



**THE COMMONWEALTH OF MASSACHUSETTS
OFFICE OF CONSUMER AFFAIRS AND BUSINESS
REGULATION**

DIVISION OF INSURANCE

REPORT OF EXAMINATION

OF THE

ARBELLA MUTUAL INSURANCE COMPANY

1100 CROWN COLONY DRIVE

QUINCY, MASSACHUSETTS 02269-9103

AS OF

DECEMBER 31, 2010

NAIC GROUP CODE 0586

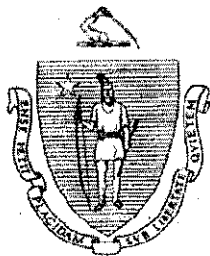
NAIC COMPANY CODE 17000

EMPLOYER ID NUMBER 04-3022050

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TABLE OF CONTENTS

	PAGE
Salutation	1
Scope of Examination	2
Information Technology Review	2
History	3
General	3
Growth of Company	4
Management	5
Annual Meeting of Members	5
Board of Directors	5
Committees of the Board	6
Officers	6
Conflict of Interest Procedures	6
Corporate Records	8
Affiliated Companies	7
Organization Chart	7
Acquisitions, Affiliations and Other Transactions	9
Intercompany Agreements	11
Management Agreement	11
Tax Sharing Agreement	11
Fidelity Bonds and Other Insurance	12
Pension, Insurance Plans and Employee Welfare	12
Retirement and Deferred Compensation Plans	12
Stock Option Plan	12
Statutory Deposits	13
Insurance Products and Related Practices	13
Territory and Plan of Operation	13
Rating and Statistical Reporting	13
Reinsurance	13
Ceded Reinsurance	13
Assumed Reinsurance	14
Intercompany Reinsurance	14
Subsequent Events	15
Accounts and Records	15
Financial Statements	16
Statement of Assets, Liabilities, Surplus and Other Funds	17
Statement of Income	18
Statement of Capital and Surplus	19
Reconciliation of Capital and Surplus	20
Note to Financial Statement	21
Conclusion	23



COMMONWEALTH OF MASSACHUSETTS
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DIVISION OF INSURANCE

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November 18, 2011

The Honorable Joseph Torti III
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Superintendent
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Honorable Superintendent and Commissioner:

In 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 located at 1100 Crown Colony Drive, Quincy, Massachusetts 02269-9103. The following report thereon respectfully is submitted.

SCOPE OF EXAMINATION

Arbella Mutual Insurance Company ("Company") was last examined as of December 31, 2005, according to the Association Plan of the National Association of Insurance Commissioners ("NAIC") by the Massachusetts Division of Insurance ("Division"). The Division made the present examination by authority of Section 4, Chapter 175 of Massachusetts General Law, under the NAIC Association Plan. This examination covers the transactions of the Company in the five-year period from the date of the prior examination through December 31, 2010, with notation of significant events occurring through the date of this report.

This examination was conducted at the same time and in conjunction with the Division's statutory financial condition examination of the Company's subsidiaries, Arbella Indemnity Insurance Company ("Indemnity"), Arbella Protection Insurance Company ("Protection"), Commonwealth Reinsurance Company ("Commonwealth Re") and Commonwealth Mutual Insurance Company ("Commonwealth Mutual") by the Division. A separate examination of Covenant Insurance Company ("Covenant") is being conducted by the Connecticut Insurance Department. Representatives from the firm of PricewaterhouseCoopers LLP ("PwC") were engaged by the Division to assist in the examination by performing certain examination procedures, including an analytical review of the Company's actuarially determined items.

During the course of this examination, the operating management and corporate policies, transactions, accounting practices and procedures and internal controls of the Company were reviewed, analyzed, and tested to the extent deemed appropriate and necessary. General operations of the Company were reviewed for compliance with applicable Massachusetts insurance statutes. Audit work conducted by the Company's external auditors, Ernst & Young LLP ("E&Y") was reviewed, relied upon wherever deemed appropriate and effective, and incorporated into the work papers supporting this examination whenever deemed appropriate. The work of the internal auditors was also reviewed and relied upon to the extent deemed appropriate. The premium, loss, reinsurance, investment and operating controls employed by the Company were reviewed and found to be effectively functioning. In performing the examination, certain procedures, reviewed and approved by the Division, were applied to selected records and transactions of the Company. NAIC JumpStart reports were utilized for procedures relating to bonds, stocks and short-term investments.

