COMMONWEALTH OF MASSACHUSETTS
Office of Consumer Affairs and Business Regulation
DIVISION OF INSURANCE
One South Station • Boston, MA 02110-2208
(617) 521-7794 • FAX (617) 521-7475
TTY/TDD (617) 521-7490
http://www.mass.gov/doi

DEVAL L. PATRICK
GOVERNOR

TIMOTHY P. MURRAY
LIEUTENANT GOVERNOR

DANIEL O'CONNELL
SECRETARY OF HOUSING AND ECONOMIC DEVELOPMENT

DANIEL C. CRANE
DIRECTOR

NONNIE S. BURNES
COMMISSIONER OF INSURANCE

March 30, 2007

The Honorable Alfred W. Gross
Chairman, NAIC Financial Condition (E) Committee
Commissioner, Bureau of Insurance
Commonwealth of Virginia
PO Box 1157
1300 East Main Street
Richmond, VA 23219

The Honorable Thomas E. Hampton
Secretary, Northeast Zone
Commissioner, Dept. of Insurance, Securities, and Banking
Government of the District of Columbia
810 First Street, N. E., Suite 701
Washington, DC 20002

The Honorable Nonnie S. Burnes
Commissioner of Insurance
The Commonwealth of Massachusetts
One South Station, 5th Floor
Boston, MA 02110

Honorable Commissioners:

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

ARBELLA MUTUAL INSURANCE COMPANY

at its statutory home office at 1100 Crown Colony Drive, Quincy, Massachusetts 02269. The following report thereon respectfully is submitted:

SCOPE OF EXAMINATION

Arbella Mutual Insurance Company (hereinafter referred to as "Arbella" or the "Company") was last examined as of December 31, 2000, under the Association Plan of the National Association of Insurance Commissioners ("NAIC") by the Massachusetts Division of Insurance (the "Division"). The current Association examination was performed by the Division under the authority of Section 4, Chapter 175 of the Massachusetts General Laws, and covers the five year period from January 1, 2001, through December 31, 2005, including any material transactions and/or events subsequent to the examination date as noted during the course of this examination.

Concurrent examinations were also conducted of four other Massachusetts domiciled insurers of the Arbella Insurance Group: Arbella Protection Insurance Company ("APIC"), Arbella Indemnity Insurance Company ("AIIC"), Commonwealth Reinsurance Company ("CRC") and Commonwealth Mutual Insurance Company ("CMIC"), (collectively, the "Group"), each of which is the subject of a separate examination report.

The examination was conducted in accordance with standards established by the Financial Condition (E) Committee of the NAIC as well as with the requirements of the NAIC Financial Condition Examiner's Handbook, the examination standards of the Division and with Massachusetts General Laws. The principal focus of the examination was as of December 31, 2005, and the year 2005 activity, however transactions both prior and subsequent thereto were reviewed as deemed appropriate.

In addition to a review of the financial condition of the Company, the examination included a review of the Company's business policies and practices, corporate records, reinsurance treaties, conflict of interest disclosure statements, fidelity bonds and other insurance, employees' pension and benefits plans, disaster recovery plan and other pertinent matters to provide reasonable assurance that the Company was in compliance with applicable laws, rules and regulations. In planning and conducting the examination, consideration was given to the concepts of materiality and risk and examination efforts were directed accordingly.

The Company is audited annually by Ernst & Young LLP ("E&Y"), an independent certified public accounting firm, in accordance with 211 CMR 23.00. E&Y expressed unqualified audit opinions on the Company's statutory basis financial statements for each of the years they audited the Company during the examination period (2001 through 2005). The E&Y workpapers for the year 2005 audit were reviewed as part of the examination process and used to assist in the planning of the examination, to supplement work performed by the Division and KPMG, and expedite the overall examination process.

Representatives from the independent certified public accounting firm of KPMG LLP ("KPMG") were engaged to complete certain agreed upon procedures, including a review and evaluation of the adequacy of the Company's loss and loss adjustment expense reserves as of December 31, 2005.

The examination included a review to verify the current status of any exceptions conditions noted in the prior Report of Examination. For a summary of findings contained within this report, refer to the "Notes to Financial Statements" section.

HISTORY

General

The Company was formed as a mutual insurance company pursuant to Chapter 189 of the Acts of 1988 and was incorporated under the laws of the Commonwealth of Massachusetts on August 26, 1988. The Company is the ultimate parent and lead member of an insurance group (the Group) which consist of four property/casualty insurance companies and a property/casualty affiliate. The Group operates solely in the New England region and collectively writes private passenger auto, commercial auto, commercial multiple peril, homeowners, personal umbrella and workers' compensation products primarily through independent agents.

