



THE COMMONWEALTH OF MASSACHUSETTS
OFFICE OF CONSUMER AFFAIRS AND BUSINESS
REGULATION

DIVISION OF INSURANCE

REPORT OF EXAMINATION OF THE
HARLEYSVILLE WORCESTER INSURANCE COMPANY

Worcester, Massachusetts

As of December 31, 2004

NAIC GROUP CODE 0253

NAIC COMPANY CODE 26182

EMPLOYER'S ID NO. 04-1989660

**THE HARLEYSVILLE WORCESTER
INSURANCE COMPANY**

TABLE OF CONTENTS

	<u>Page</u>
Salutation	1
Scope of Examination	2
History	3
General	3
Capital Stock	3
Dividends to Stockholders	3
Growth of Company	4
Management	4
Board of Directors	4
Investment Committee	5
Officers	5
Conflict of Interest	6
Corporate Records	6
Affiliated Companies	7
Annual Statement Schedule Y	8
Transactions and Agreements with Affiliates	8
Fidelity Bond and Other Insurance	9
Pension, Insurance Plans and Employee Welfare	9
Statutory Deposits	10
Insurance Products and Related Practices	11
Territory and Plan of Operation	11
Reinsurance	11
Pooling Agreement	11
Internal Catastrophe Reinsurance Agreement	12
Ceded Reinsurance	12
Assumed Reinsurance	14
Subsequent Events	14
Accounts and Records	15
Financial Statements	15
Statement of Assets, Liabilities, Surplus and Other Funds	16
Statement of Income, Capital and Surplus	18
Reconciliation of Capital and Surplus, 2000 – 2004	19
Notes to Financial Statements	20
Acknowledgement	21



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

One South Station • Boston, MA 02110-2208
(617) 521-7794 • FAX (617) 521-7475
TTY/TDD (617) 521-7490
<http://www.mass.gov/doi>

MITT ROMNEY
GOVERNOR

KERRY HEALEY
LIEUTENANT GOVERNOR

JANICE S. TATARKA
DIRECTOR, CONSUMER AFFAIRS
AND BUSINESS REGULATION

JULIANNE M. BOWLER
COMMISSIONER OF INSURANCE

May 5, 2006

The Honorable Alfred W. Gross, Chairman
Financial Condition (E) Committee
Commissioner of Insurance
Bureau of Insurance
Commonwealth of Virginia
1300 East Main Street
Richmond, Virginia 23219

The Honorable Julianne M. Bowler
Commissioner of Insurance
Secretary, Northeastern Zone, NAIC
Division of Insurance
Commonwealth of Massachusetts
One South Station
Boston, Massachusetts 02210-2208

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 as of December 31, 2004, of the

HARLEYSVILLE WORCESTER INSURANCE COMPANY
Worcester, Massachusetts

at its home office located at 120 Front Street, Suite 500, Worcester, Massachusetts, 01608-1408. The following report thereon is respectfully submitted.

SCOPE OF EXAMINATION

The Harleysville Worcester 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 current examination was also conducted by the Massachusetts Division of Insurance, (the “Division”) and covers the period from January 1, 2000 through December 31, 2004, including any material transactions and/or events subsequent to the examination date and noted during the course of this examination.

The examination was conducted in accordance with standards established by the Financial Condition (E) Committee of the NAIC as well as with requirements of the NAIC Financial Condition Examiners Handbook, the examination standards of the Division and with Massachusetts General Laws. The principal focus of the examination was 2004 activity however transactions both prior and subsequent thereto were reviewed as deemed appropriate.

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, employee pension and benefit 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 KPMG LLP, an independent certified public accounting firm in accordance with 211 CMR 23.00. 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’ work papers were made to the extent deemed appropriate and effective. As part of the December 31, 2004 examination of the Company’s ultimate parent, Harleysville Mutual Insurance Company (“HMIC”), the Pennsylvania Insurance Department has retained the actuarial services of Mercer, Oliver and Wyman, to review certain loss and loss adjustment expense reserves for the Harleysville insurance companies. The Company is a 15% participant in the Harleysville inter-company reinsurance pool (the “HMIC Pool”. It is our intention to rely on this independent actuarial review of the pre-pooled loss reserves to evaluate the adequacy of the Company’s loss and loss adjustment expense reserves as of December 31, 2004.

The Company does not own and maintain its own IT systems, but rather operates, along with other HMIC subsidiaries and members of the HMIC Pool, on systems owned and maintained by HMIC. The Pennsylvania Insurance Department retained the services of SKB and Associates to perform a review of the IT environment of HMIC. We have reviewed the independent work performed by SKB and Associates and based on this review have deemed the work completed in this area to be adequate to determine the level of reliance to be placed on summary information generated by the data processing system.

