



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

**REPORT OF EXAMINATION OF THE  
LIBERTY MUTUAL FIRE INSURANCE COMPANY  
BOSTON, MASSACHUSETTS  
AS OF DECEMBER 31, 2004**

**NAIC GROUP CODE 0111  
NAIC COMPANY CODE 23035  
EMPLOYER'S ID No. 04-1924000**

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

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May 31, 2006

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Idaho Department of Insurance  
700 West State Street, 3rd Floor  
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Honorable Commissioners and Directors:

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

**LIBERTY MUTUAL FIRE INSURANCE COMPANY**  
**BOSTON, MASSACHUSETTS**

at its home office located at 175 Berkley Street, Boston, Massachusetts, 02117. The following report thereon is respectfully submitted.

## INTRODUCTION

Liberty Mutual Fire Insurance Company (hereinafter referred to as "LMFIC" or 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 also conducted by the Division. The examination covers the intervening five-year period through December 31, 2004, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of the examination.

The current examination was conducted at the direction of, and under the overall management and control of, the examination staff of the Division in accordance with standards established by the Financial Condition (E) Committee of the NAIC as well as with the requirements of the *NAIC Financial Condition Examiners' Handbook* (the "Handbook"), the examination standards of the Division and with Massachusetts General Laws.

The examination was performed by the Division utilizing representatives of the independent certified public accounting firm of PricewaterhouseCoopers LLP ("PwC") at the direction of and under the overall management of the Division's examination staff, including the Division's representative, a qualified Certified Financial Examiner. The examination was performed at the Company's home office in Boston, Massachusetts. There was no zone participation for this examination. The Company is ultimately controlled by Liberty Mutual Holding Company, Inc. ("LMHC"), an insurance holding company domiciled in Massachusetts. Concurrent examinations were also conducted of two other Massachusetts domiciled insurers that are also controlled by LMHC, Liberty Mutual Insurance Company ("LMIC") and Liberty Life Assurance Company of Boston. Each of those examinations is the subject of separate reports.

## SCOPE OF STATUTORY EXAMINATION

This examination covers the five-year period ending December 31, 2004 and any material transactions and/or events occurring subsequent to the examination date and noted during the course of the examination. During the course of this examination, the operations, management and corporate policies, transactions, accounting practices and procedures, and internal controls of the Company were reviewed, analyzed, and tested to the extent deemed appropriate and necessary.

The Company is audited by Ernst & Young LLP ("E&Y"), an independent certified public accounting firm, in accordance with 211 CMR 23.00. Unqualified audit opinions were issued by E&Y on the Company's statutory financial statements for each of the years under examination. E&Y's audit work was evaluated and relied upon where deemed appropriate and effective. The work of the Company's internal auditors was also reviewed and relied upon to the extent deemed appropriate.

PwC was engaged to complete certain agreed upon procedures, including a review of selected elements of the Company's financial statements, an actuarial review and evaluation of the adequacy of the Company's loss and loss adjustment expense reserves as of December 31, 2004, and a review and evaluation of the adequacy and

effectiveness of the Company's information technology ("IT") controls to determine the level of reliance to be placed on summary information generated by the data processing systems. All agreed-upon procedures were reviewed and approved by the Division.

In addition to the foregoing, 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, 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.

## HISTORY

### General

The Company was incorporated as a mutual insurance company on October 31, 1908 under the laws of the Commonwealth of Massachusetts and commenced business on November 5 of that year.

In 2001, the Company reorganized into a stock insurance company as part of a mutual holding company structure. As part of its reorganization, the Company is now affiliated with (1) Liberty Mutual Holding Company Inc. ("LMHC"), a Massachusetts mutual holding company and the ultimate parent in the mutual holding company structure; (2) LMHC Massachusetts Holdings Inc. ("LMHC-MA"), a Massachusetts stock holding company, which is a direct, wholly-owned subsidiary of LMHC; and (3) Liberty Mutual Group Inc., ("LMGI" or the "Group"), a Massachusetts stock holding company which is a direct, wholly-owned subsidiary of LMHC-MA and the direct parent of the Company. The Company's reorganization was part of a series of transactions that resulted in the Company and both Liberty Mutual Insurance Company and Employers Insurance Company of Wausau ("EICOW") all reorganizing to stock companies under the common ownership of LMHC, thereby resulting in the policyholders of the Company, LMIC and EICOW becoming members of and having equity rights in LMHC.

### Capital Stock

The Company has authorized and outstanding 100,000 shares of common capital stock with a par value of \$100.00 per share. All of the outstanding capital stock of the Company is owned by LMGI. LMFI is ultimately owned by LMHC. During the period covered by this examination, the Company received a total of \$75 million additional paid-in and contributed surplus, all of which was contributed in 2004.

Report of Statutory Financial Examination of  
Liberty Mutual Fire Insurance Company  
As of December 31, 2004

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Dividends to Stockholders

The Company paid dividends to stockholders during the five-year period covered by this examination as follows:

<u>Year</u>	<u>Dividends</u>
2004	\$ 0
2003	283,308,712
2002	81,646,842
2001	0
2000	0

Growth of 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 statutory annual statements (\$000's):

<u>Year</u>	<u>Admitted Assets</u>	<u>Net Premiums Written</u>	<u>Capital &amp; Surplus</u>
2004	\$ 2,774,089	\$ 992,878	\$ 672,745
2003	2,560,603	922,939	551,230
2002	2,664,136	841,713	701,778
2001	2,791,446	739,841	816,468
2000	2,828,064	734,703	894,300

**MANAGEMENT**

Annual Meeting of the Stockholder

In accordance with the Bylaws, the annual meeting of the stockholder is held during the first six months of the calendar year, the purpose of which is to elect a Board of Directors and to act upon such matters as may properly come before that meeting. Minutes of stockholder meetings were reviewed for the period covered by this examination.

