

STATE OF MISSOURI



DEPARTMENT OF INSURANCE, FINANCIAL INSTITUTIONS AND PROFESSIONAL REGISTRATION

P.O. Box 690, Jefferson City, Mo. 65102-0690

RE: Examination Report of Arch Indemnity Insurance Company for the period ended December 31, 2014

ORDER

After full consideration and review of the report of the financial examination of Arch Indemnity Insurance Company for the period ended December 31, 2014, together with any written submissions or rebuttals and any relevant portions of the examiner's workpapers, I, John M. Huff, Director, Missouri Department of Insurance, Financial Institutions and Professional Registration pursuant to section 374.205.3(3)(a), RSMo, adopt such examination report. After my consideration and review of such report, workpapers, and written submissions or rebuttals, I hereby incorporate by reference and deem the following parts of such report to be my findings and conclusions to accompany this order pursuant to section 374.205.3(4), RSMo: summary of significant findings, subsequent events, company history, corporate records, management and control, territory and plan of operation, reinsurance, financial statements, financial statement changes resulting from examination, comments on the financial statement items, and summary of recommendations.

Based on such findings and conclusions, I hereby ORDER, that the report of the Financial Examination of Arch Indemnity Insurance Company as of December 31, 2014 be and is hereby ADOPTED as filed and for Arch Indemnity Insurance Company to take the following action or actions, which I consider necessary to cure any violation of law, regulation or prior order of the Director revealed by such report: (1) account for its financial condition and affairs in a manner consistent with the Director's findings and conclusions.

So ordered, signed and official seal affixed this 31st day of May, 2016.



A handwritten signature in blue ink, appearing to read "John M. Huff".

John M. Huff, Director
Department of Insurance, Financial Institutions
and Professional Registration

REPORT OF THE
FINANCIAL EXAMINATION OF
**ARCH INDEMNITY
INSURANCE COMPANY**

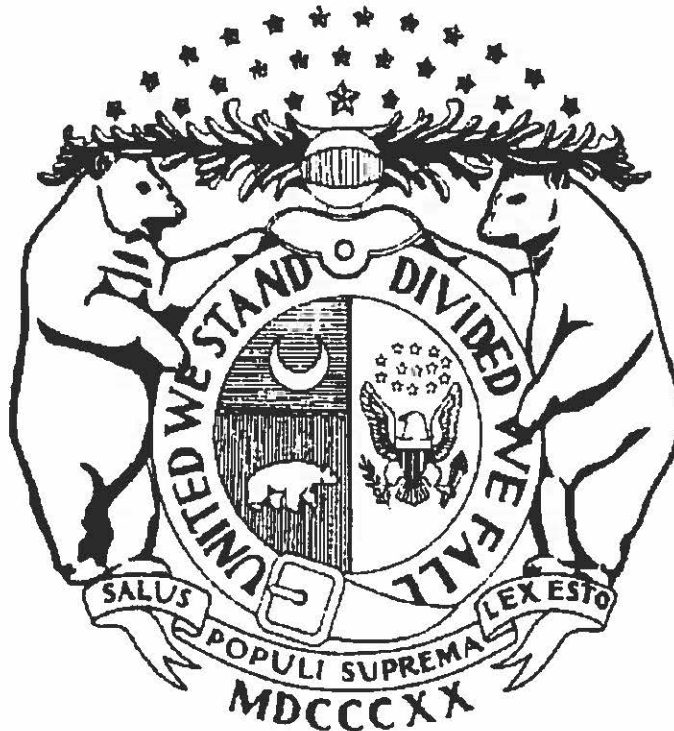
AS OF

DECEMBER 31, 2014

FILED

JUN 09 2016

DIRECTOR OF INSURANCE,
FINANCIAL INSTITUTIONS &
PROFESSIONAL REGISTRATION



STATE OF MISSOURI

DEPARTMENT OF INSURANCE, FINANCIAL INSTITUTIONS
AND PROFESSIONAL REGISTRATION

JEFFERSON CITY, MISSOURI

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Jersey City, New Jersey
March 22, 2016

Honorable John M. Huff, Director
Missouri Department of Insurance, Financial
Institutions and Professional Registration
301 West High Street, Room 530
Jefferson City, Missouri 65101

Director Huff:

In accordance with your financial examination warrant, a full scope financial examination has been made of the records, affairs and financial condition of

Arch Indemnity Insurance Company

hereinafter referred to as such, as AIIC, or as the Company. Its primary office is located at 300 Plaza Three, 3rd Floor, Jersey City, New Jersey, 07311, telephone number (201) 743-4000. This examination began on April 20, 2015 and concluded on the above date.

