

Harleysville Mutual Insurance Co. And Affiliated Property/Casualty Insurance Operating Companies

Primary Credit Analyst:

Siddhartha Ghosh, New York (1) 212-438-1466; siddhartha_ghosh@standardandpoors.com

Secondary Credit Analyst:

John Iten, New York (1) 212-438-1757; john_iten@standardandpoors.com

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Harleysville Mutual Insurance Co. And Affiliated Property/Casualty Insurance Operating Companies

Major Rating Factors

Strengths:

- Strong competitive position in the small, regional property/casualty insurance market.
- Very strong capital adequacy.
- Strong operating performance in recent years.
- Conservative financial leverage and strong interest coverage.

Weaknesses:

- Relatively high expense ratio relative to its peers'.
- Geographic concentration in the northeast.
- Reduced underwriting margin in the next couple of years.

Holding Company:
Harleysville Group Inc.

Counterparty Credit Rating

Local Currency
BBB-/Stable/--

Operating Companies Covered By This Report

Financial Strength Rating

Local Currency
A-/Stable/--

Rationale

The counterparty credit rating on Harleysville Group Inc. (HGI) and the insurer financial strength ratings on Harleysville Mutual Insurance Co. and its affiliated property/casualty insurance companies (collectively referred to as Harleysville) reflect the companies' strong competitive position in the small, regional property/casualty insurance market. The ratings also reflect their very strong capital adequacy, strong operating performance in recent years, conservative financial leverage, and strong fixed-charge coverage. Partially mitigating these positive rating factors are the companies' relatively high expense ratio relative to its peers', geographic concentration in the northeast, and reduced underwriting margin in the next couple of years.

Harleysville has a strong competitive position in the Mid-Atlantic region, where it focuses primarily on small commercial accounts with an average premium of \$25,000 or less. This small account segment constitutes more than 90% of Harleysville's commercial accounts. The company's decentralized business structure through local management teams, field underwriters, and claims-handling services has helped foster strong business relationships with independent agencies for many years. This is also demonstrated by Harleysville's commercial lines policy retention of more than 80% and personal lines policy retention of greater than 85% for the past few years.

Standard & Poor's Ratings Services considers Harleysville's capital adequacy very strong and a strength to the rating. The operating companies' consolidated statutory surplus increased by an average 7.9% over the past five years, supported by strong operating earnings. Most notably, the company's surplus dropped only 3.4% in 2008, when some of its regional peers reported a significant decline in surplus. The quality of capital is also very good because of the high-quality investment portfolio supporting its liabilities, improved loss reserve adequacy from historical levels, and relatively low reinsurance recoverables. Slightly mitigating the quality of capital is the company's relatively high property catastrophe exposures.

Harleysville's operating performance was strong in recent years despite continuing pricing pressure in its commercial lines coupled with recently volatile investment conditions. Harleysville's statutory combined ratio deteriorated to 101.7% in 2008 from 97.4% in 2007. The primary reason for the increase in the combined ratio was the catastrophe losses resulting from higher-than-usual tornado and hailstorm activities in the Midwest, which contributed 3.7 percentage points to the 2008 combined ratio, compared with 1.2 points in 2007. Another measure of operating profitability, pretax return on revenue (ROR), was strong at 12% in 2008, compared with 15.2% in 2007. The quality of earnings is also good because of the company's improved reserve adequacy, low volatility from its predominant small commercial accounts, and stable net investment income from its high-quality and conservative investment portfolio. As of June 30, 2009, Harleysville's statutory combined ratio was 101.2%, which was a slight improvement from 103.7% in 2008.

HGI's financial leverage is conservative, with debt to adjusted capital at 18.1% in 2008, a moderate increase from 11.6% in 2007 but still very conservative for the rating. Historically, HGI's adjusted financial leverage has been at or below 18% for the past five years. HGI's fixed-charge coverage was very strong at 17.8x in 2008, compared with 21x in 2007. HGI's statutory interest coverage, which measures the ordinary dividend capacity from its operating subsidiaries, was also very strong at 17.6x in 2008, versus 16.4x in 2007.

Harleysville's expense ratio remains relatively high, which averaged 34.4% over the past five years (2004-2008). To address this issue, management has taken some initiatives over the past few years, such as enhancing technology, reducing staff, outsourcing, and consolidating back-office functions. Despite such efforts, the expense ratio has not changed significantly in recent periods. The expense ratio rose further to 35.1% through June 30, 2009, from 34.0% during the same period in 2008.

Harleysville is a Mid-Atlantic-based regional writer with significant business concentration in selected northeast states, exposing the company to significant losses from potential northeast hurricanes. The top five states in terms of 2008 net premiums written were: New York (22%), Pennsylvania (18%), New Jersey (13%), Massachusetts (6%), and Virginia (5%), with a combined total of 64%. The largest risks to the company are northeast hurricanes, which could have a significant impact on its surplus. Slightly mitigating this concern is that the company does not provide property coverages in the Gulf Coast or in Florida. Management also has taken many initiatives to reduce its property exposures in the coastal regions, which include increased insurance to value (ITV) and deductibles for its personal lines policies in recent years.

