



COMMONWEALTH OF MASSACHUSETTS
OFFICE OF CONSUMER AFFAIRS AND BUSINESS
REGULATION

Division of Insurance

Report on the Statutory Examination of
The Commerce Insurance Company

Webster, Massachusetts

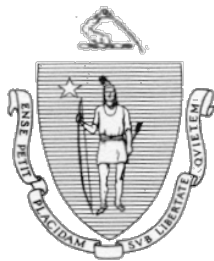
As of December 31, 2008

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COMMONWEALTH OF MASSACHUSETTS
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DIVISION OF INSURANCE

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Honorable Commissioners, Directors, and Superintendent:

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 as of December 31, 2008 of

THE COMMERCE INSURANCE COMPANY
Webster, Massachusetts

at its home office located at 211 Main Street, Webster, MA, 01570-0759. The following report thereon is respectfully submitted.

SCOPE OF EXAMINATION

The Commerce Insurance Company (hereinafter referred to as "the Company") was last examined as of December 31, 2003 for the period from January 1, 1999 thereto. The current examination covers the intervening period from January 1, 2004 through December 31, 2008, and any material transactions and/or events occurring subsequent and noted during the examination.

The current examination was conducted at the direction of and under the overall management and control of the examination staff of the Massachusetts Division of Insurance (the "Division") in accordance with standards established by the NAIC Financial Condition (E) Committee as well as with the requirements of the *NAIC Financial Condition Examiner's Handbook*, the examination standards of the Division and with Massachusetts General Laws. Representatives from the firm of KPMG LLP ("KPMG") were engaged by the Division to assist in the examination by performing certain examination procedures at the direction of and under the overall management of the Division's examination staff. This assistance included a review of accounting records, information systems, taxes, investments, and actuarially determined loss and loss adjustments expense reserves of the Inter-affiliate Reinsurance Pool (the "Commerce Pool"). The Division also conducted a concurrent examination of Citation Insurance Company ("Citation"), also a Massachusetts domiciled affiliate and participant in the Commerce Pool. Under a coordinated examination approach, insurance regulators from the states of Ohio, California and New York conducted examinations of their respective domestic insurers, all participants of the Commerce Pool, namely American Commerce Insurance Company (OH), Commerce West Insurance Company (CA), and State-Wide Insurance Company (NY).

The principal focus of the examination was 2008 activity however transactions both prior and subsequent thereto were reviewed as deemed appropriate. The examination was conducted following the NAIC Risk Focused Examination Model, and examination efforts were coordinated with regulators from Ohio, California and New York as noted above.

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 bonds and other insurance, disaster recovery plan 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 currently audited by Ernst & Young LLP ("E&Y"), an independent certified public accounting firm, in accordance with 211 CMR 23.00. The firm expressed an unqualified opinion on the Company's financial statements for the calendar year 2008. Prior to E&Y's 2008 engagement as independent auditor, PricewaterhouseCoopers LLP was engaged as the Company's independent

certified public accountants. During that time, the Company's parent was an SEC registrant and subject to the Sarbanes-Oxley Act of 2002. A review and use of the certified public accountants' work papers as well as the work of the Company's internal auditors was made and relied upon where deemed appropriate.

HISTORY

General

The Company was incorporated as a stock property and casualty insurer on September 15, 1971 under the laws of the Commonwealth of Massachusetts and commenced writing business in Massachusetts on May 10, 1972 and in New Hampshire in 2001. The Company is a wholly-owned subsidiary of The Commerce Group, Inc. ("CGI"). The Company is one of five insurance entities that make up the insurance operations of CGI. The other four affiliates include Citation Insurance Company ("Citation"), a Massachusetts domiciled insurer incorporated in September 1981; Commerce West Insurance Company ("Commerce West"), a California domiciled insurer acquired in August 1995; American Commerce Insurance Company ("ACIC"), an Ohio domiciled insurer acquired in January 1999; and State-Wide Insurance Company ("State-Wide"), a New York domiciled insurer acquired in April 2007.

Effective January 1, 2004, CGI implemented an inter-affiliated reinsurance pooling agreement, whereby all insurance members of the group at the time became participants in the pooling agreement and the Company was the lead insurer of the pool. The pooling agreement was amended to add State-Wide to the pool upon its acquisition by CGI in 2007.

On October 30, 2007, CGI entered into a merger agreement with MAPFRE, S.A. ("MAPFRE"). The merger was approved by shareholders on February 14, 2008 and became effective in June 2008 after all regulatory approvals and all other customary closing conditions were met. Under the terms of the merger agreement, CGI became an indirect wholly-owned subsidiary of MAPFRE, which became the new ultimate parent of the Company and its affiliates. MAPFRE is reported to be the leading insurer in Spain and has a presence in over 40 countries.

CGI and the Company continue to be headquartered in Webster, Massachusetts.

Capital Stock

The Company has authorized and outstanding fifty thousand (50,000) shares of common capital stock with a stated par value of \$50.00 per share, for an aggregate par value of \$2,500,000. All outstanding stock is owned by CGI. The Company's capital structure also consists of \$205,531,875 additional paid in and contributed surplus.