SCOPE OF EXAMINATION

Period Covered

The Missouri Department of Insurance, Financial Institutions and Professional Registration (DIFP) has performed a full scope financial examination of Arch Indemnity Insurance Company. The previous examination of AIIC was completed as of December 31, 2011. This examination covers the period of January 1, 2012 through December 31, 2014. This examination also included material transactions or events occurring subsequent to December 31, 2014.

This examination was performed concurrently with the Missouri DIFP examinations of Arch Insurance Company (AIC), Arch Excess & Surplus Insurance Company (AESIC), and Arch Specialty Insurance Company (ASIC).

Procedures

We conducted our examination in accordance with the National Association of Insurance Commissioners' (NAIC) Financial Condition Examiners Handbook (Handbook) except where practices, procedures and applicable regulations of the DIFP and statutes of the State of Missouri prevailed. The Handbook requires that we plan and perform the examination to evaluate the financial condition, assess corporate governance, identify current and prospective risks of the Company and evaluate system controls and procedures used to mitigate those risks. An

examination also includes identifying and evaluating significant risks that could cause an insurer's surplus to be materially misstated both currently and prospectively.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process. This may include assessing significant estimates made by management and evaluating management's compliance with Statutory Accounting Principles. The examination does not attest to the fair presentation of the financial statements included herein. If, during the course of the examination an adjustment is identified, the impact of such adjustment will be documented separately following the Company's financial statements.

The examination report includes significant findings of fact and general information about the insurer and its financial condition. There may be other items identified during the examination that, due to their nature, are not included within the examination report but separately communicated to other regulators and/or the Company.

Reliance Upon Others

The examiners relied upon information and workpapers provided by the Company's independent auditor, PricewaterhouseCoopers LLP (PwC) of New York, New York, for its audit covering the period from January 1, 2014 through December 31, 2014. Such reliance included, but was not limited to, fraud risk analysis, adjusting journal entry testing, internal control narratives, test of internal controls, and substantive testing.

SUMMARY OF SIGNIFICANT FINDINGS

There were no material adverse findings, significant non-compliance issues or material changes to the financial statements noted during the examination.

SUBSEQUENT EVENTS

A change in ownership of AIIC's indirect owner (Arch Insurance Company) occurred on December 15, 2015, when Arch Insurance Group, Inc. (AIGI) issued a stock dividend to Arch Reinsurance Company (ArchReCo), granting ArchReCo 100% of its stock ownership in AIC. There was no monetary effect on AIC as result of this dividend, and AIC's ultimate controlling entity (Arch Capital Group, Ltd., or ACGL) remained the same. The change had no impact on operations, management, or the directors/officers of AIC or its subsidiaries.

COMPANY HISTORY

General

Arch Indemnity Insurance Company (originally known as Western Diversified Casualty Insurance Company) was incorporated on August 10, 1987, as a stock casualty insurance company, and was granted authority pursuant to the provisions of Illinois Law to write insurance.

The Company began writing contractual liability and mechanical breakdown business on August 28, 1987. Effective December 21, 1989 the Company merged with Commercial Mortgage Insurance, Inc. and redomesticated to Wisconsin. On September 30, 1997 Protective Life Insurance Company acquired the Western Diversified group; and on June 23, 2003 Arch Capital Group, Ltd. purchased the Company from Protective Life and contributed it to Arch Insurance Group, Inc. Effective December 31, 2004 AIGI contributed AIIC to Arch Insurance Company. On December 18, 2006 AIIC redomesticated to Nebraska as an excess and surplus lines insurance company. On May 14, 2008 the Company changed its name to Arch Indemnity Insurance Company. Effective December 15, 2011 AIC contributed the Company to Arch Excess & Surplus Insurance Company. AIIC redomiciled to the State of Missouri effective September 30, 2014.

Dividends

No dividends were declared or paid by AIIC during the examination period.

