

2010 Management's Discussion and Analysis

**FARMERS UNION MUTUAL INSURANCE COMPANY**

**Great Falls, Montana**

NAIC Company Code: 28436

Supplement to the Statutory Annual Statement

For year ended December 31, 2010

Farmers Union Mutual Insurance Company  
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## Introduction

This discussion provides an assessment by management of the current financial position, results of operations, cash flow, liquidity and changes in financial position for Farmers Union Mutual Insurance Company (FUMICo). FUMICo is a mutual insurance company domiciled in the State of Montana with its home office in Great Falls, Montana. FUMICo is a multi-line carrier underwriting personal/farm and commercial property and casualty coverages in Montana. FUMICo is also authorized to conduct business in the State of Idaho however has no business written in that State. Information presented in this discussion supplements the financial statements, schedules and exhibits in the 2010 annual Statement.

While being a single state writer, FUMICo considers its geographical location to be a unique blend of exposure and risk. The square miles covered by the state of Montana is 145,587, while the square mile area for the nine states of New Jersey, New York, Pennsylvania, Massachusetts, Maryland, Delaware, Connecticut, New Hampshire and Vermont is 144,179 square miles. The tremendous geographical region of Montana allows for a variety of weather related exposures and a correspondingly large spread of risk.

## Financial Position

<u>ASSETS</u>	<u>2010</u>	<u>2009</u>
Bonds	\$28,522,575	\$31,878,174
Preferred Stocks	332,680	317,480
Common Stocks	8,950,259	6,723,288
Real Estate	1,595,756	1,588,124
Cash	(472,691)	(303,967)
Short-term Investments	3,166,408	1,350,268
Receivable for Securities	100,000	0
Premium Balances	2,361,211	3,640,459
Reinsurance Recoverable	458,639	98,584

**Financial Position (Cont.)**

<u>ASSETS</u>	<u>2010</u>	<u>2009</u>
Interest, Dividends and Real Estate Income Due and Accrued	194,908	209,202
Current Federal Income Tax Recoverable	850,581	521,744
Net Deferred Tax Asset	0	268,550
Receivables from Affiliates	239,787	302,400
Pension Asset	0	0
Total Assets	\$46,300,113	\$46,594,305
 <u>LIABILITIES</u>	 <u>2010</u>	 <u>2009</u>
Losses	\$3,559,538	\$4,255,446
Loss Adjusting Expense	3,614,002	3,305,353
Unearned Premiums	8,746,306	9,233,219
Federal Income Taxes	151,388	0
Ceded Reinsurance Premiums Payable	(271,714)	(411,847)
Funds Held by Company under Reinsurance Treaties	856,092	0
Provision for Reinsurance	32,155	11,650
Additional Minimum Pension Liability	0	0
Other Liabilities	538,071	863,636
Total Liabilities	\$17,225,838	\$17,257,457
 <u>POLICYHOLDERS SURPLUS</u>	 \$29,074,275	 \$29,336,848

<u>TOTAL LIABILITIES AND SURPLUS</u>	\$46,300,113	\$46,594,305
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We are extremely pleased with the Company's 2010 results when considering the challenges presented during the year as more fully described in this discussion. The year 2010 was the year of adversity we have been preparing for since the significant loss year of 1991. The financial result of this year reflects positively on our focus on overall enterprise risk management that has been at the core of corporate decision making since the 1991 loss of 38% of corporate surplus. In reflecting on the 2010 year, it can be said that it resembles the results of our corporate plan coming together.

The net financial position of FUMICo decreased slightly during 2010. Policyholders' surplus decreased 0.90% from \$29,336,848 at December 31, 2009 to \$29,074,275 at December 31, 2010. This is the first decrease in surplus the Company has recognized since 2002. The prior years had been marked with significant growth in policyholders' surplus. The year end 2009 policyholders' surplus had increased 21.70% from \$24,106,572 at December 31, 2008. Policyholders' surplus had increased 5.91% during 2008, 20.04% during 2007, 27.04% during 2006 and 43.19% during 2005.

## ASSETS

FUMICo's investment framework consists primarily of high quality fixed income assets comprised of certificates of deposit, money market funds, government and government agency obligations, preferred securities, corporate bonds, municipal bonds and affiliate common stock. Total assets at year end 2010 decreased by \$294,192 or 0.63% to \$46,300,113. This followed a 2009 increase of \$1,007,365 bringing year end 2009 to \$46,594,305 from \$45,586,940 at year end 2008. Cash and invested assets increased \$641,622 or 1.54% over 2009. At year end 2009 cash and invested assets reflected an increase of \$3,430,991 or 9.0% over 2008 which followed an increase of \$894,859 or 2.40% over 2007. This string of annual growth in cash and invested assets is due to the increased funds available for investment as a result of positive cash flow and increased investment income.

Investments in bonds decreased by \$3,355,599 primarily as a result of principal payoffs on our book of Government National Mortgage Association Real Estate Mortgage Investment Conduits (Ginnie Mae Remics). The Company also received numerous bond calls throughout 2010 on its Corporate Bond and Certificate of Deposit holdings. Investments in preferred stock increased by \$15,200 due to the positive change in the financial market over

year-end 2009. Common stock investments increased by \$2,226,971 as a result of the financial market change and increased mutual fund holdings.

Real estate owned by the Company increased by a net of \$7,632 during 2010 due to \$116,717 expended for capital improvements and depreciation expense of \$109,085. Farmers Union Mutual Insurance Company does not purchase real estate for investment purposes and current investments in real estate are limited to property occupied by the Company. The Company and its subsidiary Montana Farmers Union Insurance Agency, Inc. occupy approximately 50% of the total home office building space with the remaining 50% being tenant occupied.

