

Statutory Financial Examination of
ARECA INSURANCE EXCHANGE

FE 09-03

as of December 31, 2008

Issued by
STATE OF ALASKA
DEPARTMENT OF COMMERCE, COMMUNITY, AND
ECONOMIC DEVELOPMENT
DIVISION OF INSURANCE

NAIC Company Code: 16926
NAIC Group Code: 000

FINAL REPORT:
June 25, 2010

1
2 CERTIFIED MAIL
3 RETURN RECEIPT REQUESTED

4
5 STATE OF ALASKA
6 DEPARTMENT OF COMMERCE, COMMUNITY AND
7 ECONOMIC DEVELOPMENT
8 DIVISION OF INSURANCE
9 550 WEST 7TH AVENUE, SUITE 1560
10 ANCHORAGE, AK 99501-3567

11 Order FE 09-03)
12 In the Matter of Examination of)
13 ARECA Insurance Exchange)
14 _____)

15 FINDINGS OF FACT

16 1. A report of examination of ARECA Insurance Exchange, domiciled in the
17 State of Alaska, has been issued by the State of Alaska, Division of Insurance, to ARECA
18 Insurance Exchange.

19 2. The Report of Examination of ARECA Insurance Exchange (FE 09-03) has
20 been transmitted to Meera Kohler, Chairperson, ARECA Insurance Exchange
21 (Examinee), and Examinee has been accorded at least 30 days opportunity to review and
22 comment on this Report of Examination. A response from the examinee was received on
23 *June 24, 2010*.

24 3. The Director of the Division of Insurance has fully considered and reviewed
25 the report, the examinee response and any relevant portions of the examiner's work
26 papers to the extent she considered necessary.

CONCLUSIONS OF LAW

1. The written Report of Examination referred to in Finding of Fact No. 1 was
issued in accordance with Alaska Statute (AS) 21.06.150(b).

2. The actions set forth in finding of Fact No. 2 were conducted in accordance
with AS 21.06.150(b).

3. The Director of the Division of Insurance has reviewed the Report of
Examination, the examinee response and any other relevant work papers as set forth in
Finding of Fact No. 3 to the extent she considered necessary in accordance with
AS 21.06.150(b).

STATE OF ALASKA
DEPARTMENT OF COMMERCE, COMMUNITY, AND ECONOMIC DEVELOPMENT
DIVISION OF INSURANCE
550 WEST SEVENTH AVENUE, SUITE 1560
ANCHORAGE, ALASKA 99501-3567
PHONE: (907) 269-7900
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ORDER

IT IS ORDERED

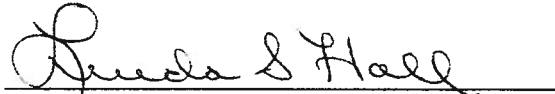
1. Pursuant to AS 21.06.150(b)(1), the Report of Examination of ARECA Insurance Exchange (FE 09-03) is approved as filed.

2. Pursuant to AS 21.06.060, the Report of Examination shall be kept in the Office of the Director of the Division of Insurance and be open to public inspection.

3. The Examinee will implement all recommendations within a reasonable amount of time but no later than one year from the issue date of this examination report, unless otherwise recommended in the Report of Examination. Failure to implement compliance recommendations may result in action against the Examinee for violation of this order.

This order is effective June 25, 2010.

Dated this 25th day of June, 2010 at Anchorage, Alaska.



Linda S. Hall, Director
State of Alaska
Division of Insurance

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STATE OF ALASKA
DEPARTMENT OF
COMMERCE
COMMUNITY AND
ECONOMIC DEVELOPMENT

Sean Parnell, Governor
Emil Notti, Commissioner
Linda S. Hall, Director

Alaska Division of Insurance

June 23, 2010

Ms. Linda S. Hall, Director
Division of Insurance
Department of Commerce, Community
and Economic Development
State of Alaska
550 West 7th Avenue, Suite 1560
Anchorage, AK 99501-3567

Dear Director Hall:

In accordance with your instructions and authorizations, and in accordance with statutory requirements, an examination has been made of the financial condition and business affairs of:

ARECA Insurance Exchange
703 West Tudor Road
Anchorage, Alaska 99503

(NAIC CoCode 16926; Group Code 000)

SCOPE OF EXAMINATION

The examination of ARECA Insurance Exchange covers a three year period from January 1, 2006 to December 31, 2008. The last financial examination of the Exchange was completed as of December 31, 2005. Transactions subsequent to this period were reviewed where deemed appropriate.

