COMMONWEALTH OF MASSACHUSETTS

OFFICE OF CONSUMER AFFAIRS AND BUSINESS REGULATION

DIVISION OF INSURANCE

*REPORT OF EXAMINATION OF THE*

# ARBELLA MUTUAL INSURANCE COMPANY

**Quincy, Massachusetts**

**As of December 31, 2015**

**NAIC GROUP CODE 0586**

**NAIC COMPANY CODE 17000**

**EMPLOYERS ID NO. 04-3022050**

**ARBELLA MUTUAL INSURANCE COMPANY**

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# COMMONWEALTH OF MASSACHUSETTS
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**GARY D. ANDERSON**
ACTING COMMISSIONER OF INSURANCE

April 26, 2017

Honorable Gary D. Anderson
Acting Commissioner of Insurance
Commonwealth of Massachusetts
Division of Insurance
1000 Washington Street, Suite 810
Boston, MA 02118-6200

Honorable Commissioner:

Pursuant to your instructions and in accordance with Massachusetts General Laws, Chapter 175, Section 4, an examination has been made of the financial condition and affairs of the

**ARBELLA MUTUAL INSURANCE COMPANY**

at its home office located at 1100 Crown Colony Drive, Quincy, MA, 02269-9103. The following report thereon is respectfully submitted.

## SCOPE OF EXAMINATION

The Arbella Mutual Insurance Company ("Company") was last examined as of December 31, 2010 by the Massachusetts Division of Insurance ("Division"). The current examination was conducted by the Division and covers the five year period from January 1, 2011 through December 31, 2015, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of this examination.

A separate examination of Covenant Insurance Company, which is a member of the Arbella Insurance Group, was conducted by the Connecticut Insurance Department. Concurrent with this examination, the following insurance affiliates in the Arbella Insurance Group were also examined and separate reports of examination have been issued by the Division:

Arbella Indemnity Insurance Company ("Indemnity")
Arbella Protection Insurance Company ("Protection")
Commonwealth Mutual Insurance Company
Commonwealth Reinsurance Company

The examination was conducted in accordance with standards and procedures established by the National Association of Insurance Commissioners ("NAIC") Financial Condition (E) Committee and prescribed by the current NAIC *Financial Condition Examiners Handbook,* the examination standards of the Division and with Massachusetts General Laws. The Handbook requires that we plan and perform the examination to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the Company, including corporate governance, identifying and assessing inherent risks within the Company, and evaluating system controls and procedures used to mitigate those risks.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process. This may include assessing significant estimates made by management and evaluating management's compliance with Statutory Accounting Principles. The examination does not attest to the fair presentation of the financial statements included herein. If, during the course of the examination an adjustment is identified, the impact of such adjustment will be documented separately following the Company's financial statements.

This examination report includes significant findings of fact, as mentioned in the Massachusetts General Laws, Chapter 175, Section 4, and general information about the insurer and its financial condition. There may be other items identified during the examination that, due to their nature (e.g., subjective conclusions, proprietary information, etc.), are not included within the examination report but separately communicated to other regulators and/or the Company.

The Company is audited annually by Ernst & Young LLP, an independent certified public accounting firm. The firm expressed unqualified opinions on the Company's financial statements for the calendar years 2011 through 2015. A review and use of the Certified Public Accountants' workpapers were made to the extent deemed appropriate and effective. Representatives from the firm of Baker Tilly Virchow Krause, LLP ("Baker Tilly") were retained by the Division to evaluate the adequacy and effectiveness of the IT systems controls to determine the level of reliance to be placed on the information generated by the data processing systems. Lewis & Ellis, Inc. was contracted by Baker Tilly to review the adequacy of the Company's loss and loss adjustment expense reserves as of December 31, 2015.

## SUMMARY OF SIGNIFICANT FINDINGS OF FACT

The examination included a review to verify the current status of findings commented upon in the Report of Examination as of December 31, 2010. There were no significant findings during the previous examination and there are no significant findings related to the current examination.

## COMPANY HISTORY

### General

The Company was formed as a mutual insurance company pursuant to Chapter 189 of the Acts of 1988. The Company was incorporated under the laws of the Commonwealth of Massachusetts on August 26, 1988 and began business on October 1, 1988. The Company was created as part of an agreement between the Division and the Kemper Group ("Kemper"), which permitted Kemper to cease writing its personal auto insurance lines in Massachusetts. The Company has no ownership or management ties to any Kemper Company and is not a member of the Kemper Group.

