAI) and Direct Adjusting Company, Inc. (DACI), provide these services to the Company and its affiliated insurers. The "other shared services" provided include appraisal, claims adjusting, claims payment and other claims-related services.

As payment for these services, DGC, DAI and DACI may "charge reasonable fees at arm's length rates based upon the allocation of the costs incurred in providing services pursuant to this Agreement." Written itemized invoices are submitted to the Company "periodically, but no less frequently than at the end of each calendar quarter" for payment. The agreement does not contain a specified due date in accordance with SSAP 96, paragraph 2.

Intercompany Premium Finance Settlement Agreement replaced Account Settlement Agreement:

On August 28, 2006, the TDCI approved a Premium Finance Settlement Agreement between the Company and Direct General Financial Insurance Services, Inc., Direct General Premium Finance Company, both Tennessee corporations, and any other affiliated premium finance company designated from time to time on the agreement's signature page (collectively the "Direct Finance Companies"). Under this agreement, Direct Finance Companies' obligations to the Company are "in the nature of an account current settlement on an agency account" consisting of premiums that the Direct Finance Companies are obligated to remit to the Company. The Company's obligation to the Direct Finance Companies consists of refund premiums arising out of cancellations of insurance policies financed by the Direct Finance Companies for the Company's insureds. The agreement states that these obligations shall be offset against each other and the balance (the Net Settlement Amount) settled not less frequently than once a month.

Intercompany Producer Agreements:

On March 19, 2004, the TDCI approved the Intercompany Producer Agreement between the Company and its affiliate Direct General Insurance Agency, Inc., a Tennessee corporation. Tennessee is the designated territory and personal automobile is the class of insurance which the agents are authorized to exercise the granted authority. The agreement grants the independent agents certain authority in the binding and issuance of policies. Agents are authorized to collect, receive, and record premiums.

The agreement may be revised by the Company by giving (30) days written notice to the agent. The agreement may be revised by mutual consent of the Company and the agent. The agreement may be terminated by either party by giving to the other written

notice not less than (30) days prior to such effective date of termination.

On December 1, 2005, the TDCI approved the Intercompany Producer Agreement between the Company and its affiliate Right Choice Insurance Agency, Inc., a Tennessee corporation. The agreement governs the property and casualty products that are produced for the Company by Right Choice Insurance Agency, Inc. through telemarketing and internet sales.

Tax Allocation Agreement:

Effective September 10, 1996, the Company became a party to a tax allocation agreement by and among DGC and its subsidiaries. The agreement applies to the taxable year ending December 31, 1995 and all subsequent periods. Under this agreement, DGC shall file a U.S. consolidated income tax return on behalf of the members of the holding company system. Payments shall be made to DGC by the subsidiaries within ten days of receiving notice of such payment from DGC and DGC shall return excess payments to the subsidiaries within ten days after the date of filing of the consolidated return for such period.

A supplement to this agreement was made effective on November 9, 2000. Its purpose was to add new subsidiaries to the affiliated group as defined in Internal Revenue Code Section 1504(a), and to provide for the addition of subsidiaries in the future.

FIDELITY BOND AND OTHER INSURANCE

The Company is a named insured under certain insurance policies being carried by its parent, DGC. The following is a summary of the various bonds and insurance policies that provided the enumerated policies to the Company at December 31, 2010:

Type of Coverage	Limits of Liability
1. Fidelity bond, crime policy financial institution	$ 7,500,000 single loss limit $15,000,000 aggregate
2. General liability/employer's liability	$ 1,000,000 premises/operations per occurrence $ 2,000,000 premises/operations aggregate $ 300,000 damage to rented premises $ 10,000 medical expense (any one person) $ 1,000,000 personal and advertising injury $ 1,000,000 stop gap (per agg & occ) $ 1,000,000 Emp. benefits (per agg & occ)
3. Fiduciary	$ 5,000,000 primary $ 5,000,000 first excess layer
4. D&O management liability & company reimbursement (run-off)	$10,000,000 primary $10,000,000 first excess layer $10,000,000 second excess layer
5. Automobile liability (AOS) Uninsured motorists	$ 1,000,000 CSL $ 1,000,000 each accident $ 5,000 medical payments $ 50,000 physical damage