Board of Directors

The Company is managed by a Board of Directors, the Chairman of which presides at stockholder meetings and meetings of the Board. The Board consists of not less than seven nor more than twenty-four members, as determined from time to time by vote of a majority of the Board or by vote of the stockholder. Directors are elected for a period of one year, with all Board members' terms expiring annually. The Company's Board of Directors is identical to that of its principal affiliate, LMIC.

The Board of Directors meets regularly throughout the year and may, in accordance with the Bylaws, hold special meetings or take action by unanimous written consent. A review was made of the minutes of meetings for the five-year period covered by this examination. During the examination period, the Board met at least four times during each calendar year.

At December 31, 2004, all Directors of the Company were inside Directors, and their names, together with their titles, were as follows:

<u>Director</u>	<u>Title</u>
Edmund F. Kelly	Chairman of the Board, President and Chief Executive Officer
J. Paul Condrin, III	Executive Vice President
Dennis J. Langwell	Senior Vice President and Chief Financial Officer
A. Alexander Fontanes	Senior Vice President and Chief Investment Officer
Gary R. Gregg	Executive Vice President
Christopher C. Mansfield	Senior Vice President and General Counsel
Thomas C. Ramey	Executive Vice President

#### Committees of the Board

The Bylaws state that the Board may elect an Investment Committee and may elect, or by vote authorize, the Chief Executive Officer to appoint members of an Executive Committee and such other committees as may be required from time to time. As of the date of this examination, the Company has designated Executive, Investment, and Audit Committees, but only the Investment Committee has held meetings or taken action without a meeting since the Company's reorganization into a mutual holding company structure. All other meetings and actions have been taken by the full Board. The following is a list of members serving on the Committees noted above as of December 31, 2004.

#### Executive Committee

Edmund F. Kelly  
Dennis J. Langwell  
Christopher C. Mansfield

#### Investment Committee

Edmund F. Kelly  
A. Alexander Fontanes  
Dennis J. Langwell

Audit Committee

Edmund F. Kelly  
Dennis J. Langwell  
Christopher C. Mansfield

Officers

Corporate officers are elected by the Board of Directors at their first meeting following the Annual Stockholder Meeting, and serve for one year in accordance with the Company's Bylaws. The elected principal officers and their respective titles at December 31, 2004 were as follows:

<u>Officer</u>	<u>Title</u>
Edmond F. Kelly	Chairman, President and Chief Executive Officer
J. Paul Condrin, III	Executive Vice President
John D. Doyle	Vice President and Comptroller
A. Alexander Fontanes	Senior Vice President and Chief Investment Officer
Gary R. Gregg	Executive Vice President
Roger L. Jean	Executive Vice President
Dennis J. Langwell	Senior Vice President and Chief Financial Officer
Dexter R. Legg	Vice President and Secretary
Christopher C. Mansfield	Senior Vice President and General Counsel
Stuart M. McGuigan	Senior Vice President and Chief Information Officer
Robert T. Muleski	Senior Vice President and Corporate Actuary
Thomas C. Ramey	Executive Vice President
Helen E.R. Sayles	Senior Vice President
Stephen G. Sullivan	Senior Vice President
Laurance H. S. Yahia	Senior Vice President and Treasurer

Conflict of Interest Procedures

The Group has developed an enterprise-wide approach to corporate compliance that specifically includes the means to manage conflict of interest issues. The enterprise-wide approach includes a *Code of Business Ethics and Conduct* as a reference guide to help personnel define and understand appropriate standards of business conduct and to establish compliance requirements. The approach also has established procedures for the disclosure of possible conflicts of interest involving Directors, officers and key employees. The Group has established an Office of Corporate Compliance with responsibility for managing this disclosure program, investigating potential conflict situations, and making recommendations to management for the resolution of any such conflicts. The Group's General Counsel reports the results



of the annual disclosure process to the Chief Executive Officer and to the Board of Directors. As a member of the Group, LMFIC follows all requirements of the approach and is an active participant in it. As part of the examination, the following were obtained and reviewed:

- The Code of Business Ethics and Conduct
- A report on the Group's (including LMFIC's) conflict of interest disclosures, dated September, 2005, analyzing the responses to the disclosure forms provided to elected officers, key employees and Directors during the 2005 annual disclosure process.

#### Corporate Records

##### *Articles of Organization and Bylaws*

The Company's Articles of Organization and Bylaws were reviewed. Effective upon the Company's reorganization to a stock insurance company as part of a mutual holding company on November 28, 2001, the Articles of Organization and Bylaws were extensively amended and restated to recognize the reorganized corporate structure.

##### *Board of Directors and Committee Minutes*

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

##### *Disaster Recovery and Business Continuity*

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

#### **AFFILIATED COMPANIES**

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. LMHC is the "ultimate controlling person" of LMGI per Form B, as filed with the Division.