HISTORY

General

The Company was incorporated on February 1, 1823 under the laws of the Commonwealth of Massachusetts and commenced business on May 1, 1824. As of August 31, 1983, the Company converted from a mutual insurer to a stock company and became a wholly owned subsidiary of Harleysville Group Inc. (HGI). HGI is the insurance holding company subsidiary of HMIC, the ultimate parent. The Company did, by a vote of its Board of Directors, change the name of the Company as indicated previously to the "Harleysville Worcester Insurance Company", effective July 1, 2001. The Company's sole shareholder, HGI also approved this name change. There have not been any mergers, or any other material changes to its corporate structure since the last examination.

Capital Stock

The Company has authorized and outstanding twenty thousand (20,000) shares of common stock with a stated par value per share of \$125.00, for an aggregate par value of \$2,500,000. All outstanding stock is owned by HGI. The Company's capital structure also consists of \$8,500,000 additional paid in and contributed surplus.

Dividends to Stockholders

During the five year period covered by this examination, the Company paid a total of \$3.7 million in dividends to HGI as follows:

<u>Year</u>	<u>Dividend</u>
2004	\$ 0
2003	(8,015,000)
2002	8,015,000
2001	2,700,000
2000	1,000,000

There were no declared but unpaid dividends as of December 31, 2004. Also in 2003, the Company revoked an \$8.0 million stockholder dividend declared October 2002 primarily due to adverse development on prior year loss and loss adjustment expense reserves. The adverse development was primarily due to higher than expected claim severity in the automobile, general liability and commercial multi-peril lines of business.

Growth of Company

The growth of the Company for the years 2000 through 2004 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 Premiums Written</u>	<u>Surplus</u>
2004	\$481,033,967	\$174,938,227	\$98,344,683
2003	474,980,936	175,736,542	90,399,174
2002	418,695,537	166,218,780	97,213,199
2001	369,169,283	155,747,205	107,152,408
2000	358,263,765	146,139,917	107,317,811

MANAGEMENT

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 by-laws of the corporation. The Board of Directors shall consist of not fewer than seven or more than twenty Directors, and the exact number of Directors shall be fixed and determined from time to time by resolution of the Board of Directors. Directors shall be elected at the annual meeting of the stockholders and shall serve for one year or until their successors have been duly elected and qualified.

At December 31, 2004, the Board was set and comprised of seven Directors, all of which are affiliated, which is in compliance with the Company's bylaws.

Directors duly elected and serving at December 31, 2004, along with their business affiliations is as follows:

<u>Director</u>	<u>Business Affiliation</u>
Michael L. Browne	Chief Executive Officer, Harleysville Group Inc. and President and Chief Executive Officer, Harleysville Mutual Insurance Company
Mark R. Cummins	Director and Treasurer of the Company. Chief Investment Officer, Executive Vice President and Treasurer, Harleysville Group Inc. and Harleysville Mutual Insurance Company.
Bruce J. Magee	Chief Financial Officer and Senior Vice President, Harleysville Group Inc. and Harleysville Mutual Insurance Company.
Theodore A. Majewski	Director and Vice President of the Company. Senior Vice President, Harleysville Group Inc. and Harleysville Mutual Insurance Company.

Dennis J. Otmaskin

Director, President and Chief Operating Officer of the Company

Matthew L. Patkus

Director and Chief Executive Officer of the Company. President and Chief Operating Officer, Harleysville Group Inc. and Executive Vice President and Chief Operating Officer, Harleysville Mutual Insurance Company.

Robert G. Whitlock, Jr.

Director and Vice President of the Company. Actuary and Vice President, Harleysville Group Inc. and Harleysville Mutual Insurance Company.

The bylaws do not specify the number of meetings to be held during any one year, however, at any meeting of the Board a majority of the Directors then in office, but not less than five, constitutes a quorum. The minutes indicated that a quorum was obtained at all meetings of the Board of Directors held during the examination period.

