Report

of the

Examination of

Luck Mutual Insurance Company

Luck, Wisconsin

As of December 31, 2012

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State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

Scott Walker, *Governor*
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August 29, 2013

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

Commissioner:

In accordance with your instructions, an examination has been performed as of December 31, 2012, of the affairs and financial condition of:

LUCK MUTUAL INSURANCE COMPANY
Luck, Wisconsin

and the following report thereon is respectfully submitted:

I. INTRODUCTION

The previous examination of Luck Mutual Insurance Company (the company) was made in 2008 as of December 31, 2007. The current examination covered the intervening time period ending December 31, 2012, and included a review of such subsequent transactions deemed essential to complete this examination.

The “Summary of Examination Results” contains elaboration on all areas of the company's operations. 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, including bookkeeping and financial statement preparation. On November 23, 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.

The company was organized as a town mutual insurance company on August 27, 1881, under the provisions of the then existing Wisconsin Statutes. The original name of the company was the Luck Mutual Fire Insurance Company. Subsequent amendments to the company's articles and bylaws changed the company's name to that presently used. On September 1, 1997, Alden and Black Brook Mutual Insurance Company merged into Luck Mutual Insurance Company.

During the period under examination, there were no amendments to the articles of incorporation and no amendments to the bylaws.

The company is currently licensed to write property, including windstorm and hail, and nonproperty insurance. The company is currently licensed to write business in the following counties:

Barron	Eau Claire
Burnett	Pierce
Chippewa	Polk
Douglas	St. Croix
Dunn	Washburn

A review was made of the policy and application forms currently used by the company. The company issues approved policies with or without endorsements for one-year terms with premiums payable on the advance premium basis. The company also charges an installment fee of $5.00.

Business of the company is acquired through nine agents, four of whom are directors of the company. Agents receive a flat 14% commission on property and liability premiums on new and renewal business. Agents do not receive commission on fees, surcharges, or premium from a policy adjustment factor.

Agents have authority to adjust losses up to $500.00. Losses in excess of this amount may be adjusted by the agent after approval by the Claims Committee. However, most losses above $500.00 are adjusted by an independent adjuster. Agents who adjust losses receive $12.00 per hour and $0.555 per mile as a travel allowance.

Policyholders may participate in the management and control of the company by attending and voting at all annual or special meetings of the members. No member may vote by proxy. The annual meeting of the company for the election of directors and special meetings of the company are held in accordance with its articles of incorporation.

Board of Directors

The board of directors consists of nine members divided into three classes. One class is elected at each annual meeting for a term of three years. Vacancies on the board may be filled by the directors for the interim to the next annual meeting when a director shall be chosen for the unexpired term.

The current board of directors consists of the following policyholders of the company:

Name	Principal Occupation	Residence	Expiry
Lyle Burke	Retired	New Richmond, Wisconsin	2015
Otto Becker	Retired	Turtle Lake, Wisconsin	2015
Glen Wright*	Retired	Amery, Wisconsin	2015
Guy Foltz*	Cabinet Maker	Frederic, Wisconsin	2014
Dale Jensen	Farmer	Amery, Wisconsin	2014
Janet Krueger*	Veterinarian Technician	Deer Park, Wisconsin	2014
Kevin Peterson	Farmer	Grantsburg, Wisconsin	2013
Darold Nelson*	Farmer	Frederic, Wisconsin	2013
Bruce Dexter	Retired	Frederic, Wisconsin	2013

Directors who are also agents are identified with an asterisk.

Members of the board currently receive $75.00 for each meeting attended and $0.555 per mile for travel expenses.

Section 612.13 (1m), Wis. Stat., requires:

(1) If a town mutual has fewer than nine directors, no more than one director may be an employee or representative of the town mutual; and

(2) Employees and representatives of a town mutual may not constitute a majority of its board.

The company is in compliance with these requirements.

Officers

Officers are elected by the board of directors from among its members and hold office for one year or until their successors are duly elected and qualified. Officers serving at the present time are as follows:

Name	Office	2012 Compensation
Glen Wright	President	$22,766
Dale Jensen	Vice-President	630
Darold Nelson	Secretary/Treasurer	14,855

Reported compensation is the total compensation paid by the insurer for the year and includes salary, commissions, director fees and rental income as applicable.

The company has two co-managers. The co-managers are Jill Cook whose salary is $47,500 and Kevin Holm whose salary is $42,500.

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 are listed below:

Claims Committee
Glen Wright, Chair
Dale Jensen
Darold Nelson
Guy Foltz

Executive Committee
Glen Wright, Chair
Dale Jensen
Darold Nelson
Otto Becker

Investment Committee
Glen Wright, Chair
Dale Jensen
Darold Nelson
Bruce Dexter

Rating Committee
Glen Wright, Chair
Lyle Burke
Darold Nelson
Dale Jensen
Otto Becker

Underwriting Committee
Glen Wright, Chair
Dale Jensen
Darold Nelson
Bruce Dexter
Kevin Peterson
Janet Krueger

Growth of Company

The growth of the company since the previous examination as compiled from its filed annual statements was as follows:

Year	Net Premiums Earned	Policies In Force	Net Income	Admitted Assets	Policyholders' Surplus
2012	$607,736	1,428	$ 136,660	$2,489,022	$1,888,260
2011	626,311	1,370	2,061	2,529,729	1,865,694
2010	649,920	1,373	(103,924)	2,588,905	1,874,162
2009	664,483	1,375	213,490	2,519,149	1,953,712
2008	692,093	1,374	14,136	2,386,787	1,803,383
2007	624,793	1,367	99,293	2,346,594	1,750,558