Information Systems Review

A review and an evaluation of the control environment of the Company's information technology systems were performed. The NAIC's Information Technology (IT) Questionnaire completed by the Company was reviewed and interviews with Company staff were conducted to gather supplemental information and corroborate the Company's responses to the questionnaire. A review was also made of the documentation supporting Management and Organization Controls, Application Systems Development and Maintenance Controls, Operating and Processing Controls, Logical and Physical Security Controls, Contingency Planning Controls, Personal Computer, Local Area Network (LAN), Wide Area Network (WAN) and Internet Controls. The control environment of the Company's information systems was reviewed and found to have in place sufficient internal controls.

Arbella Mutual Insurance Company

This Report of Examination is written on an exception basis. Explanations of and details pertaining to various phases of the examination will be found herein. Unless it is specifically noted otherwise, all references to the accounts, activities, and transactions of the Company are as of December 31, 2010. For a summary of findings contained within this report, refer to the section titled "Summary of Comments and Recommendations".

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 ("Group") which consist of five property/casualty insurance companies and a property/casualty insurance affiliate. The Group operates solely in the New England region and collectively writes private passenger auto, homeowners, commercial auto, commercial multiple peril, umbrella and workers' compensation products primarily through independent agents.

The Company owns 99.0% of Arbella, Inc., an insurance holding company. Arbella, Inc. owns 100% of Arbella Protection Insurance Company, Arbella Indemnity Insurance Company, Arbella Capital Corporation ("Capital"), Anchor Solutions Company, Inc. ("Anchor"), Arbella Service Company, Inc. ("Service"), AMIC Insurance Agency, Inc. ("AMIC") and the Covenant Group, Inc. ("CGI"). CGI owns Commonwealth Re and Covenant. Through a reinsurance and management contract, Commonwealth Re maintains significant control over Commonwealth Mutual which cedes 100% of its direct businesses to Commonwealth Re. Arbella, Inc. also owns 80% of Harrington Insurance Agency ("Harrington"). The Company participates in an intercompany pooling agreement that includes Protection, Covenant, Indemnity, and Commonwealth Re. All members of the pooling agreement are domiciled in the Commonwealth of Massachusetts except for Covenant which is domiciled in the State of Connecticut.

Beginning in 2002, the Company, along with Protection, Indemnity and Commonwealth Re entered into an intercompany pooling arrangement ("Pool") in which it shares in the Pool's combined underwriting results and certain 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. Effective January 1, 2008, the agreement was amended to change the pooling percentages of the Company and Protection. Effective January 1, 2010, the agreement was amended to include Covenant and to modify the existing pooling percentages. Refer to the following chart for the percentages of the Pool participants over the course of the exam period.

Arbella Mutual Insurance Company

	<u>2002-2007</u>	<u>2008-2009</u>	<u>2010</u>
Mutual	75%	71%	69%
Protection	18%	22%	20%
Covenant	N/A	N/A	5%
Indemnity	4%	4%	3%
Commonwealth Re*	3%	3%	3%
Total	100%	100%	100%

* Commonwealth Mutual cedes 100% of its net book to Commonwealth Re and Commonwealth Re retrocedes 100% of its net book to the Pool.

The Company has not made any significant changes to its articles of incorporation during the period covered by this examination. The by-laws were amended once during the examination period effective August 19, 2010. The amendment established the logistical requirements and details for annual and special meeting; matters considered at the annual meeting; individuals who may call a special meeting of the Board of Directors and the duties of the committees of the Board of Directors.

Any name changes, mergers, or any other material changes to its corporate structure since the last examination are discussed below in Acquisitions, Affiliations and Other Transactions.

Growth of Company

The growth of the Company for the years 2006 through 2010 is shown in the following schedule, which was prepared from the Company's Statutory Annual Statements.

