



STATE OF OREGON

DEPARTMENT OF CONSUMER AND BUSINESS SERVICES

INSURANCE DIVISION

REPORT OF FINANCIAL EXAMINATION

OF

**LIBERTY NORTHWEST INSURANCE CORPORATION
PORTLAND, OREGON**

NAIC COMPANY CODE 41939

DECEMBER 31, 2007

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SALUTATION

November 3, 2008

Alfred W. Gross, Commissioner
Chairman, NAIC Financial Condition (E) Committee
State Corporation Commission
Bureau of Insurance
Commonwealth of Virginia
PO Box 1157
Richmond, Virginia 23218

Morris J. Chavez, Superintendent
Secretary, NAIC Western Zone IV
PO Drawer 1269
Santa Fe, New Mexico 87504-1269

Honorable Cory Streisinger, Director
Department of Consumer and Business Services
State of Oregon
350 Winter Street NE, Room 440
Salem, Oregon 97301-3883

Dear Commissioner, Superintendent, and Director:

In accordance with your instructions and guidelines in the National Association of Insurance Commissioners (NAIC) Examiners Handbook, pursuant to ORS 731.300 and 731.302, respectively, we have examined the business affairs and financial condition of

LIBERTY NORTHWEST INSURANCE CORPORATION
One Liberty Centre
650 NE Holladay Street
Portland, Oregon 97232

NAIC Company Code 41939

hereinafter referred to as the "Company." The following report is respectfully submitted.

SCOPE OF EXAMINATION

This regularly scheduled examination of the Company was conducted as of December 31, 2007, covering the five year period then ended, and included a review of material transactions or events which occurred subsequent to the examination cut-off date and were noted during the examination.

The examination was conducted pursuant to ORS 731.300 and in accordance with procedures and guidelines prescribed by the NAIC for the purpose of determining the Company's financial condition, ability to fulfill its obligations, the nature of operations, and compliance with the Insurance Code. Accounting methods, internal control procedures, records and other supporting evidence were examined or tested by appropriate methods to the extent deemed necessary and appropriate for the type, volume and complexity of the accounting system and operations utilized by the Company. The record testing included, but was not limited to, assets, liabilities, income and expense related items. A review was also made of the corrective actions taken by the Company with respect to comments and recommendations in the previous financial report of examination as of December 31, 2002, published by the Oregon Insurance Division.

Work papers were reviewed that were prepared by the Company's independent auditors, Ernst & Young, LLP, in their audit of the accounts of the combined Peerless Insurance Company Pool (of which the Company is a member) for the year ended December 31, 2007. A portion of the auditors' work papers have been incorporated into our work papers and have been utilized in determining the scope and areas of emphasis in conducting the examination.

Concurrent with this examination, two insurance subsidiaries of the Company, Oregon Automobile Insurance Company and North Pacific Insurance Company, were also examined as of December 31, 2007. There was a separate report of financial examination made for each company.

COMPANY HISTORY

The Company was incorporated in Oregon on January 21, 1983, and received a Certificate of Authority on February 18, 1983, to transact property, casualty (including workers' compensation), marine & transportation, surety, and health lines of business. During the period under examination, the Company joined the Liberty Mutual Agency Market strategic business unit. As described in the Reinsurance section below, effective January 1, 2006, the Company ceded all of its risks to the lead insurer in the unit, Peerless Insurance Company, at which point the Company became a fronting insurer for Peerless.

Capital Stock

Under Article III of the Article of Incorporation, the Company is authorized to issue 10,000,000 shares of common stock of \$3 par value common stock. The Company has issued 1,000,000 shares to its direct parent, Liberty Mutual Insurance Company, representing 100% of the shares outstanding. No additional capital had been contributed to the Company during the period under examination.

Dividends to Stockholders and Other Distributions

During 2003 to 2007, the Company declared and paid the following dividend to its stockholder:

<u>Declared date</u>	<u>Paid date</u>	<u>Amount</u>	<u>Description</u>
4/6/2006	5/15/2006	180,000,000	Extraordinary

The \$180 million extraordinary distribution was approved by the Oregon Insurance Division pursuant to ORS 732.554 and 732.576.