The Company owns 99.3% of the common stock of Arbella, Inc. a holding company. Arbella, Inc. owns 100% of APIC, AIIC, Arbella Capital Corporation (Capital), Anchor Solutions Company, Inc. (Anchor), Arbella Service Company, Inc. (Service), AllGuard Insurance Agency, Inc. (AllGuard) and the Covenant Group, Inc. (CGI); CGI owns CRC, Covenant Insurance Company (CIC), Litchfield Personal Lines (LPL) and Arbella H-T Insurance Agency, Inc. (AHTA). APIC has a wholly owned subsidiary, Arbella Specialty Insurance Brokerage, Inc. (Specialty); Capital has a 100% membership interest in Arbella Property, LLC (Property). Effective 11/15/2006, AllGuard owns 100% of Arbella Customer Support Center, Inc (formerly AHTA). Through a reinsurance contract, CRC maintains significant control over CMIC.

Effective January 1, 2002, the Company entered into an intercompany pooling agreement with its Massachusetts domiciled subsidiaries. Under the terms of this agreement APIC, AIIC, and CRC cede 100% of their net book to the Company, the Company retains 75% of the pooled underwriting results and retrocedes the remaining 25% back to the other pool participants based on the percentages listed in the following table. Percentages have not changed since the pool's inception:

Arbella	75%
APIC	18%
AIIC	4%
CRC*	3%
Total	100%

* CMIC cedes 100% of its net book to CRC and CRC retrocedes 100% of this book to the Pool.

The Company has not made any significant changes to its articles of incorporation or its by-laws during the period covered by this examination. Additionally, there have not been any name changes, mergers, or any other material changes to its corporate structure since the last examination except as discussed below in Acquisitions, Affiliations and Other Transactions.

The Company and its affiliates operate under a management agreement with Service. Pursuant to this agreement, Service is the common employer for the Group and provides administrative, financial, claims, IT and underwriting resources necessary for the operations of the Company and its affiliates. The cost of such services is allocated back to the respective companies.

Growth of Company

The growth of the Company for the years 2001 through 2005 is shown in the following schedule, which was prepared from the Company's statutory Annual Statements.

Year	Admitted Assets	Net Written Premium	Capital & Surplus
2005	$ 898,097,356	$ 465,056,368	$ 345,133,221
2004	837,329,711	445,580,655	310,845,651
2003	811,465,252	452,280,978	282,889,925
2002	764,885,867	450,704,750	241,300,940
2001	651,499,896	365,767,381	229,277,757

MANAGEMENT

Annual Meeting of Members

In accordance with the by-laws, 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 at eleven o'clock unless a different hour, date, or place within the Commonwealth of Massachusetts as 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 a 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 is elected for a period of four years, 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, 2005, the Board of Directors was comprised of eleven directors which is in compliance with the Company by-laws. Directors duly elected and serving at December 31, 2005, with business affiliations, follows:

Director	Business affiliation	Residence
Patricia P. Bailey	Consultant	Santa Fe, New Mexico
Francis X. Bellotti	Arbella Insurance Group	Quincy, Massachusetts
Anne DeFrancesco	DeFrancesco Consulting	Londonderry, New Hampshire
Edmund J. Doherty	Barry & McHugh Insurance Agency	Winchester, Massachusetts
John F. Donohue	Chairman, President and Chief Executive Officer	Belmont, Massachusetts
John R. Dowling	Dowling Insurance Agency	Canton, Massachusetts
William H. DuMouchel	Lincoln Technologies, Inc.	Tucson, Arizona
Andrea Gargiulo	Retired	Boston, Massachusetts
David W. Hattman	TCS Holding, Inc	Houston, Texas
Thomas R. Kiley	Cosgrove, Eisenberg & Kiley, PC	Quincy, Massachusetts
Jeanette M. Orsino	Executive Director, Massachusetts Association of Regional Transit Authorities	Boston, Massachusetts

The by-laws do not specify the number of meetings to be held during a given calendar year. The by-laws contain provisions allowing for special meetings. Additionally, the by-laws allow the Board of Directors to take action by written consent and/or telephone conference. The minutes of the Board of Directors meetings indicated that meetings were held at least six times per year during the examination period. At any meeting of the Board of Directors a majority of the directors then in office shall constitute a quorum. The minutes indicated that a quorum was obtained at all meetings of the Board of Directors held during the examination period.

Committees of the Board

The by-laws state that the Board of Directors 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, Automation, Compensation, Executive, Investment and Planning Committees. The minutes of all of the committee meetings for the period covered by this examination were reviewed.

Officers

The by-laws of the Company provide that the officers of the Company shall be a President, Secretary, Treasurer and any other officers, as the Board of Directors deems necessary. Pursuant to the by-laws, the officers of the company are elected by the Board of Directors at the annual meeting. The elected officers and their respective titles at December 31, 2005 are as follows:

Officer	Title
John F. Donohue	Chairman, President, Chief Executive Officer, Assistant Secretary
Robert P. Medwid	Executive Vice President, Chief Financial Officer, Treasurer
Thomas S. Carpenter	Executive Vice President and Chief Actuary
Donald M. Barber (1)	Senior Vice President
Gail Eagan (2)	Vice President and General Counsel
Beverly T. Kenneally	Secretary and Clerk

(1) deceased July, 2006
(2) elected November, 2005

Conflict of Interest Procedures

The Company has established procedures for the disclosure to the Board of Directors of any material interest or affiliation on the part of any officer or director, which is in or is likely to conflict with his/her official duties. Annually, each officer and director completes a questionnaire disclosing any material conflicts of interest.