**LIBERTY MUTUAL HOLDING COMPANY  
ANNUAL STATEMENT- SCHEDULE Y LISTING**

	<b>State / Country of Domicile</b>
<b>LIBERTY MUTUAL HOLDING COMPANY INC.</b>	MA
<b>Direct &amp; Indirect Owned Subsidiaries</b>	
LMHC Massachusetts Holdings Inc.	MA
Liberty Mutual Group Inc.	MA
St. James Insurance Company LTD	Bermuda
Employers Insurance Company of Wausau	WI
<b>** Liberty Mutual Fire Insurance Company</b>	<b>MA</b>
Liberty Corporate Services LLC	MA
Helmsman Management Services LLC	MA
Liberty Life Holdings Inc.	DE
Liberty Financial Services Inc.	MA
Summit Consulting Inc.	FL
Heritage Summit Health Care of Florida Inc.	FL
Summit Consulting Inc of Louisiana	LA
Helmsman Insurance Agency LLC	MA
Helmsman Insurance Agency of Illinois Inc.	IL
Helmsman Insurance Agency of Texas Inc.	TX
Liberty Mutual Insurance Company	MA
Liberty Mutual Captive Holdings LLC	DE
Lexco Limited	Bermuda
Liberty Mutual Bermuda LTD	Bermuda
Wausau (Bermuda) LTD	Bermuda
Liberty Mutual Holdings LTD	Bermuda
Arlington Insurance Company LTD	Bermuda
The Stuart Insurance Group LTD	Bermuda
Liberty Mutual Management Bermuda LTD	Bermuda
Liberty International Holdings LLC	DE
Liberty International Holdings Inc.	DE
Liberty International Chile S.A.	Chile
Liberty Compania de Seguros Generales S.A.	Chile
Liberty International Ireland Holdings LTD	Ireland
Liberty International Insurance Company LTD	Ireland
Liberty Insurance Compania De Seguros Y Reaseguros S.A. (57.4%)	Spain
Liberty International (Spain) Holdings LLC	DE
Liberty International Iberia S.I. S. Com (24.7%)	Spain
Liberty Seguros S.A.	Portugal
Liberty International Brasil Limitada	Brazil
Liberty Paulista Seguros	Brazil
Liberty International Latin America Holdings LLC	DE
Seguros Caracas De Liberty Mutual C.A.	Venezuela
LI (Colombia) Holdings LTD	Bermuda
LILA (Colombia) Holdings LTD	Bermuda
Liberty Seguros S.A.	Columbia
Liberty Seguros De Vida	Columbia
Liberty Art S.A.	Argentina
Liberty Seguros Argentina S.A.	Argentina

**LIBERTY MUTUAL HOLDING COMPANY**  
**ANNUAL STATEMENT- SCHEDULE Y LISTING**

	<b>State / Country of Domicile</b>
<b>LIBERTY MUTUAL HOLDING COMPANY INC.</b>	MA
<b>Direct &amp; Indirect Owned Subsidiaries</b>	
Liberty Mutual Insurance Company (continued)	MA
Liberty International Holdings LLC (continued)	DE
Liberty International Holdings Inc. (continued)	DE
Liberty International Asia Pacific Holdings Inc.	DE
Liberty Citystate Holdings PTE LTD	Singapore
Liberty Insurance PTE LTD	Singapore
CI Investments LTD	Hong Kong
Liberty International Insurance LTD	Hong Kong
Liberty International (HK) LTD	Hong Kong
Kritiya Tun CO. LTD	Thailand
Tun Kaoklai CO. LTD	Thailand
LMG Insurance Company LTD	Thailand
Khoom Khao Ins. Public CO. LTD	Thailand
Liberty Europe Holdings LTD	U.K.
Liberty Corporate Capital LTD	U.K.
Liberty Mutual Insurance Europe Limited	U.K.
Marine Insurance Services PTE LTD	Singapore
Liberty Spain Insurance Group LLC	DE
Liberty Insurance Group Compania De Seguros Y Reaseguros, S.A.	Spain
Liberty Insurance Compania De Seguros Y Reaseguros, S.A. (42.5%)	Spain
Liberty Iberia S.A.	Spain
Seguros Genesis, S.A.	Spain
Genesis Seguros Generales, S.A.	Spain
Golden Eagle Insurance Corporation	CA
San Diego Insurance Company	CA
Liberty Insurance Corporation	IL
Liberty Northwest Insurance Corporation	OR
Liberty Management Services, Inc.	OR
Oregon Automobile Insurance Company	OR
Access Insurance Services Company	OR
North Pacific Insurance Company	OR
The First Liberty Insurance Corporation	IA
LM Personal Insurance Company	DE
LM Property and Casualty Insurance Company	IN
LM General Insurance Company	DE
Liberty RE Bermuda LTD	Bermuda
LM Insurance Corporation	IA
Summit Holding Southeast Inc.	FL
Bridgefield Employers Insurance Company	FL
Bridgefield Casualty Insurance Company	FL
U.S. Employers Insurance Company Inc.	Cayman Islands
Liberty Information Technology LTD	Northern Ireland