MANAGEMENT AND CONTROL

Board of Directors

Management and control of the Company is vested in a Board of Directors. Article III of the Company's Bylaws designates that the Board shall be comprised of not less than five members, the exact number thereof to be fixed by resolution. The Company's Board met all of the requirements of 732.305. As of December 31, 2007, the Company was governed by an eight member Board of Directors as follows:

<u>Name and Address</u>	<u>Principal Affiliation</u>	<u>Member Since</u>
Mary A. Augustyn Tigard, OR	VP of Finance Liberty Northwest Insurance Corporation	2007
Larry W. Becker Portland, OR	President and CEO, Liberty Northwest Insurance Corporation	2003
James F. Dore Boston, MA	Treasurer and CFO Liberty Northwest Insurance Corporation	2005
John D. Doyle Southborough, MA	Vice President and Controller, Liberty Mutual Insurance Company	2006
Scott R. Goodby Marblehead, MA	Exec. VP and COO Liberty Northwest Insurance Corporation	2005
Gary R. Gregg Milton, MA	President and CEO Liberty Northwest Insurance Corporation	2005
Thomas H. Johnson* Portland, OR	General Counsel Liberty Northwest Insurance Corporation	2007
Christopher C. Mansfield Dedham, MA	Sr. VP and General Counsel Liberty Mutual Insurance Company	2005

*Thomas Johnson resigned from the Board in May 2008. The vacancy was not filled.

During the period 2003 to 2006, the Board had authorized three committees: an Executive Committee, Audit Committee, and Investment Committee. On November 15, 2006, the Board resolved to disband all three committees.

Officers

Principal officers serving at December 31, 2007, were as follows:

<u>Officer</u>	<u>Office</u>
Gary R. Gregg	President and Chief Executive Officer
Edmund C. Kenealy	Secretary
James F. Dore	Treasurer and Chief Financial Officer
Anthony A. Fontanes	Executive Vice President and Chief Investment Officer
Scott R. Goodby	Executive Vice President and Chief Operations Officer
Joseph A. Gilles	Executive Vice President

CONFLICT OF INTEREST

The Company has established a Code of Business Ethics and Conduct for its Directors and Senior Management. This Code requires officers and directors to report annually any conflicts of interest or violations of ethical business practices to the Company. From a review of the completed conflict of interest questionnaires, it appeared that the affected personnel performed due diligence in completing the conflict of interest statements. No material conflicts of interest were noted.

CORPORATE RECORDS

Board of Director Minutes

In general, the review of 2003 to 2007 Board meeting minutes, as well as the various committees authorized by the Bylaws, indicated that the minutes support the transactions of the Company and the actions taken by its directors and officers. The minutes indicated that the Board approves investments in accordance with the provisions of ORS 733.730 and ORS

733.740. A quorum, as defined by ORS 731.302, met at all of the meetings held during the period under review. As noted earlier, all three committees of the Board were disbanded in 2006, and the Board, as a whole, now governs the Company's operations.

Articles of Incorporation

There were no changes made to the Articles of Incorporation during the period under examination. The Articles of Incorporation conformed with Oregon statutes.

Bylaws

Substantial changes were made to the Bylaws since the last examination:

- 1) The annual meeting date was changed from the 4th Friday in May, held in Portland, to a date, time and place fixed by the Board.
- 2) The number of board members was changed from between five and fifteen, to at least five or the exact number fixed by resolution by the Board.
- 3) Residency requirement for board members was silent in the old Bylaws, now at least 1/4 of the Board must be residents of Oregon, and a majority may not be salaried officers of the Corporation.
- 4) Salaried officers formerly included a Chairman, Vice-Chairman, President, Vice-President, Secretary and Chief Financial Officer. New Bylaws require a President, a Secretary and a Treasurer.

The Bylaws conformed with Oregon statutes.

Holding Company Registration Statement

A holding company registration statement was filed for each year of this examination by the Company in accordance with the provisions of ORS 732.552, ORS 732.554, and Oregon Administrative Rule (OAR) 836-027-0020(1).

Parent, Subsidiaries and Affiliates

The Company is part of a holding company system in which Liberty Mutual Holding Company, Inc. (LMHC), is the ultimate controlling entity. LMHC was formed after the

demutualization of Liberty Mutual Insurance Company during 2001, under a mutual holding company system owned by the former policyholders of Liberty Mutual Insurance Company.

Aside from the Company, other significant subsidiaries of LMHC include as follows:

LMHC Massachusetts Holdings, Inc. – a Massachusetts corporation 100% owned by LMHC.

It acts as an intermediate stock holding company within the mutual holding company system.

Liberty Mutual Group, Inc. (LMG) – a Massachusetts stock holding company 100% owned by LMHC Massachusetts Holdings. Liberty Mutual Group is based in Boston, Massachusetts, and through its subsidiaries has operations throughout the United States, employing approximately 41,000 people in over 900 offices worldwide.

Liberty Mutual Insurance Company (LMIC) – a Massachusetts stock property and casualty insurance company 100% owned by LMG. LMIC owns 100% of the outstanding shares of the Company's common stock and would be considered the direct parent.