Like many other property/casualty insurers, Harleysville continues to face competitive pricing pressure in its commercial lines, particularly in the middle market, which constitutes approximately half of its overall premium writings. This is evidenced by the 9.3% reduction in net premiums written for commercial lines through June 30, 2009. Slightly offsetting this decline is the company's personal lines premium, which increased by 7.2% in the same period.

Factors Specific To Holding Company

Standard & Poor's views HGI's overall liquidity as strong. The liquidity resources at the holding company include cash and short-term investments, which we expect to meet at least one year of the parent company's cash obligations. HGI had \$18 million of cash and marketable securities as of June 30, 2009, which the company could use for general corporate purposes. In addition, HGI received \$163.1 million of dividends from its operating

companies in 2008. Liquidity sources at the holding company are more than adequate to support its debt service, which is \$118.5 million with an estimated annual interest payment of approximately \$6.5 million in 2009. HGI has no scheduled principal payments due on its long-term senior debt outstanding until July 15, 2013. However, a loan of \$18.5 million from Harleysville Mutual Insurance Co. matures in 2012, which was used to finance the acquisition of New York Casualty Co. in 1990. HGI has maintained conservative financial leverage in its capital structure over the past few years. HGI's financial leverage was a conservative 18.1% in 2008, a moderate increase from 11.6% in 2007, and has not exceeded 18% in the past five years. HGI's fixed-charge coverage was very strong at 17.8x in 2008, compared with 21x in 2007. HGI's statutory interest coverage, which measures the ordinary dividend capacity from its operating subsidiaries, was also very strong at 17.6x in 2008, versus 16.4x in 2007.

As part of its capital management strategy, the company has been routinely using dividend income from its operating subsidiaries to finance stock repurchases over the past couple of years. HGI's board approved two share repurchase programs in 2007, each for 1.5 million shares, and approved a third repurchase plan in 2008 for 1.6 million shares. The company had completed these stock repurchases as of year-end 2008. In 2009, the board also has approved two stock repurchase programs of 800,000 shares, each over a period of two years. The company has completed half of these repurchases from the open public float, and the remainder is pending. The estimated amount of the share repurchase in 2009 is \$25 million, which HGI will finance primarily through its operating company dividends.

On Aug. 18, 2006, HGI entered into a credit agreement with HSBC Bank USA for a \$100 million, five-year revolving credit facility. The credit facility was available for general corporate purposes. HGI did not make any borrowings under the credit facility, and it remained in compliance with all applicable covenants. Effective Jan. 8, 2008, the company terminated the credit agreement because it felt it no longer needed the facility. However, this eliminates a potential liquidity source for the holding company.

Table 1

Harleysville Group Inc./Financial Statistics					
	--Year ended Dec. 31--				
	2008	2007	2006	2005	2004
Debt to capital (%)	18.1	11.7	14.3	16.3	17.5
Debt plus preferred (including hybrids) to total capital (%)	18.1	11.7	14.3	16.3	17.5
GAAP interest coverage (EBITDA) (x)	18.7	21.6	18.5	13.7	8.7
GAAP fixed-charge coverage (EBITDA) (x)	18.7	21.6	18.5	13.7	8.7
Statutory interest coverage (x)	17.6	16.4	17.7	10.3	8.9
Statutory fixed-charge coverage (x)	17.6	16.4	17.7	10.3	8.9