Dividends to Stockholders

During the five year period covered by this examination, the Company paid a total of \$562,200,000 dollars in dividends to CGI, its sole stockholder, as follows:

<u>Year</u>	<u>Dividend</u>
2008	\$111,750,000
2007	186,750,000
2006	180,750,000
2005	61,700,000
2004	<u>21,250,000</u>
Total	<u>\$562,200,000</u>

There were no declared but unpaid dividends as of December 31, 2008.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to write property and casualty insurance in all 6 New England states, is a qualified reinsurer in California and New York, and eligible or approved to write Surplus Lines in Oregon and Texas. The Company was also recently licensed in Ohio. However, the Company only writes direct business in Massachusetts and New Hampshire and its core product line is Massachusetts private passenger automobile coverage. The Company has been the largest writer of personal property and casualty insurance in Massachusetts since 1990, as measured by direct premiums written. As of December 31, 2008, the Company had a 30.9% share of the Massachusetts personal automobile market.

In addition to Massachusetts private passenger auto, although to a lesser extent, the Company writes homeowners, commercial auto, commercial multi-peril, inland marine, fire, general liability and personal and commercial umbrella insurance. The Company has greatly expanded its territory and its offerings by assuming and retro-ceding, as the lead company in the Commerce Pool that includes all five members of the CGI group. This allows the Company a broader distribution of risk by line of business as well as geographic territory.

The Company markets its products through a network of independent agents and brokers, and has in place marketing agreements with various affinity groups. The Company also has in place marketing agreements with three Massachusetts AAA Clubs.

Massachusetts Automobile Business and Regulatory Reform

As noted, the Company's principal line of business and the core of the CGI operation is Massachusetts private passenger automobile business. Until April 1, 2008, the private passenger automobile insurance market in Massachusetts was heavily regulated and the Massachusetts Commissioner of Insurance (the "Commissioner") was responsible for setting premium rates on an annual basis. In July of 2007, the Massachusetts Division of Insurance issued its "Opinion, Findings and Decision on the Operation of Competition in Private Motor Vehicle Insurance in 2008", in

which it determined that competition in the Massachusetts private passenger motor vehicle insurance market was sufficient such that the Commissioner cannot “fix-and-establish” premium rates for 2008. Accordingly, effective April 1, 2008, each insurer, including the Company, was permitted to file and use its own rates subject to disapproval by the Commissioner.

Also in July of 2007, the Division issued a decision approving rules that will implement an assigned risk plan, the Massachusetts Automobile Insurance Plan (“MAIP”), to provide private passenger insurance for those individuals unable to obtain insurance voluntarily. This new assigned risk plan will ultimately replace the current facility for high risk drivers, Commonwealth Automobile Reinsurers (“CAR”). The effect of these two decisions was to introduce “managed competition” to the Massachusetts private passenger automobile insurance market. This regulatory reform is significant to the Company and the industry as a whole. During the first year of managed competition, nine new automobile insurers entered the Massachusetts market, average premiums per vehicle have decreased, and the Company’s market share has shifted slightly lower, although they remain the market share leader in this category with approximately 30.9% as of December 31, 2008.

Growth of Company

The growth of the Company for the years 2004 through 2008 are shown in the following schedule, which was prepared from the Company’s statutory annual statements.

<u>Year</u>	<u>Admitted Assets</u>	<u>Net Premium Written</u>	<u>Surplus</u>	<u>NWP to Surplus %</u>
2008	\$2,579,440,310	\$1,279,845,583	\$ 977,827,584	130.9%
2007	2,824,481,913 ^(a)	1,357,158,081	1,127,841,497	120.3
2006	3,113,013,778	1,452,922,290	1,205,881,422	120.5
2005	2,924,765,598	1,382,008,669	1,172,985,898	117.8
2004	2,653,957,696	1,296,631,013	1,031,810,776	125.7

(a) 2007 Admitted Assets reflect a decrease of \$53,626,956 from the 2007 Annual Statement as filed due to subsequent correction of a reporting error in 2008. Total liabilities also corrected. 2007 reporting error had no impact on surplus.

MANAGEMENT AND CONTROL

Board of Directors

The bylaws of the Company provide that the Board of Directors may exercise all powers of the corporation except those reserved to the stockholders either by law, by the articles of incorporation or the bylaws of the corporation. The Board of Directors shall consist of not fewer than five, nor, more than twenty directors, and the exact number of directors shall be fixed by vote at the meeting at which they are elected. Directors shall be elected at the annual meeting of the stockholders and shall serve until their successors have been duly elected and qualified. A majority of directors present at any meeting shall constitute a quorum. When a quorum is present, a majority shall decide issues brought before the meeting.

At December 31, 2008, the Board was set and comprised of nine directors in compliance with the

Company's bylaws. Each director is also a director of the Citation Insurance Company.

Directors duly elected and serving at December 31, 2008, with business affiliations, follows:

<u>Director</u>	<u>Business Affiliation</u>
Andres Jimenez Herradon	Chairman of the Board and Chief Executive Officer of MAPFRE, S.A. and MAPFRE Internacional, S.A.
Gerald Fels	Chief Executive Officer and Chairman of the Board of Commerce Group, Inc.; Chief Executive Officer of Commerce Insurance Company and Citation Insurance Company
Jaime Tamayo	President and Chief Operating Officer of Commerce Group, Inc.; Commerce Insurance Company; Citation Insurance Company
Randall V. Becker	Executive Vice President and Chief Financial Officer of Commerce Group, Inc.; Commerce Insurance Company; Citation Insurance Company
Javier Fernandez-Cid	Director and General Manager of MAPFRE, S.A. and MAPFRE Internacional, S.A.
Henry T. Rowles	President and Chief Executive Officer of AAA Southern New England, Retired
Mark A. Shaw	President and Chief Executive Officer of AAA Southern New England
Domingo Sugranyes Bickel	Vice Chairman, MAPFRE, S.A.
Estaban Tejera Montalvo	General Manager, MAPFRE, S.A.

