REPORT OF EXAMINATION

OF THE

NORCAL MUTUAL INSURANCE COMPANY

AS OF

DECEMBER 31, 2012

Filed May 23, 2014

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San Francisco, California
April 18, 2014

Honorable Dave Jones
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

NORCAL MUTUAL INSURANCE COMPANY

(hereinafter referred to as the Company) at its home office located at 560 Davis Street, Suite 200, San Francisco, California 94111.

SCOPE OF EXAMINATION

We have performed our multi-state examination of the Company. The previous examination of the Company was made as of December 31, 2008. This examination covers the period from January 1, 2009 through December 31, 2012. The examination was conducted in accordance with the National Association of Insurance Commissioners Financial Condition Examiners Handbook (Handbook). The Handbook requires the planning and performance of the examination to evaluate the Company's financial condition, to identify prospective risks, and to obtain information about the Company, including corporate governance, identification and assessment of inherent risks, and the evaluation of the system controls and procedures used to mitigate those risks. The examination also included an assessment of the principles used and the significant estimates made by management, as well as an evaluation of the overall financial statement presentation, and management's compliance with Statutory Accounting Principles and Annual Statement instructions. All accounts and activities of the Company were considered in accordance with the risk-focused examination process.

The examination was a coordinated examination with participation from the Pennsylvania Insurance Department and was conducted concurrently with the examination of the Company's subsidiary, PMSLIC Insurance Company (PMSLIC). In addition to PMSLIC, the Company has another insurance subsidiary, Medicus Insurance Company. Collectively, the insurers in the group are known as the NORCAL Group.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; pensions, stock ownership and insurance plans; growth of company; loss experience; accounts and records; and statutory deposits.

SUBSEQUENT EVENTS

On July 19, 2011, the Company's subsidiary, NORCAL Management Company (NMC), gained control of Novus Insurance Company Risk Retention Group, later renamed as Healthcare Safety & Protection Risk Retention Group, Inc. (HSPRRG), through a management service contract. During 2011, the Company entered into two assumed reinsurance agreements with HSPRRG. Under the first agreement, the Company assumed 90% of the HSPRRG business written after July 19, 2011 on a pro-rata basis. This agreement was accounted for as prospective reinsurance. Under the second agreement, the Company agreed to assume 100% of HSPRRG's existing loss and unearned premium reserves at July 19, 2011. This agreement was accounted for as retroactive reinsurance in accordance with Statement of Statutory Accounting Principles No. 62 - Revised Property and Casualty Reinsurance. The Company received $17.3 million from HSPRRG at the inception of the retroactive reinsurance agreement which was equal to the liabilities assumed, and no surplus gain or loss was realized as a result of this transaction. At December 31, 2012, the Group reported a liability for retroactive reinsurance of $15.9 million.

On June 30, 2013, HSPRRG was dissolved. As part of the dissolution, the Company and HSPRRG entered into a series of transactions. The first set of transactions was a commutation of the two intercompany reinsurance contracts. The amount due from the Company to HSPRRG as a result of the commutation of the retroactive contract and prospective contract was $13.4 million and $7.7 million, respectively. There was also a balance of $581,825 owed by the Company to HSPRRG for paid losses on these contracts.

The second set of transactions was a Loss Portfolio Transfer (LPT) to the Company for the entire book of HSPRRG reserves at June 30, 2013. The Company assumed primary insurance responsibility for the reserves and HSPRRG was relieved of all potential liability for the policies that it originally wrote. HSPRRG also had reinsurance in place with other third party reinsurers. Those third party reinsurers agreed to assign all future reinsurance recoveries to the Company on all liabilities that were transferred in the LPT. The net additional liability recorded by the Company as a result of these transactions was $23 million. The LPT transaction was below the threshold for prior approval filing per California Insurance Code Section 1215.5(b)(3).

The total amount paid by HSPRRG to the Company to settle the net effect of these transactions and balances was $1.3 million. There was no gain or loss recorded by the Company or HSPRRG as a result of these transactions.

After satisfying all of its other liabilities, what remained on the HSPRRG balance sheet was $1.1 million of surplus notes held by PMSLIC Insurance Company (PMSLIC). This balance was distributed to PMSLIC as partial repayment of the original $12 million surplus notes issued by PMSLIC to HSPRRG on July 19, 2011. PMSLIC recorded the repayment as a gain on disposal of the surplus notes in the fourth quarter 2013 because they had previously been written down to zero.

