



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

DIVISION OF INSURANCE

REPORT OF EXAMINATION

OF THE

ARBELLA PROTECTION INSURANCE COMPANY

100 CROWN COLONY DRIVE

QUINCY, MASSACHUSETTS 02269-9103

AS OF

DECEMBER 31, 2010

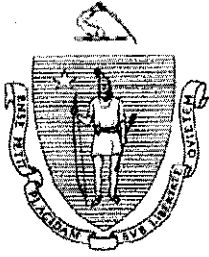
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COMMONWEALTH OF MASSACHUSETTS
Office of Consumer Affairs and Business Regulation
DIVISION OF INSURANCE

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JOSEPH C. MURPHY
COMMISSIONER OF INSURANCE

November 18, 2011

The Honorable Joseph Torti III
Chairman, NAIC Financial Condition (E) Committee
Superintendent
State of Rhode Island
Department of Business Regulation
Division of Insurance
1511 Pontiac Avenue, Building 69-2
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The Honorable Thomas B. Leonardi
Secretary, NAIC Northeastern Zone
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The Honorable Joseph G. Murphy
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Office of Consumer Affairs and
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Commonwealth of Massachusetts
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Honorable Superintendent and Commissioner:

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 PROTECTION INSURANCE COMPANY

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

SCOPE OF EXAMINATION

Arbella Protection Insurance Company (hereinafter referred to as the "Company" or "Protection") was last examined as of December 31, 2005, under the Association Plan of the National Association of Insurance Commissioners ("NAIC") by the Massachusetts Division of Insurance ("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, 2006, through December 31, 2010, including any material transactions and/or events subsequent to the examination date as noted during the course of this examination.

This examination was conducted at the same time and in conjunction with the Division's statutory financial condition examination of the Company's affiliates Arbella Mutual Insurance Company ("Mutual"), Arbella Indemnity Insurance Company ("Indemnity"), 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 actuarial review of the Company's actuarially determined amounts.

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, 2010, and the year 2010 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 (2006 through 2010). The E&Y workpapers for the year 2010 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 PwC, and expedite the overall examination process.

Information Technology 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.

This Report of Examination is written on an exception basis. Explanations for 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

Arbella Protection Insurance Company is a multi-line property and casualty insurer domiciled in the Commonwealth of Massachusetts. The Company offers a full range of commercial line products in Massachusetts, Rhode Island, Connecticut and New Hampshire through independent agents. The Company is a wholly owned subsidiary of Arbella, Inc., which is a subsidiary of Arbella Mutual Insurance Company, a property and casualty insurance company domiciled in the Commonwealth of Massachusetts. The Company has a wholly owned subsidiary, Arbella Specialty Insurance Brokerage, Inc. ("Specialty"), which is an excess and surplus lines broker for the placement of business not written on a primary basis by the Company. The Company commenced insurance operations in January 1993.

The Company is part of a group ("Group") of insurers that participate in an intercompany pooling agreement that includes the Company, Mutual, Indemnity, Covenant, and Commonwealth Re. Through a reinsurance and management contract, Commonwealth Re maintains significant control over Commonwealth Mutual which cedes 100% of its direct businesses to Commonwealth Re. These insurance companies are domiciled in the Commonwealth of Massachusetts except for Covenant which is domiciled in the State of Connecticut. The Group operates solely in the New England region and collectively writes private passenger auto, homeowners, commercial auto, commercial multi-peril, umbrella, and workers' compensation products primarily through independent agents.

Arbella Protection Insurance Company

Beginning in 2002, the Company, along with Mutual, 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 Mutual. 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:

| | <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% |
| <u>Total</u> | <u>100%</u> | <u>100%</u> | <u>100%</u> |

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

Capital Stock

The ownership of the Company resides with its stockholder, Arbella, Inc., a downstream holding company that is 99.0% owned by Mutual, which controls the Company through the election of the Board of Directors. The Company has 97,500 shares authorized of \$28.00 par value common stock and 92,674 issued and outstanding. The stock is 100% owned by Arbella, Inc.

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 | \$254,029,398 | \$122,567,067 | \$95,901,963 |
| 2009 | 252,841,668 | 128,977,821 | 92,289,521 |
| 2008 | 255,470,326 | 148,405,774 | 97,120,589 |
| 2007 | 232,753,936 | 99,484,113 | 95,409,388 |
| 2006 | 239,913,194 | 115,466,349 | 96,356,376 |

MANAGEMENT

Annual Meeting of Stockholder

In accordance with the by-laws, the Annual Meeting of the Stockholder is to be held on the third Tuesday in June of each year at the home office of the Company or at such location as determined by the Board of Directors. The holders of a majority interest of all stock issued, outstanding and entitled to vote at a meeting shall constitute a quorum, present either in person or by proxy. If two or more classes of stock are outstanding and entitled to vote as separate classes, then in the case of each such class, a quorum shall consist of the holders of a majority interest if the stock of that class issued, outstanding and entitled to vote. Additionally, the by-laws allow the stockholder to take action by written consent. The minutes indicate that a quorum was obtained at each annual meeting of the stockholder held during the examination period.

