



COMMONWEALTH OF MASSACHUSETTS

Office of Consumer Affairs and Business Regulation

DIVISION OF INSURANCE

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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:

COMMONWEALTH 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

Commonwealth Mutual Insurance Company (hereinafter referred to as “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 Mutual Insurance Company (“AMIC”), Arbella Protection Insurance Company (“APIC”), Arbella Indemnity Insurance Company (“AIIC”), Commonwealth Reinsurance Company (“CRC”) (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.

HISTORY

General

The Company was the former Attleboro Mutual Insurance Company (“Attleboro”) that discontinued operations in 1992. Effective in 1995, Attleboro amended its articles of incorporation and license and changed its name to Commonwealth Mutual Insurance Company. The Company was subsequently re-capitalized with \$5,500,000 in cash from surplus notes it issued to its affiliate Commonwealth Reinsurance Company (CRC). This transaction was approved by the Division.

The Company is licensed to write private passenger automobile and homeowners policies in Massachusetts, but currently writes only homeowner’s business exclusively through its independent agency relationship with Eastern Insurance Agency. The Company assumes premium, loss and expense from its mandatory participation in both the Massachusetts Fair Plan (“Fair Plan”) and Commonwealth Automobile Reinsurers (“CAR”). The Company is controlled by its affiliate CRC through a 100% quota share reinsurance agreement. Under the terms of this agreement, 100% of the Company’s net premium is ceded to the CRC, including activity the Company assumes from both CAR and the Fair Plan. Company retains no net underwriting risk.

The Company has not made any material changes to its articles of incorporation or its by-laws during the period covered by this examination except as discussed above. Additionally, there have not been any name changes, mergers, or any other material changes to its corporate structure during the examination period.

Surplus Note

In connection with its recapitalization, on August 1, 1995, the Company issued a surplus note to CRC in the amount of \$5,500,000 with a maturity date of August 1, 2008. The surplus note pays interest at three hundred basis points over three year treasury notes; the rate is adjusted semi-annually. Principal and interest is payable December 1 and June 1 and subject to prior approval of the Commissioner of Insurance of the Commonwealth of Massachusetts.

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.

<u>Year</u>	<u>Admitted Assets</u>	<u>Net Written Premiums</u>	<u>Capital & Surplus</u>
2005	\$ 7,981,249	\$ 0	\$ 5,699,215 *
2004	8,317,862	0	5,500,000
2003	6,496,910	0	5,500,000
2002	7,412,424	0	5,500,000
2001	9,287,746	0	5,500,000

* Does not reflect examination adjustment (See Note 1).

MANAGEMENT

Annual Meeting of Members

In accordance with the by-laws, the Annual Meeting of the Company is to be held at the home office on the fourth Tuesday of February at 2:00pm. Three members represented in person or by proxy constitute a quorum. The minutes indicate that a quorum was obtained at the 2005 annual meeting.

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 Articles of Incorporation. The Board of Directors may elect an Executive Committee and such other committees as it may determine, comprised of such number of its members as it may from time to time determine (but in any event not less than two), and delegate to such committee or committees all of its powers except those which by law, the Articles of Organization or these by-laws it is prohibited from delegating.

At December 31, 2005, the Board of Directors was comprised of eight directors, which is in compliance with the Company by-laws. Directors duly elected and serving at December 31, 2005, with business affiliations, follows:

<u>Director</u>	<u>Business affiliation</u>	<u>Residence</u>
Patricia P. Bailey	Consultant	Santa Fe, New Mexico
Francis X. Bellotti	Arbella Insurance Group	Quincy, Massachusetts
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
Andrea Gargiulo	Retired	Boston, Massachusetts
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 four times per year during the examination period. At any meeting of the Board of Directors a majority of the directors constitutes 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 Board of Directors may, by a majority vote elect an Executive Committee and such other committees as may be required from time to time. The Board of Directors of Arbella, Inc. elect committees each year and the Board of Directors votes each year to direct and authorize the Committees of Inc. to act as advisory committees to the Boards of Directors of the subsidiary companies. As of the date of this examination 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 Secretary and such 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. Each officer shall hold office until the first meeting of the Board of Directors following the next annual meeting of the Company and until his or her successor is elected or appointed and qualified. 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
Gail Eagan (1)	Vice President and General Counsel
Beyerly T. Kenneally	Secretary and Clerk

(1) elected November, 2005

The by-laws provide that the President shall be the Chief Executive Officer of the Company and shall preside at all meetings of the Board of Directors should the Chairman of the Board of Directors be absent.

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 significant 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.