## LIABILITIES

Loss and loss expense reserves are stated at the Company's estimate of the ultimate cost, net of ceded reinsurance, of settling all incurred but unpaid claims. Loss and loss expense reserves are not discounted. Salvage and subrogation recoveries are not anticipated when setting loss reserves. Reserve levels have been reviewed internally, as well as by an independent actuarial firm and have been determined to make a reasonable provision for unpaid loss and loss expenses. Activity with respect to net loss and loss expense reserves for the years 2010 and 2009 are displayed below:

<u>(Amounts in 000)</u>	<u>2010</u>	<u>2009</u>
Unpaid losses and LAE at beginning of year	\$7,561	\$8,134
Losses and LAE incurred in current year:		
For current year losses and LAE (Schedule P – Part 1)	\$11,632	\$8,067
For prior year losses and LAE	392	233
Income Statement Amounts	\$12,024	\$8,300
Losses and LAE paid in current year:		
For current year losses and LAE (Schedule P – Part 1)	\$8,997	\$4,731
For prior year losses and LAE	3,414	4,102
Underwriting Exhibits Paid Amounts	\$12,411	\$8,873
Unpaid losses and LAE at end of year	\$7,174	\$7,561

FUMICo historically has not experienced any significant adverse development of loss and loss expense reserves estimates.

Loss adjusting expense reserves were increased by \$308,649 during 2010. This follows a decrease to LAE reserves of \$444,793 during 2009. The increase is attributed to a rise in reserves for defense and cost containment expenses for small contractor claims in the Commercial Multiple Peril line of business.

Unearned premium reserves decreased by 5.27% from \$9,233,219 at year end 2009 to \$8,746,306 at year end 2010, compared to a 12.72% decrease in 2009 and a 5.25% decrease in 2008. Net premiums written during the year decreased by 5.25% from \$16,346,605 at year end 2009 to \$14,636,236 at year end 2010.

Under statutory accounting, premiums are booked as written and 100% unearned at the inception of the policy. The Company utilizes the monthly pro-rata method of calculating unearned premium. This method assumes that, on the average, the same amount of business is written each day of any month so that the mean will be the middle of the month.

FUMICo's reinsurance program has been consistent over the past few years. Schedule F – Part 8 reflects a net amount recoverable from reinsurers of \$6,584,720 that has been reduced by a statutory provision for reinsurance of \$32,155. The statutory provision for reinsurance is only \$32,155 (.11% of policyholder's surplus) because FUMICo cedes 93.5% of its total ceded premium (Schedule F, Part 3) to authorized reinsurers.

The Company does not have a minimum pension liability recorded for the years 2009 or 2010. The full pension asset of \$1,804,317 was recorded as non-admitted in 2010.

### CAPITAL AND SURPLUS ACCOUNTS

Policyholders' surplus decreased \$262,573 (0.90%) due to a net loss of \$(895,567) and a net positive change in the surplus accounts of \$632,994 compared to a 21.70% surplus increase in 2009. The components of these changes were as follows:

<u>Capital and Surplus Accounts</u>	<u>2010</u>	<u>2009</u>
Surplus as Regards Policyholders (Previous year)	\$29,336,848	\$24,106,572

### Gains and (Losses) in Surplus

Net income	(895,567)	3,291,647
Net unrealized capital gains (losses)	1,156,652	1,297,964
Change in deferred income tax	(419,938)	(1,202,807)
Change in nonadmitted assets	(83,214)	(61,463)
Change in provision for reinsurance	(20,505)	12,191
Pension asset (liability) adjustment	0	1,892,744
Change in surplus for the year	(262,573)	5,230,276
Surplus as regards policyholders (Current year)	\$29,074,275	\$29,336,848

Unrealized valuation increases from un-affiliated common and preferred stock of \$668,081 and \$15,200 respectively, were recorded during the year. An unrealized valuation increase of \$442,017 was recorded on affiliated common stock. An unrealized valuation increase of \$31,354 was recorded for bonds. In total, \$1,156,652 was recorded for unrealized valuation increases from investments for 2010.

In conformity with the NAIC model regulation and formula adopted by the Montana Insurance Department, the Company calculated its Risk-Based Capital (RBC) requirement as of year-end. The results as of year-end are as follows:

<u>Risk-Based Capital</u>	<u>2010</u>	<u>2009</u>
Total adjusted capital (TAC)	29,074,275	29,336,848
Authorized control level risk-based capital	2,001,607	1,783,103

The authorized control level RBC is equal to 50% of the RBC requirement. The Company's TAC of \$29,074,275, compared with its RBC requirement of \$4,003,214 is well above the required minimum and is in line with industry results.

### Results of Operations

<u>Income Statement</u>	<u>2010</u>	<u>2009</u>
Premiums Earned	\$15,123,149	\$17,692,304
Losses & LAE Incurred	12,023,643	8,300,448
Underwriting Expenses	5,972,823	6,581,471

Underwriting Gain (Loss)	(2,873,317)	2,810,386
Net Investment/Other Gain (Loss)	1,679,224	1,575,553
Income before Taxes	(1,194,092)	4,385,939
Federal Income Taxes	(298,525)	1,094,292
Net Income	(\$895,567)	\$3,291,647
Loss Ratio	63.1%	38.2%
Loss Adjustment Expense Ratio	16.4%	8.7%
Underwriting Expense Ratio	39.5%	37.2%
Combined Ratio	119.0%	84.1%