Board of Directors

The by-laws of the Company provide that the business and affairs of the Company shall be managed by the Board of Directors except as otherwise provided by the law, Articles of Organization, or the by-laws. The Board of Directors shall consist of not fewer than five members and shall hold office until the next annual meeting of stockholders and until his or her successors shall have been elected and qualified.

At December 31, 2010, the Board of Directors was comprised of five members, 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 L. Bailey | None |
| Francis X. Bellotti | Legal consultant for Company |
| John R. Corcoran | COO of Arbella Insurance Group |
| John F. Donohue | CEO of Arbella Insurance Group |
| Christopher E. Hall | CFO of Arbella Insurance Group |

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 four 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 elect such other committees as may be required from time to time. The Board of Directors of Arbella, Inc. elects committees each year and the Board of Directors votes each year to direct and authorize the committees of Arbella, Inc. to act as advisory committees to the Boards of Directors of the subsidiary companies of Arbella, Inc. As of the date of this examination, Arbella, Inc. 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, Treasurer, the Clerk, the Secretary, 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 their first meeting following the annual meeting of stockholders or special meeting in lieu thereof. Each officer shall hold office until the first meeting of the Board of Directors following the next annual meeting or special meeting in lieu thereof and until his successor is elected or appointed and qualified. 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 |
| Christopher E. Hall | Senior Vice President, Chief Financial Officer, Treasurer |
| Gail Eagan | Vice President and General Counsel |
| Eileen S. Currie | 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 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. All activity related to the company's funds, including all investments was examined for proper approval.

Arbella Protection Insurance Company

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.