Chart 1

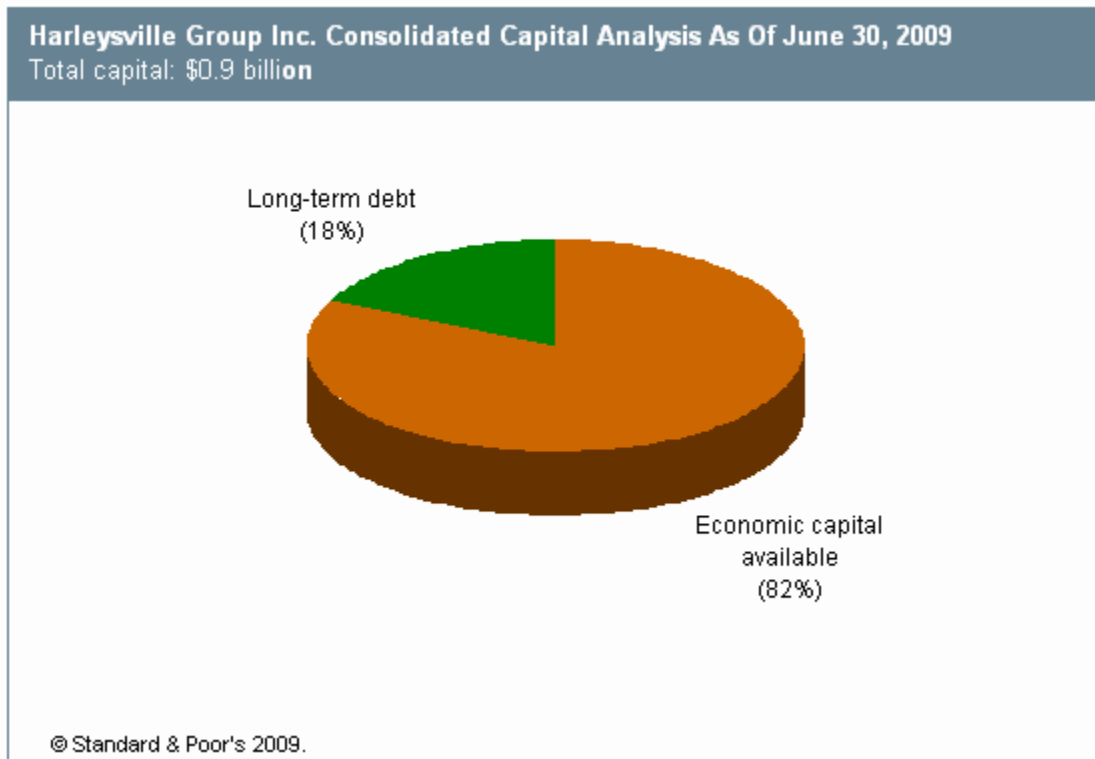
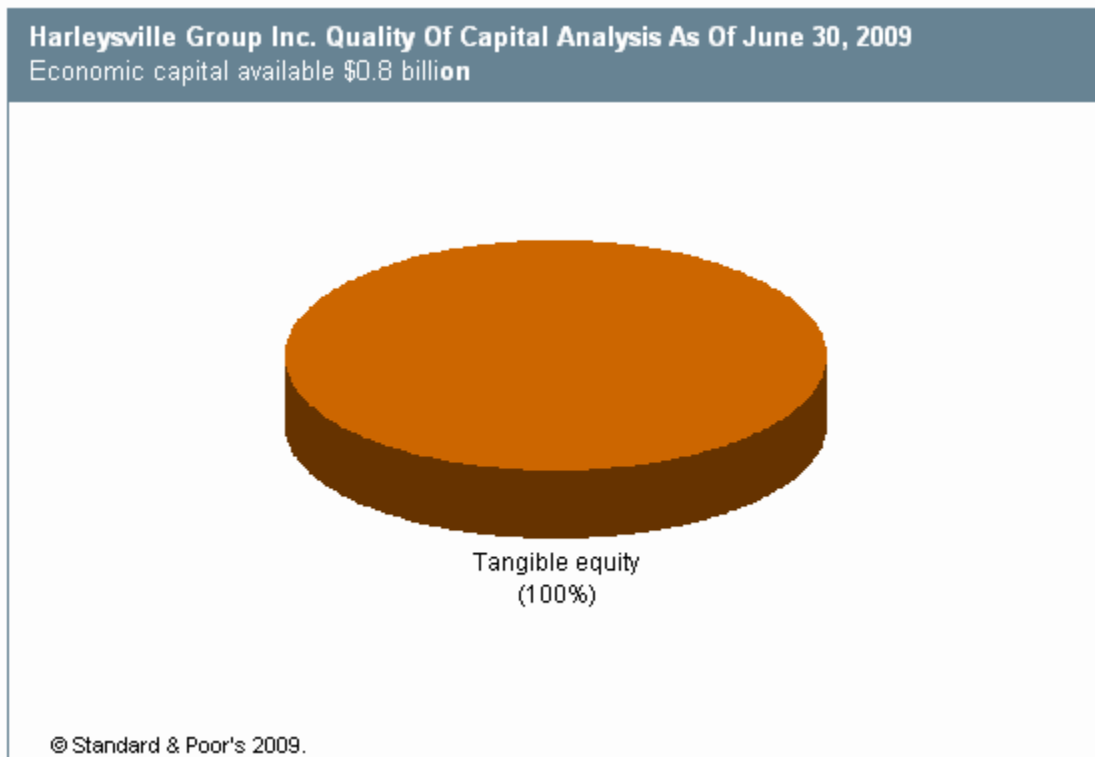


Chart 2



Outlook

Standard & Poor's expects Harleysville to maintain its strong competitive position throughout the current cycle using good underwriting discipline and strong cycle management. Standard & Poor's believes Harleysville will experience lower underwriting margins from continuing price competition in its commercial lines coupled with reduced premium income resulting from lower exposures from reduced payroll and the weak economic conditions. Harleysville's commercial lines premium will continue to decline, especially in the middle market, while its personal lines premium will show moderate growth through rate increases and increased use of the new Web-based auto quote system. Standard & Poor's expects Harleysville to report a statutory combined ratio of 101%-102% and a pretax ROR of 8%-10% over the next two years, assuming normal catastrophe losses. In addition, Harleysville's consolidated operating company capital adequacy will remain very strong for the next couple of years. Standard & Poor's also expects HGI's financial leverage to remain conservative and its GAAP fixed-charge coverage (excluding realized gains/losses) to be 3x-5x.

