Report

of the

Examination of

Farmington Mutual Insurance Company

Osceola, Wisconsin

As of December 31, 2010

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

Scott Walker, *Governor*
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August 19, 2011

Honorable Theodore K. Nickel
Commissioner of Insurance
State of Wisconsin
125 South Webster Street
Madison, Wisconsin 53703

Commissioner:

In accordance with your instructions, a compliance examination has been made of the affairs and financial condition of:

FARMINGTON MUTUAL INSURANCE COMPANY
Osceola, Wisconsin

and this report is respectfully submitted.

I. INTRODUCTION

The previous examination of Farmington Mutual Insurance Company (hereinafter also the company or FMIC) was conducted in 2006 as of December 31, 2005. The current examination covered the intervening period ending December 31, 2010, and included a review of such 2011 transactions as deemed necessary to complete the examination.

The examination was conducted using a risk-focused approach in accordance with the NAIC Financial Condition Examiners Handbook, which sets forth guidance for planning and performing an examination to evaluate the financial condition and identify prospective risks of an insurer. This approach includes the obtaining of information about the company including corporate governance, the identification and assessment of inherent risks within the company, and the evaluation of system controls and procedures used by the company to mitigate those risks. The examination also included an assessment of the principles used and significant estimates made by management, as well as an evaluation of the overall financial statement presentation and management’s compliance with statutory accounting principles, annual statement instructions, and Wisconsin laws and regulations.

The examination consisted of a review of all major phases of the company's operations and included the following areas:

History
Management and Control
Corporate Records
Conflict of Interest
Fidelity Bonds and Other Insurance
Employees' Welfare and Pension Plans
Territory and Plan of Operations
Growth of Company
Reinsurance
Financial Statements
Accounts and Records
Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

In addition to auditing, the public accounting firm performs non-auditing services for the company, which includes bookkeeping assistance in connection with closing year-end financial records, assistance in preparing statement filings, and tax return preparation. On December 14, 2010, an exemption was granted by the Commissioner, pursuant to s. Ins 50.08 (5), Wis. Adm. Code, permitting the independent auditor to perform this non-audit work for the company.

II. HISTORY AND PLAN OF OPERATION

The company was organized in 1878 as Farmington Mutual Fire Insurance Company, a town mutual insurer. It changed its name to Farmington Mutual Insurance Company through subsequent amendments to its articles and bylaws. Effective September 16, 1996, Farmington converted from a town mutual insurance company to a nonassessable mutual insurance company under ch. 611, Wis. Stat. Warren Mutual Insurance Company was merged into the company effective January 1, 1997.

The company is only authorized to transact the business of insurance in Wisconsin. The company plans limited growth concentrating in the northwestern portion of the state.

The major products marketed by the company include farmowner's, homeowner's, allied lines, fire and commercial lines of business. The major products are marketed through 23 independent and captive agents, of whom 4 are directors of the company. The company compensates agents for the total annual premium written on the following basis:

Property lines	15%
Liability lines	10%

The majority of policies renew on November 1, as this was company policy in the past. New business now renews on the anniversary of original effective date. Renewal commissions are paid on the above basis for the premium in force as of October 31 except in those cases where agents request for the commissions to be paid periodically (semiannually or quarterly).

The following table is a summary of the net insurance premiums written by the company in 2010. The growth of the company is discussed in the "Financial Data" section of this report.

Line of Business	Direct Premium	Reinsurance Assumed	Reinsurance Ceded	Net Premium
Fire	$ 48,059	$0	$ 16,394	$ 31,665
Allied lines	60,755	0	20,748	40,007
Farmowners multiple peril	1,014,753	0	346,216	668,537
Homeowners multiple peril	442,235	0	150,882	291,353
Commercial multiple peril	9,664	0	3,279	6,385
Total All Lines	$1,575,466	$0	$537,519	$1,037,947

III. MANAGEMENT AND CONTROL

Board of Directors

The board of directors consists of nine members. Three directors are elected annually to serve a three-year term. Officers are elected at the board's annual meeting. The board members currently receive $75 for each meeting they attend. In addition, they are reimbursed for mileage based on the IRS established rate and any out-of-pocket expenses for continuing education or industry meeting they may attend. Further comments on the composition of the board of directors are found in the "Summary of Examination Results" section of this report.

