

SECURITIES AND EXCHANGE COMMISSION

FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

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FILER

**HARLEYSVILLE GROUP INC**

CIK: **792013** | IRS No.: **510241172** | State of Incorporation: **DE** | Fiscal Year End: **1231**  
Type: **10-Q** | Act: **34** | File No.: **000-14697** | Film No.: **111183238**  
SIC: **6331** Fire, marine & casualty insurance

Mailing Address  
355 MAPLE AVE  
HARLEYSVILLE PA  
19438-2297

Business Address  
355 MAPLE AVE  
HARLEYSVILLE PA  
19438-2297  
2152565000

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2011

OR

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-14697

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**HARLEYSVILLE GROUP INC.**

(Exact name of registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of  
incorporation or organization)

51-0241172  
(I.R.S. Employer  
Identification No.)

355 Maple Avenue, Harleysville, PA 19438-2297

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (215) 256-5000

N/A

(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes  No .

At November 2, 2011 27,188,176 shares of common stock of Harleysville Group Inc. were outstanding.

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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

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### Item 1. Financial Statements

#### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (in thousands, except share data)

|  | September 30,<br>2011 | December 31,<br>2010 |
|--|-----------------------|----------------------|
|  | (Unaudited)           |                      |
| <b>Assets</b>  |                       |                      |
| Investments:   |                       |                      |
| Fixed maturities:  |                       |                      |
| Held to maturity, at amortized cost (fair value \$132,410 and \$156,967)   | \$125,128             | \$148,362            |
| Available for sale, at fair value (amortized cost \$1,897,400 and \$2,069,097)   | 2,052,474             | 2,165,101            |
| Equity securities, at fair value (cost \$268,338 and \$191,095)  | 317,319               | 268,104              |
| Short-term investments, at cost, which approximates fair value   | 113,588               | 79,909               |
| Total investments  | 2,608,509             | 2,661,476            |
| Cash   | 36                    | 39                   |
| Premiums receivable  | 131,972               | 133,758              |
| Reinsurance recoverables   | 272,816               | 219,149              |
| Accrued investment income  | 23,149                | 26,910               |
| Deferred policy acquisition costs  | 105,778               | 113,997              |
| Prepaid reinsurance premiums   | 55,007                | 51,625               |
| Property and equipment, net  | 12,913                | 13,312               |
| Deferred income taxes  | 4,745                 | 9,413                |
| Other assets   | 67,507                | 48,553               |
| Total assets   | <u>\$3,282,432</u>    | <u>\$3,278,232</u>   |
| <b>Liabilities and Shareholders' Equity</b>  |                       |                      |
| Liabilities:   |                       |                      |
| Unpaid losses and loss settlement expenses (affiliate \$163,330 and \$214,518)   | \$1,841,366           | \$1,771,661          |
| Unearned premiums (affiliate \$(9,692) and \$32,935)   | 467,132               | 503,532              |
| Accounts payable and accrued expenses  | 81,089                | 96,461               |
| Due to affiliate   | 22,566                | 19,445               |
| Debt (affiliate \$18,500 and \$18,500)   | 118,500               | 118,500              |
| Total liabilities  | <u>2,530,653</u>      | <u>2,509,599</u>     |
| Shareholders' equity:  |                       |                      |
| Preferred stock, \$1 par value, authorized 1,000,000 shares; none issued   |                       |                      |
| Common stock, \$1 par value, authorized 80,000,000 shares; issued 35,231,859 and 34,987,829 shares; outstanding 27,180,797 and 27,044,836 shares | 35,232                | 34,988               |
| Additional paid-in capital   | 276,558               | 263,857              |
| Accumulated other comprehensive income   | 102,675               | 80,506               |
| Retained earnings  | 582,462               | 630,603              |
| Treasury stock, at cost, 8,051,062 and 7,942,993 shares  | (245,148 )            | (241,321 )           |
| Total shareholders' equity   | <u>751,779</u>        | <u>768,633</u>       |
| Total liabilities and shareholders' equity   | <u>\$3,282,432</u>    | <u>\$3,278,232</u>   |

See accompanying notes to consolidated financial statements.



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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME (LOSS)

(Unaudited)

For the three months ended September 30, 2011 and 2010

(dollars in thousands, except per share data)

|   | <u>2011</u>        | <u>2010</u>      |
|---|--------------------|------------------|
| <b>Revenues:</b>  |                    |                  |
| Premiums earned from affiliate (ceded to affiliate, \$205,976 and \$200,174)      | \$201,736          | \$220,235        |
| Investment income, net of investment expense                                      | 23,829             | 25,323           |
| Realized investment losses, net   |                    |                  |
| Total other-than-temporary impairment losses                                      | (3,967 )           | -                |
| Portion of loss recognized in other comprehensive income                          | -                  | -                |
| Other realized investment gains, net  | 1,308              | -                |
| Total realized investment losses, net   | (2,659 )           | -                |
| Other income (affiliate \$2,595 and \$1,908)                                      | 5,273              | 4,241            |
| Total revenues  | <u>228,179</u>     | <u>249,799</u>   |
| <b>Losses and expenses:</b>   |                    |                  |
| Losses and loss settlement expenses (ceded to affiliate, \$202,522 and \$140,076) | 190,956            | 144,567          |
| Amortization of deferred policy acquisition costs                                 | 51,666             | 56,177           |
| Other underwriting expenses   | 18,676             | 20,967           |
| Interest expense (affiliate \$30 and \$35)  | 1,511              | 1,517            |
| Other expenses  | 7,190              | 841              |
| Total expenses  | <u>269,999</u>     | <u>224,069</u>   |
| Income (loss) before income taxes   | (41,820)           | 25,730           |
| Income tax expense (benefit)  | (17,023)           | 4,901            |
| Net income (loss)   | <u>\$ (24,797)</u> | <u>\$ 20,829</u> |
| <b>Per common share:</b>  |                    |                  |
| Basic net income (loss)   | <u>\$(.92 )</u>    | <u>\$.76</u>     |
| Diluted net income (loss)   | <u>\$(.92 )</u>    | <u>\$.76</u>     |
| Cash dividend   | <u>\$.38</u>       | <u>\$.36</u>     |

See accompanying notes to consolidated financial statements.

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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME (LOSS)

(Unaudited)

For the nine months ended September 30, 2011 and 2010

(dollars in thousands, except per share data)

|   | <u>2011</u>              | <u>2010</u>            |
|---|--------------------------|------------------------|
| <b>Revenues:</b>  |                          |                        |
| Premiums earned from affiliate (ceded to affiliate, \$611,708 and \$579,057)      | \$602,465                | \$642,806              |
| Investment income, net of investment expense                                      | 74,253                   | 77,020                 |
| Realized investment gains, net  |                          |                        |
| Total other-than-temporary impairment losses                                      | (3,967 )                 | -                      |
| Portion of loss recognized in other comprehensive income                          | -                        | -                      |
| Other realized investment gains, net  | 17,180                   | 526                    |
| Total realized investment gains, net  | 13,213                   | 526                    |
| Other income (affiliate \$7,148 and \$5,483)                                      | 14,437                   | 11,910                 |
| Total revenues  | <u>704,368</u>           | <u>732,262</u>         |
| <b>Losses and expenses:</b>   |                          |                        |
| Losses and loss settlement expenses (ceded to affiliate, \$527,094 and \$403,597) | 518,237                  | 439,855                |
| Amortization of deferred policy acquisition costs                                 | 154,743                  | 163,779                |
| Other underwriting expenses   | 59,173                   | 64,348                 |
| Interest expense (affiliate \$93 and \$102)                                       | 4,538                    | 4,547                  |
| Other expenses  | 9,401                    | 3,063                  |
| Total expenses  | <u>746,092</u>           | <u>675,592</u>         |
| Income (loss) before income taxes   | (41,724)                 | 56,670                 |
| Income tax expense (benefit)  | <u>(23,826)</u>          | <u>10,737</u>          |
| Net income (loss)   | <u><u>\$(17,898)</u></u> | <u><u>\$45,933</u></u> |
| <b>Per common share:</b>  |                          |                        |
| Basic net income (loss)   | <u><u>\$(.68 )</u></u>   | <u><u>\$1.66</u></u>   |
| Diluted net income (loss)   | <u><u>\$(.68 )</u></u>   | <u><u>\$1.65</u></u>   |
| Cash dividend   | <u><u>\$1.10</u></u>     | <u><u>\$1.01</u></u>   |

See accompanying notes to consolidated financial statements.



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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

(Unaudited)

For the nine months ended September 30, 2011

(dollars in thousands)

|  | Common Stock      |                 | Additional<br>Paid-in<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income | Retained<br>Earnings | Treasury<br>Stock  | Total            |
|--|-------------------|-----------------|----------------------------------|---|----------------------|--------------------|------------------|
|  | Shares            | Amount          |                                  |   |                      |                    |                  |
| Balance at December 31, 2010                                       | 34,987,829        | \$34,988        | \$263,857                        | \$ 80,506                                       | \$630,603            | \$(241,321)        | \$768,633        |
| Net loss   |                   |                 |                                  |   | (17,898)             |                    | (17,898)         |
| Other comprehensive income, net of tax:                            |                   |                 |                                  |   |                      |                    |                  |
| Unrealized investment gains, net of<br>reclassification adjustment |                   |                 |                                  | 20,177  |                      |                    | 20,177           |
| Defined benefit pension plans:                                     |                   |                 |                                  |   |                      |                    |                  |
| Recognized net actuarial loss                                      |                   |                 |                                  | 1,992   |                      |                    | 1,992            |
| Other comprehensive income   |                   |                 |                                  |   |                      |                    | 22,169           |
| Comprehensive income   |                   |                 |                                  |   |                      |                    | 4,271            |
| Issuance of common stock:  |                   |                 |                                  |   |                      |                    |                  |
| Incentive plans  | 214,166           | 214             | 6,064                            |   |                      |                    | 6,278            |
| Dividend Reinvestment Plan   | 29,864            | 30              | 959                              |   |                      |                    | 989              |
| Tax benefit from stock compensation                                |                   |                 | 589                              |   |                      |                    | 589              |
| Stock compensation   |                   |                 | 5,089                            |   |                      |                    | 5,089            |
| Purchase of treasury stock, 108,069<br>shares                      |                   |                 |                                  |   |                      | (3,827 )           | (3,827 )         |
| Dividends declared   |                   |                 |                                  |   | (30,243 )            |                    | (30,243 )        |
| Balance at September 30, 2011                                      | <u>35,231,859</u> | <u>\$35,232</u> | <u>\$276,558</u>                 | <u>\$ 102,675</u>                               | <u>\$582,462</u>     | <u>\$(245,148)</u> | <u>\$751,779</u> |

See accompanying notes to consolidated financial statements.

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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

For the nine months ended September 30, 2011 and 2010

(in thousands)

|   | <u>2011</u> | <u>2010</u> |
|---|-------------|-------------|
| Cash flows from operating activities:   |             |             |
| Net income (loss)   | \$(17,898 ) | \$45,933    |
| Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities: |             |             |
| Change in receivables, recoverables, unearned premiums and prepaid reinsurance balances         | (51,651 )   | 33,085      |
| Change in affiliate balance   | 3,121       | (15,324 )   |
| Increase in unpaid losses and loss settlement expenses  | 69,705      | 4,977       |
| Deferred income taxes   | (7,268 )    | (689 )      |
| (Increase) decrease in deferred policy acquisition costs  | 1,221       | (3,488 )    |
| Amortization and depreciation   | 7,666       | 7,554       |
| Realized investment gains, including other than temporary impairment losses, net                | (13,213 )   | (526 )      |
| Other, net  | (22,648 )   | (2,386 )    |
|   | (30,965 )   | 69,136      |
| Cash used by the change in the intercompany pooling agreement                                   | (33,014 )   |             |
| Net cash provided (used) by operating activities  | (63,979 )   | 69,136      |
| Cash flows from investing activities:   |             |             |
| Fixed maturity investments:   |             |             |
| Purchases   | (37,067 )   | (313,751)   |
| Sales or maturities   | 224,992     | 264,299     |
| Equity securities:  |             |             |
| Purchases   | (131,250)   | (27,095 )   |
| Sales   | 67,380      |             |
| Other invested assets:  |             |             |
| Sales or maturities   |             | 1,845       |
| Net (purchases) sales of short-term investments   | (33,679 )   | 54,731      |
| Purchase of property and equipment, net   | (188 )      | (274 )      |
| Net cash provided (used) by investing activities  | 90,188      | (20,245 )   |
| Cash flows from financing activities:   |             |             |
| Issuance of common stock  | 2,453       | 9,057       |
| Purchase of treasury stock  |             | (30,787 )   |
| Dividends paid (to affiliate, \$15,979 and \$14,672)  | (29,254 )   | (27,839 )   |
| Excess tax benefits from share-based payment arrangements                                       | 589         | 588         |
| Net cash used by financing activities   | (26,212 )   | (48,981 )   |
| Decrease in cash  | (3 )        | (90 )       |
| Cash at beginning of period   | 39          | 126         |
| Cash at end of period   | \$36        | \$36        |

See accompanying notes to consolidated financial statements.



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### **HARLEYSVILLE GROUP INC. AND SUBSIDIARIES (Unaudited)**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

##### 1 - Basis of Presentation

The financial information for the interim periods included herein is unaudited; however, such information reflects all adjustments which are, in the opinion of management, necessary to a fair presentation of the financial position, results of operations, and cash flows for the interim periods. The results of operations for the interim periods are not necessarily indicative of results to be expected for the full year.

These financial statements should be read in conjunction with the financial statements and notes for the year ended December 31, 2010 included in the Company's 2010 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC).

The affiliate transaction disclosures on the face of the financial statements relate to transactions with Harleysville Mutual Insurance Company (the Mutual Company). The Mutual Company owns approximately 53% of the outstanding common stock of Harleysville Group Inc. As used herein, "Harleysville Group" refers to Harleysville Group Inc. and its subsidiaries and the "Company" refers to Harleysville Group Inc.

##### 2 - Merger Agreement

On September 28, 2011, the Company and the Mutual Company entered into a merger agreement with Nationwide Mutual Insurance Company (Nationwide) under which a subsidiary of Nationwide will merge into the Company. Nationwide will acquire all of the publicly held shares of common stock of the Company for \$60.00 per share in cash, and the Mutual Company will merge into Nationwide and the policyholders of the Mutual Company will become policyholders and members of Nationwide. The Mutual Company has also entered into a voting agreement with Nationwide under which it has agreed to vote its 53% voting interest in the Company in favor of the Company's merger. The merger agreement restricts the Company from engaging in certain actions and taking certain actions without Nationwide's approval, including among others, the payment of shareholder dividends.

The transactions are subject to customary closing conditions, including, among others, approvals from stockholders of the Company, policyholders of the Mutual Company and Nationwide, the Pennsylvania Insurance Department, the Ohio Insurance Department and various other regulatory bodies. The transactions are expected to close in early 2012. The merger agreement provides certain termination rights. In the event that the agreement is terminated under certain conditions by the Company's Board of Directors, the Company will be required to pay Nationwide a termination fee of \$29.6 million and reimburse Nationwide for its transaction expenses.

##### 3 - Change in Pooling Agreement

The Company's property and casualty subsidiaries participate in a pooling agreement with the Mutual Company and its property and casualty insurance subsidiary, Harleysville Pennland Insurance Company (Pennland), whereby such subsidiaries and Pennland cede to the Mutual Company all of their insurance business and assume from the Mutual Company an amount equal to their participation in the pooling agreement. All losses and loss settlement expenses and other underwriting expenses are prorated among the parties on the basis of participation in the pooling agreement. The pooling agreement provides for the allocation of premiums, losses and loss settlement expenses and underwriting expenses between Harleysville Group and the Mutual Company. Harleysville Group is not liable for any losses incurred by its subsidiaries, Harleysville Preferred Insurance Company and Harleysville Insurance Company of New Jersey, and the Mutual Company prior to January 1, 1986, the date the pooling agreement became effective. Harleysville Group's participation in the pool has been 80% since January 1, 2008. Effective January 1, 2010, the pooling agreement was amended to exclude reinsurance premiums, losses, loss settlement expenses and underwriting expenses voluntarily assumed by the Mutual Company.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Continued)**

Effective January 1, 2011, the Company's property and casualty subsidiaries and the Mutual Company and Penland amended their intercompany pooling agreement as it relates to their workers compensation business. The amendment established that the financial results associated with the workers compensation business for accident years 2011 and following will be retained 100 percent by the Mutual Company. The financial results of this business for prior accident years will continue to be shared between the Company's property and casualty subsidiaries, the Mutual Company and Penland under the existing pool participations. Harleysville Group paid cash of \$33 million on January 3, 2011 associated with the transfer of the unearned premium liability on the workers compensation business as of January 1, 2011. Harleysville Group's unearned premium liability decreased by \$40 million and Harleysville Group received a ceding commission of \$7 million for expenses that were incurred to generate the business ceded to the Mutual Company, which ceding commission reduced deferred policy acquisition costs.

4 - Share-Based Payments

Harleysville Group has several share-based compensation plans. Harleysville Group measures compensation expense associated with the plans based on the grant-date fair value of the awards.

Harleysville Group has the following share-based compensation plans:

The Amended and Restated Equity Incentive Plan (EIP) provides for awards to key employees in the form of stock options, stock appreciation rights (SARs), restricted stock, restricted stock units or any combination of the above.

The Employee Stock Purchase Plan provides that a participant may elect to have up to 15% of base pay withheld to purchase shares. The purchase price of the stock is 85% of the lower of the beginning-of-the-subscription-period or end-of-the-subscription-period fair market value. There are two subscription periods during each year.

The Directors' Equity Compensation Plan provides for the grant of equity-based awards to non-employee directors of Harleysville Group Inc. and the Mutual Company. These awards can be in the form of stock options, deferred stock units or restricted stock.

The compensation expense for the various share-based compensation plans that has been charged against income before income taxes was \$1,478,000 and \$1,457,000 for the three months ended September 30, 2011 and 2010, respectively, with a corresponding income tax benefit of \$494,000 and \$489,000, respectively. Compensation expense for the various share-based compensation plans that has been charged against income before income taxes was \$5,089,000 and \$5,377,000 for the nine months ended September 30, 2011 and 2010, respectively, with a corresponding income tax benefit of \$1,708,000 and \$1,809,000, respectively.

During the nine months ended September 30, 2011, 232,325 stock options were granted at a Black Scholes weighted average value of \$6.58 per option. The options vest 33 1/3% per year over a three year period, subject to earlier or accelerated vesting in designated situations, including a change-in-control or qualifying retirement of the award holder. Restricted stock unit grants of 133,010 units were also made during the nine months ended September 30, 2011 and 30,855 of these units include performance conditions. The weighted average fair value of the grants of the restricted stock units was \$37.43 per unit. These awards vest over a period of three years, subject to earlier or accelerated vesting in designated situations, including a change-in-control or qualifying retirement of the award holder.

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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES (Unaudited)

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

During the nine months ended September 30, 2010, 511,790 stock options were granted at a Black Scholes weighted average value of \$6.84 per option. The options vest 33 1/3% per year over a three year period, subject to earlier or accelerated vesting in designated situations, including a change-in-control or qualifying retirement of the award holder. Restricted stock unit grants of 112,040 units were also made during the nine months ended September 30, 2010 and 39,485 of these units include performance conditions. The weighted average fair value of the grants of the restricted stock units was \$36.54 per unit. These awards vest over a period of three years, subject to earlier or accelerated vesting in designated situations, including a change-in-control or qualifying retirement of the award holder.

In accordance with the terms of the EIP, the Company acquired 108,069 shares of its common stock from employees in connection with stock option exercises and the vesting of restricted stock and restricted stock units during 2011. The stock was received in payment of the exercise price of the stock options and in satisfaction of withholding taxes due upon exercise or vesting.

As of September 30, 2011, the Company's total unrecognized compensation cost related to nonvested share-based compensation arrangements and the weighted average period over which the compensation cost is expected to be recognized is as follows:

|                              | <u>Unrecognized Compensation Cost</u><br>(in thousands) | <u>Weighted Average<br/>Period of Recognition</u><br>(in years) |
|------------------------------|---|---|
| Equity incentive plan awards | \$ 4,793  | 1.89  |
| Employee stock purchase plan | \$ 82   | 0.29  |

#### 5 - Investments

Fair value accounting guidance defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements.

Fair value measurements are determined under a three-level hierarchy which gives the highest priority to quoted prices in active markets and the lowest priority to unobservable inputs which are based on the Company's own assumptions. The three levels of the hierarchy are as follows:

Level 1 - Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level 2 - Inputs other than Level 1 that are based on observable market data. These include quoted prices for similar assets in active markets, quoted prices for identical assets in inactive markets, inputs other than quoted prices that are observable for the asset or liability and inputs that are derived from or corroborated by observable market data.

Level 3 - Inputs that are unobservable, reflecting the Company's own assumptions.

For investments that have quoted market prices in active markets, the Company uses the quoted market price as fair value and includes these investments in Level 1 of the fair value hierarchy. The Company classifies U.S. Treasury securities and publicly traded equity securities and equity mutual funds as Level 1. When quoted market prices in active markets are not available, the Company relies on a pricing service to estimate fair value. The Company classifies its fixed maturity securities other than U.S. Treasury securities and private placements as Level 2. Private placement fixed maturity securities and non-publicly traded equity securities are classified as Level 3.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Continued)**

The Company utilizes a nationally recognized independent pricing service to obtain fair value estimates for its fixed maturity holdings because of the detailed process it uses in arriving at a fair value estimate. For fixed maturity securities that have quoted prices in active markets, market quotations are provided. For fixed maturity securities that do not trade on a daily basis, the independent pricing service prepares estimates of fair value using a wide array of observable inputs including relevant market information, benchmark curves, benchmarking of like securities, sector groupings and matrix pricing. The observable market inputs that our independent pricing service utilizes include, listed in approximate order of priority: benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data including market research publications. Additionally, the independent pricing service uses an Option Adjusted Spread model to develop prepayment and interest rate scenarios.

When the independent pricing service provides a fair value estimate, the Company uses that estimate. At September 30, 2011, the independent pricing service provided a fair value estimate for all of the investments classified as Level 1 investments within the fair value hierarchy and approximately 99% of the investments classified as Level 2 estimates within the fair value hierarchy. The fair value of all Level 2 securities is based on observable market inputs.

In instances when the independent pricing service is unable to provide a fair value estimate, the Company attempts to obtain a non-binding fair value estimate from a number of broker/dealers and reviews any fair value estimate reported by an independent business news service. In instances where only one broker/dealer provides a fair value estimate for a fixed maturity security, the Company uses that estimate. In instances where the Company is able to obtain fair value estimates from more than one broker/dealer, the Company generally uses the lowest or next to lowest fair value estimate. In instances where neither the independent pricing service nor a broker/dealer is able to provide a fair value estimate, the fair value is based on cash flow analysis and other valuation techniques which utilize significant unobservable inputs and the Company classifies the fixed maturity investment as a Level 3 investment. Level 3 investments represent less than 1% of the Company's total investment portfolio.

Quotes obtained from third parties are non-binding. The third parties from whom quotes are obtained are knowledgeable market participants that have a detailed understanding of the sector, the security type and the issuer. The non-binding quotes are fair value estimates based on observable market data utilized by these market participants. The Company does not adjust quotes or prices obtained from third parties.

Management reviews, on an ongoing basis, the reasonableness of the methodologies employed by the independent pricing service. As part of the monthly review process, management examines the prices obtained from the independent pricing service. This process routinely involves reviewing any available recent transaction activity reported via various investment research tools. Additionally, the Company tracks changes in credit ratings of all fixed maturity securities on a monthly basis and performs a more in-depth, quarterly evaluation of fixed income securities that are rated below single A by Moody's and/or S&P. If, as a result of its review, management does not believe that a price received with respect to any particular security is a reasonable estimate of the fair value of the security, it will discuss this with the independent pricing service to resolve the discrepancy. Management then determines the appropriate level of classification of each investment within the fair value hierarchy based on its evaluation of the inputs used in determining the fair value.