### Capital Contributions

The Company received $119 million in cash for guaranty fund certificates issued during 1988. The certificates were subordinated to claims for losses, expenses and all other obligations of the Company. Any payment of interest or principal is subject to the prior approval of the Commissioner of the Division of Insurance. The Company has a payment schedule that started in 1998 with payments based on the financial performance of the Company. The certificates have a 48 year repayment term with the payments scheduled to end in 2045.

In 2003 the Company issued $20 million and $15 million in Surplus Notes to special purpose business trusts that mature in 2033. In 2014, the $15 million Note was redeemed. In 2006 the Company issued an additional $20 million in Surplus Notes to special purpose business trusts and these Notes mature in 2036.

## MANAGEMENT AND CONTROL

### Annual Meeting of Members

In accordance with the bylaws, the annual meeting of the members of the Company is to be held on the third Tuesday in June of each year at the home office of the Company unless a different, date, or place within the Commonwealth of Massachusetts was fixed by the Board of Directors. At any meeting of the members, not less than one-half of one percent of all members, whether present in person or by valid exercisable proxy shall constitute a quorum. The minutes indicate that a quorum was obtained at each annual meeting held during the examination period.

Board of Directors

The Company is managed by the Board of Directors, the Chairman of which presides at member meetings and meetings of the Board of Directors. The Board of Directors shall annually set the number of directors which shall be no less than seven, but not less than the minimum required by Massachusetts Insurance Laws, Massachusetts Business Corporation Laws and/or the Articles of Organization. Each director shall serve a term of office to expire at the fourth succeeding annual meeting of the members following election and until their successor shall have been elected and qualified.

At December 31, 2015 the Board of Directors was comprised of thirteen directors which is in compliance with the Company's bylaws. The director's names and business affiliation were as follows:

| Director | Business Affiliation |
|---|---|
| Patricia P. Bailey | Consultant |
| Francis X. Bellotti | Consultant |
| Thomas S. Carpenter | TS Carpenter Associates |
| Anne M. DeFrancesco | DeFrancesco Consulting |
| John F. Donohue | President and Chief Executive Officer<br>Arbella Mutual Insurance Company |
| John R. Dowling | Dowling Insurance Agency |
| William H. DuMouchel | Oracle |
| Andrea W. Gargiulo | Consultant |
| David W. Hattman | TCS Holdings, Inc. |
| Thomas R. Kiley | Cosgrove, Eisenberg & Kiley, P.C. |
| Joseph G. Murphy | Coverys |
| Jeannette M. Orsino | Orsino Consulting |
| Brian J. O'Dwyer | O'Dwyer & Bernstein LLP |

Officers

The bylaws of the Company provide that the officers of the Company shall be a President, a Treasurer, a Secretary and other officers as deemed necessary. Pursuant to the bylaws, the officers of the Company are elected by the Board of Directors at the first meeting of the Board held after the annual meeting.

The elected officers and their respective titles at December 31, 2015 follow:

| Name | Title |
|---|---|
| John F. Donohue | Chairman, Board of Directors, President, Chief Executive Officer and Assistant Secretary |
| Francis X. Bellotti * | Vice Chairman, Board of Directors |
| Christopher E. Hall | Treasurer, Chief Financial Officer and Executive Vice President |
| Eileen S. Currie * | Senior Vice President, Commercial Lines |
| Gail Eagan | Senior Vice President and General Counsel |
| James S. Hyatt | Senior Vice President, Personal Lines |
| Lynellen M. Ramirez | Chief Actuary and Vice President |
| Beverly J. Tangvik | Secretary |

* These elected Officers were not listed on the Jurat page of the 2015 Annual Statement.