The bylaws do not specify the number of meetings to be held during any one year however, corporate records indicate that the Board of Directors held regular meetings four times per year during the examination period.

Committees of the Board of Directors

During the period covered by this examination, the Company had in place an Executive Committee. Records show the Executive Committee met numerous times each year, however effective on or after February 27, 2007, the Executive Committee began to report its activity to the newly formed Strategy Committee of its parent, CGI. As of the examination date, there are no longer any committees of the Board of Directors specific to the Company. All committees are now committees of CGI's Board of Directors. Those committees at the CGI level include a compensation committee, a nominating and corporate governance committee, strategy committee, countrywide products and pricing management committee and a corporate compliance committee. Also, as a SEC publicly traded corporation, CGI had in place an audit committee. As a result of the merger with MAPFRE, the audit committee of CGI has since been dissolved and the functions of the audit committee now fall under the scope of

the audit committee of MAPFRE.

Senior Officers

The bylaws of the Company provide that the Company may have a Chairman of the Board and may have a Chief Executive Officer. The bylaws also state that the Company shall have a president, one or more vice-presidents, one of whom may be the executive vice-president, first senior vice-presidents, senior vice-presidents and assistant vice-presidents. Additionally, the Company shall have a secretary and a treasurer, and any number of assistant secretaries, treasurers and other officers as may be determined by the directors. Pursuant to the bylaws, the officers are elected by the Board of Directors at the first meeting following the annual meeting of the stockholders. Officers may be removed by the stockholders or the Board of Directors, and any vacancy may be filled by vote of the stockholders or Directors. Each senior officer is also a senior officer of Citation Insurance Company.

Senior elected officers and their respective titles at December 31, 2008 are as follows:

<u>Officer</u>	<u>Title</u>
Gerald Fels	Chief Executive Officer
Jaime Tamayo	President and Chief Operating Officer
Daniel P. Olohan	Senior Vice President, Secretary & General Counsel
Randall V. Becker	Executive Vice President and Chief Financial Officer
Arthur J. Remillard III ¹	Executive Vice President – Policyholder Benefits
Robert E. McKenna	Treasurer & Vice President and Chief Accounting Officer
David H. Cochrane	Senior Vice President – Underwriting
John W. Hawie ²	Senior Vice President & Chief Investment Officer
Patrick J. McDonald	Senior Vice President – Marketing
Debra A. Mann	Senior Vice President – Management Information Systems
Cathleen M. Moynihan	Senior Vice President – Human Resources
Warren S. Ehrlich	Appointed Actuary

¹Mr. Remillard III left the Company as of June 30, 2009.

²Mr. Hawie left the Company as of September 8, 2009.

Corporate Governance

Prior to the 2008 merger with MAPFRE, the Company's parent, CGI, was a US SEC listed entity subject to the rules and regulations of the SEC and Section 404 of the Sarbanes-Oxley Act. The requirements of Sarbanes-Oxley are fairly substantial, and CGI has not made any substantive changes to their governance structure since the merger, other than the elimination of the independent audit committee. As the principal subsidiary of CGI, the Company fell under the same standards imposed by Sarbanes-Oxley and implemented by CGI.

The Company's Board of Directors has significant influence on the entity's control consciousness. The Board, through its own activities and supported by its audit committee (prior to the MAPFRE

acquisition), is responsible for overseeing all financial reporting policies and procedures. The Board appears appropriately experienced and qualified as there has not been any significant turnover on the Board other than from the result of the MAPFRE acquisition in 2008.

During the period prior to the MAPFRE acquisition, the Company's internal audit department reports appear complete and well-documented. Audits were performed on a regular basis with results communicated to senior management, the respective department heads and external auditors. It is noted that the Company's external auditors did not identify any deficiencies in internal controls that were considered to be material.

Conflict of Interest

The Company has adopted a Policy Statement pertaining to Code of Ethics and Conflict of Interest. 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. It is noted that the Company will additionally fall under guidelines adopted by MAPFRE, which has in place its own "Code of Good Governance".

Management Continuity and National Emergency

The Company provides for the continuity of management in the event of a catastrophe or other emergency in accordance with sections 180M through 180Q of Chapter 175 of the Massachusetts General Laws.

Corporate Records

Articles of Incorporation and Bylaws

The Company's articles of incorporation and bylaws were reviewed and found to be unchanged since the prior examination.

Minutes of the Board of Directors and Committees

The minutes of all Board and committee meetings were reviewed and it was noted that a quorum was obtained at each meeting and actions taken were in compliance with guidelines established by the Board of Directors and the bylaws.

AFFILIATED COMPANIES

The Company's direct parent is CGI and the ultimate parent company is MAPFRE, S.A. MAPFRE is a company organized under the laws of Spain and controlled by a non-profit charitable organization, FUNDACION MAPFRE, which is also organized under the laws of Spain.