Investment Committee

The bylaws state that the Board of Directors or the Chairman of the Board may from time to time appoint an Executive Committee, Finance Committee, or such other committees as deemed necessary or desirable for the effective operation of the corporation. As of the examination, the only committee appointed by the Board was the Investment Committee. The Investment Committee meets on a quarterly basis primarily to review and approve all investment activity. The members of the Investment Committee at December 31, 2004 are as follows:

Mark R. Cummins
Matthew L. Patkus
Bruce J. Magee

Officers

The bylaws of the Company provide that the officers of the Company shall be Chairman of the Board, President, Treasurer, Secretary-Clerk, and such Vice Presidents, Assistant Treasurers, Assistant Secretary-Clerks, and other officers with such titles as may from time to time be determined by the Directors. Pursuant to the bylaws, the Chairman of the Board, President, Treasurer and Secretary-Clerk of the corporation shall be elected annually by the Directors at their first meeting following the annual meeting of the stockholders, or the special meeting held in lieu thereof. Other officers may be chosen by the Directors at such meeting or at any other meeting. Elected officers and their respective titles at December 31, 2004 are as follows:

<u>Officer</u>	<u>Title</u>
Matthew L. Patkus	Chief Executive Officer
Dennis J. Otmaskin	President and Chief Operating Officer
Robert A. Kauffman	Secretary

Mark R. Cummins	Treasurer
Roger J. Beekley	Vice President
Geoffrey T. Bohanan	Vice President
David K. Bond	Vice President
Theodore A. Majewski	Vice President
Robert G. Whitlock, Jr.	Vice President
Andrew M. Tuma	Vice President
Tracey Benison	Assistant Vice President
Peter Bourneuf	Assistant Vice President
Angela K. Bauer	Assistant Treasurer
Richard H. Kelsey	Assistant Treasurer
Kathleen Richardson	Assistant Secretary

Conflict of Interest Procedures

The Company has adopted a “Code of Conduct for Directors, Officers and Employees” pertaining to conflicts of interest and has established procedures 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. Additionally, each newly elected Director must submit to the Board of Directors an “Acceptance of Trust” upon election to serve as director.

Corporate Records

Articles of Incorporation and Bylaws

The Company’s articles of incorporation and bylaws were reviewed. On February 28, 2001 the Articles of Incorporation and its By-Laws were amended in order to change the Company name from Worcester Insurance Company to Harleysville Worcester Insurance Company, effective July 1, 2001.

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.

Annual Meeting of Stockholders

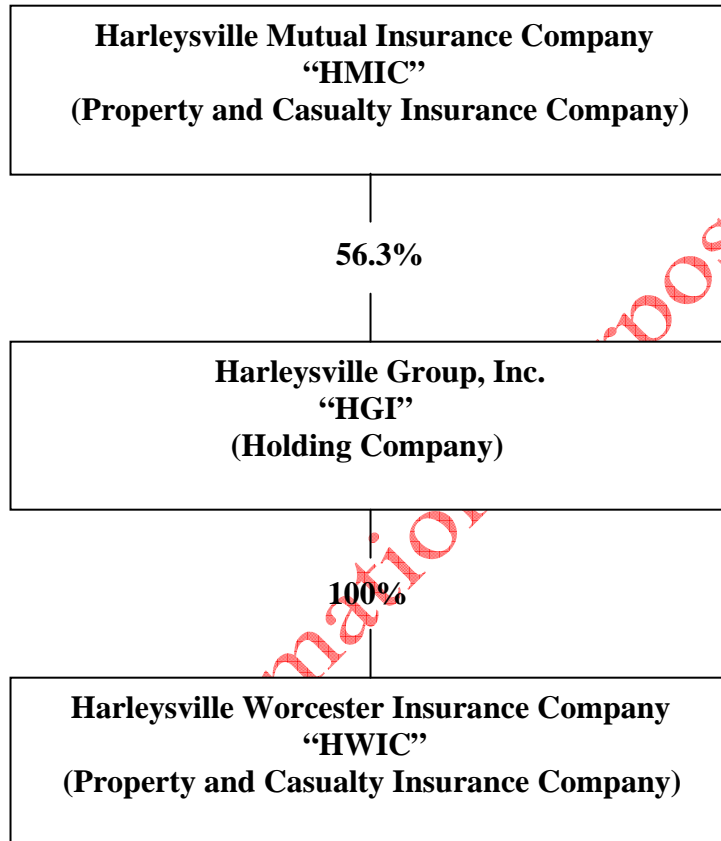
In accordance with the by-laws, the annual meeting of the Company is to be held on the Thursday following the fourth Wednesday in April. A majority in interest of all stock issued, outstanding and entitled to vote at a meeting shall constitute a quorum, whether present in person or by proxy. The minutes indicate that a quorum was obtained at each annual meeting held during the examination period.