The following is a summary of the fair value measurements of applicable Company assets by level within the fair value hierarchy as of September 30, 2011 and December 31, 2010. These assets are measured at fair value on a recurring basis. There were no transfers to or from Levels 1 and 2 of the fair value hierarchy in 2011. The Company's policy is to recognize transfers between levels as of the end of the reporting period.

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**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Continued)**

|  | September 30,<br>2011 | Fair Value Measurements at Reporting Date Using                            |   |  |
|--|-----------------------|--|---|--|
|  |                       | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (in thousands)   |                       |  |   |  |
| Fixed maturities available for sale:                     |                       |  |   |  |
| U.S. Treasury securities                                 | \$119,609             | \$ 119,609   |   |  |
| Obligations of U.S. government corporations and agencies | 9,149                 |  | \$ 9,149  |  |
| Obligations of states and political subdivisions         | 1,163,504             |  | 1,163,504   |  |
| Corporate securities                                     | 430,213               |  | 430,213   |  |
| Mortgage-backed securities                               | 329,999               |  | 329,999   |  |
| Total available for sale                                 | <u>2,052,474</u>      | <u>119,609</u>   | <u>1,932,865</u>  |  |
| Equity securities:                                       |                       |  |   |  |
| Dividend income portfolio of common stocks               | 171,842               | 171,842  |   |  |
| International fund                                       | 36,827                | 36,827   |   |  |
| Total stock market index fund                            | 108,643               | 108,643  |   |  |
| Other  | 7                     |  |   | \$ 7   |
| Total equity securities                                  | <u>317,319</u>        | <u>317,312</u>   |   | <u>7</u>   |
| Total  | <u>\$2,369,793</u>    | <u>\$ 436,921</u>  | <u>\$ 1,932,865</u>                                       | <u>\$ 7</u>  |

|  | December 31,<br>2010 | Fair Value Measurements at Reporting Date Using                            |   |  |
|--|----------------------|--|---|--|
|  |                      | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (in thousands)   |                      |  |   |  |
| Fixed maturities available for sale:                     |                      |  |   |  |
| U.S. Treasury securities                                 | \$122,857            | \$ 122,857   |   |  |
| Obligations of U.S. government corporations and agencies | 17,171               |  | \$ 17,171   |  |
| Obligations of states and political subdivisions         | 1,173,447            |  | 1,173,447   |  |
| Corporate securities                                     | 481,805              |  | 481,805   |  |
| Mortgage-backed securities                               | 369,821              |  | 369,821   |  |
| Total available for sale                                 | <u>2,165,101</u>     | <u>122,857</u>   | <u>2,042,244</u>  |  |
| Equity securities:                                       |                      |  |   |  |
| Dividend income portfolio of common stocks               | 51,684               | 51,684   |   |  |
| International fund                                       | 44,877               | 44,877   |   |  |



|                               |                    |                             |                             |             |
|-------------------------------|--------------------|-----------------------------|-----------------------------|-------------|
| Total stock market index fund | 171,536            | 171,536                     |                             |             |
| Other                         | <u>7</u>           | <u>                    </u> | <u>                    </u> | <u>\$ 7</u> |
| Total equity securities       | <u>268,104</u>     | <u>268,097</u>              | <u>                    </u> | <u>7</u>    |
| Total                         | <u>\$2,433,205</u> | <u>\$ 390,954</u>           | <u>\$ 2,042,244</u>         | <u>\$ 7</u> |

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**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Continued)**

|                               | <b>Fair Value Measurements Using Significant<br/>Unobservable Inputs (Level 3)</b> |              |
|-------------------------------|--|--------------|
|                               | <b>For the three months ended September 30, 2011</b>                               |              |
|                               | <b>Equity<br/>Securities</b>   | <b>Total</b> |
|                               | <b>(in thousands)</b>  |              |
| Balance at July 1, 2011       | \$ 7   | \$ 7         |
| Balance at September 30, 2011 | \$ 7   | \$ 7         |

|                               | <b>Fair Value Measurements Using Significant<br/>Unobservable Inputs (Level 3)</b> |              |
|-------------------------------|--|--------------|
|                               | <b>For the nine months ended September 30, 2011</b>                                |              |
|                               | <b>Equity<br/>Securities</b>   | <b>Total</b> |
|                               | <b>(in thousands)</b>  |              |
| Balance at January 1, 2011    | \$ 7   | \$ 7         |
| Balance at September 30, 2011 | \$ 7   | \$ 7         |

|                               | <b>Fair Value Measurements Using Significant<br/>Unobservable Inputs (Level 3)</b> |                              |              |
|-------------------------------|--|------------------------------|--------------|
|                               | <b>For the three months ended September 30, 2010</b>                               |                              |              |
|                               | <b>Fixed Maturities<br/>Available for<br/>Sale</b>                                 | <b>Equity<br/>Securities</b> | <b>Total</b> |
|                               | <b>(in thousands)</b>  |                              |              |
| Balance at July 1, 2010       | \$ 100   | \$ 6                         | \$ 106       |
| Balance at September 30, 2010 | \$ 100   | \$ 6                         | \$ 106       |

|                               | <b>Fair Value Measurements Using Significant<br/>Unobservable Inputs (Level 3)</b> |                              |              |
|-------------------------------|--|------------------------------|--------------|
|                               | <b>For the nine months ended September 30, 2010</b>                                |                              |              |
|                               | <b>Fixed Maturities<br/>Available for<br/>Sale</b>                                 | <b>Equity<br/>Securities</b> | <b>Total</b> |
|                               | <b>(in thousands)</b>  |                              |              |
| Balance at January 1, 2010    | \$ 100   | \$ 6                         | \$ 106       |
| Balance at September 30, 2010 | \$ 100   | \$ 6                         | \$ 106       |

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**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Continued)**

The amortized cost and estimated fair value of investments in fixed maturity and equity securities are as follows:

|  | <b>September 30, 2011</b> |                                       |  |                                     |
|--|---------------------------|---------------------------------------|--|-------------------------------------|
|  | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|  | (in thousands)            |                                       |  |                                     |
| <b>Held to maturity:</b>                                 |                           |                                       |  |                                     |
| Obligations of U.S. government corporations and agencies | \$315                     | \$19                                  |  | \$334                               |
| Obligations of states and political subdivisions         | 66,822                    | 2,974                                 |  | 69,796                              |
| Corporate securities                                     | 57,991                    | 4,383                                 | \$ (94 )                               | 62,280                              |
| <b>Total held to maturity</b>                            | <b>125,128</b>            | <b>7,376</b>                          | <b>(94 )</b>                           | <b>132,410</b>                      |
| <b>Available for sale:</b>                               |                           |                                       |  |                                     |
| U.S. Treasury securities                                 | 112,949                   | 6,660                                 |  | 119,609                             |
| Obligations of U.S. government corporations and agencies | 8,525                     | 624                                   |  | 9,149                               |
| Obligations of states and political subdivisions         | 1,078,181                 | 85,323                                |  | 1,163,504                           |
| Corporate securities                                     | 388,225                   | 42,000                                | (12 )                                  | 430,213                             |
| Mortgage-backed securities                               | 309,520                   | 20,479                                |  | 329,999                             |
| <b>Total available for sale</b>                          | <b>1,897,400</b>          | <b>155,086</b>                        | <b>(12 )</b>                           | <b>2,052,474</b>                    |
| <b>Total fixed maturities</b>                            | <b>\$2,022,528</b>        | <b>\$162,462</b>                      | <b>\$ (106 )</b>                       | <b>\$2,184,884</b>                  |
| <b>Total equity securities</b>                           | <b>\$268,338</b>          | <b>\$48,981</b>                       | <b>\$</b>                              | <b>\$317,319</b>                    |
|  | <b>December 31, 2010</b>  |                                       |  |                                     |
|  | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|  | (in thousands)            |                                       |  |                                     |
| <b>Held to maturity:</b>                                 |                           |                                       |  |                                     |
| Obligations of U.S. government corporations and agencies | \$370                     | \$8                                   |  | \$378                               |
| Obligations of states and political subdivisions         | 74,811                    | 3,722                                 |  | 78,533                              |
| Corporate securities                                     | 73,181                    | 4,875                                 |  | 78,056                              |
| <b>Total held to maturity</b>                            | <b>148,362</b>            | <b>8,605</b>                          |  | <b>156,967</b>                      |
| <b>Available for sale:</b>                               |                           |                                       |  |                                     |
| U.S. Treasury securities                                 | 119,009                   | 3,886                                 | \$(38 )                                | 122,857                             |
| Obligations of U.S. government corporations and agencies | 16,274                    | 897                                   |  | 17,171                              |
| Obligations of states and political subdivisions         | 1,140,695                 | 36,730                                | (3,978 )                               | 1,173,447                           |
| Corporate securities                                     | 447,962                   | 34,173                                | (330 )                                 | 481,805                             |
| Mortgage-backed securities                               | 345,157                   | 24,664                                |  | 369,821                             |

|                          |                    |                  |                   |                    |
|--------------------------|--------------------|------------------|-------------------|--------------------|
| Total available for sale | <u>2,069,097</u>   | <u>100,350</u>   | <u>(4,346 )</u>   | <u>2,165,101</u>   |
| Total fixed maturities   | <u>\$2,217,459</u> | <u>\$108,955</u> | <u>\$(4,346 )</u> | <u>\$2,322,068</u> |
| Total equity securities  | <u>\$191,095</u>   | <u>\$77,322</u>  | <u>\$(313 )</u>   | <u>\$268,104</u>   |

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**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Continued)**

The amortized cost and estimated fair value of fixed maturity securities at September 30, 2011 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                               | <u>Amortized</u><br><u>Cost</u> | <u>Estimated</u><br><u>Fair</u><br><u>Value</u> |
|-------------------------------|---------------------------------|---|
|                               | (in thousands)                  |   |
| Held to maturity:             |                                 |   |
| Due through December 31, 2012 | \$20,805                        | \$21,133  |
| Due 2013 through 2016         | 92,476                          | 98,790  |
| Due 2017 through 2021         | 1,823                           | 1,939   |
| Due after 2021                | 10,024                          | 10,548  |
|                               | <u>125,128</u>                  | <u>132,410</u>                                  |
| Available for sale:           |                                 |   |
| Due through December 31, 2012 | 62,438                          | 63,499  |
| Due 2013 through 2016         | 575,390                         | 618,827   |
| Due 2017 through 2021         | 569,634                         | 623,884   |
| Due after 2021                | 380,418                         | 416,265   |
|                               | <u>1,587,880</u>                | <u>1,722,475</u>                                |
| Mortgage-backed securities    | <u>309,520</u>                  | <u>329,999</u>                                  |
|                               | <u>1,897,400</u>                | <u>2,052,474</u>                                |
| Total fixed maturities        | <u>\$2,022,528</u>              | <u>\$2,184,884</u>                              |

Realized gross gains (losses) from investments were as follows:

|  | <b>For the three months</b><br><b>ended September 30,</b> |             |
|--|---|-------------|
|  | <u>2011</u>   | <u>2010</u> |
|  | (in thousands)  |             |
| Fixed maturity securities:             |   |             |
| Available for sale:                    |   |             |
| Gross gains                            | \$ 53   | \$          |
| Other than temporary impairment losses | (381 )  |             |
| Equity securities:                     |   |             |
| Gross gains                            | 1,255   |             |
| Other than temporary impairment losses | (3,586 )  |             |
| Net realized investment losses         | <u>\$ (2,659 )</u>  | <u>\$ -</u> |

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HARLEYSVILLE GROUP INC. AND SUBSIDIARIES  
(Unaudited)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Continued)

|  | For the nine months<br>ended September 30, |              |
|--|--|--------------|
|  | 2011                                       | 2010         |
|  | (in thousands)                             |              |
| Fixed maturity securities:             |  |              |
| Available for sale:                    |  |              |
| Gross gains                            | \$221                                      | \$1,161      |
| Other than temporary impairment losses | (381 )                                     |              |
| Equity securities:                     |  |              |
| Gross gains                            | 17,754                                     |              |
| Gross losses                           | (795 )                                     |              |
| Other than temporary impairment losses | (3,586 )                                   |              |
| Other invested assets:                 |  |              |
| Gross losses                           |  | (635 )       |
| Net realized investment gains          | <u>\$13,213</u>                            | <u>\$526</u> |

Harleysville Group held securities with unrealized losses at September 30, 2011 and December 31, 2010 as follows:

|                                       | September 30, 2011 |                      |  |
|---------------------------------------|--------------------|----------------------|--|
|                                       | Fair Value         | Unrealized<br>Losses | Length of<br>Unrealized Loss<br>Less Than<br>12 Months |
|                                       |                    | (in thousands)       |  |
| Fixed maturities:                     |                    |                      |  |
| Corporate securities                  | <u>\$ 3,371</u>    | <u>\$ 106</u>        | <u>\$ 106</u>  |
| Total temporarily impaired securities | <u>\$ 3,371</u>    | <u>\$ 106</u>        | <u>\$ 106</u>  |

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**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Continued)**

|  | <u>December 31, 2010</u> |  |  |
|--|--------------------------|--|--|
|  | <u>Fair Value</u>        | <u>Unrealized</u><br><u>Losses</u><br>(in thousands) | <u>Length of</u><br><u>Unrealized Loss</u><br><u>Less Than</u><br><u>12 Months</u> |
| Fixed maturities:                                |                          |  |  |
| U.S. Treasury securities                         | \$3,073                  | \$ 38  | \$ 38  |
| Obligations of states and political subdivisions | 232,551                  | 3,978  | 3,978  |
| Corporate securities                             | 33,594                   | 330  | 330  |
| Total fixed maturities                           | <u>269,218</u>           | <u>4,346</u>   | <u>4,346</u>   |
| Equity securities                                | 17,231                   | 313  | 313  |
| Total temporarily impaired securities            | <u>\$286,449</u>         | <u>\$ 4,659</u>                                      | <u>\$ 4,659</u>  |

Of the total fixed maturity securities with an unrealized loss at September 30, 2011, securities with a fair value of \$1,470,000 and an unrealized loss of \$12,000 are classified as available for sale and are carried at fair value on the balance sheet while securities with a fair value of \$1,901,000 and an unrealized loss of \$94,000 are classified as held to maturity on the balance sheet and are carried at amortized cost.

The unrealized losses on fixed maturity investments were primarily due to a widening of credit spreads on securities in the financial sector. Per Harleysville Group's current policy, a fixed maturity security is other than temporarily impaired if the present value of the cash flows expected to be collected is less than the amortized cost of the security or where the security's fair value is below cost and Harleysville Group intends to sell, or more likely than not will be required to sell, the security before recovery of its value. Harleysville Group believes, based on its analysis, that these securities are not other than temporarily impaired. However, depending on developments involving both the issuers and worsening economic conditions, these investments may be written down in the income statement in the future.

There were impairment charges in the three and nine months ended September 30, 2011 of \$3,586,000 on equity securities and \$381,000 on fixed maturity securities that the Company intends to sell. There were no impairment charges in the three and nine months ended September 30, 2010. At September 30, 2011, a bond with an amortized cost of \$999,000 was transferred from the held to maturity category to the available for sale category due to a significant deterioration in the credit worthiness of the issuer. An impairment charge of \$21,000 recognized on this security is included in the fixed maturity impairment total of \$381,000 for the three and nine months ended September 30, 2011. In October 2011, the Company sold virtually all of its equity securities and realized a gain of \$62.3 million in order to reduce potential volatility in statutory surplus.

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**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
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**(Continued)**

6 - Earnings Per Share

The computation of basic and diluted earnings per share is as follows:

|   | For the three months<br>ended September 30, |                   | For the nine months<br>ended September 30, |                   |
|---|---|-------------------|--|-------------------|
|   | 2011  | 2010              | 2011                                       | 2010              |
| (dollars in thousands, except per share data)       |   |                   |  |                   |
| Numerator for basic and diluted earnings per share: |   |                   |  |                   |
| Net income (loss)                                   | <u>\$(24,797 )</u>                          | <u>\$20,829</u>   | <u>\$(17,898 )</u>                         | <u>\$45,933</u>   |
| Denominator for basic earnings per share – weighted |   |                   |  |                   |
| average shares outstanding                          | <u>27,160,607</u>                           | <u>27,397,201</u> | <u>27,072,779</u>                          | <u>27,613,629</u> |
| Effect of stock incentive plans                     | <u>                    </u>                 | <u>157,029</u>    | <u>                    </u>                | <u>188,873</u>    |
| Denominator for diluted earnings per share          | <u>27,160,607</u>                           | <u>27,554,230</u> | <u>27,072,779</u>                          | <u>27,802,502</u> |
| Basic earnings (loss) per share                     | <u>\$(.92 )</u>                             | <u>\$.76</u>      | <u>\$(.68 )</u>                            | <u>\$1.66</u>     |
| Diluted earnings (loss) per share                   | <u>\$(.92 )</u>                             | <u>\$.76</u>      | <u>\$(.68 )</u>                            | <u>\$1.65</u>     |

The following options to purchase shares of common stock were not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price:

|                   | For the three months<br>ended September 30, |              | For the nine months<br>ended September 30, |            |
|-------------------|---|--------------|--|------------|
|                   | 2011  | 2010         | 2011                                       | 2010       |
| (in thousands)    |   |              |  |            |
| Number of options | <u>–</u>                                    | <u>1,001</u> | <u>186</u>                                 | <u>904</u> |

An additional 1,945,548 and 1,776,451 options to purchase common stock were not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2011, respectively, because their inclusion would have had an antidilutive effect. Net loss per basic and diluted common share for the three and nine months ended September 30, 2011 excluded the allocation of \$482,000 and \$692,000, respectively, of undistributed losses to participating share-based awards, since such allocation would result in anti-dilution of basic and diluted earnings per share.

7 - Reinsurance

Premiums earned are net of amounts ceded of \$33,220,000 and \$95,508,000 for the three and nine months ended September 30, 2011, respectively, and \$31,578,000 and \$92,052,000 for the three and nine months ended September 30, 2010, respectively. Losses and loss settlement expenses are net of amounts ceded of \$65,227,000 and \$83,211,000 for the three and nine months ended September 30, 2011, respectively, and \$8,431,000 and \$34,393,000 for the three and nine months ended September 30, 2010, respectively. Losses and loss settlement expenses ceded for the three and nine months ended September 30, 2011 include \$64,365,000 and \$71,345,000 of losses ceded to the federal government's National Flood Insurance Program (NFIP), primarily related to flood losses from Hurricane Irene and Tropical Storm Lee. Reinsurance recoverables include \$64,215,000 and \$2,361,000 at September 30, 2011 and December 31, 2010,



respectively, for flood losses recoverable from the NFIP. Since such flood losses are entirely ceded to the NFIP they did not impact results of operations. Such amounts ceded do not include the reinsurance transactions with the Mutual Company under the pooling arrangement (described below) which are reflected on the face of the income statements, but do include reinsurance with unaffiliated reinsurers.

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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES (Unaudited)

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Pursuant to the terms of a reinsurance pooling agreement with the Mutual Company, each of the insurance subsidiaries of the Company and Harleysville Pennland Insurance Company (Pennland), a subsidiary of the Mutual Company, cede premiums, losses and underwriting expenses on all of their respective business to the Mutual Company which, in turn, retrocedes to such subsidiaries and Pennland a specified portion of premiums, losses and underwriting expenses of the Mutual Company and such subsidiaries and Pennland. Because this agreement does not relieve the Company's insurance subsidiaries of primary liability as originating insurers, there is a concentration of credit risk arising from business ceded to the Mutual Company. However, the reinsurance pooling agreement provides for the right of offset. The Mutual Company has an A. M. Best rating of "A" (Excellent).

#### 8 - Cash Flows

Net cash tax payments of \$2,076,000 and \$5,100,000 were made in the first nine months of 2011 and 2010, respectively. Cash interest payments of \$5,844,000 and \$5,852,000 were made in the first nine months of 2011 and 2010, respectively.

#### 9 - Segment Information

The performance of the personal lines and commercial lines is evaluated based upon underwriting results as determined under statutory accounting practices (SAP).

Financial data by segment is as follows:

|   | For the three months<br>ended September 30, |                  | For the nine months<br>ended September 30, |                  |
|---|---|------------------|--|------------------|
|   | 2011  | 2010             | 2011                                       | 2010             |
| (in thousands)                            |   |                  |  |                  |
| <b>Revenues:</b>                          |   |                  |  |                  |
| Premiums earned                           |   |                  |  |                  |
| Commercial lines                          | \$147,909                                   | \$171,725        | \$445,451                                  | \$503,668        |
| Personal lines                            | 53,827                                      | 48,510           | 157,014                                    | 139,138          |
| Total premiums earned                     | 201,736                                     | 220,235          | 602,465                                    | 642,806          |
| Net investment income                     | 23,829                                      | 25,323           | 74,253                                     | 77,020           |
| Realized investment gains (losses)        | (2,659 )                                    | -                | 13,213                                     | 526              |
| Other                                     | 5,273                                       | 4,241            | 14,437                                     | 11,910           |
| Total revenues                            | <u>\$228,179</u>                            | <u>\$249,799</u> | <u>\$704,368</u>                           | <u>\$732,262</u> |
| <b>Income (loss) before income taxes:</b> |   |                  |  |                  |
| Underwriting gain (loss):                 |   |                  |  |                  |
| Commercial lines                          | \$(32,834)                                  | \$2,357          | \$(66,809 )                                | \$(14,613)       |
| Personal lines                            | (24,400)                                    | (589 )           | (51,727 )                                  | (11,246)         |
| SAP underwriting gain (loss)              | (57,234)                                    | 1,768            | (118,536)                                  | (25,859)         |
| GAAP adjustments                          | (2,328 )                                    | (3,244 )         | (11,152 )                                  | 683              |
| GAAP underwriting loss                    | (59,562)                                    | (1,476 )         | (129,688)                                  | (25,176)         |
| Net investment income                     | 23,829                                      | 25,323           | 74,253                                     | 77,020           |

|                                    |                          |                        |                           |                        |
|------------------------------------|--------------------------|------------------------|---------------------------|------------------------|
| Realized investment gains (losses) | (2,659 )                 | -                      | 13,213                    | 526                    |
| Other                              | <u>(3,428 )</u>          | <u>1,883</u>           | <u>498</u>                | <u>4,300</u>           |
| Income (loss) before income taxes  | <u><u>\$(41,820)</u></u> | <u><u>\$25,730</u></u> | <u><u>\$(41,724 )</u></u> | <u><u>\$56,670</u></u> |

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**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
**(Unaudited)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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The GAAP adjustment of \$11,152,000 for the nine months ended September 30, 2011 includes the impact on deferred acquisition costs related to the ceding commission received in January 2011 of \$6,998,000 related to the change in the intercompany pooling agreement as described in Note 3 of the Notes to Consolidated Financial Statements. The impact was all in commercial lines.