Liberty Mutual Investment Advisors LLC (LMIA) – a Massachusetts limited liability company and an indirect subsidiary of LMIC. It was formed for the purpose of making, holding, and administering investments in designated asset sectors for the insurance companies within LMG.

The Company has four for-profit stock subsidiaries, all 100% owned, as follows:

Oregon Automobile Insurance Company (OAIC) – an Oregon-domiciled stock property and casualty insurer. It was acquired on January 1, 2002, from OneBeacon Insurance Company, a member of the White Mountains Insurance Group.

North Pacific Insurance Company (NPIC) – an Oregon-domiciled stock property and casualty insurer. It, too, was acquired from OneBeacon Insurance Company in 2002.

Liberty Management Services, Inc. (LMS) – an Oregon corporation formed in 1987 as a claims servicing company, providing operational support for employers that are self-insured for workers' compensation.

Access Insurance Services Company (AISC) – an Oregon corporation formed in 2000 as an insurance agency to market property and casualty business.

Intercompany Agreements

The Company was party to the following agreements with its parent and affiliates as of December 31, 2007:

Memorandum of Understanding

The Company entered into an undated memorandum of understanding (MOU) with LMIC, which specifies the general terms wherein common facilities and personnel may be shared. The MOU stated that reimbursements are generally to be based on actual expenses.

Management Services Agreement

Effective January 1, 2006, the Company and LMIC entered into an agreement whereby LMIC will provide; a) accounting, financial, tax and auditing services, b) purchasing, payroll and employee benefits, c) information technology and support, d) policy administration and production, e) real estate management, f) legal, g) general administration, h) miscellaneous, and i) reinsurance negotiations. The Company will pay a reasonable fee to LMIC, including direct expenses and allocated expenses. There is no expiration date, but either party may

terminate the agreement with 90 days written notice. An amendment dated December 31, 2007, requires all amounts owing between the parties be settled within 45 days of the end of each calendar quarter.

Cash Management Agreement

Effective January 28, 2000, the Company entered into an agreement with LMIA to make, hold, and administer certain positions in short-term investments. Compensation will be a fee equal to the reasonable expense of providing legal, auditing, investment, accounting and money management services, in addition to reimbursement of direct commissions, transaction fees, and custodial fees incurred. Exhibit A of the agreement described the permitted assets allowed for purchase. The agreement has no expiration date, but may be terminated immediately upon written notice by the Company, or with 30 days' written notice by LMIA.

Investment Management Agreement

Effective June 19, 2003, the Company entered into an agreement with LMIA to act as discretionary investment manager of all the invested assets held by the Company, subject to the guidelines, limitations, and objectives set by the Company's Board of Directors. The agreement terminates five years from execution, and may be renewed for a period not to exceed five years. Fees are charged monthly, equal to 3.4 basis points (annualized) on the average monthly par value of bonds and market value of equities. Effective January 1, 2007, LMIC replaced LMIA on an identical agreement.

Revolving Loan Agreement and Promissory Note

Effective May 22, 2006, the Company entered into an agreement whereby the Company is authorized to borrow up to \$50 million from its direct parent, Liberty Mutual Insurance

Company. Interest will accrue at a rate of Prime + 5%. The agreement will terminate on May 22, 2011. During the period under examination, the Company did not borrow any funds from LMIC under this agreement.

Tax Sharing Agreement

On January 1, 2002, the company joined Liberty Mutual Holding Company, Inc., (LMHC) in a tax-sharing agreement. Under the agreement, the taxes payable shall be based on the separate tax return liability of each tax reporting segment, adjusted for any carryover, carryback, credit, or other attribute. Estimated tax payments are due no later than the 12th day of April, June, September and December of each tax year.

FIDELITY BOND AND OTHER INSURANCE

The Company is covered against losses through a fidelity bond for risks up to \$125,000,000 in the aggregate, after a \$1,000,000 retention. This coverage was found to comply with the limits recommended by the NAIC. The Company is insured for directors and officers liability for losses up to \$125,000,000 in aggregate, after a \$25,000,000 deductible. Other major insurance coverages in force included company securities, financial institution bond, and workers' compensation. All coverages appeared adequate as of December 31, 2007.

STATUTORY DEPOSIT

The Company has a deposit with the Oregon Insurance Division, Department of Consumer Business Services, pursuant to the provisions of ORS 731.604 and 731.628. The deposit consisted of US Treasury Notes with a par value of \$2,770,000. The Company also listed deposits with other States on Schedule E – Part 3, which were confirmed directly with those jurisdictions.