Procedures of the examination followed standards established by the NAIC Financial Condition Examiners Handbook and the rules, regulations and directives of the State of Alaska, Division of Insurance. The examination was planned and performed to evaluate the financial condition and identify prospective risks of the Exchange by obtaining information about the Exchange including corporate governance, identifying and assessing inherent risks within the company and evaluating system controls and procedures used to mitigate those risks.

All accounts and activities of the Exchange were considered in accordance with the risk-focused examination process. Key activities included: Investments, Premiums, Reinsurance, Claims and Actuarially Determined Liabilities, Affiliated Parties, Debt and Surplus, Taxes, Expenses, Management and Control. The workpapers of independent certified public accountants, KPMG LLP were reviewed and relied upon where appropriate.

An actuarial evaluation of the reserves as of December 31, 2008, was performed by Sarah K. McNair-Grove, ACAS, MAAA, Actuary for the Division of Insurance, State of Alaska, as a part of this examination.

SUMMARY OF EXAMINATION FINDINGS

Significant Findings

The Exchange was found to be out of compliance with reinsurance statutes. Issues noted by the examination included the following:

- permitting reinsurer General Reinsurance (Gen Re) the unilateral right to modify reinsurance agreements;
- using the services of a reinsurance broker without a written contract establishing the responsibilities of each party; and
- failing to file reinsurance contracts with the director as required by statute.

Paid-in surplus and unassigned surplus were incorrectly reported on the Annual Statement. Six recommendations of the prior Report of Examination as of December 31, 2005 are unremediated.

Subsequent Events

During the finalization of this examination report, an error in the 2008 financial statement came to the attention of the examiners. It was identified by ARECA's independent auditors during the audit of the 2009 financial statement. The error related to the appropriate treatment for tax purposes of the negative net income reported in 2008 amounting to \$487,000 in additional federal tax incurred. This error will be corrected in the 2009 financial statements.

Although the error is greater than the tolerable error set for this examination, it was determined to not be a material error to the financial statements taken as a whole based on the amount of surplus held by the reciprocal insurer, the typical user of the financial statements, and ARECA's breakeven approach to its operations. Therefore, correction of this error is not included in the financial statements in this examination report and restatement of the 2008 financial statement will not be required.

DESCRIPTION OF COMPANY

Company History

ARECA Insurance Exchange (the Exchange) is an Alaska-domiciled insurance reciprocal organized pursuant to Title 21, Chapter 75, of the Alaska Statutes. On December 30, 1983, the State of Alaska issued a Certificate of Authority to the Exchange authorizing them to transact the business of property, casualty, surety, boiler and machinery, marine and transportation.

The Exchange is an unincorporated reciprocal exchange for assessable policies that was formed to provide workers' compensation, property, boiler and machinery, general and automotive liability insurance to members of the Alaska Power Association (APA). As of December 31, 2008, the Exchange is licensed only in Alaska.

Pursuant to a management agreement dated December 16, 1983, the affairs of the Exchange are handled by their attorney-in-fact, ARECA Insurance Management, Inc. (AIM). A Service Contract between the Exchange and the APA dated June 3, 1994, requires that the attorney-in-fact receive reimbursement of proportionate employee costs from the Exchange. The employees for whom expenses are allocated to the Exchange are employees of APA.

Corporate Records

Bylaws and minutes of the Board of Directors/Trustees of AIM and of the Exchange were reviewed during this examination. All board meeting notices appear to have been given as required by the bylaws. All meetings had quorums. All actions of both AIM and the Exchange that required board approval were taken by resolution at meetings.

The Exchange's bylaws require that an annual and an organizational meeting be held each year in August or September. The annual meetings of the Exchange and of AIM were held as required by the bylaws for each year covered by this examination and attendance included a quorum. All elections were held in accordance with bylaws and statute.

The Exchange's bylaws were amended August 13, 2008. This amendment changed the date profit allocations are determined from March 15 to June 1. It shortened the time period from the date allocations are determined to the date funds are deposited into each subscribers' account from 120 days to 30 days.

Management and Control

The Exchange is an unincorporated association of subscribers that insure the other subscribers in the Exchange. Membership in the Exchange is effective following the execution and approval of a Subscriber's Agreement between the Exchange and each member. Each subscriber has a contingent assessment liability, as provided in the subscriber's agreement, for payment of actual losses and expenses incurred while the subscriber's policy was in force. Subscribers may be required to make contributions to surplus of the Exchange from time to time as required by the Trustees in order to maintain adequate levels of surplus. However, pursuant to the bylaws, no subscriber shall be assessed an aggregate liability in any one calendar year in excess of an amount equal to the direct premium for such policy during that year. Three new subscribers were added during the years covered by this examination.