6. E&O professional liability	$10,000,000 primary
	$10,000,000 first excess layer
	$10,000,000 second excess layer
7. Directors and officers/EPL	$10,000,000 primary
	$10,000,000 first excess layer
	$ 5,000,000 second excess layer
8. Workers compensation liability	
A. Workers compensation	Tennessee statutory limit
B. Employers liability	
a. Bodily injury by accident	$ 1,000,000 each accident
b. Bodily injury by disease	$ 1,000,000 disease
c. Bodily injury by disease	$ 1,000,000 each employee
9. Commercial property	$17,039,860 building limit
	$15,139,200 personal property
	$ 5,000,000 earthquake/flood
	$ 450,000 extra expense
10. Umbrella liability	$20,000,000 each occurrence
	$20,000,000 aggregate

Minimum fidelity coverage suggested in the National Association of Insurance Commissioners' Examiners Handbook for an insurer of the Company's size and premium volume is $500,000 to $600,000. The Company had fidelity coverage which exceeds the minimum suggested coverage. Each policy was issued by an insurance company authorized to transact business in Tennessee.

RETIREMENT PLANS AND OTHER EMPLOYEE BENEFITS

The Company has no employees. All business functions are performed for the Company by DGC or an affiliate through the cost allocation agreement. Retirement and insurance benefits are provided through the cost allocation agreement.

TERRITORY AND PLAN OF OPERATION

Territory:

The Company is licensed to transact the business of property and casualty insurance in the states of Tennessee and South Carolina and is licensed to transact property, casualty (excluding workers' compensation) and marine insurance in the state of Arkansas. Certificates of Authority for each jurisdiction were reviewed and found to be valid.

The following table shows the premiums by state for the year ending December 31, 2010 as reported in Schedule T of the Company's Annual Statement:

State	Direct Premiums Written	Direct Premiums Earned	Direct Losses Paid	Direct Losses Incurred	Direct Losses Unpaid
Arkansas	$ 1,684,351	$ 1,872,632	$ 1,146,772	$ 754,884	$ 729,376
Tennessee	50,691,044	50,297,340	31,636,133	34,882,524	21,682,647
Total	$52,375,395	$52,169,972	$32,782,905	$35,637,408	$22,412,023

Plan of Operation:

The Company writes non-standard private passenger automobile insurance in Tennessee and Arkansas. As of 2006, the Company ceased writing new business while continuing to renew existing customers. Affiliated insurance agencies sell the Company's products directly through neighborhood sales offices. Additionally, the Company uses internet and telemarketing through an affiliate to produce business. The Company is in the process of transitioning the majority of policies sold from being financed by the affiliated premium finance company to installment billing.

MARKET CONDUCT ACTIVITIES

Underwriting:

The Company writes non-standard automobile insurance that generally provides basic limits coverage as follows:

Bodily Injury: $25,000 per person/$50,000 per occurrence
Property Damage: $25,000

Additional limits ($50,000/$100,000 and $100,000/$300,000 for bodily injury and $50,000/$100,000 for property damage) and uninsured/underinsured motorist coverage are available, as are various endorsements, such as towing, rental car coverage and accidental death benefits. Discounts are given for renewals, prior insurance, multi-car policies, homeownership and senior citizens.

Rates and Policy Forms:

The current rates and policy forms were duly filed with and approved by the Tennessee Department of Commerce and Insurance.

Complaints:

The Company maintains a log for complaints which have been received from insureds, complainants, and other interested third parties such as the Better Business Bureau or attorneys. Inquiries made to consumer services and review of complaints indicated no regulatory concerns with the Company under the period of examination.

Claims:

A sample of claims reviewed during the examination indicated that claims were being paid in accordance with policy provisions and settlements were promptly made upon receipt of proper evidence of the Company's liability.

Advertising:

The Company has an advertising program that includes television, radio, billboards, printed flyers, and the internet. Advertising materials were reviewed with no material exceptions noted.

Privacy Policy:

The Company maintains a written privacy statement. It is supplied to its policyholders annually in compliance with Tenn. Comp. R & Regs. 0780-1-72-.06.