10 - Comprehensive Income (Loss)

Comprehensive income (loss) for the three and nine months ended September 30, 2011 and 2010 consisted of the following (all amounts are net of taxes):

|   | <u>For the three months</u><br><u>ended September 30,</u> |                  | <u>For the nine months</u><br><u>ended September 30,</u> |                  |
|---|---|------------------|--|------------------|
|   | <u>2011</u>   | <u>2010</u>      | <u>2011</u>  | <u>2010</u>      |
|   | (in thousands)  |                  |  |                  |
| Net income (loss)   | \$ (24,797)   | \$ 20,829        | \$ (17,898)  | \$ 45,933        |
| Other comprehensive income:   |   |                  |  |                  |
| Unrealized gains on securities:                                       |   |                  |  |                  |
| Unrealized investment holding gains (losses) arising during period    | (385 )  | 38,238           | 28,766   | 51,244           |
| Less:   |   |                  |  |                  |
| Reclassification adjustment for (gains) losses included in net income | 1,728   | —                | (8,589 )   | (342 )           |
| Net unrealized investment gains                                       | 1,343   | 38,238           | 20,177   | 50,902           |
| Defined benefit pension plans:  |   |                  |  |                  |
| Recognized net actuarial loss   | 627   | 606              | 1,992  | 1,576            |
| Other comprehensive income  | 1,970   | 38,844           | 22,169   | 52,478           |
| Comprehensive income (loss)   | <u>\$ (22,827)</u>  | <u>\$ 59,673</u> | <u>\$ 4,271</u>  | <u>\$ 98,411</u> |

Accumulated other comprehensive income (loss) at September 30, 2011 and December 31, 2010 consisted of the following amounts (which are net of tax):

|   | <u>September 30,</u><br><u>2011</u> | <u>December 31,</u><br><u>2010</u> |
|---|-------------------------------------|------------------------------------|
|   | (in thousands)                      |                                    |
| Unrealized investment gains                       | \$ 132,636                          | \$ 112,459                         |
| Defined benefit pension plan - net actuarial loss | (29,961 )                           | (31,953 )                          |
| Accumulated other comprehensive income            | <u>\$ 102,675</u>                   | <u>\$ 80,506</u>                   |

11 - Pension

Harleysville Group Inc. has a frozen pension plan that covers employees hired before January 1, 2006. The net periodic pension cost for the plan, including those incurred by the Mutual Company, consists of the following components:

|  | For the three months<br>ended September 30, |         | For the nine months<br>ended September 30, |         |
|--|---|---------|--|---------|
|  | 2011  | 2010    | 2011                                       | 2010    |
| (in thousands)                           |   |         |  |         |
| Components of net periodic pension cost: |   |         |  |         |
| Interest cost                            | \$2,977                                     | \$2,989 | \$8,905                                    | \$8,920 |
| Expected return on plan assets           | (3,148)                                     | (3,036) | (9,352)                                    | (9,060) |
| Recognized net actuarial loss            | 1,455                                       | 1,321   | 4,737                                      | 3,435   |
| Net periodic pension cost:               |   |         |  |         |
| Entire plan                              | \$1,284                                     | \$1,274 | \$4,290                                    | \$3,295 |
| Harleysville Group portion               | \$852                                       | \$899   | \$2,776                                    | \$2,325 |

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**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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Harleysville Group's portion of the 2011 contributions to the pension plan is \$7,124,000. Contributions of \$5,370,000 were made in the nine months ended September 30, 2011.

12 - Borrowings

Debt is as follows:

|  | <u>September 30,</u><br><u>2011</u> | <u>December 31,</u><br><u>2010</u> |
|--|-------------------------------------|------------------------------------|
|  | (in thousands)                      |                                    |
| Notes, 5.75%, due 2013   | \$ 100,000                          | \$ 100,000                         |
| Demand term-loan payable to the Mutual Company, LIBOR plus 0.45%, due 2012 | <u>18,500</u>                       | <u>18,500</u>                      |
| <b>Total debt</b>  | <b><u><u>\$ 118,500</u></u></b>     | <b><u><u>\$ 118,500</u></u></b>    |

The fair value of the notes was \$103,920,000 and \$99,413,000 at September 30, 2011 and December 31, 2010, respectively, based on quoted market prices for the same or similar debt. The carrying value of the remaining debt approximates fair value.

13 - Shareholders' Equity

Various states have adopted the National Association of Insurance Commissioners (NAIC) risk-based capital (RBC) standards that require insurance companies to calculate and report statutory capital and surplus needs based on a formula measuring underwriting, investment and other business risks inherent in an individual company's operations. These RBC standards have not affected the operations of Harleysville Group since each of the Company's insurance subsidiaries has statutory capital and surplus in excess of RBC requirements.

These RBC standards require the calculation of a ratio of total adjusted capital to Authorized Control Level. Insurers with a ratio below 200% are subject to different levels of regulatory intervention and action. Based upon their 2010 statutory financial statements, the ratio of total adjusted capital to the Authorized Control Level for the Company's eight insurance subsidiaries at December 31, 2010 ranged from 461% to 783%.

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**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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14 - Income Taxes

The actual income tax rate differed from the statutory federal income tax rate applicable to income (loss) before income tax expense (benefit) as follows:

|                                   | <u>For the three months</u><br><u>ended September 30,</u> |               | <u>For the nine months</u><br><u>ended September 30,</u> |               |
|-----------------------------------|---|---------------|--|---------------|
|                                   | <u>2011</u>   | <u>2010</u>   | <u>2011</u>  | <u>2010</u>   |
| Statutory federal income tax rate | (35.0 )%  | 35.0 %        | (35.0 )%   | 35.0 %        |
| Tax-exempt income                 | (8.2 )  | (12.7 )       | (24.7 )  | (17.5 )       |
| Other, net                        | 2.5   | (3.3 )        | 2.6  | 1.4           |
|                                   | <u>(40.7 )%</u>   | <u>19.0 %</u> | <u>(57.1 )%</u>  | <u>18.9 %</u> |

Due to the pre-tax net loss in 2011, the Company is unable to make a reliable estimate of its annual effective tax rate, and as such, the actual effective tax rate for the year to date is deemed to be the best estimate of the annual effective tax rate.

As of September 30, 2011, Harleysville Group had no material unrecognized tax benefits or accrued interest and penalties. The Company's policy is to account for interest as a component of interest expense and penalties as a component of other expense. Federal tax years 2007 through 2010 were open for examination as of September 30, 2011.

15 - Contingencies

The Harleysville Group insurance subsidiaries are subject to disputes, including litigation and arbitration, arising in the ordinary course of their insurance business. The Company's estimates of the costs of settling such matters are reflected in its liability for unpaid losses and loss settlement expenses, and the Company does not believe that the ultimate outcome of such matters will have a material adverse effect on its financial condition or results of operations. However, adverse outcomes of insurance claims are possible and could negatively impact the Company's financial condition and results of operations in the future.

Harleysville Group is also subject to other non-insurance claims proceedings, lawsuits and claims arising in the normal course of business. The Company does not believe that the ultimate liability associated with these claims will have a material adverse effect on its financial condition or results of operations. However, adverse outcomes are possible and could negatively impact the Company's financial condition and results of operations in the future.

Harleysville Group is also subject to two class action lawsuits in connection with the merger agreement with Nationwide described in Note 2. The Company does not believe that the ultimate liability associated with these lawsuits will have a material adverse effect on its financial condition or results of operations. However, adverse outcomes are possible and could negatively impact the Company's financial condition and results of operations in the future.

16 - New Accounting Standards

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-06, "Fair Value Measurements and Disclosures." ASU 2010-06 applies to all entities that are required to make disclosures about recurring or non-recurring fair value measurements. ASU 2010-06 provides guidance on additional disclosures on any significant transfers in and out of Level 1 and Level 2 and a description of the transfer.





**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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ASU 2010-06 also requires separate disclosures of the activity in the Level 3 category related to any purchases, sales, issuances and settlements on a gross basis. The effective date of the new disclosures relating to the existing disclosures regarding Level 1 and Level 2 categories is for interim and annual periods beginning after December 15, 2009. The effective date of the disclosures regarding purchases, sales, issuances and settlements to the Level 3 category is for interim and annual periods beginning after December 15, 2010. The adoption of this ASU did not have a material impact on the Company's results of operations or financial position.

In October 2010, the FASB issued ASU 2010-26, "Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)." This ASU amends FASB Accounting Standards Codification (ASC) Topic 944, Financial Services-Insurance, to address which costs related to the acquisition of new or renewal insurance contracts qualify for deferral. The ASU allows insurance entities to defer costs related to the acquisition of new or renewal insurance contracts that are (1) incremental direct costs of the contract transaction (i.e., would not have occurred without the contract transaction), (2) a portion of the employee's compensation and fringe benefits related to certain activities for successful contract acquisitions, or (3) direct-response advertising costs as defined in ASC Subtopic 340-20, Other Assets and Deferred Costs - Capitalized Advertising Costs. An insurance entity would expense as incurred all other costs related to the acquisition of new or renewal insurance contracts. The amendments in the ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and can be applied either prospectively or retrospectively. Early application is permitted at the beginning of an entity's annual reporting period. The impact of adopting this ASU is currently being evaluated.

In December 2010, the FASB issued ASU 2010-28, "Intangibles-Goodwill and Other." The amendments in this ASU modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For these units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. For public entities, this ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The adoption of this ASU did not have a material impact on Harleysville Group's results of operations or financial position.

In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." The amendments in this ASU result in common fair value measurement and disclosure in U.S. GAAP and IFRSs. The amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments include: (1) those that clarify the FASB's intent about the application of existing fair value measurement and disclosure requirements; and (2) those that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurement. For public entities, the amendments in this ASU are effective during interim and annual periods beginning after December 15, 2011, and are to be applied prospectively. Early application by public entities is not permitted. The adoption of this ASU is not expected to have a material impact on the Company's results of operations or financial position.

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income." Under the amendments in this ASU, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The entity is also required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income where the components of net income and the components of other comprehensive income are presented. For public

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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entities, the amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and are to be applied retrospectively. Early adoption is permitted. The adoption of this ASU is not expected to have a material impact on the Company' s results of operations or financial position.

In September 2011, the FASB issued ASU 2011-08, "Testing Goodwill for Impairment." The amendments in this ASU permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in ASC Topic 350, Intangibles-Goodwill and Other. Previous guidance under this topic required an entity to test goodwill for impairment, on at least an annual basis, by comparing the fair value of a reporting unit with its carrying amount. If the fair value of the reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. This ASU is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of this ASU is not expected to have a material impact on the Company' s results of operations or financial position.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Item 2.**

**Management' s Discussion and Analysis of Financial Condition  
and Results of Operations**

Certain of the statements contained herein (other than statements of historical facts) are forward-looking statements. Such forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and include estimates and assumptions related to economic, competitive, legislative and regulatory developments. These forward looking statements are subject to change and uncertainty which are, in many instances, beyond the Company' s control and have been made based upon management' s expectations and beliefs concerning future developments and their potential effect on Harleysville Group. There can be no assurance that future developments will be in accordance with management' s expectations or that the effect of future developments on Harleysville Group will be those anticipated by management. Actual financial results, including premium levels and underwriting results, could differ materially from those anticipated by Harleysville Group depending on the outcome of certain factors, which may include changes in property and casualty loss trends and reserves; the insurance product pricing environment; changes in applicable law; government regulation and changes therein that may impede the ability to charge adequate rates; performance of and instability in the financial markets; investment losses; fluctuations in interest rates; significant catastrophe events in the geographic regions where we do business; decreased demand for property and casualty insurance; availability and price of reinsurance; the A. M. Best group rating of Harleysville Group; and the status of labor markets in which the Company operates.

Overview

The Company' s net income is primarily determined by four elements:

- net premium income;
- investment income and realized investment gains (losses); and
- amounts paid or reserved to settle insured claims; and
- other income and expense.

Variations in premium income are subject to a number of factors, including:

- limitations on premium rates arising from the competitive marketplace or regulation;
- limitations on available business arising from a need to maintain the quality of underwritten risks;
- the Company' s ability to maintain its A (Excellent) group rating by A.M. Best; and
- the ability of the Company to maintain a reputation for efficiency and fairness in claims administration.

Variations in investment income and realized investment gains (losses) are subject to a number of factors, including:

- general interest rate levels and financial market conditions;
- specific adverse events affecting the issuers of debt obligations held by the Company; and
- changes in the prices of debt and equity securities generally and those held by the Company specifically.

Loss and loss settlement expenses are affected by a number of factors, including:

- the quality of the risks underwritten by the Company;
- the nature and severity of catastrophic losses;
- the availability, cost and terms of reinsurance; and
- underlying settlement costs, including medical and legal costs.



**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management' s Discussion and Analysis of Financial Condition  
and Results of Operations**

(Continued)

Variations in other income and expense are affected by a number of factors, including:

- the level of premiums written by the Mutual Company and its subsidiaries which are subject to the management fee;
- the amount of flood insurance written and ceded to the National Flood Insurance Program; and
- the interest rate on debt issued by the Company.

The Company seeks to manage each of the foregoing to the extent within its control. Many of the foregoing factors are partially, or entirely, outside of the control of the Company.

**Critical Accounting Policies and Estimates**

The consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles (GAAP), which require Harleysville Group to make estimates and assumptions (see Note 1 of the Notes to Consolidated Financial Statements for the year ended December 31, 2010 included in the Company' s 2010 Annual Report on Form 10-K filed with the SEC). Harleysville Group believes that of its significant accounting policies, the following may involve a higher degree of judgment and estimation. The judgments, or the methodology on which the judgments are made, are reviewed quarterly with the Audit Committee.

*Liability for Losses and Loss Settlement Expenses.* The liability for losses and loss settlement expenses represents estimates of the ultimate unpaid cost of all losses incurred, including losses for claims which have not yet been reported to Harleysville Group. The amount of loss reserves for reported claims is based primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. The amounts of loss reserves for unreported claims and loss settlement expense reserves are determined utilizing historical information by line of insurance as adjusted to current conditions. Inflation is implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results. Estimates of the liabilities are reviewed and updated on a regular basis using the most recent information on reported claims and a variety of actuarial techniques. It is expected that such estimates will be more or less than the amounts ultimately paid when the claims are settled. Changes in these estimates are reflected in current operations.

*Investments.* Generally, unrealized investment gains or losses on investments carried at fair value, net of applicable income taxes, are reflected directly in shareholders' equity as a component of comprehensive income and, accordingly, have no effect on net income. However, if the fair value of an investment in equity securities declines below its cost and that decline is deemed other than temporary, the amount of the decline below cost is charged to earnings. Per Harleysville Group' s current policy, a fixed maturity security is other than temporarily impaired if the present value of the cash flows expected to be collected is less than the amortized cost of the security or where the security' s fair value is below cost and Harleysville Group intends to sell, or more likely than not will be required to sell, the security before recovery of its value. If Harleysville Group does not intend to sell, or more likely than not will not be required to sell, a fixed maturity security whose fair value has declined below its cost, the amount of the decline below cost due to credit-related reasons is charged to earnings and the remaining difference is included in comprehensive income. Harleysville Group monitors its investment portfolio and at least quarterly reviews investments that have experienced a decline in fair value below cost to evaluate whether the decline is other than temporary. Such evaluations consider, among other things, the magnitude and reasons for a decline, the prospects for the fair value to recover in the near term and Harleysville Group' s intent to retain the investment for a period of time sufficient to allow for a recovery in value. Future adverse investment market conditions, or poor operating results of underlying investments, could result in an impairment charge in the future.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management' s Discussion and Analysis of Financial Condition  
and Results of Operations**

(Continued)

The severe downturn in the public debt and equity markets in recent years, reflecting uncertainties associated with the mortgage crisis, worsening economic conditions, widening of credit spreads, bankruptcies and government intervention in large financial institutions, has resulted in significant realized and unrealized losses in our investment portfolio in the past. Depending on market conditions going forward, we could incur additional realized and unrealized losses in future periods.

The fair value of equity securities is based on the closing market value. The fair value of mutual fund holdings is based on the closing net asset value reported by the fund. The fair value of fixed maturities is based upon data supplied by an independent pricing service. It can be difficult to determine the fair value of non-traded securities, but Harleysville Group does not own a material amount of non-traded securities.

*Policy Acquisition Costs.* Policy acquisition costs, such as commissions, premium taxes and certain other underwriting and agency expenses that vary with and are primarily related to the production of business, are deferred and amortized over the effective period of the related insurance policies and in proportion to the premiums earned. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. The estimation of net realizable value takes into account the premium to be earned, related investment income over the claim paying period, expected losses and loss settlement expenses, and certain other costs expected to be incurred as the premium is earned. Future changes in estimates, the most significant of which is expected losses and loss settlement expenses, may require adjustments to deferred policy acquisition costs. If the estimation of net realizable value indicates that the deferred acquisition costs are not recoverable, they would be written off and further analyses would be performed to determine if an additional liability would need to be accrued.

*Contingencies.* Besides claims related to its insurance products, Harleysville Group is subject to proceedings, lawsuits and claims in the normal course of business. Harleysville Group assesses the likelihood of any adverse outcomes to these matters as well as potential ranges of probable losses. There can be no assurance that actual outcomes will not differ from those assessments.

The application of certain of these critical accounting policies to the periods ended September 30, 2011 and 2010 is discussed in greater detail below.

**Results of Operations**

On September 28, 2011, the Company and the Mutual Company entered into a merger agreement with Nationwide Mutual Insurance Company (Nationwide) under which a subsidiary of Nationwide will merge into the Company. Nationwide will acquire all of the publicly held shares of common stock of the Company for \$60.00 per share in cash, and the Mutual Company will merge into Nationwide and the policyholders of the Mutual Company will become policyholders and members of Nationwide. The Mutual Company has also entered into a voting agreement with Nationwide under which it has agreed to vote its 53% voting interest in the Company in favor of the merger. The merger agreement restricts the Company from engaging in certain actions and taking certain actions without Nationwide' s approval, including among others, the payment of shareholder dividends.

The transactions are subject to customary closing conditions, including, among others, approvals from stockholders of the Company, policyholders of the Mutual Company and Nationwide, the Pennsylvania Insurance Department, the Ohio Insurance Department and various other regulatory bodies. The transactions are expected to close in early 2012. The merger agreement provides certain termination rights. In the event that the agreement is terminated under certain conditions by the Company' s Board of Directors, the Company will be required to pay Nationwide a termination fee of \$29.6 million and reimburse Nationwide for its transaction expenses.

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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

#### **Management's Discussion and Analysis of Financial Condition and Results of Operations**

(Continued)

The Company's property and casualty subsidiaries participate in a pooling agreement with the Mutual Company and its property and casualty insurance subsidiary, Harleysville Pennland Insurance Company (Pennland), whereby such subsidiaries and Pennland cede to the Mutual Company all of their insurance business and assume from the Mutual Company an amount equal to their participation in the pooling agreement. All losses and loss settlement expenses and other underwriting expenses are prorated among the parties on the basis of participation in the pooling agreement. The pooling agreement provides for the allocation of premiums, losses and loss settlement expenses and underwriting expenses between Harleysville Group and the Mutual Company. Harleysville Group is not liable for any losses incurred by its subsidiaries which were members of the pool since its inception, Harleysville Preferred Insurance Company and Harleysville Insurance Company of New Jersey, and the Mutual Company prior to January 1, 1986, the date the pooling agreement became effective. Harleysville Group's participation in the pool has been 80% since January 1, 2008. Effective January 1, 2010, the pooling agreement was amended to exclude reinsurance premiums, losses, loss settlement expenses and underwriting expenses voluntarily assumed by the Mutual Company.

Effective January 1, 2011, the Company's property and casualty subsidiaries and the Mutual Company and Pennland amended their intercompany pooling agreement as it relates to their workers compensation business. The amendment established that the financial results associated with the workers compensation business for accident years 2011 and following will be retained 100 percent by the Mutual Company. The financial results of this business for prior accident years will continue to be shared between the Company's property and casualty subsidiaries, the Mutual Company and Pennland under the existing pool participations. Harleysville Group paid cash of \$33 million on January 3, 2011 associated with the transfer of the unearned premium liability on the workers compensation business as of January 1, 2011. Harleysville Group's unearned premium liability decreased by \$40 million and Harleysville Group received a ceding commission of \$7 million for expenses that were incurred to generate the business ceded to the Mutual Company, which ceding commission reduced deferred policy acquisition costs.

Effective January 1, 2010, the management agreement under which the Company provides certain management services to the Mutual Company was amended to include voluntary assumed reinsurance business written by the Mutual Company.

Premiums earned decreased \$18.5 million, or 8.4%, during the three months ended September 30, 2011 compared to the same period in the prior year primarily due to the change to the pooling agreement effective January 1, 2011, whereby premiums earned on workers compensation business is retained 100% by the Mutual Company. Excluding 2010 premiums earned on workers compensation business, premiums earned increased 0.7% during the three months ended September 30, 2011 compared to the same period in the prior year.

Premiums earned for commercial lines decreased \$23.8 million during the three months ended September 30, 2011 compared to the same period in the prior year primarily, due to the change in the pooling agreement described in the preceding paragraph. Excluding 2010 premiums earned on workers compensation business, premiums earned for the three months ended September 30, 2011 decreased 2.6% compared to the same period in the prior year.

Premiums earned for personal lines increased \$5.3 million, or 11.0%, during the three months ended September 30, 2011 compared to the same period in the prior year, primarily due to higher average premiums and greater policy counts.

Premiums earned decreased \$40.3 million, or 6.3%, during the nine months ended September 30, 2011 compared to the same period in the prior year primarily due to the change to the pooling agreement effective January 1, 2011, whereby premiums earned on workers compensation business is retained 100% by the Mutual Company. Excluding 2010 premiums earned on workers compensation business, premiums earned increased 3.0% during the nine months ended September 30, 2011 compared to the same period in the prior year.





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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

#### Management's Discussion and Analysis of Financial Condition and Results of Operations

(Continued)

Premiums earned for commercial lines decreased \$58.2 million during the nine months ended September 30, 2011 compared to the same period in the prior year primarily due to the change in the pooling agreement described in the preceding paragraph. Excluding 2010 premiums earned on workers compensation business, premiums earned were essentially flat during the nine months ended September 30, 2011 compared to the same period in the prior year.

Premiums earned for personal lines increased \$17.9 million, or 12.8%, during the nine months ended September 30, 2011 compared to the same period in the prior year, primarily due to higher average premiums and greater policy counts.

Investment income decreased \$1.5 million and \$2.8 million for the three and nine months ended September 30, 2011, respectively, compared to the same prior year periods. The decreases were primarily due to a lower investment yield on fixed income securities and short-term investments and lower average invested assets, partially offset by greater dividends on equity securities.

Net realized investment losses were \$2.7 million in the three months ended September 30, 2011 as compared to zero in the same period in the prior year primarily due to impairment charges. There were impairment charges of \$3,586,000 on equity securities and \$381,000 on fixed maturity securities that the Company intends to sell in the 2011 period. There were no impairment charges in the 2010 period. In October 2011, the Company sold virtually all of its equity securities and realized a gain of \$62.3 million in order to reduce potential volatility in statutory surplus.

Net realized investment gains increased \$12.7 million in the nine months ended September 30, 2011 as compared to the same period in the prior year, primarily due to realized gains on the sale of equity mutual funds in the first quarter of 2011, partially offset by the impairment charges recorded in the third quarter of 2011. The sales of the equity mutual funds were made in order to invest in dividend paying equities.

Harleysville Group held securities with unrealized losses at September 30, 2011 as follows:

|                                       | <u>Fair Value</u> | <u>Unrealized<br/>Losses</u><br>(in thousands) | <u>Length of<br/>Unrealized Loss<br/>Less Than<br/>12 Months</u> |
|---------------------------------------|-------------------|--|--|
| Fixed maturities:                     |                   |  |  |
| Corporate securities                  | <u>\$ 3,371</u>   | <u>\$ 106</u>                                  | <u>\$ 106</u>  |
| Total temporarily impaired securities | <u>\$ 3,371</u>   | <u>\$ 106</u>                                  | <u>\$ 106</u>  |

Of the total fixed maturity securities with an unrealized loss at September 30, 2011, securities with a fair value of \$1,470,000 and an unrealized loss of \$12,000 are classified as available for sale and are carried at fair value on the balance sheet while securities with a fair value of \$1,901,000 and an unrealized loss of \$94,000 are classified as held to maturity on the balance sheet and are carried at amortized cost.

The unrealized losses on fixed maturity investments were primarily due to a widening of credit spreads on securities in the financial sector. Per the Company's current policy, a fixed maturity security is other than temporarily impaired if the present value of the cash flows expected to be collected is less than the amortized cost of the security or where the security's fair value is below cost and the Company intends to sell or more likely than not will be required to sell the security before recovery of its value. The Company

believes, based on its analysis, that these securities are not other than temporarily impaired. However, depending on developments involving both the issuers and overall economic conditions, these investments may be written down in the income statement in the future.

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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

#### Management' s Discussion and Analysis of Financial Condition and Results of Operations (Continued)

The fair value and amortized cost of general obligation and special revenue bonds held by the Company as of September 30, 2011 is as follows:

|                          | <u>Fair Value</u>  | <u>Amortized Cost</u> |
|--------------------------|--------------------|-----------------------|
|                          | (in thousands)     |                       |
| General obligation bonds | \$861,696          | \$796,832             |
| Special revenue bonds    | 371,604            | 348,171               |
| Total                    | <u>\$1,233,300</u> | <u>\$1,145,003</u>    |

For each category above, no state, municipality or political subdivision comprised more than 10% of the total.