### Catastrophe Losses

During 2010, FUMICo endured catastrophic wind/hail storm losses of the most severity since 1991. The Company has recorded through December 31<sup>st</sup> \$10,571,050 and \$4,195,961 of 2010 storm related losses direct and net, respectively. The storm in 1991 had a direct occurrence loss of \$5,300,000 which equates to today's dollars of \$15,500,000. Even with the severity of the 2010 storms, the financial impact to the Company was minimal. Policyholder surplus decreased \$262,573; less than 1% from 2009 to 2010. In addition to the numerous educational, underwriting, inspection and pricing initiatives of the past number of years, this minimal decrease in surplus is largely due to the reinsurance program the company has in place as well as the investment income that is generated from the Company's investment portfolio. Below is a table summarizing the Company's catastrophe losses and the effect of reinsurance for the years 2000 through 2010:

Date of Loss	Total Direct Incurred Losses	Reinsurance Loss (at 95%)	Total Net Incurred Losses
7/2-4/2000	\$297,856	\$0	\$297,856
7/8-10/2000	437,324	0	437,324
6/26-28/2001	454,573	0	454,573
6/29-7/01/2001	1,315,103	299,348	1,015,755
2002	None		
6/19-21/2003	1,348,696	331,261	1,017,435

2004	None		
2005	None		
8/16-18/2006	540,577	0	540,577
5/13-15/2007	489,905	0	489,905
6/15-17/2007	3,752,804	2,852,664	900,140
7/22-24/2008	1,323,305	544,640	778,665
2009	None		
5/2-4/2010	504,116	0	504,116
6/15-17/2010	2,823,851	1,732,659	1,091,193
6/19-21/2010*	1,356,314	0	1,356,314
6/29-7/1/2010	5,886,769	4,642,431	1,244,338

\* No recovery on this loss as coverage of first layer was exhausted.

## Premium

Tables reflecting the change in premium written, both direct and net, and the change in policyholder surplus for the years 1995 through 2010 is as follows:

Year	Direct Written Premium	% Increase / (Decrease)	Surplus	% Increase / (Decrease)
1995	12,228,357	0.54%	4,993,493	13.84%
1996	12,632,449	3.30%	6,003,735	20.23%
1997	12,460,354	-1.36%	6,526,284	8.70%
1998	12,218,868	-1.94%	7,002,397	7.30%
1999	11,977,582	-1.97%	6,249,657	-10.75%
2000	12,638,801	5.52%	6,344,762	1.52%
2001	13,808,735	9.26%	6,235,257	-1.73%
2002	16,575,546	20.04%	5,640,554	-9.54%
2003	20,367,135	22.87%	7,748,842	37.38%
2004	21,744,398	6.76%	10,393,437	34.13%
2005	22,359,801	2.83%	14,882,157	43.19%
2006	23,099,936	3.31%	18,906,042	27.04%
2007	22,771,591	-1.42%	22,762,026	20.40%
2008	21,998,717	-3.39%	24,106,572	5.91%
2009	18,035,474	-18.02%	29,336,848	21.70%
2010	16,804,529	-6.83%	29,074,275	-0.90%

Year	Net Written Premium	% Increase/ (Decrease)
1995	5,236,951	44.52%
1996	6,180,358	18.01%
1997	6,601,432	6.81%
1998	6,531,935	-1.05%
1999	6,350,867	-2.77%
2000	7,099,715	11.79%
2001	8,094,212	14.01%
2002	13,848,394	71.09%
2003	16,914,901	22.14%
2004	18,096,962	6.99%
2005	18,754,005	3.63%
2006	19,348,126	3.17%
2007	18,812,002	-2.77%
2008	18,403,656	-2.17%
2009	16,346,605	-11.18%
2010	14,636,236	-10.46%

During 2010, the Company experienced a decrease in written premium. The 6.83% decrease in 2010 and the 18.02% and 3.39% decrease FUMICO experienced in 2009 and 2008, respectively, all resemble the insurance arena industry wide as we continued to be in a soft property/casualty insurance market throughout 2010. However, the largest contributor to the Company's decrease in written premium during 2009 was the decision FUMICO made to exit the Commercial Auto line of business effective January 1, 2009. A full discussion of this decision is on page 11. Other than a modest increase to our Umbrella rates in 2010, the Company has not filed for a rate increase since 2008; which was to our Small Contractors Commercial line of business. The increase in premiums during 2002 through 2006 is due primarily to rate increases taken during those years, increased market share and the implementation of our "Insurance-to-Value" program. By design, rate increases had a lesser impact during 2005 and 2006. The variation in net written premium in 1995 and 1996 and 2000, 2001 and 2002 is due to the various retention levels on the Quota Share Reinsurance Treaty during those years and the ultimate running off of the program during the 2002 year.

The change in policyholder count from 2002 through December 31, 2010 is as follows:

LINE OF BUSINESS	2010	2009	2008	2007	2006	2005	2004	2003	2002
HOMEOWNERS	6,527	6,889	7,668	8,263	8,485	8,698	9,009	9,048	8,525
MOBILE HO	0	0	0	0	0	0	27	586	637
DWELLING	898	967	1,108	1,192	1,213	1,281	1,293	1,298	1,231
FARM & RANCH	2,824	2,915	3,181	3,361	3,452	3,542	3,697	3,751	3,743

FARM LIABILITY	2,564	2,634	2,855	3,001	3,107	3,164	3,326	3,361	3,348
COMMERCIAL FIRE	114	137	152	165	175	188	189	191	183
COMMERCIAL PKG	1,695	1,847	2,178	2,427	2,498	2,294	2,164	2,112	1,757
BUSINESSOWNERS	1,073	1,125	1,238	1,294	1,301	1,272	1,314	1,331	1,330
COMM IN MARINE	69	82	96	100	109	116	131	129	118
GENERAL LIABILITY	245	250	248	246	231	228	221	205	192
COMMERCIAL UMB	73	82	84	85	73	61	58	62	60
PERSONAL UMB	161	149	153	136	123	118	117	118	109
FARM UMB	237	230	263	265	261	235	237	222	198
COMMERCIAL AUTO	0	49	377	486	573	579	638	697	700
GARAGEOWNERS	30	34	41	48	51	54	54	58	57
Total	16,510	17,390	19,642	21,069	21,652	21,830	22,475	23,169	22,188
CHG FROM PRIOR YR	(880)	(2,252)	(1,427)	(583)	(178)	(645)	(694)	981	1,459
% CHANGE	-5.06%	-11.47%	-6.77%	-2.69%	-0.82%	-2.87%	-3.00%	4.09%	7.04%