Corporate Records

The Company's records were reviewed for the period covered by this examination. They were assessed for accuracy and compliance with the Company's by-laws, Articles of Incorporation, as well as for compliance with Massachusetts General Laws, and the Commonwealth of Massachusetts Regulations ("211 CMR"). During the examination period there were no changes to these documents and all changes made were properly disclosed to all regulatory authorities. All activity related to the company's funds, including all investments was examined for proper approval.

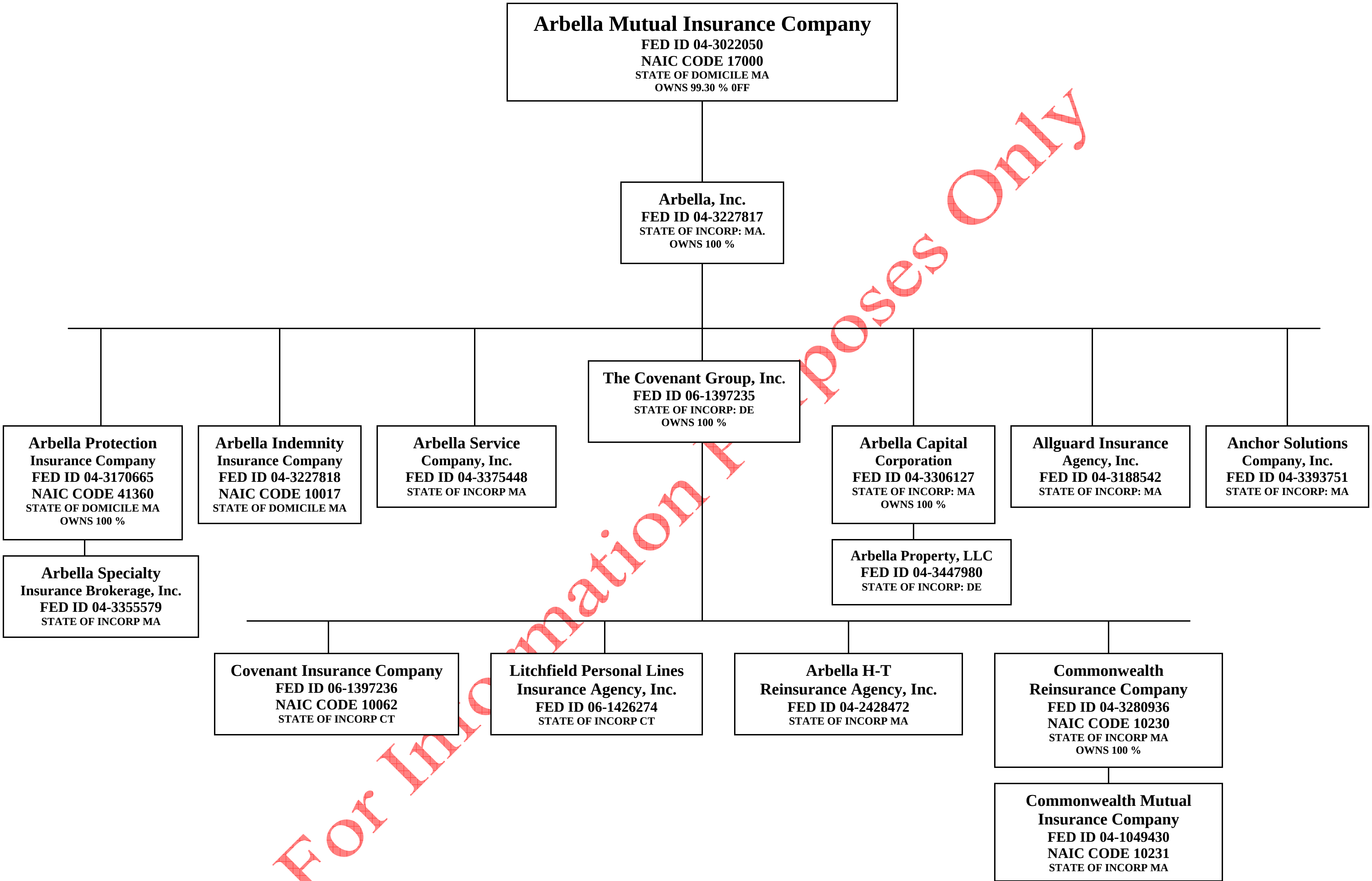
The Company has a disaster recovery plan and business continuity plan however, its by-laws do not contain explicit provisions for the continuity in the event of a national emergency; hence, under such circumstances, the succession of officers will be as prescribed in Sections 180M through 180Q of MGL Chapter 175.

AFFILIATED COMPANIES

The Company's insurance affiliates include the following Massachusetts domiciled property and casualty insurance companies: APIC, AIIC, CRC and CMIC. CIC is domiciled in the State of Connecticut.

Organization Chart

An organization chart of Arbella Mutual Insurance Company and subsidiaries is presented below.