LOSS EXPERIENCE

As developed from applicable amounts included in the Company's annual statements filed with the TDCI, the ratios of losses and loss adjustment expenses (LAE) incurred to earned premiums for the period subject to this examination were as follows:

Year	Losses and LAE Incurred	Earned Premiums	Loss Ratio
2006	$ 46,901,179	$ 62,555,103	75.0%
2007	42,176,761	56,560,597	74.6%
2008	43,497,958	54,863,454	79.3%
2009	39,540,175	51,507,910	76.8%
2010	42,101,416	52,061,027	80.9%
Total	$214,217,489	$277,548,091	77.2%

REINSURANCE AGREEMENTS

Reinsurance Ceded:

The primary intent of the Company's reinsurance agreements is to manage the Company's overall exposure to loss at or below a level that is within the capacity of its capital resources.

The Company carries property catastrophe excess of loss reinsurance with $10 million of coverage in excess of $2 million retention on gross losses. The treaty, effective January 1, 2010 through January 1, 2011, covers in force, new, renewal, and assumed private passenger automobile physical damage business with the maximum value per vehicle covered of $75,000. The major reinsurers and their participation are

summarized below:

Reinsurers/Participation:

	Layer 1st	Layer 2nd
Endurance Specialty Insurance Ltd.	30.0%	30.0%
QBE Reinsurance Corporation	15.0%	15.0%
R + V Versicherung AG	7.5%	5.0%
XL Re Ltd.	10.0%	10.0%
Lloyd's Underwriter Syndicate No. 2001	13.5%	10.0%
Lloyd's Underwriter Syndicate No. 2010	9.0%	10.0%
Lloyd's Underwriter (5 syndicates)	10.0%	15.0%

The reinsurance agreements were found to contain acceptable clauses for insolvency and arbitration. The Company's reinsurance agreements appear to effectuate proper transfer of risk in accordance with SSAP No. 62 and NAIC guidelines.

COMMITMENT AND CONTINGENT LIABILITIES

From the examination data made available, it appears that the only matters of law in which the Company was involved during the period under review were those rising out of the normal course of business. The outcome of such actions should not have a material effect on the financial position of the Company.

STATUTORY DEPOSITS

In compliance with statutory and other requirements, the Company maintained the following deposits with the named jurisdictions or custodians as of December 31, 2010:

Deposits Which Are Not for the Benefit of all Policyholders:

Jurisdiction	Description of Security	Par Value	Book/Adjusted Carrying Value	Market Value
Arkansas – Dept. of Insurance	First American Treasury Obligation 0.00% Cusip # 31846V203	$400,000	$400,000	$400,000
Total deposits which are not for the benefit of all policyholders:		$400,000	$400,000	$400,000

Deposits Which are for the Benefit of All Policyholders:

Jurisdiction	Description of Security	Par Value	Book/Adjusted Carrying Value	Market Value
Tennessee – Dept. of Insurance	U.S Treasury N/B 1.5%, Due 12-31-13 Cusip # 912828JW1	$ 228,000	$ 226,360	$231,265

Tennessee – Dept. of Insurance	Tennessee ST 5.0%, Due 05-01-18 Cusip # 880541ML8	$ 500,000	$ 592,486	$572,130
Tennessee – Dept. of Insurance	Metro Govt. Nashville & Davidson Co. 5.0%, Due 05-15-11 Cusip # 592030VB3	$ 235,000	$ 236,701	$239,076
Tennessee – Dept. of Insurance	Knoxville Tenn. Electric Revenue 4.5%, Due 7-1-12 Cusip # 499746QP3	$ 255,000	$ 255,000	$269,512
Tennessee – Dept. of Insurance	Tennessee St School Board Authority 5.0%, Due 05-1-18 Cusip # 880557Z48	$ 555,000	$ 630,141	$626,040
Total deposits which are for the benefit of all policyholders:		$1,773,000	$1,940,688	$1,938,023
Total Deposits		$2,173,000	$2,340,688	$2,338,023

Deposits with said jurisdictions or custodians were verified by direct correspondence with the custodian of such deposit with no exceptions.

ACCOUNTS AND RECORDS

During the course of examination, such tests and audit procedures were made as were considered necessary, including verification of postings, extensions and footings. General ledger trial balances were reconciled with the Annual Statements for the years 2006, 2007, 2008, 2009 and 2010.

Accounting records conform to generally accepted insurance accounting practices and appear to properly reflect the operations during the period under examination and the status of the Company at the date of examination.

Intercompany balances, including management fees, federal income taxes, premiums, losses and loss adjustment expenses are settled between the Company and its affiliates on a monthly basis.