TERRITORY AND PLAN OF OPERATION

During the period under examination, the Company wrote property and casualty business, including a comprehensive set of personal and commercial coverages, through independent agents. At December 31, 2007, the Company wrote direct premiums in six of the nine states in which it is licensed, as follows:

Alaska	\$ 30,124,245
California	9,817,547
Idaho	54,436,768
Massachusetts	0
Montana	36,222,696
Oregon	143,191,029
Utah	0
Washington	40,068,364
Wyoming	0
Total Direct Premium	<u>\$313,860,649</u>

The Company is a member of the Liberty Mutual Agency Market (LMAM) strategic business unit, which offers agribusiness protection, commercial lines, personal lines, and workers' compensation. It writes business in the Northwest Region under the following brands: American Fire and Casualty Company, Indiana Insurance Company, Liberty Northwest Insurance Corporation, North Pacific Insurance Company, The Ohio Casualty Insurance Company, Ohio Security Insurance Company, Oregon Automobile Insurance Company, Peerless Insurance Company and West American Insurance Company.

For the Northwest Region (which includes AK, ID, MT, OR, and WA), the Liberty Mutual group has established 17 sales offices staffed by approximately 800 employees.

GROWTH OF THE COMPANY

The growth of the Company since the last financial examination is reflected in the following schedule. The amounts were derived from Company's filed annual statements, except in those years where a report of examination has been prepared by the Oregon Insurance Division.

<u>Year</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Surplus and Other Funds</u>	<u>Net Income (Loss)</u>
2002*	\$ 773,646,387	\$605,052,692	\$168,593,695	\$ 5,580,635
2003	890,603,728	698,214,948	192,388,780	5,733,421
2004	994,099,296	789,074,939	205,024,357	10,866,188
2005	1,120,771,569	889,014,175	231,757,394	21,984,809
2006	203,014,321	113,072,131	89,942,190	65,304,800
2007*	126,400,165	37,558,633	88,841,532	(2,981,167)

*Per examination

The changes in assets and liabilities reported in 2006 and 2007 were due to the effects of the 100% quota-share reinsurance agreement with Peerless Insurance Company. All unpaid loss and LAE reserves were transferred to Peerless, together with assets equal to the liabilities, effective January 1, 2006. Changes in surplus were primarily due to net income, less cash dividends paid to the direct parent, Liberty Mutual Insurance Company.

LOSS EXPERIENCE

The following exhibit reflects the annual underwriting results of the Company over the last five years. The amounts were compiled from copies of the Company's filed annual statements and, where indicated, from examination reports.

<u>Year</u>	<u>(1) Premium Earned</u>	<u>(2) Losses and LAE Incurred</u>	<u>(3) Other Underwriting Expenses Incurred</u>	<u>(2)+(3)/(1) Combined Ratio</u>
2002*	\$228,686,939	\$191,481,623	\$ 54,924,304	107.7%
2003	329,809,857	272,355,267	77,423,075	106.1%
2004	391,723,405	304,530,850	105,695,304	102.6%
2005	408,137,912	331,085,218	97,406,512	105.0%
2006	0	0	0	0.0%
2007*	0	0	164	0.0%

*Per examination

REINSURANCE

Effective January 1, 2006, the Company entered into a 100% quota-share reinsurance agreement with an affiliate, Peerless Insurance Company, the lead insurer in the Liberty Mutual Agency Market strategic business group. The agreement calls for Peerless to assume all risks from first dollar.

Assumed Business

The Company assumed a significant part of its business through participation in the National Workers' Compensation Assigned Risk Pool. The Company recorded its respective financial results from the pool as reported to them in quarterly statements. Because of the reporting lags commonly associated with pools and associations, the Company often supplements the reported results with more current estimates of its share of premiums or losses relating to this business. Additionally, the Company assumed business through its voluntary operations.

Ceded Business

The quota share reinsurance agreement with Peerless described above is further broken down into nine contracts covering different layers and lines of business.

All Lines Casualty Excess of Loss

- \$10 million excess of \$10 million (\$15 million maximum for Terrorism)

Property Excess of Loss Reinsurance

- \$25 million excess of \$25 million
- \$50 million excess of \$50 million

Property Catastrophe Excess of Loss Reinsurance

- \$50 million excess of \$50 million
- \$50 million excess of \$100 million
- \$50 million excess of \$150 million
- \$50 million excess of \$200 million
- \$50 million excess of \$250 million
- \$50 million excess of \$300 million

Property Catastrophe Excess of Loss Reinsurance

- \$200 million excess of \$500 million
- \$350 million excess of \$750 million
- \$300 million excess of \$1,100 million
- \$250 million excess of \$1,400 million
- \$300 million excess of \$1,650 million

Workers' Compensation Clash Excess of Loss Reinsurance

- \$5 million excess of \$5 million ultimate net loss, any one loss occurrence

Workers' Compensation Catastrophe Excess of Loss Reinsurance

- \$75 million excess of \$25 million (excludes Terrorism)
- \$100 million excess of \$100 million
- \$300 million excess of \$200 million