Capital Contributions

AIIC received capital contributions during 2012 and 2013 in the amounts of \$15,153 and \$144,566, respectively. In 2014, the Company returned \$30,413 of the 2013 contributions due to an adjustment related to tax benefits on employee stocks and options.

Mergers and Acquisitions

On January 30, 2014, Arch U.S. MI Holdings (the U.S. based subsidiary of ACGL) acquired CMG Mortgage Insurance Company (CMG MI) from CUNA Mutual Group and PMI Mortgage Insurance Co. The acquisition of CMG MI and the operating platform will form the foundation for Arch Mortgage Insurance Company to offer mortgage insurance throughout the United States. The acquisition had no impact on operations, management, or the directors/officers of AIC or its subsidiaries.

CORPORATE RECORDS

AIIC's Articles of Incorporation and Bylaws were reviewed for any changes or updates during the period under examination. As a result of the redomestication from Nebraska to Missouri, both the Articles and the Bylaws were amended during 2014 to comply with Missouri statutes and regulations.

MANAGEMENT AND CONTROL

Board of Directors

The Company's Articles of Incorporation specify that the Board of Directors (Board) shall consist of between nine and twenty-five members. This complies with 379.035 RSMo (Articles

of Incorporation for Stock Companies). The Directors elected and serving as of December 31, 2014 were as follows:

<u>Name and Address</u>	<u>Business Affiliation</u>
David H. McElroy West Simsbury, CT	Chairman and Chief Executive Officer Arch Insurance Company and subsidiaries
Dennis R. Brand Harvard, IL	Senior Executive Vice President and Chief Administrative Officer Arch Insurance Company and subsidiaries
Thomas J. Ahern Ridgewood, NJ	Senior Vice President, Chief Financial Officer, and Treasurer Arch Insurance Company and subsidiaries
Michael D. Price Westfield, NJ	Executive Vice President and Chief Underwriting Officer Arch Insurance Company and subsidiaries
John S. Edack ¹ Oakland, CA	Senior Executive Vice President, Casualty Arch Insurance Company and subsidiaries
Lawrence F. Harr ¹ Omaha, NE	Practicing Attorney Lamson, Dugan and Murray, LLP
Michael R. Murphy Short Hills, NJ	Vice Chairman Arch Insurance Company and subsidiaries
Martin J. Nilsen ¹ Rockville Center, NY	Director Arch Insurance Company and subsidiaries
Marita A. Oliver New York, NY	Senior Vice President, Corporate Underwriting Arch Insurance Company and subsidiaries

Although all but one of the members of AIIC’s Board of Directors as indicated above are employees of ACGL entities, indicating a lack of independence in the Company’s governance, this is not unusual given the ownership structure of AIIC as a subsidiary of a publicly-held corporation. To ascertain independence and prudent corporate governance standards, the examination reviewed the composition of the Board of Directors of ACGL, the ultimate controlling entity of AIIC. ACGL’s current Board of Directors is comprised of eleven directors, two of whom are employees. ACGL’s Board of Directors concluded that the nine non-employee directors are independent as defined under the applicable listing standards of the NASDAQ Stock Market, LLC (NASDAQ). The audit, compensation and nominating committees of the ACGL Board are composed entirely of independent directors.

¹ During the first quarter of 2015, these Board members were replaced by John P. Mentz, Patrick K. Nails, and John A. Rafferty.

Senior Officers

The following officers were elected and serving as of December 31, 2014:

<u>Name</u>	<u>Office</u>
David H. McElroy	Chairman and Chief Executive Officer
John P. Mentz	President
Dennis R. Brand	Senior Executive Vice President and Chief Administrative Officer
David M. Siesko	Senior Executive Vice President
Michael D. Price	Executive Vice President, Chief Underwriting Officer
Thomas J. Ahern	Senior Vice President, Chief Financial Officer, and Treasurer
Patrick K. Nails	Senior Vice President, Secretary, and General Counsel

Principal Committees

Pursuant to AIIC’s Bylaws, the Board of Directors may designate one or more committees comprised solely of members of the Board, each of which shall consist of at least three members. At the June 1, 2011 meeting, the Board appointed members to an Executive Committee and an Investment and Finance Committee. The appointed members of the Investment and Finance Committee as of December 31, 2014 were David H. McElroy, Thomas J. Ahern, Dennis R. Brand, Michael R. Murphy, and Martin J. Nilsen². Although the Executive Committee was inactive during the examination period, its members as of December 31, 2014 were David H. McElroy, Dennis R. Brand, and Michael R. Murphy.

