



**THE COMMONWEALTH OF MASSACHUSETTS  
OFFICE OF CONSUMER AFFAIRS AND BUSINESS  
REGULATION**

**DIVISION OF INSURANCE**

***REPORT OF EXAMINATION OF THE*  
BAY STATE INSURANCE COMPANY**

**Andover, Massachusetts**

**As of December 31, 2004**

**NAIC GROUP CODE 0022**

**NAIC COMPANY CODE 19763**

**EMPLOYERS ID NO. 04-2200004**

# BAY STATE INSURANCE COMPANY

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**COMMONWEALTH OF MASSACHUSETTS**  
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**DIVISION OF INSURANCE**

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November 14, 2005

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Honorable Commissioners,

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 the

**BAY STATE INSURANCE COMPANY**  
**Andover, MA**

at its home office located at 95 Old River Road, Andover, MA, 01810-1078. The following report thereon is respectfully submitted.

## **SCOPE OF EXAMINATION**

The Bay State Insurance Company (hereinafter referred to as “the Company”) was last examined as of December 31, 1999 under the association plan of the National Association of Insurance Commissioners (NAIC) by the Massachusetts Division of Insurance (the “Division”). The current association plan examination was conducted by the Division and covers the five year period from January 1, 2000 through December 31, 2004, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of this examination.

Concurrent with this examination, the following insurance affiliates in the Andover Insurance Group were also examined and separate reports have been issued:

Merrimack Mutual Fire Insurance Company  
Cambridge Mutual Fire Insurance Company

The examination was conducted in accordance with standards and procedures established by the NAIC Financial Condition (E) Committee and prescribed by the current NAIC Financial Condition Examiners Handbook.

In addition to a review of the financial condition of the Company, the examination included a review of the Company’s business policies and practices, corporate records, reinsurance treaties, conflict of interest disclosure statements, fidelity bond and other insurance, employees’ pension and benefits plans, disaster recovery plan, treatment of policyholders and other pertinent matters to provide reasonable assurance that the Company was in compliance with applicable laws, rules and regulations. In planning and conducting the examination, consideration was given to the concepts of materiality and risk and examination efforts were directed accordingly.

The Company is audited annually by PricewaterhouseCoopers LLP, an independent certified public accounting firm. The firm expressed unqualified opinions on the Company’s financial statements for the calendar years 2000 through 2004. A review and use of the Certified Public Accountants’ workpapers were made to the extent deemed appropriate and effective. An independent actuarial and accounting consulting firm, KPMG LLP, was retained by the Division to evaluate the adequacy of the Company’s loss and loss adjustment expense reserves as of December 31, 2004. Additionally, the Division reviewed the adequacy and effectiveness of the EDP systems controls to determine the level of reliance to be placed on summary information generated by the data processing systems.

For a summary of findings contained within this report, refer to the “Notes to Financial Statements” section.

## Bay State Insurance Company

### Status of Prior Examination Findings

The previous Report of Examination dated May 21, 2001 had one comment and recommendation. It was recommended that the company obtain a written tax sharing agreement with its parent, Merrimack Mutual Fire Insurance Company. An agreement was prepared with an effective date of January 1, 2001.

### HISTORY

#### General

The Company, a stock company, was incorporated on May 31, 1955 under the laws of the Commonwealth of Massachusetts and commenced business on July 1, 1955. The Company is authorized to issue non-assessable policies insuring personal and commercial property risks.

#### Capital Stock

As of December 31, 2004, the authorized and outstanding capital stock of the Company consisted of 100,000 shares of common stock with a par value of \$35 per share, all of which was owned by Merrimack Mutual Fire Insurance Company, and/or directors and certain officers of the Company.

#### Dividends to Stockholders

No stockholder dividends were declared or paid during the examination period.

#### Growth of the Company

The growth of the Company for the years 2000 through 2004 is shown in the following schedule, which was prepared from the Company's Annual Statements, including any changes as a result of the examination.