Currently the board of directors consists of the following persons:

Name and Residence	Principal Occupation	Term Expires
Dale Berends Glenwood City, Wisconsin	Dairy Farmer	2012
Gary Berget New Richmond, Wisconsin	Construction	2013
John Heintz * New Richmond, Wisconsin	Electrician and Insurance Agent	2013
James Klemesrud New Richmond, Wisconsin	Retired Engineer	2012
Richard McCurdy # Centuria, Wisconsin	Accountant and Life & Disability Insurance Agent	2012
David Neidermire * New Richmond, Wisconsin	Company's Secretary & Treasurer, Insurance Agent and Dairy Farmer	2013
Edward Sontag * Somerset, Wisconsin	Company's President, Insurance Agent and Crop Farmer	2014
Thomas Stack *# Glenwood City, Wisconsin	Company's Vice President, Insurance Agent and Bus Driver	2014
David Thiel New Richmond, Wisconsin	Retired Machinist	2014

* Indicates the director is an agent for the company.
# Indicates the director's spouse is an agent for the company.
The four directors and the two wives of the directors wrote approximately 69% of the company's 2010 direct premiums.

Officers of the Company

The officers serving at the time of this examination are as follows:

Name	Office	2010 Compensation *
Edward Sontag	President	$10,030
Thomas Stack	Vice President	49,243
David Neidermire	Secretary/Treasurer	7,656
Ronald Lais	Manager	54,570

* Compensation includes officer and director fees, salary, and agent commissions, data are as reported on the Report of Executive Compensation.

The President is the only officer paid a salary, which was $1,000. The Secretary/Treasurer receives $20 per hour to balance the company's checkbook each month and charged the company one hour for this service each month in 2010. Officers of the company are also captive agents for the company and are paid commissions for the premiums written. For 2010, the President received $8,280 in commissions, the Vice President received $48,343 and the Secretary/Treasurer received $6,831.

Officers who are also captive agents receive $20 per hour for performing claim adjusting services on behalf of the company. Agents are only allowed to adjust basic property claims that are under $2,500. They also receive compensation for completing renewal applications after visiting with policyholders on the three-year anniversary of their policies ($30 for farmowner's policies and $15 for all other policies). For 2010, the President received $275 for the aforementioned services, the Vice President received $1,875 and the Secretary/Treasurer received $420. However, the compensation paid officers in 2010 relating to claims adjusting services and completing renewal applications were not included in the balances reported in the above table, which is based upon the company's 2010 Report on Executive Compensation. This issue is discussed further in the section of the report titled "Summary of Examination Results."

Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination include an investment committee and a claims adjusting committee, both of which were comprised of all directors.

IV. REINSURANCE

The company's reinsurance portfolio and strategy is described below. A list of the companies that have a significant amount of reinsurance in force at the time of the examination follows. During the examination, it was noted that although a First Surplus treaty was included in the reinsurance contract, the company chose not to cede any risks under this treaty. It was also noted that the company cedes to its sole reinsurer, under facultative reinsurance, all property risks exceeding its per risk excess of loss reinsurance coverage. This is consistent with what was observed in previous examinations. The contract contained proper insolvency provisions.

Ceding Contracts

Reinsurer:	Wisconsin Reinsurance Corporation
Effective date:	January 1, 2011, continuous
Termination provisions:	By either party, on any January 1, with 90 days' advanced written notice

The types of coverage provided under this treaty are summarized as follows:

1.	Type of contract:	Casualty Excess of Loss
	Lines reinsured:	All casualty or liability business written by the company
	Company's retention:	$10,000 in respect to each and every loss occurrence up to policy limits
	Coverage:	100% in excess of retention including loss adjusting expense, subject to policy limits of $1,000,000 for bodily injury and property damage, and $25,000 per person and $25,000 per accident for medical payments
	Reinsurance premium:	45% of gross liability premiums charged for each policy issued, subject to a minimum annual premium equal to 75% of the annual deposit premium of $127,602
2.	Type of contract:	First Surplus
	Lines reinsured:	All property business written by the company
	Company's retention:	$1,000,000 of each risk ceded pro rata. If net retention for a risk is $1,000,000 or less, the company may cede 50% pro rata. The company is also subject to a 10% per loss retention.
	Coverage:	Pro rata portion of each loss and LAE up to $800,000 above retention