The ratios of gross and net premiums written to surplus as regards policyholders since the previous examination were as follows:

Year	Gross Premiums Written	Net Premiums Written	Policyholders' Surplus	Writings Ratios	
				Gross	Net
2012	$ 988,290	$622,203	$1,888,260	52%	33%
2011	931,617	622,245	1,865,694	50	33
2010	941,238	648,200	1,874,162	50	35
2009	946,780	677,677	1,953,712	48	35
2008	919,950	666,105	1,803,383	51	37
2007	1,019,364	744,769	1,750,558	58	43

For the same period, the company's operating ratios were as follows:

Year	Net Losses and LAE Incurred	Other Underwriting Expenses Incurred	Net Premiums Earned	Loss Ratio	Expense Ratio	Com-posite Ratio
2012	$231,798	$284,786	$607,736	38%	46%	84%
2011	407,491	279,633	626,311	65	45	110
2010	511,719	276,980	649,920	79	43	122
2009	214,704	278,473	664,483	32	41	73
2008	453,844	276,822	692,093	66	42	108
2007	259,167	311,803	624,793	41	42	83

During the period under examination gross premium written and net premium written decreased by 10% and 23%, respectively. The decrease in gross premium written was attributed to a 7% decrease in nonproperty insurance sales while the decrease in net premium written was the result of a larger portion of property premiums being ceded to Wisconsin Reinsurance Corporation. Policies in force increased by 5%. This was the result of an increase in the amount of low value policies sold. Net losses, as a percent of net premiums earned, decreased over the period while other underwriting expenses, as a percent of net premiums earned, increased. The total of these ratios, the combined ratio, closely followed the levels seen at the end of the previous examination period.

II. REINSURANCE

The examiners' review of the company's reinsurance portfolio revealed there is currently one ceding treaty. The treaty contained a proper insolvency clause and complied with s. Ins 13.09 (3), Wis. Adm. Code, concerning maximum wind loss. Company retentions of risk complied with s. Ins 13.06, Wis. Adm. Code.

Reinsurer:	Wisconsin Reinsurance Corporation (WRC)
Effective date:	January 1, 2013
Termination provisions:	Either party may terminate on any January 1st by giving at least 60 days' written notice to the other party

The coverages provided under this treaty are summarized as follows:

1.	Type of contract:	Class AX1 Casualty Excess of Loss
	Lines reinsured:	Casualty business
	Company's retention:	$5,000 in respect to each and every loss occurrence
	Coverage:	100% of each and every loss occurrence, including loss adjustment expense, in excess of the company's retention subject to the maximum policy limits of: a. $1,000,000 per occurrence, single limit or combined for bodily injury and property damage liability b. $1,000,000 split limits, in any combination of bodily injury and property damage liability c. $25,000 for medical payments, per person; $25,000 per accident
	Reinsurance premium:	50% of the premium written Annual deposit premium = $85,000
2.	Type of contract:	Class B First Surplus
	Lines reinsured:	All property business
	Company's retention:	If net retention is $400,000 or more on a risk, the company may cede on a pro rata basis, and the reinsurer is obligated to accept, up to $800,000. If net retention is $400,000 or less on a risk, the company may cede on a pro rata basis, and the reinsurer is obligated to accept, up to 50% of such risk.
	Coverage:	Pro rata share of each and every loss, including loss adjustment expense, corresponding to the amount of the risk ceded

	Reinsurance premium:	The pro rata portion of all premiums, fees and assessments charged by the company corresponding to the amount of each risk ceded Annual deposit premium = $67,941
	Ceding commission:	Commission allowance: 15% of the premium paid Profit commission: 15% of the net profit
3.	Type of contract:	Class C-1 Excess of Loss First Layer
	Lines reinsured:	All property business
	Company's retention:	$50,000 per loss per occurrence
	Coverage:	$75,000 excess of retention including loss adjusting expenses
	Reinsurance premium:	The rate in effect shall be determined by taking the sum of the four years' losses incurred (paid plus outstanding) by the reinsurer divided by the total of the net premiums written for the same period, multiplied by the factor 100/80ths. Current rate is 14.76%. Minimum rate = 6.50% Maximum rate = 20.00% Annual deposit premium = $114,694
4.	Type of contract:	Class C-2 Second Excess of Loss Second Layer
	Lines reinsured:	All property business
	Company's retention:	$125,000 per loss per occurrence
	Coverage:	$275,000 excess of retention including loss adjustment expenses for each and every loss occurrence
	Reinsurance premium:	6.0% of net premiums written, subject to an annual deposit premium of $46,624
5.	Type of contract:	Class D/E-1 First Aggregate Stop Loss Reinsurance
	Lines reinsured:	All business including nonproperty
	Company's retention:	75% of net premium written
	Coverage:	65% of annual aggregate losses, including loss adjustment expenses, exceeding 75% of net premium written and in excess of the company's retention
	Reinsurance premium:	The rate for each annual period shall be determined by taking the sum of the eight years' losses incurred by the reinsurer divided by the total of the net premiums written for the same period multiplied by the factor of 100/80ths. The current rate is 6.45%.

		Minimum rate = 6.45% Maximum rate = 15.0% Annual deposit premium = $55,603
6.	Type of contract:	Class D/E-2 Second Aggregate Stop Loss Reinsurance
	Lines reinsured:	All business including nonproperty
	Company's retention:	140% of net premium written
	Coverage:	100% of annual aggregate losses, including loss adjustment expenses, in excess of the company's retention
	Reinsurance premium:	Rate = 2.0% Annual deposit premium = $17,241

III. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported to the Commissioner of Insurance in the December 31, 2012, annual statement. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Policyholders' Surplus."