	Admitted			Direct	Net
<u>Year</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Surplus</u>	<u>Premiums</u>	<u>Premiums</u>
				<u>Written</u>	<u>Written</u>
2004	\$ 231,178,094	\$ 90,602,528	\$ 140,575,566	\$ 16,300,209	\$ 63,573,143
2003	209,569,725	76,389,379	133,180,348	10,791,679	57,192,066
2002	187,905,142	65,017,818	122,887,325	6,360,606	46,871,650
2001	179,385,869	58,520,503	120,865,367	2,054,098	37,723,123
2000	173,447,260	47,507,068	125,940,193	369,416	34,185,329

## Bay State Insurance Company

### Management

#### *Annual Meeting*

In accordance with the bylaws, the Annual Meeting of the Stockholders is held on the second Monday in May of each year. One-third in interest of the Capital Stock issued and outstanding and entitled to vote shall constitute a quorum. The minutes indicated that a quorum was obtained at each annual meeting held during the examination period.

#### *Board of Directors*

The bylaws provide that the business and affairs of the Company shall be managed by the Board of Directors except as otherwise provided by the Articles of Incorporation or by a valid shareholder agreement. The Board of Directors shall consist of not fewer than five or more than fifteen directors with the number determined at each annual meeting by resolution of the stockholders. Each director holds office for a term of four years and each director shall be a stockholder of the Company. Upon expiration or resignation, his/her successor is elected at the next Annual Meeting.

At December 31, 2004 the Board was comprised of eleven Directors, which is in compliance with the Company bylaws.

Directors duly elected and serving at December 31, 2004, with addresses and business affiliations, follow:

<u>Year Term Expires</u>	<u>Director</u>	<u>Business Affiliation</u>
2007	John Appleton Boston, MA	Retired, Senior Vice President Fidelity Investments
2005	Charles A. Austin, III Boston, MA	Principal Appleton Partners Inc.
2005	Benjamin C. Bixby Kingston, NH	President and Director Bixby International Corporation
2004	Malcolm W. Brawn Ipswich, MA	Executive Vice President and Secretary The Andover Companies
2008	David F. Dietz Andover, MA	Partner Goodwin, Procter & Hoar LLP
2004	Alan R. Kober Franklin, MA	Vice President The Andover Companies
2006	Robert P. McDonald Needham, MA	Chairman and Treasurer Erland Construction Inc.

## Bay State Insurance Company

2008	William E. Nichols North Andover, MA	President, CEO and Treasurer The Andover Companies
2005	Edward F. Stokham Andover, MA	Vice President The Andover Companies
2006	Donald F. Vose Boxford, MA	Vice President The Andover Companies
2007	C. Edward Wallis Nashua, NH	Vice President and Assistant Treasurer The Andover Companies

The bylaws do not specify the number of meetings to be held during a year. The minutes of the Board of Directors meetings indicated that meetings were held four times per year during the examination period. At any meeting of the Board a majority of directors in office (minimum of four), shall constitute a quorum. The minutes indicated that a quorum was obtained at all meetings of the Board of Directors held during the examination period.

The Board of Directors appointed an Investment committee in accordance with the bylaws. The membership of the committee at December 31, 2004 follows.

John Appleton  
Benjamin C. Bixby  
William E. Nichols

### *Officers*

The bylaws of the Company provide that the officers of the Company shall be a President, a Treasurer, a Secretary and other officers as deemed necessary. Pursuant to the bylaws, the officers of the Company are elected by the Board of Directors at the first meeting of the Board held after the Annual Meeting. Vacancies among the officers may be filled and new officers created and filled by the Board of Directors, or by the President to the extent authorized by the Board of Directors.

The elected officers and their respective titles at December 31, 2004 follow:

<u>Name</u>	<u>Title</u>
William E. Nichols	President, Chief Executive Officer and Treasurer
Malcolm W. Brawn	Executive Vice President and Secretary
Alan R. Kober	Vice President
Edward F. Stokham	Vice President
Donald F. Vose	Vice President
C. Edward Wallis	Vice President and Assistant Treasurer

## Bay State Insurance Company

### Conflict of Interest Procedures

The Company has adopted a policy statement pertaining to conflict of interest in accordance with Question 10 of the General Interrogatories of the Annual Statement. The Company has an established procedure for the disclosure to the Board of Directors of any material interest or affiliation on the part of any officer or director, which is in or is likely to conflict with his/her official duties.

