Report

of the

Examination of

Farmington Mutual Insurance Company

Osceola, Wisconsin

As of December 31, 2015

**TABLE OF CONTENTS**

**State of Wisconsin** / OFFICE OF THE COMMISSIONER OF INSURANCE

***Scott Walker,*** *Governor*
***Theodore K. Nickel,*** *Commissioner*

***Wisconsin.gov***

125 South Webster Street • P.O. Box 7873
Madison, Wisconsin 53707-7873
Phone: (608) 266-3585 • Fax: (608) 266-9935
E-Mail: ociinformation@wisconsin.gov
Web Address: oci.wi.gov

February 16, 2017

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

Commissioner:

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

FARMINGTON MUTUAL INSURANCE COMPANY
Osceola, Wisconsin

and this report is respectfully submitted.

## I. INTRODUCTION

The previous examination of Farmington Mutual Insurance Company (FMIC or the company) was conducted in 2011 as of December 31, 2010. The current examination covered the intervening period ending December 31, 2015, and included a review of such 2016 transactions as deemed necessary to complete the examination.

The examination was conducted using a risk-focused approach in accordance with the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook. This approach sets forth guidance for planning and performing the examination of an insurance company to evaluate the financial condition, assess corporate governance, identify current and prospective risks (including those that might materially affect financial condition, either currently or prospectively), and evaluate system controls and procedures used to mitigate those risks.

All accounts and activities of the company were considered in accordance with the risk-focused examination process. This may include assessing significant estimates made by management and evaluating management’s compliance with statutory accounting principles, annual statement instructions, and Wisconsin laws and regulations. The examination does not attest to the fair presentation of the financial statements included herein. If during the course of the examination an adjustment is identified, the impact of such adjustment will be documented separately at the end of the “Financial Data” section in the area captioned "Reconciliation of Surplus per Examination."

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

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

In addition to auditing, the public accounting firm performs non-auditing services for the company, including bookkeeping assistance in connection with the year-end close, assistance with the preparation of the annual statement, and tax return preparation. On December 14, 2010, an exemption was granted by the Commissioner, pursuant to s. Ins 50.08 (4), Wis. Adm. Code, permitting the independent auditor to perform this non-audit work for the company.

## II. HISTORY AND PLAN OF OPERATION

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

The company is only licensed in Wisconsin. The company plans to grow, concentrating in the northwestern portion of the state.

The major products marketed by the company include farmowner's, homeowner's, allied lines, fire and commercial lines of business. The company plans to offer umbrella coverage starting in late 2017. The products are marketed through five independent agencies and three independent agents. Three agents, and one agent's spouse, serve on the board of directors of the company.

Agents and/or agencies receive a 15% commission on new and renewal property business and 10% commission on new and renewal liability premium. Commissions are paid every three months. In addition to the standard commission, the company offers a termination buy-out commission equal to one annual commission payment in addition to any regular commissions due at the time of termination.

The following table is a summary of the net insurance premiums written by the company in 2015. The growth of the company is discussed in the "Financial Data" section of this report.

| Line of Business | Direct Premium | Reinsurance Assumed | Reinsurance Ceded | Net Premium |
|---|---|---|---|---|
| Fire | $ 59,336 | $0 | $ 18,260 | $ 41,076 |
| Allied lines | 68,671 | 0 | 21,130 | 47,541 |
| Farmowner's multiple peril | 922,034 | 0 | 283,553 | 638,481 |
| Homeowner's multiple peril | 551,841 | 0 | 169,686 | 382,155 |
| Commercial multiple peril | 7,330 | 0 | 2,228 | 5,102 |
| Total All Lines | $1,609,212 | $0 | $494,857 | $1,114,355 |

## III. MANAGEMENT AND CONTROL

**Board of Directors**

The board of directors consists of nine members that are divided into three separate classes. One class of directors is elected annually to serve a three-year term. Board Officers are elected annually at the policyholders' meeting to serve one-year terms. Board members currently receive $75 per meeting attended, mileage reimbursement at the IRS established rate, plus any out-of-pocket expenses for continuing education or industry meetings attended in relation to their director responsibilities.