Despite the soft market the insurance industry has been experiencing, the renewal offer/acceptance by our insureds has continued to remain in the mid ninetieth percentile. Our renewal offer/acceptance rate was 95.52% in 2010, 94.19% in 2009, 94.96% in 2008, 96.35% in 2007 and 95.86% in 2006. The overall Company retention has also remained consistent. In 2010 our retention was 88.49%, 82.97% in 2009 87.07% in 2008, 88.92% in 2007 and 89.15% in 2006.

Average premium per policy has increased 5.33% between 2004 and 2010. A chart detailing average premium per policy by year for this seven year period, by line of business, follows:

<u>Line of Business</u>	<u>2010</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Businessowners	2,019	1,996	2,057	1,994	1,916	1,805	1,813
Commercial Multi Peril	2,106	2,173	2,264	1,956	1,878	1,838	1,747
Commercial Fire	1,446	1,339	1,480	1,327	1,436	1,307	1,194
Inland Marine	203	431	200	468	413	419	421
Commercial Auto	0	2,822	3,843	4,019	4,076	4,085	4,239
Garageowners	1,560	1,520	1,450	1,317	1,392	1,284	1,251
General Liability	423	443	455	496	557	555	560
Commercial Umbrella	1,430	1,409	1,249	1,119	1,095	1,084	1,148
Farm & Ranch	1,485	1,464	1,470	1,425	1,380	1,367	1,265
Homeowners	803	808	797	765	746	727	671
Dwelling	478	459	474	443	428	402	366
Farm Liability	287	336	455	352	350	347	339
Farm Umbrella	689	653	681	684	679	700	689
Personal Umbrella	267	261	263	261	258	242	244
Average	1,028	1,049	1,119	1,080	1,063	1,026	976

For reasons outlined below, in our corporate analysis assessing enterprise risk management, we identified the financial exposure with our commercial

automobile program as exceeding our appetite for risk. This resulted in the following action:

Farmers Union Mutual Insurance Company made the decision to exit the Commercial Automobile line of business during 2009. Our decision was based solely on prior rulings made by the Montana Supreme Court in regard to the permitted stacking of UM/UIM policy limits. Montana Supreme Court case rulings have allowed for the policy limits from multiple vehicles covered under one commercial policy to be aggregated (stacked) and applied to the incident of a single vehicle in the covered fleet. In spite of Montana legislative attempts to eliminate the stacking of policy limits, in our judgment, the Montana Supreme Court lacks predictability as to where they will come down on this issue in the future. This uncertainty results in this action.

To offset for the reduction in written premium due to the expiring Commercial Auto program, Farmers Union Mutual Insurance Company has entered into a Quota Share Reinsurance Contract with National Farmers Union Property and Casualty Company, a member of the QBE insurance family, effective January 1, 2009.

National Farmers Union Property and Casualty Company shall cede, and Farmers Union Mutual Insurance Company shall accept as reinsurance premium, a 10.00% share of all subject Private Passenger and Commercial Auto business written with National Farmers Union. This Contract shall apply to policies issued to insureds located within the territorial limits of the State of Montana only. FUMICo shall pay to National Farmers Union FUMICo's quota share of losses under the policies and loss adjustment expenses covered under the contract, subject to a maximum casualty business recovery, exclusive of loss adjustment expenses, of \$101,000 per policy as respects any one occurrence. This represents a significant reduction in our corporate financial exposure from the automobile line of business.

Farmers Union Mutual Insurance Company shall allow National Farmers Union a 35% commission on all premiums ceded to FUMICo. National Farmers Union shall allow FUMICo a return commission on return premiums at the same rate.

Within 90 days following the end of each Contract Year, and annually thereafter until all losses occurring during the Contract Year are settled, a contingent commission calculation shall be prepared by National Farmers Union and a contingent commission, if any, shall be paid to National Farmers Union by FUMICo.

The business subject to the Quota Share Reinsurance Contract is business that FUMICo is completely familiar with. All of the National Farmers Union automobile business currently written in Montana is written by Montana Farmers Union Insurance Agency, Inc (MFUIAI). The exclusive MFUIAI agent force also writes 100% of the FUMICo business. As discussed in other areas of this MD&A, Montana Farmers Union Insurance Agency, Inc., is a totally owned subsidiary of FUMICo.

### Reinsurance Programs

The reinsurance program the Company currently has in place has been greatly simplified. For a number of years, prior to 2004, the Company held reinsurance treaties providing General Excess of Loss Reinsurance, Casualty Second Excess of Loss Reinsurance, several layers of Aggregate Excess of Loss Reinsurance and Excess Catastrophe Reinsurance. Beginning in 2004, in addition to our regular working layers, various layers of catastrophe reinsurance were purchased as well as limited aggregate excess of loss coverage. This change came about after a thorough analysis of premiums and losses. It was then determined that the move to additional occurrence protection would benefit the Company more than the multiple layers of aggregate protection the Company had in years prior. An additional consideration at the time was that the reinsurance market had changed so that aggregate coverage became less affordable and less available.