Board of Directors Minutes

The minutes of the Board of Directors and committee meetings for the period under examination were read and indicated that all meetings were held in accordance with the Company bylaws and the laws of the Commonwealth of Massachusetts.

AFFILIATED COMPANIES

Per Form B, as filed with the Division, the Company is a member of a holding company system and is subject to the registration requirements of Chapter 175, Section 206C of the Massachusetts General Laws. HMIC, a Pennsylvania domiciled insurer, is the “ultimate controlling person” for 18 entities, including 13 insurance and 5 non-insurance corporations. As the ultimate controlling person, HMIC owns 56.3% of HGI. HGI is a publicly traded corporation, and the remaining 43.7% is publicly owned, with no other entity owning more than 10%.



ANNUAL STATEMENT SCHEDULE Y

Harleysville Mutual Insurance Company
Harleysville Group, Inc. (Holding Company)
Harleysville Services Inc.
Harleysville Life Insurance Company
Harleysville Insurance Company (U.K.) LTD.
Harleysville Pennland Insurance Company
Mainland Insurance Company
Harleysville Insurance Company of New York
Harleysville Worcester Insurance Company
Harleysville Lake States Insurance Company
Harleysville-Atlantic Insurance Company
Harleysville, LTD.
Harleysville Preferred Insurance Company
Carlton Holding Corporation
Mid-America Insurance Company
Harleysville Insurance Company of New Jersey
Harleysville Insurance Company of Ohio
Harleysville Insurance Company
Insurance Management Resources, L.P.

Transactions and Agreements with Affiliates

Salary Allocation Agreement – Effective 2/8/99

This agreement provides that the Company will reimburse HGI, serving as paymaster, an amount equal to the salary and employee benefit costs of the Company. The basis for reimbursement shall be time fairly allocable and attributable to services performed on behalf of the Company.

Equipment and Supplies Allocation Agreement – 2/8/94

This agreement provides for reimbursement to HMIC for the cost of all equipment and supplies required by the Company and supplied by HMIC.

Premium and Agent Commission Receivables – Effective 3/15/96

This agreement provides for the transfer to and collection by HMIC of insurance premiums receivables and agent commissions and providing further for the provision of such receivables which become uncollectible.

Administrative Service Agreement for Short-term Disability Insurance – Effective 1/1/97

This agreement calls for the Company to provide administrative services for group short-term disability insurance written in Massachusetts by Harleysville Life Insurance Company in connection with workers' compensation written by the Company

Management Services Agreement – Effective 4/1/99

This agreement provides for reimbursement to Insurance Management Resources, L.P. by the Company a percentage of all costs associated directly or indirectly through retaining a third-party provider, all administrative services associated with its participation in the National Flood Insurance Plan.

Tax Sharing Agreement

The Company participates in a tax allocation agreement with its eligible subsidiaries pursuant to Internal Revenue Code Section 1504(a). The allocation method is based upon the respective tax liability of each member computed as if a separate return were filed, in accordance with the Internal Revenue Code 1552.

FIDELITY BOND AND OTHER INSURANCE

The Company maintains fidelity bond coverage with an authorized Massachusetts insurer, under a Financial Institutions Bond, designed for insurance companies, consistent with Massachusetts General Laws Chapter 175, Section 60. The aggregate limit of liability exceeds the NAIC suggested minimum. Other coverage provided under this policy includes assorted loss of property coverage, losses due to forgery, counterfeit currency losses and computer systems fraud. The Company has further protected its interest 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, INSURANCE PLANS AND EMPLOYEE WELFARE

The Company offers various insurance plans, including life, AD&D and dependent life plans, and group health, dental and vision care to all full time employees.

The Company offers an Extra Compensation Plan under section 401(k) of the Internal Revenue Code. The plan, which is a defined contribution plan, is available to all full time employees without a required eligibility period. Employees participating in the plan will receive a matching contribution from the Company if they contribute during the calendar year and are employed on December 31st of that year. The amount contributed is based on the Company's profitability, up to six percent (6%) of each employee's base salary.

Full time employees also participate in a defined benefit pension plan. The plan is administered by HGI on behalf of all member companies whose employees are covered by the plan.

At December 31, 2004, the plan was fully funded. The Company is charged its proportionate share of all funding and pension expense cost based on salary and pooling ratios. All pension fund financial information is disclosed in the Notes to the Financial Statements appearing in the “Audited Financial Statements of Pension Plan of Harleysville Group Inc. and Associated Employers”.

In addition to pension benefits, the Company participates in other post-retirement benefit plans with its affiliates. These benefits are set at a fixed amount and do not change for inflation.