The break-down of the special revenue bonds category, by nature of activity for activities comprising more than 10% of the category, is as follows:

|                                   | <u>Fair Value</u>      | <u>Amortized Cost</u> | <u>Moody' s Average Credit Rating</u> |
|-----------------------------------|------------------------|-----------------------|---------------------------------------|
|                                   | (dollars in thousands) |                       |                                       |
| Education                         | \$117,968              | \$109,139             | Aa                                    |
| Water & sewer                     | 102,160                | 96,563                | Aaa                                   |
| Transportation                    | 49,098                 | 45,448                | Aa                                    |
| Escrowed To Maturity/Pre-refunded | 40,634                 | 38,929                | Aa                                    |
| Total                             | <u>\$309,860</u>       | <u>\$290,079</u>      |                                       |

An insurance company' s statutory combined ratio is a standard measure of underwriting profitability. This ratio is the sum of (1) the ratio of incurred losses and loss settlement expenses to net earned premium; (2) the ratio of expenses incurred for commissions, premium taxes, administrative and other underwriting expenses to net written premium; and (3) the ratio of dividends to policyholders to net earned premium. The statutory combined ratio does not reflect investment income, federal income taxes or other non-operating income or expense. A ratio of less than 100 percent generally indicates underwriting profitability. Harleysville Group' s statutory combined ratio increased to 129.5% for the three months ended September 30, 2011 from 99.9% for the three months ended September 30, 2010 and increased to 122.1% for the nine months ended September 30, 2011 from 102.9% for the nine months ended September 30, 2010. The combined ratio for the nine months ended September 30, 2011 includes 1.3% due to the impact of the statutory treatment of the ceding commission received on the unearned premiums ceded to the Mutual Company on January 1, 2011. Excluding the impact of the pool transfer, the statutory combined ratio was 120.8% for the nine months ended September 30, 2011. The greater statutory combined ratios in 2011 were primarily due to greater catastrophe losses and other weather-related losses affecting property coverages in both the three and nine months ended September 30, 2011. Catastrophe losses increased to \$39.2 million for the three months ended September 30, 2011 from \$3.7 million for the three months ended September 30, 2010. Catastrophe losses for the nine months ended September 30, 2011 increased to \$82.6 million from \$32.7 million for the nine months ended September 30, 2010.

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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

#### Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)

The statutory combined ratios by line of business for the three and nine months ended September 30, 2011, as compared to the three and nine months ended September 30, 2010, are shown below.

|  | For the three months<br>ended September 30, |         | For the nine months<br>ended September 30, |         |
|--|---|---------|--|---------|
|  | 2011  | 2010    | 2011                                       | 2010    |
| <b>Commercial:</b>   |   |         |  |         |
| Automobile   | 110.9 %                                     | 104.0 % | 105.5 %                                    | 100.2 % |
| Workers compensation   |   | 105.1 % |  | 107.8 % |
| Commercial multi-peril   | 141.0 %                                     | 102.4 % | 131.7 %                                    | 106.1 % |
| Other commercial   | 100.7 %                                     | 84.8 %  | 95.6 %                                     | 87.8 %  |
| Total commercial   | 125.0 %                                     | 100.9 % | 119.2 %                                    | 102.3 % |
| Total commercial excluding the impact of the pool transfer                 |   |         | 117.2 %                                    |         |
| <b>Personal:</b>   |   |         |  |         |
| Automobile   | 121.2 %                                     | 104.1 % | 117.1 %                                    | 104.9 % |
| Homeowners   | 178.4 %                                     | 94.9 %  | 156.8 %                                    | 113.2 % |
| Other personal   | 77.2 %                                      | 60.0 %  | 73.6 %                                     | 58.8 %  |
| Total personal   | 142.8 %                                     | 97.2 %  | 131.3 %                                    | 105.4 % |
| Total personal and commercial  | 129.5 %                                     | 99.9 %  | 122.1 %                                    | 102.9 % |
| Total personal and commercial excluding the impact of<br>the pool transfer |   |         | 120.8 %                                    |         |

The commercial lines statutory combined ratio increased to 125.0% and 117.2% for the three and nine months ended September 30, 2011 (excluding the impact of the pool transfer) from 100.9% and 102.3% for the three and nine months ended September 30, 2010. These increases are primarily due to unusually high catastrophe and non-catastrophe weather losses experienced in each of the three quarters of 2011. In the three months ended March 31, 2011, unusually severe winter weather resulting in catastrophe and non-catastrophe losses contributed to elevated loss activity during this period, particularly in the Northeast and Mid-Atlantic regions. For the three months ended June 30, 2011, all regions were significantly impacted by catastrophes with the Southeast and Midwest regions being most adversely affected due to tornado and hail losses. For the three months ended September 30, 2011, Hurricane Irene, Tropical Storm Lee, and other hail and windstorm events contributed to significant losses, particularly in the Northeast and Mid-Atlantic regions. Catastrophe losses in the commercial lines represented 15.7 points of the combined ratio in the three months ended September 30, 2011 compared to 0.4 points in the three months ended September 30, 2010. Catastrophe losses in the commercial lines represented 11.0 points of the combined ratio in the nine months ended September 30, 2011 compared to 3.2 points in the nine months ended September 30, 2010.

The personal lines statutory combined ratio increased to 142.8% and 131.3% for the three and nine months ended September 30, 2011 from 97.2% and 105.4% for the three and nine months ended September 30, 2010. The increase in the statutory combined ratio for the three and nine months ended September 30, 2011 is primarily due to higher catastrophe and non-catastrophe weather losses affecting property coverages during the respective periods. The unusually severe winter weather described for commercial lines also impacted personal lines during the three and nine months ended September 30, 2011. Catastrophe losses in the personal lines represented 29.8 points of the combined



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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

#### Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)

ratio in the three months ended September 30, 2011 compared to 6.2 points in the three months ended September 30, 2010. Catastrophe losses in the personal lines represented 21.5 points of the combined ratio in the nine months ended September 30, 2011 compared to 11.9 points in the nine months ended September 30, 2010.

The following table presents the liability for unpaid losses and loss settlement expenses by major line of business:

|                               | September 30,<br><u>2011</u> | December 31,<br><u>2010</u> |
|-------------------------------|------------------------------|-----------------------------|
|                               | (in thousands)               |                             |
| <b>Commercial:</b>            |                              |                             |
| Automobile                    | \$283,353                    | \$288,289                   |
| Workers compensation          | 320,966                      | 370,838                     |
| Commercial multi-peril        | 680,734                      | 634,145                     |
| Other commercial              | 143,256                      | 143,070                     |
| Total commercial              | <u>1,428,309</u>             | <u>1,436,342</u>            |
| <b>Personal:</b>              |                              |                             |
| Automobile                    | 84,176                       | 78,505                      |
| Homeowners                    | 55,308                       | 36,427                      |
| Other personal                | 2,761                        | 2,791                       |
| Total personal                | <u>142,245</u>               | <u>117,723</u>              |
| Total personal and commercial | 1,570,554                    | 1,554,065                   |
| Plus reinsurance recoverable  | <u>270,812</u>               | <u>217,596</u>              |
| Total liability               | <u>\$1,841,366</u>           | <u>\$1,771,661</u>          |

The following table presents the increase (decrease) in the estimated ultimate loss and loss settlement expenses attributable to insured events of prior years for the nine months ended September 30, 2011 by line of business:

|                        |                 | Accident Years |                |                            |
|------------------------|-----------------|----------------|----------------|----------------------------|
|                        | Total           | 2010           | 2009           | 2008 and<br>Prior<br>Years |
|                        | (in thousands)  |                |                |                            |
| <b>Commercial:</b>     |                 |                |                |                            |
| Automobile             | \$(5,049 )      | \$1,083        | \$(110 )       | \$(6,022 )                 |
| Workers compensation   | (8,998 )        | 1,904          | 482            | (11,384)                   |
| Commercial multi-peril | (8,039 )        | 2,312          | 636            | (10,987)                   |
| Other commercial       | <u>(3,849 )</u> | <u>821</u>     | <u>(1,557)</u> | <u>(3,113 )</u>            |
| Total commercial       | <u>(25,935)</u> | <u>6,120</u>   | <u>(549 )</u>  | <u>(31,506)</u>            |
| <b>Personal:</b>       |                 |                |                |                            |
| Automobile             | (543 )          | 6,038          | 189            | (6,770 )                   |

|                       |                   |                 |               |                   |
|-----------------------|-------------------|-----------------|---------------|-------------------|
| Homeowners            | (441 )            | 530             | 937           | (1,908 )          |
| Other personal        | <u>(50 )</u>      | <u>157</u>      | <u>(298 )</u> | <u>91</u>         |
| Total personal        | <u>(1,034 )</u>   | <u>6,725</u>    | <u>828</u>    | <u>(8,587 )</u>   |
| Total net development | <u>\$(26,969)</u> | <u>\$12,845</u> | <u>\$279</u>  | <u>\$(40,093)</u> |

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### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

#### Management's Discussion and Analysis of Financial Condition and Results of Operations

(Continued)

There was \$27.0 million of net favorable development in the provision for insured events in prior years for the nine months ended September 30, 2011, (\$6.8 million in the third quarter of 2011), of which \$25.9 million was in commercial lines and \$1.0 million was in personal lines. The favorable development primarily related to the 2001 through 2008 accident years as a result of lower than expected claim severity experienced broadly across all lines of business, particularly workers compensation, commercial multi-peril, commercial automobile and other commercial lines, partially offset by adverse development in accident year 2010.

There was \$35.1 million of net favorable development in the provision for insured events in prior years for the nine months ended September 30, 2010, (\$13.0 million in the third quarter of 2010), of which \$30.9 million was in commercial lines and \$4.2 million was in personal lines. The favorable development primarily related to the 2004 through 2007 accident years as a result of lower than expected claim severity experienced broadly across most lines of business.

Harleysville Group records the actuarial central estimate, which is management's best estimate, of the ultimate unpaid losses and loss settlement expenses incurred. The estimate represents the actuarially determined expected amount of future payments on all loss and loss settlement expenses incurred on or before September 30, 2011. Actuarial loss reserving techniques and assumptions, which rely on historical information as adjusted to reflect current conditions, have been consistently applied, after including consideration of recent case reserve activity, during the periods presented. Changes in the estimate of the liability for unpaid losses and loss settlement expenses reflect actual payments and evaluations of new information and data since the last reporting date. These changes correlate with actuarial trends.

The following table presents the liability for unpaid losses and loss settlement expenses (LAE) by case and incurred but not reported (IBNR) reserves by line of business as of September 30, 2011:

|                         | <u>Case</u>      | <u>IBNR</u>      | <u>LAE Liability</u> | <u>IBNR</u>        | <u>Total</u>       |
|-------------------------|------------------|------------------|----------------------|--------------------|--------------------|
|                         |                  |                  |                      | <u>(Incl. LAE)</u> | <u>Liability</u>   |
|                         |                  |                  | (in thousands)       |                    |                    |
| <b>Commercial:</b>      |                  |                  |                      |                    |                    |
| Automobile              | \$99,047         | \$133,467        | \$ 50,839            | \$184,306          | \$283,353          |
| Workers compensation    | 138,529          | 135,215          | 47,222               | 182,437            | 320,966            |
| Commercial multi-peril  | 185,966          | 317,851          | 176,917              | 494,768            | 680,734            |
| Other commercial        | 29,990           | 78,644           | 34,622               | 113,266            | 143,256            |
| Total commercial        | <u>453,532</u>   | <u>665,177</u>   | <u>309,600</u>       | <u>974,777</u>     | <u>1,428,309</u>   |
| <b>Personal:</b>        |                  |                  |                      |                    |                    |
| Automobile              | 41,297           | 27,934           | 14,945               | 42,879             | 84,176             |
| Homeowners              | 19,517           | 27,362           | 8,429                | 35,791             | 55,308             |
| Other personal          | 777              | 1,561            | 423                  | 1,984              | 2,761              |
| Total personal          | <u>61,591</u>    | <u>56,857</u>    | <u>23,797</u>        | <u>80,654</u>      | <u>142,245</u>     |
| Total net liability     | <u>515,123</u>   | <u>722,034</u>   | <u>333,397</u>       | <u>1,055,431</u>   | <u>1,570,554</u>   |
| Reinsurance recoverable | <u>136,874</u>   | <u>133,422</u>   | <u>516</u>           | <u>133,938</u>     | <u>270,812</u>     |
| Total gross liability   | <u>\$651,997</u> | <u>\$855,456</u> | <u>\$333,913</u>     | <u>\$1,189,369</u> | <u>\$1,841,366</u> |



**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management's Discussion and Analysis of Financial Condition  
and Results of Operations**

(Continued)

Reinsurance recoverables were \$272.8 million and \$219.1 million at September 30, 2011 and December 31, 2010, respectively. Of these amounts, \$159.7 million and \$102.3 million, or 59% and 47%, respectively, of the recoverables were due from governmental bodies, regulatory agencies or quasi-governmental pools and reinsurance facilities where, Harleysville Group believes, there is limited credit risk. The remainder of the reinsurance recoverables are principally due from reinsurers rated A- or higher by A.M. Best. Ceded reinsurance contracts do not relieve Harleysville Group's primary obligation to its policyholders. Consequently, an exposure exists with respect to reinsurance recoverables to the extent that any reinsurer is unable to meet its obligation or disputes the liabilities assumed under the reinsurance contract. From time to time, Harleysville Group may encounter such disputes with its reinsurers. In addition, the creditworthiness of our reinsurers could deteriorate in the future due to adverse events affecting the reinsurance industry, such as a large number of major catastrophes.

Because of the nature of insurance claims, there are uncertainties inherent in the estimates of ultimate losses. Harleysville Group's changes in its claims operation in recent years have resulted in new people and processes involved in settling claims. As a result, more recent statistical data reflects different patterns than in the past and gives rise to uncertainty as to the pattern of future loss settlements. There are uncertainties regarding future loss cost trends particularly related to medical treatments and automobile repair. Court decisions, regulatory changes and economic conditions can affect the ultimate cost of claims that occurred in the past. Accordingly, the ultimate liability for unpaid losses and loss settlement expenses will likely differ from the amount recorded at September 30, 2011.

The property and casualty industry has had substantial aggregate loss experience from claims related to asbestos-related illnesses, environmental remediation, product liability, mold, and other uncertain exposures. Harleysville Group has not experienced significant losses from such claims.

Effective January 1, 2011, the Company's subsidiaries and the Mutual Company and its wholly owned subsidiary purchased additional property catastrophe reinsurance for one year, providing coverage of 75% of up to \$50.0 million in excess of \$475.0 million.

Effective for one year from July 1, 2011, the Company's subsidiaries and the Mutual Company and its wholly owned subsidiary renewed their catastrophe reinsurance treaty under which they are increasing their retention and changing their co-participations. Annual retentions and limits on the expiring and new treaties are set forth below:

| <u>NEW TREATY FOR 2011-2012</u>                  | <u>EXPIRING TREATY FOR 2010-2011</u>            |
|--|---|
| <u>Retention:</u> \$60 million                   | <u>Retention:</u> \$50 million                  |
| <u>Coverage for Losses</u>                       | <u>Coverage for Losses</u>                      |
| 71.45% of losses between \$60 and \$90 million   | 82% of losses between \$50 and \$90 million     |
| 75.7% of losses between \$90 and \$200 million   | 78% of losses between \$90 and \$200 million    |
| 80.34% of losses between \$200 and \$475 million | 75.4% of losses between \$200 and \$425 million |
|  | 75% of losses between \$425 and \$475 million   |

TREATY EFFECTIVE JANUARY 1, 2011 TO DECEMBER 31, 2011

Coverage for Losses

75% of losses between \$475 and \$525 million

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management's Discussion and Analysis of Financial Condition  
and Results of Operations**

(Continued)

The maximum recovery under the new program effective July 1, 2011 is \$363.1 million; under the prior program it was \$363.2 million. Harleysville Group's current pooling share of this maximum recovery would be \$290.5 million, compared to a maximum recovery of \$290.5 million under the prior program. The treaties include reinstatement provisions providing for coverage for a second catastrophe and requiring payment of an additional premium in the event a first catastrophe occurs.

Other expenses increased \$6.3 million for the three and nine months ended September 30, 2011 compared to the same prior year periods due to merger-related expenses of \$6.3 million incurred in the 2011 periods.

Income (loss) before income taxes decreased \$67.6 million and \$98.4 million for the three and nine months ended September 30, 2011, compared to the same prior year periods. The decreases were primarily due to greater underwriting losses in the 2011 periods compared to the prior year periods, decreases in investment income and merger-related expenses in 2011. The greater underwriting losses in 2011 were primarily due to greater catastrophe losses and other weather-related losses affecting property coverages in both the three and nine month periods of 2011 compared to the prior year periods. The nine month period ended September 30, 2011 also includes greater realized gains of \$12.7 million compared to the same prior year period.

The Company's income tax benefits of \$17.0 million and \$23.8 million in the three and nine months ended September 30, 2011, respectively, result primarily from the pre-tax net losses in the three and nine months ended September 30, 2011 and the impact of tax-exempt investment income on the calculation of the Company's tax provision in both periods. The income tax benefit for the three and nine months ended September 30, 2011 includes a tax benefit of \$3.4 million and \$10.3 million associated with tax-exempt income compared to \$3.3 million and \$9.9 million in the same prior year periods.

**Liquidity and Capital Resources**

Operating activities used net cash of \$64.0 million and provided net cash of \$69.1 million for the nine months ended September 30, 2011 and 2010, respectively. The 2011 amount includes \$33.0 million paid in connection with the change to the intercompany pooling agreement effective January 1, 2011. The remaining decrease of \$100.1 million is due to a decrease in underwriting cash flow, primarily from an increase in paid losses from greater catastrophe losses and a decrease in premiums due to the change in the pooling agreement.

Investing activities provided net cash of \$90.2 million and used net cash of \$20.2 million for the nine months ended September 30, 2011 and 2010, respectively. The change is primarily due to net sales of investments in the 2011 period due to the use of cash by operating activities and financing activities.

Financing activities used \$26.2 million and \$49.0 million of net cash for the nine months ended September 30, 2011 and 2010, respectively. The decrease is primarily due to the decrease in the purchase of treasury stock, partially offset by a decrease in common stock issued, in the 2011 period compared to the 2010 period.

Harleysville Group's investment strategy is designed to complement and support the insurance operations. Harleysville Group considers projected cash flow (premiums, investment income, reinsurance programs, liability payout patterns, general expenses, large seasonal obligations, intercompany transfers, etc.) to assure that sufficient liquidity exists within Harleysville Group and the Mutual Company. Maintaining a regular maturity schedule in readily marketable securities is an essential part of addressing liquidity. This regular maturity schedule is maintained in all interest rate environments. After-tax yield will be maximized consistent with safety and liquidity considerations by investment in taxable or tax-exempt securities, depending on Harleysville Group's tax position.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Management' s Discussion and Analysis of Financial Condition  
and Results of Operations**

(Continued)

Harleysville Group Inc. had \$36.1 million of cash and marketable securities at September 30, 2011 which is available for general corporate purpose including dividends, debt service, capital contributions to subsidiaries, acquisitions and the repurchase of stock. On July 30, 2009, the Board of Directors authorized the Company to repurchase up to 800,000 shares of its outstanding common stock over a two year period in the open market or in privately negotiated transactions. Additionally, the Board authorized the Company to make purchases under the terms of a Rule 10b5-1 trading plan, which allows the Company to purchase its shares at times when it ordinarily would not be in the market because of self-imposed trading blackout periods, such as the time preceding its quarterly earnings releases or because its officers are in possession of material, non-public information. The Company repurchased shares in open market transactions from the public float, and did not repurchase shares from the Mutual Company. This program was completed on August 3, 2010. On August 6, 2010, the Board of Directors authorized the Company to repurchase up to an additional 800,000 shares of its common stock over a two year period under terms similar to the repurchase authorization of July 30, 2009. As of September 30, 2011, the Company had repurchased 245,084 shares under this authorization, leaving 554,916 shares authorized to be repurchased. Provisions in the merger agreement with Nationwide restrict the Company from repurchasing further shares. Harleysville Group has no other material commitments for capital expenditures as of September 30, 2011.

As a holding company, the Company' s principal source of cash for the payment of dividends is dividends from its insurance subsidiaries. The Company' s insurance subsidiaries are subject to state laws that restrict their ability to pay dividends. The Company' s insurance subsidiaries paid dividends of \$43.4 million to the Company in 2011, \$24.2 million of these dividends had been declared in 2010.

The timing of future cash payments associated with unpaid losses and loss settlement expenses and contractual obligations pursuant to debt agreements is not expected to be materially different from that disclosed in the Company' s Annual Report on Form 10-K for fiscal year 2010.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Item 3.**

**Quantitative and Qualitative Disclosures  
About Market Risk**

Harleysville Group's market risk generally represents the risk of gain or loss that may result from the potential change in the fair value of Harleysville Group's investment portfolio as a result of fluctuations in prices and interest rates. Harleysville Group attempts to manage its interest rate risk by maintaining an appropriate relationship between the average duration of the investment portfolio and the approximate duration of its liabilities. Changes to Harleysville Group's market risk since December 31, 2010 are reflected within Management's Discussion and Analysis of Financial Condition and Results of Operations and within the financial statements contained within this quarterly report on Form 10-Q.

Harleysville Group has maintained approximately the same duration of its investment portfolio to its liabilities from December 31, 2010 to September 30, 2011. During the first quarter of 2011, the Company increased its holdings of equity securities by approximately \$80 million. During the third quarter of 2011, the Company recognized an impairment loss of \$4.0 million on securities it intends to sell. The Company sold virtually all of its equity securities in October 2011.

**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**Item 4.**

**Controls and Procedures**

- (a) *Evaluation of disclosure controls and procedures.* Our management, under the supervision and with the participation of the chief executive officer and the chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures as required by Rule 13a-15(b) or Rule 15d-15(b) of the Securities Exchange Act of 1934, as amended, as of September 30, 2011, which is the end of the period covered by this quarterly report on Form 10-Q. Based on that evaluation, the chief executive officer and chief financial officer have concluded that these disclosure controls and procedures are effective to provide that (a) material information relating to us, including our consolidated subsidiaries, is made known to these officers by other employees of us and our consolidated subsidiaries, particularly material information related to the third quarter of 2011, for which this periodic report is being prepared; and (b) this information is recorded, processed, summarized, evaluated and reported, as applicable, within the time periods specified in the rules and forms of the SEC.
- (b) *Change in internal control over financial reporting.* There was no change in the Company' s internal control over financial reporting that occurred during the third quarter of 2011 that has materially affected, or is reasonably likely to materially affect, the Company' s internal control over financial reporting.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

PART II. OTHER INFORMATION

**Item 1.** Legal Proceedings

On October 4, 2011, the Company received a class action complaint, captioned *Louisiana Municipal Police Employees Retirement System on behalf of itself and all others similarly situated v. Harleysville Group Inc., et al.*, Case No. 6907VCP. This purported class action complaint was filed in the State of Delaware Chancery Court. The complaint contains two counts: (1) a count that alleges breach of fiduciary duties by the individually-named directors of the Company; and (2) a count that alleges that Nationwide Mutual Insurance Company aided and abetted such breach of fiduciary duties. Both counts relate to the announced merger transaction between Nationals Sub, Inc., a wholly owned subsidiary of Nationwide Mutual Insurance Company, and the Company. The complaint seeks relief in the form of an injunction, damages and attorney' s fees. The Company is still in the process of reviewing the complaint, but believes that the plaintiff' s allegations are without merit, and intends to vigorously defend against these claims.

On October 6, 2011, the Company received a class action complaint, captioned *Eric H. Berger, on behalf of himself and all other similarly situated v. Harleysville Group Inc. et al.*, Case No. 6918-VCP. This purported class action complaint was filed in the State of Delaware Chancery Court. The complaint contains two counts: (1) a count that alleges breach of fiduciary duties by the individually-named directors of the Company; and (2) a count that alleges that Nationwide Mutual Insurance Company aided and abetted such breach of fiduciary duties. Both counts relate to the announced merger transaction between Nationals Sub, Inc., a wholly owned subsidiary of Nationwide Mutual Insurance Company, and the Company. The complaint seeks relief in the form of an injunction, damages and attorney' s fees. The Company is still in the process of reviewing the complaint, but believes that the plaintiff' s allegations are without merit, and intends to vigorously defend against these claims.