The Company’s Board of Directors designated the ACGL Audit Committee to act as its Audit Committee. As of December 31, 2014, ACGL’s Audit Committee consisted of James J. Meenaghan (Chairman), Yiorgis Lillikas, Brian S. Posner and Robert F. Works. AGCL’s Board determined that all of the Audit Committee members were independent under the applicable standards of NASDAQ and the Securities Exchange Act of 1934 and that Mr. Meenaghan qualifies as an "audit committee financial expert" under the rules of the Securities and Exchange Commission.

Besides the Board committees discussed above, AIIC has established various management committees to provide oversight and guidance. These include the Enterprise Risk Management Committee, the Reserve Review Committee, the Reinsurance Steering Committee, the IT Steering Committee, and the Anti-Fraud Committee.

Holding Company, Subsidiaries and Affiliates

AIIC is a member of an insurance holding company system as defined by Section 382.010 RSMo (Definitions). AIIC is a wholly owned subsidiary of AESIC, which is a wholly owned subsidiary of AIC. As of December 31, 2014, AIC was a wholly owned subsidiary of AIGI, which is ultimately owned by ACGL, a Bermuda-based publicly held limited liability company whose

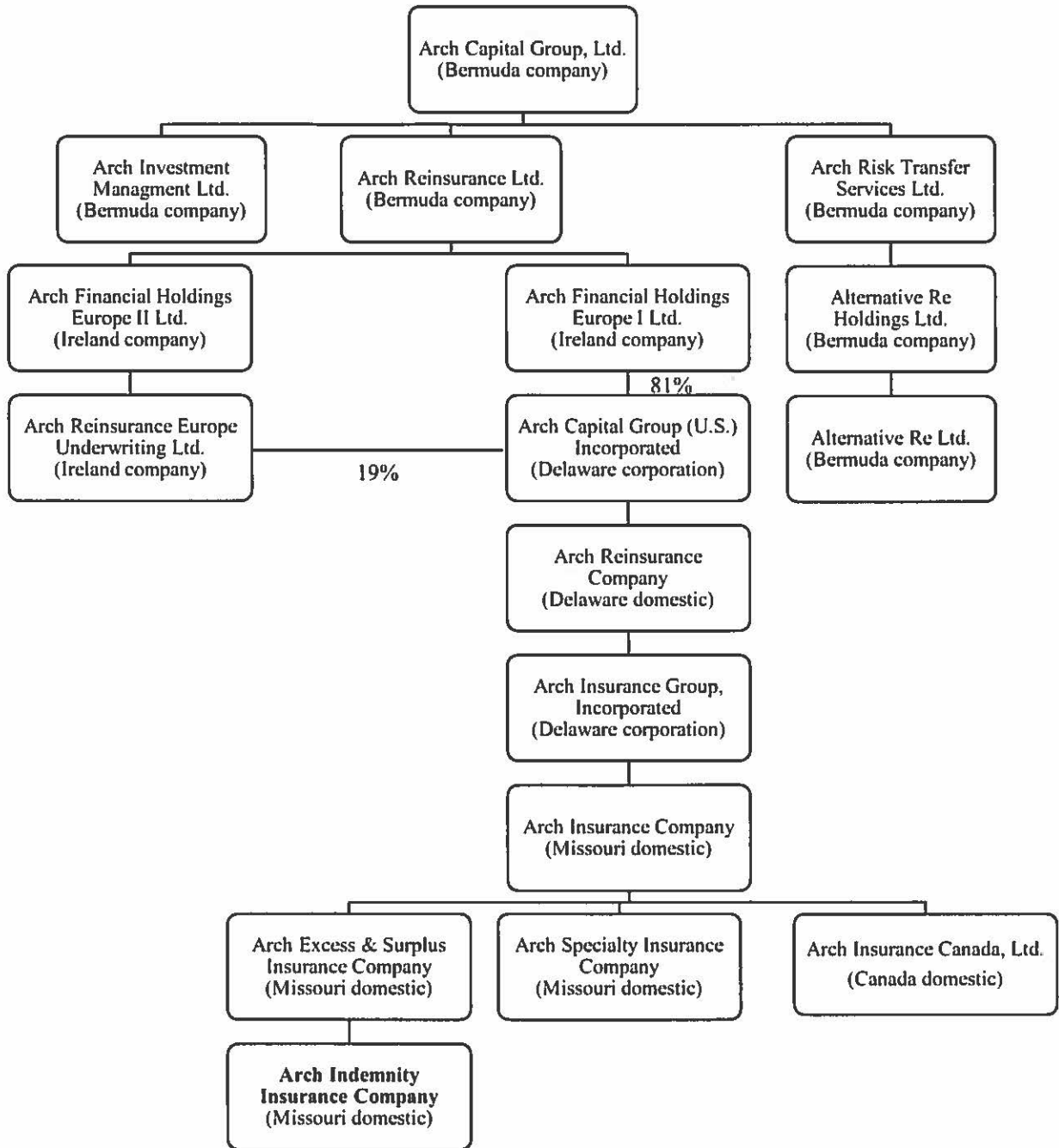
² During the first quarter of 2015, Martin J. Nilsen was replaced by Patrick K. Nails.