Workers' Compensation Catastrophe Excess of Loss Reinsurance

- \$200 million excess of \$500 million (excludes Terrorism)
- \$300 million excess of \$700 million
- \$200 million excess of \$1,000 million (excludes CA earthquake)

Multi-line Terrorism Aggregate Excess of Loss Reinsurance

- \$200 million in excess of aggregate ultimate loss of \$150 million, subject to recoveries under TRIA of 2002 and Extension Act of 2005

Commercial Umbrella Excess of Loss Reinsurance

- Peerless is liable for 100% of the net loss in excess of \$5 million for each and every loss, each and every occurrence, not to exceed \$10 million.

Risk Retention and Transfer

The Company retains no risk on any one insured. As such, the Company was in compliance with the provisions of ORS 731.504. In addition, it was determined that the Company's pooled reinsurance agreements are reported in accordance with the requirements specified in the NAIC Accounting Practices and Procedures Manual, SSAP No. 63.

Insolvency Clause

Each of the reinsurance agreements contained a proper insolvency clause that specified payments would be made to a statutory successor without diminution in the event of insolvency, as required by the provisions of ORS 731.508.

ACCOUNTS AND RECORDS

In general, the Company's accounting and corporate records were maintained in a manner in which the financial condition was verifiable as required by the provisions of ORS 733.170; however, the examiners experienced significant delays in getting information from the Boston offices of Liberty Mutual Insurance Company. The Company should be aware of the provisions of ORS 731.308(3), which require timely and convenient access to records and require the officers, directors, employees and agents of the insurer to facilitate the examination.

The Company maintained its accounting records on a Statutory Accounting Principles (SAP) basis for NAIC Annual Statement reporting and adjusts to a Generally Accepted Accounting Principles (GAAP) basis of accounting for its purposes. The Company, as part of the combined Peerless Insurance Company Pool, is audited annually by the certified public accounting firm of Ernst & Young LLP. The Company (prior to 2006) and the combined

companies received an unqualified opinion for all years under review. The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning and testing phase of the examination and no material exceptions were noted.

The management of the Company is sufficiently knowledgeable of the information systems (IS) process. Systems development, acquisition, and maintenance controls were evaluated to gain assurance that appropriate controls are in place. Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed; and the controls exercised to maintain data security. Sufficient internal controls are in place and monitored by the Company. The Company's IS Department has the ability to recover from an incident or disaster and has documented these procedures in a detailed, written disaster recovery plan.

The following issues were noted as result of this examination:

Schedule P

The Company did not provide a copy of Schedule P with the 2007 annual statement filed with the Oregon Insurance Division and the NAIC I-Site electronic database. Due to the intercompany quota-share reinsurance agreement, the Company retained no risk, and believed they were not required to complete the filing. At the request of the Oregon Insurance Division, the Company did complete a Schedule P and submitted it on May 28, 2008.

According to the NAIC Annual Statement Instructions for Property/Casualty manual, unless an insurer is party to a pooling arrangement and the lead insurer in the pool assumes 100% of the risks, the insured companies will be required to complete Schedule P.

I recommend the Company file Schedule P with all future filings of the annual statements in accordance with NAIC Annual Statement Instructions and ORS 731.574(1).

COMPLIANCE WITH PRIOR EXAMINATION RECOMMENDATIONS

The Company took corrective action with respect to the one recommendation made in the 2002 report of examination. The follow-up report was prepared on December 14, 2004.

SUBSEQUENT EVENTS

On May 23, 2008, the Oregon Insurance Division received notice of an ordinary cash dividend declaration in the amount of \$9,009,421 (10% of surplus as of December 31, 2007), to be paid on or after June 30, 2008 to the parent, Liberty Mutual Insurance Company. The Oregon Insurance Division approved the ordinary dividend in a letter dated June 9, 2008.

On December 16, 2008, the director issued an Order of Exemption, Case No. INS 08-12-007, regarding a LMIC request dated October 27, 2008, to contribute on or before December 31, 2008, the shares of the Company downstream through intervening holding companies and ultimately to Peerless Insurance Company (“PIC”), a downstream subsidiary. Because NPIC and OAIC were wholly-owned subsidiaries of the Company, they, along with two non-insurance subsidiaries of the Company, would become indirect wholly-owned subsidiaries of PIC.

The director determined the contribution of shares did not have the effect of changing or influencing the control or ownership of a domestic insurer since LMIC and LMHC would remain controlling parties of the Company, NPIC, and OAIC as before the contribution. The proposed transaction thereby met the requirements for exemption from the provisions of ORS 732.521(1) pursuant to ORS 732.521(2).