The advisory committee (Board of Trustees) supervises the business of the Exchange. It is comprised of one person selected by the governing body of each member. The Board of Trustees elects the following officers: Chairperson of the Board of Trustees, Secretary, and any other officers as the business of the Exchange may require. Listed below are the officers elected by the Exchange as of December 31 of each year covered by this examination, as reported in the Exchange's minutes.

ARECA Insurance Exchange

NAME	TITLE	December 31		
		2006	2007	2008
Meera Kohler	Chairman	X	X	X
Bill Nordmark	Vice Chairman	X	X	X
Cliff Davidson	Treasurer	X	X	X
Marilyn Leland	Secretary	X	X	X

AIM serves as the Exchange's attorney-in-fact and is wholly-owned by the Exchange. AIM manages the daily operations of the reciprocal. Any subscriber credited with more than 20% of capital and surplus of the Exchange shall be entitled to designate one director to the Board of Directors of the attorney-in-fact.

Fidelity Bonds and Other Insurance

The Exchange has fidelity bonding issued by Fidelity and Deposit Company of Maryland and is limited to \$1,000,000 with a \$5,000 deductible for each type of coverage. Bonding covers all employees of the attorney-in-fact. Coverage is deemed adequate.

Directors and Officers are covered by a separate insurance policy issued by Chubb.

Employees' and Agents' Pensions, Stock Ownership, and Other Insurance

The Exchange does not have employees. Personnel costs incurred by the attorney-in-fact are allocated to the Exchange. Included in the cost allocation are the employee pension and retirement plans.

Territory and Plan of Operation

The Exchange is authorized to transact the following kinds of business: property, casualty, surety, disability, marine, and transportation policies. As of December 31, 2008 they were licensed only in Alaska. The Exchange does not maintain a written plan for the acquisition of business and does not employ an agency system.

Based on the lines of business for which the Exchange is licensed, and pursuant to the requirements of AS 21.75.050 and AS 21.09.070, the Exchange is required to maintain a minimum policyholders' surplus of \$4,125,000.

Growth of Company

Results of the Exchange's operation for the period of December 31, 2006 to December 31, 2008 are shown in the following exhibit. Figures presented below are from the Exchange's Annual Statements for the years 2006, 2007 and 2008.

Year	Admitted Assets	Liabilities	Surplus
2006	\$22,493,265	\$2,954,544	\$19,538,721
2007*	\$22,790,648	\$4,908,947	\$17,881,701
2008*	\$20,180,010	\$6,635,462	\$13,544,548
*as amended			

Loss Experience

The following schedule shows the loss experience of the Exchange during the period of examination:

Year	Premiums Earned	Losses Incurred	Ratio	Loss Expense Incurred	
2006	\$ 3,376,081	\$ 754,077	22.3%	\$ 276,439	8.2%
2007*	3,700,255	2,602,692	70.3%	476,376	12.9%
2008*	3,789,036	3,889,125	102.6%	851,352	22.5%
*as amended					

Reinsurance

The Exchange has reinsured its various risks with specific excess of loss per occurrence reinsurance agreements through broker placements and direct placement with a reinsurer.

As of December 31, 2008, the Exchange had a maximum retention per occurrence of \$500,000 on automobile liability, \$1,000,000 on general liability and worker's compensation. Boiler and machinery retention and coverage vary for each insured within the Exchange.

The Exchange is reinsured for auto liability over the Exchange's retention to the policy limit of \$1,000,000. General liability is insured over the Exchange's retention to the policy limit of \$2,000,000 aggregate. Worker's compensation reinsurance is \$5,000,000 over the Exchange's retention. Property Excess of Loss reinsurance is up to \$50,000,000.

Accounts and Records

The accounting and record keeping system employed by the Exchange is maintained in their Anchorage office and is designed to provide support for the Annual Statement. All claims have been handled in-house since late 1996. The Exchange utilizes claims software for processing claims and maintaining loss reserves.

KPMG, LLC audits the records of the Exchange annually. For each year in the examination period, KPMG issued an unqualified opinion.

Statutory Deposits

A \$300,000 statutory deposit is maintained by the Exchange at a bank in Anchorage, Alaska.

SUMMARY OF ACTUARIAL REVIEW

As of December 31, 2008, ARECA carried \$5,725,000 in net loss and loss adjustment expense reserves and \$5,838,000 in gross loss and loss adjustment expense reserves. Using data provided by ARECA and discussions with the insurer's staff, the division actuary reviewed the reserves held by ARECA as well as the Willis of Tennessee, Inc. actuarial report in support of the 2008 Statement of Actuarial Opinion. Based on this review, ARECA's overall reserve position is within a reasonable range of acceptable reserve estimates and should be accepted as stated.

FINANCIAL STATEMENTS

The following pages contain statutory financial statements for the Exchange as of December 31, 2008 as reported to the division and as determined by the examiners.