Competitive Position: Strong Regional Business Focus With Increased Emphasis On Predictive Modeling

Harleysville has a strong competitive position in the northeast and Mid-Atlantic regions, where it offers personal and commercial lines that are distributed in 32 states. The company's decentralized business structure through local management teams, field underwriters, and claims-handling services has helped foster strong business relationships with independent agencies for many years. Harleysville's commercial lines policy retention of more than 80% and personal lines policy retention in excess of 85% over the past few years also demonstrate this strong relationship with independent agents. The company operates through four regional offices in Chicago; Atlanta; Worcester, Massachusetts; and Harleysville, Pennsylvania (headquarter), as well as 14 branch offices. The company uses approximately 1,400 independent agents to distribute its personal and commercial lines products, and it is ranked in the top two carriers among 60% of its agencies and is in the top four among 80%. The company has a well-developed predictive model for pricing and underwriting commercial accounts. Using this model, the company is able to assess risk-based pricing by individual lines in real time, which is then rolled up to an account level pricing before being quoted to its agents. Harleysville has been able to improve the overall quality of its commercial lines risks using this predictive model, which the company has been using since 2006.

Harleysville is primarily a commercial lines writer, which constitutes 82% of its overall premiums in 2008 and hasn't changed much in the past few years. In commercial lines, the company focuses on small accounts (average premium size of \$25,000 or less), which constitute more than 93% of its commercial lines accounts. Although middle market (account size of more than \$25,000) commercial business represents a moderate 7% of the company's accounts, it represents about half of Harleysville's overall commercial lines premium writings. As prices continue to decline in commercial lines, especially in the midmarket sector, top-line premium will continue to decrease. This is evidenced by a 2.2% decline in the company's direct premiums written for small accounts in 2008, in contrast with a much deeper decline of 5.1% for midmarket accounts. This is even more pronounced for new business, which showed an increase of 3.8% in small accounts versus a decline of 9.4% for midmarket commercial accounts. Workers' compensation was a poorly performing line for the company, as evidenced by many years of adverse reserve development in this line prior to 2004. Since then, the company has made a number of improvements, which include focusing on small accounts, reducing exposures in construction business, using

predictive modeling for alignment of risks, and improving its claims reporting systems. Despite these efforts, workers' compensation remains highly unprofitable for the company, as demonstrated by its accident-year combined ratios of more than 110% in the past three years. Slightly mitigating this issue is that the company's workers' compensation business is a moderate 13% of its overall commercial lines direct premiums written and that the related exposures are well diversified into many classes and states without a meaningful concentration.

Table 2

Harleysville Insurance Group/Selected Statistics					
--Year ended Dec. 31--					
(Mil. \$)	2008	2007	2006	2005	2004
Total revenue	1,319.9	1,331.3	1,329.1	1,319.9	1,310.6
Net income	74.7	189.9	196.1	104.7	70.3
Combined ratio (%)	101.7	97.4	99.4	101.9	106.4
Return on revenue (%)	12.0	15.2	12.8	8.9	4.3
Total assets	3,780.1	4,060.9	3,922.4	3,666.3	3,396.1
Statutory surplus	1,095.6	1,135.1	1,083.2	915.0	818.8
Capital adequacy ratio (%)	N.A.	152.1	220.3	220.3	195.2

N.A.--Not available.

Table 3

Harleysville Insurance Group/Business Statistics					
--Year ended Dec. 31--					
(Mil. \$)	2008	2007	2006	2005	2004
Commercial multiple peril liability	223.5	234.7	232.6	227.3	212.0
Commercial multiple peril nonliability	214.2	218.0	213.6	205.5	194.7
Commercial auto liability	203.0	215.5	228.3	242.7	244.6
Workers' compensation	125.9	134.7	134.9	133.1	133.9
Homeowners' multiple peril	94.9	93.0	87.7	84.3	87.1
Other liability	68.2	66.0	63.5	59.6	55.8
Other premiums	200.8	202.0	204.5	225.1	250.5
Total net premiums written	1,130.5	1,163.9	1,165.0	1,177.6	1,178.7
Total change in net premiums written (%)	(2.9)	(0.1)	(1.1)	(0.1)	N.A.

N.A.--Not available.