**LIBERTY MUTUAL HOLDING COMPANY  
ANNUAL STATEMENT- SCHEDULE Y LISTING**

	<b>State / Country of Domicile</b>
<b>LIBERTY MUTUAL HOLDING COMPANY INC.</b>	MA
<b>Direct &amp; Indirect Owned Subsidiaries</b>	
Liberty Mutual Insurance Company (Continued)	
Wausau Service Corporation	WI
Wausau Business Insurance Company	WI
Wausau General Insurance Company	WI
Wausau Underwriters Insurance Company	WI
Wausau Insurance Company LTD	U.K.
Colorado Casualty Insurance Company	CO
Liberty Insurance Holdings Inc.	DE
LIH US P&C Corporation	DE
Indiana Insurance Company	IN
Consolidated Insurance Company	IN
The Netherlands Insurance Company	NH
Gulf States AIF Inc	TX
America First Lloyds Insurance Company	TX
Diversified Settlements Inc	NH
America First Insurance Company	NH
Excelsior Insurance Company	NH
Peerless Insurance Company	NH
Liberty-USA Corporation	DE
The National Corporation	IN
National Insurance Association	IN
LIH-RE of America Corporation	DE
Peerless Indemnity Insurance Company	IL
Globe American Casualty Company	OH
American Ambassador Casualty Company	IL
The Midwestern Indemnity Company	OH
Mid-American Fire & Casualty Company	OH
Liberty Insurance Underwriters	NY
Hawkeye-Security Insurance Company	WI
Liberty Energy Holdings LLC	DE
Liberty Energy Corporation	MA
Liberty Surplus Insurance Corporation	NH
Berkeley Management Corporation	TX
Liberty Lloyds of Texas Insurance Company	TX
Liberty Insurance Company of America	IL
Liberty Mutual Managed Care Inc.	MA
Cascade Disability Management Inc	WA
Liberty Personal Insurance Company	MI
Liberty Mutual Equity LLC	MA
LRE Properties Inc	MA
Liberty / Sanibel II Limited Partnership	MA
Liberty Life Assurance Company of Boston	MA

“\*\*\*” Re-domesticated to Wisconsin, December 2005. See Subsequent Events, page 15.

Acquisitions, Affiliations, Transactions

With the exception of the previously disclosed reorganization as part of the mutual holding company structure, the Company has not been a party to any material acquisitions, affiliations, or other such material transactions during the period covered by this examination.

Agreement with Subsidiaries and Affiliates

*Tax Sharing Agreement*

The Company has in place a tax sharing agreement pursuant to which it joins with other affiliates in the filing of the consolidated U.S. federal income tax return of LMHC.

**FIDELITY BOND AND OTHER INSURANCE**

The Company is a named insured with its affiliate, LMIC, which maintains fidelity 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 on these policies was \$150,000,000 at December 31, 2004, an amount of coverage that appears adequate based upon NAIC recommended amounts. The Company is also a named insured, either itself or together with other subsidiaries and affiliates, on policies with external carriers that provide coverage for aircraft liability, excess umbrella and property damage. All policies evidencing these coverages were with licensed and / or authorized carriers in Massachusetts and were in force at December 31, 2004.

**PENSION AND INSURANCE PLANS / EMPLOYEE WELFARE**

The Company does not have any direct employees and therefore does not have any direct obligations for a defined benefit plan, deferred compensation arrangements, compensated absences or other post-retirement benefit plans. The costs of these plans are allocated to LMFIC through the inter-company Reinsurance Agreement as generally described in the Reinsurance section of this report.

### STATUTORY DEPOSITS

The following identifies the special deposits maintained by the Company with numerous jurisdictions as of December 31, 2004 and are listed below in the aggregate per location:

<u>Location</u>	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
Arizona	\$ 7,500,000	\$ 9,505,045	\$ 9,584,475
Arkansas	210,000	208,472	237,741
California	127,519,000	132,203,337	136,759,781
Connecticut	12,700,000	12,572,720	13,521,527
Delaware	125,000	125,000	125,000
Florida	110,000	107,236	112,250
Georgia	155,000	155,000	156,516
Idaho	1,005,000	1,045,092	1,163,720
Illinois	32,505,000	33,111,387	34,934,277
Indiana	7,685,000	7,731,468	7,968,972
Kansas	5,890,000	5,990,932	6,528,832
Louisiana	70,000	75,733	81,952
Maryland	17,750,000	17,626,243	18,589,388
Maine	27,750	27,689	27,579
Massachusetts	3,010,000	3,097,981	3,297,164
New Hampshire	9,865,000	9,838,334	9,417,799
New Mexico	320,000	323,219	345,328
New York	94,120,000	106,105,317	108,190,525
North Carolina	300,000	299,861	298,149
Oregon	9,325,000	9,319,113	9,481,931
Vermont	50,000	49,977	49,692
All Other	28,720,280	30,015,547	28,227,774
<b>Total</b>	<b>\$ 358,962,030</b>	<b>\$ 379,543,163</b>	<b>\$ 389,084,272</b>

### INSURANCE PRODUCTS AND RELATED PRACTICES

#### Territory and Plan of Operation

As a subsidiary of LMGI, the Company is an integral participant in a diversified international group of insurance companies, which is the 9th largest property and casualty insurer in the United States, based on net premiums written. The property and casualty operations of the Group are engaged in the underwriting of virtually all lines of commercial and personal business. The product mix is approximately 59% commercial and 41% personal lines. LMGI ranks as the number two provider of workers' compensation insurance in the United States and such premiums represent approximately 29% of the Group's total direct premium writings. While committed to its traditional direct sales representative distribution system, the Company also distributes products and services through independent agents and brokers, employer and office groups, marketing alliances, direct response call centers and the Internet. The Company believes that this multi-

channel distribution strategy permits potential customers to access the Company's full product portfolio through the channel of their choice.