Arbella Mutual Insurance Company
FED ID 04-3022050
NAIC CODE 17000
STATE OF DOMICILE MA
OWNS 99.30 % 0FF
Arbella, Inc.
FED ID 04-3227817
STATE OF INCORP: MA.
OWNS 100 %
Arbella Protection Insurance Company
FED ID 04-3170665
NAIC CODE 41360
STATE OF DOMICILE MA
OWNS 100 %
Arbella Specialty Insurance Brokerage, Inc.
FED ID 04-3355579
STATE OF INCORP MA
Arbella Indemnity Insurance Company
FED ID 04-3227818
NAIC CODE 10017
STATE OF DOMICILE MA
Arbella Service Company, Inc.
FED ID 04-3375448
STATE OF INCORP MA
The Covenant Group, Inc.
FED ID 06-1397235
STATE OF INCORP: DE
OWNS 100 %
Arbella Capital Corporation
FED ID 04-3306127
STATE OF INCORP: MA
OWNS 100 %
Arbella Property, LLC
FED ID 04-3447980
STATE OF INCORP: DE
Allguard Insurance Agency, Inc.
FED ID 04-3188542
STATE OF INCORP: MA
Anchor Solutions Company, Inc.
FED ID 04-3393751
STATE OF INCORP: MA
Covenant Insurance Company
FED ID 06-1397236
NAIC CODE 10062
STATE OF INCORP CT
Litchfield Personal Lines Insurance Agency, Inc.
FED ID 06-1426274
STATE OF INCORP CT
Arbella H-T Reinsurance Agency, Inc.
FED ID 04-2428472
STATE OF INCORP MA
Commonwealth Reinsurance Company
FED ID 04-3280936
NAIC CODE 10230
STATE OF INCORP MA
OWNS 100 %
Commonwealth Mutual Insurance Company
FED ID 04-1049430
NAIC CODE 10231
STATE OF INCORP MA

Acquisitions, Affiliations and Other Transactions

During the period January 1, 2000, through December 31, 2005, the Company's material transactions included the following items:

- Effective with its initial capitalization in 1988, the Company received cash of $119,000,000 from the issuance of guaranty fund certificates (surplus notes). The Company has an agreement with the MA Division of Insurance for repayment of interest and principal of the notes. The outstanding principal bears interest at a rate of 7% per annum and is scheduled for repayment in forty-eight equal installments commencing in 1998. Annually, if the Company achieves certain performance criteria, the payment due the following year is not required to be repaid and a portion of the surplus note is transferred to unassigned funds. The Company has met all required criteria for each year during the examination period.

- The Company recorded the cumulative effect of adoption of Codification which resulted in an adjustment that increased unassigned surplus as of January 1, 2001, by approximately $23,300,000, primarily as a result of recording a net deferred tax asset of $9,600,000, a change in its reserving basis of $14,400,000 offset by a decrease in miscellaneous liabilities of $700,000.

- Effective January 1, 2001, the Company prepared its statutory basis financial statements in accordance with the following prescribed or permitted practices from the Division:

    - To amortize capitalized non-admitted system software through unassigned surplus as opposed to the statement of operations. There is no net impact to surplus as amounts would be non-admitted. Under Codification, such amounts would be amortized through the statement of operations over the lesser of its useful life or a five-year period.

    - To recognize agency loans written by Arbella Capital Corporation as an admitted asset as of December 31, 2001. The permitted practice was conditioned upon Arbella Capital obtaining a firm commitment of sale of the loans by March 1, 2002. In accordance with the terms of the permitted practice, Arbella Capital obtained a firm commitment of sale of the loans. As a result, the loans were admitted as of December 31, 2001. The impact of this practice was to increase surplus by approximately $2,700,000 as of December 31, 2001. During April 2002, the commitment for the sale of the loans was terminated at the option of the prospective buyer. The Company advised that the previously noted surplus benefit was reversed in the quarterly statutory financial report as of March 31, 2002, as a result of the prospective buyer's action.

To amortize the remaining Allied goodwill of $24,000,000 as of December 31, 2000, using a 10-year amortization period effective for the year 2001. In addition, the Company was permitted to carry the unamortized goodwill as an admitted asset, but only for the year ended December 31, 2001. The impact of this practice was to increase surplus by $6,000,000 as of December 31, 2001. The permitted practice did not apply to periods after December 31, 2001.

- On June 1, 2001, the Company purchased 2,462,122 shares of Arbella, Inc. stock for $6,500,000. Arbella, Inc. in turn contributed $6,000,000 to APIC and $500,000 to CGI.

- On December 20, 2001, Mass Managers, Inc. was merged into Mass Holdings, Inc. and Connecticut Managers, Inc. was merged into Constitution Holdings, Inc. Subsequently, Constitution Holdings, Inc. and Mass Holdings, Inc. merged into CGI. As a result, CGI is the sole stockholder of CIC and CRC.

- On December 20, 2001, the Company purchased 4,924,243 shares of Arbella, Inc. stock for $13,000,000. Arbella, Inc., in turn, contributed $5,000,000 to APIC, $4,000,000 to CRC and $4,000,000 to CIC.