FINANCIAL STATEMENTS
STATEMENT OF ASSETS, LIABILITIES AND SURPLUS
As of December 31, 2008

	<u>As Reported</u>	<u>Adjustments</u>	Finding No.	<u>As Adjusted</u>
<u>Assets</u>				
Bonds	\$ 13,858,927			\$ 13,858,927
Stocks				
Preferred stock	8,200			8,200
Common Stock	3,446,800			3,446,800
Real Estate				
Properties occupied by company	240,620			240,620
Properties held for the production	286,745			286,745
Cash and short investments	1,729,971			1,729,971
Receivable for securities	389,172			389,172
Investment income due and accrued				
Premiums and considerations:	112,479			112,479
Uncollected premiums and agents'				
Balances in the coursed of collection	22,159			22,159
Deferred premiums, agents' balances	17,326			17,326
Reinsurance				
Other amounts receivable under contract	11,424			11,424
Net deferred tax asset	56,187			56,187
	<u> </u>	<u> </u>		<u> </u>
Total Admitted Assets	<u>\$ 20,180,010</u>			<u>\$ 20,180,010</u>
<u>Liabilities, Surplus and Other Funds</u>				
<u>Liabilities</u>				
Losses	\$ 4,796,482			\$ 4,796,482
Loss adjustment expenses	928,473			928,473
Other expenses	212,792			212,792
Taxes, licenses and fees	42,739			42,739
Unearned premiums	210,962			210,962
Advance premium	45,914			45,914
Payable for securities	397,839			397,839
Aggregate write-ins for liabilities	261			261
	<u> </u>	<u> </u>		<u> </u>
Total Liabilities	<u>\$ 6,635,462</u>			<u>\$ 6,635,462</u>
<u>Surplus</u>				
Gross paid in and contributed surplus	\$16,606,029	421,015	(7)	\$17,027,044
Unassigned funds (surplus)	(180,875)	(421,013)	(7)	(601,888)
Surplus allocated to policyholders	(2,880,606)			(2,880,606)
Surplus as regards policyholders	<u>\$13,544,548</u>	<u> 2</u>		<u>\$ 13,544,550</u>
Total Liabilities and Surplus	<u>\$20,180,010</u>			<u>\$ 20,180,010</u>

FINANCIAL STATEMENTS
STATEMENT OF UNDERWRITING AND INVESTMENT
as of December 31, 2007

	<u>As Reported</u>	<u>Examination Adjustments</u>	<u>Finding Number</u>	<u>As Adjusted</u>
<u>Underwriting Income</u>				
<u>Revenue</u>				
Premiums earned	\$ 3,789,036			\$ 3,789,036
Total Revenue	<u>\$ 3,789,036</u>			<u>\$ 3,789,036</u>
<u>Deductions</u>				
Losses incurred	\$ 3,889,125			\$ 3,889,125
Loss expenses incurred	851,352			851,352
Other underwriting expenses	1,281,553			1,281,553
Total underwriting deductions	<u>\$ 6,022,030</u>			<u>\$ 6,022,030</u>
Net underwriting gain or loss	<u>\$ (2,232,994)</u>			<u>\$(2,232,994)</u>
<u>Investment Income</u>				
Net investment income earned	\$ 638,618			638,618
Net realized capital gains or (losses)	(1,342,856)			(1,342,856)
Net investment gain or (loss)	<u>\$ (704,238)</u>			<u>\$ (704,238)</u>
<u>Other Income</u>	<u>\$ 56,626</u>			<u>\$ 56,626</u>
Net income before dividends	\$ (2,880,606)			(2,880,606)
Dividends to policyholders	0			0
Net Income (Loss)	<u>(2,880,606)</u>			<u>(2,880,606)</u>
<u>Capital and Surplus Account</u>				
Surplus, December 31, prior year	<u>\$ 17,881,701</u>			<u>\$17,881,701</u>
<u>Gains and (Losses) in Surplus</u>				
Net income (loss)	\$ (2,880,606)			\$(2,880,606)
Change in net unrealized capital gains	8,874			8,874
Change in non-admitted assets	(1,083,722)			(1,083,722)
Surplus adjustments: Paid in	1,267,284			1,267,284
Aggregate write-ins for losses in surplus	(1,648,983)			(1,648,983)
Change in surplus as regards policyholders	<u>\$ (4,337,153)</u>			<u>\$(4,337,153)</u>
Surplus for the period ended December 31, 2008	<u><u>\$ 13,544,548</u></u>			<u><u>\$13,544,548</u></u>