<u>Year</u>	<u>Admitted Assets</u>	<u>Net Written Premium</u>	<u>Capital & Surplus</u>
2010	\$1,093,078,844	\$437,079,320	\$473,855,021
2009	984,493,495	416,246,606	468,191,431
2008	948,785,808	430,803,066	437,778,770
2007	961,778,538	414,517,136	441,267,501
2006	954,274,823	481,109,785	391,093,629

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 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 determine 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, 2010, the Board of Directors was comprised of twelve directors which is in compliance with the Company by-laws. The Directors and any business affiliation with the Company as of December 31, 2010, are as follows:

<u>Director</u>	<u>Business Affiliation</u>
Patricia P. Bailey	None
Francis X. Bell	Legal consultant for Company
Thomas Cameron	None
Anne DeLuca	None
Edmund J. Doherty	None
John F. Donohue	CEO of Arbella Insurance Group
J. Robert Dowling	Partial Owner of Dowling Insurance Agency, which does business with the Company
William H. DuMouchel	None
Andrea Gargiulo	None
David W. Hattman	None
Thomas R. Kiley	Legal consulting services are provided to the Company by his firm, Cosgrove, Eisenberg & Kiley, PC
Jeanette M. Orsino	None

The by-laws do not specify the number of meetings to be held during a given calendar year. The by-laws

Arbella Mutual Insurance Company

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, 2010, are as follows:

<u>Officer</u>	<u>Title</u>
John F. Donohue	Chairman, President, Chief Executive Officer, Assistant Secretary
John F. Kittel	Executive Vice President
Christopher E. Hall	Senior Vice President, Chief Financial Officer, Treasurer
Gail Eagan	Vice President and General Counsel
James S. Hyatt	Vice President
Beverly J. Tangvik	Secretary and Clerk

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 reasonableness 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

Arbella Mutual Insurance Company

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 M.G.L., Chapter 175.

AFFILIATED COMPANIES

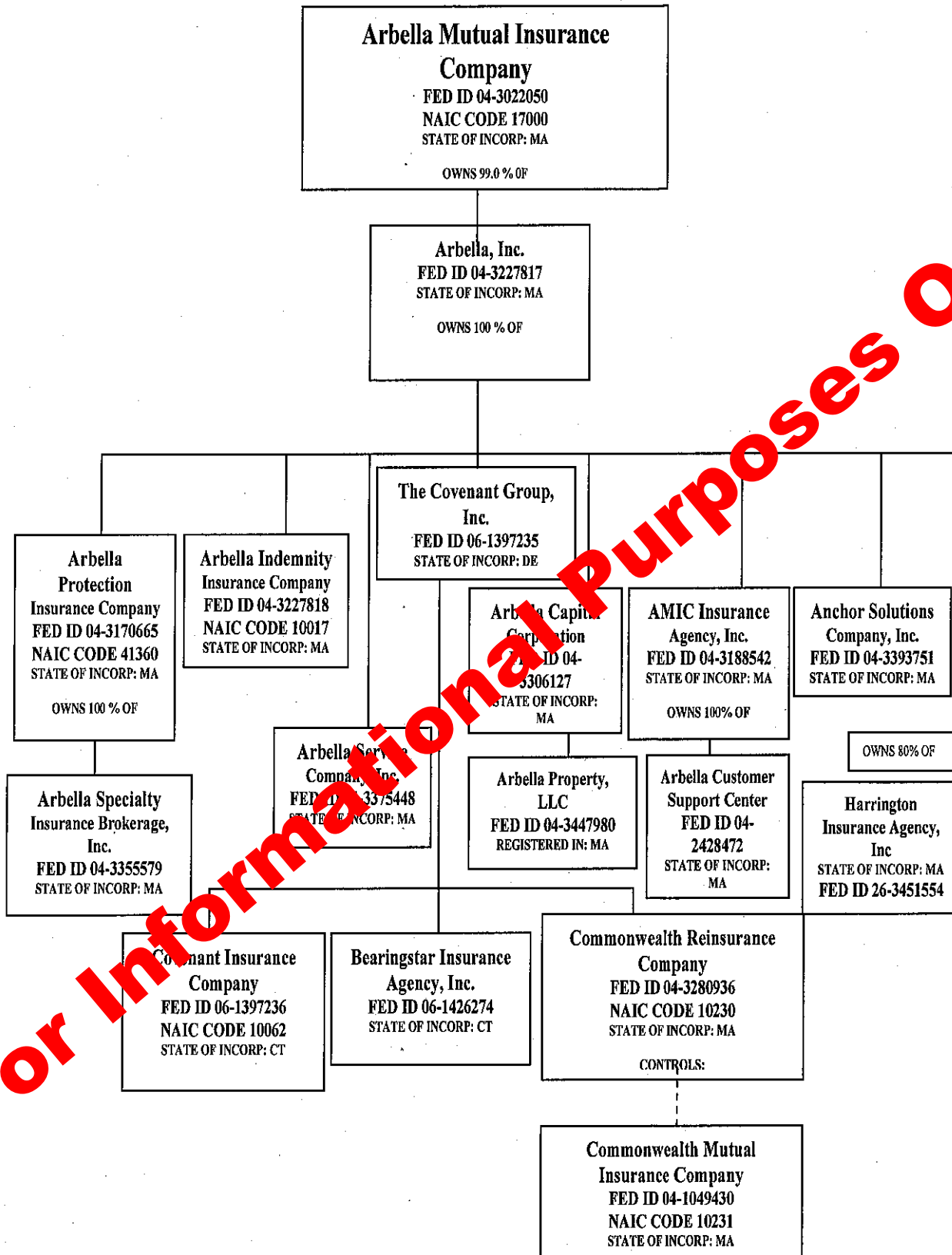
The Company's insurance affiliates include the following Massachusetts domiciled property and casualty insurance companies: Protection, Indemnity, Commonwealth Re and Commonwealth Mutual. Covenant is domiciled in the State of Connecticut.