Luck Mutual Insurance Company
Statement of Assets and Liabilities
As of December 31, 2012

Assets	Ledger	Nonledger	Not Admitted	Net Admitted
Cash on hand	$ 100	$	$	$ 100
Cash in checking	14,605			14,605
Cash deposited at interest	314,061			314,061
Bonds	1,325,100			1,325,100
Stocks and mutual fund investments	663,461			663,461
Real estate	26,495			26,495
Premiums, agents' balances and installments:				
In course of collection	114,693		428	114,265
Investment income accrued		10,341		10,341
Reinsurance recoverable on paid losses and LAE	10,650			10,650
Other expense-related assets:				
Reinsurance commission receivable	9,004			9,004
Other nonexpense-related assets:				
Federal income tax recoverable	940			940
Furniture and fixtures	8,104		8,104	
Totals	$2,487,213	$10,341	$8,532	$2,489,022

Liabilities and Surplus

Net unpaid losses	$ 31,473
Unpaid loss adjustment expenses	2,862
Commissions payable	23,814
Fire department dues payable	308
Unearned premiums	470,441
Reinsurance payable	53,362
Amounts withheld for the account of others	3,808
Payroll taxes payable (employer's portion)	1,279
Other liabilities:	
Expense-related:	
Accounts payable	1,588
Accrued property taxes	2,650
Nonexpense-related:	
Premiums received in advance	9,177
Total liabilities	600,762
Policyholders' surplus	1,888,260
Total Liabilities and Surplus	$2,489,022

Luck Mutual Insurance Company
Statement of Operations
For the Year 2012

Net premiums and assessments earned		$607,736
Deduct:		
Net losses incurred	$192,214	
Net loss adjustment expenses incurred	39,584	
Net other underwriting expenses incurred	284,786	
Total losses and expenses incurred		516,584
Net underwriting gain (loss)		91,152
Net investment income:		
Net investment income earned	48,949	
Net realized capital gains (losses)	1,459	
Total investment gain (loss)		50,408
Other income (expense):		
Miscellaneous income	9,388	
Total other income		9,388
Net income (loss) before federal income taxes		150,948
Federal income taxes incurred		14,288
Net Income (Loss)		$136,660

Luck Mutual Insurance Company
Reconciliation and Analysis of Surplus as Regards Policyholders
For the Five-Year Period Ending December 31, 2012

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

	2012	**2011**	**2010**	**2009**	**2008**
Surplus, beginning of year	$1,865,694	$1,874,162	$1,953,712	$1,803,383	$1,750,558
Net income	136,660	2,061	(103,924)	213,490	14,136
Net unrealized capital gain or (loss)	(109,919)	(11,867)	27,892	(67,404)	36,021
Change in nonadmitted assets	(4,175)	1,338	(3,518)	4,243	2,668
Surplus, End of Year	$1,888,260	$1,865,694	$1,874,162	$1,953,712	$1,803,383

Reconciliation of Policyholders' Surplus

The examination resulted in no adjustments to policyholders' surplus. The amount reported by the company as of December 31, 2012, is accepted.

Examination Reclassifications

	Debit	Credit
Premiums, agents' balances, and installments in course of collection	$	$107,804
Premiums, agents' balances, and installments deferred and not yet due	107,804	
Total Reclassifications	$107,804	$107,804

IV. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

The prior examination resulted in no adverse comments or recommendations.

Current Examination Results

Corporate Records

The minutes of the annual meetings of policyholders and meetings of the board of directors and committees thereof were reviewed for the period under examination and also for the subsequent period.

Biographical data relating to company officers and directors have been reported in accordance with the provisions of s. Ins 6.52, Wis. Adm. Code.

The company has executed formal written agreements with its agents. The contracts include language indicating the agent will represent the company's interests "in good faith."

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 with no apparent conflicts being noted.

Fidelity Bond and Other Insurance

The company is afforded coverage under the terms of the following bonds or contracts and has complied with s. Ins 13.05 (6), Wis. Adm. Code, which sets forth the minimum requirements for fidelity bond coverage:

Type of Coverage	Coverage Limits
Fidelity bond	$ 250,000
Worker's compensation:	
Employee injury	Statutory
Employee liability:	
Each accident	100,000
Each employee	100,000
Policy limit	500,000
Professional liability:	
Claim limit	1,000,000
Policy limit	1,000,000
Directors and officers liability:	
Claim limit	1,000,000
Policy limit	1,000,000
Insurance agents and brokers liability	
Claim limit	2,000,000
Policy limit	2,000,000
Property coverage:	
Home office building	242,000
Commercial personal property	40,000
Loss of income	60,000
Commercial general liability home office:	
Liability – bodily injury and property damage	1,000,000
Medical – per person	1,000
Fire legal liability	100,000

Underwriting

The company has a written underwriting guide. The guide covers all the lines of business that the company is presently writing.

The company has an inspection procedure for both new and renewal business. A sampling of new applications and renewal business is inspected by the company's co-managers and outside adjusters who are independent of the risk under consideration and review.

Claims Adjusting

The company has an adjusting committee consisting of at least three directors as required by s. 612.13 (4), Wis. Stat. The function of this committee is to adjust or supervise the adjustment of losses.

Accounts and Records

The examiners' review of the company's records indicated that the company is in compliance with s. Ins 13.05, Wis. Adm. Code, which sets forth the minimum standards for the handling of cash and recording of cash transactions by town mutual insurance companies. The examiners noted the following:

1. A proper policy register is maintained.
2. A proper cash receipts journal is maintained.
3. A proper cash disbursements journal is maintained.
4. A proper general journal is maintained.
5. A proper general ledger is maintained.