COMPANY HISTORY

During the examination period, there were several transactions involving the ownership of subsidiaries and affiliated companies of the NORCAL Group. The changes were as follows:

On October 9, 2009, Medical Group Holdings, Inc. (MGH), a wholly-owned subsidiary of the Company and direct parent of PMSLIC Insurance Company (PMSLIC), was dissolved. With the dissolution of MGH, PMSLIC became a wholly-owned subsidiary of the Company.

On May 20, 2010, PMSLIC filed the Articles of Dissolution with the Pennsylvania Insurance Department for its wholly-owned subsidiary, Infinity Management Services, Inc. which ceased operations on May 15, 2007, and was formally dissolved on May 20, 2010.

On September 29, 2010, the Company entered into an operating agreement in connection with the formation of Specialty Program Managers, LLC (SPM), a Delaware limited liability company. Upon execution of the agreement, the Company was admitted to SPM as an initial member, obtaining 50% of the outstanding shares. The Company made a capital contribution of $175,000 to SPM. On November 13, 2012, SPM was dissolved.

On July 19, 2011, the Company’s subsidiary, NORCAL Management Company (NMC) gained control of Novus Insurance Company Risk Retention Group, later renamed to Healthcare Safety & Protection Risk Retention Group, Inc. (HSPRRG), through a management service contract. NMC contracts with a third party captive manager to manage the day-to-day operations of HSPRRG. On June 30, 2013, HSPRRG was dissolved.

On July 29, 2011, a subsidiary of the Company, Medical Risk Management Insurance Services, Inc. (which the Company had 50% ownership share) was dissolved.

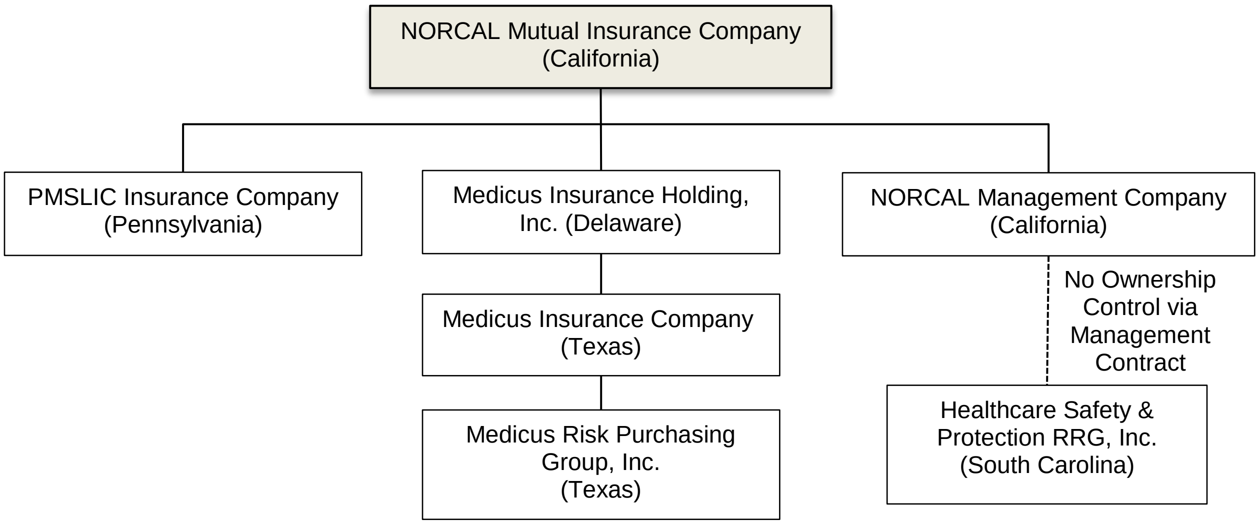
On October 5, 2011, the Company acquired 100% of Medicus Insurance Holdings, Inc. and its wholly owned subsidiaries Medicus Insurance Company and Medicus Risk Purchasing Group, Inc. for $60.2 million. This acquisition was approved by the California Department of Insurance (CDI) on October 4, 2011 and Texas Department of Insurance.

On October 5, 2012, an affiliate of the Company, OB Protect Risk Purchasing Group, Inc, was dissolved.