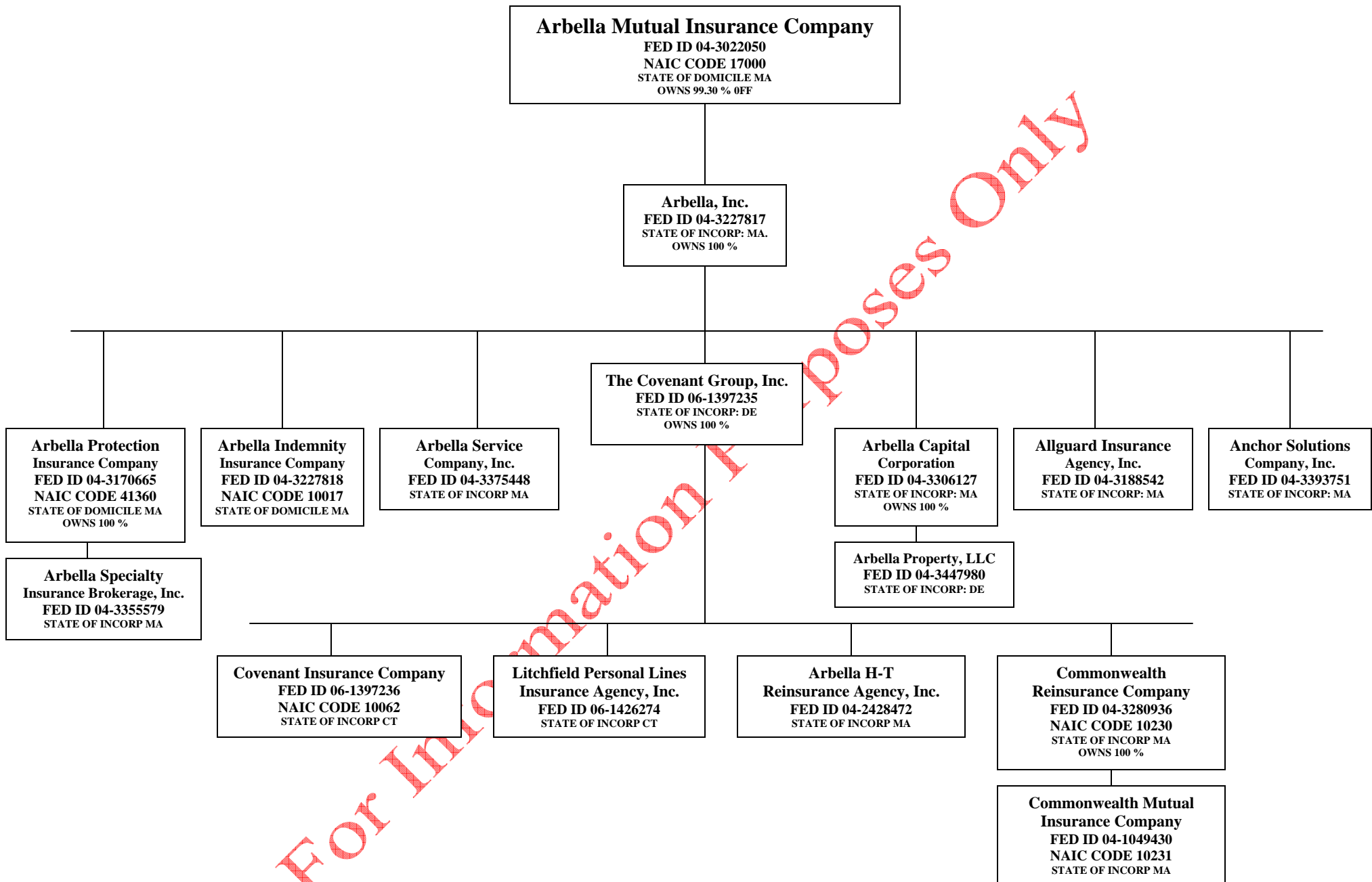
The Company has a disaster recovery plan and business continuity plan however, its by-laws do not contain explicit provisions for the continuity in the event of a national emergency; hence, under such circumstances, the succession of officers will be as prescribed in Sections 180M through 180Q of MGL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

AFFILIATED COMPANIES

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

Organization Chart

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



Acquisitions, Affiliations and Other Transactions

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

- The Company recorded a cumulative effect of adoption of Codification which resulted in no adjustment to unassigned surplus as of January 1, 2001.
- CAR's rules of operation require that only one member company of each insurance group can be appointed as a CAR servicing carrier for private passenger auto risks. Consistent with these rules, AMIC replaced the Company as the servicing carrier for the Group in early 2001. Massachusetts private passenger auto policies previously written by the Company were transferred to AMIC upon renewal.
- Effective April 2, 2002, the Group received a rating of B++ from A.M. Best. Previously, the Group's A.M. Best rating was A-.

INTERCOMPANY AGREEMENTS

Management Agreement

Effective July 1, 2000, the Company entered into a management agreement with Arbella Service Company ("Service"), a wholly owned subsidiary of Arbella, Inc. 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.

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 has no employees, however, it does participate in 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 has no employees, however, it does participate in 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 has no employees, however, it does participate in 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.

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.

Rating and Statistical Reporting

The significant rating and statistical organizations to which the Company subscribes include Commonwealth Automobile Reinsurers.

SUBSEQUENT EVENTS

There were no details noted as “subsequent events”, the disclosure of which in this Examination Report were considered appropriate.

REINSURANCE

The Company and its 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. 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 is for homeowners property damage business 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 damage business in 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 is for casualty damage business 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 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.