Annually, each officer, director and responsible employee completes a questionnaire disclosing any material conflicts of interest. The completed questionnaires were reviewed, and no discrepancies were noted in the responses to the General Interrogatories regarding conflicts of interest as reflected in the Company's 2004 Annual Statement.

### Corporate Records

#### *Articles of Incorporation and Bylaws*

The bylaws and Articles of Incorporation and amendments thereto were read. There were no changes to the bylaws or Articles of Incorporation since the prior examination.

#### *Disaster Recovery and Business Continuity*

The Company provides for the continuity of management and operations in the event of a catastrophe or national emergency in accordance with M.G.L. c.175 ss.180M-180Q.

#### *Board of Directors Minutes*

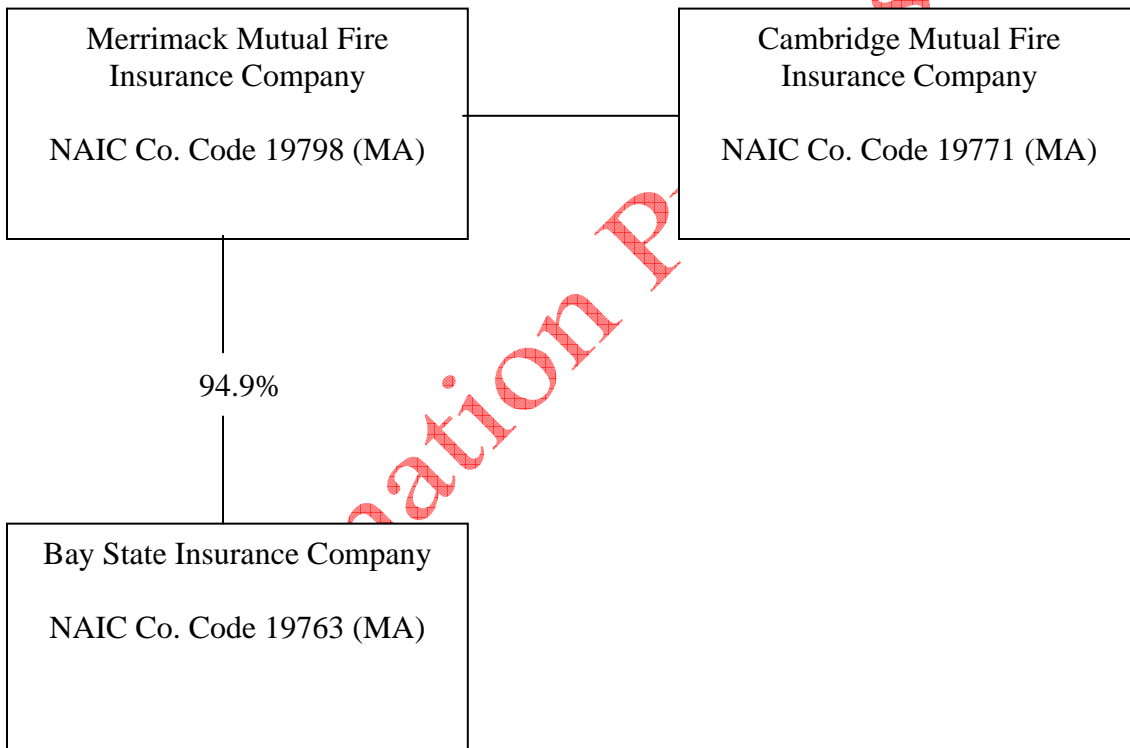
The minutes of the Board of Directors and Committee meetings for the period under statutory examination were read and indicated that all meetings were held in accordance with the Company bylaws and the laws of the Commonwealth of Massachusetts. Activities of the Committees were ratified at each meeting of the Board of Directors.