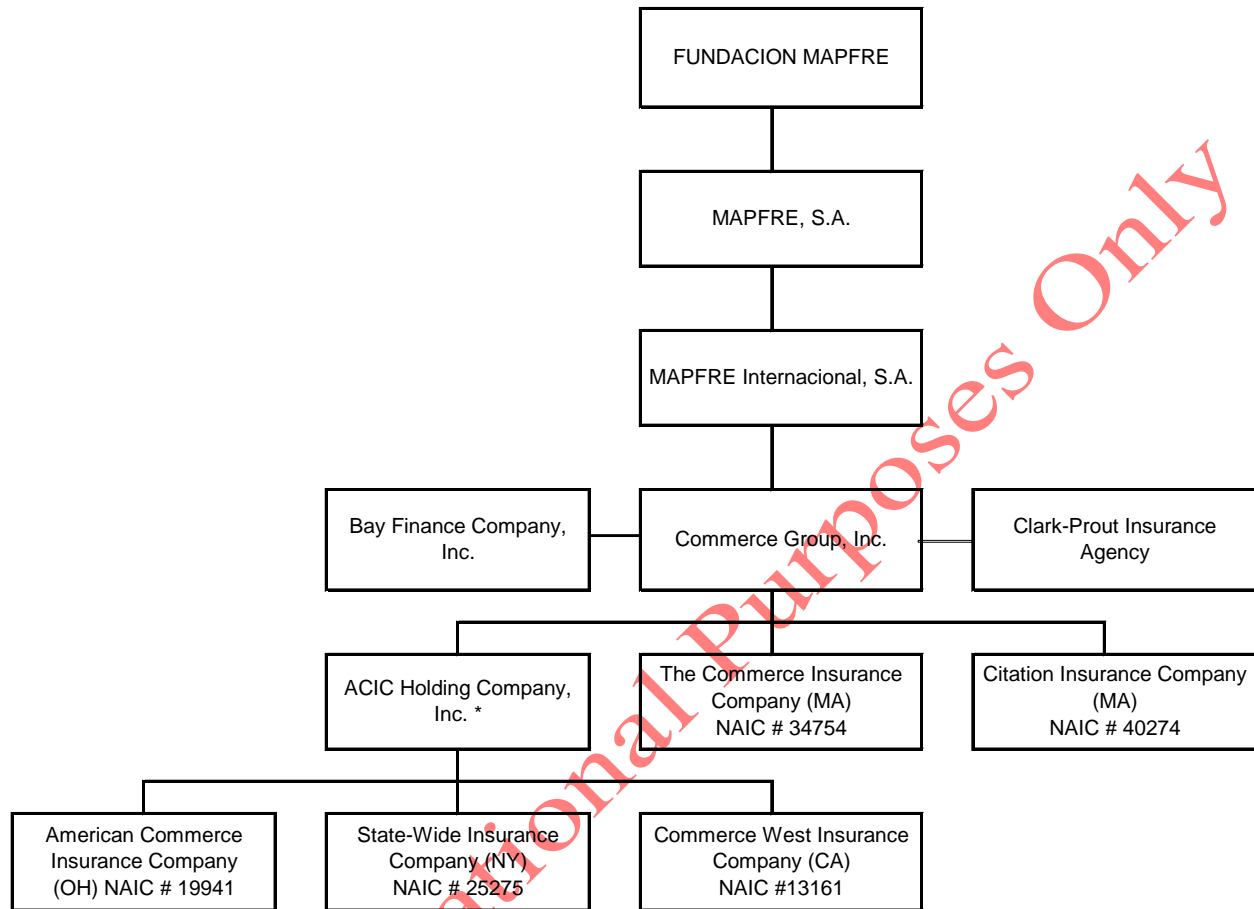
CGI's wholly-owned subsidiaries are the Company and Citation. The ACIC Holding Company, a Rhode Island corporation is 95% owned by CGI and 5% owned by AAA Southern New England and has wholly-owned subsidiaries; ACIC, Commerce West, and State-Wide. Refer to the Organizational Chart which depicts the ownership structure as of the examination date.

The affiliated companies' structure has changed subsequent to the examination date. Bay Finance Company, Inc., Clark-Prout Insurance Agency and New Main Street Liquidation Company, all non-insurance affiliates of CGI were merged into CGI effective April 16, 2009.

Subsequent to the examination date, the Company acquired MAPFRE U.S.A. Corp. and its affiliates from MAPFRE Internacional, S.A., which included two insurance companies and an insurance agency. As part of a restructuring of the organization, MAPFRE U.S.A. Corp. was then dissolved and ownership of its subsidiaries transferred to the Company. The Inter-affiliated Pooling Agreement was expanded to include MAPFRE Insurance Company of Florida. See the Subsequent Events Section of this report for additional details of this transaction.

ORGANIZATION CHART

The organizational structure of the Company and its subsidiary, affiliated and controlled entities as of December 31, 2008 is as follows:



* Note: 5% of ACIC Holding Company, Inc. is owned by AAA Southern New England.

Transactions and Agreements with Affiliates

Management Cost Allocation Agreement

The Company is party to a “Management Cost Allocation Agreement” whereby all companies in the group may provide from time to time to each other personnel, property, and services necessary to perform certain “Management Services”. Services are generally classified as non-investment related and investment related.

Non-investment related services include normal and customary management and operational functions. Compensation for such services, or the “management fee” is based on actual cost and expenses and shall be based upon recorded time spent providing the services, shall not include a profit factor, and shall not exceed those actual cost incurred to provide those services.

Investment related services are broken out into two categories; investment management services and investment recordkeeping services. Compensation for investment related services is based on a

formula of actual cost multiplied by a corresponding “basis point” factor and compensation is also limited not to exceed the actual cost incurred in providing the services. Investment related services are provided in accordance with the investment guidelines approved by the Board of Directors of each Company. All management fees shall be settled within 30 days of the end of each calendar quarter.