assets primarily consist of investments in subsidiaries. ACGL provides insurance and reinsurance on a worldwide basis through its wholly owned subsidiaries in Europe, Bermuda, the United States, and Canada.

ACGL is traded on the NASDAQ National Market under the symbol ACGL. Funds associated with Artisan Partners Holdings LP (Artisan) owned 17.9% and 16.7% of the shares of ACGL in 2014 and 2013 respectively. Artisan submitted to the DIFP a disclaimer of affiliation stating the holdings in ACGL are held for investment purposes only. No other stockholder owned 10% or more of ACGL.

Organizational Chart

The following organizational chart depicts the applicable portion of the holding company group as of December 31, 2014 (all subsidiaries shown are wholly owned unless otherwise noted):



Intercompany Transactions

The Company is a party to significant intercompany agreements in effect as of December 31, 2014 as outlined below:

1. Type: Service Agreement
 Parties: AIGI and AIIC
 Effective: July 1, 2003
 Terms: AIGI provides AIIC with supervision of all phases of its operations, including, but not limited to, the following: underwriting, actuarial studies, claims service, accounting, data processing, and other responsibilities. For the services provided, AIGI is compensated for the direct costs incurred in providing services.

2. Type: Investment Manager Agreement
 Parties: Arch Investment Management Ltd. (AIM) and AIIC
 Effective: June 1, 2006
 Terms: AIM is to provide investment management services on behalf of AIIC. The services are to include the investment and reinvestment of the AIIC's assets, the reporting of the market value of investments, the reconciliation of accounting, transaction, and investment summary data with custodian reports, and the appointment of brokers. AIM is also to advise, oversee, and review any third-party investment manager's services. AIIC shall compensate AIM on a quarterly basis in arrears based upon its pro-rata portion of the average of the total assets of the ACGL Companies managed by AIM. AIM shall receive 10 basis points for the first \$500 million of assets and 8 basis points for assets over \$500 million for directly managed accounts and 7.5 basis points for indirectly managed accounts.

3. Type: Intercompany Short Term Advance Agreement
 Parties: AIGI, AIC, ASIC, AESIC, and AIIC
 Effective: December 31, 2007
 Terms: Parties to the agreement are authorized to make advances to one another for a maximum term of thirty (30) days. No advances may exceed more than three percent (3%) of the lending or borrowing party's policyholders' surplus as of December 31 of the preceding year. The rate of interest will be the prime rate plus 100 basis points.

4. Type: Amended and Restated Tax Sharing Agreement
 Parties: Arch Capital Group, Inc. (ACGI) and subsidiaries, including AIC, ASIC, AESIC, and AIIC
 Effective: November 1, 2014
 Terms: ACGI is to collect from, or refund to, each subsidiary the amount of federal income taxes or benefits determined as if the subsidiary filed a separate return. Balances arising out of the agreement are to be settled no less often than quarterly.