STATUTORY DEPOSITS

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

Location	Description of Deposit	Par Value	Statement Value	Fair Value
Connecticut	US Treasury Notes			
	6.125 due 8/2007	110,000	113,153	118,052
	5.875 due 11/2005	1,000,000	999,860	1,026,600
	3.000 due 11/2007	3,590,000	3,642,247	3,567,850
	1.625 due 10/2005	2,610,000	2,607,685	2,587,685
	1.875 due 12/2005	160,000	159,873	158,613
New Hampshire	US Treasury Notes			
	6.125 due 8/2007	560,000	576,050	600,992
	4.750 due 11/2008	585,000	580,584	612,717
	4.750 due 11/2008	235,000	233,226	246,134
	3.500 due 11/2006	420,000	419,021	423,545
	3.500 due 11/2006	250,000	249,417	252,110
	1.875 due 12/2005	90,000	89,928	89,220
	5.875 due 11/2005	800,000	799,888	821,280
	3.000 due 11/2007	345,000	350,021	342,871
New York	US Treasury Notes			
	6.125 due 8/2007	1,300,000	1,337,260	1,395,160
	4.750 due 11/2008	1,415,000	1,404,320	1,482,043
	4.750 due 11/2008	590,000	585,547	617,954
	1.875 due 12/2005	2,000,000	1,998,409	1,982,660
	3.000 due 11/2007	1,165,000	1,181,955	1,157,812
Massachusetts	US Treasury Notes			
	1.875 due 12/2005	700,000	699,443	693,931
Total All Locations		17,925,000	18,027,887	18,177,229

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operation

The Company is licensed to write property and casualty business in the six New England states and is also licensed in the states of New York, Michigan and Ohio. Although licensed in Michigan and Ohio, it currently does not write business in those states. Approximately 78.4% of all direct written premium is generated in Massachusetts and New York. The Company's principal lines of business are homeowners and commercial multiple peril, auto liability and physical damage, and workers compensation coverage. The Company is a member of, and cedes all direct premium to the Harleysville inter-company reinsurance pool, and a percentage of the total post-pooled business is ceded to and assumed by the Company as described below.

REINSURANCE

Pooling Agreement

The Company participates in a reinsurance pooling agreement with its ultimate parent, HMIC which serves as the lead insurer. Under the terms of the agreement, each pool participant subsidiary cedes all of its net insurance business to HMIC and assumes from HMIC an amount equal to its participating percentage in the pooling agreement. Reinsurance with all non-affiliated reinsureds/reinsurers is prior to the cession to the pool. Cessions to HMIC under a separate excess catastrophe agreement are made after the assumption of pooled business. The Company's pool participation ratio has been 15% for all years covered by this examination. Each member company reports its own non-pooled statutory provision for reinsurance. The write-off of uncollectible reinsurance, if any, is shared in accordance with the pool participation percentage.

As of December 31, 2004, the participants in the pool and their respective pooling percentages are as follows:

NAIC Company Code	Company	Percentage
14168	Harleysville Mutual Insurance Company	23%
42900	Harleysville Insurance Company of New Jersey	19%
35696	Harleysville Preferred Insurance Company	18%
26182	Harleysville Worcester Insurance Company	15%
14516	Harleysville Lake States Insurance Company	8%
40983	Harleysville Pennland Insurance Company	5%
13382	Harleysville-Atlantic Insurance Company	5%
23582	Harleysville Insurance Company	3%
33235	Harleysville Insurance Company of New York	2%
37630	Mid-America Insurance Company	1%
10060	Harleysville Insurance Company of Ohio	1%

Internal Catastrophe Reinsurance Agreement – Harleysville Mutual Insurance Company

As of January 1, 1997, the Company entered into an internal catastrophe reinsurance agreement along with other property and casualty insurance subsidiaries of the Harleysville Group whereby HMIC will reinsure property line catastrophes insured by HGI property and casualty subsidiaries on a post-pooled basis. Under this agreement, HMIC will pay the Company 100% of the ultimate net loss in excess of the Company's retention equal to their pooling percentage times \$5 million but not exceeding 100% of a liability of \$20 million times the Company's pooling percentage (up to \$3,000,000 in excess of \$750,000) with respect to accumulated losses resulting from covered loss occurrences commencing during each calendar quarter. This agreement excludes catastrophe losses resulting from earthquakes or hurricanes and acts of terrorism.

This agreement was in effect at December 31, 2004, but as of December 31, 2005 the Company cancelled this agreement as noted in the Subsequent Events section of this report.