**AFFILIATED COMPANIES**

Per Form B, as filed with the Massachusetts Division of Insurance, the Company is a member of a holding company system and is subject to the registration requirements of Chapter 175, Section 206C of the Massachusetts General Laws. The “ultimate controlling person” of the Company is Merrimack Mutual Fire Insurance Company (“Merrimack”), a mutual insurer incorporated in Massachusetts. The Company shares common management with Merrimack and with Cambridge Mutual Fire Insurance Company (“Cambridge”).

**2004 Organizational Chart**



## Bay State Insurance Company

### Transactions and Agreements with Subsidiaries and Affiliates

#### *Management and Reinsurance Agreement*

The Company participates in a Management and Reinsurance Agreement with its affiliates, Merrimack and Cambridge. Under this agreement all net insurance shall be pooled and distributed in the following proportions: Merrimack 50%, Cambridge 35% and Bay State 15%. Merrimack provides management and administration services for Cambridge and Bay State. Cambridge and Bay State reimburse Merrimack for the expenses incurred in providing these services based on the percentage set forth above.

#### *Tax Sharing Agreement*

The Company participates in a consolidated Federal Income Tax return with Merrimack. There is a written tax sharing agreement with an effective date of January 1, 2001.

### **FIDELITY BOND AND OTHER INSURANCE**

The Company maintains fidelity coverage with an authorized Massachusetts insurer, consistent with M.G.L. c.175 s.60. The aggregate limit of liability exceeds the NAIC suggested minimum.

The Company has further protected its interests and property by policies of insurance covering other insurable risks. Coverage is provided by insurers licensed in the Commonwealth of Massachusetts and was in force as of December 31, 2004.

### **PENSION, STOCK OWNERSHIP AND INSURANCE PLANS**

All Company personnel are actually named employees of Merrimack. As employees of Merrimack, employees are offered various insurance plans including group and family life and health coverages and long-term disability and personal accident insurance.

Merrimack offers a Savings and Investment Plan under section 401(k) of the Internal Revenue Code. The plan, which is a defined contribution plan, covers all participating employees of the Company beginning with the month following the date of employment.

Merrimack's employees participate in a defined benefit pension plan. The pension fund is reviewed annually by an independent consulting actuary. At December 31, 2004, the pension fund was fully funded. All pension fund financial information is disclosed in the Notes to the Financial Statements appearing in the Company's Annual Statement.

Merrimack provides health insurance benefits for retired employees. The Company utilizes the services of an independent consulting actuary to calculate the projected year end balance sheet liability. The projected amount of post-retirement benefit obligation for retirees and eligible or vested employees is included on page 3, lines 3 and 5 of the Annual Statement. The Company intends to fund the accumulated post-retirement benefit obligation as benefits become due.

Bay State Insurance Company

**STATUTORY DEPOSITS**

The statutory deposits of the Company as of December 31, 2004 are as follows:

<u>Location</u>	<u>Description of Deposit</u>	<u>Par Value</u>	<u>Statement Value</u>
Georgia	U.S. Treasury Bonds 9.375% due 2006	\$50,000	\$50,523
Total – All Policyholders		1,550,000	1,605,913
Total Deposits		<u>\$1,600,000</u>	<u>\$1,656,436</u>

**INSURANCE PRODUCTS AND RELATED PRACTICES**

Territory and Plan of Operation

The Company is licensed to write business in twelve states. All of the Company's direct business is written in New Jersey and New York.

The Company's principal line of business is homeowner's coverage provided to personal risks through its appointed independent agents.