An extensive review was made of income and disbursement items. Cash receipts were traced from source records and the proper recording and eventual deposit thereof ascertained. Negotiated checks issued during the period under examination were reviewed, test checked for proper endorsement, and traced to cash records. The verification of assets and determination of liabilities were made as of December 31, 2012.

The company is audited annually by an outside public accounting firm.

EDP Environment

Company personnel were interviewed with respect to the company's electronic data processing environment. Access to the computers is limited to people authorized to use the computers.

Company personnel back up the computers daily and the backed-up data is kept off-site.

The company has manuals documenting the use of its software and outlining the steps to complete specific tasks. The manuals assist in the continuity of operations by providing instructions for seldom-used applications or when staff turnover occurs. The examination determined that the level of documentation contained in the manuals was reasonable.

Business Continuity Plan

A business continuity plan identifies steps to be performed by a company in the event of business interruptions including, but not limited to, the inability to access its computer, the loss of information on its computer, the loss of a key employee, or the destruction of its office building.

The company has developed a business continuity plan. The company's business continuity plan appears to be adequate.

Invested Assets

Section 610.23, Wis. Stat., requires insurers to hold all investments and deposits of its funds in its own name except that:

(1) Securities kept under a custodial agreement or trust arrangement with a bank or banking and trust company may be issued in the name of a nominee of the bank or banking and trust company; and

(2) Any insurer may acquire and hold securities in bearer form.

For securities not held under a custodial agreement or trust arrangement with a bank or banking and trust company, s. Ins 13.05 (4), Wis. Adm. Code, requires that:

> Non-negotiable evidences of company investments such as registered bonds, certificates of deposits, notes, etc., shall be maintained in a safe or vault with adequate safety controls or in a safety deposit box in a bank. Negotiable evidences of company investments shall be maintained in a safety deposit box in a bank. Access to a company safety deposit box containing negotiable securities shall require the presence and signature of at least 2 officers, directors or employees of the company.

The company is in compliance with these requirements.

It was noted that the company had a custodial agreement with Waukesha State Bank as of December 31, 2012; however, the bank used a non-bank sub-custodian, the brokerage arm of Fidelity Investments, for all company assets held by the bank. Since the custodial agreement, which dates from August 28, 2003, does not include provisions for a sub-custodian, it was unclear what responsibility the bank had with respect to the non-bank sub-custodian. Furthermore, the examination could only confirm specific assets held on behalf of the company through statements from the brokerage firm. It is recommended that the company obtain a custodial agreement with an authorized custodian under s. 610.23, Wis. Stat., and if a sub-custodian is used, the custodian's indemnification for negligence or dishonesty under the custodial agreement should be extended to apply to any sub-custodians. It is further recommended that the company obtain custodial statements from their custodian that include a detailed list of securities under custody at least quarterly and such statements should be reconciled to any applicable statements from the investment brokerage firm.

On December 3, 2012, the company entered into a Custody Agreement with Community Bank & Trust. This agreement also does not include provisions for a sub-custodian and thus it is unclear what responsibility the bank would have with respect to any sub-custodian, even though banks of its size may be expected to use sub-custodians. The custodial statements from Community Bank & Trust appeared to include a detailed list of securities under custody.

Investment Rule Compliance

The investment rule for town mutual insurers allows a company to invest in common stocks, common stock mutual funds, and other higher risk investments (referred to as "Type 2") provided that the town mutual has a sufficient amount of lower risk investments (referred to as "Type 1"). A town mutual may invest in Type 2 securities only if it already has sufficient Type 1 investments. Type 1 investments must equal or exceed the greater of items 1, 2, or 3.

1.	Liabilities plus $300,000	$ 900,762
2.	Liabilities plus 33% of gross premiums written	926,898
3.	Liabilities plus 50% of net premiums written	911,864
4.	Amount required (greater of 1, 2, or 3)	926,898
5.	Amount of Type 1 investments as of 12/31/2012	1,763,101
6.	Excess or (deficiency)	$ 836,203

The company has sufficient Type 1 investments.

During review of the company's bonds it was noted the company had two bonds that were rated below BBB- that were not correctly classified as Type 2 investments. According to the Town Mutual Annual Statement Instructions, bonds that have a rating below 'BBB-' by Standard and Poor's or a Moody's rating equivalent should be considered Type 2 bonds and valued at the lower of amortized book value or market value. The bonds' statement value as of December 31, 2012, was reported correctly; however, the company should properly classify its investments between Type 1 and Type 2 in order to determine the adequacy of Type 1 investments, as required by s. Ins 6.20 (c), Wis. Adm. Code. (The amount of Type 1 investments listed in the calculation above has been adjusted to reflect the proper classification of investments.) It is recommended that the company properly classify its bonds between Type 1 and Type 2 investments in accordance with the Town Mutual Annual Statement Instructions.

The holding of these non-investment grade bonds is in violation of the company's investment policy, which prohibits the company from holding bonds with ratings below investment grade. The policy also prohibits the company from holding bonds with a maturity in excess of 15 years. During the review it was noted that the company has two bonds whose maturities exceed 15 years (one of the bonds matures in 2035, the other in 2037). It is recommended that the company adhere to its investment policy.

ASSETS

Cash and Invested Cash **$328,766**

The above asset is comprised of the following types of cash items:

Cash in company's office	$ 100
Cash deposited in banks—checking accounts	14,605
Cash deposited in banks at interest	314,061
Total	$328,766

Cash in company's office at year-end represents the company's petty cash fund.