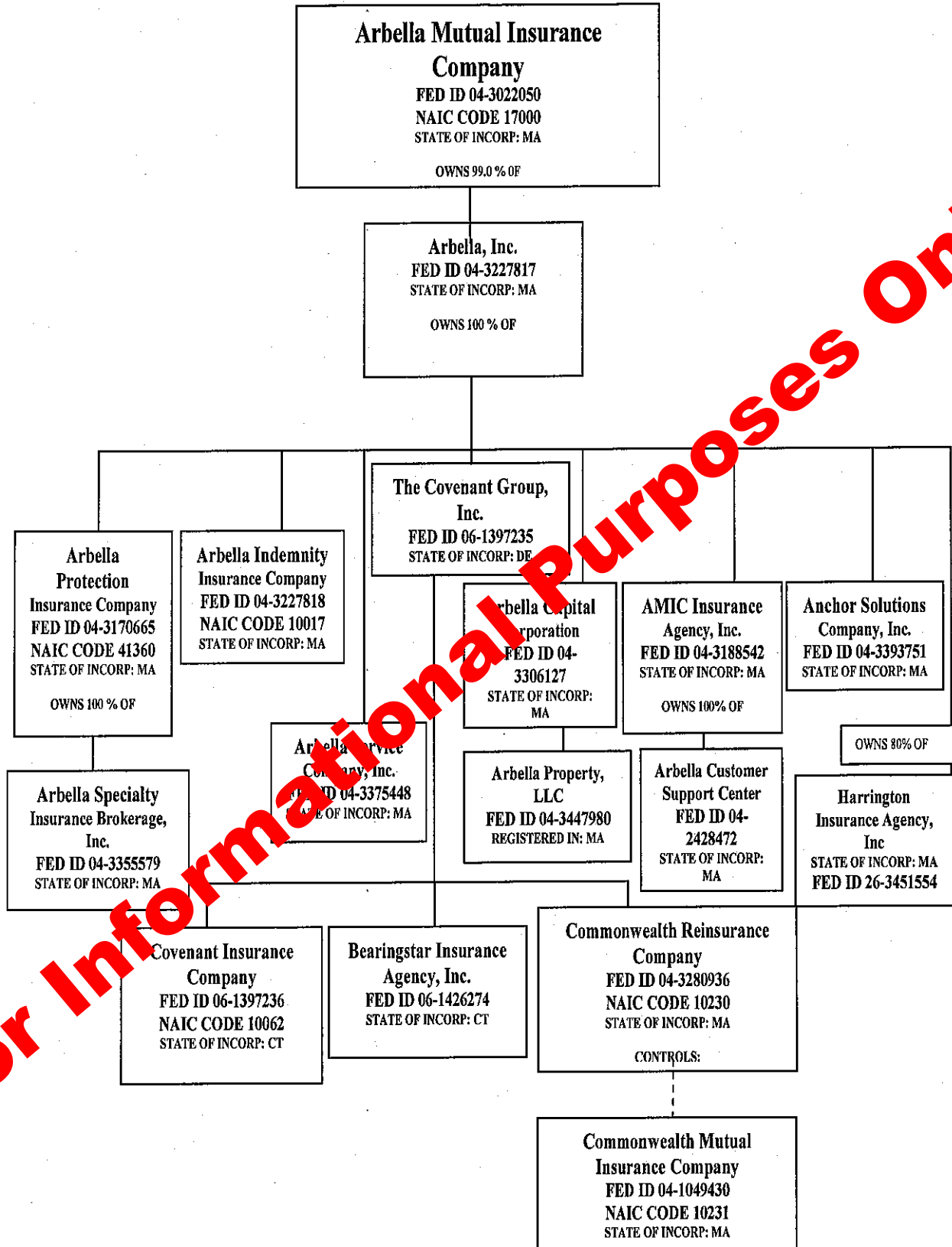
AFFILIATED COMPANIES

The Company's insurance affiliates include the following Massachusetts domiciled property and casualty insurance companies: Mutual, 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.

Arbella Protection 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:

- In December 2006, Mutual 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 Group 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.
- 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 January 1, 2008, the intercompany pooling agreement was amended to align the pooling percentages of Mutual and the Company in accordance to their proportionate share of the Group's unattached statutory surplus as required by the company's pooling agreement.
- Effective January 1, 2008, Mutual entered into a quota share reinsurance contract with Brit Insurance Limited ("Brit Re"). Under the terms of the agreement, the Group 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 Group reduced its participation to 25%.
- 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 31, 2008, the Company paid an ordinary dividend of \$2,600,000 to its stockholder, Arbella, Inc.
- 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 Group 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

Arbella Protection Insurance Company

of the other members in accordance with the requirements of the pooling agreement.

- In October of 2010, Mutual entered into a settlement with the Massachusetts Attorney General's Office on the allegations that insurance companies used inflated and un-depreciated motorcycle values to calculate the premiums that they charged to their motorcycle insurance customers. The Group agreed to return premium payments to qualifying policyholders and pay interest and penalties to the AG Office.
- On December 31, 2010, the Company paid an ordinary dividend of \$1,500,000 to its stockholder, Arbella, Inc.

INTERCOMPANY AGREEMENTS

Management Agreement

Effective January 1, 1998, the Company and its affiliates ("Participants") have been participants in a Services Agreement pursuant to which an affiliate, Arbella Service Company, 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, an affiliate, Arbella Capital Corporation, provides all members of the Group with property and related property management services.

Tax Sharing Agreement

The Company files a consolidated tax return with Mutual and its subsidiaries. Effective January 1, 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 Mutual for the payment of such tax liability. The Agreement provides that all subsidiaries of Mutual 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 were 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 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, 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 has no employees, however, it does share the cost of a qualified defined contribution retirement plan sponsored by Mutual 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 Mutual under an expense sharing arrangement. Effective December 31, 2009, Mutual froze the plan at which point all participants became 100% vested and future contributions would no longer be made.

The Company also shares the cost of a qualified 401(k) savings plan sponsored by Mutual 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 Internal Revenue Service ("IRS") annual limitations. Mutual retains the right to change, modify, or terminate the plan at any time. The cost of this plan is allocated to various companies under Mutual under an expense sharing arrangement.

Effective with the aforementioned freezing of the retirement plan, Mutual 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 ten-year expiration period. Stock options are granted at exercise prices not less than the fair value of 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 reserved for issuance under these plans as of December 31, 2010.

STATUTORY DEPOSITS

The statutory deposits of the Company as of December 31, 2010, were as follows:

| <u>Location</u> | <u>Description of Deposit</u> | <u>Par Value</u> | <u>Statement Value</u> | <u>Market Value</u> |
|-----------------|--|------------------|------------------------|---------------------|
| Connecticut | U.S., Treasury Note 7.25% due 5/15/2016 | \$ 50,000 | \$ 55,986 | \$ 63,070 |
| Massachusetts | U.S., Treasury Note 6.75% due 8/15/2026 | 500,000 | 603,235 | 664,160 |
| New Hampshire | U.S., Treasury Note 7.25% due 5/15/2016 | 1,135,000 | 1,270,878 | 1,700 |
| New York | U.S., Treasury Note 7.25% due 5/15/2016 | 50,000 | 55,986 | 63,070 |
| Rhode Island | U.S., Treasury Note 7.25% due 5/15/2016 | 500,000 | 559,878 | 630,706 |