FINANCIAL STATEMENTS

The following examination financial statements show the financial condition of Liberty

Northwest Insurance Corporation:

Assets

Liabilities, Surplus and Other Funds

Summary of Operations

Reconciliation of Surplus for the Period Since the last Examination

Analysis of Changes in Financial Statements Resulting from the Examination

The financial statements are presented on the basis of statutory accounting practices permitted or prescribed by the Oregon Insurance Division as of December 31, 2007.

LIBERTY NORTHWEST INSURANCE CORPORATION
ASSETS
December 31, 2007

<u>ASSETS</u>	Balance Per Company	Examination Adjustments	Balance Per Examination	Notes
Bonds	\$ 75,991,940	\$ -	\$ 75,991,940	1
Stocks:				
Common stocks	17,050,712	(1,252,686)	15,798,026	1
Cash, cash equivalents and short-term investments	(4,107,212)		(4,107,212)	1
Other long-term invested assets	3,529,586		3,529,586	
Receivable for securities	49,435		49,435	
Aggregate write-ins for invested assets	-		-	
Subtotal, cash and invested assets	<u>92,514,461</u>	<u>(1,252,686)</u>	<u>91,261,775</u>	
Investment income due and accrued	870,123		870,123	
Agents' balances or uncollected premiums:				
Premiums and agents' balances in course of collection	2,001,115		2,001,115	
Reinsurance				
Amounts recoverable from reinsurers	17,941,387		17,941,387	
Federal and foreign income tax recoverable and interest thereon	3,527,000		3,527,000	
Net deferred tax asset	-		-	
Receivable from parent, subsidiaries and affiliates	10,530,289		10,530,289	
Aggregate write-ins for other than invested assets	268,476		268,476	
From Separate Accounts, Segregated Accounts and Protected Cell Accounts	-		-	
Total Assets	<u>\$ 127,652,851</u>	<u>\$ (1,252,686)</u>	<u>\$ 126,400,165</u>	

LIBERTY NORTHWEST INSURANCE CORPORATION
LIABILITIES, SURPLUS AND OTHER FUNDS
December 31, 2007

<u>LIABILITIES, SURPLUS AND OTHER FUNDS</u>	Balance Per Company	Examination Adjustments	Balance Per Examination	Notes
Losses	\$ -	\$ -	\$ -	
Reinsurance payable on paid loss and loss adjustment expenses	3,960,605		3,960,605	
Loss adjustment expenses	-		-	
Taxes, licenses and fees (excluding federal and foreign income taxes)	73,457		73,457	
Current federal and foreign income taxes	-		-	
Ceded reinsurance premiums payable	22,224,854		22,224,854	
Payable to parent, subsidiaries and affiliates	10,853,082		10,853,082	
Aggregate write-ins for liabilities	446,635		446,635	
Protected cells liabilities	-		-	
Total Liabilities	<u>37,558,633</u>	<u>-</u>	<u>37,558,633</u>	
Common capital stock	3,000,000		3,000,000	
Gross paid in and contributed surplus	58,400,000		58,400,000	
Unassigned funds (surplus)	<u>28,694,218</u>	<u>(1,252,686)</u>	<u>27,441,532</u>	
Surplus as regards policyholders	90,094,218	(1,252,686)	88,841,532	
Total Liabilities, Surplus and other Funds	<u>\$ 127,652,851</u>	<u>\$ (1,252,686)</u>	<u>\$ 126,400,165</u>	

LIBERTY NORTHWEST INSURANCE CORPORATION
STATEMENT OF INCOME
For the Year Ended December 31, 2007

	Balance Per Company	Examination Adjustments	Balance Per Examination	Notes
UNDERWRITING INCOME				
Premiums earned	\$ -	\$ -	\$ -	
Deductions:				
Losses incurred	-		-	
Loss expenses incurred	-		-	
Other underwriting expenses incurred	164		164	
Aggregate write-ins for underwriting deductions	-		-	
Total underwriting deductions	164		164	
Net underwriting gain or (loss)	(164)		(164)	
INVESTMENT INCOME				
Net investment income earned	6,019,031		6,019,031	
Net realized capital gains or (losses)	(2,007,506)		(2,007,506)	
Net investment gain or (loss)	4,011,525		4,011,525	
OTHER INCOME				
Net gain or (loss) from agents' or premium balances charged off	-		-	
Finance and service charges not included in premiums	7,698		7,698	
Aggregate write-ins for miscellaneous income	(243,611)		(243,611)	
Total other income	(235,913)		(235,913)	
Dividends to policyholders	-		-	
Federal and foreign income taxes incurred	6,756,615	-	6,756,615	
Net income	\$ (2,981,167)	\$ -	\$ (2,981,167)	