Cash deposited in banks subject to the company's check and withdrawal consists of one account maintained in one bank. Verification of checking account balance was made by obtaining confirmation directly from the depository and reconciling the amounts shown thereon to company records.

Cash deposited in banks represents the aggregate of six deposits in three depositories. Deposits were verified by direct correspondence with the respective depositories. Interest received during the year 2012 totaled $3,715 and was verified to company cash records. Rates of interest earned on cash deposits ranged from 0.03% to 1.3%. Accrued interest on cash deposits totaled $408 at year-end.

Book Value of Bonds **$1,325,100**

The above asset consists of the aggregate book value of bonds held by the company as of December 31, 2012. Bonds owned by the company are held in an account through Fidelity Investments.

Bonds were traced from an Investment Report from Fidelity Investments to a direct confirmation from the Waukesha State Bank to the annual statement. Bond prospectuses for many, though not all, of the company’s bonds were inspected by the examiners. Bond purchases and sales for the period under examination were checked to investment advisor and custodial statements.

In February 2004, the company hired its current investment advisor, although he has represented a number of firms during his work with the company, and over the years rapidly expanded its bond portfolio. While under the investment advisor, the company has been investing in a number of securities issued by banks and other financial corporations, which were designed and packaged as debt securities but with floating rates that appeared to aid the issuer in hedging its own risks or those of clients. In these cases the floating rates cause the cash flows of the securities to be unpredictable because the interest payments are based on specified variables such as market or consumer indexes, rates, or other variables. The floating rates can be subject to wide fluctuation based on changing economic conditions or other circumstances.

The volume of floating rate corporate bonds issued in the United States fluctuates from year to year. From 1996 to 2012 the percentage of corporate bonds that have been issued on a floating rate basis has ranged from 4.8% to 48.9% of corporate bond issuance, with the average for the period amounting to 25% of corporate bond issuance. The following table was drawn from data made available to the public from the Web site of the Securities Industry and Financial Markets Association, with the source attributed to Thomson Reuters.

U.S. Corporate Bond Issuance* 1996 – 2012
Callable and Non-Callable by Coupon Type
(Billions in U.S. Dollars)

	Callable		**Non-Callable**		**Total %**
	Fixed Rate	**Floating Rate**	**Fixed Rate**	**Floating Rate**	**Floating Rate**
1996	$ 79.1	$ 4.3	$ 200.3	$ 60.0	18.7%
1997	131.4	5.9	232.9	95.9	21.8
1998	240.5	7.8	228.0	134.4	23.3
1999	211.8	5.0	248.8	163.7	26.8
2000	196.6	16.1	166.1	208.6	38.3
2001	400.3	7.5	232.7	135.5	18.4
2002	283.4	2.7	187.8	162.8	26.0
2003	360.4	23.1	177.4	215.0	30.7
2004	238.6	31.7	207.8	302.6	42.8
2005	233.5	59.0	152.3	307.9	48.7
2006	348.3	88.0	192.4	430.2	48.9
2007	420.9	99.0	251.6	356.0	40.4
2008	352.4	57.7	185.7	111.4	23.9
2009	618.3	5.6	236.2	41.1	5.2
2010	575.2	7.8	413.2	66.7	7.0
2011	582.9	8.2	306.4	114.6	12.1
2012	882.9	13.5	412.0	51.5	4.8
Totals	$6,156.5	$442.9	$4,031.6	$2,957.9	25.0%

* Includes all non-convertible corporate debt, medium-term notes, and Yankee bonds, but excludes all issues with maturities of one year or less and CDs.

Town mutual insurers are considered restricted insurers under s. 620.03 (1), Wis. Stat., and s. Ins 6.20 (6) (a), Wis. Adm. Code, and, as such, are subject to limitation over their investments. This office has imposed and may impose additional special investment restrictions for town mutual insurers if the investment creates additional risk which may compromise their financial position and ability to pay policyholders' claims in full and a timely manner. Furthermore, pursuant to s. 620.04 (1), Wis. Stat., this office may impose reasonable and temporary restrictions upon the investments of an individual insurer, including prohibition or divestment of a particular asset. This office concludes that the company's investment strategy presents an unreasonable amount of risk to the company and is not appropriate for a town mutual insurance company at this time. The basis for this conclusion and the company's action required by this office is described below.

The examination reviewed the prospectuses of the bonds owned by the company and found multiple instances of corporate bonds with variable rates of interest tied to various complex indices. Examples of these bonds include instances where the interest rate was dependent on:

- Year over year changes in the Consumer Price Index
- The difference between the 30-year and the 10-year constant maturity swap rate (CMS Spread)
- Changes in the S&P 500 Index

For instance, for each interest payment on one Morgan Stanley security, interest is paid each month only when the closing S&P 500 Index exceeds 1,000. Various of the company's variable rate corporate debt securities are linked to the Consumer Price Index, which can turn negative some months. During such months no interest payments could be accrued on these securities. The absence of interest payments would likely have a negative impact on the security's market value. Furthermore, during prolonged economic conditions that unfavorably affect interest payments of the security, the security may trade, if at all, at a significant discount to its purchase price. Some of the prospectuses disclosed a potential risk that the market for trading these securities may not necessarily exist or be maintained in the future.