Harleysville's personal lines business generated 18% of the company's overall 2008 premium, which was equally split between personal auto and homeowners businesses. The company's personal line has performed well in recent years except for 2008, which was adversely affected by tornadoes and hailstorms in the Midwest that were more severe than normal. The single biggest risk associated with the company's personal lines business is its exposure to northeast hurricanes, which could have a large impact on the company's surplus. The company has been actively addressing this issue by reducing its PML exposures, increasing distance to coastal regions, and implementing deductibles in catastrophe-prone exposures, in addition to purchasing higher limits on property catastrophe reinsurance coverage. The company recently rolled out a new Web-based portal to increase its agency penetration and to more easily quote activities in its personal lines. Early signs indicate that there has been some progress through the first half of 2009, which saw an increase in new personal lines net premiums written of 7.2% over the

same period in 2008.

Diversification

Harleysville is primarily a Mid-Atlantic-based regional writer. It has a significant business concentration in the northeast, exposing the group to natural catastrophe losses. The group's top five states in terms of premium volume are New York (22%), Pennsylvania (18%), New Jersey (13%), Massachusetts (6.0%), and Virginia (5%), which together produced 64% of the company's 2008 direct premiums written. The company has large exposures to northeast hurricanes, as evidenced by its modeled net probable maximum loss (PML) to surplus ratio for a one-in-250-year property catastrophe event of 25% as of year-end 2008, which we consider quite high, especially compared with some of its peers'. However, this ratio declined slightly from 30% in 2007 as the company has reduced its PML exposures in the coastal regions. Slightly offsetting this property catastrophe concentration risk is that Harleysville does not provide any property coverage in the Gulf Coast or in Florida.

Prospective

We expect Harleysville to maintain its strong competitive position in the small commercial accounts through the use of predictive modeling. The company's overall premium likely will decline in the next couple of years as commercial lines premiums decrease as a result of currently competitive pricing. However, moderate growth in personal lines through increased agency penetration resulting from the use of the company's Web-based quote system should slightly mitigate this decline. We expect the company to withstand the current underwriting cycle using strong underwriting discipline and cycle management, as well as by monitoring its risks as part of its ERM process.

Management And Corporate Strategy: Focusing On Increasing Operating Efficiency

Harleysville's corporate strategy focuses on greater efficiency within the organization through strong corporate oversight as well as improving operating profitability. Strategically, the company is underwriting focused, servicing small- to medium-size markets and offering both personal and commercial lines products through independent agents. Senior management has spent a considerable amount of time, money, and resources over the past few years to restructure its agency force to retain only the profitable agents and eliminate the ones with weaker operating results.

Under the leadership of CEO Michael Browne since 2004, the organization has made many changes to its business processes, technological efficiencies, and risk-management culture, particularly in the underwriting culture. Prior to joining the company, Mr. Browne was an independent director who served on the board for 18 years and was a Pennsylvania insurance commissioner from 1980-1983. The company brought in many senior professionals at various levels, ranging from underwriting, actuarial, claims, and technology. The management team has been stable in the past few years. The management compensation structure is tied to the performance of the public company, HGI.

Operational management

The company has extensive risk controls and performance measures in the areas of loss reserving, claims management, and operational efficiencies. Under the current management, Harleysville has undertaken many initiatives over the past few years in the areas of technological efficiencies, replacing many legacy systems by integrating systems for ease of doing business with the agents, terminating unprofitable agents, and instilling an underwriting performance-based culture in the company. Harleysville's operational structure is based on a

decentralized strategy, where the individual territory managers are responsible for both new and renewal businesses at the branch offices. The performance measure of these managers is directly tied to the underwriting profitability of the businesses generated. The company also has developed a state-of-the-art multivariate predictive model, which it uses to underwrite its commercial accounts based on various risk classifications. The application of this modeling has improved the overall quality of risks in the commercial area.

Financial management

We consider Harleysville's financial risk tolerances to be moderate. The company has a conservative stance in terms of using financial leverage, which has averaged less than 20% in the past five years. However, Harleysville remains highly exposed to northeast hurricanes, which makes the company vulnerable to large catastrophe losses that could reduce its surplus significantly. Slightly mitigating this concern is the excess capital at the operating companies, which could partially mitigate such losses. Management also has been proactive in reducing its balance-sheet volatility in the past few years by applying a higher level of confidence to its loss reserves than its pre-2004 levels. Historically, Harleysville had a high expense ratio structure, which reveals some operational inefficiencies and a slight competitive disadvantage. However, an increased focus on technological improvements, a reduction of staff to support the current business, and the outsourcing of noncore functions to third parties will potentially reduce the company's overall expense ratio, though not in the near term as premium volume continues to decline because of the currently competitive pricing conditions.