As a member of the Harleysville group of companies, the Company participates as a "named insured" on various reinsurance policies of the group. The following is a brief description of each of these agreements.

Ceded Reinsurance

☐ Property Per Risk Excess of Loss Coverage

Effective January 1, 2002, The Company entered into a property per risk excess of loss reinsurance agreement with the General Reinsurance Corporation. This agreement covers property business written by the Company as fire, allied lines, inland marine, commercial multiple peril, homeowners multiple peril and farmers multiple peril. The agreement is written on an excess of loss basis for any one event or occurrence with a maximum recovery of \$8.5 million over a net retention of \$1.5 million. A separate Terror covers provides \$12 million in aggregate terror protection.

☐ Property Catastrophe Excess of Loss Coverage

Effective July 1, 2004, the Company entered into a treaty, brokered with Guy Carpenter, which covers property and automobile physical damage on a pooled basis. This treaty provides for 85% to 95% of \$155 million excess of \$30 million retention per occurrence. The treaty has one reinstatement clause.

☐ Casualty First, Second, Third and Fourth Excess of Loss

Effective January 1, 2004, the Company entered into a treaty, brokered with Willis Re Inc., which covers all casualty policies and provides \$38 million excess of \$2 million in several layers. Coverage includes losses from acts of terrorism.

❑ Workers' Compensation Per Person Excess of Loss and Catastrophe Excess of Loss

Effective January 1, 2004 the Company entered into a Workers Compensation Per Person Excess of Loss agreement with the American Re-Insurance Company. The agreement provides for \$8 million excess of \$2 million per occurrence.

❑ Blanket Excess Liability Per Risk Excess of Loss

Effective January 1, 1999 the Company entered into a Casualty Excess of Loss agreement with the American Re-Insurance Company. This agreement covers Commercial Umbrella Liability policies, Commercial Blanket Excess Liability policies and Personal Umbrella Liability policies. This treaty provides coverage of \$4 million excess of \$1 million with special acceptance possible to \$10 million for commercial risk

❑ Surety, Fidelity & Forgery Excess of Loss

Effective January 1, 2004 the Company entered into a Surety Excess of Loss reinsurance agreement which was brokered by Aon Re and included three subscribers. The agreement has three layers of coverage. The first layer provides coverage of 95% of \$3 million excess of \$2 million. The second layer provides coverage of 90% of \$5 million excess of \$5 million. The third layer provides coverage of 90% of \$5 million excess of \$10 million.

❑ Equipment Breakdown Coverage

Effective January 1, 2001, the Company entered into an equipment breakdown coverage reinsurance agreement with The Hartford Steam Boiler Inspection and Insurance Company. In this Agreement, the Company obligates itself to cede to the reinsurer and the reinsurer obligates itself to accept as reinsurance 100% of the equipment breakdown liability coverage written by the Company. The reinsurer's liability shall not exceed \$50,000,000 for any one accident.

❑ Facultative Reinsurance Agreement

Effective August 1, 2004, the Company entered into a property facultative reinsurance agreement with the General Reinsurance Corporation. The reinsurer shall pay the Company, with respect to each risk the amount of net loss sustained by the Company in excess of the Company retention but not exceeding the limit of liability of the reinsurer that is stated in the Schedule of Reinsurance or the amount of reinsurance ceded to the reinsurer on the monthly bordereau report, whichever is less.

❑ Specialty Products

Effective January 1, 2003 the Company entered into a Lawyers Professional Liability agreement with the General Reinsurance Corporation. The agreement provides coverage for excess of loss over the Company's retention of \$250,000. The reinsurer's liability is 100% of

\$750,000 excess of \$250,000 and 90% of the difference, if any, between the policy limit and the first \$1,000,000 each claim.

Effective May 1, 1999 the Company entered into an Employment Practices Liability and Not for Profit Directors, Officers and Trustees liability quota share reinsurance agreement with the General Reinsurance Corporation. The agreement has various retentions and limits.

Assumed Reinsurance

The Company does not in the normal course of business assume reinsurance risks other than through its participation in the Harleysville reinsurance pool. The only exception to this rule is business assumed by the Company through its participation in various underwriting pools and associations.

SUBSEQUENT EVENTS

As noted previously, effective December 31, 2005, the internal Aggregate Catastrophe Agreement of Reinsurance ("Agreement") between the HMIC and its subsidiaries, including the Company has been terminated. The agreement was originally intended to supplement the existing external catastrophe reinsurance program. This external catastrophe reinsurance program has now been deemed by management to be adequate.