FINANCIAL STATEMENTS
STATEMENT OF CAPITAL AND SURPLUS ACCOUNT
As of December 31, 2008

	Allocated to Policy Holders	SURPLUS		TOTAL
		Paid-In	Unassigned	
Balance at December 31, 2005	\$ 880,130	\$18,079,761	\$ 617,961	\$ 19,577,852
Net income - 2006			2,228,969	2,228,969
Net unrealized capital gains or (losses)			109,239	109,239
Change in net deferred tax			5,178	5,178
Change in nonadmitted assets			6,570	6,570
Surplus allocated to policyholders	2,228,969		(2,228,969)	
Allocation of prior year surplus	(880,130)	880,130		
Payment of surplus to policyholders		(2,389,086)		(2,389,086)
Balance at December 31, 2006 (As Corrected)	\$ 2,228,969	\$ 16,570,805	\$ 738,948	\$ 19,538,722
Net income -2007			1,267,285	1,267,285
Net unrealized capital gains or (losses)			(361,614)	(361,614)
Change in net deferred tax			88,295	88,295
Change in nonadmitted assets			7,331	7,331
Surplus allocated to policyholders	1,267,285		(1,267,285)	
Allocation of prior year surplus	(2,228,969)	2,228,969		
Payment of capital to policyholders		(2,658,316)		(2,658,316)
Balance at December 31, 2007 (As Corrected)	\$ 1,267,285	\$ 16,141,458	\$ 472,960	\$ 17,881,703
Net income - 2008			(2,880,606)	(2,880,606)
Net unrealized capital gains or (losses)			8,874	8,874
Change in nonadmitted assets			(1,083,722)	(1,083,722)
Surplus allocated to policyholders	(2,880,606)		2,880,606	
Allocation of prior year surplus	(1,267,285)	1,267,285		
Payment of surplus to policyholders		(381,699)		(381,699)
Balance at December 31, 2008 (As Corrected)	\$ (2,880,606)	\$ 17,027,044	\$(601,888)	\$ 13,544,550

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

The following changes were made to the financial statements as a result of this examination. Paid-in surplus was increased by \$421,015 and unassigned surplus was decreased by \$421,013.

**COMPLIANCE WITH RECOMMENDATIONS IN
PRIOR REPORT OF EXAMINATION**

During the examination the following recommendations in the prior report of examination were found to have been implemented or the issue was no longer present:

- Prior Finding 3 – System Restore and Archive Practices
- Prior Finding 6 – Non-admitted Premiums Receivable
- Prior Finding 7 – Earned But Unbilled Premiums
- Prior Finding 8 – Wire Transfer Authorization
- Prior Finding 9 – Real Estate Carrying Value and Reporting on Schedule A
- Prior Finding 10 – Interest Received
- Prior Finding 11 – Remittances and Items Not Allocated
- Prior Finding 13 – Inter-company Settlements
- Prior Finding 15 – Custodial Agreement
- Prior Finding 16 – Exhibit of Net Investment Income
- Prior Finding 17 – Minimum Surplus

The following prior findings were not found to be resolved during the current examination:

Prior Finding 1 – Business Contingency Plan and Disaster Recovery

The Exchange does not have a formalized and tested business contingency plan or disaster recovery plan in place. The lack of a business contingency plan does not create a direct financial implication for this Examination. However, the inability to restore operations could result in material financial implications if operations at the Company's primary location could not be restored in a timely manner, such as could occur during a catastrophic event. This is a repeat exception from the prior examination .

Prior Recommendation: It is recommended that the Company formally develop and document a complete business contingency plan. The plan should reflect the current EDP environment for all financially significant processes. This plan should be thoroughly tested, and the results of the test should be documented. All employees of the Company

should be informed of the policy and should be aware of their responsibilities in the event that systems need to be restored from the ground up.

Current Status: The Exchange has a formalized business contingency plan. However, the plan has not been tested. A test is necessary to confirm the Exchange's ability to restore operations in a timely manner. See Current Finding 13.

Prior Finding 2 – System Development and Implementation

It was noted during the examination that there is no formal system development and implementation plan regarding financially significant production applications. Although this is a small company, the lack of a system development and implementation plan resulted in significant problems in the general ledger conversion that was performed in 2004.

Prior Recommendation: It is recommended that the Exchange document a systems development project plan for developing and implementing financially significant production applications. The plan should include reasoning behind the conversion and development, a vendor support analysis and comparison, parallel processing guidelines and a system restore contingency plan.

Current Status: A formal system development and implementation plan has not been completed. See Current Finding 7.

Prior Finding 4 – Conflict of Interest Statements

During the examination period, the Exchange did not require board members or officers to complete conflict of interest statements on an annual basis to ensure that all potential conflicts are properly disclosed. Per discussion with management, these forms were completed for 2006 and will be completed annually going forward. This is a repeat exception from the prior examination.