Tax Sharing Agreement

The Company is a member of an affiliated group within the meaning of Section 1504(a) of the Internal Revenue Code of 1986 of which CGI is the common parent. As such, the Company files its taxes on a consolidated basis following the “Tax Allocation Agreement” restated and in effect as of April, 2007. The individual corporate income tax liability for each affiliate in the consolidated group shall be calculated for each affiliate as if such affiliate had never been a member of the CGI Group, but giving effect to the intercompany rules contained in the U.S. Treasury Regulations. The Company has been designated as the payor of taxes on behalf of CGI, and shall pay, or cause to be paid, the consolidated payments due on behalf of the group. All member of the Group shall settle with the Company all amounts due no later than 30 days after the filing /payment date.

FIDELITY BOND AND OTHER INSURANCE

The Company, as a named insured on policies issued to CGI, maintains fidelity coverage with an authorized Massachusetts insurer, consistent with Massachusetts General Laws, Chapter 175, Section 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, 2008.

SPECIAL DEPOSITS

Special Deposits of the Company at December 31, 2008 are as follows:

<u>State</u>	<u>Purpose of Deposit</u>	<u>Book Value</u>	<u>Fair Value</u>
Massachusetts	Benefit of All Policyholders	\$1,551,278	\$1,596,072

TREATMENT OF POLICYHOLDERS AND RELATED PRACTICES

Treatment of Policyholders – Market Conduct

During the financial examination of the Company, the Division’s Market Conduct Section initiated a comprehensive market conduct examination of Massachusetts business of the Company and its affiliate, Citation, for the period January 1, 2008 through December 31, 2008. The market conduct examination was called pursuant to authority in Massachusetts General Laws Chapter 175, Section 4. The market conduct examination was 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 Rudmose & Noller Advisors, LLC 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 reviewed under this market conduct examination are company operations/management; complaint handling; marketing and sales; producer licensing; policyholder services; underwriting and rating; and claims. Once this market conduct examination is completed, a Report on the Comprehensive Market Conduct Examination for the period January 1, 2008 through December 31, 2008 will be issued and become available as a public document.

REINSURANCE

Inter-Affiliate Reinsurance Pooling Agreement

As previously noted, the Company and its insurance affiliates adopted an "Inter-affiliate Reinsurance Pooling Agreement" effective January 1, 2004. The Company is the "lead insurer" in the Commerce Pool and along with its affiliates (collectively called "Pool Participants"), share in the underwriting results of the business written and retained by the group. Under the pooling agreement, each of the Pool Participants cedes 100% of their combined premiums, losses, loss adjustment expenses and underwriting expenses to Commerce as the lead company in the Pool. This business is combined with its own direct and assumed business, and then retro-ceded back to each Pool Participant in accordance with each participant's participation percentage of the total pool.

The pooling agreement was revised effective April 2, 2007 to include its newest affiliate, State-Wide Insurance Company. The Company's participation ratio during the examination period has decreased from 79.6% as of January 1, 2004 to 76.2% as a result of this new Pool Participant. The Pool Participants and their respective participation percentages as of April 2, 2007 and in effect at December 31, 2008 were as follows:

<u>Company (State of Domicile)</u>	<u>NAIC CoCode</u>	<u>Participation Ratio</u>
Commerce Insurance Company (MA)	34754	76.2%
Citation Insurance Company (MA)	40274	8.9%
American Commerce Insurance Company (OH)	19941	8.3%
Commerce West Insurance Company (CA)	13161	3.8%
State-Wide Insurance Company (NY)	25275	<u>2.8%</u>
		100.0%

In addition to the inter-company pooling arrangement, the Company uses a variety of reinsurance mechanisms to protect against loss. The Company reinsures on a claims incurred basis a portion of its potential exposure written under its own policies. The objective of the reinsurance program is to mitigate the adverse financial consequences of a severe loss under individual policies, or a catastrophic loss from an extraordinary aggregate loss. This reinsurance does not discharge the Company of its primary liability. The Company seeks to only do business with reinsurers they consider adequately capitalized and financially able to meet their obligations under the agreements entered.

Catastrophe Reinsurance Program

Effective July 1, 2008, the Company renewed its catastrophe reinsurance program across five layers. The program provides for an aggregate reinsurance recoverable of a maximum of \$508 million dollars in the event of a \$570 million dollar or greater occurrence, and includes all states' FAIR Plan losses.

FAIR Plans

The Company is required to participate in various Property Insurance Underwriting Associations, the most significant of which is the Fair Access to Insurance Requirements Plan (FAIR Plan) in Massachusetts. The Massachusetts FAIR Plan includes coastal policies which could result in losses that could be material to the FAIR Plan and participating insurance companies. As noted, the Company's exposure to FAIR Plan losses is capped under the catastrophe program noted above.

American Nuclear Insurers

The Company is a member company of American Nuclear Insurers ("ANI"). ANI is a voluntary, non-profit, unincorporated association of insurers through which members provide, on a several and not joint basis, property insurance protection and nuclear energy liability insurance protection. This protection covers hazards arising out of risks related to nuclear installations, operations, or facilities.

Casualty Reinsurance

The Company has in place casualty reinsurance, excluding umbrella policies with Swiss Re America Corporation on an excess of loss basis for any one event or occurrence with a maximum recovery of \$8.0 million over a net retention of \$2.0 million.