**Item 1A.** Risk Factors

**The announcement of the merger agreement among Harleysville Group Inc., Harleysville Mutual Insurance Company and Nationwide Mutual Insurance Company could have an adverse effect on our stock price, financial condition, results of operations or business prospects.**

The announcement of the merger agreement with Nationwide could disrupt our business in the following ways, among others:

employees may experience uncertainty regarding their future roles with the merged company, which might adversely affect the Company' s ability to retain, recruit and motivate key personnel;

the attention of the Company' s management may be directed toward the completion of the merger and transaction-related considerations and may be diverted from the day-to-day business operations of the Company, and the matters related to the merger may require commitments of time and resources that could otherwise have been devoted to other opportunities that might have been beneficial to the Company; and

third parties with business relationships with the Company may seek to terminate or renegotiate their relationships with the Company as a result of the merger.

The merger agreement also restricts the Company from engaging in certain actions and taking certain actions without Nationwide' s approval, which could prevent us from pursuing opportunities that may arise prior to the closing of the merger or termination of the agreement.

Any of these matters could adversely affect our financial condition, results of operations or business prospects.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

PART II. OTHER INFORMATION

(Continued)

**Failure to complete the merger could negatively affect our stock price and our future business and financial results.**

If the merger is not completed, our ongoing business may be adversely affected and we will be subject to the following risks, among others:

we may have to pay significant costs relating to the merger without receiving the benefits of the merger; and

any resulting negative customer perception could adversely affect our ability to compete for, or to win, new and renewal business in the marketplace.

**We will incur substantial transaction and merger-related costs in connection with the merger.**

We expect to incur a number of substantial non-recurring transaction fees and other costs associated with the merger. During the third quarter of 2011, we incurred expenses of approximately \$6.3 million related to the merger. Additional unanticipated costs may be incurred in the integration of the merged businesses. In the event the merger agreement is terminated, under certain circumstances we may be required to pay Nationwide a termination fee of \$29.6 million and reimburse them for their expenses.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

**Issuer Purchases Of Equity Securities <sup>(1)</sup>**

| <u>Period</u>                    | <u>Total Number<br/>of Shares<br/>Purchased <sup>(2)</sup></u> | <u>Average Price<br/>Paid Per<br/>Share</u> | <u>Total Number of<br/>Shares Purchased<br/>as Part of Publicly<br/>Announced Plans<br/>or Programs</u> | <u>Maximum Number<br/>of Shares<br/>that May Yet<br/>Be Purchased<br/>Under<br/>the Plans or<br/>Program</u> |
|----------------------------------|--|---|---|--|
| July 1 - July 31, 2011           | 61   | \$ 32.04                                    | -0-   | 554,916  |
| August 1 - August 31, 2011       | -0-  |   | -0-   | 554,916  |
| September 1 - September 30, 2011 | -0-  |   | -0-   | 554,916  |

- (1) On July 30, 2009, the Board of Directors authorized the Company to repurchase up to 800,000 shares of its outstanding common stock over a two year period in the open market or in privately negotiated transactions. Additionally, the Board authorized the Company to make purchases under the terms of a Rule 10b5-1 trading plan, which allows the Company to purchase its shares at times when it ordinarily would not be in the market because of self-imposed trading blackout periods, such as the time preceding its quarterly earnings releases, or because its officers are in possession of material, non-public information. The Company repurchased shares in open market transactions from the public float, and did not repurchase shares from the Mutual Company. This program was completed on August 3, 2010. On August 6, 2010, the Board of Directors authorized the Company to repurchase up to an additional 800,000 shares of its outstanding common stock over a two year period under terms similar to the repurchase authorization of July 30, 2009. As of September 30, 2011, the Company had repurchased 245,084 shares under this authorization, leaving 554,916 shares authorized to be repurchased. Provisions in the merger agreement with Nationwide restrict the Company from repurchasing further shares.

HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

PART II. OTHER INFORMATION

(Continued)

- (2) In accordance with the terms of its Equity Incentive Plan, the Company acquired all of the above shares from employees in connection with stock option exercises and the vesting of restricted stock. The stock was received in payment of the exercise price of the stock options and in satisfaction of withholding taxes due upon exercise or vesting.

**Item 6.** a. Exhibits

|           |   |
|-----------|---|
| 10.1*     | Change in Control Employment Agreement with Arne Herenstein - July 11, 2011                         |
| 31.1*     | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2*     | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1*     | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2*     | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS** | XBRL Instance Document.   |
| 101.SCH** | XBRL Taxonomy Extension Schema Document.  |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase Document.  |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase Document.  |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase Document.   |
| 101.DEF** | XBRL Taxonomy Extension Definition Linkbase Document.   |

\* Filed herewith.

\*\* Furnished and not filed herewith.



**HARLEYSVILLE GROUP INC. AND SUBSIDIARIES**

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 7, 2011

**Harleysville Group Inc.**

By: /s/ ARTHUR E. CHANDLER

Arthur E. Chandler  
Senior Vice President and  
Chief Financial Officer  
(duly elected officer and principal financial officer)

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## Table of Contents

### HARLEYSVILLE GROUP INC. AND SUBSIDIARIES

#### EXHIBIT INDEX

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|-------------------|---|
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\* Filed herewith.

\*\* Furnished and not filed herewith.

**Michael L. Browne**  
Chief Executive Officer

**Harleysville Insurance**  
355 Maple Avenue  
Harleysville, PA 19438-2297  
www.harleysvillegroup.com

Tel (215) 256-5013  
Fax (215) 256-5008  
mbrowne@harleysvillegroup.com



July 11, 2011

Arne Herenstein  
Senior Vice President  
Harleysville Insurance  
355 Maple Ave  
Harleysville, PA 19438

**RE: CHANGE IN CONTROL AGREEMENT**

Dear Arne:

Harleysville Group Inc. (“Employer”) considers the establishment and maintenance of a sound and vital management team essential to protecting and enhancing the best interests of it and its stockholders and those of its parent company, Harleysville Mutual Insurance Company (“Parent”) and the Parent’s policyholders. In this connection, the Employer recognizes that, as is the case with many publicly held corporations, the possibility of a change in control of the Employer exists and that such possibility and the uncertainty and questions which it may raise among management personnel as to the effect of such change in control on the Employer, may result in the departure or distraction of such personnel to the detriment of the Employer, the Parent, the Employer’s stockholders and the Parent’s policyholders. Accordingly, the Board of Directors of the Employer (“Board”) has determined that appropriate steps should be taken to reinforce and encourage the continued attention and dedication of the key members of the Employer’s management, including yourself, to their assigned duties without the distraction arising from the possibility of a change in control.

In order to induce you to remain in the Employer’s employ, this letter agreement (“Agreement”) supersedes and replaces any prior similar agreement, and sets forth the severance benefits which the Employer agrees will be provided to you in the event your employment is terminated subsequent to a “Change in Control” (as defined in Section 2) and under the circumstances described below.

**1. Term.** This Agreement shall commence on July 11, 2011 and shall continue in effect through December 31, 2012 (the “Initial Expiration Date”); provided, however, that commencing on January 1, 2013, and each January 1 thereafter, the term of this Agreement shall automatically be extended for one additional year (each, an “Extended Expiration Date”) unless, not later than twelve (12) months prior to the Initial Expiration Date or any Extended Expiration Date, as the case may be, the Employer shall have given notice that it does not wish to extend this Agreement; provided, further, if a Change in Control of the Employer shall have occurred during the original or extended term of this Agreement, this Agreement shall continue in effect for a period of twenty-four (24) months beyond the month in which such Change in Control occurred.

## 2. Change in Control.

For purposes of this Agreement, "Change in Control" of the Employer shall be deemed to have occurred:

(a) if the "beneficial ownership" (as defined in Rule 13d-3 under the Securities Exchange Act of 1934) of securities representing more than twenty percent (20%) of the combined voting power of the Employer Voting Securities (as herein defined) is acquired by any individual, entity or group (a "Person"), other than the Parent, the Employer, any trustee or other fiduciary holding securities under any employee benefit plan of the Employer or an affiliate thereof, or any corporation owned, directly or indirectly, by the stockholders of the Employer in substantially the same proportions as their ownership of stock of the Employer (for purposes of this Agreement, "Employer Voting Securities" shall mean the then outstanding voting securities of the Employer entitled to vote generally in the election of directors); provided, however, that the following shall not constitute a Change in Control under this paragraph (a) : (i) any acquisition pursuant to a transaction which complies with clauses (i), (ii) and (iii) of paragraph (c) of this Section 2; (ii) any acquisition of the Employer Voting Securities from the Parent pursuant to a Business Combination (as herein defined) or otherwise, if (x) the acquiring or resulting entity is organized in the mutual form, and (y) persons who were members of the Incumbent Board (as herein defined) of the Parent immediately prior to such acquisition constitute at least two-thirds of the members of the Board of Directors of the acquiring entity immediately following such acquisition and (iii) any acquisition of voting securities from the Employer or the Parent by a person engaged in business as an underwriter of securities who acquires the shares through his participation in good faith in a firm commitment underwriting registered under the Securities Act of 1933; and (iv) any acquisition otherwise within the terms of this paragraph (a) during any period in which Parent owns at least a majority of the combined voting power of Employer Voting Securities (the "Parent Control Period"), but if such an acquisition is made during a Parent Control Period by any Person and such Person continues to hold more than 20% of the combined voting power of all Employer Voting Securities on the first day following the termination of a Parent Control Period, such acquisition will be deemed to have been first made on such date; or

(b) if, during any period of twenty-four (24) consecutive months, individuals who, as of the beginning of such period, constitute the Board of Directors of the Employer or the Parent, as the case may be (the "Applicable Incumbent Board"), cease for any reason to constitute at least a majority of the Board of Directors of the Employer or the Parent, as the case may be; provided, however, that (x) any individual becoming a director of the Employer or the Parent, as the case may be, during such period whose election, or nomination for election, was approved by a vote of at least a two-thirds of the directors then comprising the Applicable Incumbent Board (other than in connection with the settlement of a threatened proxy contest) shall be considered as though such individual were a member of the Incumbent Board of Directors of the Employer or the Parent, as the case may be, and (y) the provisions of this paragraph (b) shall not be applicable to the composition of the Board of Directors of Parent if Parent shall cease to own at least 20% of the combined voting power of all Employer Voting Securities; or

(c) upon consummation by the Employer of a reorganization, merger or consolidation or sale or other disposition of all or substantially all of the assets of the Employer or the acquisition of assets or stock of another entity (a "Business Combination"), unless, in any such

case, immediately following such Business Combination the following three conditions are met: (i) more than 50% of the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors of (x) the corporation resulting from such Business Combination (the "Surviving Corporation"), or (y) if applicable, a corporation which as a result of such transaction owns the Employer or all or substantially all of the Employer's assets either directly or through one or more subsidiaries (the "New Parent Corporation"), is represented, in either such case, directly or indirectly, by Employer Voting Securities outstanding immediately prior to such Business Combination (or, if applicable, is represented by shares into which such Employer Voting Securities were converted pursuant to such Business Combination), and such voting power is distributed among the holders thereof in substantially the same proportions as their ownership, immediately prior to such Business Combination, of the Employer Voting Securities, and (ii) no Person (excluding any employee benefit plan (or related trust) of the Employer or such corporation resulting from such Business Combination) beneficially owns, directly or indirectly, 50% or more of the combined voting power of the then outstanding voting securities eligible to elect directors of the New Parent Corporation (or, if there is no New Parent Corporation, the Surviving Corporation) except to the extent that such ownership of the Employer existed prior to the Business Combination, and (iii) at least a majority of the members of the board of directors of the New Parent Corporation (or, if there is no New Parent Corporation, the Surviving Corporation) were members of the Board of Directors of the Employer at the time of the execution of the initial agreement, or the action of the Board, providing for such Business Combination; or

(d) Parent affiliates with, or acquires by merger, a third party and, as a consequence thereof, persons who were members of the Incumbent Board of Parent immediately prior to such transaction cease to constitute at least two-thirds of the directors of Parent following such transaction provided, however, that this paragraph (d) shall not apply if immediately prior to such affiliation or merger, Parent does not own more than 20% of the combined voting power of Employer Voting Securities; or

(e) upon approval by the stockholders of the Employer and all necessary regulatory authorities of a complete liquidation or dissolution of the Employer; or

(f) any other event shall occur that would be required to be reported by the Employer in response to Item 6(e) of Schedule 14A of Regulation 14A promulgated under the Exchange Act (or any provision successor thereto); or

(g) the Employer or Parent has entered into a management agreement or similar arrangement pursuant to which an entity other than the Employer or the Parent or the Boards of Directors or the executive officers and management of the Employer or the Parent has the power to direct or cause the direction of the management and policies of the Employer or the Parent; provided, however, that this paragraph (g) shall not apply to Parent if, immediately prior to entering into any such management agreement or similar arrangement, Parent does not own more than 20% of Employer Voting Securities.

**3. Termination Following Change in Control.** If any of the events described in Section 2 hereof constituting a Change in Control shall occur during the term hereof, you shall be entitled to the benefits provided in Section 4 hereof upon the subsequent termination of your employment within twenty-four months following such Change in Control unless such termination is (a) because of your death or Retirement, (b) by the Employer for Cause, or (c) by you other than for Good Reason, in accordance with the following:

(a) **Disability; Retirement.**

- (i) If, as a result of your incapacity due to physical or mental illness, you shall have been absent from your duties with the Employer on a full time basis for six (6) consecutive months and within 30 days after written notice of termination is given you shall not have returned to the full time performance of your duties, the Employer may terminate this Agreement for "Disability."
- (ii) Termination of your employment based on "Retirement" shall mean termination in accordance with the Employer's retirement policy, including early retirement, generally applicable to its salaried employees or in accordance with any retirement arrangement established with your consent with respect to you.

- (b) **Cause.** The Employer may terminate your employment for Cause. Termination by the Employer of your employment for "Cause" shall mean termination upon (A) the willful and continued failure by you to substantially perform your duties with the Employer (other than any such failure resulting from your incapacity due to physical or mental illness), or any such actual or anticipated failure after the issuance of a Notice of Termination by you for Good Reason, as such terms are defined in Subsections 3(d) and 3(c), respectively, after a written demand specifically identifies the manner in which the Board believes that you have not substantially performed your duties, or (B) the willful engaging by you in conduct which is demonstrably and materially injurious to the Company, monetarily or otherwise. For purposes of this paragraph, no act or failure to act on your part shall be considered "willful" unless done or omitted to be done by you not in good faith and without reasonable belief that your action or omission was in the best interest of the Employer. Notwithstanding the foregoing, you shall not be deemed to have been terminated for Cause unless and until there shall have been delivered to you a copy of a resolution duly adopted by the affirmative vote of not less than three-quarters of the entire membership of the Board of a meeting of the Board called and held for the purpose (after reasonable notice to you and an opportunity for you, together with your counsel, to be heard before the Board) finding that, in the good faith opinion of the Board, you were guilty of conduct set forth above and specifying the particulars thereof in detail.

- (c) **Good Reason.** You may terminate your employment for Good Reason. For purposes of this Agreement, "Good Reason" shall mean, within twenty four (24) months following any Change in Control and without your express written consent:

- (i) the assignment to you of any duties inconsistent with your positions, duties, responsibilities and status with the Employer immediately prior to a Change in Control or a change in your reporting responsibilities, titles or offices as in effect immediately prior to a Change in Control, or any removal of you from or any failure to re-elect you to any of such positions, except in connection with the termination of your employment for Cause, Disability, Retirement or by you other than for Good Reason or as a result of your death;

- (ii) a reduction in your base salary under the Employer's Wage and Salary Program in effect immediately prior to a Change in Control or as the same may be increased from time to time thereafter;
- (iii) a failure by the Employer (A) to continue its executive incentive plans, as the same may be amended or modified from time to time but substantially in the form in effect immediately prior to a Change in Control ("Program"), or failure by the Employer to continue you as a participant in the Program on at least the basis in effect immediately preceding a Change in Control, provided that the failure to continue any one or more plans constituting the Program, or to continue you in any one or more plans shall not constitute Good Reason as long as, after giving effect to any such changes, the aggregate of the compensation which may be earned by you and the circumstances under which such amounts may be earned are substantially comparable, taken as a whole, as the Program, or (B) to pay you any installment of a previous award or of deferred compensation, if any, under the Program or any deferred compensation program in which you participated immediately prior to a Change in Control;
- (iv) the Employer requiring you to be based anywhere other than within fifty (50) miles of the office in Harleysville, Pennsylvania, except for required travel on business to an extent substantially consistent with the business travel obligations you experienced immediately preceding a Change in Control;
- (v) the failure by the Employer to continue in effect any benefit or compensation plan or arrangement, in which you are participating immediately preceding Change in Control, the taking of any action by the Employer not required by law which would adversely affect your participation in or materially reduce your benefits under any of such plans or deprive you of any material fringe benefit enjoyed by you at the time of the Change in Control or the failure by the Employer to provide you with the number of paid vacation days, holidays and personal days to which you are then entitled in accordance with the Employer's normal leave policy in effect immediately preceding a Change in Control; provided, however, that the failure to continue any plan or benefit or the taking of any

action which adversely affects your participation in, or materially reduces your benefits under any plan or deprives you of any material fringe benefit shall not be Good Reason under this Section 3(c)(v) if the failure to continue or other action applies equally to all employees or executives covered by the plan or benefit.

- (vi) the failure of the Employer to obtain the assumption of the agreement to perform this Agreement by any successor as contemplated in Section 5 hereof; or
  - (vii) any purported termination of your employment by the Employer which is not effected pursuant to a Notice of Termination satisfying the requirements of subparagraph (d) below (and, if applicable, subparagraph (b) above). Your continued employment shall not constitute consent to, or a waiver of rights with respect to, any circumstance constituting Good Reason hereunder.
- (d) **Notice of Termination.** Any termination by the Employer pursuant to subparagraphs (a) or (b), above, or by you pursuant to subparagraph (c), above, shall be communicated by a written Notice of Termination to the other party hereto. For purposes of this Agreement, a “Notice of Termination” shall mean a notice which shall indicate the specific termination provision in this Agreement relied upon and shall set forth, in reasonable detail, the facts and circumstances claimed to provide a basis for termination of your employment under the provision so indicated.
- (e) **Date of Termination.** “Date of Termination” shall mean (A) if this Agreement is terminated for Disability, 30 days after Notice of Termination is given (provided that you shall not have returned to the performance of your duties on a full-time basis during such 30-day period), (B) if your employment is terminated pursuant to subparagraph (c), above, the date specified in the Notice of Termination and (C) if your employment is terminated for any other reason, the date on which a Notice of Termination is given; provided that, if within 30 days after any Notice of Termination is given, the party receiving such Notice of Termination gives notice to the other party, other than in Bad Faith, that a dispute exists concerning the termination and the party giving such Notice shall pursue his claim diligently and in other than Bad Faith, the Date of Termination shall be the date on which the dispute is finally resolved, either by mutual written agreement of the parties, by a binding and final arbitration award or by a final judgment, order or decree of a court of competent jurisdiction (the time for appeal therefrom having expired and no appeal having been perfected). As used in this Agreement, “Bad Faith” shall mean that a dispute was asserted or maintained by you (i) for an improper purpose, such as to harass or cause unnecessary delay or needlessly increase the cost of resolution, or (ii) on a basis not warranted by existing law or a non-frivolous argument for the extension, modification, or reversal of existing law or the establishment of new law, or (iii) in the absence of evidentiary support (unless evidentiary support was reasonably likely to exist after



investigation or discovery). Bad Faith shall only be determined to exist for purposes of this Agreement if the arbitrator selected pursuant to Section 10 hereof makes a specific finding thereof in his award.

**4. Compensation Upon Termination Or During Disability Following A Change In Control.**

- (a) During any period following a Change in Control that you fail to perform your duties hereunder as a result of incapacity due to physical or mental illness, you shall continue to receive your full base salary at the rate then in effect and any installments of deferred portions of awards under the Program paid during such period until your employment is terminated pursuant to paragraph 3(a) hereof. Thereafter, your benefits shall be determined in accordance with the Employer's Long-Term Disability Plan, or any substitute plan then in effect.
- (b) If, following a Change in Control, you terminate your employment other than for Good Reason or your employment shall be terminated for Cause, the Employer shall pay you your full base salary through the Date of Termination at the rate in effect at the time Notice of Termination is given plus all other amounts to which you are entitled under any compensation plan, the annual incentive plan, long-term incentive plan, or stock option plan of the Employer at the time such payments are due and the Employer shall have no further obligation to you.
- (c) If, following a Change in Control, the Employer shall terminate your employment other than pursuant to paragraph (a) or (b) hereof or if you shall terminate your employment for Good Reason, then the Employer shall pay to you as severance pay in a lump sum at the time specified in Section 4(f), the following amounts:
  - (i) your full base salary through the Date of Termination at the rate in effect at the time Notice of Termination is given and an amount equal to the amount, if any, of the deferred portion of any awards which have been awarded to you pursuant to the Program but which have not yet been paid to you and the amount of Deferred Compensation, if any, under the Program which has accrued to your account; and
  - (ii) in lieu of any further salary payments to you for periods subsequent to the Date of Termination, an amount equal to the product of (a) the higher of your annual base salary in effect as of (i) the date of the Change in Control, and (ii) the Date of Termination, *plus* the average target awards under any annual incentive plan for the last three years, multiplied by (b) the number 2.000; and
  - (iii) in lieu of payments of any type under any long-term incentive plan, and to the extent not covered by any other subsection of this

Section 4(c), a cash amount equal to the sum of the target bonuses, pro-rated on a month-completed basis, for all long-term incentive plan periods in which you are currently participating plus any incentive compensation which has been allocated or awarded to you for a fiscal year or other measuring period preceding the Date of Termination but has not yet been paid. If all or part of a target award is comprised of shares of Employer' s stock, the amount paid in cash shall be equal to the fair market value of the stock at the beginning of the plan period; and

- (iv) in the event that any payments made to you under this Agreement or otherwise (the "Payments") for a termination event occurring under this Agreement that arises on or prior to December 31, 2014 are subject to the excise tax imposed by Section 4999 of the Internal Revenue Code (the "Excise Tax"), then the Employer shall pay you an additional amount ("Gross Up") such that the net amount retained by you after deduction of any Excise Tax on the Payments and any Federal, State and local income taxes and Excise Tax upon the payments provided for by this Section 4(c)(iv) shall be equal to the total value of the Payments at the time such payments are to be made. For the avoidance of doubt, (1) this Section 4(c)(iv) shall not provide you any additional amounts in respect of Federal, State, and local income taxes payable by you on amounts payable to you under any other section of this Agreement; and (2) this Section 4(c)(iv) shall not apply to any Payments made for any termination event arising under this Agreement with a Date of Termination after December 31, 2014. For purposes of determining the amount of the Gross Up, you shall be deemed to pay Federal, State and local income taxes at the highest marginal rate of taxation in the calendar year in which the Payment is to be made. State and local income taxes shall be determined based upon the state and locality of your domicile on the Date of Termination. The determination of whether such Excise Tax is payable, the amount thereof, and the Gross Up shall be based upon the opinion of tax counsel selected by the Employer and acceptable to you. If such opinion is not finally accepted by the IRS upon audit, then appropriate adjustments shall be computed (without interest but with Gross Up, if applicable) by such tax counsel based upon the final amount of the Excise Tax so determined. The amount shall be paid by the appropriate party in one lump cash sum within 30 days of such computation. Notwithstanding anything to the contrary in this Section 4(c)(iv), if the Payments would be subject to excise tax pursuant to Section 4999 of the Internal Revenue Code (the "Code") (or any similar federal or state excise tax), but would not be so subject if the total of such Payments would be reduced by 10% or less, then such Payments shall be reduced by the minimum amount necessary so as not to cause the Employer to have paid an Excess Parachute Payment as

defined in Section 280G(b)(1) of the Code and so you will not be subject to Excise Tax pursuant to Section 4999 of the Code. The calculation of any potential reduction pursuant to this paragraph or any disputes related thereto shall be made as described above with respect to the calculation of the Gross Up. In the event that the amount of any Payments that would be payable to or for your benefit under this Agreement must be modified or reduced to comply with this provision, you shall direct which Payments are to be modified or reduced; provided, however, that no change in the amount of any Payment or change in the timing of the Payment shall be made without the consent of the Employer. In no event shall the total Payments be reduced by more than 10% in order to avoid treatment as an Excess Parachute Payment. In no event shall any Gross Up under this provision be paid to you later than the end of the year following the year in which you pay the Excise Tax; and

- (v) the Employer shall pay all legal fees and expenses incurred by you as a result of such termination (including all such fees and expenses, if any, incurred in contesting or disputing any such termination or in seeking to obtain or enforce any right or benefit provided by this Agreement or in connection with any tax audit or proceeding to the extent attributable to the application of Section 4999 of the Code to any payment or benefit hereunder). Reimbursement of such legal fees and expenses shall be made on a regular and periodic basis by the Employer upon your presentation to the Employer of a statement of such fees and expenses prepared by your counsel under standard and customary methods; provided, however, that any such payments shall be made by the end of the year following the year in which such fees and expenses incurred; and
- (vi) the Employer shall maintain in full force and effect, for your continued benefit for twenty-four (24) months after the Date of Termination, all employee health and welfare benefit plans, programs or arrangements in which you were entitled to participate immediately prior to the Date of Termination, including, without limitation, medical and dental, life, disability, accident and death insurance plans, provided your continued participation is possible under the general terms and provisions of such plans and programs. In the event that your participation in any such plan or program is barred, the Employer shall arrange to provide you with benefits substantially similar to those which you would have been entitled to receive under such plans and programs. Except for any insurance policy used by the Employer to fund any Rabbi Trust, at the end of the period of coverage, you shall have the option to have assigned to you at no cost and with no apportionment of prepaid premiums, any assignable insurance policy owned by the Employer immediately preceding the Change in Control; and

- (d) You shall not be required to mitigate the amount of any payment provided for in this Section 4 by seeking other employment or otherwise, nor shall the amount of any payment or benefit provided for in this Section 4 be reduced by any compensation earned by you or benefits including retirement benefits provided to you as the result of employment by another employer after the Date of Termination or otherwise.
- (e) In addition to all other amounts payable to you under Section 4, and to the extent not payable by reason of the other provisions hereof, you shall be entitled to receive all benefits which have accrued through the Date of Termination and are payable to you under the Harleysville Retirement Savings Plus Plan, the Supplemental Retirement Plan, the Pension Plan, the Non-Qualified Deferred Compensation Plan, and any other plan or agreement relating to retirement benefits.
- (f) Any payments due under Sections 4(c)(i)-(iii) of this Agreement shall be paid on the thirtieth day following the Date of Termination. Notwithstanding the foregoing, no payments shall be made under Sections 4(c)(i)-(iii) until the first business day of the seventh calendar month following the month in which the Date of Termination occurs (except that any base salary accrued and unpaid as of the Date of Termination shall be paid in accordance with the Employer's standard payroll practice).