The reinsurance program in place for the 2010 year is similar in structure to the program in place during the 2009 and 2008 years. Effective January 1, 2010, the Company increased its retention on a per risk basis from \$180,000 to \$200,000. The limit for property coverage under our General Excess of Loss contract is now \$1,300,000 excess of \$200,000. This limit provides the Company blanket coverage for property values up to \$1,500,000 prior to using our facultative reinsurance. The Company also increased its retention for 2010 from \$750,000 to \$1,000,000 for Property Catastrophe Excess of Loss Reinsurance. Our catastrophe recovery limit for 2010 is 95% of \$19,000,000 excess of \$1,000,000. FUMICo's assumed automobile physical damage (comprehensive only) under the Quota Share Reinsurance contract with National Farmers Union is covered hereunder. Our 2010 Aggregate Excess of Loss Reinsurance remains the same as in 2009. We should note that FUMICo's assumed automobile physical damage (comprehensive only) under the Quota Share Reinsurance contract with National Farmers Union is also covered hereunder. A summary of both the 2010 and 2009 reinsurance programs and the various reinsurers on our program during those years is attached to this discussion and analysis.

Additional reinsurance contracts are in place between the Company and General Reinsurance Corporation. These agreements apply to our umbrella lines of business and excess limits of property and casualty exposure. The Company's umbrella exposure is 15% of the first \$1,000,000 of limits of liability, to a maximum of \$150,000. All umbrella exposure in excess of \$1,000,000 is ceded 100%. The Company cedes 100% of the excess limits of property and casualty exposure.

A clash cover is in place applicable to property and casualty (including umbrella) and quota share assumed that eliminates the possibility of more than one retention from a single loss.

The Company has had a 100% Quota Share Reinsurance Treaty with Factory Mutual Insurance Company automatically covering Boiler and Machinery Insurance on its Businessowners policies in place since 2001. During 2010, FUMICo made this extended coverage available as a voluntary option under its Homeowners and Farmowners lines of business. Traditionally, property policies have excluded the three perils covered under Boiler & Machinery policies. Those three perils are mechanical breakdown, electrical breakdown and pressure equipment breakdown. Under the treaty, Factory Mutual assumes 100% of the liability for all claims and loss adjustment expense arising out of coverage provided under Boiler and Machinery endorsements issued on Businessowners, Homeowners and Farm and Ranch policies.

For purposes of assessing exposure and catastrophic reinsurance coverage, Guy Carpenter & Co., Inc. of Pennsylvania regularly conducts a thorough catastrophe analysis for our Company. Another analysis was undertaken during the 2010 year. Company data as of August 31, 2010 was utilized along with updated industry data to conduct the catastrophe analysis. Guy Carpenter & Co., Inc. utilizes a software program (AIR CLASIC/2 Version 12.0) that models loss potential from the effects of atmospheric perils other than hurricane. The program analyzed the Company's property exposure portfolio against a series of probabilistic events involving loss due to severe thunderstorms (tornado and/or hail). The Company will continue to update and conduct catastrophe analyses on a regular basis as part of our catastrophe management strategy. A copy of the Catastrophe Analysis completed in December 2010, as described above, is attached to this report. Previously submitted along with earlier Management's Discussion and Analysis documents were the catastrophe analysis reports completed in those years.

## Summary of Pricing/Underwriting Actions

During 2010, FUMICo made numerous changes in pricing, policy forms and coverage enhancements. The changes made to each line of business and the corresponding impact to premium is as follows:

### HOMEOWNERS

#### Effective January 1, 2010:

The Company introduced a new Home/Auto package discount of 5% that applies to the Homeowner premium if the insured also has an auto insured through National Farmers Union Property and Casualty Company. Estimated premium decrease: (\$167,000)

FUMICo enhanced policy coverage by adding the Personal Injury endorsement to all policies – no premium charge for this new endorsement. Estimated change in premium: (\$5,700)

#### Effective July 1, 2010:

The Company introduced a new Equipment Breakdown Enhancement Endorsement. Premium charge for this endorsement is \$19.

FUMICo added another new discount titled the New Business Policyholder Credit. This new credit is 10%. To be eligible for this discount, the new policyholder must have been continuously insured with the prior carrier for the last five years or only two years if the policyholder was a client of the agent.

#### Effective August 1, 2010:

FUMICo revised the existing New Home Discount factors by increasing the discount percentages and spreading the discount over a greater number of years. The old program provided discounts over 7 years; the new program provides discounts over 9 years. Estimated premium decrease: (\$71,300)

Summary of estimated Homeowners premium changes: (\$244,000)

### FARM LIABILITY

#### Effective January 1, 2010:

The Company introduced all new policy forms and made premium adjustments (decreases) where needed. Estimated premium decrease: (\$154,735)

### **FARM AND RANCH**

Effective date: January 1, 2010:

The Company introduced a new Home/Auto package discount of 5% that applies to qualified farm dwelling premium if the insured also has an auto insured through National Farmers Union Property and Casualty Company. Estimated premium decrease: (\$92,000)

Effective date: July 1, 2010:

FUMICo introduced a new Equipment Breakdown Enhancement Endorsement. Premium charge ranges from \$30 to \$175 based upon the applicable policy premium.

The Company added another new discount titled the New Business Policyholder Credit. This new credit of 10% is applicable only to farm dwelling premium. To be eligible for this discount, the new policyholder must have been continuously insured with the prior carrier for the last five years or only two years if the policyholder was a client of the agent.

Effective August 1, 2010:

FUMICo revised the existing New Home Discount factors by increasing the discount percentages and spreading the discount over a greater number of years. The old program provided discounts over 7 years; the new program provides discounts over 9 years. Estimated decrease in premium: (\$23,200)

The Company introduced a new endorsement titled Ingestion of Foreign Objects in Farm Implements and Farm Machinery. This endorsement replaces the old endorsement and offers coverage options of \$5,000, \$10,000, \$20,000 and \$30,000. The old form only provided a limit of \$5,000.