Personal and Commercial Umbrella

Personal and commercial liability umbrella policies are reinsured on a 95% quota share basis in regard to limits up to \$1.0 million and 100% quota share basis for limits in excess of \$1.0 million but not exceeding \$5.0 million for policies with underlying automobile liability coverage of \$250,000/\$500,000 or more. Commerce also has personal liability umbrella reinsurance coverage for policies with underlying automobile liability coverage of \$100,000/\$300,000 on a 65% quota share basis for limits up to \$1.0 million and 100% quota share basis for limits in excess of \$1.0 million but not exceeding \$3.0 million. These coverages are also placed with Swiss Re America Corporation.

AAA Southern New England (SNE) Agreement

Effective January 1, 2007, the Company entered into a quota share agreement with an insurance company that is a wholly-owned subsidiary of AAA SNE. The underwriting results of five insurance subsidiaries coupled with CGI corporate expenses that are integral to the insurance operations of the group are ceded to AAA SNE at a quota share rate of 1.5%. The underwriting results ceded to AAA SNE include the underwriting results of all external reinsurance assumed from or ceded to Commerce. Effective January 1, 2008, the quota share rate increased to 2.25%. As of September 2009 and effective July 1, 2009, the AAA SNE quota share agreement has been terminated and

recaptured by the Company.

Commonwealth Automobile Reinsurers (CAR)

CAR is the Massachusetts state-mandated reinsurance mechanism which enables all insurers of private passenger and commercial automobile lines of business to reinsure (cede) any risk the insurer perceives or deems to be “under-priced” based on state mandated policy rates. CAR is the mechanism by which all premiums, expenses, and losses on business ceded to the pool are shared by all insurers. Since its inception, CAR has annually generated multi-million dollar underwriting losses, primarily in the personal automobile pool. Commerce is required to share in the underwriting results of CAR business for its respective product lines. Under current regulations, the Company’s share of the CAR “personal automobile” results is based upon the market share of automobile risks for the particular pool, adjusted by a “utilization” concept.

CAR implemented a new method for handling ceded “commercial automobile” risks effective January 1, 2006. This new system provided for six servicing carriers, including Commerce, who were appointed after a competitive bid process for five-year terms. The six appointed servicing carriers were the only carriers permitted to cede business to CAR, and all eligible producers were assigned to one of the servicing carriers in order to provide all producers with a market for their ceded business. Since 2006, the commercial results from all ceded commercial business are shared between all carriers, including the appointed servicing carriers, based upon each carrier's voluntary market share of commercial automobile business.

With the introduction of “managed competition” to the Massachusetts automobile insurance market, the Commissioner of Insurance began the implementation of the Massachusetts Automobile Insurance Plan (MAIP) in 2008 to provide private passenger automobile insurance for those individuals unable to obtain insurance in the voluntarily market. MAIP will ultimately replace CAR for private passenger automobile risks deemed unacceptable in the open market. MAIP assigns individuals directly to an insurance company, as opposed to CAR. The MAIP transition period was from April 1, 2008 to March 31, 2009. Beginning with policy effective dates after March 31, 2009, all personal automobile business is eligible for MAIP and can no longer be ceded to CAR.

SUBSEQUENT EVENTS

As noted previously, the affiliated companies’ structure has changed subsequent to the examination date. Bay Finance Company, Inc., Clark-Prout Insurance Agency and New Main Street Liquidation Company, all non-insurance affiliates of CGI were merged into CGI effective April 16, 2009.

Effective July 1, 2009, the Company purchased MAPFRE U.S.A. Corp. and its subsidiaries from MAPFRE Internacional, S.A. MAPFRE U.S.A. Corp. was then dissolved and ownership of its remaining subsidiaries transferred directly to the Company. The subsidiaries include MAPFRE Insurance Company of Florida, MAPFRE Insurance Company and MAPFRE Intermediaries, Inc. MAPFRE Insurance Company of Florida is a property and casualty insurer domiciled in Florida. MAPFRE Insurance Company is a property and casualty insurer domiciled in New Jersey. MAPFRE Intermediaries is an insurance agency in Florida. The inter-affiliate pooling agreement was revised to include MAPFRE Insurance Company of Florida as a 2.0% Pool Participant.

As of September 2009 and effective July 1, 2009, the AAA SNE Quota Share Reinsurance

Agreement has been terminated and recaptured by the Company.

ACCOUNTS AND RECORDS

The Company's internal control structure was discussed with management through questionnaires and through a review of the work performed by the Company's independent certified public accountants, Ernst & Young LLP in 2008, and including work papers generated to support the requirements of the Sarbanes-Oxley Act of 2002. As part of its engagement for the Massachusetts Insurance Division, KPMG performed a review and evaluation of the control environment of Commerce Group's IT systems. The NAIC's Information Systems Questionnaire (ISQ) completed by the Company was reviewed and interviews with Company management and IT staff were conducted to gather supplemental information and corroborate the Company's responses to the ISQ. Included was a review of the documentation supporting management and organization controls, application systems development and maintenance controls, operating and processing controls, logical and physical security controls, contingency planning controls, personal computers, Local Area Network (LAN), Wide Area Network (WAN) and internet controls. The control environment of the Company's information systems was found to have in place sufficient internal controls.

No material internal control weaknesses were noted in connection with the examination, nor were any such matters reported in the CPA firm's filings with the Division.