Prior Recommendation: It is recommended that all directors, officers, and responsible employees of the Exchange annually complete the conflict of interest statements to ensure that all potential conflicts are properly disclosed.

Current Status: Most board members completed a conflict of interest statement. However, four board members did not submit the required statements. See Current Finding 8.

Prior Finding 5 – Premium Deficiency Reserves

The Exchange does not have a process in place to review insurance contracts for premium deficiency situations. Insurance contracts should be periodically reviewed in accordance with SSAP 53, paragraph 15. For purposes of determining if a premium deficiency exists, insurance contracts are grouped in a manner consistent with how policies are marketed, serviced, and measured. When the anticipated losses, loss adjustment expenses, and maintenance costs exceed the recorded unearned premium reserve, and any future installment premiums on existing policies, a premium deficiency reserve is recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. This is a repeat exception from the prior examination.

Prior Recommendation: It is recommended that the Exchange establish a process to periodically analyze their insurance contracts for premium deficiency issues in accordance with SSAP 53, paragraph 15.

Current Status: A process has not been developed to review insurance contracts for premium deficiency situations. See Current Finding 10.

Prior Finding 12 – Anti-fraud Plan

Per discussion with management, the Exchange has not developed an anti-fraud plan or initiatives.

Prior Recommendation: It is recommended that the Exchange develop an anti-fraud plan and communicate that plan to all applicable personnel. It is further recommended that procedures be established to report any fraudulent acts to the Alaska Division of Insurance.

Current Status: The Exchange is in the process of developing an anti-fraud plan. However, it has not been presented to the board and finalized. See Current Finding 11.

Prior Finding 14 – Intercompany Services Agreement and Related Party Transaction Disclosures

The Exchange has a Services Contract with the Association, signed in 1994. The agreement covers only an allocation of expenses related to employee services for the sole purpose of supporting the underwriting functions of the Exchange. However, it appears that other types of expenses are being charged to the Exchange in addition to employee expenses such as government relations expense allocations, safety expenses, interim CEO expenses, and 100% of quarterly payroll taxes. The manner of settlement of the cost allocations is not included in the agreement. The 1994 Services Contract is out of date and the Exchange and the Association are not complying with the terms of the agreement. Further, it appears that it is inadequate to meet the needs of the Exchange.

SSAP No. 25 indicates that a major issue for such related-party transactions is whether or not such transactions are “arms-length” transactions. SSAP No. 25, paragraph 16, states that transactions involving services provided between related parties shall be recorded at the amount charged and are subject to regulatory scrutiny of transactions where amount charged for services do not satisfy a fair and reasonable standard which could result in amounts charged being reversed, receivable balances being non-admitted, or other regulatory action. Also, the books and records of each party shall disclose clearly and accurately the precise nature and details of transactions.

SSAP No. 25, paragraph 17, requires certain disclosures in the financial statements of any material related-party transactions including a description of the transactions and whatever other information is considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Cost allocation transactions and any non-insurance transactions that involve less than half (1/2) of 1% of total assets are excluded from this disclosure requirement. Footnote No.10 in the Annual Statement does disclose a general description and states that the attorney-in-fact utilizes the services of an affiliated company for services to operate the insurance company and that the services are primarily recorded at cost. Review of the Services Agreement

and of the cash advances and other transactions recorded between the companies indicate that the information provided in Footnote No. 10 may not be adequate.

Prior Recommendation: It is recommended that the Services Contract be updated so that it clearly describes the services to be provided, the related basis and methodologies for allocating the expenses incurred between the Exchange and its related parties, and the required manner and frequency of settlement of the applicable balances. It is also recommended that related party disclosures be adequately disclosed to comply with SSAP No. 25.

Current Status: The Services Contract has not been updated. Disclosures regarding transactions between the Exchange and APA are adequate. See Current Finding 12.

EXAMINATION FINDINGS AND RECOMMENDATIONS

Finding 1 – Reinsurance Agreement Modification

The Exchange's reinsurance agreement with General Reinsurance Corporation (Gen Re) gives Gen Re the unilateral right to change the reinsurance agreement. Gen Re's agreement only requires endorsement by a duly authorized representative of the reinsurer to make a change. Alaska regulation 3 AAC 21.635(5) states that a change or modification to the agreement is void unless it is made by a written amendment to the agreement and signed by both parties.

Recommendation: It is recommended that changes be made to the Exchange's reinsurance agreement with Gen Re to comply with 3 AAC 21.635(5).