Enterprise Risk Management: Adequate, With Good Risk Controls In Most Key Areas Of Operations

We view Harleysville's overall ERM process as adequate. Management has elevated the importance of ERM throughout the organization by going through significant changes in internal risk controls, underwriting processes, and audit controls in the past five years under the leadership of Michael Browne (CEO), who has been in this position since 2004. The company recently formed an ERM council (ERMC) with many members from cross-functional teams within the organization. Each member has individual accountability and ownership of key risks. Prior to the appointment of Mr. Browne, each business unit managed its risks separately with limited coordination with senior management. The divergence of disciplines resulted in significant errors in projecting the direction of claims cost and pricing risk adequately, as the company's long history of subpar underwriting results demonstrates. A historical weakness for the group is its inadequate reserving controls, which led to significant reserve strengthening in those years. The company has made several risk-control improvements in the area of claims, which make reserving risk controls less of a concern.

We view the group's risk culture, which is integral to the entire organization, as strong. There are formal risk committees and risk controls to identify and mitigate risks at all functional levels.

The company's major risks are controlled in an adequate to strong manner. We do not expect the group to experience losses outside of what is normal for its traditional risk areas. In addition to the risk controls, the company has developed a sophisticated predictive model, which it has used to make key underwriting and pricing decisions for small commercial lines. In addition, the company has developed a benchmark capital model that it uses for making strategic decisions in terms of growth and new product opportunities.

The company is in the process of developing additional tools to measure returns on risk-based capital as determined by its benchmark capital model. We expect the ERM process under the current management team to continue to

improve as the company makes good progress in its strategic risk management. This will largely be predicated on a fully developed economic capital model and proven success with reserve risk management. ERM will remain a key component of the company's business strategy in the long run.

Accounting

Harleysville reports its financials on both GAAP and statutory bases. One important area, which requires judgments and estimates, is the group's ability to estimate its loss and loss-adjustment expense reserves appropriately. We often adjust our capital model for an insurer to reflect the company's view of its reserve redundancy, adequacy, or deficiency. We viewed Harleysville's reserves as adequate based on our own analysis of Schedule P data as of year-end 2008. Based on our findings, we did not make any adjustments related to reserve deficiency/redundancy while calculating the group's consolidated capital adequacy in 2008. We believe there are no material accounting issues that have had a material adverse impact on the company's earnings or capital adequacy.

Operating Performance: Steady Investment Income Supports Strong Operating Performance

Harleysville's operating results have been strong in recent years and were supported by strong net investment income and, to a lesser extent, underwriting profitability. The company's statutory combined ratio deteriorated slightly to 101.7% in 2008, of which 3.7 percentage points were related to catastrophe losses, primarily because of tornado and hailstorm activities in the Midwest (Minnesota and Arkansas). In 2007, the statutory combined ratio was 97.4%, of which 1.2 percentage points were related to catastrophe losses. Another measure of operating profitability, as determined by Standard & Poor's, is the pretax ROR (defined as pretax income excluding realized gains/losses divided by total revenue). The company's statutory ROR was strong at 12% in 2008, compared with 15.2% in 2007. The quality of earnings is very good as a result of the company's improved loss reserve adequacy from historical levels prior to 2004, low volatility from its primarily small accounts (less than \$25,000), and stable investment income from its high-quality and conservative investment portfolio with very modest equity exposures.

Harleysville's expense ratio remains relatively high, averaging 34.4% over the past five years. Management has been proactively addressing the expense issue by taking some initiatives in the past few years, which include enhancing technological efficiencies and IT systems, reducing staff levels, outsourcing, and consolidating its back-office functions. Management spent a considerable amount of time, money, and resources restructuring its agency force--keeping the agents that were profitable and eliminating the weak performers. Nevertheless, these efforts have not paid off in recent years in terms of improving the expense ratio, which continues to increase slightly.

Table 4

Harleysville Insurance Group/Operating Statistics					
	--Year ended Dec. 31--				
(Mil. \$)	2008	2007	2006	2005	2004
Total revenues	1,319.9	1,331.3	1,329.1	1,319.9	1,310.6
Pretax operating income (excluding realized gains)	158.6	201.8	170.8	117.3	56.6
Net income	74.7	189.9	196.1	104.7	70.3
Return on revenue (%)	12.0	15.2	12.8	8.9	4.3
Return on assets (%)	1.9	4.8	5.2	3.0	2.1