The risk that the market for trading these securities may not necessarily exist or be maintained in the future is substantially exacerbated by the very small size of the variable rate corporate debt issues that the company has purchased. Large issues tend to trade more frequently than small issues and investors may have greater awareness about a larger issue because it is widely held and analyzed. An issue size of $250 million represents an approximate lower boundary for a bond issue to attract significant institutional interest when liquidity is a concern. For example, the minimum par amount outstanding for a bond issue's inclusion in the Barclays U.S. Corporate Index is $250 million. The minimum par amount outstanding for a bond issue's inclusion in the Barclays U.S. Floating Rate Note Index is $300 million. Of the company's total corporate bond portfolio nearly half of its statement value consists of variable rate corporate debt securities. The issue size of the company's variable rate corporate debt securities ranged from $4,500,000 to $900,000,000, based on review of prospectuses and other information that could be located during the course of the examination, with the majority of these types of debt securities having initial issue sizes of less than $43,000,000.

The objectives of investment regulations as defined in s. 620.01, Wis. Stat., include, in part, to provide for the safety of principal and, to the extent consistent therewith, maximum yield and growth, and to provide sufficient liquidity to avoid the necessity in reasonably expected circumstances for selling assets at undue sacrifice. The interest rate on some of these bonds could drop to 0% for a prolonged period of time, which could significantly impair the value of the bond and prevent the company from earning a reasonable return on their investment. There also may not be a trading market for the security rendering the investment illiquid. In the event that the company may need to dispose of the bond in order to pay claims, there may be no readily available market. It is recommended that, if the company invests in any variable rate corporate debt security, such security must have the following characteristics:

a. The reference for setting the interest rate must be a U.S. Dollar London Interbank Offered Rate of a single specified duration; and
b. The interest rate must have a floor in excess of zero percent; and
c. The total outstanding principal amount of the security at the time of issuance must equal or exceed $250 million.

For the avoidance of any doubt, in investing in any variable rate corporate debt security, the company:

a. May assume that any U.S. Dollar London Interbank Offered Rate will exceed zero percent; and
b. May invest in a security that specifies some increment of interest in excess of a U.S. Dollar London Interbank Offered Rate of a single specified duration; and
c. May invest in a security that is leveraged relative to a U.S. Dollar London Interbank Offered Rate of a single specified duration, provided that there is no basis point reduction in the index provided by the interest rate formula (for example, 125% of the 3-month U.S. Dollar London Interbank Offered Rate is acceptable, while 125% of the 3-month U.S. Dollar London Interbank Offered Rate minus 0.10% is not acceptable); and
d. May not invest in a security that specifies some increment of interest less than a U.S. Dollar London Interbank Offered Rate of a single specified duration, unless such increment is expressed as a percentage of the index (for example, 80% of the 3-month U.S. Dollar London Interbank Offered Rate is acceptable, while the 3-month U.S. Dollar London Interbank Offered Rate minus 0.10% is not acceptable).

It is further recommended that the company divest itself of any variable rate corporate debt security maturing after December 31, 2015, that does not meet the foregoing standards and provide this office with evidence of the disposal within 60 days of the adoption of this report.

It is the responsibility of the board of directors to supervise and direct all investments acquired and held by the company pursuant to s. Ins 6.20 (6) (h), Wis. Adm. Code. This section requires the company's investment strategies and practices are commensurate with its technical and administrative capabilities and expertise with regard to investments. Investments whose interest rate payment is based on complex conditions tied to the results of multiple indices fall outside the area of expertise of town mutual insurers. Further, the board may not delegate its responsibility for overseeing the company's investments to a third-party contractor, pursuant to ss. 612.16 and 611.67, Wis. Stat. The company's board is responsible to oversee the company's investments and the actions of the investment advisor and must understand the details of its investments.

The review of the company's bonds also disclosed the following issues:

1. It was determined that when money is added to the company's investment account which is held by the custodian the check is made out to Fidelity Investments and then mailed to Cubic, the investment advisor, who then forwards the check to Fidelity Investments to be added to the company's investment account. It is recommended that the company send deposits for their investment account directly to the investment account which is covered by the company's custodian.

2. The company did not have a prospectus for many of its investments in debt securities. It is recommended that the company maintain prospectuses for its current investments.

3. It is recommended that the board of directors modify its written investment policy to specify, in accordance with the instructions included in this report, acceptable characteristics of the investments in variable rate corporate debt securities and provide this office with a copy of the revised investment policy within 60 days of the adoption of this report.

Interest received during 2012 on bonds amounted to $58,307 and a review of investment income verified the accuracy of the balance. Accrued interest of $9,933 at December 31, 2012, was checked and allowed as a nonledger asset.

Stocks and Mutual Fund Investments $663,461

The above asset consists of the aggregate market value of stocks and mutual funds held by the company as of December 31, 2012. Stocks owned by the company are located in a custodial account at Community Bank and Trust.

Stock and mutual fund purchases and sales for the period under examination were checked to brokers' invoices and advices. It was noted that while the company's investment in stocks was in conformance with Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers, its investment in its one mutual fund holding was not. The market value of the company's money market mutual fund investment was 10.6% of assets at year-end. Wisconsin Statutes prohibit town mutuals from holding a mutual fund investment that exceeds 10% of assets in any single family of mutual funds. It is recommended that the company comply with s. Ins 6.20 (6), Wis. Adm. Code, in regards to its mutual fund investments.

Dividends received during 2012 on stocks and mutual funds amounted to $80 and were traced to cash receipts records. There were no accrued dividends at December 31, 2012.

Book Value of Real Estate **$26,495**

The above amount represents the company's investment in real estate, net of depreciation, as of December 31, 2012. The company's real estate holdings consisted of the company's home office, which it purchased in 1989.

The required documents supporting the validity of this asset were reviewed and were in order. Adequate hazard insurance was carried on the real estate and contents as noted under the caption "Fidelity Bond and Other Insurance." The company's investment in real estate and related items was in conformance with the Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers. Real estate depreciation is calculated using the straight-line method.