Finding 2 – Reinsurance Intermediary Broker Contract

The Exchange used Alliant Insurance Services, Inc. as its reinsurance intermediary broker for 2008. The Exchange and Alliant did not formalize the arrangement with a contract as required by AS 21.27.690(a).

Recommendation: It is recommended that the Exchange have a written contract with its reinsurance broker as outlined in AS 21.27.690(a). The written contract should establish the responsibilities of each party, indicate each party's share of responsibility for each particular function, and specify the division of responsibilities. It should include all of the provisions of this statute.

Finding 3 – Filing of Reinsurance Agreements

Reinsurance agreements have not been filed with the director within 30 days after all parties have signed the agreement as required by AS 21.69.620. Reinsurance agreements signed in 2007 and 2008 were not filed with the director.

Recommendation: It is recommended that the Exchange submit reinsurance agreements as required by AS 21.69.620.

Finding 4 – Retention Period

The Exchange's Record Retention Policy does not comply with the required 10-year period for reinsurance transactions and the 5-year retention for all other records or until completion of a full examination whichever is longer. The Exchange's current policy requires a three-year retention for insurance policies and 2 to 3 years for other records. Although in practice records are maintained longer than 2 to 3 years, the retention policy should provide the correct guidelines.

Recommendation: It is recommended that the Exchange modify their retention policy to comply with AS 21.69.390 and regulation 3 AAC 21.470.

Finding 5 – Remote Systems Access

The Exchange has permitted software vendor RSG ParaRisk continuous remote access to its claims database to perform software updates to ParaRisk. Vendor remote access should be limited to the time required for updates. Limited access by third parties is important to assure the integrity of the claims database.

Recommendation: It is recommended that the Exchange limit access to its claims database.

Finding 6 – Incorrect Gross Paid-in and Unassigned Surplus

During a review of the 2006, 2007 and 2008 Annual Statements it was noted that amounts reported for Gross Paid-in and Unassigned Surplus were incorrect. Paid-in Surplus is understated by \$421,015. At December 31, 2008, it was reported at \$16,606,029 and should have been reported at \$17,027,044. Unassigned Surplus is overstated by \$421,013. It was reported at -\$180,875 and should have been reported at -\$601,888.

Recommendation: It is recommended that the Company comply with the NAIC Annual Statement Instructions and properly report amounts for Gross Paid-in and Unassigned Funds.

Finding 7 – System Development and Implementation

It was noted during the examination that there is no formal information system development and implementation plan regarding financially significant production applications. Although this is a small company, the lack of an information system development and implementation plan resulted in significant problems in the general ledger conversion that was performed in 2004. This is a repeat exception from the prior examination. See Prior Finding 2.

Recommendation: It is recommended that the Exchange document an information systems development project plan for developing and implementing financially significant production applications. The plan should include reasoning behind the conversion and development, a vendor support analysis and comparison, parallel processing guidelines and a system restore contingency plan.

Finding 8 – Conflict of Interest Statements

During the examination period, the Exchange required board members and officers to complete conflict of interest statements annually to ensure that all potential conflicts were properly disclosed. In 2008, four board members did not complete the conflict of interest forms. This is a repeat exception from the prior examination. See Prior Finding 4.

Recommendation: It is recommended that all board members complete conflict of interest statements on an annual basis.

Finding 9 – Earned But Unbilled Premiums

The Exchange needs to revisit the methodology used in estimating earned but unbilled (EBUB) premiums. Review of actual audit premiums charged in 2009 showed that estimates recorded of EBUB premium at year-end 2008 were not reasonably close to the actual premiums charged. According to SSAP No. 53, paragraph 10, adjustments to the premium charged for changes in the level of exposure to insurance risk (audit premiums on workers compensation policies) are generally determined based upon audits conducted after the policy has expired.

Recommendation: It is recommended that the Exchange evaluate various methods for estimating EBUB premiums including historical information and member surveys to determine the most reasonably accurate approach for financial statement reporting.

Finding 10 – Premium Deficiency Reserves

A process to review insurance contracts for premium deficiencies has not been developed. Insurance contracts should be periodically reviewed in accordance with SSAP 53, paragraph 15. For purposes of determining if a premium deficiency exists, insurance contracts are grouped in a manner consistent with how policies are marketed, serviced, and measured. When the anticipated losses, loss adjustment expenses, and maintenance costs exceed the recorded unearned premium reserve, and any future installment premiums on existing policies, a premium deficiency reserve is recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. This is a repeat exception from the prior examination. See Prior Finding 5.

Recommendation: It is recommended that the Exchange establish a process to periodically analyze their insurance contracts for premium deficiency issues in accordance with SSAP 53, paragraph 15.