#### **5. Successors' Binding Agreement.**

- (a) The Employer will require any successor (whether direct or indirect, by purchase, merger, consolidation or otherwise) to all or substantially all of the business and/or assets of the Employer, by agreement in form and substance reasonably satisfactory to you, to expressly assume and agree to perform this Agreement in the same manner and to the same extent that the Employer would be required to perform it if no such succession had taken place. The Employer will also obtain agreement from such successor that it will not exercise its non-renewal option at any time within one year from the date of the Change in Control. Failure of the Employer to obtain such agreement prior to the effectiveness of any such succession shall be a breach of this Agreement and shall entitle you to compensation from the Employer in the same amount and on the same terms as you would be entitled hereunder if you terminated your employment for Good Reason, except that for purposes of implementing the foregoing, the date on which any such succession becomes effective shall be deemed the Date of Termination. As used in the Agreement, "Employer" shall mean the Employer as hereinbefore defined and any successor to its business and/or assets as aforesaid which executes and delivers the agreement provided for in this Section 5 or which otherwise becomes bound by all the terms and provisions of this Agreement by operation of law.

- (b) This Agreement shall inure to the benefit of and be enforceable by your personal or legal representatives, executors, administrators, successors, heirs, distributees, devisees and legatees. If you should die while any amounts would still be payable to you hereunder if you had continued to live, all such amounts, unless otherwise provided herein, shall be paid in accordance with the terms of this Agreement to your devisee, legatee, or other designee or, if there be no such designee, to your estate.

**6. Notice.** For the purposes of this Agreement, notices and all other communications provided for in the Agreement shall be in writing and shall be deemed to have been duly given when delivered or mailed by United States registered mail, return receipt requested, postage prepaid, addressed to the respective addresses set forth on the first page of this Agreement, provided that all notices to the Employer shall be directed to the attention of the Corporate Secretary or to such other address as either party may have furnished to the other in writing in accordance herewith, except that notices of change of address shall be effective only upon receipt.

**7. Miscellaneous.** No provisions of this Agreement may be modified, waived or discharged unless such waiver, modification or discharge is agreed to in writing and signed by you and such officer as may be authorized by the Board. No waiver by either party hereto at any time of any breach by the other party hereto of or compliance with any condition or provision of this Agreement to be performed by such other party shall be deemed a waiver of similar or dissimilar provision or conditions at the same or at any prior or subsequent time. No agreements or representations, oral or otherwise, express or implied, with respect to the subject matter hereof have been made by either party which are not set forth expressly in the Agreement. It is intended that the benefits payable hereunder shall be considered paid to you for your past services to the Employer and continuing services from the date hereof. Any payment provided for hereunder shall be paid net of any applicable withholding required under Federal, State and local law. No termination of this Agreement shall terminate the Employer's obligation to complete the payments of all amounts and benefits to which you became entitled, by operation of the provisions hereof, prior to expiration hereof. This is not an employment agreement; you remain an employee at will; in the event your employment is terminated prior to a Change in Control for any reason or no reason, no amounts are payable to you by reason of this Agreement. The validity, interpretation, construction and performance of this Agreement shall be governed by the substantive law of the Commonwealth of Pennsylvania.

**8. Validity.** The invalidity or unenforceability of any provisions of this Agreement shall not affect the validity of enforceability of any other provisions of this Agreement, which shall remain in full force and effect.

**9. Counterparts.** This Agreement may be executed in one or more counterparts, each of which shall be deemed to be an original but all of which together will constitute one and the same instrument.

**10. Arbitration.** Any dispute or controversy arising under or in connection with this Agreement shall be settled exclusively by arbitration before a single arbitrator in the Commonwealth of Pennsylvania in accordance with the Commercial Rules of the American Arbitration Association then in effect. Notwithstanding the pendency of any such dispute or controversy, the Employer will continue to pay your full compensation in effect when the notice

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Change in Control Agreement

giving rise to the dispute was given (including, but not limited to, base salary and installments under the Program) and, to the extent permitted by law, continue you as a participant in all compensation, benefits and insurance plans in which you were participating when the notice giving rise to the dispute was given, until the dispute is finally resolved in accordance with paragraph 3(e) hereof. Amounts paid under the previous sentence shall be offset against, and shall reduce, any other amounts due under this Agreement. If the Employer is successful in the arbitration and the arbitrator makes a specific finding that the controversy was commenced or maintained in Bad Faith, then all amounts paid to you pursuant to Section 4(c)(vi) and the second sentence of this Section 10 shall be repaid by you to the Employer within thirty (30) days of the award. Judgment may be entered on the arbitrator's award in any court having jurisdiction; provided, however, that you shall be entitled to seek specific performance of your right to be paid until the Date of Termination during pendency of any dispute or controversy arising under or in connection with this Agreement.

Very truly yours,

HARLEYSVILLE GROUP, INC.

By /s/ Michael L. Browne

Michael L. Browne  
Chief Executive Officer

/s/ Arnold F. Herenstein

EMPLOYEE'S SIGNATURE

AGREED TO THIS 11th DAY

OF JULY, 2011

**CERTIFICATION PURSUANT TO THE SECTION 302  
OF THE SARBANES-OXLEY ACT OF 2002**

I, Michael L. Browne, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Harleysville Group Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2011

/s/ MICHAEL L. BROWNE

Michael L. Browne

President and Chief Executive Officer

**CERTIFICATION PURSUANT TO THE SECTION 302  
OF THE SARBANES-OXLEY ACT OF 2002**

I, Arthur E. Chandler, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Harleysville Group Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2011

/s/ ARTHUR E. CHANDLER

Arthur E. Chandler

Senior Vice President and Chief Financial Officer



**HARLEYSVILLE GROUP INC.**  
**CERTIFICATION PURSUANT TO**  
**18 U.S.C. SECTION 1350,**  
**AS ADOPTED PURSUANT TO**  
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Harleystville Group Inc. (the "Company") on Form 10-Q for the period ended September 30, 2011, as filed with the U.S. Securities and Exchange Commission on the date hereof (the "Report"), I, Michael L. Browne, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that based on my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 7, 2011

/s/ MICHAEL L. BROWNE

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Michael L. Browne

President and Chief Executive Officer

**HARLEYSVILLE GROUP INC.**  
**CERTIFICATION PURSUANT TO**  
**18 U.S.C. SECTION 1350,**  
**AS ADOPTED PURSUANT TO**  
**SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Harleystville Group Inc. (the "Company") on Form 10-Q for the period ended September 30, 2011, as filed with the U.S. Securities and Exchange Commission on the date hereof (the "Report"), I, Arthur E. Chandler, Senior Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that based on my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 7, 2011

/s/ ARTHUR E. CHANDLER

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Arthur E. Chandler

Senior Vice President and Chief Financial Officer

**Consolidated Balance Sheets**  
**(Parenthetical) (USD \$)**  
**In Thousands, except Share**  
**data**

**Sep. 30, 2011 Dec. 31, 2010**

**Consolidated Balance Sheets [Abstract]**

|  |            |            |
|--|------------|------------|
| <u>Held to maturity, fair value</u>                          | \$ 132,410 | \$ 156,967 |
| <u>Available for sale, amortized cost</u>                    | 1,897,400  | 2,069,097  |
| <u>Equity securities, cost</u>                               | 268,338    | 191,095    |
| <u>Unpaid losses and loss settlement expenses, affiliate</u> | 163,330    | 214,518    |
| <u>Unearned premiums, affiliate</u>                          | (9,692)    | 32,935     |
| <u>Debt, affiliate</u>                                       | \$ 18,500  | \$ 18,500  |
| <u>Preferred stock, par value</u>                            | \$ 1       | \$ 1       |
| <u>Preferred stock, shares authorized</u>                    | 1,000,000  | 1,000,000  |
| <u>Preferred stock, shares issued</u>                        | 0          | 0          |
| <u>Common stock, par value</u>                               | \$ 1       | \$ 1       |
| <u>Common stock, shares authorized</u>                       | 80,000,000 | 80,000,000 |
| <u>Common stock, shares issued</u>                           | 35,231,859 | 34,987,829 |
| <u>Common stock, shares outstanding</u>                      | 27,180,797 | 27,044,836 |
| <u>Treasury stock, shares</u>                                | 8,051,062  | 7,942,993  |

| Consolidated Statements Of<br>Income (Loss) (USD \$)<br>In Thousands, except Per<br>Share data | 3 Months Ended   |                  | 9 Months Ended   |                  |
|--|------------------|------------------|------------------|------------------|
|  | Sep. 30,<br>2011 | Sep. 30,<br>2010 | Sep. 30,<br>2011 | Sep. 30,<br>2010 |
| <b>Revenues:</b>   |                  |                  |                  |                  |
| <u>Premiums earned from affiliate</u>  | \$ 201,736       | \$ 220,235       | \$ 602,465       | \$ 642,806       |
| <u>Investment income, net of investment expense</u>  | 23,829           | 25,323           | 74,253           | 77,020           |
| <b>Realized investment losses, net</b>   |                  |                  |                  |                  |
| <u>Total other-than-temporary impairment losses</u>  | (3,967)          |                  | (3,967)          |                  |
| <u>Portion of loss recognized in other comprehensive income</u>                                |                  |                  |                  |                  |
| <u>Other realized investment gains, net</u>  | 1,308            |                  | 17,180           | 526              |
| <u>Total realized investment gains (losses), net</u>   | (2,659)          |                  | 13,213           | 526              |
| <u>Other income</u>  | 5,273            | 4,241            | 14,437           | 11,910           |
| <u>Total revenues</u>  | 228,179          | 249,799          | 704,368          | 732,262          |
| <b>Losses and expenses:</b>  |                  |                  |                  |                  |
| <u>Losses and loss settlement expenses</u>   | 190,956          | 144,567          | 518,237          | 439,855          |
| <u>Amortization of deferred policy acquisition costs</u>                                       | 51,666           | 56,177           | 154,743          | 163,779          |
| <u>Other underwriting expenses</u>   | 18,676           | 20,967           | 59,173           | 64,348           |
| <u>Interest expense</u>  | 1,511            | 1,517            | 4,538            | 4,547            |
| <u>Other expenses</u>  | 7,190            | 841              | 9,401            | 3,063            |
| <u>Total expenses</u>  | 269,999          | 224,069          | 746,092          | 675,592          |
| <u>Income (loss) before income taxes</u>   | (41,820)         | 25,730           | (41,724)         | 56,670           |
| <u>Income tax expense (benefit)</u>  | (17,023)         | 4,901            | (23,826)         | 10,737           |
| <u>Net income (loss)</u>   | \$ (24,797)      | \$ 20,829        | \$ (17,898)      | \$ 45,933        |
| <b>Per common share:</b>   |                  |                  |                  |                  |
| <u>Basic net income (loss)</u>   | \$ (0.92)        | \$ 0.76          | \$ (0.68)        | \$ 1.66          |
| <u>Diluted net income (loss)</u>   | \$ (0.92)        | \$ 0.76          | \$ (0.68)        | \$ 1.65          |
| <u>Cash dividend</u>   | \$ 0.38          | \$ 0.36          | \$ 1.10          | \$ 1.01          |

## Income Taxes

## 9 Months Ended Sep. 30, 2011

### [Income Taxes \[Abstract\]](#)

#### [Income Taxes](#)

#### 14 – Income Taxes

The actual income tax rate differed from the statutory federal income tax rate applicable to income (loss) before income tax expense (benefit) as follows:

|                                   | For the three months<br>ended September 30, |               | For the nine months<br>ended September 30, |               |
|-----------------------------------|---|---------------|--|---------------|
|                                   | 2011  | 2010          | 2011                                       | 2010          |
| Statutory federal income tax rate | (35.0 )%                                    | 35.0 %        | (35.0 )%                                   | 35.0 %        |
| Tax-exempt income                 | (8.2 )                                      | (12.7 )       | (24.7 )                                    | (17.5 )       |
| Other, net                        | 2.5   | (3.3 )        | 2.6  | 1.4           |
|                                   | <u>(40.7 )%</u>                             | <u>19.0 %</u> | <u>(57.1 )%</u>                            | <u>18.9 %</u> |

Due to the pre-tax net loss in 2011, the Company is unable to make a reliable estimate of its annual effective tax rate, and as such, the actual effective tax rate for the year to date is deemed to be the best estimate of the annual effective tax rate.

As of September 30, 2011, Harleysville Group had no material unrecognized tax benefits or accrued interest and penalties. The Company's policy is to account for interest as a component of interest expense and penalties as a component of other expense. Federal tax years 2007 through 2010 were open for examination as of September 30, 2011.

**Document And Entity  
Information**

**9 Months Ended  
Sep. 30, 2011**

**Nov. 02, 2011**

**[Document And Entity Information \[Abstract\]](#)**

|  |                        |            |
|--|------------------------|------------|
| <u><a href="#">Document Type</a></u>                           | 10-Q                   |            |
| <u><a href="#">Amendment Flag</a></u>                          | false                  |            |
| <u><a href="#">Document Period End Date</a></u>                | Sep. 30, 2011          |            |
| <u><a href="#">Document Fiscal Year Focus</a></u>              | 2011                   |            |
| <u><a href="#">Document Fiscal Period Focus</a></u>            | Q3                     |            |
| <u><a href="#">Entity Filer Category</a></u>                   | Accelerated Filer      |            |
| <u><a href="#">Entity Registrant Name</a></u>                  | HARLEYSVILLE GROUP INC |            |
| <u><a href="#">Entity Central Index Key</a></u>                | 0000792013             |            |
| <u><a href="#">Current Fiscal Year End Date</a></u>            | --12-31                |            |
| <u><a href="#">Entity Common Stock, Shares Outstanding</a></u> |                        | 27,188,176 |

## Change In Pooling Agreement

9 Months Ended  
Sep. 30, 2011

### [Change In Pooling Agreement \[Abstract\]](#)

#### [Change In Pooling Agreement](#)

##### 3 – Change in Pooling Agreement

The Company's property and casualty subsidiaries participate in a pooling agreement with the Mutual Company and its property and casualty insurance subsidiary, Harleysville Pennland Insurance Company (Pennland), whereby such subsidiaries and Pennland cede to the Mutual Company all of their insurance business and assume from the Mutual Company an amount equal to their participation in the pooling agreement. All losses and loss settlement expenses and other underwriting expenses are prorated among the parties on the basis of participation in the pooling agreement. The pooling agreement provides for the allocation of premiums, losses and loss settlement expenses and underwriting expenses between Harleysville Group and the Mutual Company. Harleysville Group is not liable for any losses incurred by its subsidiaries, Harleysville Preferred Insurance Company and Harleysville Insurance Company of New Jersey, and the Mutual Company prior to January 1, 1986, the date the pooling agreement became effective. Harleysville Group's participation in the pool has been 80% since January 1, 2008. Effective January 1, 2010, the pooling agreement was amended to exclude reinsurance premiums, losses, loss settlement expenses and underwriting expenses voluntarily assumed by the Mutual Company.

Effective January 1, 2011, the Company's property and casualty subsidiaries and the Mutual Company and Pennland amended their intercompany pooling agreement as it relates to their workers compensation business. The amendment established that the financial results associated with the workers compensation business for accident years 2011 and following will be retained 100 percent by the Mutual Company. The financial results of this business for prior accident years will continue to be shared between the Company's property and casualty subsidiaries, the Mutual Company and Pennland under the existing pool participations. Harleysville Group paid cash of \$33 million on January 3, 2011 associated with the transfer of the unearned premium liability on the workers compensation business as of January 1, 2011. Harleysville Group's unearned premium liability decreased by \$40 million and Harleysville Group received a ceding commission of \$7 million for expenses that were incurred to generate the business ceded to the Mutual Company, which ceding commission reduced deferred policy acquisition costs.

## New Accounting Standards

**9 Months Ended  
Sep. 30, 2011**

### [New Accounting Standards](#)

#### [\[Abstract\]](#)

### [New Accounting Standards](#)

#### 16 – New Accounting Standards

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-06, "Fair Value Measurements and Disclosures." ASU 2010-06 applies to all entities that are required to make disclosures about recurring or non-recurring fair value measurements. ASU 2010-06 provides guidance on additional disclosures on any significant transfers in and out of Level 1 and Level 2 and a description of the transfer. ASU 2010-06 also requires separate disclosures of the activity in the Level 3 category related to any purchases, sales, issuances and settlements on a gross basis. The effective date of the new disclosures relating to the existing disclosures regarding Level 1 and Level 2 categories is for interim and annual periods beginning after December 15, 2009. The effective date of the disclosures regarding purchases, sales, issuances and settlements to the Level 3 category is for interim and annual periods beginning after December 15, 2010. The adoption of this ASU did not have a material impact on the Company's results of operations or financial position.

In October 2010, the FASB issued ASU 2010-26, "Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)." This ASU amends FASB Accounting Standards Codification (ASC) Topic 944, Financial Services-Insurance, to address which costs related to the acquisition of new or renewal insurance contracts qualify for deferral. The ASU allows insurance entities to defer costs related to the acquisition of new or renewal insurance contracts that are (1) incremental direct costs of the contract transaction (i.e., would not have occurred without the contract transaction), (2) a portion of the employee's compensation and fringe benefits related to certain activities for successful contract acquisitions, or (3) direct-response advertising costs as defined in ASC Subtopic 340-20, Other Assets and Deferred Costs – Capitalized Advertising Costs. An insurance entity would expense as incurred all other costs related to the acquisition of new or renewal insurance contracts. The amendments in the ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and can be applied either prospectively or retrospectively. Early application is permitted at the beginning of an entity's annual reporting period. The impact of adopting this ASU is currently being evaluated.

In December 2010, the FASB issued ASU 2010-28, "Intangibles-Goodwill and Other." The amendments in this ASU modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For these units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. For public entities, this ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The adoption of this ASU did not have a material impact on Harleystown Group's results of operations or financial position.

In May 2011, the FASB issued ASU 2011-04, "Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." The amendments in this ASU result in common fair value measurement and disclosure in



U.S. GAAP and IFRSs. The amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments include: (1) those that clarify the FASB's intent about the application of existing fair value measurement and disclosure requirements; and (2) those that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurement. For public entities, the amendments in this ASU are effective during interim and annual periods beginning after December 15, 2011, and are to be applied prospectively. Early application by public entities is not permitted. The adoption of this ASU is not expected to have a material impact on the Company's results of operations or financial position.

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income." Under the amendments in this ASU, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The entity is also required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income where the components of net income and the components of other comprehensive income are presented. For public entities, the amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and are to be applied retrospectively. Early adoption is permitted. The adoption of this ASU is not expected to have a material impact on the Company's results of operations or financial position.

In September 2011, the FASB issued ASU 2011-08, "Testing Goodwill for Impairment." The amendments in this ASU permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in ASC Topic 350, Intangibles-Goodwill and Other. Previous guidance under this topic required an entity to test goodwill for impairment, on at least an annual basis, by comparing the fair value of a reporting unit with its carrying amount. If the fair value of the reporting unit is less than its carrying amount, then the second step of the test must be performed to measure the amount of the impairment loss, if any. Under the amendments in this ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. This ASU is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of this ASU is not expected to have a material impact on the Company's results of operations or financial position.

## Cash Flows

**9 Months Ended  
Sep. 30, 2011**

[Cash Flows \[Abstract\]](#)

[Cash Flows](#)

### 8 – Cash Flows

Net cash tax payments of \$2,076,000 and \$5,100,000 were made in the first nine months of 2011 and 2010, respectively. Cash interest payments of \$5,844,000 and \$5,852,000 were made in the first nine months of 2011 and 2010, respectively.

**Consolidated Statements Of  
Cash Flows (USD \$)  
In Thousands**

**9 Months Ended  
Sep. 30,      Sep. 30,  
2011              2010**

**Cash flows from operating activities:**

|   |             |           |
|---|-------------|-----------|
| <u>Net income (loss)</u>  | \$ (17,898) | \$ 45,933 |
| <b><u>Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities:</u></b> |             |           |
| <u>Change in receivables, recoverables, unearned premiums and prepaid reinsurance balances</u>                | (51,651)    | 33,085    |
| <u>Change in affiliate balance</u>  | 3,121       | (15,324)  |
| <u>Increase in unpaid losses and loss settlement expenses</u>   | 69,705      | 4,977     |
| <u>Deferred income taxes</u>  | (7,268)     | (689)     |
| <u>(Increase) decrease in deferred policy acquisition costs</u>   | 1,221       | (3,488)   |
| <u>Amortization and depreciation</u>  | 7,666       | 7,554     |
| <u>Realized investment gains, including other than temporary impairment losses, net</u>                       | (13,213)    | (526)     |
| <u>Other, net</u>   | (22,648)    | (2,386)   |
| <u>Cash provided by operating activities- before adjustment of pooling activities</u>                         | (30,965)    | 69,136    |
| <u>Cash used by the change in the intercompany pooling agreement</u>  | (33,014)    |           |
| <u>Net cash provided (used) by operating activities</u>   | (63,979)    | 69,136    |
| <b><u>Cash flows from investing activities:</u></b>   |             |           |
| <u>Purchases</u>  | (37,067)    | (313,751) |
| <u>Sales or maturities</u>  | 224,992     | 264,299   |
| <b><u>Equity securities:</u></b>  |             |           |
| <u>Purchases</u>  | (131,250)   | (27,095)  |
| <u>Sales</u>  | 67,380      |           |
| <b><u>Other invested assets:</u></b>  |             |           |
| <u>Sales or maturities</u>  |             | 1,845     |
| <u>Net (purchases) sales of short-term investments</u>  | (33,679)    | 54,731    |
| <u>Purchase of property and equipment, net</u>  | (188)       | (274)     |
| <u>Net cash provided (used) by investing activities</u>   | 90,188      | (20,245)  |
| <b><u>Cash flows from financing activities:</u></b>   |             |           |
| <u>Issuance of common stock</u>   | 2,453       | 9,057     |
| <u>Purchase of treasury stock</u>   |             | (30,787)  |
| <u>Dividends paid (to affiliate, \$15,979 and \$14,672)</u>   | (29,254)    | (27,839)  |
| <u>Excess tax benefits from share-based payment arrangements</u>  | 589         | 588       |
| <u>Net cash used by financing activities</u>  | (26,212)    | (48,981)  |
| <u>Decrease in cash</u>   | (3)         | (90)      |
| <u>Cash at beginning of period</u>  | 39          | 126       |
| <u>Cash at end of period</u>  | \$ 36       | \$ 36     |

## Investments

**9 Months Ended  
Sep. 30, 2011**

[Investments \[Abstract\]](#)  
[Investments](#)

### 5 – Investments

Fair value accounting guidance defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements.