The Company uses an automated general ledger system. Trial balances were traced from the general ledger and supporting documents to the 2008 Annual Statement. No material exceptions were noted.

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 NAIC as of December 31, 2008.

Statement of Assets, Liabilities, Surplus and Other Funds as of December 31, 2008

Statement of Income for the Year Ended December 31, 2008

Statement of Capital and Surplus as of December 31, 2008

Reconciliation of Capital and Surplus for Each Year in the Five Year Period Ended December 31, 2008

The Commerce Insurance Company
Statement of Assets, Liabilities, Surplus and Other Funds
as of December 31, 2008

	Per Company	Examination Changes	Notes	Per Examination
Assets				
Bonds	\$1,379,616,366	\$0		\$1,379,616,366
Stocks:				
Preferred stocks	187,710,266			187,710,266
Common stocks	129,005,459			129,005,459
Real Estate:				
Properties occupied by the company	51,229,775			51,229,775
Cash on hand and on deposit	75,696,739			75,696,739
Other invested assets	55,033,079			55,033,079
Subtotals, cash and invested assets	1,878,291,684			1,878,291,684
Investment income due and accrued	16,828,314			16,828,314
Premium and considerations:				
Uncollected premiums and agents' balances in the course of collection	73,982,489			73,982,489
Deferred premiums, agents' balances and installments booked but deferred and not yet due	306,663,018			306,663,018
Reinsurance:				
Amounts recoverable from reinsurers	96,451,219			96,451,219
Other amounts receivable under reinsurance contracts	97,471,260			97,471,260
Current federal and foreign income tax recoverable and interest thereon	20,332,153			20,332,153
Net deferred tax asset	70,228,732			70,228,732
Electronic data processing equipment and software	1,749,494			1,749,494
Aggregate write-ins for other than invested assets				
Equity in pools and associations	17,281,947			17,281,947
Miscellaneous assets	160,000			160,000
Total Assets	<u>\$2,579,440,310</u>	<u>\$0</u>		<u>\$2,579,440,310</u>

The Commerce Insurance Company
Statement of Assets, Liabilities, Surplus and Other Funds
as of December 31, 2008

	Per Company	Examination Changes	Notes	Per Examination
Liabilities, Surplus and Other Funds				
Losses	\$515,428,309	\$0	1	\$515,428,309
Reinsurance payable on paid losses and loss adjustment expenses	67,889,844			67,889,844
Loss adjustment expenses	114,906,486		1	114,906,486
Commissions payable, contingent commissions and other similar charges	133,844,842			133,844,842
Other expenses (excluding taxes, licenses and fees)	14,049,291			14,049,291
Unearned premiums	607,945,726			607,945,726
Advance premium	23,743,839			23,743,839
Ceded reinsurance premiums payable (net of ceding commission)	70,683,062			70,683,062
Funds held by company under reinsurance treaties	17,563,813			17,563,813
Amounts withheld or retained by company for account of others	1,269,330			1,269,330
Payable to parent, subsidiaries and affiliates	28,542,079			28,542,079
Aggregate write-ins for liabilities				
Miscellaneous liabilities	2,704,816			2,704,816
Unclaimed property	3,041,289			3,041,289
Total Liabilities	1,601,612,726	0		1,601,612,726
Common capital stock	2,500,000			2,500,000
Gross paid in and contributed surplus	205,531,875			205,531,875
Unassigned funds (surplus)	769,795,709			769,795,709
Surplus as regards policyholders	977,827,584			977,827,584
Total liabilities and policyholders surplus	\$2,579,440,310	\$0		\$2,579,440,310

The Commerce Insurance Company
Statement of Income, Capital and Surplus
For the Year Ended December 31, 2008

	Per Company	Examination Changes	Per Examination
Underwriting Income			
Premiums earned	\$1,315,133,795	\$0	\$1,315,133,795
Deductions:			
Losses incurred	740,412,574		740,412,574
Loss adjustment expenses incurred	154,501,582		154,501,582
Other underwriting expenses incurred	367,669,471		367,669,471
Total underwriting deductions	<u>1,262,583,627</u>		<u>1,262,583,627</u>
Net underwriting gain or (loss)	<u>52,550,168</u>		<u>52,550,168</u>
Net investment income earned	107,548,675		107,548,675
Net realized capital gains or (losses)	<u>(69,148,261)</u>		<u>(69,148,261)</u>
Net investment gain or (loss)	<u>38,400,414</u>		<u>38,400,414</u>
Finance and service charges not included in premiums	30,678,654		30,678,654
Aggregate write-ins for miscellaneous income	<u>14,952</u>		<u>14,952</u>
Total other income	<u>30,693,606</u>		<u>30,693,606</u>
Net income before dividends to policyholders and before federal income taxes	121,644,188		121,644,188
Foreign and federal income taxes incurred	35,602,479		35,602,479
Net income	<u>\$86,041,709</u>	<u>0</u>	<u>\$86,041,709</u>
Capital and Surplus Account			
Surplus as regards policyholders, December 31 prior year	\$1,127,841,497	0	\$1,127,841,497
Net income	86,041,709		86,041,709
Change in net unrealized capital gains (losses)	(56,870,191)		(56,870,191)
Change in net deferred income tax	400,210		400,210
Change in nonadmitted assets	(67,835,641)		(67,835,641)
Dividends to stockholders	<u>(111,750,000)</u>		<u>(111,750,000)</u>
Change in surplus	<u>(150,013,913)</u>	<u>0</u>	<u>(150,013,913)</u>
Surplus as regards policyholders, December 31 current year	<u>\$977,827,584</u>	<u>\$0</u>	<u>\$977,827,584</u>