## Committees of the Board

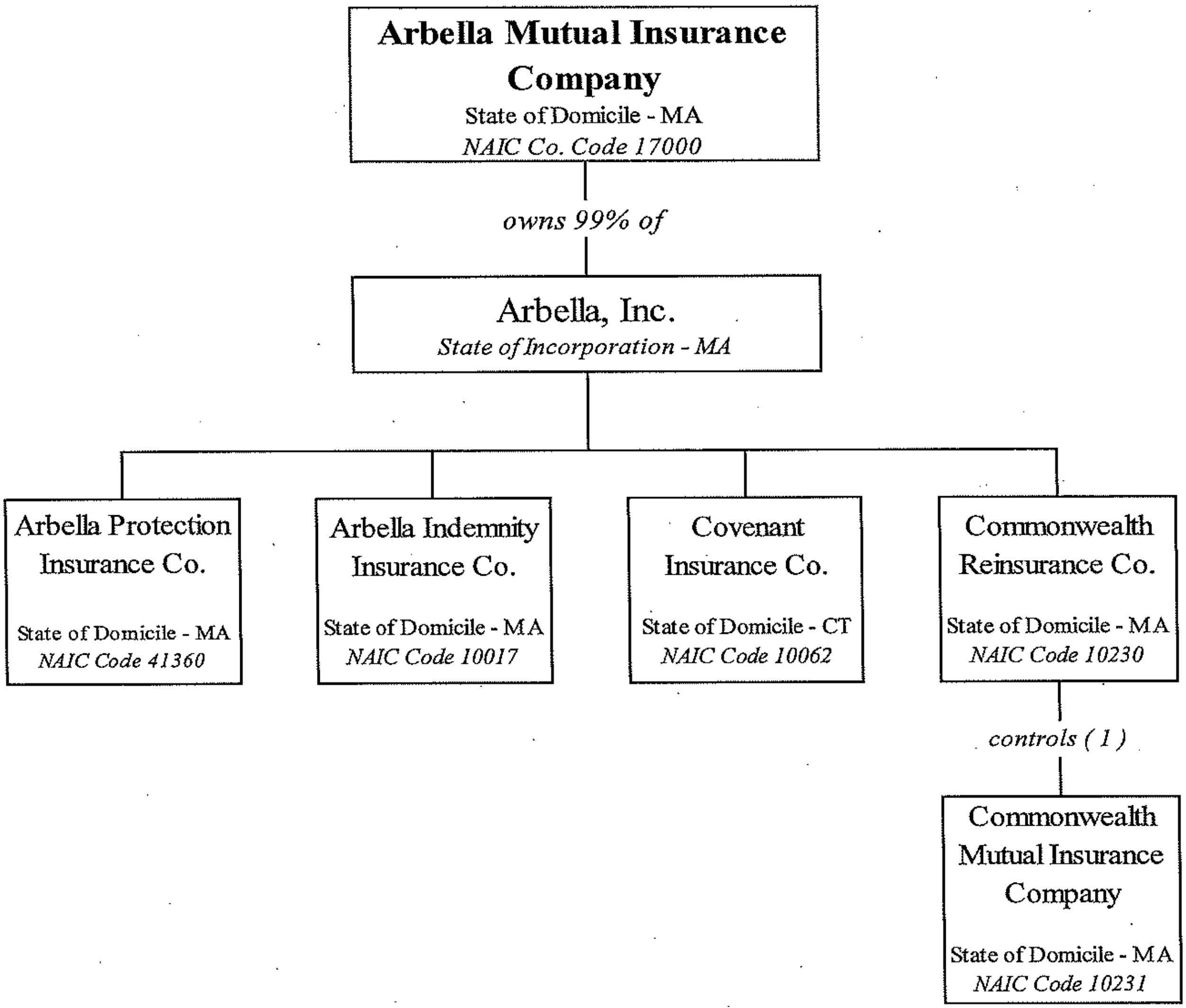
The bylaws state that the Board of Directors ("Board") may elect an Executive Committee and may form an Audit Committee and shall elect other committees as may be required from time to time. As of the date of this examination, the Company operated with designated Audit, Compensation, Executive, Investment, Planning and Technology Committees. The minutes of all committee meetings for the period covered by this examination were reviewed.

## Holding Company

As stated in the Insurance Holding Company System Form B, as filed with the Massachusetts Division of Insurance, the Company is a member of a holding company system and is subject to the registration requirements of Chapter 175, Section 206C and 211 CMR 7.00 of the Massachusetts General Laws. The Company is defined as the "ultimate controlling person".

## Organization Chart

The Company's insurance subsidiaries are shown on the organization chart below and the Company's other holdings including various insurance agencies are not shown. At December 31, 2015, the Company is a member of the following organizational structure:




*( 1 )* - Commonwealth Reinsurance Company controls Commonwealth Mutual Insurance Company through a reinsurance agreement, which terminated in 2014 in connection with the winding down of the two companies. See the Subsequent Events section for further details.