Organization Chart

An organization chart of Mutual and subsidiaries is presented below.

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Arbella Mutual Insurance Company



Acquisitions, Affiliations and Other Transactions

During the period January 1, 2006, through December 31, 2010, the Company's material transactions included the following items:

- During 2006, the Company issued two additional surplus notes for a total amount of \$20,000,000 for cash, a description of each note, as 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 November 15, 2006, 100% of the ownership of Hastings Policy Agency ("HTA") was transferred from Covenant to AllGuard (now AMIC Insurance Agency, Inc.) and HTA's name was changed to the Arbella Customer Support Center, Inc.
- In December 2006, the Company entered into an Industry Loss Warranty ("ILW") reinsurance contract with Montpelier Re Ltd. that was to expire on December 31, 2007. Under the terms of the contract, the Company was 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 ILW was subsequently retroceded to Poseidon Re Ltd. in 2007, prior to its expiration.
- In December 2006, Arbella, Inc. contributed \$10 million to Arbella Insurance Group Charitable Foundation.
- On December 10, 2007, Mutual reached a settlement for a lawsuit brought by a Massachusetts automobile insurer whereby the insurer alleged damages arising out of interference with contractual relations and violation of M.G.L., c. 93A and other claims.
- Effective December 23, 2007, the "Repayment Agreement for Guaranty Fund Certificates issued by Arbella Mutual Insurance Company dated October 1, 1988" between the Company and the Commissioner of Insurance of the Commonwealth of Massachusetts was amended. Under the amended agreement, certain performance criteria were adjusted with respect to the amount of the minimum annual payment and the requirements for making the scheduled annual principal and interest payment. This included a change in the Company's mandatory premium to surplus ratio from 2:1 to 1.5:1. This also included a change in the minimum annual payment from \$250,000 to \$500,000.

Arbella Mutual Insurance Company

- Effective January 1, 2008, the intercompany pooling agreement was amended to align the pooling percentages of the Company and Protection in accordance to their proportionate share of the Group's unstacked statutory surplus as required by the pooling agreement.
- Effective January 1, 2008, the Company entered into a quota share reinsurance contract with Brit Insurance Limited ("Brit Re"). Under the terms of the agreement, the Company assumed 40% of Brit Re's United Kingdom's auto insurance business subject to certain loss limits. In 2009 and 2010, the treaty was renewed, but the Company reduced its participation to 25%.
- On December 1, 2008, Harrington Insurance Agency, Inc. ("Harrington") acquired the assets of Harrington Insurance Agency, LLC for \$5.9 million. It then issued 200 shares, representing a 20% interest in Harrington, to a third party.
- On December 19, 2008, the Intercompany Services Agreement was amended and restated to update the settlement terms between the companies and to clarify the expense allocation methodology.
- On December 19, 2008, the Tax Sharing Agreement was amended and restated to ensure that settlement terms between the companies were in accordance with current statutory accounting guidance and to correct certain references to the Internal Revenue Code.
- In May of 2009, Harrington acquired substantially all of the assets of Allguard Insurance Agency from Arbella, Inc. in exchange for \$5.2 million.
- Effective August 10, 2009, Allguard Insurance Agency changed its name to AMIC Insurance Agency.
- On October 1, 2009, in accordance with the terms of a Stock Pledge Agreement, the sole stockholder of Emery Insurance Agency, Inc. (Emery) put his shares of Emery to CGI. As a result of this transaction, CGI became the sole shareholder of Emery.
- In October of 2009, the Group received a rating of A- from A.M. Best. Previously, the Group's A.M. Best rating was B++, which the Group had held since 2002.
- Effective December 31, 2009, the Company froze its sponsored qualified defined contribution retirement plan ("retirement plan") and implemented a supplemental company contribution that would provide for a 4% employer contribution under the 401(K) savings plan subject to the Group's attainment of certain performance criteria.
- Effective January 1, 2010, the intercompany pooling agreement was amended to add Covenant as a participant and to modify the existing pooling participation percentages of the other members in accordance with the requirements of the pooling agreement.
- Effective January 1, 2010, the 100% Quota Share Agreement of Reinsurance and 100% Quota Share Agreement of Retrocession among and between the Company, Indemnity and Covenant was terminated.