Summary of estimated Farm and Ranch premium changes: (\$115,200)

## **PERSONAL UMBRELLA**

Effective date: January 1, 2010:

The Company introduced all new policy forms.

Effective date: June 1, 2010:

FUMICo introduced new declaration pages and a rate increase of 5% on base premium and on autos and recreational vehicles. Estimated premium increase: \$1,800

## **FARM UMBRELLA**

Effective date: January 1, 2010:

The Company introduced all new policy forms.

Effective date: June 1, 2010:

FUMICo introduced new declaration pages and a rate increase of 5% on base premium and on trucks and semi-tractor/trailers. Estimated premium increase: \$7,100

## **COMMERCIAL UMBRELLA**

Effective date: September 1, 2010:

The Company introduced all new policy forms. The new Umbrella forms replaced the Commercial Excess Liability form.

## **TOTAL ESTIMATED PREMIUM CHANGE: (\$505,035)**

For purposes of the reader gaining a historical perspective of a variety of recent years undertakings, following are several items beyond the underwriting and pricing actions taken that were discussed and elaborated upon in earlier MD&A's.

Mountain Commercial Specialists continues to perform audits on our Small Contractors book of business. Special attention is being directed toward information regarding confirmation of employees, subcontractors and the type

of work the contractor is performing. This is a valuable tool for the re-underwriting and renewal process.

Originally developed in 2005, the Company's Insurance-to-Value program continued to be a strong underwriting focus during 2010. The objective of this program is to ensure property coverage is reflective of property value or replacement cost. We continue with our five year re-writes of Homeowners, Dwelling and Farm and Ranch policies where agents are required to complete an updated replacement cost estimator for the dwellings. Values are continuing to trend higher but at a much lower percentage than at the introduction of the program. Emphasis is also being placed on having the agents get an adequate limit of coverage on farm outbuildings and on farm machinery. For outbuildings, agents are focusing on the appropriate coverage limit for the condition of the property and the type of construction. For farm machinery under blanket coverage, the amount of coverage cannot be less than 80% of the estimated total value of all machinery owned by the insured. For Businessowners policies, coverage limits were automatically increased 10% in 2006 and 2007 unless reviewed by an underwriter and adjusted manually. Coverage on Commercial Package policies are being reviewed on an individual, case by case basis and coverage increased as needed. With the utilization of pricing debits and credits, significant attention can be directed on an individual risk basis. Any significant additional premiums anticipated as a result of this program was mitigated by insured selection of higher levels of deductible to help contain costs.

FUMICo originally introduced its IRPM (Individual Risk Premium Modification) rating program June 1, 2006. In response to current market conditions for the Farm and Ranch line of business, we have taken a serious look at our portfolio and made an enhancement to this program. The original IRPM program allowed up to a 15% debit/credit on new business only. Effective in 2009, we expanded the Farm and Ranch IRPM program to also apply to existing business at renewal date. The IRPM for Commercial Lines of business currently allows and will continue to allow up to a 40% debit/credit on new and existing business at renewal date based on the merit/quality of the risk. All IRPM debits/credits are reviewed annually.

As increased incentive for our agent force to solicit new business, FUMICo adopted the following commission schedule for the period of March 1 – December 31, 2009: For all new business written with an effective date of March 1 – December 31, 2009, the commission rate was increased from 12% to 17%, an increase of 5 percentage points for the first policy term only. The new commission rate will be applicable to all Farm Lines (Farm Liability, Farm

& Ranch and Farm Umbrella), and Commercial Lines (mono – line General Liability, BOP, CPP and Excess).

During 2007, the Company added an Asbestos Exclusion and an Expected or Intended Injury Exclusion to our Homeowners, Businessowners, Garage and Commercial General Liability Coverage Forms. In addition, we revised the wording of our Watercraft Endorsement that can be added to Homeowner policies.

In the Personal/Farm Lines of business an intensive review of the historical loss ratios by individual agent was undertaken. Following this review, and effective April 15, 2006, a number of rating and territory changes were made. The majority of changes were in the western part of the state. This was undertaken within the Homeowners line of business and carried over to the Farm & Ranch dwelling program that mirrors the Homeowners program. This Company writes a stand alone property only Farm & Ranch policy, and a stand alone Farm Liability policy. Our rating model for the Farm & Ranch policy has been 85% of whatever the Homeowner rate would be. This 15% is to recognize the absence of the liability coverage. Effective June 1, 2006, this factor of 15% was increased to 20% for all rating territories.

As an enhancement to our Homeowner and Farm and Ranch programs, effective April 1, 2006 an identity theft remediation benefit is being provided these policyholders. This benefit is being provided, outside the insuring agreement, under an agreement entered into with the firm, Identity Theft 911.

In 1999 the Company implemented and developed an Inspection/Risk Engineering Program. Initially, all new personal lines property applications were physically inspected by locally contracted home warranty real estate inspectors. The program has developed to include review of renewal books of business of particular agents and/or locations as well as reviews of commercial property risks. This program has been additionally refined to include an evaluation of liability exposures of all inspected risks. The on-site inspectors transmit via e-mail photographs of each risk and written documentation to underwriters regarding quality of roofs, appropriateness of coverage forms, other structures on site, and various miscellaneous concerns including swimming pools, prior hail damage, woodstoves, tenancy and general quality of risk. In 2004 an additional full-time employee was hired to conduct inspections. During the 2010 year, 1,456 inspections were conducted with 524 or 36% of those inspections resulting in some type of underwriting action. These results are typical of what we have experienced since the 1999 implementation of the program. During 2005 and 2006 the inspection program

was expanded to include the inspection of farm outbuildings that are insured for Basic or Broad perils. In addition, in an attempt to eliminate or lessen exposure to claims due to the peril of slip-and-fall, at all insured motels, individual sleeping rooms are being inspected for the existence of non-slip strips or rough surfaces in all bath and shower areas. New to the program during 2008 was an effort to have interior inspections done on homes built prior to 1950 and interior inspections done for any home with a wood burning stove. Emphasis on this Inspection/Risk Engineering program will continue during 2011 as will the ongoing fine tuning of the program.