## Transactions and Agreements with Subsidiaries and Affiliates

The Company owns 99.0% of Arbella, Inc., an insurance holding company. Arbella, Inc. directly owns the four insurance companies shown on the organization chart above. Arbella Protection owns 100% of Arbella Specialty Brokerage, Inc. In addition Arbella Inc. owns 100% of Arbella Capital Corporation, Arbella Service Company, Inc., AMIC Insurance Agency, Inc. and its subsidiary, Arbella Service Center, and is the sole member of the Arbella Insurance Group Charitable Foundation, Inc. Arbella Inc. owns two insurance agencies in Massachusetts, Viveiros Insurance Agency, Inc. and Bearingstar Insurance Agency, Inc.

Intercompany Pooling Agreement

The Company participates in an intercompany pooling arrangement ("Pool") with Arbella Protection, Arbella Indemnity and Covenant Insurance Company in which it shares in the Pool's combined underwriting results and related balance sheet accounts. After processing its external reinsurance, each affiliated pooled company cedes its remaining net underwriting activity to the Company, which subsequently retrocedes the pooled results to the participants based on their percentage share of the Pool. Refer to the following chart for the percentages of the Pool participants as of the examination date.

| Company | Pool Percent |
|---|---|
| Arbella Mutual Insurance Company | 76% |
| Arbella Protection Insurance Company | 16% |
| Covenant Insurance Company | 5% |
| Arbella Indemnity Insurance Company | 3% |

Management Agreement

The Company and its affiliates ("Participants") are participants in a Services Agreement pursuant to which Arbella Service Company, Inc. provides administrative, operational and managerial services to all the individual companies. The Participants have agreed to a method to allocate the costs of the services which is based on generally accepted accounting principles. The settlement terms among the companies are in accordance with statutory accounting guidance.

Tax Sharing Agreement

The Company files a consolidated tax return with all of its subsidiaries. Since 1996, the Company and its affiliates have been Participants to a Tax Allocation Agreement ("Agreement") for the purpose of establishing a method for allocating the consolidated tax liability of the Participants and for reimbursing the Company for the payment of such tax liability. The Agreement provides that all subsidiaries of the Company shall be subject to the Agreement.

## TERRITORY AND PLAN OF OPERATION

As of December 31, 2015, the Company is only licensed in Massachusetts and primarily provides insurance coverage for homeowners and personal automobile.

Treatment of Policyholders – Market Conduct

During the financial examination of the Company, the Division's Market Conduct Department initiated a comprehensive market conduct examination of the Company for the period January 1, 2015 through December 31, 2015. The market conduct examination was called pursuant to authority in M.G.L. Chapter 175, Section 4. The market conduct examination was conducted at the direction of, and the overall management and control of, the market conduct examination staff of the Division. Representatives from the firm of Rudmose and Noller Advisors, LLC were engaged to complete certain agreed upon procedures which were developed using the guidance and standards of the NAIC Market Regulation Handbook, the market conduct examination standards of the Division, and the Commonwealth of Massachusetts insurance laws, regulations and bulletins. The business areas that were reviewed under the market conduct examination are Company Operations/Management; Complaint Handling; Marketing and Sales; Producer Licensing; Policyholder Services; Underwriting and Rating and Claims. Each business area reviewed includes the identification and evaluation of the insurer's internal controls.

## REINSURANCE

The Company and its affiliates participate in the intercompany pooling agreement described above. Assumed and ceded reinsurance with unaffiliated companies is also subject to the inter-company pooling agreement, as described below.

### Ceded Reinsurance

The Company and its insurance affiliates utilize and share the cost of a common reinsurance program to reduce loss exposures from catastrophic and individual risks. The Company has catastrophe excess of loss contracts that provide coverage in excess of the Company's retention of $25 million up to $570 million. The Company has an aggregate catastrophe treaty providing coverage in excess of $7.5 million up to $22.5 million per occurrence excess and otherwise recoverable deductible of $15 million. There are contracts for property and liability excess of loss contracts providing coverage up to $10 million in excess of $1.5 million. The workers' compensation contract provides coverage in excess of the Company's retention of $1.5 million up to $10 million. In addition, the Group purchased facultative reinsurance and catastrophic workers compensation protection for risk in excess of its property and liability excess of loss treaty limits. Lastly, the Group purchases various reinsurance to reduce insurance risk from its umbrella, boiler and machinery and other product offerings.