- In October of 2010, the Company entered into a settlement with the Massachusetts Attorney General's ("AG") Office on allegations that insurance companies used inflated and un-depreciated motorcycle values to calculate the premiums that they charged to their motorcycle insurance customers. The Company agreed to return premium payments to qualifying policyholders and pay interest and penalties to the AG Office.
- Effective November 18, 2010, Emery was liquidated and dissolved.
- On December 31, 2010, Arbella, Inc. contributed \$15 million to Arbella Insurance Group Charitable Foundation. The contribution was funded via a loan between the Company and Arbella, Inc. which will be repaid in subsequent periods.

INTERCOMPANY AGREEMENTS

Management Agreement

Since January 1, 1998, the Company and its affiliates ("Participants") have been participants in a Services Agreement pursuant to which Service 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. This Agreement was amended and restated as of December 19, 2008, to update the settlement terms between the companies and to clarify the expense allocation methodology. The settlement terms among the companies are in accordance with statutory accounting guidance. Additionally, Capital provides all members of the Group with property and related property management services.

Tax Sharing Agreement

The Company files consolidated tax return with Arbella, Inc. and its subsidiaries. Since 1996, the Company and its affiliates have been participants ("Participants") to a Tax Allocation 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 Tax Agreement. This agreement was amended and restated as of December 19, 2008, to ensure that settlement terms among the companies are in accordance with current statutory accounting guidance and to correct certain references to the Internal Revenue Code.

FIDELITY BOND AND OTHER INSURANCE

The Company and its affiliates maintain fidelity coverage 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, 2010. 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) under 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. Plan participants vest based on the years of service contributed. The expense of the retirement plan is allocated to various companies under the Company under an expense sharing arrangement. As noted above, effective December 31, 2009, the Company froze the plan at which point all participants became 100% vested and future contributions would no longer be made.

The Company sponsors a qualified 401(k) 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% of contributions and a 50% match of the next 2%, subject to IRS annual limitations. The Company retains the right to change, modify or terminate the plan at any time. The cost of this plan is allocated to various companies under the Company under an expense sharing arrangement.

Effective with the aforementioned freezing of the retirement plan, the Company implemented a supplemental company contribution that would provide for a 4% contribution under the 401(K) savings plan subject to the Group's attainment of certain performance criteria beginning with the year ending December 31, 2010. For the year ended December 31, 2010, the Group did not meet these performance criteria.

Stock Option Plans

Arbella, Inc. has stock option plans for certain executives and board members under which each option granted can be used to purchase one share of Arbella, Inc.'s stock, with a vesting period of three years and a tenyear expiration period. Stock options are granted at exercise prices not less than the fair value of the Arbella, Inc.'s common stock on the date of the grant. The terms and conditions

upon which options become exercisable vary depending on when the amount was granted. There are 1,860,000 shares authorized and reserved for issuance under these plans as of December 31, 2010.

STATUTORY DEPOSIT

The statutory deposit of the Company as of December 31, 2010, was as follows:

<u>Location</u>	<u>Description of Deposit</u>	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
	U.S. Treasury Note			
Massachusetts	5.25% due 2/15/2029	\$ 200,000	\$ 223,125	\$ 229,400

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operation

As of December 31, 2010, 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 marine, earthquake, 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.

REINSURANCE

Ceded 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. At December 31, 2010, the following reinsurance agreements were in place, as follows:

Property Per Risk Excess of Loss Treaty

This reinsurance agreement with Gen Re is for homeowners property damage business, as follows: 1st layer: \$500,000 xs \$1,500,000; 2nd layer: \$4,000,000 xs \$2,000,000. The limit for other property damage business is 1st layer: \$500,000 xs \$1,500,000; 2nd layer: \$4,000,000 xs \$2,000,000. The limit for workers compensation business is 1st layer: \$3,500,000 xs \$1,500,000; 2nd layer: \$5,000,000 xs \$5,000,000.