The Commerce Insurance Company
Reconciliation of Capital and Surplus
For Each Year in the Five Year Period Ended December 31, 2008

	2008	2007	2006	2005	2004
Surplus as regards policyholders, December 31 previous year	<u>\$1,127,841,497</u>	<u>\$1,205,881,422</u>	<u>\$1,172,985,898</u>	<u>\$1,031,810,776</u>	<u>\$855,377,233</u>
Net income (loss)	86,041,709	178,338,836	186,889,762	181,897,283	206,264,359
Change in net unrealized capital gains (losses)	(56,870,191)	(57,012,917)	24,980,894	8,205,598	(2,543,769)
Change in net deferred income taxes	400,210	2,594,725	12,171,812	21,004,034	(6,401,624)
Change in nonadmitted assets	(67,835,641)	(12,541,775)	(10,396,944)	(8,723,925)	(397,355)
Dividends to stockholders	(111,750,000)	(186,750,000)	(180,750,000)	(61,700,000)	(21,250,000)
Aggregate write-ins for gains and losses in surplus		<u>(2,668,794)</u>		<u>492,132</u>	<u>761,932</u>
Change in surplus	<u>(150,013,913)</u>	<u>(78,039,925)</u>	<u>32,895,524</u>	<u>141,175,122</u>	<u>176,433,543</u>
Surplus as regards policyholders, December 31 current year	<u><u>\$977,827,584</u></u>	<u><u>\$1,127,841,497</u></u>	<u><u>\$1,205,881,422</u></u>	<u><u>\$1,172,985,898</u></u>	<u><u>\$1,031,810,776</u></u>

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NOTES TO FINANCIAL STATEMENTS

Note 1: Loss and Loss Adjustment Expense (LAE) Reserves

As part of the coordinated financial examination of the Company and its affiliate, Citation, by the Massachusetts Division of Insurance, the “lead state” of the Group, the Division retained the actuarial services of KPMG to perform an actuarial analysis of the loss and loss adjustment expenses (LAE) reserves of the Commerce Inter-affiliate Reinsurance Pool, which includes all reinsured affiliates as of December 31, 2008. Actuarial data utilized by KPMG, as provided by the Company, was reviewed and tested by the examination staff for both accuracy and completeness by performing various examination procedures on samples of paid losses and case reserves. KPMG has made an independent assessment of the Pool’s loss and LAE reserves as of December 31, 2008 to determine whether the reserve amounts carried are reasonably stated in accordance with sound actuarial principles. This analysis was performed both gross and net of reinsurance.

The Inter-affiliate Reinsurance Pooling Agreement became effective January 1, 2004. Through the pooling agreement, the Company, as the lead company in the Pool, assumed from the other insurance affiliates all of their combined premiums, losses, loss adjustment expenses, and underwriting expenses. The Company then combined this business with its own direct and assumed business, and then ceded back to the Pool Participants, net of applicable reinsurance, each member’s respective pooling participation percentage. This allows each company to share in the consolidated underwriting experience of the group. The Company’s participation ratio in the Pool as of December 31, 2008 was 76.2%. The remaining 23.8% of the Pool is assumed by the other participants in the following ratios: Citation 8.9%; ACIC 8.3%; Commerce West 3.8%; and State-Wide 2.8%.

KPMG has concluded that based on its review of the Inter-affiliate Reinsurance Pool’s loss and LAE reserve calculations, as well as its own independent testing, that loss and LAE reserves held by the pool are reasonably stated and fall within a range of reasonableness as of December 31, 2008. The tables below summarize a comparison of KPMG’s gross, ceded, and net loss and LAE reserve estimates to those carried by the Pool in total and the Company’s based on its pro-rata participation percentage as of December 31, 2008.

<u>Commerce Inter-Affiliate Reinsurance Pool (in thousands)</u>					
	<u>KPMG Estimates</u>			<u>Total Pool Carried</u>	<u>Redundancy/ (Deficiency)</u>
	<u>Low</u>	<u>Selected</u>	<u>High</u>		
Gross Loss & LAE	\$ 805,430	\$ 885,520	\$ 975,030	\$ 921,353	\$ 35,833
Ceded Loss & LAE	83,552	95,030	102,786	94,142	888
Total Net Loss & LAE	<u>\$ 721,878</u>	<u>\$ 790,490</u>	<u>\$ 872,244</u>	<u>\$ 827,211</u>	<u>\$ 36,721</u>

<u>Commerce Insurance Company Net Loss and LAE Reserves (in thousands)</u>					
	<u>KPMG Estimates</u>			<u>Company Carried</u>	<u>Redundancy/ (Deficiency)</u>
	<u>Low</u>	<u>Selected</u>	<u>High</u>		
Company Net Loss and LAE Reserves	\$550,071	\$602,353	\$664,650	\$630,335	\$27,982

Total net reserves for loss and LAE carried by the Pool as of December 31, 2008 are \$827,211,019 and are approximately 4.6% greater than KPMG's selected point estimate and fall within a range of reasonableness. Based on the Company's pool participation ratio of 76.2%, the Company reported net carried reserves for loss and LAE are \$630,334,795.

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.

John M. Curran, CFE
Supervising Examiner and Examiner-in-Charge
Commonwealth of Massachusetts
Division of Insurance
Representing Northeastern Zone, NAIC

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