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operation

As of December 31, 2010, the Company is licensed in the Commonwealth of Massachusetts, the states of Connecticut, New York, Rhode Island, and Vermont, and the Commonwealth of Pennsylvania. The Company maintains a restricted license in the state of New Hampshire. The Company transacts business only in the Commonwealth of Massachusetts and the states of Connecticut, New Hampshire, and Rhode Island. The Company is duly organized under the laws of the Commonwealth of Massachusetts and is authorized to write all personal and commercial lines except life and reinsurance under section 47 of Chapter 175 of the Massachusetts General Laws.

Rating and Statistical Reporting

The significant rating and statistical organizations to which the Company subscribes include the Workers' Compensation Rating and Inspection Bureau of Massachusetts, the Insurance Service Office, the National Council on Compensation Insurance, and Commonwealth Automobile Reinsurers.

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 homeowner 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: \$5,000,000 xs \$25,000,000; 2nd layer: \$85,000,000 xs \$50,000,000; 3rd layer: \$165,000,000 xs \$135,000,000; 4th layer: \$100,000,000 xs \$300,000,000.

Assumed Reinsurance

The Company assumes business is through its participation in certain other involuntary pools and associations. The Company assumes business from the National Council on Compensation Insurance (NCCI) worker's compensation residual market pool.

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 Mutual and the Company, and effective January 1, 2010, the agreement was amended to include Covenant and to modify the existing pooling percentages.

SUBSEQUENT EVENT

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

- Effective January 1, 2011, Mutual did not renew its quota share reinsurance contract with Brit Re. The Group remains liable for its share of losses related to the prior years in which it participated.

There were no other details noted as "subsequent events" the disclosure of which in this Examination Report were 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 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, 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.

For Informational Purposes Only

Arbella Protection Insurance Company

Arbella Protection 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 | \$ 194,600,020 | \$ - | \$ 194,600,020 | |
| Common stocks | 56,487 | | 56,487 | |
| Cash and short-term investments | (1,130,246) | | (1,130,246) | |
| Other invested assets | 564,700 | | 564,700 | |
| Cash and invested assets | 194,090,962 | - | 194,090,962 | |
| Investment income due and accrued | 2,293,268 | | 2,293,268 | |
| Premiums and considerations: | | | | |
| Uncollected premiums and agents' balances in course of collection | 1,021,723 | | 1,021,723 | |
| Deferred premiums, agents' balances and installments booked but deferred | 32,705,986 | | 32,705,986 | |
| Reinsurance: | | | | |
| Amounts recoverable from reinsures | 3,658,655 | | 3,658,655 | |
| Net deferred tax asset | 5,967,838 | | 5,967,838 | |
| Aggregate write-ins for other than invested assets | 14,290,966 | | 14,290,966 | |
| Total assets | \$ 254,029,398 | \$ - | \$ 254,029,398 | |
| <u>Liabilities</u> | | | | |
| Losses | \$ 61,608,493 | \$ - | \$ 61,608,493 | 1 |
| Loss adjustment expenses | 11,604,400 | | 11,604,400 | 1 |
| Commissions payable, contingent commissions and other similar charges | 4,114,184 | | 4,114,184 | |
| Taxes, licenses and fees | 104,876 | | 104,876 | |
| Current federal and foreign income taxes | 1,480,962 | | 1,480,962 | |
| Unearned premiums | 65,451,845 | | 65,451,845 | |
| Advance premium | 2,192,640 | | 2,192,640 | |
| Ceded reinsurance premiums payable | 1,685,514 | | 1,685,514 | |
| Payable to parent, subsidiaries and affiliates | 9,849,003 | | 9,849,003 | |
| Aggregate write-ins for other liabilities | 35,516 | | 35,516 | |
| Total liabilities | 158,127,435 | - | 158,127,435 | |
| Common capital stock | 2,594,872 | | 2,594,872 | |
| Gross paid in and contributed surplus | 55,863,191 | | 55,863,191 | |
| Unassigned funds (surplus) | 37,443,899 | | 37,443,899 | |
| Surplus as regards policyholders | 95,901,963 | - | 95,901,963 | |
| Total liabilities, surplus and other funds | \$ 254,029,398 | \$ - | \$ 254,029,398 | |