Currently the board of directors consists of the following persons:

| Name and Residence | Principal Occupation | Term Expires |
|---|---|---|
| Edward Sontag*<br>President<br>Somerset, WI | Crop Farmer and Insurance Agent | 2017 |
| Thomas Stack*#<br>Vice President<br>Glenwood City, WI | Insurance Agent | 2017 |
| David Neidermire*<br>Secretary/Treasurer<br>New Richmond, WI | Dairy Farmer and Insurance Agent | 2019 |
| James Klemesrud<br>New Richmond, WI | Retired Engineer | 2018 |
| Richard McCurdy#<br>Centuria, WI | Accountant and Life & Disability Insurance Agent | 2018 |
| Craig Gustafson<br>Osceola, WI | Manager – Federated Co-operative | 2018 |
| David Thiel<br>New Richmond, WI | Retired Machinist | 2017 |
| Carol Schiltgen<br>Amery, WI | Office Manager | 2019 |
| Gary Berget<br>New Richmond, WI | Construction Contractor | 2019 |

* Indicates the director is an agent for the company.
\# Indicates the director's spouse is an agent for the company.
The three directors, and the wife of one of the members of the board of directors, wrote approximately 69% of the company's 2015 direct premiums.

**Officers of the Company**

Three of the company's directors serve as the executive officers of the company. In addition, the company has one general manager. The company's long-serving general manager, Ronald Lais, passed away unexpectedly in September 2015. The board took on additional duties during this difficult time for the company to ensure that the company would continue to protect its policyholders until a new manager could be hired. David Neidermire was appointed to serve as interim manager. A new manager, Mike Soldan, was eventually hired and began work at the company in April 2016.

The compensation paid to the company's officers and managers at the time of this examination is depicted below:

| Name | Office | 2015 Compensation* |
|---|---|---|
| Edward Sontag | President | $12,238 |
| Thomas Stack | Vice President | 49,020 |
| David Neidermire | Secretary/Treasurer | 24,891** |
| Mike Soldan | Manager | See Below*** |
| Ronald Lais | Manager | 51,434 |

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

** David Neidermire received $15,000 as compensation for serving as the interim manager in addition to the $1,200 and $8,691 he received as director's salary and agent commissions, respectively.

*** Mike Soldan started work in April of 2016 and is contracted to receive gross annual compensation of $73,650, which includes employee benefits.

The President is the only officer who is paid a salary, which was $1,200. The Secretary/Treasurer received a salary of $5,000 per month to serve as the company's interim manager. Officers of the company are also captive agents for the company and are paid commissions. For 2015, the President received $9,988 in commissions, the Vice President received $48,045 and the Secretary/Treasurer received $8,691.

During the years under examination, officers who were also captive agents of the company received $20 per hour for performing claim adjusting services for smaller, less complex property claims on behalf of the company. Starting in 2017, agents no longer perform adjusting services for the company. Agents also received compensation for completing renewal applications on the three-year anniversary of policies ($30 for farmowner's policies and $15 for all other policies). This renewal compensation was eliminated when the company switched from three-year renewals to annual renewals beginning in 2015. For 2015, the President received $155 for the aforementioned services, the Vice President received $170 and the Secretary/Treasurer received $60. It was noted that the compensation paid to officers in 2015 relating to claims adjusting services, and completing renewal applications, was not included in the balances reported in the above table, which is based upon the company's 2015 Report on Executive Compensation. This issue is discussed further in the section of the report titled "Summary of Examination Results."

**Committees of the Board**

The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination included the Investment Committee and the Claims Adjusting Committee; both committees were comprised of all directors.

## IV. REINSURANCE

The examiners' review of Farmington Mutual Insurance Company's reinsurance portfolio revealed that there is currently one ceding treaty. It was noted that the current treaty includes quota share and excess of loss provisions for umbrella coverage, which has not been offered by the company in the past but may be offered in the future. The contract contained a proper insolvency clause.