The Company is audited annually as part of the audit conducted for the holding company system, of which it is a member, by an independent accounting firm. The audit was performed by Ernst & Young, LLP for the year ending December 31, 2010.

The Company's Risk-Based Capital Report was reviewed and found to be in compliance with Tenn. Code Ann. § 56-46-101, *et seq.*

SUBSEQUENT EVENTS

Subsequent to the December 31, 2010 date of examination, the Company and U.S. Bank executed a new custodial agreement that contained the proper provisions as required by Tenn. Comp. R. & Regs., 0780-1-46.04. This new custodial agreement was signed by an authorized representative of the Company on August 31, 2011 and U.S.

Bank on September 2, 2011. See the "Comments" section of this report for further information. Previously, the Company did not have a custodial agreement for assets held with U.S. Bank in accordance with Tenn. Comp. R. & Regs., 0780-1-46.04.

On January 28, 2011, Carey Benson resigned as the Company's President and CEO. On March 29, 2011 John W. Mullen was appointed President and CEO. In the interim from January 28, 2011 through March 28, 2011, the Company's sole shareholder established the office of the presidency which was comprised of three members of management.

FINANCIAL STATEMENT

There follows a statement of assets, liabilities and statement of income at December 31, 2010, together with a reconciliation of capital and surplus for the period under review, as established by this examination:

ASSETS

	Assets	Non-admitted Assets	Net Admitted Assets
Bonds	$50,352,827	0	$50,352,827
Common stocks	2,873,309	0	2,873,309
Real estate occupied by the company	468,111	0	468,111
Cash and short-term investments	1,270,349	0	1,270,349
Subtotals, cash and invested assets	54,964,596	0	54,964,596
Investment income due and accrued	488,651	0	488,651
Uncollected premiums and agents' balances in the course of collection	2,903,023	0	2,903,023
Deferred premiums, agents' balances and installments booked but deferred and not yet due	8,171,025	0	8,171,025
Amounts recoverable from reinsurers	95,745	96,838	(1,093)
Funds held by or deposited with reinsured companies	44,935	0	44,935
Current federal and foreign income tax recoverable and interest thereon	193,857	0	193,857
Net deferred tax asset	2,646,467	799,036	1,847,371
Receivables from parent, subsidiaries and affiliates	587,864	0	587,684
Aggregate write-ins for other than invested assets	9,815	0	9,815
Totals	$70,105,978	$895,874	$69,210,104

LIABILITIES, SURPLUS AND OTHER FUNDS

Losses		$22,316,243
Reinsurance payable on paid losses and loss adjustment expenses		(470)
Loss adjustment expenses		896,854
Commissions payable, contingent commissions and other similar charges		161,675
Other expenses (excluding taxes, licenses and fees)		137,837
Taxes, licenses and fees (excluding federal and foreign income taxes)		72,444
Unearned premiums		25,645,037
Funds held by company under reinsurance treaties		101,990
Amounts withheld or retained by company for account of others		14,808
Payable to parent, subsidiaries and affiliates		1,075,091
Aggregate write-ins for liabilities		10
Total liabilities		$50,421,529
Aggregate write-ins for special surplus funds	1,393,011	
Common capital stock	2,519,175	
Gross paid in and contributed surplus	11,823,125	
Unassigned funds (surplus)	3,053,264	
Surplus as regards policyholders		$18,788,575
Totals		$69,210,104

STATEMENT OF INCOME

UNDERWRITING INCOME		
Premiums earned		$ 52,061,027
Deductions		
Losses incurred	35,752,732	
Loss expenses incurred	6,348,684	
Other underwriting expenses incurred	13,845,573	
Total underwriting deductions		$ 55,946,989
Net underwriting gain		($ 3,885,962)
INVESTMENT INCOME		
Net investment income earned	1,801,183	
Net realized capital gains or (losses)	1,184,994	
Net investment gain or (loss)		$ 2,986,177
OTHER INCOME		
Net gain (loss) from agents' or premium balances charged off	(148,081)	
Aggregate write-ins for miscellaneous income	653,780	
Total other income		$ 505,699
Net income before federal and foreign income taxes		(394,086)
Federal and foreign income taxes incurred		(747,618)
Net income		$ 353,532