Additionally, pursuant to the 100% quota share agreement with CRC, the Company cedes 100% of its net risks to CRC.

Assumed Reinsurance

The Company assumes premiums, losses and expenses from its mandatory participation in the Fair Plan. Additionally, through 2005 the Company continued to assume premiums, losses and expenses from CAR generated by its former status as a CAR servicing carrier, these amounts are immaterial. All business assumed by the Company is 100% ceded to CRC under the Quota Share treaty.

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 review by the Division as part of our 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.

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

	Per Annual <u>Statement</u>	Examination <u>Adjustments</u>	Per <u>Examination</u>	<u>Note</u>
<u>Assets</u>				
Bonds	\$ 7,771,987	\$ -	\$ 7,771,987	
Cash	(293,866)		(293,866)	
Short-term investments	1,369,168		1,369,168	
Investment income due and accrued	71,839		71,839	
Total assets	<u>\$ 8,919,128</u>	<u>\$ -</u>	<u>\$ 8,919,128</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Current federal income taxes	\$ 107,000	\$ (107,000)	\$ -	1
Payable to parent, subsidiaries and affiliates	380,253		380,253	
Other liabilities	2,732,660		2,732,660	
Total liabilities	<u>3,219,913</u>	<u>(107,000)</u>	<u>3,112,913</u>	
Surplus notes	5,500,000		5,500,000	
Unassigned funds	199,215	107,000	306,215	1
Surplus as regards policyholders	<u>5,699,215</u>	<u>107,000</u>	<u>5,806,215</u>	
Total liabilities, surplus and other funds	<u>\$ 8,919,128</u>	<u>\$ -</u>	<u>\$ 8,919,128</u>	

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

	Per Annual <u>Statement</u>	Examination <u>Adjustments</u>	Per <u>Examination</u>	<u>Note</u>
Net investment income earned	\$ 306,215		\$ 306,215	
Net income before taxes	306,215	-	306,215	
Federal income taxes incurred	107,000	(107,000)	-	1
Net income	<u>\$ 199,215</u>	<u>\$ 107,000</u>	<u>\$ 306,215</u>	

For Information Purposes Only

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

	Per Annual <u>Statement</u>	Examination <u>Adjustments</u>	Per <u>Examination</u>	<u>Note</u>
Surplus as regards policyholders, December 31, 2004	\$ 5,500,000	\$ -	\$ 5,500,000	
Net income	199,215	107,000	306,215	1
Change in surplus as regards policyholders for the year	199,215	107,000	306,215	
Surplus as regards policyholders, December 31, 2005	<u>\$ 5,699,215</u>	<u>\$ 107,000</u>	<u>\$ 5,806,215</u>	

For Information Purposes Only

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

	<u>2005 *</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
Surplus as regards policyholders, December 31, prior year	\$ 5,500,000	\$ 5,500,000	\$ 5,500,000	\$ 5,500,000	\$ 5,500,000
Net income	306,215	-	-	-	-
Change in surplus as regards policyholders for the year	306,215	-	-	-	-
Surplus as regards policyholders, December 31, current year	<u>\$ 5,806,215</u>	<u>\$ 5,500,000</u>	<u>\$ 5,500,000</u>	<u>\$ 5,500,000</u>	<u>\$ 5,500,000</u>

* As per Examination

NOTES TO FINANCIAL STATEMENT

NOTE 1:

The Company's Annual Statement, as filed, reflected an overaccrual of the Federal income taxes payable liability in the amount of \$107,000. This overaccrual has been adjusted in the E&Y audited financial statements and in this Report of Examination.

NOTE 2:

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 thousands of dollars).

<u>Reserve Category</u>	<u>Low End of Range</u>	<u>KPMG Selection</u>	<u>High End of Range</u>	<u>Company Carried</u>
Net Loss Reserves	\$ 289,815	\$ 314,728	\$ 347,148	\$ 337,656
Net Defense & Cost Containment Expense Reserves	52,249	53,817	56,035	32,691
Net Adjusting & Other Expense Reserves	<u>13,276</u>	<u>14,415</u>	<u>15,214</u>	<u>15,579</u>
Total Net Loss and Loss Adjustment Expense Reserves	<u>\$ 355,340</u>	<u>\$ 382,960</u>	<u>\$ 418,398</u>	<u>\$ 385,925</u>

<u>Reserve Category</u>	<u>Low End of Range</u>	<u>KPMG Selection</u>	<u>High End of Range</u>	<u>Company Carried</u>
Gross Loss Reserves	\$ 344,202	\$ 375,866	\$ 414,922	\$ 405,671
Gross Defense & Cost Containment Expense Reserves	67,461	69,837	73,103	42,387
Gross Adjusting & Other Expense Reserves	<u>13,276</u>	<u>14,415</u>	<u>15,214</u>	<u>16,575</u>
Total Gross Loss and Loss Adjustment Expense Reserves	<u>\$ 424,940</u>	<u>\$ 460,118</u>	<u>\$ 503,239</u>	<u>\$ 464,632</u>

CONCLUSION

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

Yvette P. Nelson-Smith
Steven C. Tsimsos

Insurance Examiner II
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