	Reinsurance premium:	The pro rata portion of all premiums, fees, and assessments charged by the company corresponding to the amount of each risk ceded
	Ceding commission:	The current commission rate of 15% of the premiums ceded. Return commission shall be allowed at the same rate on all return premiums paid to the company. The company also pays a profit commission rate of 15% of the net profit.
3.	Type of contract:	First Per Risk Excess of Loss
	Lines reinsured:	All property business written by the company
	Company's retention:	$125,000 for each and every risk from one loss occurrence
	Coverage:	100% of each and every loss, including loss adjustment expense in excess of the company's net retention, $125,000, subject to a limit of $125,000
	Reinsurance premium:	Rate based on net premium written and losses incurred for immediate preceding four years. Minimum rate of 6% and maximum rate of 15% of current net premium written. The 2011 annual rate is 8.21%, subject to a minimum annual premium equal to 75% of the annual deposit premium of $107,525.
4.	Type of contract:	Second Per Risk Excess of Loss
	Lines reinsured:	All property business written by the company
	Company's retention:	$250,000 for each and every risk from one loss occurrence
	Coverage:	100% of each and every loss, including loss adjustment expense, in excess of the company's net retention, $250,000, subject to a limit of $250,000
	Reinsurance premium:	3% of net premiums written for business covered, subject to minimum annual premium equal to 75% of the annual deposit premium of $39,290
5.	Type of contract:	Third Per Risk Excess of Loss
	Lines reinsured:	All property business written by the company
	Company's retention:	$500,000 for each and every risk from one loss occurrence
	Coverage:	100% of each and every loss, including loss adjustment expense, in excess of the company's net retention, $500,000, subject to a limit of $500,000
	Reinsurance premium:	2% of net premiums written for business covered, subject to minimum annual premium equal to 75% of the annual deposit premium of $26,194

6.	Type of contract:	First Aggregate Excess of Loss
	Lines reinsured:	All business written by the company
	Company’s retention:	Losses in aggregate equal to 75% of the net premiums written for the annual period
	Coverage:	65% of aggregate net losses, including loss adjustment expenses, in the annual period that exceed the retention
	Reinsurance premium:	Rate of losses incurred divided by net premiums written for last eight years losses incurred times 125%, applied to net premiums written with a minimum rate of 6.5% and maximum of 12%. The 2011 annual rate is 10%, subject to minimum annual premium equal to 75% of the annual deposit premium of $136,564.
7.	Type of contract:	Second Aggregate Excess of Loss
	Lines reinsured:	All business written by the company
	Company's retention:	Losses in aggregate equal to 140% of the net premiums written for the annual period
	Coverage:	100% of aggregate net losses, including loss adjustment expenses, in the annual period that exceed the retention
	Reinsurance premium:	5% of net premiums written for business covered, subject to minimum annual premium equal to 75% of the annual deposit premium of $73,282

V. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported to the Commissioner of Insurance in the December 31, 2010, annual statement. Also included in this section are schedules that reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination."

Farmington Mutual Insurance Company
Assets
As of December 31, 2010

	Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	$2,388,547	$ 0	$2,388,547
Stocks:			
Preferred stocks	200,000	0	200,000
Common stocks	2,871,312	0	2,871,312
Real estate:			
Occupied by the company	5,676	0	5,676
Cash, cash equivalents, and short-term investments	726,263	0	726,263
Investment income due and accrued	25,051	0	25,051
Premiums and considerations:			
Uncollected premiums and agents' balances in course of collection	4,528	0	4,528
Deferred premiums, agents' balances, and installments booked but deferred and not yet due	427,859	0	427,859
Reinsurance:			
Amounts recoverable from reinsurers	556	0	556
Net deferred tax asset	92,617	6,799	85,818
Furniture and equipment, including health care delivery assets	539	539	0
Total Assets	$6,743,948	$7,338	$6,735,610

Farmington Mutual Insurance Company
Liabilities, Surplus, and Other Funds
As of December 31, 2010

Losses		$ 197,218
Loss adjustment expenses		14,900
Commissions payable, contingent commissions, and other similar charges		146,281
Other expenses (excluding taxes, licenses, and fees)		2,100
Taxes, licenses, and fees (excluding federal and foreign income taxes)		3,112
Current federal and foreign income taxes		59,209
Unearned premiums		1,186,643
Advance premium		7,280
Ceded reinsurance premiums payable (net of ceding commissions)		(22,905)
Total liabilities		1,593,838
Unassigned funds (surplus)	$5,141,772	
Surplus as regards policyholders		5,141,772
Total Liabilities and Surplus		$6,735,610

Farmington Mutual Insurance Company
Summary of Operations
For the Year 2010

Underwriting Income		
Premiums earned		$1,054,532
Deductions:		
Losses incurred	$515,798	
Loss adjustment expenses incurred	71,260	
Other underwriting expenses incurred	357,862	
Total underwriting deductions		944,920
Net underwriting gain (loss)		109,612
Investment Income		
Net investment income earned	90,655	
Net realized capital gains (losses)	25,726	
Net investment gain (loss)		116,381
Other Income		
Finance and service charges not included in premiums	11,272	
Total other income		11,272
Net income (loss) before federal and foreign income taxes		237,265
Federal and foreign income taxes incurred		59,288
Net Income		$ 177,977