**Ceding Contracts**

| | |
|---|---|
| Reinsurer: | Wisconsin Reinsurance Corporation (WRC) |
| Effective date: | January 1, 2017 |
| Termination provisions: | Either party may terminate this contract on any January 1 by giving the other party at least 90 days' advance notice in writing |

The coverages provided under this treaty are summarized as follows:

| | | |
|---|---|---|
| 1. | Type of contract: | Exhibit AX1 – Casualty Excess of Loss Reinsurance |
| | Lines reinsured: | All casualty or liability business written by the company (excluding umbrella liability) |
| | Company's retention: | $10,000 in respect to each and every loss occurrence |
| | Coverage: | 100% of each and every loss occurring of the business covered, including loss adjustment expenses in excess of the retention, subject to maximum policy limits of $1,000,000 per occurrence, $1,000,000 split limits, $25,000 for medical payments, per person; $25,000 per accident for personal lines |
| | Reinsurance premium: | 50% of casualty or liability net premium written<br>Annual premium deposit: $127,500 |
| 2. | Type of contract: | Exhibit AUQ99X1 – Combination Umbrella Quota Share and Excess of Loss |
| | Lines reinsured: | All umbrella liability business written by the company, subject to a maximum policy limit of $2,000,000 |
| | Coverage: | <u>Part 1 – 99% Quota Share of the first $1,000,000 limit of liability</u><br>The company shall cede on a pro rata basis and the reinsurer shall assume a 99% quota share of the business covered, subject to the limits of liability set forth in the following paragraph<br><br>The reinsurer shall be liable for 99% of each loss occurrence, including loss adjustment expense, on the |

| | | |
|---|---|---|
| | | business covered, subject to a maximum limit of liability of $990,000 (99% of $1,000,000) on each loss occurrence<br><br><u>Part 2 – 100% of $1,000,000 in excess of $1,000,000 excess loss occurrence</u><br>The reinsurer shall be liable for 100% of each loss occurrence, on the business covered, in excess of the company's retention of $1,000,000 in Part 1, subject to the reinsurer's limit of liability of $1,000,000 for each loss occurrence under Part 2<br><br>Loss adjustment expense is included in addition to losses covered hereunder and in addition to the reinsurer's limit of liability for Part 1 and Part 2 |
| | Reinsurance premium: | 99% of net umbrella liability premium written |
| | Commission: | 27.5% of the premium paid to the reinsurer |
| 3. | Type of contract: | Exhibit C1 – Excess of Loss - First Layer |
| | Lines reinsured: | All property business written by the company |
| | Company's retention: | $125,000 per occurrence |
| | Coverage: | 100% of any loss, including loss adjustment expense, in excess of $125,000, subject to a limit of liability to the reinsurer of $125,000 |
| | Reinsurance premium: | Rate: 6% of the company's net premiums in respect to the business covered<br>Annual premium deposit: $89,700 |
| 4. | Type of contract: | Exhibit C2 – Excess of Loss - Second Layer |
| | Lines reinsured: | All property business written by the company |
| | Company's retention: | $250,000 per occurrence |
| | Coverage: | 100% of any loss, including loss adjustment expense, in excess of $250,000, subject to a limit of liability to the reinsurer of $750,000 |
| | Reinsurance premium: | 4.25% of the company's net premiums in respect to the business covered<br>Annual premium deposit: $63,538 |
| 5. | Type of contract: | Exhibit C3 – Excess of Loss - Third Layer |
| | Lines reinsured: | All property business written by the company |
| | Company's retention: | $1,000,000 per occurrence |
| | Coverage: | 100% of each and every loss, including loss adjustment expense, in excess of $1,000,000, subject to a limit of liability to the reinsurer of $1,000,000 |