Casualty Per Risk Excess of Loss Treaty

This reinsurance agreement with Gen Re is for casualty damage business, as follows: 2nd layer: \$3,000,000 xs \$2,000,000.

Property Catastrophe Excess of Loss Treaty

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

1st layer: \$25,000,000 xs \$25,000,000; 2nd layer: \$85,000,000 xs \$100,000,000; 3rd layer: \$165,000,000 xs \$135,000,000; 4th layer: \$100,000,000 xs \$300,000,000.

Assumed Reinsurance

The Company primarily assumes business through its participation in Commonwealth Automobile Reinsurers ("CAR") and the Massachusetts FAAR Plan. Beginning in April of 2008, the Massachusetts Insurance Commissioner formed an assigned risk plan, Massachusetts Auto Insurance Plan ("MAIP"), as part of the deregulation of the personal auto insurance market. The MAIP replaced CAR as the involuntary market mechanism in the Massachusetts personal auto insurance market.

Additionally, effective January 1, 2008, the Company entered into a quota share reinsurance contract with Brit Insurance Limited ("Brit Re") whereby the Company assumed 40% of Brit Re's U.K. Motor Account, subject to certain loss limits, which includes personal and commercial auto policies in the United Kingdom and the Republic of Ireland. In 2009 and 2010, this treaty was renewed whereby the Company assumed 25% of Brit Re's business.

Intercompany Reinsurance

As previously noted, since 2002, the Company has been a member of the Group's intercompany pooling agreement. During the examination period, there were two amendments to this agreement as follows: effective January 1, 2008, the agreement was amended to change the pooling percentages of the Company and Protection, and effective January 1, 2010, the agreement was amended to include Covenant and to modify the existing pooling percentages.

Effective January 1, 2010, the 100% Quota Share Agreement of Reinsurance and 100% Quota Share Agreement of Retrocession among and between the Company, Indemnity and Covenant was terminated. These agreements provided for the direct business of Covenant Insurance to be reinsured by the Company, through its affiliate Indemnity, and the Company, through its affiliate Indemnity, to cede the business back to Covenant. The purpose was to allow Covenant to receive the same claims paying ability rating as the Group's rating. Since Covenant became a participant to the intercompany

pooling agreement, these agreements were no longer deemed necessary.

SUBSEQUENT EVENTS

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

- Effective January 1, 2011, the Company did not renew its quota share reinsurance contract with Brit Re. The Company remains liable for its share of losses related to the prior years in which it participated.
- Effective May 11, 2011, the "Repayment Agreement for Guaranty Fund Certificates" issued by Arbella Mutual Insurance Company dated October 1, 1988 between the Company and the Commissioner of Insurance of the Commonwealth of Massachusetts was amended to adjust certain performance criteria for making the scheduled annual principal and interest payment. This included a change in the Company's mandatory premium to surplus ratio from 1.5:1 to 1:1. There were no other details noted as "subsequent events", the disclosure of which in this Examination Report was considered appropriate.

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 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, 2010;
- Statement of Income for the Year Ended December 31, 2010;
- Statement of Capital and Surplus for the Year Ended December 31, 2010;
- Reconciliation of Capital and Surplus for the Five Year Period Ended December 31, 2010.

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Arbella Mutual Insurance Company

Arbella Mutual Insurance Company Statement of Assets, Liabilities, Surplus and Other Funds December 31, 2010