5. Type: (Computer Equipment) Cost Allocation Agreement
Parties: AIGI, AIC, ASIC, AESIC, and AIIC
Effective: June 1, 2004
Terms: AIGI has the primary responsibility for purchases of computer equipment; however, this agreement is in place in the event management determines a purchase should be made by an insurance entity. Depreciation shall be allocated among AIC, ASIC, AESIC, and AIIC in direct proportion to the ratio of direct premiums written by each of the Companies to total direct premiums written. AIC will bill ASIC, AESIC, and AIIC for their share of the depreciation expense on no less than a quarterly basis with payment due within thirty days of receipt of the bill.
6. Type: Cost Allocation Agreement – 3rd Amended and Restated Property Catastrophe Excess of Loss Reinsurance
Parties: ACGL and subsidiaries, including AIC, ASIC, AESIC, and AIIC
Effective: January 1, 2011
Terms: ACGL is to purchase property catastrophe excess of loss reinsurance protection on behalf of its subsidiaries. Costs of the reinsurance protection are to be allocated to each business line written by the subsidiaries based upon each business line's loss exposure and then allocated to each subsidiary based upon gross net earned premiums. Payments are to be made to ACGL within ten business days after each deposit premium quarterly installment. Annual adjustments are to be paid within 10 business days after notification of the final amount. Any recoveries under the coverage are to be paid to the subsidiaries which paid the losses.

TERRITORY AND PLAN OF OPERATION

AIIC is licensed as a property and casualty insurer by the DIFP under Chapter 379 RSMo (Insurance Other than Life). The Company is licensed in all 50 states except for Connecticut and is also licensed in the District of Columbia. However, New York was the only state with direct written premium in 2014.

The Company only wrote workers' compensation business in 2014. The direct parent, AIC, manages operations by various business units that mirror the products that are marketed. The Company participates with AIC in the CNAX (Construction, National Accounts, Alternative Markets, and High Excess Workers' Compensation) business unit. CNAX covers a variety of customer classes, including contactors, manufacturing, retail stores, service industries, restaurant chains, hotels, and financial institutions.

REINSURANCE

General

The Company's written premium activity on a direct, assumed and ceded basis for the period under examination is detailed below:

	2012	2013	2014
Direct Business	\$ -	\$ 10,000,376	\$ 12,551,928
Reinsurance Assumed			
Affiliates	-	-	-
Non-Affiliates	-	-	-
Reinsurance Ceded			
Affiliates	-	(9,960,300)	(12,358,815)
Non-Affiliates	-	(40,076)	(193,113)
Net Premiums Written	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Assumed

The Company did not assume any business during the examination period.

Ceded

During the examination period, AIIC's most significant reinsurer was its indirect parent, AIC. In 2014, AIIC ceded \$12.4 million or 98.4% of its total ceded premiums to AIC. AIIC's December 31, 2014 net reinsurance recoverable from AIC was \$11.4 million, representing 94.8% of its total net reinsurance recoverable. Under its agreements with AIC, AIIC cedes 100% of its net retained liability under all policies, contracts, agreements, binders, endorsements, etc.

During 2014, the Company was party to a property catastrophe excess of loss program purchased by ACGL, on behalf of AIIC and other ACGL subsidiaries. The total aggregate net loss the Company would incur in any single event was \$150 million. The Company also maintained a worker's compensation excess of loss program. The total aggregate net loss the Company would incur in any single event was \$50 million.

The Company is contingently liable for all reinsurance losses ceded to others. This contingent liability would become an actual liability in the event that an assuming reinsurer should fail to perform its obligations under its reinsurance agreement with the Company.

FINANCIAL STATEMENTS

The following financial statements are based on the statutory financial statements filed by the Company with the DIFP and present the financial condition of the Company for the period-ending December 31, 2014. The accompanying comments on financial statements reflect any examination adjustments to the amounts reported in the annual statement and should be considered an integral part of the financial statements.

There may have been additional differences found in the course of this examination, which are not shown in the "Comments on Financial Statement Items". These differences were determined to be immaterial concerning their effect on the financial statements and therefore were only communicated to the Company and noted in the workpapers for each individual activity.