- On April 2, 2002, the Group received a rating of B++ from A.M. Best. Previously, the Group's A.M. Best rating was A-.

- During 2002, Arbella, Inc. contributed $7.3 million to APIC ($2 million on June 30 and $5.3 million on July 31).

- The December 31, 2002, sale of assets of the Allied American Agency, Inc. (Allied) to a third party produced a gain in surplus of $17.7 million. A portion of the proceeds was used to repay intercompany loans.

- During 2003 the Company issued three additional surplus notes in the amount of $35,000,000 for cash, a description of each notes follows:

    - $12,000,000 was issued on May 15, 2003. The note's interest rate is based on the 3 month Libor rate plus 410 basis points and the note matures on May 13, 2033.
    - $15,000,000 was issued on May 22, 2003. The note's interest rate is fixed at 9.65% and matures on May 22, 2033.
    - $8,000,000 was issued on October 29, 2003. The note's interest rate is based on the 3 month Libor rate plus 340 basis points and the note matures on October 29, 2033.

These surplus notes were purchased by special purchase business trusts. The trusts in turn sold collateralized obligations to investors in the private market.

All surplus notes are subordinated to claims for losses, expenses and all other obligations of the Company. Any interest or principal repayment must be approved by the Commissioner of Insurance, Commonwealth of Massachusetts.

As of December 31, 2005, the balance of all surplus notes outstanding was $150,543,958.

- During 2005 Arbella Life & Health Insurance Company surrendered its license to insurance departments of Massachusetts and New Hampshire, and Arbella, Inc. dissolved the corporation.

- On November 15, 2005, the Company loaned $5,500,000 to Arbella Capital Corp (Capital) under Capital's existing line of credit. Capital, in turn loaned these proceeds to AllGuard Insurance Agency (AllGuard) in order for AllGuard to purchase policy expiration rights from a third party.

INTERCOMPANY AGREEMENTS

Management Agreement

Effective January 1, 1998, the Company entered into a management agreement with Service whereby Service provides the Company (and its affiliates) with management services including data processing and system support, underwriting, marketing, claims, actuarial, cash and investment management, personnel, legal, accounting, and other such management oversight as is required and requested by the Company for the necessary and efficient management of its operation.

Tax Sharing Agreement

The Company files a consolidated tax return with Arbella Inc. and its subsidiaries. The Company has executed a tax sharing agreement effective January 1, 1996, which provides for the allocation of taxes based upon the separate return calculations with current credit for net losses incurred by any one of the companies to the extent such losses are utilized in the consolidated return.

FIDELITY BOND AND OTHER INSURANCE

The Company and its affiliates maintain fidelity coverage with an authorized Massachusetts insurer, under a financial institutions bond designed for insurance companies, consistent with M.G.L. c. 175 s. 60. The Company, a member of the Group, is covered by a blanket fidelity bond with an aggregate liability of $6,000,000 and a single loss limit of liability of $3,000,000 and a single loss deductible of $25,000. Coverage is provided by insurers licensed in the Commonwealth of Massachusetts and was in force as of December 31, 2005. The aggregate limit of liability exceeds the NAIC suggested minimum as well as Massachusetts General Law requirements. Other coverage provided under the bond includes assorted loss of property coverage, losses due to forgery and counterfeit currency losses, and computer systems fraud. The Company has further protected its interest and property by policies of insurance covering other insurable risks.

PENSION, INSURANCE PLANS AND EMPLOYEE WELFARE

Retirement and Deferred Compensation Plans

The Company sponsors a qualified defined contribution retirement plan (retirement plan) for which all employees of Service are eligible to participate on the first month following their attainment of age 18 and completion of eleven months of service. The retirement plan is allocated to various companies within the Group under a Generally Accepted Accounting Practices ("GAAP") cost sharing arrangement.

The Company sponsors a qualified 401K savings plan which uses the same eligibility requirements as the retirement plan. Under the terms of this plan employees contribute from 1% to 60% of their annual earnings, with the sponsor matching 100% of the employee's first 3% and a 50% match for the next 2%, subject to Internal Revenue Service ("IRS") annual limitations. The cost of this plan is allocated to various companies within the Group under a GAAP cost sharing arrangement.

The Company sponsors a defined contribution plan, which provides certain postretirement health and life insurance benefits. Substantially all employees may become eligible for these benefits if they reach retirement age (62) while working for Service, and have at least five years of service credit. Annually, the plan sponsor determines the amount of money it will contribute that year towards the cost of the benefits for the individuals that are currently retired. The sponsor retains the right to change or modify the plan at any time and makes no promise to current employees that it will annually contribute to the cost of their postretirement benefits.

Stock Option Plan

Arbella, Inc. has an incentive bonus and stock option plans for senior management as well as the Board of Directors for shares of Arbella, Inc. Under the terms of these plans, each option granted can be used to purchase one share of Arbella, Inc.'s stock. There are 4,289,375 shares reserved for issuance under these plans as of December 31, 2005.