CAPITAL AND SURPLUS ACCOUNT

GAINS AND LOSSES IN SURPLUS

Surplus as regards policyholders, December 31 previous year		$21,034,171
Net income	353,532	
Change in net unrealized capital gains (or) losses	139,878	
Change in net deferred income tax	(55,186)	
Change in non-admitted assets	(631,803)	
Dividends to stockholders	(2,100,000)	
Aggregate write-ins for gains and losses in surplus	47,983	
Change in surplus as regards policyholders for the year		(2,245,596)
Surplus as regards policyholders, December 31 current year		$18,788,575

RECONCILIATION OF CAPITAL AND SURPLUS FOR THE PERIOD UNDER EXAMINATION

	2006	2007	2008	2009	2010
Surplus as regards policyholders, December 31, previous year	$26,919,235	$27,333,593	$26,147,713	$26,012,164	$21,034,171
Net income	4,366,535	3,182,080	3,111,682	1,562,748	353,532
Net unrealized capital gains or (losses)	0	0	(106,598)	402,873	139,878
Change in net deferred income tax	(422,975)	(66,430)	277,636	280,274	(55,186)
Change in non-admitted assets	420,798	(1,530)	(538,654)	276,112	(631,803)
Dividends to stockholders	(3,950,000)	(4,300,000)	(2,879,615)	(7,500,000)	(2,100,000)
Aggregate write-ins for gains and losses in surplus	0	0	0	0	47,983
Net change for the year	414,358	(1,185,880)	(135,549)	(4,977,993)	(2,245,596)
Surplus as regards policyholders, December 31, current year	$27,333,593	$26,147,713	$26,012,164	$21,034,171	$18,788,575

ANALYSIS OF CHANGES IN FINANCIAL STATEMENT AND COMMENTS RESULTING FROM EXAMINATION

Differences in various items were noted during the course of examination; however, none were considered to produce a material effect on surplus funds as regards policyholders, either singly or in the aggregate.

ANALYSIS OF CHANGES IN FINANCIAL STATEMENT AS THEY AFFECT SURPLUS

No schedule or comment is applicable. All noted differences were below the materiality threshold established for examination purposes.

COMMENTS AND RECOMMENDATIONS

Comments

The Company and U.S. Bank executed a custodial agreement with the proper provisions as required by Tenn. Comp. R. & Regs., 0780-1-46. The new custodial agreement was signed by an authorized representative of the Company on August 31, 2011 and U.S. Bank on September 2, 2011. Previously the Company did not have a custodial agreement for assets held by U.S. Bank in accordance with Tenn. Comp. R. & Regs., 0780-1-46.04. Corrective actions taken by the Company are discussed in the "Subsequent Events" section of this report.

The Company's auditing firm, Ernst & Young, L.L.P., identified during their audit that no formal process for the transfer or modification of user access is in place. Managers notify System Administrators to add/remove/change access when a user transfers. Documentation around the modification was not retained.

A formal process for the transfer or modification of user access should be adopted and documentation should be retained for periodic review. The Company's IT Department should be involved in the development of the process so that proper security measures can be developed. Periodic review should be performed by business unit management and IT.

Recommendations

The Company is not properly reporting advance premiums in accordance with SSAP No. 53. The amounts are being credited to a suspense account and offset against uncollected premiums. The amounts should be reported separately on the appropriate line item for advance premium.

It is recommended that the Company comply with SSAP No. 53 and Tenn. Code Ann. § 56-1-501(g) when completing the Annual Statement.

The Company's cost allocation agreement does not contain a specified due date for account settlements. In accordance with SSAP No. 96, transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be non-admitted. If a due date is not addressed by the written agreement, any uncollected receivable is non-admitted.

It is recommended that the Company amend the intercompany agreement to include a specified due date to comply with SSAP No. 96.

CONCLUSION

The customary insurance examination practices and procedures, as established by the NAIC, have been utilized in connection with the verification and valuation of assets and the determination of liabilities in the financial statement of this report.

In such manner, it was determined that as of December 31, 2010, the Company had net admitted assets of $69,210,104 and liabilities, exclusive of capital, of $50,421,529. Thus, there existed for the additional protection of the policyholders, the amount of $18,788,575 in the form of aggregate write-ins for special surplus funds, paid-up capital, gross paid-in and contributed surplus and unassigned funds (surplus).

In addition to the undersigned, Mike Bacon and James T. Pearce, Insurance Examiners for the State of Tennessee, and Robert P. Daniel, ACAS, MAAA, of Merlinos & Associates, Inc., participated in this examination.