Assets

	<u>Assets</u>	<u>Non-Admitted Assets</u>	<u>Net Admitted Assets</u>
Bonds	\$ 23,375,675	\$ -	\$ 23,375,675
Cash and short-term investments	6,125,269	-	6,125,269
Receivables for securities	5,775	-	5,775
Investment income due and accrued	160,769	-	160,769
Uncollected premiums and agents' balances in course of collection	23,748	-	23,748
Deferred premiums, agents' balances and installments booked but deferred	2,961,568	-	2,961,568
Net deferred tax asset	74,827	-	74,827
Receivables from parent, subsidiaries and affiliates	783,031	-	783,031
Aggregate write-ins for other assets:			
Advance claim payments	7,857	-	7,857
Deductible recovery	19,967	19,967	-
TOTAL ASSETS	\$ 33,538,486	\$ 19,967	\$ 33,518,519

Liabilities, Surplus and Other Funds

Loss adjustment expenses	\$	338,960
Commissions payable, contingent commissions and other similar charges		40,169
Other expenses (excluding taxes, licenses and fees)		55,632
Taxes, licenses and fees (excluding federal and foreign income taxes)		3,331,288
Current federal and foreign income taxes		158,979
Advance premium		135,295
Ceded reinsurance premiums payable (net of ceding commissions)		3,106,506
Amounts withheld or retained by company for account of others		1,051,728
Remittances and items not allocated		11,414
Provision for reinsurance		318,414
Payable to parent, subsidiaries and affiliates		425,425
Aggregate write-ins for liabilities:		
Deferred ceding commission liability		176,771
Claims payable		72
TOTAL LIABILITIES	\$	9,150,652
Common capital stock		5,000,000
Gross paid in and contributed surplus		15,173,541
Unassigned funds (surplus)		4,194,326
Surplus as regards policyholders	\$	24,367,867
TOTAL LIABILITIES AND SURPLUS	\$	33,518,519

Statement of Income

Underwriting Income	
Premiums earned	\$ -
Deductions:	
Loss adjustment expenses	572,455
Other underwriting expenses incurred	(8,546,509)
Total underwriting deductions	<u>\$ (7,974,054)</u>
Net underwriting gain or (loss)	<u>\$ 7,974,054</u>
Investment Income	
Net investment income earned	\$ 380,774
Net realized capital gains or (losses)	127,629
Net investment gain or (loss)	<u>\$ 508,403</u>
Other Income	
Net gain (loss) from agents' premium balances charged off	\$ 1
Total other income	46
Total other income	<u>\$ 47</u>
Net income before dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	\$ 8,482,504
Dividends to policyholders	-
Net income after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	\$ 8,482,504
Federal and foreign income taxes incurred	2,347,510
NET INCOME	<u><u>\$ 6,134,994</u></u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2013	\$ 18,989,744
Net income	6,134,994
Change in net deferred income tax	(388,077)
Change in nonadmitted assets	(19,967)
Change in provision for reinsurance	(318,414)
Paid in surplus	(30,413)
Net change in surplus as regards policyholders for the year	<u>\$ 5,378,123</u>
Surplus as regards policyholders, December 31, 2014	<u><u>\$ 24,367,867</u></u>

FINANCIAL STATEMENT CHANGES RESULTING FROM EXAMINATION

None.

COMMENTS ON FINANCIAL STATEMENT ITEMS

None.

SUMMARY OF RECOMMENDATIONS

None.

ACKNOWLEDGMENT

The assistance and cooperation extended by the officers and the employees of Arch Indemnity Insurance Company during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Tim Tunks, Examiner-In-Charge, CPA, CFE, Steven Koonse, CFE, Sara McNeely, CFE, Marc Peterson, CFE and Bernie Troop, CFE, examiners for the Missouri DIFP, also participated in this examination. Kimberly Dobbs, CFE, AES, Information Systems Financial Examiner for the Missouri DIFP, performed a review of the information system environment. Glenn A. Tobleman, FSA, FCAS, MAAA, of Lewis & Ellis, Inc., also participated as a consulting actuary.

VERIFICATION

State of Missouri)
)
County of)

I, Jennifer R. Danz, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of Arch Indemnity Insurance Company, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.

Jennifer R. Danz
Jennifer R. Danz, CPA, CFE
Examiner-In-Charge
Missouri Department of Insurance, Financial
Institutions and Professional Registration

Sworn to and subscribed before me this 6th day of April, 2016.

My commission expires: 5-27-2018 *Amber King*
Notary Public



SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with NAIC procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed except where practices, procedures and applicable regulations of the MO DIFP and statutes of the State of Missouri prevailed.



Mark A. Nance, CPA, CFE
Senior Examiner-In-Charge
Missouri Department of Insurance, Financial
Institutions and Professional Registration