On October 30, 2012, the Company received approval from the CDI to redeem the two surplus notes that were issued on May 12, 2004. The principal amounts on the surplus notes were $13 million and $12 million. Both surplus notes were redeemed on December 17, 2012.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system which includes a Pennsylvania insurer and a Texas insurer. The following organizational chart depicts the Company's relationship within the holding company system at December 31, 2012 (all ownership is 100%):



Management of the Company is vested in a ten-member board of directors elected annually. The members of the board and principal officers serving as of December 31, 2012 were as follows:

<u>Board of Directors</u>

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
Sandra L. Beretta, M.D. Hillsborough, California	Physician Sandra Beretta, MD, Inc. & Medical Arts Obstetrics & Gynecology
Fabiola Cobarrubias, M.D. San Francisco, California	Physician Pacific Inpatient Medical Group
Patricia A. Dailey, M.D. Hillsborough, California	Physician Anesthesia Care Associations Medical Group
Alice H. Gannon San Antonio, Texas	Senior Vice President and Actuary United Services Automobile Association
Roger M. Hayashi, M.D. Los Gatos, California	Physician
Mary D. Koken Lancaster, Pennsylvania	Attorney & Consultant

Directors (continued)

Name and Location	Principal Business Affiliation
Steven J. Packer, M.D[(A)] Monterey, California	President & Chief Executive Officer Community Hospital Foundation
Rebecca J. Patchin, M.D. Riverside, California	Physician Rebecca J. Patchin, MD, Inc. & Loma Linda Anesthesiology Medical Group
Jaan E. Sidorov, M.D. Harrisburg, Pennsylvania	Physician Sidorov Health Solutions
Scott C. Syphax Elk Grove, California	President and Chief Executive Officer Nehemiah Companies

Principal Officers

Name	Title
Theodore S. Diener	President and Chief Executive Officer
Katherine H. Crocker	Executive Vice President, Chief Legal Officer and Secretary
Mark D. Johnson	Senior Vice President and Chief Financial Officer
Timothy J. Friers	Senior Vice President and Chief Underwriting Officer
Paul R. Gabel	Senior Vice President, Claims and Risk Management
Eugenie H. Shea[(B)]	Senior Vice President, Chief Strategic Development Officer
Jeffery J. Smith	Vice President and Chief Actuary
Denis J. Dillon	Vice President, Finance and Treasurer
Dennis A. Meisel	Vice President, Finance and Controller
Douglas M. Hall	Vice President, Information Technology
Julia L. Burns	Vice President, Human Resources
Keith A. Hui	Vice President, Lead Integration Officer
Theodore G. Otto III[(C)]	Vice President and Managing General Counsel

Principal Officers (continued)

Dustin A. Shaver	Vice President, Risk Management
Neil E. Simons	Vice President, Regulatory Compliance and Product Development
Lucy D. Sam	Associate Vice President, Underwriting and Policyholder Services
Jane. M Tishkoff[C]	Associate Vice President and Assistant General Counsel
Bruce P. Williams	Associate Vice President, Actuarial

[A] As of December 31, 2012, there was one vacancy on the Board of Directors. On January 1, 2013, Steven J. Packer was appointed to fill that vacancy.

[B] On June 1, 2013, Ronald C. Rumin replaced Eugenie H. Shea as Senior Vice President, Chief Strategic Development Officer.

[C] Effective 2014, Theodore G. Otto III and Jane M. Tishkoff retired and the positions have not been filled.

Intercompany Agreements

Intercompany Affiliate Service Agreement: Effective January 1, 2009, the Company and PMSLIC Insurance Company (PMSLIC) entered into an Intercompany Affiliate Service Agreement which replaced the previous Cost Sharing Agreement. On July 23, 2011, the Intercompany Affiliate Service Agreement was amended to include NORCAL Management Company (NMC). Effective October 6, 2011, this agreement was amended and restated to include Medicus Insurance Holdings, Inc. (MIH) and Medicus Insurance Company (MIC). This Restated Intercompany Affiliate Service Agreement between the Company, PMSLIC, NMC, MIH, and MIC was approved by the California Department of Insurance (CDI) on October 20, 2011 pursuant to California Insurance Code (CIC) Section 1215.5(b)(4). Under the terms of this agreement, all the companies may share in and use the services of personnel and facilities of the other in carrying out the NORCAL Group’s business. The service rendered under this agreement may include accounting; taxes; auditing; underwriting; claims; investment; and functional support services. Compensation for the services is based on the actual cost. Indirect and shared expenses are allocated in accordance with a method of cost allocation in conformity with Statement of Statutory Accounting Principles No. 70 – Allocation of Expenses.