Management's strategic objectives are to continue to grow revenues, cash flow, earnings and equity to enhance its position as a premier property and casualty insurer with a global focus. The key elements of this strategy are disciplined underwriting, leverage scale, capital and technology to provide high quality and high value insurance products and services, enhance financial strength and claim-paying ability ratings, leverage and opportunistically expand, diversified and well-established multi-channel distribution capabilities and selectively pursue strategic acquisitions and divest non-core and non-performing business lines.

#### Treatment of Policyholders and Claimants - 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 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.

#### Dividends to Policyholders

Incurred policyholders' dividends for the years 2000 through 2004 is shown in the following schedule, which was prepared from the Company's statutory annual statements.

<u>Year</u>	<u>Dividends</u>
2004	\$ 3,943,250
2003	(240,136)
2002	6,487,568
2001	7,726,028
2000	9,379,350

### **REINSURANCE**

#### Pooling Agreement

The Company shares the results of its underwriting operations through the Liberty Mutual Inter-company Reinsurance Pool (the "Pool") with a number of subsidiaries and



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Liberty Mutual Fire Insurance Company  
As of December 31, 2004

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affiliates. After external reinsurance, all participants cede 100% of underwriting operations to the Pool, and assume from the Pool their respective share of the net underwriting results of the Pool on a pro-rata basis. Since the last examination the members of the Pool have changed as well as the percentages under which each company shares in the underwriting results of the Pool. The following are the member companies of the Pool and their respective pro-rata pooling percentages as of December 31, 2004.

		Pooling %
Lead Company:	Liberty Mutual Insurance Company (LMIC)	66.50
Affiliated Pool Companies:	Employers Insurance Company of Wausau (EICOW)	16.00
	<b>Liberty Mutual Fire Insurance Company (LMFIC)</b>	<b>10.00</b>
	Liberty Insurance Corporation (LIC)	6.00
	Wausau Business Insurance Company (WBIC)	0.40
	Wausau General Insurance Company (WGIC)	0.40
	Wausau Underwriters Insurance Company (WUIC)	0.40
	LM Insurance Corporation (LM Ins Corp)	0.20
	The First Liberty Insurance Corporation (FLIC)	0.10
	Liberty Personal Insurance Company (LPIC)	0.00
	Liberty Insurance Company of America (LICA)	0.00
	Liberty Surplus Insurance Corporation (LSIC)	0.00
		100.00
100% Quota Share Affiliated Companies:	Liberty Lloyd's of Texas Insurance Company (Lloyds)	-
	Liberty County Mutual Insurance Company (LCMIC)	-
	Liberty Insurance Underwriters, Inc. (LIU)	-
	Bridgfield Employers Insurance Company (BEIC)	-
	Bridgfield Casualty Insurance Company (BCIC)	-
	LM Property and Casualty Insurance Company (LMPAC)	-
	LM General Insurance Company (LMGIC)	-
	LM Personal Insurance Company (LMPIC)	-

Under the terms of the Reinsurance Agreements, the sequence of transactions is as follows:

- (a) Except for WBIC, WGIC and WUIC, each Affiliated Pool Company cedes its underwriting activity to the lead company. WBIC, WGIC and WUIC cede 100% of its direct underwriting activity to EICOW.
- (b) With the exception of LMGIC and LMPIC, each 100% Quota Share Affiliated Company cedes its net underwriting activity to the lead company. LMGIC and LMPIC cede its net underwriting activity to LMPAC.
- (c) After recording the assumed affiliate transactions noted above, the lead company records 100% of its external assumed and ceded reinsurance activity.
- (d) The lead company's remaining underwriting activity, after processing all internal and external reinsurance is retroceded to the pool members in



accordance with each company's pool participation percentage, as noted above.

(e) There were no members that are parties to reinsurance agreements with non-affiliated reinsurers covering business subject to the pooling agreement and have a contractual right of direct recovery from the non-affiliated reinsurer per the terms of such reinsurance agreements.

(f) There were no discrepancies between entries regarding pooled business on the assumed and ceded reinsurance schedules of the lead company and corresponding entries on the assumed and ceded reinsurance schedules of other pooled participants.

(g) The write-off of uncollectible reinsurance is pooled and the provision for reinsurance is recognized by the entity placing the outbound external reinsurance.

#### **SUBSEQUENT EVENTS**

The following details are noted as "subsequent events", the disclosure of which in this Examination Report is considered appropriate.

- During the fourth quarter of 2005 the Company received capital contributions of \$100,000,000 from its parent, LMGI.
- In December of 2005, the Company, with the appropriate regulatory authorities' approval, transferred its domicile from Massachusetts to Wisconsin.

#### **ACCOUNTS AND RECORDS**

The Company's accounts and records are maintained on a general ledger system consisting of a general ledger ("ledger") and numerous automated feeder systems which interface with the ledger. Manual entries are also input into the ledger. The ledger maintains account level detail on a company basis. The ledger interfaces with a reporting tool that is used to produce financial statements and supplemental reports.