LIBERTY NORTHWEST INSURANCE CORPORATION
RECONCILIATION OF SURPLUS FOR THE PERIOD SINCE LAST
EXAMINATION
For the Year Ended December 31, 2007

	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Surplus as regards policyholders, December 31, previous year	\$89,942,190	\$231,757,394	\$205,024,357	\$192,388,780	\$168,593,695
Net Income	(2,981,167)	65,304,800	21,984,809	10,866,188	5,733,421
Net transfers (to) from Protected Cell accounts	0	0	0	0	0
Change in unrealized capital gains (losses)	517,282	(2,834,483)	(1,326,523)	3,651,381	9,658,338
Change in net unrealized foreign exchange capital gain (loss)	0	0	0	0	0
Change in net deferred income tax	1,797,890	(58,830,998)	3,469,749	2,039,113	4,601,610
Change in nonadmitted assets	818,023	37,018,561	2,605,002	(3,921,105)	(2,659,423)
Change in provisions for reinsurance	0	0	0	0	0
Change in surplus notes	0	0	0	0	0
Cumulative effect of changes in accounting principles	0	0	0	0	3,750,000
Surplus adjustments					
Paid in	0	0	0	0	0
Transferred to capital (Stock Dividend)	0	0	0	0	0
Tranferred from capital	0	0	0	0	0
Net remittances from or (to) Home Office	0	0	0	0	0
Dividends to stockholders	0	(180,000,000)	0	0	0
Change in Treasury Stock	0	0	0	0	0
Examination Adjustments	(1,252,686)	0	0	0	0
Aggregate write-ins for gains and losses in surplus	<u>0</u>	<u>(2,473,084)</u>	<u>0</u>	<u>0</u>	<u>2,711,139</u>
Net change in capital and surplus for the year	<u>(1,100,658)</u>	<u>(141,815,204)</u>	<u>26,733,037</u>	<u>12,635,577</u>	<u>23,795,085</u>
Surplus as regards policyholders, December 31, current year	<u>\$88,841,532</u>	<u>\$89,942,190</u>	<u>\$231,757,394</u>	<u>\$205,024,357</u>	<u>\$192,388,780</u>

LIBERTY NORTHWEST INSURANCE CORPORATION
ANALYSIS OF CHANGES IN FINANCIAL STATEMENTS RESULTING FROM
THE EXAMINATION
December 31, 2007

	<u>PER COMPANY</u>	<u>PER EXAMINATION</u>	<u>INCREASE (DECREASE) IN SURPLUS</u>	<u>TOTAL</u>
Capital and Surplus, 12/31/2007- Per Annual Statement				<u>\$90,094,218</u>
<u>ASSETS</u>				
Common Stocks	17,050,712	15,798,026	(1,252,686)	(1,252,686)
Net def. tax asset				
Guaranty fund receiv.				
<u>LIABILITIES</u>				
Losses				
Losses adj. expenses				
Comm. Payable, conting. Comm				
Ceded rein.prem. Payable				
Payable to parent, subs. & affili.				
Change in surplus				<u>(1,252,686)</u>
Capital and Surplus, 12/31/2007 Per Examination				<u><u>\$88,841,532</u></u>

NOTES TO THE FINANCIAL STATEMENTS

Note 1 - Investments

Most of the Company's long-term bond investments were in US Treasury obligations, federal agency bonds, municipal obligations, and corporate issues. The Company did have a significant exposure to mortgaged-backed and asset-backed securities. All MBS/ABS issues were investment rated at year-end 2007, but the book carrying value of \$27.4 million comprised over 36% of the total long-term bond portfolio, or almost 30% of all invested assets. An additional \$9.0 million was invested in bonds of banking and financial corporations. Cash and short-term deposits consisted of cash on deposit and two short-term money market funds. A comparison of the investments over the past five years is as follows:

<u>Year</u>	<u>A</u> <u>Bonds</u>	<u>B</u> <u>Cash and</u> <u>Short-term</u>	<u>Ratio</u> <u>A/</u> <u>Total Assets</u>	<u>Ratio</u> <u>B/</u> <u>Total Assets</u>
2003	698,026,397	21,529,473	78.4%	2.4%
2004	805,857,512	13,360,903	81.1%	1.3%
2005	930,124,103	6,811,912	83.0%	0.6%
2006	70,392,981	46,929,651	34.7%	23.1%
2007	75,991,940	(4,107,212)	59.5%	(3.2)%

The Board of Directors approved the investment transactions, pursuant to ORS 733.740. As of December 31, 2007, invested assets of \$17,981,827, representing 19.4% of the total invested assets, were invested in amply secured obligations of the United States or FDIC insured cash deposits. This exceeded the amount that must be invested in these types of assets as required by ORS 733.580.