Tax-Sharing Agreement: Effective January 1, 2010, the Company entered into a Tax-Sharing Agreement with its subsidiaries NMC, PMSLIC and Infinity Management Services Inc. In October 2011, this agreement was amended and restated to include MIH and MIC. This Restated Tax-Sharing Agreement was approved by the CDI on December 9, 2011 pursuant to CIC Section 1215.5(b)(4) with a retroactive effective date of January 1, 2011. The agreement sets forth the manner in which the total combined federal income tax is allocated to each entity that is a party to the agreement. Pursuant to the agreement, the Company has the enforceable right to recoup federal income taxes paid in prior years in the event of future net losses that it may incur, or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes. The allocation is based upon separate return calculations with current credit for net losses and/or credit where the losses and/or credits result in an actual reduction in tax liability of the consolidated group.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2012, the Company is licensed to transact property and casualty insurance in the following states and territories:

Alaska	Maryland	Ohio
Arizona	Massachusetts	Oregon
California	Michigan	Pennsylvania
Connecticut	Nevada	Rhode Island
District of Columbia	New Jersey	Texas
Georgia	New Mexico	Virginia
Illinois	North Carolina	

Subsequent to December 31, 2012, the Company obtained licenses in the following states:

Alabama	Kansas	Nebraska
Arkansas	Kentucky	Oklahoma
Delaware	Louisiana	South Carolina
Florida	Minnesota	Utah
Indiana	Mississippi	Washington
Iowa	Missouri	West Virginia

Direct premiums written during 2012 totaled $149.1 million and were written in California (88.0%), Rhode Island (8.1%), Alaska (3.3%), New Jersey (0.5%), and New Mexico (0.1%). The Company's primary line of business written during 2012 was medical professional liability - claims-made (95.9%).

The Company issues professional and premises liability to physicians, medical groups and hospitals on a claims-made basis. Tail coverage (including death, disability and retirement) is offered as well and is issued on an occurrence basis. Business is acquired directly and through general agents and independent brokers. Underwriting is performed and policy files are kept at the home office in San Francisco, California. Claims are handled at the home office and the district offices in Anchorage, Alaska; Pasadena, California; and Providence, Rhode Island.

During 2013, a national expansion effort was initiated across the NORCAL Group of companies to allow the Company and Medicus Insurance Company (MIC) to become admitted carriers and PMSLIC Insurance Company (PMSLIC) to become a surplus lines carrier nationwide. As part of this effort, MIC has begun to transition its policies to the Company's paper effective January 1, 2014 for Texas policyholders and April 1, 2014 for Illinois policyholders. The remaining MIC and PMSLIC policyholders will transition to the Company's paper over the course of several years.

REINSURANCE

Pooling

Effective January 1, 2007, the Company entered into a pooling agreement with its wholly-owned subsidiary, PMSLIC Insurance Company (PMSLIC). Under the terms of this agreement, the Company is the lead company and assumes 100% of PMSLIC's net business. The Company retains 73% of the pooled business and cedes 27% to PMSLIC. The pooling agreement was approved by the California Department of Insurance (CDI) on March 6, 2007.

The Company also assumes 100% of Medicus Insurance Company's (MIC) net business under the reinsurance agreements discussed in the "Assumed" section below. The business assumed from MIC is pooled and retroceded in the pooling agreement above; however, MIC does not participate in the pool.

Assumed

The following assumed reinsurance contracts with its affiliates were in place during the examination period:

On July 19, 2011, the Company entered into two quota share reinsurance agreements with Healthcare Safety & Protection Risk Retention Group, Inc. (HSPRRG). Under the first agreement, the Company reinsures 90% of HSPRRG's book of business on a prospective basis from July 19, 2011 forward. Under the second agreement, the Company assumes 100% of the net liability of HSPRRG policies issued or renewed before the contract effective date on a retrospective basis. On June 30, 2013, HSPRRG was dissolved and the two reinsurance contracts were commuted. The Company then entered into a loss portfolio transfer (LPT) agreement to assume the entire book of business from HSPRRG (refer to the "Subsequent Events" section for further information).