	As Reported by Company	Examination Changes	Per Statutory Examination	Notes
<u>Assets</u>				
Bonds	\$ 553,363,966	\$ -	\$ 553,363,966	
Common stocks	178,275,474		178,275,474	
Cash and short-term investments	16,502,062		16,502,062	
Other invested assets	14,646,079		14,646,079	
Cash and invested assets	762,787,581	-	762,787,581	
Investment income due and accrued	5,130,561		5,130,561	
Premiums and considerations:				
Uncollected premiums and agents' balances in course of collection	3,524,944		3,524,944	
Deferred premiums, agents' balances and installments booked but deferred	112,835,649		112,835,649	
Reinsurance:				
Amounts recoverable from reinsurers	2,371,798		2,371,798	
Funds held by or on deposit with reinsured companies	9,762,337		9,762,337	
Current federal and foreign income tax recoverable and interest thereon	3,734,222		3,734,222	
Net deferred tax asset	21,044,225		21,044,225	
Receivables from parent, subsidiaries and affiliates	28,498,367		28,498,367	
Aggregate write-ins for other than invested assets	53,389,157		53,389,157	
Total assets	\$ 1,003,078,844	\$ -	\$ 1,003,078,844	
<u>Liabilities</u>				
Losses	\$ 212,549,302	\$ -	\$ 212,549,302	1
Loss adjustment expenses	40,035,181		40,035,181	1
Commissions payable on agent commissions and other similar charges	14,193,963		14,193,963	
Other expenses	5,162,776		5,162,776	
Taxes, licenses and fees	298,544		298,544	
Unearned premiums	225,808,866		225,808,866	
Advance premium	7,564,607		7,564,607	
Ceded reinsurance premiums payable	5,815,024		5,815,024	
Net adjustments in assets and liabilities due to foreign exchange rates	1,613,995		1,613,995	
Aggregate write-ins for other liabilities	16,181,565		16,181,565	
Total liabilities	529,223,823	-	529,223,823	
Surplus notes	167,215,569		167,215,569	
Unassigned funds (surplus)	306,639,452		306,639,452	
Surplus as regards policyholders	473,855,021	-	473,855,021	
Total liabilities, surplus and other funds	\$ 1,003,078,844	\$ -	\$ 1,003,078,844	

Arbella Mutual Insurance Company

Arbella Mutual Insurance Company Statement of Income For the Year Ended December 31, 2010

	As Reported by Company	Examination Changes	Per Statutory Examination	Notes
<u>Underwriting income</u>				
Premiums earned	\$ 417,357,911	\$ -	\$ 417,357,911	
Deductions:				
Losses incurred	246,227,013		246,227,013	
Loss adjustment expenses incurred	35,730,623		35,730,623	
Other underwriting expenses incurred	149,329,985		149,329,985	
Total underwriting deductions	431,287,621	-	431,287,621	
Net underwriting gain (loss)	(13,929,711)	-	(13,929,711)	
<u>Investment income</u>				
Net investment income earned	18,964,665		18,964,665	
Net realized capital gains (losses) less capital gains tax	(1,260,032)		(1,260,032)	
Net investment gain (loss)	17,704,633	-	17,704,633	
<u>Other income</u>				
Net gain (loss) from agents' or premium balances charged off	(2,057,159)		(2,057,159)	
Finance and service charges	9,123,530		9,123,530	
Aggregate write-ins for miscellaneous income	(131,645)		(131,645)	
Total other income	6,934,726	-	6,934,726	
Net income before dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	10,709,648	-	10,709,648	
Dividends to policyholders	-		-	
Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	10,709,648	-	10,709,648	
Federal and foreign income taxes incurred	3,069,407		3,069,407	
Net income	\$ 7,640,241	\$ -	\$ 7,640,241	

Arbella Mutual Insurance Company

Arbella Mutual Insurance Company Statement of Capital and Surplus For the Year Ended December 31, 2010

	As Reported by Company	Examination Changes	Per Statutory Examination	Notes
Surplus as regards policyholders, December 31 prior year	\$ 468,191,431		\$ 468,191,431	
Net income	7,640,241		7,640,241	
Change in net unrealized capital gains or (losses) less capital gains tax	(2,678,051)		(2,678,051)	
Change in net unrealized foreign exchange capital gain (loss)	(291,236)		(291,236)	
Change in net deferred income tax	433,729		433,729	
Change in nonadmitted assets	1,317,564		1,317,564	
Change in surplus notes	(758,657)		(758,657)	
Change in surplus as regards policyholders for the year	5,663,590	-	5,663,590	
Surplus as regards policyholders, December 31 current year	\$ 473,855,021	\$ -	\$ 473,855,021	

For Informational Purposes Only

Arbella Mutual Insurance Company

Arbella Mutual Insurance Company Reconciliation of Capital and Surplus For the Five Year Period Ended December 31, 2010