ACCOUNTS AND RECORDS

The internal control structure was discussed with management through questionnaires and through transaction testing and 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 information technology (IT) environment. The Company operates on information systems owned, operated and maintained by HMIC. The NAIC Exhibit C Questionnaire was completed by HMIC. This questionnaire was reviewed by the Division as part of our evaluation of the adequacy of the IT controls. We also reviewed the independent work of SKB and Associates who performed an independent review of the HMIC IT environment on behalf of the Pennsylvania Insurance Department. No material deficiencies were noted.

The Company maintains its accounts and records on an electronic data processing basis. All entries are input to this data processing system, which then generates general ledger and supporting reports as well as other reports common to the insurance industry.

FINANCIAL STATEMENTS

The following financial statements reflect the assets, liabilities, capital and surplus as determined by our examination, showing the Statement of Assets, Liabilities, Surplus and Other Funds as of December 31, 2004, together with a Statement of Income for the year ended December 31, 2004, and a Reconciliation of Capital and Surplus for the years ended December 31, 2004, 2003, 2002, 2001 and 2000.

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.

Form Information Purposes Only

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

	Per Company	Examination Changes	Per Examination
Assets			
Bonds	\$300,826,127	\$0	\$300,826,127
Common stocks	40,013,162		40,013,162
Cash on hand and on deposit	31,654,273		31,654,273
Short-term investments	23,609,856		23,609,856
Other invested assets	954,398		954,398
Investment income due and accrued	4,143,670		4,143,670
Premiums and considerations:			
Uncollected premiums and agents' balances in course of collection	19,406,951		19,406,951
Deferred premiums, agents' balances and installments booked but deferred and not yet due	47,682,534		47,682,534
Reinsurance:			
Amounts recoverable from reinsurers	1,421,428		1,421,428
Funds held by or deposited with reinsured companies	240,946		240,946
Net deferred tax assets	5,705,217		5,705,217
Guaranty funds receivable or on deposit	373,887		373,887
Electronic data processing equipment and software	679		679
Receivable from parent, subsidiaries and affiliates	2,644,164		2,644,164
Equity and deposits in pools and associations	2,356,675		2,356,675
 Total Assets	 \$481,033,967	 \$0	 \$481,033,967

Harleysville Worcester Insurance Company
Statement of Assets, Liabilities, Surplus and Other Funds
as of December 31, 2004

	Per Company	Examination Changes	Notes	Per Examination
Liabilities, Surplus and Other Funds				
Losses	\$189,871,273		(1)	\$189,871,273
Loss adjustment expenses	45,880,660		(1)	45,880,660
Commissions payable, contingent commissions and other similar charges	2,329,240			2,329,240
Other expenses (excluding taxes, licenses and fees)	1,670,860			1,670,860
Taxes, licenses and fees (excluding federal and foreign income taxes)	3,013,193			3,013,193
Current federal and foreign income taxes	142,262			142,262
Unearned premiums	85,212,972			85,212,972
Advance premiums	1,755,483			1,755,483
Dividends declared and unpaid to policyholders	75,517			75,517
Ceded reinsurance premiums payable	18,474,739			18,474,739
Funds held by company under reinsurance treaties	152,564			152,564
Amounts withheld or retained by company for account of others	1,241,735			1,241,735
Provision for reinsurance	30,187			30,187
Payable for securities	1,203,124			1,203,124
Securities lending obligation	31,619,051			31,619,051
Aggregate write-ins for liabilities	16,424			16,424
Total Liabilities	382,689,284	0		382,689,284
Common capital stock	2,500,000			2,500,000
Gross paid in and contributed surplus	8,500,000			8,500,000
Unassigned funds (surplus)	87,344,683			87,344,683
Surplus as regards policyholders	98,344,683			98,344,683
Total liabilities and policyholders surplus	\$481,033,967	\$0		\$481,033,967

Harleysville Worcester Insurance Company
Statement of Income, Capital and Surplus
For the Year Ended December 31, 2004