Treatment of Policyholders – Market Conduct

During the financial examination of the Company, the Division's Market Conduct Department initiated a comprehensive market conduct examination of the Company for the period January 1, 2004 through December 31, 2004. The market conduct examination was called pursuant to authority in Massachusetts General Laws Chapter (M.G.L. c.) 175, Section 4. The market conduct examination is being conducted at the direction of, and under the overall management and control of, the market conduct examination staff of the Division. Representatives from the firm of Eide Bailly, LLP were engaged to complete certain agreed upon procedures which were developed using the guidance and standards of the NAIC Market Conduct Examiner's Handbook, the market conduct examination standards of the Division, and the Commonwealth of Massachusetts insurance laws, regulations and bulletins. The basic business areas that are being reviewed under this market conduct examination are Company Operations/Management; Complaint Handling; Marketing and Sales; Producer Licensing; Policyholder Services; Underwriting and Rating; Claims, in addition to an assessment of the Company's internal control environment. Once this market conduct examination is completed a Report on the Comprehensive Market Conduct Examination of the Company for the period January 1, 2004 through December 31, 2004 will be issued and become available as a public document.

## REINSURANCE

The Company and its affiliates operate under a pooling agreement as described in the “Affiliated Companies” section in this report. Assumed and ceded reinsurance with unaffiliated companies is also subject to the inter-company pooling agreement.

### Ceded Reinsurance

On behalf of Cambridge and Bay State, Merrimack has entered into various reinsurance agreements. Below is a brief summary of the treaties.

		<u>Retention</u>	<u>Limit</u>
XS of Loss	Personal and Commercial Umbrella	\$2,000,000	\$3,000,000
Property Facultative Automatic	Homeowners	\$100,000	\$1,000,000
	EDP Equipment	\$0	\$10,000,000
	Equipment Breakdown	\$0	\$25,000,000

Merrimack has additional coverage under Excess Property Catastrophe reinsurance with the limits and retention as follows:

	<u>Limit and Retention</u>	<u>Percent Placed</u>	<u>Percent Retained</u>
First Layer	\$50,000,000 excess of \$50,000,000	90	10
Second Layer	\$75,000,000 excess of \$100,000,000	81.27	18.73
Third Layer	\$75,000,000 excess of \$175,000,000	95	5
Fourth Layer	\$300,000,000 excess of \$250,000,000	87.65	12.35

Each treaty reviewed contained an insolvency clause in accordance with M.G.L. c.175 s.20A.

## Bay State Insurance Company

### Assumed Reinsurance

Merrimack assumes business from four quota share agreements with the participation percentage varying by treaty. Coverage is limited to property business only. During 2004, one treaty was commuted. There are several treaties terminated in previous years that may still have a financial statement impact.

### Pools

The Company participates in two voluntary pools, the Selected Insurance Risk Plan ("SIR") and Associated Inland Marine ("AIM"). SIR and AIM were established as a means for insurers to underwrite larger policies and spread the risk among the members. SIR is used for commercial policies and AIM for inland marine personal line policies. Membership in both is composed of New England Mutual Companies.

Additionally, Bay State participates in various state-mandated pools. These include the Illinois Mine Subsidence Program and state FAIR plans.

### ACCOUNTS AND RECORDS

The internal controls structure was discussed with management through questionnaires and through a review of the work performed by the Company's independent Certified Public Accountants. No material deficiencies were noted.

The NAIC provides a questionnaire covering the evaluation of the controls in the IT systems environment. The questionnaire was completed by the Company and reviewed by the Division to evaluate the adequacy of the IT controls. No material deficiencies were noted.

The Company uses an automated general ledger system. Trial balances were traced from the general ledger and supporting documents to the 2004 Annual Statement. No material exceptions were noted.

The books and records of the Company are audited annually by PricewaterhouseCoopers LLP, independent Certified Public Accountants, in accordance with 211 CMR 23.00.