Table 4

Harleysville Insurance Group/Operating Statistics (cont.)					
Return on statutory surplus (%)	6.7	17.1	19.6	12.1	8.9
Loss ratio (%)	66.9	63.0	64.6	66.9	72.5
Expense ratio (%)	34.6	34.2	34.7	34.9	33.5
Policyholders' dividend ratio (%)	0.1	0.2	0.2	0.2	0.3
Combined ratio (%)	101.7	97.4	99.4	101.9	106.4
Operating ratio (%)	13.1	17.5	14.4	9.7	4.7
Portfolio performance					
Net investment income	169.9	172.4	160.8	136.8	130.5
Net yield (%)	4.9	4.9	4.8	4.5	4.5
Net capital gain or loss	(53.7)	33.9	23.2	8.0	24.8
Portfolio composition					
Cash and short-term investments (%)	7.3	8.7	8.6	10.8	11.4
Bonds (%)	85.4	82.9	82.5	76.4	76.2
Preferred and common stocks (%)	6.5	7.9	8.2	11.6	11.5
Real estate and mortgage loans (%)	0.0	0.0	0.1	0.2	0.2
Other invested assets (%)	0.8	0.5	0.6	1.0	0.7
Invested assets to total assets (%)	86.9	88.3	87.6	87.5	86.0
Average maturity of bond portfolio (years)	4.5	4.7	5.2	4.9	5.7

Current performance

As of June 30, 2009, Harleysville's statutory combined ratio was an unprofitable 101.2%, a moderate improvement from 103.7% during the same period in 2008. The statutory expense ratio increased slightly to 35.1% through June 30, 2009 (including 0.5 points related to management fees), compared with 34.0% in the same period in 2008. Prior-year reserve releases and catastrophe losses together contributed favorably to the combined ratio in 2009 by adding 2.7 percentage points, and they were unfavorable in 2008, adding 3.6 percentage points.

Prospective

Although the company's primary focus on small commercial lines and its disciplined underwriting would somewhat mitigate a steep decline in pricing, overall underwriting results will remain unprofitable for the next couple of years. The commercial lines premium will continue to decline, especially in the middle market, while personal lines premium will grow modestly through rate increases and the company's new Web-based auto quote system. We also expect Harleysville to report a statutory combined ratio of 101%-102% and a pretax ROR of 8%-10% over the next 12 months, assuming normalized catastrophe losses. The expense ratio will remain relatively high at or slightly above its current level.

Investments And Liquidity: Conservative, High-Quality Investment Portfolio And Flat Investment Income In 2008 Despite A Tough Year

Standard & Poor's views Harleysville's investment strategy as conservative. The company maintains a high-quality and diversified portfolio of assets that inherently limits the amount of credit risk. The company's investment portfolio is designed to perform consistently in all market conditions. A testament to this investment strategy was the company's modest investment-related losses in 2008, which were lower than many of its peers'. The company

assumes an aftertax investment income strategy, not a total return focus. There is very little portfolio turnover and a high municipal allocation, which is common for this sector. The company's equity investment is largely based on an index strategy via vanguard funds--midcap to large cap and some international funds. The total impairment on a pretax basis was a very modest \$22.8 million in 2008, which was 2.1% of its year-end 2008 surplus. As of March 31, 2009, the investment portfolio consisted of corporate, 31.4%; municipals, 37.7%; U.S. government and agency securities, 5.6%; mortgage-backed securities, 15.4%; common equity, 6.2%; and short-term investments, 3.7%. The fixed-income portfolio is of a high quality, with an average credit rating of 'AA+', and 51% of investments are in 'AAA' rated securities, 32% in 'AA', 13% in 'A', and a modest 4% in 'BBB' or lower. The interest rate risk is relatively low, with an average duration of 3.8 years, which closely matches the average liability duration of 3.0 years.

Table 5

Harleysville Insurance Group/Financial Statistics					
	--Year ended Dec. 31--				
(Mil. \$)	2008	2007	2006	2005	2004
Total assets	3,780.1	4,060.9	3,922.4	3,666.3	3,396.1
Statutory surplus	1,095.6	1,135.1	1,083.2	915.0	818.8
Capital adequacy ratio (%)	N.A.	152.1	220.3	220.3	195.2
Loss and loss adjustment expense reserves/statutory surplus (x)	1.8	1.7	1.8	1.9	2.0
Common stock to surplus (%)	19.4	24.8	25.9	40.7	41.2
Reinsurance utilization ratio (%)	10.2	9.9	9.4	9.2	8.7
Reinsurance recoverables to surplus (%)	33.1	341.9	343.0	396.6	407.6
Underwriting cash flow ratio (%)	101.3	110.5	112.1	113.9	100.5
Operating cash flow ratio (%)	112.9	119.5	122.5	125.5	112.8

N.A.--Not available.

Harleysville's operating cash flow remains strong, with an operating cash flow ratio of 112.9% in 2008, compared with 119.5% in 2007. The decline resulted primarily from larger catastrophe losses and lower premium income in 2008. Despite a tough year, the company's net investment income remained about flat at \$170 million in 2008 from \$172 million in 2007.