Farmington Mutual Insurance Company
Cash Flow
For the Year 2010

Premiums collected net of reinsurance			$1,045,614
Net investment income			101,245
Miscellaneous income			11,272
Total			1,158,131
Benefit- and loss-related payments		$ 445,705	
Commissions, expenses paid, and aggregate write-ins for deductions		436,734	
Federal and foreign income taxes paid (recovered)		8,471	
Total deductions			890,910
Net cash from operations			267,221
Proceeds from investments sold, matured, or repaid:			
Bonds	$ 757,923		
Stocks	1,185,169		
Total investment proceeds		1,943,092	
Cost of investments acquired (long-term only):			
Bonds	1,008,293		
Stocks	1,304,315		
Total investments acquired		2,312,608	
Net cash from investments			(369,516)
Cash from financing and miscellaneous sources:			
Other cash provided (applied)		(161)	
Net cash from financing and miscellaneous sources			(161)
Reconciliation:			
Net change in cash, cash equivalents, and short-term investments			(102,456)
Cash, cash equivalents, and short-term investments:			
Beginning of year			828,719
End of Year			$ 726,263

Farmington Mutual Insurance Company
Compulsory and Security Surplus Calculation
December 31, 2010

Assets		$6,735,610
Less security surplus of insurance subsidiaries		0
Less liabilities		1,593,838
Adjusted surplus		5,141,772
Annual premium:		
Lines other than accident and health	$1,037,947	
Factor	20%	
Compulsory surplus (subject to a minimum of $2 million)		2,000,000
Compulsory Surplus Excess (or Deficit)		$3,141,772
Adjusted surplus (from above)		$5,141,772
Security surplus: (140% of compulsory surplus, factor reduced 1% for each $33 million in premium written in excess of $10 million, with a minimum factor of 110%)		2,800,000
Security Surplus Excess (or Deficit)		$2,341,772

Farmington Mutual Insurance Company
Reconciliation and Analysis of Surplus
For the Five-Year Period Ending December 31, 2010

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	2010	2009	2008	2007	2006
Surplus, beginning of year	$4,803,010	$4,611,419	$4,814,796	$4,930,657	$4,115,606
Net income	177,977	139,554	(55,518)	(18,244)	354,164
Change in net unrealized capital gains/losses	163,051	(38,831)	(149,750)	34,949	325,091
Change in net deferred income tax	(39,255)	131,872	0	(133,162)	133,162
Change in nonadmitted assets	36,989	(41,004)	1,891	596	2,634
Surplus, End of Year	$5,141,772	$4,803,010	$4,611,419	$4,814,796	$4,930,657

Farmington Mutual Insurance Company
Insurance Regulatory Information System
For the Five-Year Period Ending December 31, 2010

The company's NAIC Insurance Regulatory Information System (IRIS) results for the period under examination are summarized below. Unusual IRIS results are denoted with asterisks and discussed below the table.

	Ratio	2010	2009	2008	2007	2006
#1	Gross Premium to Surplus	31%	33%	37%	32%	35%
#2	Net Premium to Surplus	20	22	28	23	26
#3	Change in Net Premiums Written	-1	-19	16	-14	0
#4	Surplus Aid to Surplus	0	0	0	0	0
#5	Two-Year Overall Operating Ratio	82	93	106*	86	83
#6	Investment Yield	1.5*	1.9*	2.1*	2.5*	2.2*
#7	Gross Change in Surplus	7	4	-4	-2	20
#8	Change in Adjusted Surplus	7	4	-4	-2	20
#9	Liabilities to Liquid Assets	19	19	24	21	20
#10	Agents' Balances to Surplus	0	0	0	0	0
#11	One-Year Reserve Development to Surplus	-2	-4	-2	-2	-2
#12	Two-Year Reserve Development to Surplus	-4	-4	-4	-4	10
#13	Estimated Current Reserve Deficiency to Surplus	-5	-5	1	0	1

The Two-Year Operating Ratio (IRIS ratio #5) measures the company's profitability over the previous two-year period and was exceptional in 2008. This is primarily due to two large catastrophic storm loss events that were incurred by the company, in August 2007 (wind storm) and May 2008 (hail storm), which caused it to reach its aggregate excess of loss reinsurance coverage both years.