Effective October 6, 2011 and concurrently with the Company's acquisition of Medicus Insurance Holdings, Inc. and its wholly owned subsidiary, Medicus Insurance Company (MIC), the Company entered into two reinsurance agreements with MIC. Both agreements were approved by the CDI on October 20, 2011 pursuant to California Insurance Code Section 1215.5(b)(3). Under the first agreement, the Company assumes 100% of MIC's net liability on policies issued or renewed on or after the closing date of the acquisition on a prospective basis. Under the second agreement, the Company assumes 100% of MIC's net liability on policies issued or renewed before the closing date of the acquisition.

Ceded

The following is a summary of principal reinsurance agreement in-force as of December 31, 2012:

Type of Contract	**Line(s) of Business**	**Reinsurer(s) and Participation**	**Company's Retention**	**Reinsurer's Limits**
Clash, Excess of Loss and Excess of Policy Limit Coverage Loss	Property and Casualty	Unauthorized: Hanover Reinsurance (Ireland) Ltd (60%) Torus Insurance (Bermuda) Limited (15%) Tokio Millenium Re Ltd (25%)	$2 million per occurrence	$20 million excess of $2 million per occurrence

In addition, the Company secures facultative coverage for policies which do not meet the conditions of the above treaty.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2012

Underwriting and Investment Exhibit for the Year Ended December 31, 2012

Reconciliation of Surplus as Regards Policyholders from December 31, 2008 through December 31, 2012

Statement of Financial Condition as of December 31, 2012

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$ 582,299,333	$	$ 582,299,333	(1)
Preferred stocks	7,449,890		7,449,890	
Common stocks	542,858,771	263,659	542,595,112	
Cash and short-term investments	53,114,865		53,114,865	
Other invested assets	10,215,566		10,215,566	
Aggregate write-ins for invested assets	24,792,903		24,792,903	
Investment income due & accrued	6,829,709		6,829,709	
Uncollected premiums and agents' balances in course of collection	72,606	72,606	0	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	63,368,981		63,368,981	
Amount recoverable from reinsurers	14,153,175		14,153,175	
Net deferred tax asset	16,622,987		16,622,987	
Electronic data processing equipment and software	2,185,312	1,562,318	622,994	
Furniture and equipment, including health care delivery assets	2,055,670	2,055,670		
Receivables from parent, subsidiaries and affiliates	1,315,632		1,315,632	
Aggregate write-ins for other than invested assets	17,144,172	16,877,929	266,243	
Total assets	$ 1,344,479,572	$ 20,832,182	$1,323,647,390	

Liabilities, Surplus and Other Funds			Notes
Losses		$ 311,856,625	(2)
Reinsurance payable on paid losses and loss adjustment expenses		10,848,999	
Loss adjustment expenses		175,911,154	(2)
Commissions payable, contingent commissions and other similar charges		974,706	
Other expenses (excluding taxes, licenses and fees)		14,874,937	
Taxes, licenses and fees (excluding federal and foreign income taxes)		18,810	
Current federal and foreign income taxes		3,730,157	
Borrowed money		9,379,688	
Unearned premiums		89,656,010	(2)
Advance premium		17,972,514	
Dividends declared and unpaid: Policyholders		12,400,000	
Ceded reinsurance premiums payable		4,201,618	
Funds held by company under reinsurance treaties		22,950,744	
Amounts withheld or retained by company for account of others		24,238,689	
Remittances and items not allocated		234,942	
Provision for reinsurance		55,808	
Payable to parent, subsidiaries and affiliates		96,500	
Payable for securities		734,406	
Aggregate write-ins for liabilities		15,953,104	
Total liabilities		716,089,411	
Unassigned funds (surplus)	$ 607,557,979		
Surplus as regards policyholders		607,557,979	
Total liabilities, surplus and other funds		$1,323,647,390	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2012

Statement of Income

Underwriting Income		
Premiums earned		$ 201,699,404
Deductions:		
Losses incurred	$ 82,148,407	
Loss expenses incurred	62,796,723	
Other underwriting expenses incurred	53,912,369	
Total underwriting deductions		198,857,499
Net underwriting gain		2,841,905
Investment Income		
Net investment income earned	$ 21,843,218	
Net realized capital gain	23,570,274	
Net investment gain		45,413,492
Other Income		
Net loss from agents' or premium balances charged off	$ (42,382)	
Aggregate write-ins for miscellaneous income	(6,682,727)	
Total other income		(6,725,110)
Net income before dividends to policyholders and federal and foreign income taxes		41,530,287
Dividends to policyholders		11,351,748
Federal and foreign income taxes incurred		356,500
Net income		$ 29,822,039