STATUTORY DEPOSIT

The statutory deposit of the Company as of December 31, 2005, was as follows:

Location	**Description of Deposit**	**Par Value**	**Statement Value**	**Market Value**
Massachusetts	U.S. Treasury Note 5.25% due 2/15/2029	$ 200,000	$ 222,861	$ 218,248

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operation

As of December 31, 2005, the Company is authorized to provide coverage in the Commonwealth of Massachusetts only. The Company is duly organized under the laws of the Commonwealth of Massachusetts and is authorized under section 47 of Chapter 175 of the Massachusetts General Laws to provide the following coverages: fire, inland, liability other than automobile, automobile liability, comprehensive motor vehicle and aircraft, personal property floater and dwelling and reinsurance (except life).

Rating and Statistical Reporting

The significant rating and statistical organizations to which the Company subscribes include Insurance Service Office, Commonwealth Automobile Reinsurers and Automobile Insurance Bureau of Massachusetts.

SUBSEQUENT EVENTS

The following details are noted as "subsequent events", the disclosure of which in this Examination Report is considered appropriate.

- During 2006 the Company issued two additional surplus notes for a total amount of \$20,000,000 for cash, a description of each notes follows:
  - \$10,000,000 was issued on October 6, 2006, the note's interest rate is based on the 3 month Libor rate plus 340 basis points. The note matures on September 15, 2036.
  - \$10,000,000 was issued on October 6, 2006, the note's interest rate is based on the 3 month Libor rate plus 330 Basis points. The note matures on September 15, 2036.
- On September 1, 2006 the Company advanced \$10,200,000 to Service in order for Service to buy back certain software assets that it had previously sold to a third party under a sale leaseback agreement.
- On November 15, 2006, 100% of the ownership of HTA was transferred from CIC to AllGuard and HTA's name was changed to the Arbella Customer Support Center, Inc.
- On December 15, 2006, the Company entered into an Industry Loss Warranty ("ILW") reinsurance contract with Montpelier Re Ltd. that expires on December 31, 2007. Under the terms of the contract, the Company is liable for losses from natural perils which result in industry losses above established monetary thresholds in the specific geographic areas of North America, Europe and Japan. The Company's liability under the contract is subject to a \$50 million limit per each loss occurrence and an aggregate

limit of $100 million. The Company recorded $26.1 million in assumed written premium related to the ILW in 2006; no losses were reported or recorded under the contract in 2006.

REINSURANCE

The Company and its insurance affiliates utilize and share the cost of a common reinsurance program to reduce loss exposures from catastrophe as well as individual risks. The Group maintains treaties for property excess of loss, casualty excess of loss, workers' compensation excess of loss and umbrella treaties placed directly with General Reinsurance Company ("Gen Re"). Additionally, the Group maintains a facultative treaty with Hartford Steam Boiler for machinery and equipment coverage. The Group utilizes the services of a reinsurance broker, Guy Carpenter, to place certain catastrophe reinsurance. The Company remains contingently liable to the extent that its reinsurers are unable to meet their obligations under the reinsurance agreements.

Ceded Reinsurance

Property Per Risk Excess of Loss Treaty

This reinsurance agreement with Gen Re covers homeowners property losses as follows: 1st layer: $1,000,000 xs $1,000,000; 2nd layer: $4,000,000 xs $2,000,000. The limit for other property losses is: 1st layer: $800,000 xs $1,200,000; 2nd layer: $4,000,000 xs $2,000,000.

Casualty Per Risk Excess of Loss Treaty

This reinsurance agreement with Gen Re covers casualty losses as follows: 1st layer $800,000 xs $1,200,000; 2nd layer: $4,000,000 xs $2,000,000.

Property Catastrophe Excess of Loss Treaty

This reinsurance agreement is placed with various subscribing reinsurers through a broker, Guy Carpenter, as follows:

1st layer: $25,000,000 xs $25,000,000; 2nd layer: $120,000,000 xs $50,000,000; 3rd layer: $50,000,000 xs $170,000,000.

Assumed Reinsurance

The Company primarily assumes business through its participation in Commonwealth Automobile Reinsurers ("CAR") and the Massachusetts FAIR Plan. As a servicing carrier for CAR the Company provides coverage on certain private passenger auto policies which are ceded to CAR. The Company is required to assume from CAR a percentage of CAR's aggregate private passenger auto premiums, losses and expenses based on participation ratios as determined by CAR.

Intercompany Reinsurance

As previously noted on January 1, 2002, the Company entered into an intercompany pooling agreement with several of its subsidiaries. Under the terms of this agreement APIC, AIIC and CRC cede 100% of their net book to the Company, the Company retains 75% of the pooled underwriting results and retrocedes the remaining 25% to the other pool participants.

In order for CIC to receive the same claims paying ability rating as the Group, there is an inter-company reinsurance agreement whereby CIC cedes 100% of its direct written premium to AIIC. AIIC cedes this premium to the Company, and the Company simultaneously retrocedes the premium to CIC. Because there is no net impact to any of the companies, this transfer has been eliminated from this statement.