	<u>2010 *</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
Surplus as regards policyholders, December 31 prior year	\$ 468,191,431	\$ 437,778,770	\$ 441,267,500	\$ 391,093,629	\$ 345,133,221
Net income	7,640,241	12,512,399	21,895,117	26,144,022	37,551,383
Change in net unrealized capital gains or (losses) less capital gains tax	(2,678,051)	11,787,127	(11,791,520)	25,985,253	(14,953,680)
Change in net unrealized foreign exchange capital gain (loss)	(291,236)	823,080	(2,145,842)	-	-
Change in net deferred income tax	433,729	274,190	369,560	(1,902,969)	1,902,000
Change in nonadmitted assets	1,317,564	5,724,891	(11,153,404)	(52,434)	1,150,776
Change in surplus notes	(758,657)	(709,025)	(662,641)	(619,290)	9,420,24
Aggregat write-ins for gains and losses in surplus	-	-	-	619,290	578,776
Change in surplus as regards policyholders for the year	5,663,590	30,412,661	(3,488,730)	50,173,871	45,960,408
Surplus as regards policyholders, December 31 current year	\$ 473,855,021	\$ 468,191,431	\$ 437,778,770	\$ 441,267,500	\$ 391,093,629

* Per Statutory Examination

NOTE TO FINANCIAL STATEMENT**NOTE 1:**

As part of the examination by the Division, PwC was directed to review the reasonableness of the reserves for loss and loss adjustment expenses of the Company as of December 31, 2010.

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 PwC's actuarial review indicated that the Company's reserves at December 31, 2010, fell within a range of reasonable estimates for all unpaid loss and loss adjustment expense obligations of the Company.

The following table summarizes the reserve ranges as developed by PwC, the selected point estimate reserve and the Company's carried loss and loss adjustment expense reserves as of December 31, 2010, for each reserve category (all amounts in thousands of dollars).

Net of Reinsurance

<u>Reserve Category</u>	<u>Low End of Range</u>	<u>PwC Selection</u>	<u>High End of Range</u>	<u>Company Carried</u>
Loss Reserves	\$112,485	\$202,957	\$218,821	\$212,549
Loss Adjustment Expense Reserves	6,256	37,822	41,216	40,035
Total Loss and Loss Adjustment Expense Reserves	\$228,740	\$240,779	\$260,037	\$252,584

Gross of Reinsurance

<u>Reserve Category</u>	<u>Low End of Range</u>	<u>PwC Selection</u>	<u>High End of Range</u>	<u>Company Carried</u>
Loss Reserves	\$197,107	\$219,296	\$253,944	\$228,888
Loss Adjustment Expense Reserves	38,383	42,359	49,451	44,572
Total Loss and Loss Adjustment Expense Reserves	\$235,490	\$261,655	\$303,395	\$273,460

The following table summarizes the reserve ranges as developed by PwC, the selected point estimate reserve, and the carried loss and loss adjustment expense reserves as of December 31, 2010, (all amounts in thousands of dollars) for the Arbella Insurance Group.

Arbella Mutual Insurance Company

Net of Reinsurance

<u>Reserve Category</u>	<u>Low End of Range</u>	<u>PwC Selection</u>	<u>High End of Range</u>	<u>Compan y Carried</u>
Loss Reserves	\$279,434	\$294,141	\$317,667	\$308,042
Loss Adjustment Expense Reserves	52,074	54,815	59,199	58,022
Total Loss and Loss Adjustment Expense Reserves	\$331,508	\$348,956	\$376,866	\$366,064

Gross of Reinsurance

<u>Reserve Category</u>	<u>Low End of Range</u>	<u>PwC Selection</u>	<u>High End of Range</u>	<u>Compan y Carried</u>
Loss Reserves	\$331,722	\$317,622	\$368,034	\$331,722
Loss Adjustment Expense Reserves	64,597	61,390	71,668	64,597
Total Loss and Loss Adjustment Expense Reserves	\$396,319	\$379,211	\$439,702	\$396,319

CONCLUSION

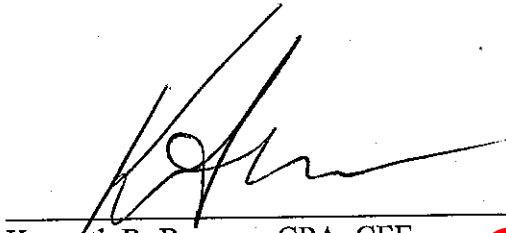
The undersigned gratefully acknowledges the participation of the following member of the Commonwealth of Massachusetts, Division of Insurance in this examination:

Linh La, CFE

Insurance Examiner II

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

Respectfully submitted,



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