Respectfully submitted,

Bryant Cummings, CFE
Examiner-in-Charge
State of Tennessee
Southeastern Zone, NAIC

AFFIDAVIT

The undersigned deposes and says that he has duly executed the attached examination report of Direct Insurance Company dated December 20, 2011, and made as of December 31, 2010, on behalf of the Tennessee Department of Commerce and Insurance. Deponent further says he is familiar with such instrument and the contents thereof, and that the facts therein set forth are true to the best of his knowledge, information and belief.

Bryant Cummings, CFE
Insurance Examiner
State of Tennessee
Southeastern Zone, NAIC

Subscribed and sworn to before me this
20th day of December, 2011

Notary Helen W. Dorsey

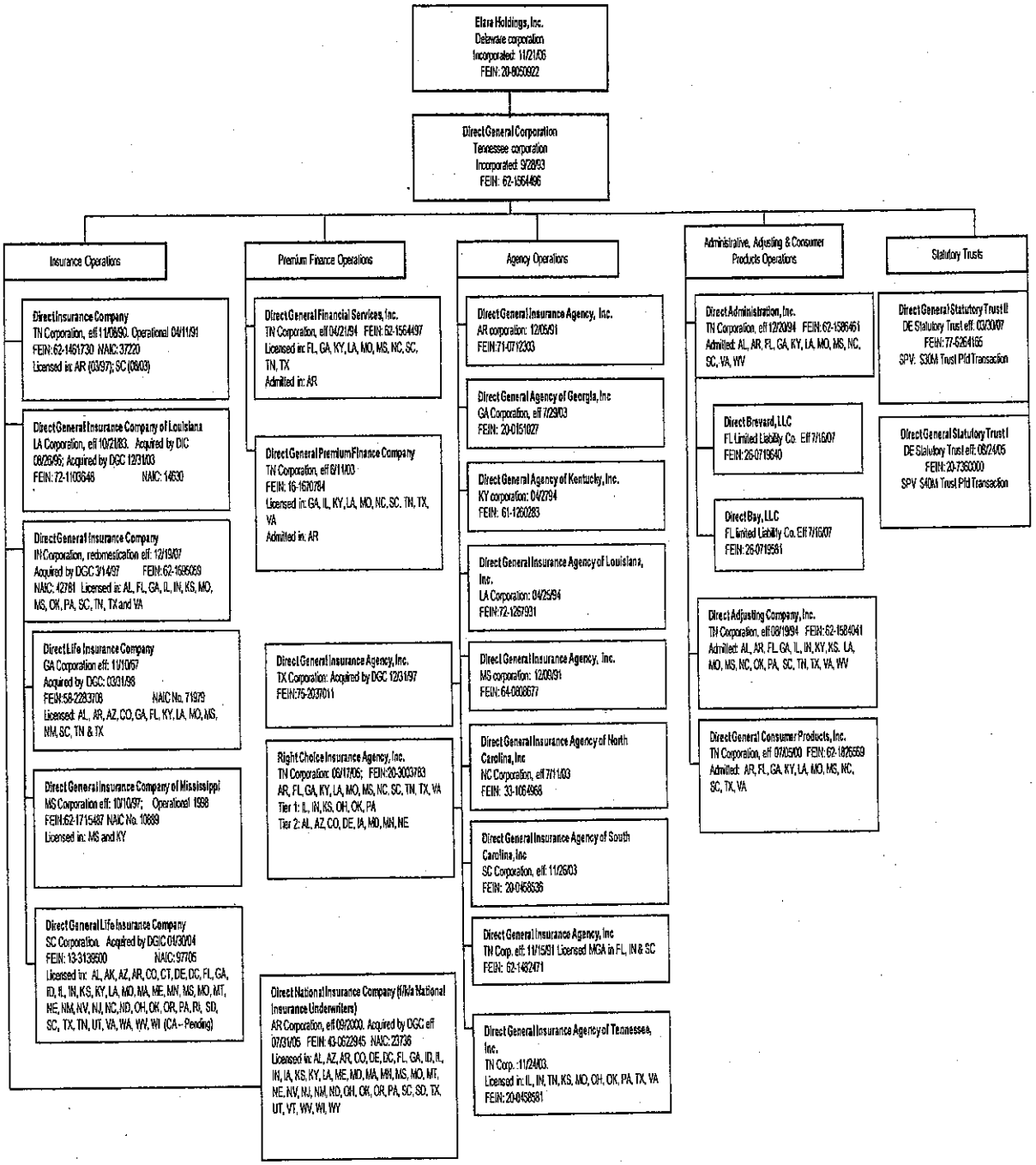
County Davidson

State Tennessee

Commission Expires 03/03/2014

HELEN W DORSEY
STATE OF TENNESSEE NOTARY PUBLIC
DAVIDSON COUNTY

ORGANIZATIONAL CHART



DIRECT INSURANCE COMPANY
1281 Murfreesboro Road ♦ Nashville, Tennessee 37217
Phone: 615.399.4700 ♦ Fax: 615.366.3722

RECEIVED
JAN 13 2012
Dept. of Commerce & Insurance
Company Examinations

January 4, 2011

Mr. Horace Gaddis, Jr., CFE
Insurance Examinations Director
Tennessee Department of Commerce and Insurance
500 James Robertson Parkway
Nashville, TN 37243

RE: Direct Insurance Company
Report of Examination as of December 31, 2010

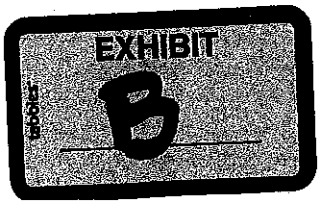
Dear Mr. Gaddis:

On behalf of Direct Insurance Company (the "Company"), please accept this letter with respect to the comments and recommendations contained in the Report on Examination dated December 20, 2011 (the "Report"). The comments and recommendations from the Report and our responses are as follows:

Comments

Observation:
The Company and U.S. Bank executed a custodial agreement with the proper provisions as required by Tenn. Comp. R. & Regs., 0780-1-46. The new custodial agreement was signed by an authorized representative of the Company on August 31, 2011 and U.S. Bank on September 2, 2011. Previously the company did not have a custodial agreement for assets held by U.S. Bank in accordance with Tenn. Comp. R. & Regs., 0780-1-46.04. Corrective actions taken by the Company are discussed in the "Subsequent Events" section of this Report.

Company Response:
As stated above and in the "Subsequent Events" section of the Report, an agreement with U.S. Bank was executed and a copy of the agreement was provided to the Department.



Observation:
The Company's auditing firm, Ernst & Young, L.L.P., identified during their audit that no formal process for the transfer or modification user access is in place. Managers notify system administrators to add/remove/change access when there are user transfers. Documentation around the modification was not retained.