### Assumed Reinsurance

The Company assumes business from the Massachusetts FAIR Plan and the Massachusetts Automobile Insurance Plan. The Company also serves as the lead company of the Group to assume commercial automobile results from Commonwealth Automobile Reinsurers, which it then internally cedes to Arbella Protection.

## FINANCIAL STATEMENTS

The following financial exhibits are based on the statutory financial statements prepared by management and filed by the Company with the Division and present the financial condition of the Company for the period ending December 31, 2015. The financial statements are the responsibility of Company management.

Statement of Assets, Liabilities, Surplus and Other Funds as of December 31, 2015

Statement of Income as of December 31, 2015

Statement of Capital and Surplus for the Year Ended December 31, 2015

Reconciliation of Capital and Surplus for the Five-Year Period Ended December 31, 2015

Arbella Mutual Insurance Company
Statement of Assets, Liabilities, Surplus and Other Funds
As of December 31, 2015

| Assets | As Reported by the Company |
|---|---|
| Bonds | $ 707,824,515 |
| Common stocks | 255,767,417 |
| Cash and short-term investments | 37,858,896 |
| Other invested assets | 1,959,900 |
| Subtotals, cash and invested assets | 1,003,410,728 |
| | |
| Investment income due and accrued | 6,001,598 |
| Premiums and considerations: | |
| Uncollected premiums and agents' balances in the course of collection | 18,515,022 |
| Deferrred premiums, agents' balances and installments booked but deferred and not yet due | 178,201,522 |
| Amounts recoverable from reinsurers | 40,793,528 |
| Current federal income tax recoverable | 9,931,016 |
| Net deferred tax asset | 32,607,668 |
| Aggregate write-ins for other-than-invested assets | 44,734,088 |
| Total Assets | $1,334,195,170 |

Arbella Mutual Insurance Company
Statement of Assets, Liabilities, Surplus and Other Funds (Continued)
As of December 31, 2015

| Liabilities | As Reported by the Company |
|---|---|
| Losses | $ 280,415,904 |
| Reinsurance payable on paid loss and LAE | 26,522,639 |
| Loss adjustment expenses | 55,187,265 |
| Commissions payable | 11,706,006 |
| Other expenses | 30,564,895 |
| Unearned premiums | 327,500,099 |
| Advance premiums | 13,343,620 |
| Ceded reinsurance premiums payable | 37,791,353 |
| Amounts withheld | 90,694 |
| Drafts outstanding | 25,184,662 |
| Payable to parent, subsidiares and affiliates | 13,386,956 |
| Aggregate write-ins for liabilities | 2,006,399 |
| Total Liabilities | 823,700,490 |
| | |
| Surplus notes | 147,547,330 |
| Unassigned funds (surplus) | 362,947,350 |
| Surplus as regards policyholders | 510,494,680 |
| | |
| Total Liabilities, Capital and Surplus | $1,334,195,170 |

Arbella Mutual Insurance Company
Statement of Income
For the Year Ended December 31, 2015

| | As Reported by the Company |
|---|---|
| Premiums earned | $ 587,569,844 |
| Deductions: | |
| Losses incurred | 422,911,086 |
| Loss expenses incurred | 60,115,989 |
| Other underwriting expenses incurred | 190,507,399 |
| Total underwriting deductions | 673,534,474 |
| Net underwriting gain (loss) | (85,964,630) |
| | |
| Net investment income earned | 19,869,936 |
| Net realized capital gains | 6,951 |
| Net investment gain | 19,876,887 |
| | |
| Net gain (loss) from agents' balances or premium balances charged off | (1,094,084) |
| Finance and service charges not included in premiums | 9,139,746 |
| Aggregate write-ins for miscellaneous income | 3,879,853 |
| Total other income | 11,925,515 |
| | |
| Net income before dividends to policyholders and before federal and foreign income taxes | (54,162,227) |
| Federal and foreign income taxes incurred | (9,200,898) |
| | |
| Net Income | $ (44,961,330) |

Arbella Mutual Insurance Company
Capital and Surplus
For the Year Ended December 31, 2015

| | As Reported by the Company |
|---|---|
| Surplus as regards policyholders, December 31, 2014 | $561,235,353 |
| Net income | (44,961,330) |
| Change in net unrealized capital gains or (losses) | (17,753,850) |
| Change in net deferred tax | 12,001,590 |
| Change in nonadmitted assets | (160,534) |
| Change in surplus notes | (1,064,056) |
| Aggregate write-ins for gains and losses in surplus | 1,197,507 |
| Change in surplus as regards policyholders for the year | (50,740,673) |
| Surplus as regards policyholders, December 31, 2015 | $510,494,680 |