The Investment Yield Ratio (IRIS ratio #6) measures the amount of the company's net investment income as a percentage of the average amount of cash and invested assets and was considered exceptional in each of the years under examination. The exceptional ratios are primarily a result of low returns on its common stock portfolio. The company's investment in its reinsurer on average comprised of 49% of its stock portfolio for the five-year period under examination, but it only paid dividends totaling $8,000 in those years; therefore it was not a large contributor towards FMIC's net investment income even though it is a significant portion of the company's investment holdings. The company acquired the aforementioned common stock through the demutualization of the reinsurance company as well as through the merger with Warren Mutual in 1997. (FMIC does benefit from capital gains on the reinsurer's stock – the stock was issued in 1991 at $14.98/share; FMIC valued it at $63.42/share at year-end 2005 and $76.79 at year-end 2010.) Also contributing to the company's low investment returns from its common stock holdings were poor economic conditions in 2008, 2009 and 2010, which caused dividend declarations to decrease significantly by publicly traded companies. Net investment income from bond holdings was limited in 2008, 2009 and 2010 and was affected by the low interest rate bond market during those years, where the company sold higher interest bearing bonds and reinvested proceeds in both common stocks and bonds that had lower returns.

Growth of Farmington Mutual Insurance Company

Year	Admitted Assets	Liabilities	Surplus as Regards Policyholders	Net Income
2010	$6,735,610	$1,593,838	$5,141,772	$177,977
2009	6,303,863	1,500,853	4,803,010	139,554
2008	6,116,846	1,505,427	4,611,419	(55,518)
2007	6,366,606	1,551,810	4,814,796	(18,244)
2006	6,665,561	1,734,904	4,930,657	354,164
2005	5,847,133	1,731,527	4,115,606	191,772

Year	Gross Premium Written	Net Premium Written	Premium Earned	Loss and LAE Ratio	Expense Ratio	Combined Ratio
2010	$1,575,466	$1,037,947	$1,054,532	55.7%	33.4%	89.1%
2009	1,561,539	1,044,519	1,078,396	59.4	33.1	92.5
2008	1,707,344	1,289,883	1,353,779	77.2	31.7	108.9
2007	1,558,759	1,115,547	1,169,647	83.3	41.5	124.8
2006	1,729,976	1,291,030	1,322,822	41.1	31.5	72.6
2005	1,756,435	1,297,127	1,339,874	79.8	29.5	109.3

Surplus steadily increased during the period under examination, except for 2007 and 2008 primarily due to losses incurred from two catastrophic storm events in those years as explained in the IRIS ratios section of this report. Surplus as of December 31, 2010, is above the level recorded in 2006 and over the five-year period under examination increased approximately 4.3%, which is primarily a result of underwriting profits and investment income.

The company's gross premium written to surplus and net premium written to surplus ratios have averaged about 0.34 to 1 and 0.24 to 1, respectively, over the period under examination. Gross premiums written decreased by 10% in 2007 and 8% in 2009. The decrease in 2007 was mainly a result of increased competition in the company's territory. The decrease in gross writings in 2009 relates to: 1) the retirement of an agent, where a large number of policyholders of that agent's block of business began to cancel their policies due to not having an agent they could directly contact; and 2) a large number of properties insured by the company were foreclosed on. Gross premiums written increased in 2008 by 9% primarily due to the re-underwriting of a large number of property risks insured by the company so that they were properly insured-to-value (closer to replacement cost). This was a result of the company obtaining valuable information from claim adjusters it utilized to adjust property claims relating to the 2008 hail storm mentioned earlier. Approximately 30% of the company's policyholders submitted a claim related to the 2008 hail storm. The same explanations also apply to the changes in net premiums written during those years. The decrease in net premiums written in 2009 was also affected by increased reinsurance costs as the negative underwriting results in 2007 and 2008 caused reinsurance rates (which are partially based on the company's historical loss results) to increase.

The expense ratio stayed fairly steady during the period under examination and was considered fairly reasonable for a company of FMIC's size, except for 2007 where it increased by 10% to 41.5%. The increase relates to the company reporting fourteen months of agents' commissions instead of twelve months as it did in the past – it formerly reported commissions expense from November of the previous year to October of the current year as paid in the current year. The company acquired new policy administration software in 2007, which gave the company the capability to easily determine unpaid commissions at year-end, which they couldn't easily do before. Therefore, the company recorded the twelve months of paid agents' commissions in 2007 and accrued the two months of unpaid agents' commissions. This was a one-time event.

The company's average combined ratio (net of reinsurance) during the period under examination has been below 100%. The company reported fairly good underwriting results and net income during that period even though FMIC incurred large losses in 2007 and 2008 as noted earlier. On a gross basis the company's combined ratio has averaged 103% over that same period, which will have negative effect on the rates charged by its reinsurer as described earlier in this section of the report.

Reconciliation of Surplus per Examination

No adjustments were made to surplus as a result of the examination. The amount of surplus reported by the company as of December 31, 2010, of $5,141,772 is accepted.

Examination Reclassifications

	Debit	Credit
Cash	$480,366	
Common stocks		$480,366

VI. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

There were two specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

1. Furniture and Equipment—It is recommended that the company properly calculate depreciation on EDP equipment in accordance with SSAP #16.