Capitalization: Very Strong, Enhanced By Strong Operating Earnings And Improved Reserve Adequacy

Harleysville's capital adequacy historically has been very strong and is a clear strength to the rating. Harleysville's consolidated operating company capital adequacy, as determined by Standard & Poor's capital model as of year-end 2008, shows significant redundancy and is well above the rating. Although the company's statutory surplus declined by a moderate 3.4% in 2008, it increased by an average 7.9% over the past five years (2002-2008), fueled by strong earnings in recent years. The quality of capital is very good because of the company's high-quality investment portfolio, with no subprime exposures and very modest equity exposures. Somewhat mitigating the company's quality of capital is its relatively high property catastrophe exposures relative to surplus, as measured by the modeled one-in-250-year property catastrophe event, which the company estimates at 25% of its year-end 2008 surplus. This is relatively high compared with some of its regional peer companies'.

Prospective

Assuming no major capital losses from investments or otherwise, we expect Harleysville's capital adequacy to remain very strong over the next couple of years, enhanced by strong earnings and stable investment results.

Reserves

Standard & Poor's believes Harleysville's loss reserves are adequate, and we expect them to remain so for the next couple of years. The company's loss reserve adequacy has improved significantly since its pre-2004 level. The company posted relatively stable average prior-period reserve releases (as a percentage of prior year-end surplus) of negative 0.5% over the past five years. Harleysville has had favorable prior-year reserve developments for the past four years. The reserving philosophy has changed significantly under the new management, which set forth strict guidelines that are in sharp contrast with the group's prior practices of setting reserves. Management is more proactive in its reserving philosophy than it had been.

Harleysville also has a moderate amount of asbestos and environmental (A&E) exposures. As of year-end 2008, the group's net asbestos reserves totaled \$11.5 million, compared with \$14.2 million in 2007. In addition, the group's net environmental reserves totaled \$16.3 million at year-end 2008, versus \$16.8 million in 2007. Because of its relatively small size compared with the total net reserve base of \$2.0 billion as of year-end 2008, we believe the company's A&E reserves do not pose any material threat to its overall reserve adequacy or capital adequacy.

Reinsurance

Harleysville uses reinsurance to protect its balance sheet and manage earnings volatility related to catastrophe and noncatastrophe losses. The company uses a diverse group of reinsurers, 90% of which have strong credit quality. The current property catastrophe reinsurance program covers losses up to \$425 million in excess of \$50 million retention, with coparticipations averaging 24%. The current coverage limit has been expanded for the current year from the expiring limit of \$375 million. The company has been actively increasing its property catastrophe limits in the past couple of years because of its increased ITV exposures from its homeowners' coverages. Harleysville does not provide property coverage in the Gulf Coast or Florida, which eliminates the potential for hurricane-related losses in this region. The other reinsurance programs include its major casualty lines with various limits of up to \$58 million and net retentions of up to \$2.5 million. These casualty coverages include nuclear, biological, and chemical exposures.

Financial Flexibility: Enhanced By Conservative Financial Leverage And Low Reinsurance Utilization

Standard & Poor's views Harleysville's financial flexibility as strong. HGI's adjusted financial leverage remains conservative, with debt to adjusted capital of 18.1% as of year-end 2008, compared with 11.6% in 2007. On a historical basis, HGI's financial leverage had been less than 18% in each of the past five years. Also, HGI's GAAP fixed-charge coverage was a strong 17.8x as of year-end 2008, compared with 21x in 2007. HGI's statutory interest coverage, which measures the ordinary dividend capacity from its operating subsidiaries, was also very strong at 17.6x in 2008, compared with 16.4x in 2007. In addition to the dividend stream from operating companies, HGI receives a modest management fee income from Harleysville Mutual Insurance Co., which is an additional source of cash at the holding company. Also enhancing financial flexibility is the company's low reliance on reinsurance utilization, which averaged 9.5% over the past five years.

Ratings Detail (As Of October 19, 2009)*

Holding Company: Harleysville Group Inc.

Issuer Credit Rating	
<i>Local Currency</i>	BBB-/Stable/--
Senior Unsecured (1 Issue)	BBB-

Operating Companies Covered By This Report

Harleysville Mutual Insurance Co.

Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Counterparty Credit Rating	
<i>Local Currency</i>	A-/Stable/--

Harleysville-Atlantic Insurance Co.

Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--

Harleysville Insurance Co.

Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--

Harleysville Insurance Co. of New York

Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--

Harleysville Insurance Co. of NJ

Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--

Harleysville Insurance Co. of Ohio

Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--

Harleysville Lake States Insurance Co.

Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--

Harleysville Pennland Insurance Co.

Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--

Ratings Detail (As Of October 19, 2009)*(cont.)	
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--
Harleysville Preferred Insurance Co.	
Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--
Harleysville Worcester Insurance Co.	
Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--
Mainland Insurance Co.	
Financial Strength Rating	
<i>Local Currency</i>	A-/Stable/--
Issuer Credit Rating	
<i>Local Currency</i>	A-/Stable/--
Domicile	Pennsylvania

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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