ACCOUNTS AND RECORDS

The internal control structure was discussed with management through questionnaires and through transaction testing and a review of the work performed by the Company's independent Certified Public Accountants. No material deficiencies were noted.

The NAIC provides a questionnaire covering the evaluation of the controls in the information systems (IS) environment. The Company operates on information systems owned, operated and maintained by the Company. The NAIC Exhibit C Questionnaire was completed by the Company. These independent work products were reviewed by the Division as part of the evaluation of the adequacy of the IS controls. No material deficiencies were noted.

The Company maintains its accounts and records on an electronic data processing basis. All entries are input to this data processing system, which then generates general ledger and supporting reports as well as other reports common to the insurance industry.

FINANCIAL STATEMENTS

The following financial statements are presented on the basis prescribed by the NAIC Accounting Practices and Procedures Manual which are the principal accounting practices and procedures promulgated by the National Association of Insurance Commissioners and the Commonwealth of Massachusetts Division of Insurance:

- Statement of Assets, Liabilities, Surplus and Other Funds, December 31, 2005;
- Statement of Income for the Year Ended December 31, 2005;
- Statement of Capital and Surplus for the Year Ended December 31, 2005;
- Reconciliation of Capital and Surplus for the Five Year Period Ended December 31, 2005.

Arbella Mutual Insurance Company
Statement of Assets, Liabilities, Surplus and Other Funds
December 31, 2005

Assets	Per Annual Statement	Examination Adjustments	Per Examination	Note
Bonds	$ 497,595,370	$ -	$ 497,595,370	
Common stocks	127,681,718		127,681,718	
Cash	(14,741,059)		(14,741,059)	
Short-term investments	25,880,106		25,880,106	
Other invested assets	44,942,312		44,942,312	
Investment income due and accrued	4,913,433		4,913,433	
Uncollected premiums	6,521,948		6,521,948	
Deferred premiums	123,916,996		123,916,996	
Amounts recoverable from reinsurers	12,164,678		12,164,678	
Net deferred tax asset	21,900,000		21,900,000	
Receivables from parent, subsidiaries and affiliates	13,398,526		13,398,526	
Other assets	33,923,328		33,923,328	
Total assets	$ 898,097,356	$ -	$ 898,097,356	
Liabilities, Surplus and Other Funds				
Losses	$ 253,241,364	$ 16,135,000	$ 269,376,364	1
Loss adjustment expenses	36,203,902	(16,135,000)	20,068,902	1
Commissions payable	15,854,236		15,854,236	
Other expenses	2,297,505		2,297,505	
Current federal income taxes	6,151,108		6,151,108	
Unearned premiums	221,804,779		221,804,779	
Advance premiums	6,427,231		6,427,231	
Other liabilities	10,984,010		10,984,010	
Total liabilities	552,964,135	-	552,964,135	
Surplus notes	150,543,958		150,543,958	
Unassigned funds	194,589,263		194,589,263	
Surplus as regards policyholders	345,133,221	-	345,133,221	
Total liabilities, surplus and other funds	$ 898,097,356	$ -	$ 898,097,356	

Arbella Mutual Insurance Company
Statement of Income
for the Year Ended December 31, 2005

	Per Annual Statement	Examination Adjustments	Per Examination	Note
Premiums earned	$ 453,603,163	$ -	$ 453,603,163	
Losses incurred	246,524,762	16,135,000	262,659,762	**1**
Loss expenses incurred	45,761,745	(16,135,000)	29,626,745	**1**
Other underwriting expenses incurred	151,309,374		151,309,374	
Net underwriting gain	10,007,282	-	10,007,282	
Net investment income earned	21,329,656		21,329,656	
Net gain or (loss) from agents' or premium balances charged off	(1,856,347)		- (1,856,347)	
Finance or service charges	10,956,751		10,956,751	
Miscellaneous income	(66,478)		(66,478)	
Net income before dividends and taxes	40,370,864	-	40,370,864	
Federal income taxes incurred	15,232,000		15,232,000	
Net income	$ 25,138,864	$ -	$ 25,138,864	

Arbella Mutual Insurance Company
Statement of Capital and Surplus
for the Year Ended December 31, 2005

	Per Annual Statement	Examination Adjustments	Per Examination	Note
Surplus as regards policyholders, December 31, 2004	$ 310,845,651	$ -	$ 310,845,651	
Net income	25,138,864		25,138,864	
Change in net unrealized capital gains and (losses)	8,833,480		8,833,480	
Change in net deferred income tax	4,307,000		4,307,000	
Change in nonadmitted assets	(3,991,774)		(3,991,774)	
Change in surplus notes	(540,912)		(540,912)	
Surplus adjustments - Paid in	540,912		540,912	
Change in surplus as regards policyholders for the year	34,287,570	-	34,287,570	
Surplus as regards policyholders, December 31, 2005	$ 345,133,221	$ -	$ 345,133,221	

Arbella Mutual Insurance Company
Reconciliation of Capital and Surplus
for the Five Year Period Ended December 31, 2005