   Action—Compliance.

2. Other Expenses—It is again recommended that the company properly report other expenses in accordance with the NAIC's Annual Statement Instructions-Property and Casualty on all future annual statements.

   Action—Compliance.

Summary of Current Examination Results

This section contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

Conflict of Interest

In accordance with a directive of the Commissioner of Insurance, each company is required to establish a procedure for the disclosure to its board of directors of any material interest or affiliation on the part of its officers, directors, or key employees which conflicts or is likely to conflict with the official duties of such person. A part of this procedure is the annual completion of a conflict of interest questionnaire by the appropriate persons. The company has adopted such a procedure for disclosing potential conflicts of interest. Conflict of interest questionnaires were reviewed for the period under examination, and the four directors who are also agents for the company properly disclosed that fact in their respective questionnaires.

However, one of the directors' spouses is an agent for the company, but this fact was not disclosed in that director's signed conflict of interest questionnaires. This office considers that a spouse being an agent for the company to be a potential conflict that should be disclosed in the director's annual conflict of interest questionnaire, including disclosing the spouse's commission income for the previous year (if the board of directors does not otherwise receive reports on commissions earned by agents). In situations where there is a potential conflict directors should not vote on items closely related to them (in this situation items would include, but not limited to, changing agent commission rates and establishing criteria to evaluate agents), and the director's abstention should be recorded in the board of directors' meeting minutes. Therefore, it is recommended that the company's officers, directors, or key employees annually disclose all potential conflicts with their respective duties with the company, which includes, but is not limited to, those instances where a spouse is also a representative of the company in accordance with a directive of the Commissioner of Insurance. It is further recommended that board members abstain from voting on items closely related to stated conflicts, which are to be clearly reported in the board of directors' meeting minutes.

Business Continuity Plan

A business continuity plan identifies steps to be performed in case the company loses a key employee, is not able to access its computer, information on its computer was lost, or the office building was destroyed, to name a few contingencies. The company has not established a formal written disaster recovery plan. It is recommended that the company develop a comprehensive disaster recovery plan that would clearly identify what would be done in cases where it is not able to access its computers, the office building is destroyed or if a key employee is lost.

Corporate Records

The Report on Executive Compensation filed with this office for year-end 2010 was reviewed to determine whether the report included all compensation provided employees or directors in 2010. Examiners reviewed the company’s records regarding the report. It was discovered that the company did not include contributions made to an employee's health savings account in 2010, nor did the company include compensation paid to the four directors who are also captive agents of the company for performing claim adjusting services on behalf of the company or for completing renewal applications after visiting with policyholders on the three-year anniversary of their policies. According to s. 611.63 (4), Wis. Stat., companies are to report to the Commissioner, on an annual basis, all direct and indirect remuneration for services paid or accrued each year for the benefit of each director and each officer and employee whose remuneration exceeds the amount established by the Commissioner. For FMIC, the contributions made to an employee's health savings account and compensation paid to directors for all services provided to the company should be reported. It is recommended that the company report all remuneration paid to or accrued on behalf of employees or directors (for those individuals whose remuneration meets the requirements) to be reported to the Commissioner in accordance with s. 611.63, Wis. Stat.

Underwriting

The company has a written underwriting guide that is provided to its independent agents and captive agents. The guide covers all the lines of business that the company is presently writing. Captive agents consist of the four directors that write business for the company, an individual who is a son of one of the directors, a former director, and spouses of two of the directors. Approximately 57% of the company's gross premiums written in 2010 were produced by the company's captive agents, 18% were considered company produced policies that consist of blocks of business inherited by the company from former independent agents or retired captive agents, while the remainder was produced by independent agents. Individuals that contact the company home office directly looking for insurance coverage are assigned to one of the company's agents, as determined by the manager.

Review of the company's underwriting process noted that the company does not include photographs of all new and renewed business risks in its policy files. Examiners sampled 50 underwriting files, and 70% of the sample did not have photographs in them. According to the company's underwriting guidelines photographs of an insured's property are mandatory for all new buildings insured but only for business written by independent agents. Maintaining photographs of insured property will assist management's evaluation of the condition and value of each property and in the event of a claim.

The company writes its policies for a three-year period and the policies are renewed annually subject to the rates and forms in use at that time. The company established different underwriting procedures for each class of agent, where captive agents are expected to complete a new application signed by the policyholder prior to an insured's three-year policy anniversary date, while independent agents are to submit a completed renewal questionnaire prior to an insured's three-year policy anniversary date. Company-produced policies are also subject to the completion of a new application prior to an insured's three-year anniversary date, which are assigned to a captive agent to perform based on proximity to the insured, and receive $30 for completion of farmowner's applications and $15 for homeowner's applications.