**FINANCIAL STATEMENTS**

The following financial statements are presented on the basis of accounting practices prescribed or permitted by the Division of Insurance of the Commonwealth of Massachusetts and by the National Association of Insurance Commissioners as of December 31, 2004:

Statement of Assets, Liabilities, Surplus and Other Funds as of, December 31, 2004

Statement of Income for the Year Ended December 31, 2004

Reconciliation of Capital and Surplus, for the five year period ended December 31, 2004

For Information Purposes Only

Bay State Insurance Company  
Statement of Assets, Liabilities, Surplus and Other Funds  
As of December 31, 2004

Assets	As Reported by the Company	Examination Changes	Per Statutory Examination
Bonds	\$ 186,530,294	\$ 0	\$ 186,530,294
Common stocks	22,244,459		22,244,459
Cash and short-term investments	2,549,573		2,549,573
Subtotals, cash and invested assets	211,324,326		211,324,326
Investment income due and accrued	2,726,457		2,726,457
Agents' balances and uncollected premiums:			
Premiums and agents' balances in course of collection	10,220,064		10,220,064
Premiums, agents' balances and installments booked but deferred and not yet due	6,253,345		6,253,345
Amounts recoverable from reinsurers	610,673		610,673
Funds held by reinsured companies	17,984		17,984
Electronic data processing equipment	25,246		25,246
Total Assets	<u>\$ 231,178,095</u>	<u>\$ 0</u>	<u>\$ 231,178,095</u>

Bay State Insurance Company  
Statement of Assets, Liabilities, Surplus and Other Funds (Continued)  
As of December 31, 2004

Liabilities	As Reported by the Company	Examination Changes	Per Statutory Examination	Notes
Losses	\$ 34,643,351	\$ 0	\$ 34,643,351	( 1 )
Reinsurance payable on paid loss and LAE	2,881,806		2,881,806	
Loss adjustment expenses	6,268,950		6,268,950	( 1 )
Commissions payable	2,288,700		2,288,700	
Other expenses	3,987,150		3,987,150	
Taxes, licenses and fees	306,300		306,300	
Net deferred tax liability	2,317,818		2,317,818	
Borrowed money	1,805,100		1,805,100	
Unearned premiums	31,502,365		31,502,365	
Advance premiums	1,116,300		1,116,300	
Ceded reinsurance premiums payable	1,654,237		1,654,237	
Amounts withheld	2,191		2,191	
Drafts outstanding	670,556		670,556	
Payable to parent; subsidiaries and affiliates	1,081,804		1,081,804	
Aggregate write-ins for liabilities	75,900		75,900	
Total Liabilities	<u>90,602,528</u>		<u>90,602,528</u>	
Common capital stock	3,500,000		3,500,000	
Unassigned funds (surplus)	137,075,566		137,075,566	
Surplus as regards policyholders	<u>140,575,566</u>		<u>140,575,566</u>	
Total Liabilities, Capital and Surplus	<u>\$ 231,178,095</u>	<u>\$ 0</u>	<u>\$ 231,178,095</u>	



Bay State Insurance Company  
Summary of Operations  
For the Year Ended December 31, 2004

	As Reported by the Company	Examination Changes	Per Statutory Examination
Premiums earned	\$ 60,758,952	\$ 0	\$ 60,758,952
Deductions:			
Losses incurred	30,470,034		30,470,034
Loss expenses incurred	4,883,808		4,883,808
Other underwriting expenses incurred	23,972,308		23,972,308
Total underwriting deductions	59,326,150		59,326,150
Net underwriting gain (loss)	1,432,802		1,432,802
Net investment income earned	10,682,472		10,682,472
Net realized capital gains	418,526		418,526
Net investment gain	11,100,998		11,100,998
Net gain (loss) from agents' balances or premium balances charged off	(1,197)		(1,197)
Finance and service charges not included in premiums	207,545		207,545
Aggregate write-ins for miscellaneous income	(33,600)		(33,600)
Total other income	172,748		172,748
Net income before dividends to policyholders and before federal and foreign income taxes	12,706,548		12,706,548
Federal and foreign income taxes incurred	4,843,630		4,843,630
Net Income	\$ 7,862,918	\$ 0	\$ 7,862,918

Bay State Insurance Company  
Capital and Surplus  
For the Year Ended December 31, 2004