Arbella Mutual Insurance Company
Reconciliation of Capital and Surplus
For the Five Year Period Ended December 31, 2015

| | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|
| Capital and surplus, December 31, prior year | $561,235,355 | $523,929,333 | $480,883,624 | $407,990,325 | $473,855,021 |
| Net income | (44,961,330) | 28,575,570 | 22,846,570 | 35,196,735 | (58,315,472) |
| Change in net unrealized capital gains or (losses) | (17,753,850) | 27,604,157 | 23,889,022 | 30,434,330 | (16,483,244) |
| Change in net unrealized foreign exchange capital gain | | | | | 1,613,997 |
| Change in net deferred income tax | 12,001,590 | (1,083,736) | (2,351,043) | (11,334,277) | 18,028,807 |
| Change in nonadmitted assets | (160,534) | 641,854 | 791,949 | 6,094,264 | (9,897,021) |
| Change in surplus notes | (1,064,056) | (15,994,445) | (929,289) | (868,587) | (811,763) |
| Cumulative effect of changes in accounting principles | | | | 13,370,834 | |
| Aggregate write-ins for gains and losses in surplus | 1,197,507 | (2,437,380) | (1,201,500) | | |
| Net change in capital and surplus for the year | (50,740,673) | 37,306,019 | 43,045,709 | 72,893,299 | (65,864,696) |
| Capital and surplus, December 31, current year | $510,494,680 | $561,235,355 | $523,929,333 | $480,883,624 | $407,990,325 |

## ANALYSIS OF CHANGES IN FINANCIAL STATEMENTS RESULTING FROM THE EXAMINATION

There have been no changes made to the financial statements as a result of the examination.

## COMMENTS ON FINANCIAL STATEMENT ITEMS

As a result of the examination, no significant issues with non-compliance, adverse findings, or material changes to the financial statements were identified.

The Division engaged the consulting actuaries from Lewis & Ellis, Inc. to review the reasonableness of the Loss and Loss Adjustment Expense Reserves (the "Reserves") of the Company as of December 31, 2015. The review was conducted in a manner consistent with the Code of Professional Conduct and Qualification Standards of the American Academy of Actuaries and the Standards of Practice adopted by the Actuarial Standards Board.

Lewis & Ellis's actuarial review utilized year-end paid and incurred loss data developed through December 31, 2015. The tables below summarize a comparison of Lewis & Ellis's range of reasonable net estimates for the Reserves to the Company's carried net reserves as of December 31, 2015.

| | Low Point of Range | Central Estimate | High Point of Range |
|---|---|---|---|
| Lewis & Ellis Total Net Loss & LAE Reserves | $292,642,560 | $322,265,840 | $352,360,320 |
| Total Company Carried Net Loss & LAE Reserves | 335,602,320 | 335,602,320 | 335,602,320 |
| Difference | 42,959,760 | 13,336,480 | (16,758,000) |

The Company's total net carried reserves are above Lewis & Ellis's central estimate and below their high point. Therefore the Division concludes the Company's reserves are a reasonable estimate of their ultimate liability.

## SUBSEQUENT EVENTS

During 2016, Commonwealth Reinsurance Company ("Comm Re") converted to a non-insurance company and was renamed Arb CR, Inc. On December 28, 2016, Arb CR, Inc. was dissolved. The transaction had no impact on the Group's capital. Consequently, there is no longer any affiliation to Commonwealth Mutual Insurance Company, an entity previously included on the Group's organizational chart as a result of its former controlling arrangements with Comm Re.

## SUMMARY OF RECOMMENDATIONS

There were no significant recommendations noted by the examination team for improvements in process, activities and/or controls that should be noted in this report. Recommendations of a lesser degree will be communicated to the Board of Directors in the Company's Management Letter.

**SIGNATURE PAGE**

Acknowledgement is made of the cooperation and courtesies extended by the officers and employees of the Company during the examination.

Kenneth R. Plumb
Kenneth R. Plumb, CPA, CFE
Supervising Examiner
Commonwealth of Massachusetts
Division of Insurance

Arthur C. Hughes
Arthur C. Hughes
Examiner-in-Charge
Commonwealth of Massachusetts
Division of Insurance