Finding 11 – Anti-fraud Plan

The Exchange is in the process of developing an anti-fraud plan. However, it has not been presented to the board and finalized. This is a repeat exception from the prior examination. See Prior Finding 12.

Recommendation: It is recommended that the Exchange complete and adopt an anti-fraud plan and communicate that plan to all applicable personnel. It is further recommended that procedures be established to report any fraudulent acts to the Alaska Division of Insurance.

Finding 12 – Intercompany Services Agreement and Related Party Transaction Disclosures

The Exchange has a Services Contract with APA, signed in 1994. The agreement covers only an allocation of expenses related to employee services for the sole purpose of supporting the underwriting functions of the Exchange. However, it appears that other types of expenses are being charged to the Exchange in addition to employee expenses such as government relations expense allocations, safety expenses, interim CEO expenses, and 100% of quarterly payroll taxes. The manner of settlement of the cost allocations is not included in the agreement. The Exchange and the Association are not complying with the terms of the agreement and the agreement is inadequate to meet the needs of the Exchange.

SSAP No. 25 indicates that a major issue for related party transactions is whether or not such transactions are “arms-length” transactions. SSAP No. 25, paragraph 16, states that transactions involving services provided between related parties shall be recorded at the amount charged and are subject to regulatory scrutiny where the amount charged does not satisfy a fair and reasonable standard. Unacceptable charges could result in amounts being reversed, receivable balances being non-admitted, or other regulatory action. Also, the books and records of each party shall disclose clearly and accurately the precise nature and details of such transactions. See Prior Finding 14.

Recommendation: It is recommended that the Services Contract be updated so that it clearly describes the services to be provided, the related basis and methodologies for allocating the expenses incurred between the Exchange and its related parties, and the required manner and frequency of settlement of the applicable balances.

Finding 13 – Business Contingency Plan and Disaster Recovery

The Exchange has developed a formalized business contingency plan. However, the plan has not been tested. A test is necessary to confirm the Exchange’s ability to restore operations in a timely manner. This is a repeat exception from the prior examination. See Prior Finding 1.

Recommendation: It is recommended that the Exchange thoroughly test its Contingency Plan, and document the results of the test.

Finding 14 – Audit Committee Meetings

The Audit Committee Charter indicates meetings will be held on a quarterly basis. Based on the review of the minutes and a discussion with the Audit Committee Chairman Robert Wilkinson, these meetings are not held quarterly. Meetings are generally held twice a year, at the time of the annual meeting and then again during the budget process. Other meetings may occur but are on an as needed basis only.

Recommendation: It is recommended that either the meetings be held as required by the Charter or the Board consider modifying the Audit Committee Charter to require two meetings per year.

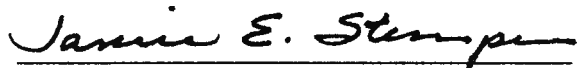
CLOSING

This examination was conducted in accordance with practices and procedures promulgated by the NAIC. This examination also includes a compliance review of applicable Alaska Statutes.

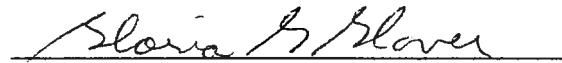
In addition to the undersigned, the following examiners participated in the examination: Actuary Sarah McNair-Grove, FCAS, MCAA and Insurance Financial Examiner Douglas Hartman, AFE, of the Division of Insurance and Cathie Stewart, CFE, Daniel Callahan, CFE, Mary Hartell, CFE and Patrick White, CFE of RMS McGladrey.

We wish to express our appreciation for the courteous cooperation and assistance extended to us by the management and staff of ARECA Insurance Exchange during the course of this examination.

This report is respectfully submitted,



Janice E. Stamper, CFE
Examiner-in-Charge



Gloria G. Glover, CFE
Chief Financial Examiner

AFFIDAVIT

Anchorage, Alaska
April 22, 2010

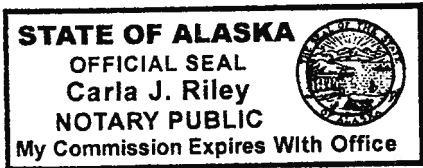
STATE OF ALASKA
THIRD JUDICIAL DISTRICT

We, the undersigned, being duly sworn, do verify that the report of examination as of December 31, 2008, of ARECA Insurance Exchange, an Alaska domiciled company holding Certificate of Authority D-1530, is true to the best of our knowledge and belief.

Janice E. Stamper
Janice E. Stamper, CFE
Examiner-in-Charge

Gloria G. Glover
Gloria G. Glover, CFE
Chief Financial Examiner

Subscribed and sworn to before me this 23 day of June, 2010.



Carla J. Riley
Notary Public for the State of Alaska
with
My commission expires: office