The Company reported investments of common stocks in the amount of \$17,050,712, which is the book value of four subsidiaries. Two of these are Oregon domiciled property and casualty insurers reported at statutory surplus, adjusted for the unamortized value of goodwill booked when the subsidiaries were purchased in 2002. During 2007, the Company began reporting the book value of two other insurance related subsidiaries, Liberty Management Services and Access Insurance Services Company, contrary to the provisions of SSAP No. 97, paragraph 8(b)(i), in that the book value of the subsidiaries were not recorded based on the underlying audited statutory equity. The examination reduced the balance of common stocks by \$1,252,686. **I recommend the Company nonadmit the book value of subsidiaries that do not meet the valuation approach described in SSAP No. 97.**

The Company entered into a global custody agreement with JP Morgan Chase dated January 10, 2002. This agreement did not contain a protection required under OAR 836-027-0200(4)(f), stating the custodian agrees to notify the Director of DCBS within three business days in the event the agreement is terminated or if 100% of the assets are withdrawn from any one custodial account. **I recommend the Company amend its custodial agreement with JP Morgan Chase to contain all of the protections of OAR 836-027-0200(4).**

Note 2 – Actuarial Reserves

The Company did not report loss reserves as a result of the 100% quota-share reinsurance agreement, under which 100% of losses were ceded to Peerless Insurance Company.

Note 3 – Other Invested Assets (Schedule BA)

The Company reported an ownership interest in a limited partnership that owns the Company's office headquarters building and parking lot. The audited GAAP report stated the proportionate share owned by the Company was valued at \$5,541,817, while the Annual Statement amount was reported at \$3,529,586, resulting in a difference of \$2,012,231. The difference in amount was due to the time lag in the monthly financial statements from Ashforth Pacific, the general partner. As a result, the price reported in the 2007 Annual Statement was based on the November 2007, financial statements, rather than the year-end statement.

No adjustment was made to the balance reported by the Company.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

In addition to the following recommendations, DCBS has presented the Company with a management letter containing matters not considered material for purposes of this examination.

Page

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| 19 | I recommend the Company file Schedule P with all future filings of the annual statements in accordance with NAIC Annual Statement Instructions and ORS 731.574(1). |
| 26 | I recommend the Company nonadmit the book value of subsidiaries that do not meet the valuation approach described in SSAP No. 88. |
| 26 | I recommend the Company amend its custodial agreement with JP Morgan Chase to contain all of the protections of OAR 836-027-0200(4). |

CONCLUSION

During the five year period covered by this examination, the surplus of the Company has decreased from \$168,593,695, as presented in the December 31, 2002, report of examination, to \$88,841,532, as shown in this report of examination. There was an adjustment made to the financial statements of \$1,252,686, as a result of this examination. The comparative assets and liabilities are shown below:

	<u>2007</u>	<u>December 31,</u>	<u>2002</u>	<u>Change</u>
Assets	\$ 126,400,165		\$773,646,387	\$(647,246,222)
Liabilities	<u>37,558,633</u>		<u>605,052,692</u>	<u>567,494,059</u>
Surplus	<u>\$ 88,841,532</u>		<u>\$168,593,695</u>	<u>\$ (79,752,163)</u>

ACKNOWLEDGMENT

The cooperation and assistance extended by the officers and employees of the Company during the examination process are gratefully acknowledged.

In addition to the undersigned, Mark Giffin, CFE, and Michael P. Phillips, CFE, CPA, AES, insurance examiners for the State of Oregon, Department of Consumer and Business Services, Insurance Division, participated in the examination.

Respectfully submitted,

Greg A. Lathrop, CFE
Supervising Insurance Examiner
Department of Consumer and Business Services
State of Oregon

AFFIDAVIT

STATE OF OREGON)
)
County of Marion) ss

Greg A. Lathrop, CFE, being duly sworn, states as follows:

1. I have authority to represent the state of Oregon in the examination of Liberty Northwest Insurance Corporation, Portland, Oregon.
2. The Insurance Division of the Department of Consumer and Business Services of the state of Oregon is accredited under the National Association of Insurance Commissioners Financial Regulation Standards and Accreditation.
3. I have reviewed the examination work papers and examination report, and the examination of Liberty Northwest Insurance Corporation was performed in a manner consistent with the standards and procedures required by the Oregon Insurance Code.

The affiant says nothing further.

Greg A. Lathrop, CFE
Supervising Financial Examiner
Department of Consumer and Business Services
State of Oregon

Subscribed and sworn to me this _____ day of _____, 2009.

Notary Public for the State of Oregon

My Commission Expires: _____