Agents are expected to underwrite and value buildings appropriately as part of earning the commission. The company does not provide its captive agents a building valuation manual or software to utilize when valuing buildings (i.e., dwellings) other than farm outbuildings. Two of the captive agents have access to software that assists in estimating replacement cost on buildings, and all of the company's independent agents have access to resources that assist them in valuing buildings, but the remaining captive agents do not have such access.

The manager is responsible to make sure that new and renewal policy applications submitted by its agents adhere to the underwriting criteria/standards described in the FMIC's written underwriting manual and that the appropriate rates filed with this office are applied. However, due to the differences in how the two classes of agents are treated by the company in terms of the underwriting process, it makes the company's task of reviewing applications more challenging.

The company does not have a formal inspection process for either new or renewal business. The company's underwriting guidelines require that all new business must be inspected by the issuing agent, but no inspection checklist or guide has been established by the company and therefore there is no documentation in company files that agents have performed this required task. It should be noted that most of the company's new business is produced by independent agents. The establishment of a formal inspection process would assist the company's management to determine whether risks submitted by its agents meet the company's underwriting guidelines, are insured to value and are rated appropriately. It is suggested that for new business the company create an inspection checklist or guide for the inspection of each class of business the company writes.

For new business it is recommended that the company adopt a procedure for the company to perform or obtain an inspection if an agent's application submission is incomplete or does not contain adequate information to base underwriting decisions on; s. 631.36 (2) (c), Wis. Stat., governs the statutory deadlines for cancelling new policies.

For renewal business it is recommended that the company promptly adopt criteria that determines the priority of which risks are to be inspected, a checklist or guide for the inspection of each class of business the company writes (homeowner's, farmowner's, mobile home, etc.), and a procedure to ensure that information from the inspection report is evaluated before the statutory deadlines for notices of nonrenewal or changes in coverage to the policyholder [pursuant to s. 631.36 (4) and (5), Wis. Stat.]. It is further recommended that the company track the inspection results, report the results to the board of directors, and use the results to plan for future inspections. It is further recommended that the company consistently follow its inspection criteria when deciding which policies to inspect or amend the inspection criteria in order to better prioritize the risks to be inspected.

Investments

The examination team reviewed the company's investment schedules and verified whether its investments were reported in accordance with NAIC Annual Statement Instructions - Property and Casualty and Statements of Statutory Accounting Principles (SSAP), which included the utilization of NAIC exception reports and review of the NAIC's SVO Purposes and Procedures Manual. The following was discovered:

- The company reported 4 bonds with a NAIC designation of 1FE (filing exempt), but had ratings from NAIC acceptable rating organizations with NAIC designation equivalents of 2FE and 3FE according to the NAIC's SVO Purposes and Procedures Manual.
- The company failed to report the CUSIP number for its stock mutual fund holding in Schedule D - Part 2 - Section 2, which is not in compliance with NAIC Annual Statement Instructions - Property and Casualty.
- The company reported the transactions relating to the acquisition of shares of 1 mutual fund and 2 bonds, and the disposal of 3 bonds on their settlement dates rather than on their trade dates in Schedule D - Parts 3 and 4. According to SSAP 26, paragraph 4, and SSAP 30, paragraph 5, the acquisition and disposal of bonds and non-affiliated common stocks (including stock mutual funds) are to be recorded on their trade date.
- The company reported cash deposited with a bank that its broker utilizes for its cash management and brokerage program as a money market mutual fund in Schedule D - Part 2 - Section 2. According to the NAIC Annual Statement Instructions - Property and Casualty cash deposits maintained in banks, trust companies, savings and loans, and building and loan associations are to be reported in Schedule E - Part 1. It is further instructed that companies report separately all deposits with an aforementioned entity in excess of $250,000 or less than -$250,000. A reclassification was made to correct this

reporting issue as documented in section V of this report, sub-section titled “Examination Reclassifications.”

It is recommended that the company report the correct NAIC designation that corresponds with equivalent ratings from NAIC acceptable rating organizations in accordance with the NAIC’s SVO Purposes and Procedures Manual. It is recommended that the company report CUSIP numbers for all investment holdings, including stock mutual funds, in accordance with NAIC Annual Statement Instructions - Property and Casualty. It is also recommended that the company record bond and non-affiliated common stock investment transactions, other than acquiring privately placed securities, on their trade dates in accordance with SSAP 26, paragraph 4, and SSAP 30, paragraph 5, respectively. It is recommended that the company report all cash deposits maintained in banks, trust companies, savings and loans, and building and loan associations in accordance with NAIC Annual Statement Instructions - Property and Casualty.