	Per Company	Examination Changes	Per Examination
Underwriting Income			
Premiums earned	\$174,513,606	\$0	\$174,513,606
Deductions:			
Losses incurred	102,449,111		102,449,111
Loss expenses incurred	23,784,105		23,784,105
Other underwriting expenses incurred	58,122,900		58,122,900
Total underwriting deductions	184,356,116		184,356,116
Net underwriting gain or (loss)	(9,842,510)		(9,842,510)
Net investment income earned	15,975,900		15,975,900
Net realized capital gains or (losses)	2,586,194		2,586,194
Net investment gain or (loss)	18,562,094		18,562,094
Net gain (loss) from agents' or premium balances charged off	(443,060)		(443,060)
Finance and service charges not included in premiums	1,007,393		1,007,393
Aggregate write-ins for miscellaneous income	(33,899)		(33,899)
Total other income	530,434		530,434
Net income before dividends to policyholders and before federal income taxes	9,250,018		9,250,018
Dividends to policyholders	582,354		582,354
Net income after dividends to policyholders but before federal income taxes	8,667,664		8,667,664
Federal income taxes incurred	1,147,105		1,147,105
Net income	\$7,520,559	0	\$7,520,559
Capital and Surplus Account			
Surplus as regards policyholders, December 31 prior year	\$90,399,174	0	\$90,399,174
Net income	7,520,559		7,520,559
Change in net unrealized capital gains (losses)	241,216		241,216
Change in net deferred income tax	72,327		72,327
Change in nonadmitted assets	141,594		141,594
Change in provision for reinsurance	(30,187)		(30,187)
Change in surplus	7,945,509	0	7,945,509
Surplus as regards policyholders, December 31 current year	\$98,344,683	\$0	\$98,344,683

Harleysville Worcester Insurance Company Reconciliation of Capital and Surplus For The Five Year Period Ended December 31, 2004					
	2004	2003	2002	2001	2000
Surplus as regards policyholders, December 31 previous year	\$90,399,174	\$97,213,199	\$107,152,408	\$107,317,811	\$104,953,860
Net income (loss)	7,520,559	(21,620,016)	6,358,892	5,920,754	9,349,859
Change in net unrealized capital gains (losses)	241,216	4,562,928	(5,251,267)	(4,853,787)	(6,571,122)
Change in net deferred income taxes	72,327	6,288,340	596,172	2,151,295	0
Change in nonadmitted assets	141,594	(4,068,995)	(3,619,288)	(4,270,561)	83,016
Change in provision for reinsurance	(30,187)	374	(374)	4,000	400,000
Change in excess of statutory reserves over statement reserves	0	0	0	0	102,198
Cumulative effect of changes in accounting principles	0	0	0	3,582,896	0
Dividends to stockholders	0	8,015,000	(8,015,000)	(2,700,000)	(1,000,000)
Aggregate write-ins for gains and (losses) in surplus	0	8,344	(8,344)	0	0
Change in surplus	7,945,509	(6,814,025)	(9,939,209)	(165,403)	2,363,951
Surplus as regards policyholders, December 31 current year	\$98,344,683	\$90,399,174	\$97,213,199	\$107,152,408	\$107,317,811

NOTES TO THE FINANCIAL STATEMENTS

Note 1: Loss and Loss Adjustment Expense Reserves

In conjunction with its review of HMIC and the other Pennsylvania domiciled members of the Harleysville group of insurance companies, the Pennsylvania Insurance Department retained the actuarial consulting firm of Mercer, Oliver, and Wyman (Mercer) to evaluate reserves for loss and allocated loss adjustment expenses (ALAE), as of December 31, 2004 of the total Harleysville inter-company reinsurance pool. This review encompassed loss and ALAE reserves for each line of business, although four major lines of business represent approximately 90% of the pooled net losses and represent the major focus of Mercer's review. These four lines of business are private passenger automobile liability/medical, commercial automobile liability/medical, workers compensation, and commercial multi-peril.

Mercer has concluded that loss and loss adjustment expense reserves recorded by the Harleysville inter-company insurance pool, on a gross and net basis are reasonable. On a gross basis, the pool's carried reserves are approximately \$72 million dollars less, (or 4.1%), than Mercer's point estimate. On a net basis, the deficiency noted is reduced to approximately \$23 million dollars (or 1.5%) of the Pool's carried reserves. On a post-pooled basis, the Company's carried reserves would be deficient of Mercer's point estimate by approximately \$3.5 million dollars (or less than 1.5%). As a result, the Company's carried reserves for losses and loss adjustment expenses, as reported in its 2004 annual statement, are considered reasonable and no examination adjustment is recommended.

ACKNOWLEDGEMENT

Acknowledgement 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 Daniel R. Dowd of the Massachusetts Division of Insurance as a participant in this examination is hereby acknowledged.

John M. Curran, CFE
Supervising Examiner
Commonwealth of Massachusetts
Division of Insurance

Arthur C. Hughes
Examiner-in-Charge
Commonwealth of Massachusetts
Division of Insurance

Form Information Purposes Only