Fair value measurements are determined under a three-level hierarchy which gives the highest priority to quoted prices in active markets and the lowest priority to unobservable inputs which are based on the Company's own assumptions. The three levels of the hierarchy are as follows:

Level 1 – Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level 2 – Inputs other than Level 1 that are based on observable market data. These include quoted prices for similar assets in active markets, quoted prices for identical assets in inactive markets, inputs other than quoted prices that are observable for the asset or liability and inputs that are derived from or corroborated by observable market data.

Level 3 – Inputs that are unobservable, reflecting the Company's own assumptions.

For investments that have quoted market prices in active markets, the Company uses the quoted market price as fair value and includes these investments in Level 1 of the fair value hierarchy. The Company classifies U.S. Treasury securities and publicly traded equity securities and equity mutual funds as Level 1. When quoted market prices in active markets are not available, the Company relies on a pricing service to estimate fair value. The Company classifies its fixed maturity securities other than U.S. Treasury securities and private placements as Level 2. Private placement fixed maturity securities and non-publicly traded equity securities are classified as Level 3.

The Company utilizes a nationally recognized independent pricing service to obtain fair value estimates for its fixed maturity holdings because of the detailed process it uses in arriving at a fair value estimate. For fixed maturity securities that have quoted prices in active markets, market quotations are provided. For fixed maturity securities that do not trade on a daily basis, the independent pricing service prepares estimates of fair value using a wide array of observable inputs including relevant market information, benchmark curves, benchmarking of like securities, sector groupings and matrix pricing. The observable market inputs that our independent pricing service utilizes include, listed in approximate order of priority: benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data including market research publications. Additionally, the independent pricing service uses an Option Adjusted Spread model to develop prepayment and interest rate scenarios.

When the independent pricing service provides a fair value estimate, the Company uses that estimate. At September 30, 2011, the independent pricing service provided a fair value estimate for all of the investments classified as Level 1 investments within the fair value hierarchy and approximately 99% of the investments classified as Level 2 estimates within the fair value hierarchy. The fair value of all Level 2 securities is based on observable market inputs.

In instances when the independent pricing service is unable to provide a fair value estimate, the Company attempts to obtain a non-binding fair value estimate from a number of broker/dealers and reviews any fair value estimate reported by an independent business news service. In instances where only one broker/dealer provides a fair value estimate for a fixed maturity security, the Company uses that estimate. In instances where the Company is able to obtain fair value estimates from more than one broker/dealer, the Company generally uses the lowest or next to lowest fair value estimate. In instances where neither the independent pricing service nor a broker/dealer is able to provide a fair value estimate, the fair value is based on cash flow analysis and other valuation techniques which utilize significant unobservable inputs and the Company classifies the fixed maturity investment as a Level 3 investment. Level 3 investments represent less than 1% of the Company's total investment portfolio.

Quotes obtained from third parties are non-binding. The third parties from whom quotes are obtained are knowledgeable market participants that have a detailed understanding of the sector, the security type and the issuer. The non-binding quotes are fair value estimates based on observable market data utilized by these market participants. The Company does not adjust quotes or prices obtained from third parties.

Management reviews, on an ongoing basis, the reasonableness of the methodologies employed by the independent pricing service. As part of the monthly review process, management examines the prices obtained from the independent pricing service. This process routinely involves reviewing any available recent transaction activity reported via various investment research tools. Additionally, the Company tracks changes in credit ratings of all fixed maturity securities on a monthly basis and performs a more in-depth, quarterly evaluation of fixed income securities that are rated below single A by Moody's and/or S&P. If, as a result of its review, management does not believe that a price received with respect to any particular security is a reasonable estimate of the fair value of the security, it will discuss this with the independent pricing service to resolve the discrepancy. Management then determines the appropriate level of classification of each investment within the fair value hierarchy based on its evaluation of the inputs used in determining the fair value.

The following is a summary of the fair value measurements of applicable Company assets by level within the fair value hierarchy as of September 30, 2011 and December 31, 2010. These assets are measured at fair value on a recurring basis. There were no transfers to or from Levels 1 and 2 of the fair value hierarchy in 2011. The Company's policy is to recognize transfers between levels as of the end of the reporting period.

|   | Fair Value Measurements at Reporting Date Using                            |   |  |
|---|--|---|--|
|   | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|   | September 30,<br>2011  |   |  |
|   | (in thousands)   |   |  |
| Fixed maturities available<br>for sale: |  |   |  |
| U.S. Treasury<br>securities             | \$ 119,609   | \$ 119,609  |  |

|  |             |            |              |      |
|--|-------------|------------|--------------|------|
| Obligations of U.S. government corporations and agencies | 9,149       |            | \$ 9,149     |      |
| Obligations of states and political subdivisions         | 1,163,504   |            | 1,163,504    |      |
| Corporate securities                                     | 430,213     |            | 430,213      |      |
| Mortgage-backed securities                               | 329,999     |            | 329,999      |      |
| Total available for sale                                 | 2,052,474   | 119,609    | 1,932,865    |      |
| Equity securities:                                       |             |            |              |      |
| Dividend income portfolio of common stocks               | 171,842     | 171,842    |              |      |
| International fund                                       | 36,827      | 36,827     |              |      |
| Total stock market index fund                            | 108,643     | 108,643    |              |      |
| Other  | 7           |            |              | \$ 7 |
| Total equity securities                                  | 317,319     | 317,312    |              | 7    |
| Total  | \$2,369,793 | \$ 436,921 | \$ 1,932,865 | \$ 7 |

**Fair Value Measurements at Reporting Date Using**

| December 31,<br>2010 | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|----------------------|--|---|--|
|                      |  |   |  |

(in thousands)

|  |           |            |           |  |
|--|-----------|------------|-----------|--|
| Fixed maturities available for sale:                     |           |            |           |  |
| U.S. Treasury securities                                 | \$122,857 | \$ 122,857 |           |  |
| Obligations of U.S. government corporations and agencies | 17,171    |            | \$ 17,171 |  |
| Obligations of states and political subdivisions         | 1,173,447 |            | 1,173,447 |  |
| Corporate securities                                     | 481,805   |            | 481,805   |  |
| Mortgage-backed securities                               | 369,821   |            | 369,821   |  |

|  |             |            |              |      |
|--|-------------|------------|--------------|------|
| Total available for sale                   | 2,165,101   | 122,857    | 2,042,244    |      |
| Equity securities:                         |             |            |              |      |
| Dividend income portfolio of common stocks | 51,684      | 51,684     |              |      |
| International fund                         | 44,877      | 44,877     |              |      |
| Total stock market index fund              | 171,536     | 171,536    |              |      |
| Other                                      | 7           |            |              | \$ 7 |
| Total equity securities                    | 268,104     | 268,097    |              | 7    |
| Total                                      | \$2,433,205 | \$ 390,954 | \$ 2,042,244 | \$ 7 |

**Fair Value Measurements Using Significant Unobservable Inputs (Level 3)**  
**For the three months ended September 30, 2011**

|                               | <u>Equity Securities</u> | <u>Total</u> |
|-------------------------------|--------------------------|--------------|
|                               | (in thousands)           |              |
| Balance at July 1, 2011       | \$ 7                     | \$ 7         |
| Balance at September 30, 2011 | \$ 7                     | \$ 7         |

**Fair Value Measurements Using Significant Unobservable Inputs (Level 3)**  
**For the nine months ended September 30, 2011**

|                               | <u>Equity Securities</u> | <u>Total</u> |
|-------------------------------|--------------------------|--------------|
|                               | (in thousands)           |              |
| Balance at January 1, 2011    | \$ 7                     | \$ 7         |
| Balance at September 30, 2011 | \$ 7                     | \$ 7         |

**Fair Value Measurements Using Significant Unobservable Inputs (Level 3)**  
**For the three months ended September 30, 2010**

|                               | <u>Fixed Maturities Available for Sale</u> | <u>Equity Securities</u> | <u>Total</u> |
|-------------------------------|--|--------------------------|--------------|
|                               | (in thousands)                             |                          |              |
| Balance at July 1, 2010       | \$ 100                                     | \$ 6                     | \$ 106       |
| Balance at September 30, 2010 | \$ 100                                     | \$ 6                     | \$ 106       |

**Fair Value Measurements Using Significant  
Unobservable Inputs (Level 3)  
For the nine months ended September 30, 2010**

|                                  | <b>Fixed Maturities</b>       |                              |               |
|----------------------------------|-------------------------------|------------------------------|---------------|
|                                  | <b>Available for<br/>Sale</b> | <b>Equity<br/>Securities</b> | <b>Total</b>  |
|                                  |                               | (in thousands)               |               |
| Balance at January 1, 2010       | \$ 100                        | \$ 6                         | \$ 106        |
| Balance at September 30,<br>2010 | <u>\$ 100</u>                 | <u>\$ 6</u>                  | <u>\$ 106</u> |

The amortized cost and estimated fair value of investments in fixed maturity and equity securities are as follows:

|  | <b>September 30, 2011</b> |                                       |  |                                     |
|--|---------------------------|---------------------------------------|--|-------------------------------------|
|  | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|  |                           | (in thousands)                        |  |                                     |
| <b>Held to maturity:</b>                                       |                           |                                       |  |                                     |
| Obligations of U.S.<br>government corporations<br>and agencies | \$315                     | \$19                                  |  | \$334                               |
| Obligations of states and<br>political subdivisions            | 66,822                    | 2,974                                 |  | 69,796                              |
| Corporate securities   | <u>57,991</u>             | <u>4,383</u>                          | \$ (94 )                               | <u>62,280</u>                       |
| <b>Total held to maturity</b>                                  | <u>125,128</u>            | <u>7,376</u>                          | <u>(94 )</u>                           | <u>132,410</u>                      |
| <b>Available for sale:</b>                                     |                           |                                       |  |                                     |
| U.S. Treasury securities                                       | 112,949                   | 6,660                                 |  | 119,609                             |
| Obligations of U.S.<br>government corporations<br>and agencies | 8,525                     | 624                                   |  | 9,149                               |
| Obligations of states and<br>political subdivisions            | 1,078,181                 | 85,323                                |  | 1,163,504                           |
| Corporate securities   | 388,225                   | 42,000                                | (12 )                                  | 430,213                             |
| Mortgage-backed securities                                     | <u>309,520</u>            | <u>20,479</u>                         |  | <u>329,999</u>                      |
| <b>Total available for sale</b>                                | <u>1,897,400</u>          | <u>155,086</u>                        | <u>(12 )</u>                           | <u>2,052,474</u>                    |
| <b>Total fixed maturities</b>                                  | <u>\$2,022,528</u>        | <u>\$162,462</u>                      | <u>\$ (106 )</u>                       | <u>\$2,184,884</u>                  |
| <b>Total equity securities</b>                                 | <u>\$268,338</u>          | <u>\$48,981</u>                       | <u>\$</u>                              | <u>\$317,319</u>                    |

|                          | <b>December 31, 2010</b>  |                                       |  |                                     |
|--------------------------|---------------------------|---------------------------------------|--|-------------------------------------|
|                          | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair<br/>Value</b> |
|                          |                           | (in thousands)                        |  |                                     |
| <b>Held to maturity:</b> |                           |                                       |  |                                     |



|  |                    |                  |                   |                    |
|--|--------------------|------------------|-------------------|--------------------|
| Obligations of U.S.<br>government corporations<br>and agencies | \$370              | \$8              |                   | \$378              |
| Obligations of states and<br>political subdivisions            | 74,811             | 3,722            |                   | 78,533             |
| Corporate securities   | <u>73,181</u>      | <u>4,875</u>     |                   | <u>78,056</u>      |
| Total held to maturity   | <u>148,362</u>     | <u>8,605</u>     |                   | <u>156,967</u>     |
| Available for sale:  |                    |                  |                   |                    |
| U.S. Treasury securities                                       | 119,009            | 3,886            | \$(38 )           | 122,857            |
| Obligations of U.S.<br>government corporations<br>and agencies | 16,274             | 897              |                   | 17,171             |
| Obligations of states and<br>political subdivisions            | 1,140,695          | 36,730           | (3,978 )          | 1,173,447          |
| Corporate securities   | 447,962            | 34,173           | (330 )            | 481,805            |
| Mortgage-backed securities                                     | <u>345,157</u>     | <u>24,664</u>    |                   | <u>369,821</u>     |
| Total available for sale                                       | <u>2,069,097</u>   | <u>100,350</u>   | <u>(4,346 )</u>   | <u>2,165,101</u>   |
| Total fixed maturities   | <u>\$2,217,459</u> | <u>\$108,955</u> | <u>\$(4,346 )</u> | <u>\$2,322,068</u> |
| Total equity securities  | <u>\$191,095</u>   | <u>\$77,322</u>  | <u>\$(313 )</u>   | <u>\$268,104</u>   |

The amortized cost and estimated fair value of fixed maturity securities at September 30, 2011 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                               | Amortized<br>Cost  | Estimated<br>Fair<br>Value |
|-------------------------------|--------------------|----------------------------|
| (in thousands)                |                    |                            |
| Held to maturity:             |                    |                            |
| Due through December 31, 2012 | \$20,805           | \$21,133                   |
| Due 2013 through 2016         | 92,476             | 98,790                     |
| Due 2017 through 2021         | 1,823              | 1,939                      |
| Due after 2021                | <u>10,024</u>      | <u>10,548</u>              |
|                               | <u>125,128</u>     | <u>132,410</u>             |
| Available for sale:           |                    |                            |
| Due through December 31, 2012 | 62,438             | 63,499                     |
| Due 2013 through 2016         | 575,390            | 618,827                    |
| Due 2017 through 2021         | 569,634            | 623,884                    |
| Due after 2021                | <u>380,418</u>     | <u>416,265</u>             |
|                               | <u>1,587,880</u>   | <u>1,722,475</u>           |
| Mortgage-backed securities    | <u>309,520</u>     | <u>329,999</u>             |
|                               | <u>1,897,400</u>   | <u>2,052,474</u>           |
| Total fixed maturities        | <u>\$2,022,528</u> | <u>\$2,184,884</u>         |

Realized gross gains (losses) from investments were as follows:

|  | <b>For the three months<br/>ended September 30,</b> |             |
|--|---|-------------|
|  | <b>2011</b>   | <b>2010</b> |
|  | (in thousands)                                      |             |
| <b>Fixed maturity securities:</b>      |   |             |
| Available for sale:                    |   |             |
| Gross gains                            | \$ 53   | \$          |
| Other than temporary impairment losses | (381 )  |             |
| <b>Equity securities:</b>              |   |             |
| Gross gains                            | 1,255   |             |
| Other than temporary impairment losses | (3,586 )  |             |
| Net realized investment losses         | <u>\$ (2,659 )</u>                                  | <u>\$—</u>  |

|  | <b>For the nine months<br/>ended September 30,</b> |              |
|--|--|--------------|
|  | <b>2011</b>  | <b>2010</b>  |
|  | (in thousands)                                     |              |
| <b>Fixed maturity securities:</b>      |  |              |
| Available for sale:                    |  |              |
| Gross gains                            | \$221  | \$1,161      |
| Other than temporary impairment losses | (381 )   |              |
| <b>Equity securities:</b>              |  |              |
| Gross gains                            | 17,754   |              |
| Gross losses                           | (795 )   |              |
| Other than temporary impairment losses | (3,586 )   |              |
| <b>Other invested assets:</b>          |  |              |
| Gross losses                           |  | (635 )       |
| Net realized investment gains          | <u>\$13,213</u>                                    | <u>\$526</u> |

Harleysville Group held securities with unrealized losses at September 30, 2011 and December 31, 2010 as follows:

|                                       | <b>September 30, 2011</b> |                              |  |
|---------------------------------------|---------------------------|------------------------------|--|
|                                       | <b>Fair Value</b>         | <b>Unrealized<br/>Losses</b> | <b>Length of<br/>Unrealized Loss<br/>Less Than<br/>12 Months</b> |
|                                       | (in thousands)            |                              |  |
| <b>Fixed maturities:</b>              |                           |                              |  |
| Corporate securities                  | <u>\$ 3,371</u>           | <u>\$ 106</u>                | <u>\$ 106</u>  |
| Total temporarily impaired securities | <u>\$ 3,371</u>           | <u>\$ 106</u>                | <u>\$ 106</u>  |
|                                       | <b>December 31, 2010</b>  |                              |  |

|  | <u>Fair Value</u> | <u>Unrealized<br/>Losses</u> | <u>Length of<br/>Unrealized Loss<br/>Less Than<br/>12 Months</u> |
|--|-------------------|------------------------------|--|
|  |                   | (in thousands)               |  |
| <b>Fixed maturities:</b>                         |                   |                              |  |
| U.S. Treasury securities                         | \$3,073           | \$ 38                        | \$ 38  |
| Obligations of states and political subdivisions | 232,551           | 3,978                        | 3,978  |
| Corporate securities                             | <u>33,594</u>     | <u>330</u>                   | <u>330</u>   |
| <b>Total fixed maturities</b>                    | <u>269,218</u>    | <u>4,346</u>                 | <u>4,346</u>   |
| Equity securities                                | <u>17,231</u>     | <u>313</u>                   | <u>313</u>   |
| <b>Total temporarily impaired securities</b>     | <u>\$286,449</u>  | <u>\$ 4,659</u>              | <u>\$ 4,659</u>  |

Of the total fixed maturity securities with an unrealized loss at September 30, 2011, securities with a fair value of \$1,470,000 and an unrealized loss of \$12,000 are classified as available for sale and are carried at fair value on the balance sheet while securities with a fair value of \$1,901,000 and an unrealized loss of \$94,000 are classified as held to maturity on the balance sheet and are carried at amortized cost.

The unrealized losses on fixed maturity investments were primarily due to a widening of credit spreads on securities in the financial sector. Per Harleystown Group's current policy, a fixed maturity security is other than temporarily impaired if the present value of the cash flows expected to be collected is less than the amortized cost of the security or where the security's fair value is below cost and Harleystown Group intends to sell, or more likely than not will be required to sell, the security before recovery of its value. Harleystown Group believes, based on its analysis, that these securities are not other than temporarily impaired. However, depending on developments involving both the issuers and worsening economic conditions, these investments may be written down in the income statement in the future.

There were impairment charges in the three and nine months ended September 30, 2011 of \$3,586,000 on equity securities and \$381,000 on fixed maturity securities that the Company intends to sell. There were no impairment charges in the three and nine months ended September 30, 2010. At September 30, 2011, a bond with an amortized cost of \$999,000 was transferred from the held to maturity category to the available for sale category due to a significant deterioration in the credit worthiness of the issuer. An impairment charge of \$21,000 recognized on this security is included in the fixed maturity impairment total of \$381,000 for the three and nine months ended September 30, 2011. In October 2011, the Company sold virtually all of its equity securities and realized a gain of \$62.3 million in order to reduce potential volatility in statutory surplus.

**Comprehensive Income  
(Loss)**

**9 Months Ended  
Sep. 30, 2011**

**Comprehensive Income**

**(Loss) [Abstract]**

**Comprehensive Income (Loss)**

10 – Comprehensive Income (Loss)

Comprehensive income (loss) for the three and nine months ended September 30, 2011 and 2010 consisted of the following (all amounts are net of taxes):

|   | For the three months<br>ended September 30, |                 | For the nine months<br>ended September 30, |                 |
|---|---|-----------------|--|-----------------|
|   | 2011  | 2010            | 2011                                       | 2010            |
|   | (in thousands)                              |                 |  |                 |
| Net income (loss)   | \$(24,797)                                  | \$20,829        | \$(17,898)                                 | \$45,933        |
| Other comprehensive income:   |   |                 |  |                 |
| Unrealized gains on securities:   |   |                 |  |                 |
| Unrealized investment<br>holding gains (losses)<br>arising during period    | (385 )                                      | 38,238          | 28,766                                     | 51,244          |
| Less:   |   |                 |  |                 |
| Reclassification adjustment for<br>(gains) losses included in net<br>income | 1,728                                       | —               | (8,589 )                                   | (342 )          |
| Net unrealized investment gains   | 1,343                                       | 38,238          | 20,177                                     | 50,902          |
| Defined benefit pension plans:  |   |                 |  |                 |
| Recognized net actuarial loss   | 627   | 606             | 1,992                                      | 1,576           |
| Other comprehensive income  | 1,970                                       | 38,844          | 22,169                                     | 52,478          |
| Comprehensive income (loss)   | <u>\$(22,827)</u>                           | <u>\$59,673</u> | <u>\$4,271</u>                             | <u>\$98,411</u> |

Accumulated other comprehensive income (loss) at September 30, 2011 and December 31, 2010 consisted of the following amounts (which are net of tax):

|  | September 30,<br>2011 | December 31,<br>2010 |
|--|-----------------------|----------------------|
|  | (in thousands)        |                      |
| Unrealized investment gains                          | \$ 132,636            | \$ 112,459           |
| Defined benefit pension plan - net<br>actuarial loss | (29,961 )             | (31,953 )            |
| Accumulated other comprehensive<br>income            | <u>\$ 102,675</u>     | <u>\$ 80,506</u>     |

## Earnings Per Share

**9 Months Ended  
Sep. 30, 2011**

### Earnings Per Share

#### [Abstract]

### Earnings Per Share

#### 6 – Earnings Per Share

The computation of basic and diluted earnings per share is as follows:

|  | <u>For the three months<br/>ended September 30,</u> |                   | <u>For the nine months<br/>ended September 30,</u> |                   |
|--|---|-------------------|--|-------------------|
|  | <u>2011</u>   | <u>2010</u>       | <u>2011</u>  | <u>2010</u>       |
| (dollars in thousands, except per share data)                                  |   |                   |  |                   |
| Numerator for basic and diluted earnings per share:                            |   |                   |  |                   |
| Net income (loss)  | <u>\$ (24,797 )</u>                                 | <u>\$ 20,829</u>  | <u>\$ (17,898 )</u>                                | <u>\$ 45,933</u>  |
| Denominator for basic earnings per share — weighted average shares outstanding |   |                   |  |                   |
|  | <u>27,160,607</u>                                   | <u>27,397,201</u> | <u>27,072,779</u>                                  | <u>27,613,629</u> |
| Effect of stock incentive plans  |   |                   |  |                   |
|  | <u>—</u>  | <u>157,029</u>    | <u>—</u>   | <u>188,873</u>    |
| Denominator for diluted earnings per share                                     |   |                   |  |                   |
|  | <u>27,160,607</u>                                   | <u>27,554,230</u> | <u>27,072,779</u>                                  | <u>27,802,502</u> |
| Basic earnings (loss) per share  |   |                   |  |                   |
|  | <u>\$ (.92 )</u>                                    | <u>\$ .76</u>     | <u>\$ (.68 )</u>                                   | <u>\$ 1.66</u>    |
| Diluted earnings (loss) per share  |   |                   |  |                   |
|  | <u>\$ (.92 )</u>                                    | <u>\$ .76</u>     | <u>\$ (.68 )</u>                                   | <u>\$ 1.65</u>    |

The following options to purchase shares of common stock were not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price:

|                   | <u>For the three months<br/>ended September 30,</u> |              | <u>For the nine months<br/>ended September 30,</u> |             |
|-------------------|---|--------------|--|-------------|
|                   | <u>2011</u>   | <u>2010</u>  | <u>2011</u>  | <u>2010</u> |
| (in thousands)    |   |              |  |             |
| Number of options | <u>—</u>  | <u>1,001</u> | <u>186</u>   | <u>904</u>  |

An additional 1,945,548 and 1,776,451 options to purchase common stock were not included in the computation of diluted earnings per share for the three and nine months ended September 30, 2011, respectively, because their inclusion would have had an antidilutive effect. Net loss per basic and diluted common share for the three and nine months ended September 30, 2011 excluded the allocation of \$482,000 and \$692,000, respectively, of undistributed losses to

participating share-based awards, since such allocation would result in anti-dilution of basic and diluted earnings per share.