The internal control structure was examined using the following major approaches: review of the work performed by E&Y, the Company's independent certified public accountants; discussions with management based on the use of the NAIC's Exhibit C Questionnaire, and re-performance testing to the extent necessary and deemed appropriate.

With respect to the review of E&Y's work, in its July, 2005 report to the Audit Committee of the Board of Directors of LMHC, the Company's parent, E&Y noted two internal control matters that were considered material weaknesses as of December 31, 2004. The first of those material weaknesses related to the misallocation of incurred losses and some smaller account balances between subsidiaries in the LM and LIH Pools. In combination, this misallocation had no impact on combined surplus. However, the 2004

individual annual statements of certain members of the Pool, including the Company, as originally filed, were materially misstated due to the misallocation. In April 2005, and prior to the commencement of the examination, management identified this problem through its analytical review process and re-filed revised annual statements for those subsidiaries impacted by the misallocation error. The second material weakness was due to the fact that, as part of the financial statement closing process, the Company did not accurately complete and file the required supplementary information to be filed with regulators on June 1, 2005 until June 17, 2005. Management has made a formal representation to the Division that the Company has implemented additional controls over its pooling accounting processes with the objective of strengthening its internal controls over its financial statement closing process.

Additionally, it was determined prior to the commencement of the IT review that control weaknesses existed relating to certain application and operating system access and program change controls associated with the Company's investment system (CAMRA). Based on this condition, PwC did not perform a general controls review over the investment related systems, but incorporated enhanced substantive testing of account balances and transactions into the examination approach of investment related accounts.

The NAIC Questionnaire is designed to cover the evaluation of the controls in the information technology (IT) environment. It was completed by the Company and reviewed by PwC to determine the adequacy of the Company's overall IT control environment. Key systems and processes were identified as critical systems and extensive control testing was performed. Additionally, the examination of the internal controls included re-performance testing to the extent necessary and deemed appropriate.

Based on the results of the internal control review through the approaches noted in the second paragraph of this section, no further material weaknesses or significant deficiencies were identified. With respect to the investment area, the testing of investments did not result in any examination changes.

#### **FINANCIAL STATEMENTS**

The financial statements section includes the following, as determined by our examination: Statement of Assets, Liabilities, Surplus and Other Funds as of December 31, 2004; Statement of Income for the year ended December 31, 2004; Summary of Capital and Surplus 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 financial statements are presented on the basis of accounting practices prescribed or permitted by the Division and by the NAIC, as of December 31, 2004.

**Liberty Mutual Fire Insurance Company**  
**Statement of Assets, Liabilities, Surplus and Other Funds**  
**as of December 31, 2004**

	<b>Per Annual Statement</b>	<b>Statutory Examination Adjustments</b>	<b>Per Statutory Examination</b>
<b>Admitted assets</b>			
Bonds	\$1,911,210,393	\$ 0	\$1,911,210,393
Preferred Stocks	7,307,286		7,307,286
Common Stocks	226,403,422		226,403,422
Cash and short-term investments	65,949,371		65,949,371
Other invested assets	82,910,316		82,910,316
Receivables for securities	10,659,628		10,659,628
Cash and invested assets	2,304,440,416		2,304,440,416
Investment income due and accrued	18,757,646		18,757,646
Uncollected premiums and agents' balances	67,138,962		67,138,962
Deferred premiums, agents' balances and installments	191,577,831		191,577,831
Accrued retrospective premiums	76,682,925		76,682,925
Current federal and foreign income tax recoverable	2,645,344		2,645,344
Net deferred tax asset	58,558,300		58,558,300
Guaranty funds receivable	5,628,129		5,628,129
Aggregate write-ins for other than invested assets	48,659,062		48,659,062
<b>Total admitted assets</b>	<b>\$2,774,088,615</b>	<b>\$ 0</b>	<b>\$2,774,088,615</b>

**Liberty Mutual Fire Insurance Company**  
**Statement of Assets, Liabilities, Surplus and Other Funds**  
**as of December 31, 2004**

	<u>Per Annual Statement</u>	<u>Statutory Examination Adjustments</u>	<u>Per Statutory Examination</u>
<b>Liabilities, Surplus and Other Funds</b>			
Liabilities:			
Losses	\$1,339,024,139	\$ 0	\$1,339,024,139
Loss adjustment expense	255,401,951		255,401,951
Commissions payable, contingent commissions and other similar charges	13,603,862		13,603,862
Other expense (excluding taxes, licenses and fees)	49,072,851		49,072,851
Taxes, licenses and fees (excluding federal and foreign income taxes)	30,355,854		30,355,854
Unearned premiums	403,391,948		403,391,948
Advance premium	3,750,178		3,750,178
Dividends declared and unpaid to policyholders	1,101,146		1,101,146
Amounts withheld or retained by company for account of others	378,157		378,157
Draft outstanding	36,807,246		36,807,246
Payable to parent, subsidiaries and affiliates	45,288,657		45,288,657
Payable for securities	39,546,507		39,546,507
Aggregate write-ins for liabilities	(116,378,423)		(116,378,423)
Total liabilities	<u>2,101,344,073</u>		<u>2,101,344,073</u>
Capital and surplus:			
Common stock	10,000,000		10,000,000
Aggregate write-ins for special surplus funds	113,937,022		113,937,022
Aggregate write-ins for other than special surplus funds	1,250,000		1,250,000
Gross paid in and contributed surplus	75,000,000		75,000,000
Unassigned funds (surplus)	472,557,520		472,557,520
Total capital and surplus	<u>672,744,542</u>		<u>672,744,542</u>
<b>Total Liabilities, Surplus and Other Funds</b>	<u><u>\$ 2,774,088,615</u></u>	<u><u>\$ 0</u></u>	<u><u>\$ 2,774,088,615</u></u>