	2005 *	2004	2003	2002	2001
Surplus as regards policyholders, December 31, prior year	$ 310,845,651	$ 282,889,925	$ 241,300,316	$ 229,277,757	$ 213,031,737
Net income	25,138,864	23,424,531	3,251,198	(9,975,569)	9,404,584
Change in net unrealized capital gains and (losses)	8,833,480	1,273,594	4,284,495	18,625,261	(14,494,775)
Change in net deferred income tax	4,307,000	6,415,000	-	4,400,000	-
Change in nonadmitted assets	(3,991,774)	(3,157,399)	(946,084)	(1,026,509)	(1,918,789)
Change in surplus notes	(540,912)	(505,525)	34,527,547	(441,545)	(412,659)
Cumulative effect of changes in accounting principles	-	-	-	-	23,255,000
Surplus adjustments - Paid in	540,912	505,525	472,453	441,545	412,659
Change in surplus as regards policyholders for the year	34,287,570	27,955,726	41,589,609	12,023,183	16,246,020
Surplus as regards policyholders, December 31, current year #	345,133,221	310,845,651	282,889,925	241,300,940	229,277,757
Subsequent adjustment	-	-	-	(624)	-
Adjusted surplus as regards policyholders, December 31, current year	$ 345,133,221	$ 310,845,651	$ 282,889,925	$ 241,300,316	$ 229,277,757

* As per Examination
\# As reported in that year's Annual Statement

NOTES TO FINANCIAL STATEMENT

NOTE 1:

The Company's Annual Statement, as filed, did not reflect a reclassification necessary to bring the Loss Reserves and Reserve for Loss Adjustment Expenses into agreement with the actuarial analysis prepared by the Company's Appointed Actuary. This examination reclassified those amounts in both the liabilities and in the underwriting expenses. There was no effect on Surplus.

NOTE 2:

As part of the examination by the Division, KPMG was directed to review the reasonableness of the reserves for loss and loss adjustment expenses of the Company as of December 31, 2005.

The review was conducted in a manner consistent with the Code of Professional Conduct and the Qualification Standards of the American Academy of Actuaries and the Standards of Practice adopted by the Actuarial Standards Board.

The results of KPMG's actuarial review indicated that the Company's reserves at December 31, 2005 fell within the range of reasonable estimates for all unpaid loss and loss adjustment expense obligations of the Company under the terms of its policies and reinsurance agreements.

The following table summarizes the reserve ranges as developed by KPMG, the selected point estimate reserve and the Company's carried loss and loss adjustment expense reserves as of December 31, 2005, for each reserve category (all amounts in millions of dollars).

Net of Reinsurance

Reserve Category	Low End of Range	KPMG Selection	High End of Range	Company Carried
Loss Reserves	$ 217.4	$ 236.0	$ 260.4	$ 253.2
Loss Adjustment Expense Reserve	47.2	49.3	51.3	36.2
Total Loss and Loss Adjustment Expense Reserves	$ 264.6	$ 285.3	$ 311.7	$ 289.4

Gross of Reinsurance

Reserve Category	Low End of Range	KPMG Selection	High End of Range	Company Carried
Loss Reserves	$ 258.2	$ 281.9	$ 311.2	$ 304.3
Loss Adjustment Expense Reserve	58.6	61.3	64.2	43.2
Total Loss and Loss Adjustment Expense Reserves	$ 316.8	$ 343.2	$ 375.4	$ 347.5

The following table summarizes the reserve ranges as developed by KPMG, the selected point estimate reserve and the Arbella Insurance Group carried loss and loss adjustment expense reserves as of December 31, 2005, for each reserve category (all amounts in millions of dollars).

Reserve Category	Low End of Range	KPMG Selection	High End of Range	Company Carried
Net Loss Reserves	$ 289.8	$ 314.8	$ 347.2	$ 337.7
Net Defense & Cost Containment Expense Reserves	52.2	53.8	56.0	32.7
Net Adjusting & Other Expense Reserves	13.3	14.4	15,2	15.6
Total Net Loss and Loss Adjustment Expense Reserves	$ 355.3	$ 383.0	$ 418.4	$ 386.0

Reserve Category	Low End of Range	KPMG Selection	High End of Range	Company Carried
Gross Loss Reserves	$ 344.2	$ 375.9	$ 414.9	$ 405.6
Gross Defense & Cost Containment Expense Reserves	67.4	69.8	73.1	42.4
Gross Adjusting & Other Expense Reserves	13.3	14.4	15.2	16.6
Total Gross Loss and Loss Adjustment Expense Reserves	$ 424.9	$ 460.1	$ 503.2	$ 464.6

CONCLUSION

The undersigned gratefully acknowledges the participation of the following members of the Massachusetts Division of Insurance in this examination:

Yvette P. Nelson-Smith	Insurance Examiner II
Steven C. Tsimtsos	Insurance Examiner II

The undersigned also express their appreciation for the courteous cooperation of the officers and employees of the Company in the course of the examination.

Respectfully submitted,

____

Hilton A. Irizarry, CFE
Examiner-in-Charge
Commonwealth of Massachusetts

____

Kenneth R. Brenner, CPA
Supervising Examiner
Commonwealth of Massachusetts