## Share-Based Payments

**9 Months Ended  
Sep. 30, 2011**

### [Share-Based Payments](#)

#### [\[Abstract\]](#)

### [Share-Based Payments](#)

#### 4 – Share-Based Payments

Harleysville Group has several share-based compensation plans. Harleysville Group measures compensation expense associated with the plans based on the grant-date fair value of the awards.

Harleysville Group has the following share-based compensation plans:

The Amended and Restated Equity Incentive Plan (EIP) provides for awards to key employees in the form of stock options, stock appreciation rights (SARs), restricted stock, restricted stock units or any combination of the above.

The Employee Stock Purchase Plan provides that a participant may elect to have up to 15% of base pay withheld to purchase shares. The purchase price of the stock is 85% of the lower of the beginning-of-the-subscription-period or end-of-the-subscription-period fair market value. There are two subscription periods during each year.

The Directors' Equity Compensation Plan provides for the grant of equity-based awards to non-employee directors of Harleysville Group Inc. and the Mutual Company. These awards can be in the form of stock options, deferred stock units or restricted stock.

The compensation expense for the various share-based compensation plans that has been charged against income before income taxes was \$1,478,000 and \$1,457,000 for the three months ended September 30, 2011 and 2010, respectively, with a corresponding income tax benefit of \$494,000 and \$489,000, respectively. Compensation expense for the various share-based compensation plans that has been charged against income before income taxes was \$5,089,000 and \$5,377,000 for the nine months ended September 30, 2011 and 2010, respectively, with a corresponding income tax benefit of \$1,708,000 and \$1,809,000, respectively.

During the nine months ended September 30, 2011, 232,325 stock options were granted at a Black Scholes weighted average value of \$6.58 per option. The options vest 33 1/3% per year over a three year period, subject to earlier or accelerated vesting in designated situations, including a change-in-control or qualifying retirement of the award holder. Restricted stock unit grants of 133,010 units were also made during the nine months ended September 30, 2011 and 30,855 of these units include performance conditions. The weighted average fair value of the grants of the restricted stock units was \$37.43 per unit. These awards vest over a period of three years, subject to earlier or accelerated vesting in designated situations, including a change-in-control or qualifying retirement of the award holder.

During the nine months ended September 30, 2010, 511,790 stock options were granted at a Black Scholes weighted average value of \$6.84 per option. The options vest 33 1/3% per year over a three year period, subject to earlier or accelerated vesting in designated situations, including a change-in-control or qualifying retirement of the award holder. Restricted stock unit grants of 112,040 units were also made during the nine months ended September 30, 2010 and 39,485 of these units include performance conditions. The weighted average fair value of the grants of the restricted stock units was \$36.54 per unit. These awards vest over a period of three

years, subject to earlier or accelerated vesting in designated situations, including a change-in-control or qualifying retirement of the award holder.

In accordance with the terms of the EIP, the Company acquired 108,069 shares of its common stock from employees in connection with stock option exercises and the vesting of restricted stock and restricted stock units during 2011. The stock was received in payment of the exercise price of the stock options and in satisfaction of withholding taxes due upon exercise or vesting.

As of September 30, 2011, the Company's total unrecognized compensation cost related to nonvested share-based compensation arrangements and the weighted average period over which the compensation cost is expected to be recognized is as follows:

|                       | <u>Unrecognized Compensation Cost</u><br>(in thousands) | <u>Weighted Average<br/>Period of Recognition</u><br>(in years) |
|-----------------------|---|---|
| Equity incentive plan |   |   |
| awards                | \$ 4,793  | 1.89  |
| Employee stock        |   |   |
| purchase plan         | \$ 82   | 0.29  |



| <b>Consolidated Statement Of Shareholders' Equity (USD \$)</b><br><b>In Thousands, except Share data</b> | <b>Common Stock [Member]</b> | <b>Additional Paid-in Capital [Member]</b> | <b>Accumulated Other Comprehensive Income [Member]</b> | <b>Retained Earnings [Member]</b> | <b>Treasury Stock [Member]</b> | <b>Total</b> |
|--|------------------------------|--|--|-----------------------------------|--------------------------------|--------------|
| <u>Balance at Dec. 31, 2010</u>  | \$ 34,988                    | \$ 263,857                                 | \$ 80,506  | \$ 630,603                        | \$ (241,321)                   | \$ 768,633   |
| <u>Balance, shares at Dec. 31, 2010</u>  | 34,987,829                   |  |  |                                   |                                | 34,987,829   |
| <u>Net loss</u>  |                              |  |  | (17,898)                          |                                | (17,898)     |
| <b><u>Other comprehensive income, net of tax:</u></b>  |                              |  |  |                                   |                                |              |
| <u>Unrealized investment gains, net of reclassification adjustment</u>                                   |                              |  | 20,177   |                                   |                                | 20,177       |
| <b><u>Defined benefit pension plans:</u></b>   |                              |  |  |                                   |                                |              |
| <u>Recognized net actuarial loss</u>   |                              |  | 1,992  |                                   |                                | 1,992        |
| <u>Other comprehensive income</u>  |                              |  |  |                                   |                                | 22,169       |
| <u>Comprehensive income</u>  |                              |  |  |                                   |                                | 4,271        |
| <b><u>Issuance of common stock:</u></b>  |                              |  |  |                                   |                                |              |
| <u>Incentive plans</u>   | 214                          | 6,064                                      |  |                                   |                                | 6,278        |
| <u>Incentive plans, shares</u>   | 214,166                      |  |  |                                   |                                |              |
| <u>Dividend Reinvestment Plan</u>  | 30                           | 959  |  |                                   |                                | 989          |
| <u>Dividend Reinvestment Plan, shares</u>  | 29,864                       |  |  |                                   |                                |              |
| <u>Tax benefit from stock compensation</u>   |                              | 589  |  |                                   |                                | 589          |
| <u>Stock compensation</u>  |                              | 5,089                                      |  |                                   |                                | 5,089        |
| <u>Purchase of treasury stock, 108,069 shares</u>  |                              |  |  |                                   | (3,827)                        | (3,827)      |
| <u>Dividends declared</u>  |                              |  |  | (30,243)                          |                                | (30,243)     |
| <u>Balance at Sep. 30, 2011</u>  | \$ 35,232                    | \$ 276,558                                 | \$ 102,675   | \$ 582,462                        | \$ (245,148)                   | \$ 751,779   |
| <u>Balance, shares at Sep. 30, 2011</u>  | 35,231,859                   |  |  |                                   |                                | 35,231,859   |

**Consolidated Statements Of  
Cash Flows (Parenthetical)  
(USD \$)  
In Thousands**

**9 Months Ended  
Sep. 30, 2011 Sep. 30, 2010**

**Consolidated Statements Of Cash Flows [Abstract]**

|                                    |           |           |
|------------------------------------|-----------|-----------|
| <u>Dividends paid to affiliate</u> | \$ 15,979 | \$ 14,672 |
|------------------------------------|-----------|-----------|

## **Basis Of Presentation**

**9 Months Ended  
Sep. 30, 2011**

[Basis Of Presentation](#)

[\[Abstract\]](#)

[Basis Of Presentation](#)

### 1 – Basis of Presentation

The financial information for the interim periods included herein is unaudited; however, such information reflects all adjustments which are, in the opinion of management, necessary to a fair presentation of the financial position, results of operations, and cash flows for the interim periods. The results of operations for the interim periods are not necessarily indicative of results to be expected for the full year.

These financial statements should be read in conjunction with the financial statements and notes for the year ended December 31, 2010 included in the Company's 2010 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC).

The affiliate transaction disclosures on the face of the financial statements relate to transactions with Harleysville Mutual Insurance Company (the Mutual Company). The Mutual Company owns approximately 53% of the outstanding common stock of Harleysville Group Inc. As used herein, "Harleysville Group" refers to Harleysville Group Inc. and its subsidiaries and the "Company" refers to Harleysville Group Inc.

## Segment Information

**9 Months Ended  
Sep. 30, 2011**

### [Segment Information](#)

#### [\[Abstract\]](#)

### [Segment Information](#)

#### 9 – Segment Information

The performance of the personal lines and commercial lines is evaluated based upon underwriting results as determined under statutory accounting practices (SAP).

Financial data by segment is as follows:

|   | For the three months<br>ended September 30, |                  | For the nine months<br>ended September 30, |                  |
|---|---|------------------|--|------------------|
|   | 2011  | 2010             | 2011                                       | 2010             |
| (in thousands)                            |   |                  |  |                  |
| <b>Revenues:</b>                          |   |                  |  |                  |
| Premiums earned                           |   |                  |  |                  |
| Commercial lines                          | \$147,909                                   | \$171,725        | \$445,451                                  | \$503,668        |
| Personal lines                            | 53,827                                      | 48,510           | 157,014                                    | 139,138          |
| Total premiums<br>earned                  | 201,736                                     | 220,235          | 602,465                                    | 642,806          |
| Net investment income                     | 23,829                                      | 25,323           | 74,253                                     | 77,020           |
| Realized investment gains<br>(losses)     | (2,659 )                                    | —                | 13,213                                     | 526              |
| Other                                     | 5,273                                       | 4,241            | 14,437                                     | 11,910           |
| <b>Total revenues</b>                     | <b>\$228,179</b>                            | <b>\$249,799</b> | <b>\$704,368</b>                           | <b>\$732,262</b> |
| <b>Income (loss) before income taxes:</b> |   |                  |  |                  |
| Underwriting gain (loss):                 |   |                  |  |                  |
| Commercial lines                          | \$(32,834)                                  | \$2,357          | \$(66,809 )                                | \$(14,613)       |
| Personal lines                            | (24,400)                                    | (589 )           | (51,727 )                                  | (11,246)         |
| SAP underwriting gain<br>(loss)           | (57,234)                                    | 1,768            | (118,536)                                  | (25,859)         |
| GAAP adjustments                          | (2,328 )                                    | (3,244 )         | (11,152 )                                  | 683              |
| GAAP underwriting loss                    | (59,562)                                    | (1,476 )         | (129,688)                                  | (25,176)         |
| Net investment income                     | 23,829                                      | 25,323           | 74,253                                     | 77,020           |
| Realized investment gains<br>(losses)     | (2,659 )                                    | —                | 13,213                                     | 526              |
| Other                                     | (3,428 )                                    | 1,883            | 498  | 4,300            |
| <b>Income (loss) before income taxes</b>  | <b>\$(41,820)</b>                           | <b>\$25,730</b>  | <b>\$(41,724 )</b>                         | <b>\$56,670</b>  |

The GAAP adjustment of \$11,152,000 for the nine months ended September 30, 2011 includes the impact on deferred acquisition costs related to the ceding commission received in January 2011 of \$6,998,000 related to the change in the intercompany pooling agreement as

described in Note 3 of the Notes to Consolidated Financial Statements. The impact was all in commercial lines.

## Merger Agreement

**9 Months Ended  
Sep. 30, 2011**

[Merger Agreement](#)

[\[Abstract\]](#)

[Merger Agreement](#)

### 2 – Merger Agreement

On September 28, 2011, the Company and the Mutual Company entered into a merger agreement with Nationwide Mutual Insurance Company (Nationwide) under which a subsidiary of Nationwide will merge into the Company. Nationwide will acquire all of the publicly held shares of common stock of the Company for \$60.00 per share in cash, and the Mutual Company will merge into Nationwide and the policyholders of the Mutual Company will become policyholders and members of Nationwide. The Mutual Company has also entered into a voting agreement with Nationwide under which it has agreed to vote its 53% voting interest in the Company in favor of the Company's merger. The merger agreement restricts the Company from engaging in certain actions and taking certain actions without Nationwide's approval, including among others, the payment of shareholder dividends.

The transactions are subject to customary closing conditions, including, among others, approvals from stockholders of the Company, policyholders of the Mutual Company and Nationwide, the Pennsylvania Insurance Department, the Ohio Insurance Department and various other regulatory bodies. The transactions are expected to close in early 2012. The merger agreement provides certain termination rights. In the event that the agreement is terminated under certain conditions by the Company's Board of Directors, the Company will be required to pay Nationwide a termination fee of \$29.6 million and reimburse Nationwide for its transaction expenses.

## Borrowings

9 Months Ended  
Sep. 30, 2011

[Borrowings \[Abstract\]](#)  
[Borrowings](#)

### 12 – Borrowings

Debt is as follows:

|  | <u>September 30,</u><br><u>2011</u> | <u>December 31,</u><br><u>2010</u> |
|--|-------------------------------------|------------------------------------|
|  | (in thousands)                      |                                    |
| Notes, 5.75%, due 2013   | \$ 100,000                          | \$ 100,000                         |
| Demand term-loan payable to the<br>Mutual Company, LIBOR plus<br>0.45%, due 2012 | <u>18,500</u>                       | <u>18,500</u>                      |
| <b>Total debt</b>  | <b><u><u>\$ 118,500</u></u></b>     | <b><u><u>\$ 118,500</u></u></b>    |

The fair value of the notes was \$103,920,000 and \$99,413,000 at September 30, 2011 and December 31, 2010, respectively, based on quoted market prices for the same or similar debt. The carrying value of the remaining debt approximates fair value.

**Consolidated Statements Of  
Income (Loss)  
(Parenthetical) (USD \$)  
In Thousands**

| <b>3 Months Ended</b>    |                          | <b>9 Months Ended</b>    |                          |
|--------------------------|--------------------------|--------------------------|--------------------------|
| <b>Sep. 30,<br/>2011</b> | <b>Sep. 30,<br/>2010</b> | <b>Sep. 30,<br/>2011</b> | <b>Sep. 30,<br/>2010</b> |

**Consolidated Statements Of Income (Loss)**

**[Abstract]**

|  |            |            |            |            |
|--|------------|------------|------------|------------|
| <u>Premiums earned, ceded to affiliate</u>                     | \$ 205,976 | \$ 200,174 | \$ 611,708 | \$ 579,057 |
| <u>Income from affiliate</u>                                   | 2,595      | 1,908      | 7,148      | 5,483      |
| <u>Losses and loss settlement expenses, ceded to affiliate</u> | 202,522    | 140,076    | 527,094    | 403,597    |
| <u>Interest expense, affiliate</u>                             | \$ 30      | \$ 35      | \$ 93      | \$ 102     |



## Shareholders' Equity

**9 Months Ended  
Sep. 30, 2011**

[Shareholders' Equity](#)

[\[Abstract\]](#)

[Shareholders' Equity](#)

### 13 – Shareholders' Equity

Various states have adopted the National Association of Insurance Commissioners (NAIC) risk-based capital (RBC) standards that require insurance companies to calculate and report statutory capital and surplus needs based on a formula measuring underwriting, investment and other business risks inherent in an individual company's operations. These RBC standards have not affected the operations of Harleysville Group since each of the Company's insurance subsidiaries has statutory capital and surplus in excess of RBC requirements.

These RBC standards require the calculation of a ratio of total adjusted capital to Authorized Control Level. Insurers with a ratio below 200% are subject to different levels of regulatory intervention and action. Based upon their 2010 statutory financial statements, the ratio of total adjusted capital to the Authorized Control Level for the Company's eight insurance subsidiaries at December 31, 2010 ranged from 461% to 783%.

## Contingencies

**9 Months Ended  
Sep. 30, 2011**

[Contingencies \[Abstract\]](#)  
[Contingencies](#)

### 15 – Contingencies

The Harleysville Group insurance subsidiaries are subject to disputes, including litigation and arbitration, arising in the ordinary course of their insurance business. The Company's estimates of the costs of settling such matters are reflected in its liability for unpaid losses and loss settlement expenses, and the Company does not believe that the ultimate outcome of such matters will have a material adverse effect on its financial condition or results of operations. However, adverse outcomes of insurance claims are possible and could negatively impact the Company's financial condition and results of operations in the future.

Harleysville Group is also subject to other non-insurance claims proceedings, lawsuits and claims arising in the normal course of business. The Company does not believe that the ultimate liability associated with these claims will have a material adverse effect on its financial condition or results of operations. However, adverse outcomes are possible and could negatively impact the Company's financial condition and results of operations in the future.

Harleysville Group is also subject to two class action lawsuits in connection with the merger agreement with Nationwide described in Note 2. The Company does not believe that the ultimate liability associated with these lawsuits will have a material adverse effect on its financial condition or results of operations. However, adverse outcomes are possible and could negatively impact the Company's financial condition and results of operations in the future.

**Consolidated Statement Of  
Shareholders' Equity  
(Parenthetical)**

**9 Months Ended  
Sep. 30, 2011**

**Consolidated Statement Of Shareholders' Equity [Abstract]**

Purchase of treasury stock, shares

108,069

## Reinsurance

**9 Months Ended  
Sep. 30, 2011**

[Reinsurance \[Abstract\]](#)  
[Reinsurance](#)

### 7 – Reinsurance

Premiums earned are net of amounts ceded of \$33,220,000 and \$95,508,000 for the three and nine months ended September 30, 2011, respectively, and \$31,578,000 and \$92,052,000 for the three and nine months ended September 30, 2010, respectively. Losses and loss settlement expenses are net of amounts ceded of \$65,227,000 and \$83,211,000 for the three and nine months ended September 30, 2011, respectively, and \$8,431,000 and \$34,393,000 for the three and nine months ended September 30, 2010, respectively. Losses and loss settlement expenses ceded for the three and nine months ended September 30, 2011 include \$64,365,000 and \$71,345,000 of losses ceded to the federal government's National Flood Insurance Program (NFIP), primarily related to flood losses from Hurricane Irene and Tropical Storm Lee. Reinsurance recoverables include \$64,215,000 and \$2,361,000 at September 30, 2011 and December 31, 2010, respectively, for flood losses recoverable from the NFIP. Since such flood losses are entirely ceded to the NFIP they did not impact results of operations. Such amounts ceded do not include the reinsurance transactions with the Mutual Company under the pooling arrangement (described below) which are reflected on the face of the income statements, but do include reinsurance with unaffiliated reinsurers.

Pursuant to the terms of a reinsurance pooling agreement with the Mutual Company, each of the insurance subsidiaries of the Company and Harleysville Pennland Insurance Company (Pennland), a subsidiary of the Mutual Company, cede premiums, losses and underwriting expenses on all of their respective business to the Mutual Company which, in turn, retrocedes to such subsidiaries and Pennland a specified portion of premiums, losses and underwriting expenses of the Mutual Company and such subsidiaries and Pennland. Because this agreement does not relieve the Company's insurance subsidiaries of primary liability as originating insurers, there is a concentration of credit risk arising from business ceded to the Mutual Company. However, the reinsurance pooling agreement provides for the right of offset. The Mutual Company has an A. M. Best rating of "A" (Excellent).

## Pension

## 9 Months Ended Sep. 30, 2011

[Pension \[Abstract\]](#)  
[Pension](#)

### 11 – Pension

Harleysville Group Inc. has a frozen pension plan that covers employees hired before January 1, 2006. The net periodic pension cost for the plan, including those incurred by the Mutual Company, consists of the following components:

|  | For the three months<br>ended September 30, |         | For the nine months<br>ended September 30, |         |
|--|---|---------|--|---------|
|  | 2011  | 2010    | 2011                                       | 2010    |
|  | (in thousands)                              |         |  |         |
| Components of net periodic pension cost: |   |         |  |         |
| Interest cost                            | \$2,977                                     | \$2,989 | \$8,905                                    | \$8,920 |
| Expected return on plan assets           | (3,148)                                     | (3,036) | (9,352)                                    | (9,060) |
| Recognized net actuarial loss            | 1,455                                       | 1,321   | 4,737                                      | 3,435   |
| Net periodic pension cost:               |   |         |  |         |
| Entire plan                              | \$1,284                                     | \$1,274 | \$4,290                                    | \$3,295 |
| Harleysville Group portion               | \$852                                       | \$899   | \$2,776                                    | \$2,325 |

Harleysville Group's portion of the 2011 contributions to the pension plan is \$7,124,000. Contributions of \$5,370,000 were made in the nine months ended September 30, 2011.

**Consolidated Balance Sheets**  
**(USD \$)**  
**In Thousands**

**Sep. 30, Dec. 31,**  
**2011 2010**

**Assets**

|   |            |            |
|---|------------|------------|
| <u>Held to maturity, at amortized cost (fair value \$132,410 and \$156,967)</u>       | \$ 125,128 | \$ 148,362 |
| <u>Available for sale, at fair value (amortized cost \$1,897,400 and \$2,069,097)</u> | 2,052,474  | 2,165,101  |
| <u>Equity securities, at fair value (cost \$268,338 and \$191,095)</u>                | 317,319    | 268,104    |
| <u>Short-term investments, at cost, which approximates fair value</u>                 | 113,588    | 79,909     |
| <u>Total investments</u>  | 2,608,509  | 2,661,476  |
| <u>Cash</u>   | 36         | 39         |
| <u>Premiums receivable</u>  | 131,972    | 133,758    |
| <u>Reinsurance recoverables</u>   | 272,816    | 219,149    |
| <u>Accrued investment income</u>  | 23,149     | 26,910     |
| <u>Deferred policy acquisition costs</u>  | 105,778    | 113,997    |
| <u>Prepaid reinsurance premiums</u>   | 55,007     | 51,625     |
| <u>Property and equipment, net</u>  | 12,913     | 13,312     |
| <u>Deferred income taxes</u>  | 4,745      | 9,413      |
| <u>Other assets</u>   | 67,507     | 48,553     |
| <u>Total assets</u>   | 3,282,432  | 3,278,232  |

**Liabilities:**

|   |           |           |
|---|-----------|-----------|
| <u>Unpaid losses and loss settlement expenses (affiliate \$163,330 and \$214,518)</u> | 1,841,366 | 1,771,661 |
| <u>Unearned premiums (affiliate \$(9,692) and \$32,935)</u>                           | 467,132   | 503,532   |
| <u>Accounts payable and accrued expenses</u>  | 81,089    | 96,461    |
| <u>Due to affiliate</u>   | 22,566    | 19,445    |
| <u>Debt (affiliate \$18,500 and \$18,500)</u>   | 118,500   | 118,500   |
| <u>Total liabilities</u>  | 2,530,653 | 2,509,599 |

**Shareholders' equity:**

|   |           |           |
|---|-----------|-----------|
| <u>Preferred stock, \$1 par value, authorized 1,000,000 shares; none issued</u>   |           |           |
| <u>Common stock, \$1 par value, authorized 80,000,000 shares; issued 35,231,859 and 34,987,829 shares; outstanding 27,180,797 and 27,044,836 shares</u> | 35,232    | 34,988    |
| <u>Additional paid-in capital</u>   | 276,558   | 263,857   |
| <u>Accumulated other comprehensive income</u>   | 102,675   | 80,506    |
| <u>Retained earnings</u>  | 582,462   | 630,603   |
| <u>Treasury stock, at cost, 8,051,062 and 7,942,993 shares</u>  | (245,148) | (241,321) |
| <u>Total shareholders' equity</u>   | 751,779   | 768,633   |
| <u>Total liabilities and shareholders' equity</u>   | \$        | \$        |
|   | 3,282,432 | 3,278,232 |