Arbella Protection Insurance Company

Arbella Protection 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 | \$ 120,973,307 | \$ - | \$ 120,973,307 | |
| Deductions: | | | | |
| Losses incurred | 71,370,148 | | 71,370,148 | |
| Loss adjustment expenses incurred | 10,356,701 | | 10,356,701 | |
| Other underwriting expenses incurred | 41,837,024 | | 41,837,024 | |
| Total underwriting deductions | 123,563,873 | - | 123,563,873 | |
| Net underwriting gain (loss) | (2,590,566) | - | (2,590,566) | |
| <u>Investment income</u> | | | | |
| Net investment income earned | 7,317,469 | | 7,317,469 | |
| Net realized capital gains (losses) less capital gains tax | 51,714 | | 451,714 | |
| Net investment gain (loss) | 7,69,183 | - | 7,769,183 | |
| <u>Other income</u> | | | | |
| Net gain (loss) from agents' or premium balances charged off | (596,278) | | (596,278) | |
| Finance and service charges | 2,644,502 | | 2,644,502 | |
| Aggregate write-ins for miscellaneous income | (764,498) | | (764,498) | |
| Total other income | 1,283,726 | - | 1,283,726 | |
| Net income before dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes | 6,462,341 | - | 6,462,341 | |
| Dividends to policyholders | - | | - | |
| Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes | 6,462,341 | - | 6,462,341 | |
| Federal and foreign income taxes incurred | 1,116,365 | | 1,116,365 | |
| Net income | \$ 5,345,975 | \$ - | \$ 5,345,975 | |

Arbella Protection Insurance Company

Arbella Protection 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 | \$ 92,289,523 | | \$ 92,289,523 | |
| Net income | 5,345,975 | | 5,345,975 | |
| Change in net unrealized capital gains or (losses) less capital gains tax | 7,614 | | 7,614 | |
| Change in net unrealized foreign exchange capital gain (loss) | | | | |
| Change in net deferred income tax | (289,774) | | (289,774) | |
| Change in nonadmitted assets | 48,626 | | 48,626 | |
| Dividend to stockholders | (1,500,000) | | (1,500,000) | |
| Change in surplus as regards policyholders for the year | 3,612,440 | | 3,612,440 | |
| Surplus as regards policyholders, December 31 current year | \$ 95,901,963 | \$ - | \$ 95,901,963 | |

Arbella Protection Insurance Company

Arbella Protection 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 | \$ 92,289,523 | \$ 97,120,589 | \$ 95,409,389 | \$ 96,356,377 | \$ 85,225,883 |
| Net income | 5,345,975 | 4,785,648 | 2,969,329 | 10,644,372 | 10,969,880 |
| Change in net unrealized capital gains (losses) less capital gains tax | 7,614 | (67,909) | 187,030 | 1,458 | (12,446) |
| Change in net unrealized foreign exchange capital gain (loss) | - | (114,309) | 1,628,858 | (795,833) | 260,000 |
| Change in net deferred income tax | (289,774) | 277,503 | (474,017) | 172,115 | (87,190) |
| Change in nonadmitted assets | 48,626 | - | - | - | - |
| Dividend to stockholders | (1,500,000) | (9,712,000) | (2,600,000) | (10,969,000) | - |
| Change in surplus as regards policyholders for the year | 3,612,440 | (4,831,066) | 1,621,200 | (946,988) | 11,130,494 |
| Surplus as regards policyholders, December 31 current year | <u>\$ 95,901,963</u> | <u>\$ 92,289,523</u> | <u>\$ 97,120,589</u> | <u>\$ 95,409,389</u> | <u>\$ 96,356,377</u> |

* 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 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 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 | \$55,792 | \$58,828 | \$63,426 | \$61,608 |
| Loss Adjustment Expense Reserves | 10,509 | 10,963 | 11,947 | 11,605 |
| Total Loss and Loss Adjustment Expense Reserves | \$66,302 | \$69,791 | \$75,373 | \$73,213 |

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 | \$57,132 | \$63,564 | \$73,606 | \$66,344 |
| Loss Adjustment Expense Reserves | 11,126 | 12,278 | 13,335 | 12,920 |
| Total Loss and Loss Adjustment Expense Reserves | \$68,258 | \$75,842 | \$87,941 | \$79,264 |

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 Protection 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>Company 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>Company Carried</u> |
|--|-----------------------------|--------------------------|------------------------------|----------------------------|
| Loss Reserves | \$331,722 | \$317,821 | \$368,041 | \$331,722 |
| Loss Adjustment Expense Reserves | 64,597 | 61,390 | 71,368 | 64,597 |
| Total Loss and Loss Adjustment Expense Reserves | \$396,319 | \$379,211 | \$439,409 | \$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