	As Reported by the Company	Examination Changes	Per Statutory Examination
Surplus as regards policyholders, December 31, 2003	\$ 133,180,348	\$ 0	\$ 133,180,348
Net income	7,862,918		7,862,918
Change in net unrealized capital gains or (losses)	(927,387)		(927,387)
Change in net deferred tax	414,684		414,684
Change in nonadmitted assets	5		5
Change in minimum pension liability	45,000		45,000
Change in surplus as regards policyholders for the year	7,395,219		7,395,219
Surplus as regards policyholders, December 31, 2004	\$ 140,575,566	\$ 0	\$ 140,575,566

Bay State Insurance Company  
Reconciliation of Capital and Surplus  
For the Five Year Period Ended December 31, 2004

	2004	2003	2002	2001	2000
Capital and surplus, December 31, prior year	\$ 133,180,348	\$ 122,887,325	\$ 120,865,367	\$ 125,940,193	\$ 108,023,096
Net income	7,862,918	6,177,150	6,210,914	4,230,302	5,253,634
Change in net unrealized capital gains or (losses)	(927,387)	3,557,392	(4,598,648)	(1,879,621)	12,857,564
Change in net deferred income tax	414,684	691,507	455,208	248,358	
Change in nonadmitted assets	5	(12,126)	(45,517)	(17,250)	(3,600)
Change in excess of statutory reserves over statement reserves					(190,500)
Cumulative effect of changes in accounting principles				(7,656,615)	
Aggregate write-ins for gains and (losses) in surplus	45,000	(120,900)			
Net change in capital and surplus for the year	7,395,219	10,293,023	2,021,958	(5,074,826)	17,917,098
Capital and surplus, December 31, current year	<u>\$ 140,575,566</u>	<u>\$ 133,180,348</u>	<u>\$ 122,887,325</u>	<u>\$ 120,865,367</u>	<u>\$ 125,940,193</u>

**NOTES TO THE FINANCIAL STATEMENTS**

**NOTE 1: Losses and Loss Adjustment Expenses**

The Division requested that KPMG review the reasonableness of the Loss and Loss Adjustment Expense Reserves (the "Reserves") of the Company as of December 31, 2004. The review was conducted in a manner consistent with the Code of Professional Conduct and Qualification Standards of the American Academy of Actuaries and the Standards of Practice adopted by the Actuarial Standards Board.

KPMG's actuarial review utilized year-end paid and incurred loss data developed through December 31, 2004. The tables below summarize a comparison of KPMG's range of reasonable gross and net estimates for the Reserves to the Company's carried gross and net Reserves as of December 31, 2004.

**COMPARISON OF INDICATED GROSS RESERVES  
TO CARRIED GROSS RESERVES as of 12/31/04**

	Low Point of Range	Selected Estimate	High Point of Range
KPMG Total Gross Loss & Loss Adjustment Expense Reserves	\$37,160,550	\$40,097,550	\$43,934,100
Total Company Carried Gross Loss & LAE Reserves	41,173,950	41,173,950	41,173,950
Difference	4,013,400	1,076,400	(2,760,150)

**COMPARISON OF INDICATED NET RESERVES  
TO CARRIED RESERVES as of 12/31/04**

	Low Point of Range	Selected Estimate	High Point of Range
KPMG Total Net Loss & Loss Adjustment Expense Reserves	\$35,817,600	\$39,130,650	\$42,508,500
Total Company Carried Net Loss & LAE Reserves	40,912,950	40,912,950	40,912,950
Difference	5,095,350	1,782,300	(1,595,550)

The Company's total net carried reserves are above KPMG's selected estimate and below their high point. Therefore the Division concludes the Company's reserves are a reasonable estimate of their ultimate liability.

ACKNOWLEDGEMENT

Acknowledgment is made of the cooperation and courtesies extended by the officers and employees of the Company to all the examiners during the course of the examination.

The assistance rendered by the following Massachusetts Division of Insurance examiners who participated in this examination is hereby acknowledged:

Ravinder Chana, Examiner III  
Linda Dow, Examiner II

---

Kenneth Plumb, CFE, CPA  
Supervising Examiner  
Commonwealth of Massachusetts  
Division of Insurance

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Maria Gannon, CFE  
Examiner-In-Charge  
Commonwealth of Massachusetts  
Division of Insurance

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