Beginning January 1, 2003, the Company began adding two new endorsements to all Homeowners, Farm & Ranch and Mobile Homeowners (which we no longer write) policies. The first endorsement is Accidental Discharge or Overflow of Water or Steam. The purpose of this endorsement was to add an exclusion to the policy for loss caused from "continuous or repeated seepage or leakage of water or steam". As has occurred within the industry, we have experienced an increase in the number of losses caused by accidental discharge and/or water damage. Adding exclusionary language for continuous or repeated seepage or leakage will assist in reducing claims that should have been prevented with on-going maintenance or repair. We continue to monitor loss costs associated with this peril and have experienced an improvement in both frequency and severity.

The second endorsement added to all Homeowners and Farm & Ranch policies adds a limit to Coverage B – Household Personal Property of \$300 for theft of compact discs, tapes, records and other media. We have determined it necessary to limit the amount of recovery due to the advancements in technology in recent years which have allowed the copying of various types of media with no original purchase or cost. This action has also yielded positive results.

During 2003, the Windstorm and Hail deductible increased from \$500 to \$1,000 on all property policies, both personal and commercial lines. Effective January 1, 2003, all new business, whether personal or commercial lines, was written with a \$1,000 Windstorm and Hail deductible. No additional changes have been implemented since 2003. With the catastrophic storms FUMICO has experienced the past several years, the financial impact of adopting this program of a split deductible was considerable.

The Company discontinued writing Mobilehomeowners policies beginning in February 2004. This decision was made due to superior products being available in the market place for the buying public, our lack of underwriting and

pricing expertise for the mobilehome exposure and the costs associated with maintaining this line of business for minimum premium volume and policy count. Policies were non-renewed but included a renewal option provided through a specialty company contracted through our subsidiary company, Montana Farmers Union Insurance Agency, Inc. This project was completed in early February 2005.

Our focus during the year 2010 and to be carried on into 2011 is directed toward the continued effort of "fine tuning". This will be an in depth analysis, evaluation and fine tuning of the actions taken and programs implemented over the recent past, designed to assist in achieving net underwriting profits.

### Company Ratios

Over the course of the past four years, control of our loss and loss adjustment expense ratio has out performed industry averages for companies writing similar lines of business. During 2010, the Company was impacted by two catastrophe storm losses which attributes to the increased Loss/LAE ratio. The combined loss and loss adjustment expense ratios for this five year period are indicated below.

2006	46.0%
2007	50.5%
2008	50.9%
2009	46.9%
2010	79.5%

As in 2009, the underwriting expense ratio for the 2010 year was impacted as a result of the Company taking advantage of the additional defined benefit pension plan funding opportunity created through the passage of the Pension Protection Act of 2006. The passage of this Act created a tax remediation opportunity in addition to the opportunity to financially strengthen the Plan. An additional expense impacting the ratio for 2009 and 2010 is the commission on the Quota Share Reinsurance Contract with National Farmers Union. The underwriting expense ratio for 2010 (39.5%) increased by 2.30% from the 2009 ratio of 37.2%. The most recent five year underwriting expense ratios are indicated below.

2006	35.1%
2007	34.6%
2008	33.0%
2009	37.2%

2010 39.5%

The ratio of Direct Written Premium to Surplus and the ratio of Net Written Premium to Surplus for the five year period 2006 to 2010 are reflected below.

<u>Year</u>	<u>DWP/Surplus</u>	<u>NWP/Surplus</u>
2006	1.22	1.02
2007	1.00	0.83
2008	0.91	0.76
2009	0.67	0.56
2010	0.58	0.50

### Investment Income

During 2010, investment income remained reflective of FUMICo's conservative investment strategy despite marginal financial market conditions. Below is a table reflecting our rate of return on invested assets over the last five years.

2006	4.73%
2007	4.84%
2008	4.36%
2009	4.43%
2010	3.69%

On January 1, 2004, Farmers Union Mutual Insurance Company acquired the issued and outstanding 403 shares of common stock of Montana Farmers Union Insurance Agency, Inc., from the Farmers Educational and Cooperative Union of America, Montana Division. Montana Farmers Union Insurance Agency, Inc. is a general agency with approximately 50 exclusive agents under agent contract to market products made available to them by Montana Farmers Union Insurance Agency, Inc. Approximately one-third of the total business written by these agents and placed through Montana Farmers Union Insurance Agency, Inc., is that of Farmers Union Mutual Insurance Company. During 2009, the Board of Directors of Montana Farmers Union Insurance Agency, Inc. declared and made payment of a dividend in the amount of \$150 per share. The financial result of this action during 2010 was the payment of a dividend in the amount of \$60,450 to Farmers Union Mutual Insurance Company. Montana Farmers Union Insurance Agency, Inc., is valued using the GAAP Equity Method (adjusted to statutory) and is carried as an admitted asset to the Company's common stock portfolio.