**Liberty Mutual Fire Insurance Company**  
**Statement of Income**  
**for the year ended December 31, 2004**

	<u>Per Annual Statement</u>	<u>Statutory Examination Adjustments</u>	<u>Per Statutory Examination</u>
Premiums earned	\$ 970,017,487	\$ 0	\$ 970,017,487
Deductions:			
Losses incurred	644,870,788		644,870,788
Loss expenses incurred	158,276,093		158,276,093
Other underwriting expenses incurred	241,429,963		241,429,963
Total underwriting deductions	<u>1,044,576,844</u>		<u>1,044,576,844</u>
Net underwriting gain (loss)	(74,559,357)		(74,559,357)
Net investment income earned	111,120,233		111,120,233
Net realized capital gains	16,958,611		16,958,611
Net investment gain	<u>128,078,844</u>		<u>128,078,844</u>
Other Income			
Net gain (loss) from agents' or premium balances charged off	(4,670,754)		(4,670,754)
Finance and service charges not included in premiums	5,945,767		5,945,767
Aggregate write-ins for miscellaneous income	(19,554,445)		(19,554,445)
Total Other Income	<u>(18,279,432)</u>		<u>(18,279,432)</u>
Net Income before dividends to policyholders and before federal and foreign income taxes	35,240,055		35,240,055
Dividends to policyholders	3,943,250		3,943,250
Net Income after dividends to policyholders and before federal and foreign income taxes	<u>31,296,805</u>		<u>31,296,805</u>
Federal and foreign income taxes incurred	<u>(3,328,959)</u>		<u>(3,328,959)</u>
<b>Net Income</b>	<u><u>\$ 34,625,764</u></u>	<u><u>\$ 0</u></u>	<u><u>\$ 34,625,764</u></u>

Liberty Mutual Fire Insurance Company  
Statement of Capital and Surplus  
for the year ended December 31, 2004

	Per Annual Statement	Statutory Examination Adjustments	Per Statutory Examination
<b>Capital and Surplus, December 31, prior year</b>	<u>\$ 551,229,659</u>	<u>\$ 0</u>	<u>\$ 551,229,659</u>
Net income (loss)	34,625,764		34,625,764
Change in net unrealized capital gains and (losses)	15,711,707		15,711,707
Change in net unrealized foreign exchange capital gain	(703,780)		(703,780)
Change in net deferred income tax	6,995,567		6,995,567
Change in non-admitted assets and related items	(23,304,327)		(23,304,327)
Surplus adjustment:			
Paid in	75,000,000		75,000,000
Aggregate write-in for gains and losses in surplus	<u>13,189,952</u>		<u>13,189,952</u>
Net change in capital and surplus for the year	<u>121,514,883</u>		<u>121,514,883</u>
<b>Capital and Surplus, December 31, current year</b>	<u>\$ 672,744,542</u>	<u>\$ 0</u>	<u>\$ 672,744,542</u>

**Liberty Mutual Fire Insurance Company**  
**Reconciliation of Capital and Surplus Account for the Years Ended**  
**December 31, 2004, 2003, 2002, 2001 and 2000**

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
<b>Capital and Surplus, December 31, prior year</b>	<b>\$ 551,229,659</b>	<b>\$ 701,778,030</b>	<b>\$ 816,468,425</b>	<b>\$ 894,299,856</b>	<b>\$ 856,795,933</b>
Net income (loss)	34,625,764	72,680,114	79,696,626	19,385,776	66,805,785
Change in net unrealized capital gains and (losses)	15,711,707	42,439,242	(125,488,080)	(93,403,860)	(22,502,246)
Change in foreign exchange adjustment	(703,780)	(1,210,443)	-	-	-
Change in net deferred income tax	6,995,567	(27,723,601)	61,297,952	15,638,232	-
Change in non-admitted assets and related items	(23,304,327)	33,941,271	(46,856,293)	12,570,921	(2,883,392)
Cumulative effect of changes in accounting principles	-	-	-	(29,481,791)	-
Capital changes:					
Transferred from surplus	-	-	10,000,000	-	-
Surplus adjustment:					
Paid in	75,000,000	-	-	-	-
Transferred to capital	-	-	(10,000,000)	-	-
Dividends to stockholders	-	(283,308,712)	(81,646,842)	-	-
Aggregate write-in for gains and losses in surplus	13,189,952	12,633,758	(1,693,758)	(2,540,709)	(3,916,224)
Net change in capital and surplus for the year	121,514,883	(150,548,371)	(114,690,395)	(77,831,431)	37,503,923
<b>Capital and Surplus, December 31, current year</b>	<b>\$ 672,744,542</b>	<b>\$ 551,229,659</b>	<b>\$ 701,778,030</b>	<b>\$ 816,468,425</b>	<b>\$ 894,299,856</b>

For Information Purposes Only



## NOTES TO THE FINANCIAL STATEMENTS

### Note 1: Loss and Loss Adjustment Expense Reserves

The Division retained PwC to review the reasonableness of LMIC's and LMFIC's loss and loss adjustment expense reserves as of December 31, 2004. In order to review the reasonableness of their reserves, PwC reviewed the reasonableness of the Pool's reserves. The Pooling Agreement described in the Reinsurance section of this report identifies all members of the Pool as well as each entity's pro-rata share of the Pool's underwriting results.