Premiums, Agents' Balances in Course of Collection **$6,461**

This asset represents the amounts due from agents or policyholders which are not in excess of 90 days past due at year-end. The company reported a balance for this line item of $114,265, while the examination resulted in a balance of $6,461. During the course of the exam it was noted that the company erroneously included premiums, agents' balances, and installments deferred and not yet due in this line item. This examination reclassification is reflected in the section of this report captioned "Reconciliation of Policyholders' Surplus."

Premiums Deferred and Not Yet Due **$107,804**

This asset represents modal premium installments (such as monthly, quarterly, etc.) that are not yet due. A review of a sample from the company's detailed list of deferred premiums noted that the company is incorrectly reporting the amount of premium deferred and not yet due. This amount was incorrectly included as premium in course of collection. It is recommended that the company classify its premiums deferred and not yet due in accordance with the Town Mutual Statement Instructions.

Investment Income Accrued **$10,341**

Interest due and accrued on the various assets of the company at December 31, 2012, consists of the following:

Cash at interest	$ 408
Bonds	9,933
Total	$10,341

Reinsurance Recoverable on Paid Losses and LAE **$10,650**

The above asset represents recoveries due to the company from reinsurance on losses and loss adjusting expenses which were paid on or prior to December 31, 2012. A review of year-end accountings with the reinsurer verified the above asset.

Reinsurance Commission Receivable **$9,004**

The above asset represents the amount of reinsurance commissions that the company expected to receive as of December 31, 2012, under its reinsurance contract with Wisconsin Reinsurance Corporation. A review of the terms of the reinsurance agreement and year-end accountings with the reinsurer verified the above asset.

Furniture and Fixtures **$0**

This asset consists of $8,104 of equipment and furniture owned by the company at December 31, 2012. In accordance with annual statement requirements, this amount has been reported as a nonadmitted asset, thus the balance shown above is $0.

Federal Income Taxes Recoverable **$940**

This asset represents the amount of federal income taxes paid to the federal government that was recoverable as of December 31, 2012.

The examiners reviewed the company's federal income taxes recoverable calculation and found this asset to be correctly calculated.

LIABILITIES AND SURPLUS

Net Unpaid Losses **$31,473**

This liability represents losses incurred on or prior to December 31, 2012, that remained unpaid as of that date. The examiners reviewed the reasonableness of this liability by totaling actual loss payments made subsequent to December 31, 2012, with incurred dates in 2012 and prior years. The examiners' development of unpaid losses is compared with the amount estimated by the company in the following schedule.

	Company Estimate	Examiners' Development	Difference
Incurred but unpaid losses	$35,891	$27,290	$ 8,601
Less: Reinsurance recoverable on unpaid losses	4,418	5,888	(1,470)
Net Unpaid Losses	$31,473	$21,402	$10,071

Surplus was not adjusted for the above difference of $10,071 as the amount was not considered material for purposes of this examination.

The examiners' review of claim files included open claims, paid claims, claims closed without payment, and claims that were denied during the examination period. The review indicated that claims are investigated and evaluated properly and that payments are made promptly and in accordance with policy provisions upon the submission of a proper proof of loss. In addition, the review of claims handling procedures and files revealed the following:

1. A proper loss register is maintained.
2. Claim files contained sufficient investigatory data and documentation to verify settlement payments or reserve estimates.
3. Proofs of loss were properly signed.

Unpaid Loss Adjustment Expenses **$2,862**

This liability represents the company's estimate of amounts necessary to settle losses which were incurred prior to December 31, 2012, but which remained unpaid as of year-end. The methodology used by the company in establishing this liability is by estimating the amounts to be paid to the outside adjuster.

The examiners' analysis of expenses incurred in the current year related to the settlement of prior year losses, as well as estimates of amounts necessary to settle any prior losses remaining unpaid at the examination date, determined this liability to be adequately stated.

Commissions Payable **$23,814**

This liability represents the commissions payable to agents as of December 31, 2012. The examiners reviewed the company's commission calculation and subsequent commission payments and found the liability to be reasonably stated.

Fire Department Dues Payable **$308**

This liability represents the fire department dues payable to the state of Wisconsin as of December 31, 2012.

The examiners reviewed the company's fire department dues calculation and found this liability to be correctly calculated. The actual amount paid was verified to the cash disbursement records.

Unearned Premiums **$470,441**

This liability represents the reserve established for unearned premiums in compliance with s. Ins 13.08 (3), Wis. Adm. Code. This reserve was established using a daily pro rata methodology.

Reinsurance Payable **$53,362**

This liability consists of amounts due to the company's reinsurer at December 31, 2012, relating to transactions which occurred on or prior to that date.

Class A – Liability	$ 6,083
Class B – First Surplus	4,663
Class C-1 – First Layer	8,582
Class C-2 – Second Layer	3,737
Class D/E-1 – Stop Loss	4,409
Class D/E – 2 Stop Loss	1,367
Current Year Adjustment	8,104
Deferred First Surplus	16,417
Total	$53,362

Amounts Withheld for the Account of Others **$3,808**

This liability represents employee payroll deductions in the possession of the company at December 31, 2012. Supporting records and subsequent cash disbursements verified this item.

Payroll Taxes Payable **$1,279**

This liability represents the company's portion of payroll taxes incurred prior to December 31, 2012, which had not yet been paid. Supporting records and subsequent cash disbursements verified this item.