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2011		$ 579,475,220
Net income	$ 29,822,039	
Change in net unrealized capital gains	22,862,790	
Change in net deferred income tax	(90,389)	
Change in nonadmitted assets	516,792	
Change in provision for reinsurance	(28,469)	
Change in surplus notes	(25,000,000)	
Change in surplus as regards policyholders for the year		28,082,763
Surplus as regards policyholders, December 31, 2012		$ 607,557,979

Reconciliation of Surplus as Regards Policyholders from December 31, 2008 through December 31, 2012

	Gain in Surplus	Loss in Surplus	
Surplus as regards policyholders, December 31, 2008, per Examination			$ 388,943,949
Net income	$ 154,928,873	$	
Change in net unrealized capital gains	83,275,095		
Change in net deferred income tax		3,373,296	
Change in nonadmitted assets	459,724		
Change in provision for reinsurance		19,709	
Change in surplus notes		25,000,000	
Aggregate write-ins for gains in surplus	8,343,343		
Total gains and losses	$ 247,007,035	$ 28,393,005	
Net increase in surplus as regards policyholders			218,614,030
Surplus as regards policyholders, December 31, 2012, per Examination			$ 607,557,979

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Bonds

On September 14, 2011, the Company entered into a Credit Agreement with Wells Fargo Bank, National Association (Wells Fargo) to establish a $25 million revolving line of credit (LOC). In connection with this LOC, investment securities with a book adjusted carrying value of $37.7 million at December 31, 2012 were deposited into a custodial account with Wells Fargo as collateral. Effective September 14, 2011, the Company also entered into a Security Agreement: Securities Account and Securities Account Control Agreement with Wells Fargo granting Wells Fargo security interest in the above assets. The above agreements were reviewed and it was observed that the language in the agreements appear to be restrictive and do not seem to provide the type of "availability" contemplated by Statement of Statutory Accounting Principles (SSAP) No. 4. As such, it does not appear that the assets in the above custodial account qualify as admitted assets under SSAP No. 4. As of examination date, there was no outstanding balance on the LOC. The Company agrees to nonadmit any assets that are encumbered by amounts drawn on the LOC. The California Department Insurance's (CDI) concerns were presented to the Company along with recommendations to address them. It is recommended the Company amend the aforementioned agreements to address the concerns raised by the CDI and to permit the assets to be treated as admitted assets in accordance with SSAP No.4.

(2) Losses, Loss Adjustment Expenses, and Unearned Premiums

A Casualty Actuary from the California Department of Insurance reviewed the Summary of Estimated Unpaid Indemnity (Losses) and Loss Adjustment Expense (LAE) as of December 31, 2012 and the Provision for Future Utilization of Death, Disability and Retirement (DD&R) Benefit as of December 31, 2012 prepared by the Company's independent actuary and concurred with the independent actuary's conclusion that the

Company's reserves for losses and LAE and DD&R as of December 31, 2012 are reasonable and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Comments on Financial Statement items – Bonds (Page 16): It is recommended the Company amend the agreements surrounding the line of credit to address the concerns raised by the California Department of Insurance and to permit the assets to be treated as admitted assets in accordance with Statement of Statutory Accounting Principles No. 4.

Previous Report of Examination

Management and Control – Intercompany Agreements (Page 4): It was recommended that the Company amend its tax allocation agreement and file it with California Department of Insurance pursuant to California Insurance Code Section 1215.5(b)(4). The Company and its subsidiaries entered into a tax sharing agreement effective January 1, 2010. This agreement was amended and restated in October 2011. The restated tax sharing agreement was approved by the California Department of Insurance (CDI) on December 9, 2011. The Company is now in compliance.

Comments on Financial Statement Items – Common Stocks (Page 11): It was recommended that the Company file its subsidiary investments annually in accordance with the National Association of Insurance Commissioners Practices and Procedures of the Securities Valuation Office (SVO) Manual, Part 8. Effective April 14, 2014, the Company has established procedures to ensure compliance with SVO filling requirements and has filed its subsidiary investments as of December 31, 2012 with the SVO. *(Note: The filing requirements for subsidiary investments have since been moved to Part 5, Section 2 of the SVO Manual).* The Company is now in compliance.

<u>ACKNOWLEDGMENT</u>

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

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Li S. Lim, CFE
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California