The actuarial review process included individual consideration of the Pool's direct, assumed, and ceded components in order to determine the reasonableness of its net loss and loss adjustment expense reserves. The net result for the Pool is then allocated to individual pooling members based on its pro-rata share of the Pool.

The review was conducted in a manner consistent with the Code of Professional Conduct and the Qualification Standards of the American Academy of Actuaries and the Standards of Practice adopted by the Actuarial Standards Board.

The results of PwC's actuarial review indicated that the Company's reserves at December 31, 2004 made a reasonable provision for all unpaid loss and loss adjustment expense obligations of the Company under the terms of its policies and reinsurance agreements.

The tables below summarize a comparison of PwC's loss and loss adjustment expense reserve estimates, both including and excluding EBNR and Retrospective Reinsurance, to those carried by the LMFIC as of December 31, 2004. All amounts shown are in millions, (\$000,000s omitted):

<u>Net Loss &amp; LAE Reserves excl. EBNR and Retroactive Reinsurance</u>	<u>Carried Reserve</u>	<u>PwC Best Estimate</u>			<u>Carried vs. PwC Best</u>		
Net Environmental Reserve / Estimate	156		171			(15)	
Net excl Environmental Reserve / Estimate	1,438		1,466			(28)	
Total Net	1,594		1,637			(43)	

	<u>Carried Reserve</u>	<u>PwC Range</u>			<u>Carried vs. PwC</u>		
<u>Net Loss &amp; LAE Reserves incl. EBNR and Retroactive Reinsurance</u>		<u>Low</u>	<u>Best</u>	<u>High</u>	<u>Low</u>	<u>Best</u>	<u>High</u>
Net Environmental Reserves / Estimate	156	131	171	210	25	(15)	(54)
Net excl. Environmental Reserves / Estimate (Loss and LAE only)	1,438		1,466			(28)	
EBNR	(84)		(59)			(25)	
Retroactive Reinsurance	(200)		(216)			16	
Net excl. Environmental Reserves / Estimate	1,154	1,132	1,191	1,300	22	(37)	(146)
Independence / Covariance Adjustment		31		(31)	(31)		31
Total Net Loss & LAE Reserves	1,310	1,294	1,362	1,479	16	(52)	(169)

While PwC presented the ranges for the Environmental and other-than-Environment liabilities, they were the intermediate results of the calculations made at various levels in order to derive the range for the Company in total. While they serve to illustrate the relative position of the Company's reserves at these intermediate levels, the overall analysis was designed to evaluate a range for the Company in total. The Independence – Covariance Adjustment in the table above reflected the judgment that the outcomes among the environmental and non-environment exposures would be statistically independent of each other. Therefore, the breadth of the overall range was narrower than the breadth of the simple sum of the two intermediate ranges.

LMFIC provided the Division with information on significant reserving events subsequent to the December 31, 2004 analysis. During calendar year 2005, LMFIC recorded the following loss and allocated loss adjustment expense development for accident years 2004 and prior:

(\$millions)	Change in Booked <u>Loss and ALAE</u>
A&E	\$22.0
Non-A&E	<u>29.2</u>
Total	<u>\$51.2</u>

While the Company's development in 2005 increases PwC's comfort with its December 31, 2004 indicated reserve point estimate, no conclusions should be made as to the overall adequacy of LMFIC's reserve position as of December 31, 2005 or the 2005 accident year.

## **ACKNOWLEDGEMENT AND REPORT OF CERTIFIED FINANCIAL EXAMINER**

This is to certify that the undersigned is a duly qualified Certified Financial Examiner ("CFE"), and that pursuant to a proposal submitted by PricewaterhouseCoopers LLP to the Division of Insurance of the Commonwealth of Massachusetts ("Division") dated June 27, 2005, certain agreed-upon procedures have been applied to the accounting and corporate records of Liberty Mutual Fire Insurance Company for the purpose of assisting the Division in fulfilling its requirements regarding periodic Association Statutory Examinations of Massachusetts domiciled insurers.

The undersigned's participation in this Association Financial Examination as the Examiner-In-Charge encompassed responsibility for the coordination and direction of the statutory examination performed which was in accordance with, and substantially complied with those standards established by the Financial Condition (E) Committee of the NAIC and the NAIC Handbook. This participation consisted of involvement in the planning (development, supervision, and review of agreed-upon procedures), administration, review of work papers prepared as documentary evidence of examination procedures performed, and preparation of the statutory examination report.

The cooperation and assistance of the officers and employees of Liberty Mutual Fire Insurance Company extended to all examiners during the course of the examination is hereby acknowledged.

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John M. Curran, CFE  
Supervising Examiner and Examiner-In-Charge  
Commonwealth of Massachusetts  
Division of Insurance  
Boston, Massachusetts