Accounts Payable **$1,588**

This liability represents the company's estimate for unpaid general expenses at December 31, 2012. Supporting records and subsequent cash disbursements verified the items and that the liability was reasonable.

Accrued Property Taxes **$2,650**

This liability represents the company's unpaid property taxes at December 31, 2012. Supporting records and subsequent cash disbursements verified this item.

Premiums Received in Advance **$9,177**

This liability represents the total premiums received prior to year-end for policies with effective dates after December 31, 2012. The examiners reviewed 2012 premium and cash receipt records to verify the accuracy of this liability.

V. CONCLUSION

Luck Mutual Insurance Company is a town mutual insurer with an authorized territory of 10 counties. The company has been providing property and liability insurance to policyholders since 1881.

The following schedule summarizes the cumulative increases and decreases to the policyholders' surplus of Luck Mutual Insurance Company from December 31, 2007, when policyholders' surplus was last verified by examination, to December 31, 2012:

Policyholders' surplus, December 31, 2007	$1,750,558
Net income	262,423
Unrealized capital gains or (losses)	(125,277)
Change in nonadmitted assets	556
Policyholders' Surplus, December 31, 2012	$1,888,260

The company reported assets of $2,489,022, liabilities of $600,762 and policyholders' surplus of $1,888,260 at year-end 2012. Surplus increased by 7.9% since the last examination, while gross premium written and net premium written decreased by 10% and 23%, respectively. The decrease in gross premium written was attributed to a 7% decrease in nonproperty insurance sales while the decrease in net premium written was the result of a larger portion of property premiums being ceded to Wisconsin Reinsurance Corporation. During the period under examination, the number of policies in force increased by 5%. The company reported underwriting gains in two of the five years under examination and net income in four of the five years. Net losses, as a percent of net premiums earned, decreased over the period while other underwriting expenses, as a percent of net premiums earned, increased.

Areas of improvement recommended by this examination were related to custody and investment matters and the financial statement reporting of premiums, agents' balances, and installments, resulting in eleven recommendations. There were no adjustments to policyholders' surplus and one reclassification to the balance sheet.

VI. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 19 - Invested Assets—It is recommended that the company obtain a custodial agreement with an authorized custodian under s. 610.23, Wis. Stat., and if a sub-custodian is used, the custodian's indemnification for negligence or dishonesty under the custodial agreement should be extended to apply to any sub-custodians.

2. Page 19 - Invested Assets—It is further recommended that the company obtain custodial statements from their custodian that include a detailed list of securities under custody at least quarterly and such statements should be reconciled to any applicable statements from the investment brokerage firm.

3. Page 21 - Investment Rule Compliance—It is recommended that the company properly classify its bonds between Type 1 and Type 2 investments in accordance with the Town Mutual Annual Statement Instructions.

4. Page 21 Investment Rule Compliance—It is recommended that the company adhere to its investment policy.

5. Page 25 - Book Value of Bonds—It is recommended that, if the company invests in any variable rate corporate debt security, such security must have the following characteristics:
   a. The reference for setting the interest rate must be a U.S. Dollar London Interbank Offered Rate of a single specified duration; and
   b. The interest rate must have a floor in excess of zero percent; and
   c. The total outstanding principal amount of the security at the time of issuance must equal or exceed $250 million.

   For the avoidance of any doubt, in investing in any variable rate corporate debt security, the company:
   a. May assume that any U.S. Dollar London Interbank Offered Rate will exceed zero percent; and
   b. May invest in a security that specifies some increment of interest in excess of a U.S. Dollar London Interbank Offered Rate of a single specified duration; and
   c. May invest in a security that is leveraged relative to a U.S. Dollar London Interbank Offered Rate of a single specified duration, provided that there is no basis point reduction in the index provided by the interest rate formula (for example, 125% of the 3-month U.S. Dollar London Interbank Offered Rate is acceptable, while 125% of the 3-month U.S. Dollar London Interbank Offered Rate minus 0.10% is not acceptable); and
   d. May not invest in a security that specifies some increment of interest less than a U.S. Dollar London Interbank Offered Rate of a single specified duration, unless such increment is expressed as a percentage of the index (for example, 80% of the 3-month U.S. Dollar London Interbank Offered Rate is

acceptable, while the 3-month U.S. Dollar London Interbank Offered Rate minus 0.10% is not acceptable).

6. Page 26 - Book Value of Bonds—It is further recommended that the company divest itself of any variable rate corporate debt security maturing after December 31, 2015, that does not meet the foregoing standards and provide this office with evidence of the disposal within 60 days of the adoption of this report.

7. Page 27 - Book Value of Bonds—It is recommended that the company send deposits for their investment account directly to the investment account which is covered by the company's custodian.

8. Page 27 - Book Value of Bonds—It is recommended that the company maintain prospectuses for its current investments.

9. Page 27 - Book Value of Bonds—It is recommended that the board of directors modify its written investment policy to specify, in accordance with the instructions included in this report, acceptable characteristics of the investments in variable rate corporate debt securities and provide this office with a copy of the revised investment policy within 60 days of the adoption of this report.

10. Page 27 - Stocks and Mutual Fund Investments—It is recommended that the company comply with s. Ins 6.20 (6), Wis. Adm. Code, in regards to its mutual fund investments.

11. Page 28 - Premiums Deferred and not yet Due—It is recommended that the company classify its premiums deferred and not yet due in accordance with the Town Mutual Statement Instructions.

VII. ACKNOWLEDGMENT

The courteous cooperation extended to the examiners by the company's personnel is hereby acknowledged.

In addition to the undersigned, Raymond Kangogo of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination.

Respectfully submitted,

Margaret Callahan
Examiner-in-Charge