VII. CONCLUSION

The company reported admitted assets of $6.7 million, liabilities of $1.6 million, and policyholders' surplus of $5.1 million for 2010. Operations for 2010 produced net income of $178,000. Over the five-year period under examination the company's reported policyholders' surplus increased by approximately 4.3%, primarily due to the company earning consistent investment income and underwriting profits, except for 2007 and 2008 where catastrophic storm events caused the company to report large underwriting losses that partially offset positive underwriting results in the other three years. Gross premium volume decreased by 10.3% since 2005 and is primarily a result of the effects of increased competition, loss of an agent, and the state of the housing market and the economy. This also explains the 20% decrease in net premiums written over that same period. In 2009 the decrease in net premiums written was also caused by increased reinsurance costs affected by catastrophic losses incurred by the company as discussed earlier.

The examination verified the financial condition of the company as reported in its annual statement as of December 31, 2010. The examination of FMIC resulted in nine recommendations, none of which were repeated from the previous examination, one suggestion, no adjustments to surplus and one reclassification. The recommendations relate to conflict of interest disclosures, composition of the board of directors, establishing a business continuity plan, meeting filing requirements relating to executive compensation, various underwriting issues, and a number of investment reporting errors. The suggestion relates to the creation of an inspection checklist or guide that agents would utilize when writing new business. The reclassification pertains to the company reporting cash held by a banking institution as a money market mutual fund.

VIII. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 20 - <u>Conflict of Interest</u>—It is recommended that the company's officers, directors, or key employees annually disclose all potential conflicts with their respective duties with the company, which includes, but is not limited to, those instances where a spouse is also a representative of the company in accordance with a directive of the Commissioner of Insurance. It is further recommended that board members abstain from voting on items closely related to stated conflicts, which are to be clearly reported in the board of directors' meeting minutes.

2. Page 21 - <u>Business Continuity Plan</u>—It is recommended that the company develop a comprehensive disaster recovery plan that would clearly identify what would be done in cases where it is not able to access its computers, the office building is destroyed or if a key employee is lost.

3. Page 21 - <u>Corporate Records</u>—It is recommended that the company report all remuneration paid to or accrued on behalf of employees or directors (for those individuals whose remuneration meets the requirements) to be reported to the Commissioner in accordance with s. 611.63, Wis. Stat.

4. Page 23 - <u>Underwriting</u>—It is suggested that for new business the company create an inspection checklist or guide for the inspection of each class of business the company writes.

5. Page 23 - <u>Underwriting</u>—For new business it is recommended that the company adopt a procedure for the company to perform or obtain an inspection if an agent's application submission is incomplete or does not contain adequate information to base underwriting decisions on; s. 631.36 (2) (c), Wis. Stat., governs the statutory deadlines for cancelling new policies.

6. Page 23 - <u>Underwriting</u>—For renewal business it is recommended that the company promptly adopt criteria that determines the priority of which risks are to be inspected, a checklist or guide for the inspection of each class of business the company writes (homeowner's, farmowner's, mobile home, etc.), and a procedure to ensure that information from the inspection report is evaluated before the statutory deadlines for notices of nonrenewal or changes in coverage to the policyholder [pursuant to s. 631.36 (4) and (5), Wis. Stat.]. It is further recommended that the company track the inspection results, report the results to the board of directors, and use the results to plan for future inspections. It is further recommended that the company consistently follow its inspection criteria when deciding which policies to inspect or amend the inspection criteria in order to better prioritize the risks to be inspected.

7. Page 25 - <u>Investments</u>—It is recommended that the company report the correct NAIC designation that corresponds with equivalent ratings from NAIC acceptable rating organizations in accordance with the NAIC's SVO <u>Purposes and Procedures Manual</u>.

8. Page 25 - <u>Investments</u>—It is recommended that the company report CUSIP numbers for all investment holdings, including stock mutual funds, in accordance with NAIC <u>Annual Statement Instructions - Property and Casualty</u>.

9. Page 25 - Investments—It is recommended that the company record bond and non-affiliated common stock investment transactions, other than acquiring privately placed securities, on their trade dates in accordance with SSAP 26, paragraph 4, and SSAP 30, paragraph 5, respectively.

10. Page 25 - Investments—It is recommended that the company report all cash deposits maintained in banks, trust companies, savings and loans, and building and loan associations in accordance with NAIC Annual Statement Instructions - Property and Casualty.

IX. ACKNOWLEDGMENT

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Name	Title
Angelita M. Romaker	Insurance Financial Examiner
Randy F. Milquet	IT Specialist
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Respectfully submitted,

John E. Litweiler
Examiner-in-Charge