A formal process for the transfer or modification of user access should be adopted and documentation should be retained for a periodic review. The Company's IT Department should be involved in the development of the process so that proper security measures can be developed. Periodic review should be performed by business unit management and IT.

Company Response:
We are currently working with the Human Resource Department on implementation of a new feature in our ADP payroll software which is planned to go live in 2Q12. This enhancement to our current system will ensure an effective and time efficient way for System Administrators to be notified of changes in users, which will include process documentation and training for managers.

Recommendations

Observation:
The Company is not reporting advance premiums in accordance with SSAP No. 53. The amounts are being credited to a suspense account and offset against uncollected premiums. The amounts should be reported separately on the appropriate line item for advance premium.

It is recommended that the Company comply with SSAP. No. 53 and Tenn. Code Ann. § 56-1-501(g) when completing the Annual Statement.

Company Response:
While the amount of advance premium that should have been segregated in our quarterly/annual statements was an immaterial amount, the Company built better internal reporting during 2011 to segregate this amount per the NAIC rules.

Observation:
The Company's cost allocation agreement does not contain a specified due date for account settlements. In accordance with SSAP No. 96, transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be non admitted. If a due date is not addressed by the written agreement, any uncollected receivable is non-admitted.

It is recommended that the Company amend the intercompany agreement to include a specified due date to comply with SSAP No. 96.

Company Response:
We amended our intercompany agreements and submitted to the TN Department on October 20, 2011 under a Form D Filing.

The above is respectfully submitted for inclusion in the Examination Report of the Company. It is the Company's understanding that a copy of this document will be included as part of the Examination Report package to be filed with regulatory authorities and other interested parties.

If you have questions or need additional information, please contact me directly at (800) 330-4541 x 3605.

Sincerely,

J. Todd Hagely
Executive Vice President and CFO