Our federal income tax liability for the recent four year period totals \$3,300,230. Federal income tax liability incurred for those periods, by year, are as follows: 2007 - \$1,451,035; 2008 - \$1,053,428; 2009 - \$1,094,292; and 2010 – (\$298,525). The significant tax liability in the years 2007 through 2009 is in direct relationship to the improved underwriting results, investment income and overall results from operations during these years. For 2010, the tax recovery is a result of the underwriting loss (significantly mitigated by investment income) incurred from the current year catastrophe losses. The level of income taxes paid and our optimism for future favorable results from operations has influenced our investment strategy. This deviation and refinement in our investment strategy is reflected by the acquisition of a diverse portfolio of municipal bonds. This strategy has provided us the opportunity to acquire a significant number of tax-free investments on which the real rate of return is greater than the after tax real rate of return on comparable available taxable fixed income securities and at the same time further diversify our investment portfolio.

### Cash Flow and Liquidity

The following table summarizes cash flow.

	<u>2010</u>	<u>2009</u>
Cash from Underwriting	(\$3,109,253)	\$1,837,727
Investment Income Received	1,357,198	1,491,212
Miscellaneous Income	856,092	0
Federal Income Taxes (Paid) Recovered	<u>(100,000)</u>	<u>(1,193,824)</u>
Cash Provided by Operations	(995,963)	2,135,115
Investment Proceeds	9,520,681	14,494,442
Investments Acquired	(6,939,881)	(18,482,875)
Total Other Cash Provided	<u>62,579</u>	<u>(42,506)</u>
Net Change in Cash & Short Term Investments	\$1,647,416	(\$1,895,824)

Cash flows from operations are invested primarily in high quality fixed income assets consisting of certificates of deposit, money market funds, government

and government agency obligations, preferred securities, corporate bonds and municipal bonds. These investments are held in a laddered portfolio of maturities ranging from one to thirty years.

The Company's operations typically generate substantial positive cash flows from operations as most premiums are received in advance of the time when claim and benefit payments are required. These positive operating cash flows we've experienced are expected to continue to meet the liquidity requirements of the Company.

FUMICo maintains a relatively liquid portfolio as 51% of the balance sheet value of bonds, cash and short-term investments mature within the next 10 years (Schedule D-Part 1A). As a component of Enterprise Risk Management, the Company continually monitors its investment portfolio in an effort to balance the maturity spread of its invested assets.

#### Other Items

During 2006, Farmers Union Mutual Insurance Company became licensed in the state of Idaho. The Company has not yet written any business in Idaho and has no immediate plans of entering the Idaho market.

During 2007 the Company paid considerable attention to our Enterprise Risk Management Model (ERM). We developed our model to provide us insight into FUMICo's tolerance for risk, make us aware of the elements of risk and assist us in identifying, measuring and managing those risks. As outlined earlier in this MD&A, this evaluative process resulted in our exiting the Commercial Automobile line of business during the 2009 calendar year. We understand the elements of risk are never consistent. During 2010 and 2011 we continue to evaluate our ERM model and believe it will always be a work in progress.

2010 for the Information Technology department started with the replacement of our firewall and Virtual Private Network (VPN) server, followed by the purchase, testing & deployment of a new file server for our disaster recovery 'hot site' and new recovery software. In addition to our annual disaster recovery testing we ran a second battery of tests with our new recovery server. Also early in 2010 we conducted a prototyping project to assess our capability to develop and support enhanced customer website functionality.

Several new initiatives requested by our underwriting department were started and completed as detailed elsewhere in this discussion. In addition, we also completed several key projects continuing from 2009 including the Medicare Section 111 reporting with our first report being filed in June 2010. We are required to report quarterly under Section 111 any medical claims involving a claimant who is a Medicare/Medicaid beneficiary. We continue to make improvements to our Agent Portal on a regular basis. This year included substantial development work on our Farm and Ranch and Farm Liability online application process scheduled to be released in 2011.

We recognize the significant role of technology in achieving our corporate goals and will continue to invest in those technologies that will contribute to those goals.

The total claims count for 2010 reflected an increase of 1,258 claims for an 82.7% increase over 2009. This large increase is due to the catastrophic storm activity we experienced in 2010. Storm claims alone increased 414% over prior year with an incurred number of 1,357. Of the total claims reported in 2010, 87.2% were paid and/or reserved between \$0 and \$25,000, 8.7% were paid and/or reserved between \$25,001 and \$50,000 and the remaining 4.1% were paid and/or reserved in excess of \$50,000. Legal expenses rose 18.9% in 2010 with 59.3% of total legal expense attributable to contractor claims. Salvage recoveries also increased in 2010 by 193% which we attribute to the increase in claims activity.

In 2010 our Claims Department continued to use the property estimating program Xactimate, a product of Xactware Solutions, Inc., a division of ISO. During 2010 Company claims associated with property losses continued to be our largest contributor to overall claims count and incurred loss cost. We consistently upgrade to the latest version of this software as we feel this tool gives our claims staff the ability to expedite a more accurate estimate and payment to our policyholders resulting in better customer service.

As the market continued to remain soft during 2010 and thus far during 2011, management's intent is to continue aggressive and progressive actions to maintain loss, underwriting and operating ratios at acceptable levels. Changes already implemented and discussed in prior Management's Discussion and Analysis documents along with current information contained herein have had a favorable impact on policyholder surplus during seven of the past eight years. It is our expectation that the impact of all of these various undertakings along with an enlarged investment portfolio will continue to favorably impact net operating results and policyholder surplus in future years.

This Management's Discussion and Analysis provides our assessment of the financial position, results of operations, cash flow and liquidity, and changes in financial position for Farmers Union Mutual Insurance Company for the year ended December 31, 2010. Representations contained herein are those of management according to the best of their information, knowledge, and belief.

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Larry D. Trainor, CLU  
President & C.E.O.

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Robert L. Fields  
Senior Vice President & C.O.O.,  
Secretary/Treasurer

March 9, 2011  
Date