| | | |
|---|---|---|
| | Reinsurance premium: | 1.5% of the company's net premiums in respect to the business covered<br>Annual premium deposit: $22,425 |
| 6. | Type of contract: | Exhibit D1 – First Aggregate Excess of Loss Reinsurance |
| | Lines reinsured: | All business written by the company |
| | Company's retention: | 70% of net written premium (estimated at $1,135,820) |
| | Coverage: | 100% of aggregate net losses, including loss adjustment expenses, in the annual period that exceed the retention with a limit of 65% of net written premium (losses from 70% to 135% of net written premium) |
| | Reinsurance premium: | Rate: 10.75%<br>Annual premium deposit: $174,430<br>Estimated attachment point: $1,135,820 |
| 7. | Type of contract: | Exhibit D2 – Second Aggregate Excess of Loss Reinsurance |
| | Lines reinsured: | All business written by the company |
| | Company's retention: | 135% of net written premium |
| | Coverage: | 100% of aggregate net losses, including loss adjustment expenses, in the annual period that exceed the retention |
| | Reinsurance premium: | Rate: 4.50%<br>Annual premium deposit: $73,017 |

## V. FINANCIAL DATA

The following financial statements reflect the financial condition of the company as reported to the Commissioner of Insurance in the December 31, 2015, annual statement. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination." Also included in this section are schedules that reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation.

**Farmington Mutual Insurance Company**
**Assets**
**As of December 31, 2015**

| | Assets | Nonadmitted Assets | Net Admitted Assets |
|---|---|---|---|
| Bonds | $3,362,445 | $ | $3,362,445 |
| Stocks: | | | |
| Preferred stocks | 226,238 | | 226,238 |
| Common stocks | 2,950,650 | | 2,950,650 |
| Real estate: | | | |
| Occupied by the company | 15,019 | | 15,019 |
| Cash, cash equivalents, and short-term investments | 1,003,271 | | 1,003,271 |
| Investment income due and accrued | 18,979 | | 18,979 |
| Premiums and considerations: | | | |
| Uncollected premiums and agents' balances in course of collection | 2,008 | | 2,008 |
| Deferred premiums, agents' balances, and installments booked but deferred and not yet due | 354,584 | | 354,584 |
| Reinsurance: | | | |
| Other amounts receivable under reinsurance contracts | 13,384 | | 13,384 |
| Net deferred tax asset | 493 | 493 | |
| Electronic data processing equipment and software | 1,928 | | 1,928 |
| Total Assets | $7,948,999 | $493 | $7,948,506 |

**Farmington Mutual Insurance Company**
**Liabilities, Surplus, and Other Funds**
**As of December 31, 2015**

| | | |
|---|---|---|
| Losses | | $ 85,161 |
| Loss adjustment expenses | | 4,100 |
| Commissions payable, contingent commissions, and other similar charges | | 163,169 |
| Other expenses (excluding taxes, licenses, and fees) | | 4,271 |
| Taxes, licenses, and fees (excluding federal and foreign income taxes) | | 20,553 |
| Current federal and foreign income taxes | | 85,621 |
| Net deferred tax liability | | 4,558 |
| Unearned premiums | | 1,127,256 |
| Advance premium | | 14,735 |
| Amounts withheld or retained by company for account of others | | 2,135 |
| Total liabilities | | 1,511,559 |
| Unassigned funds (surplus) | $6,436,947 | |
| Surplus as regards policyholders | | 6,436,947 |
| Total Liabilities and Surplus | | $7,948,506 |

**Farmington Mutual Insurance Company**
**Summary of Operations**
**For the Year 2015**

| | | |
|---|---|---|
| **Underwriting Income** | | |
| Premiums earned | | $1,125,078 |
| | | |
| Deductions: | | |
| Losses incurred | $372,156 | |
| Loss adjustment expenses incurred | 51,353 | |
| Other underwriting expenses incurred | 436,312 | |
| Total underwriting deductions | | 859,821 |
| Net underwriting gain | | 265,257 |
| | | |
| **Investment Income** | | |
| Net investment income earned | 67,096 | |
| Net realized capital gains | 63,409 | |
| Net investment gain | | 130,505 |
| | | |
| **Other Income** | | |
| Finance and service charges not included in premiums | 8,854 | |
| Total other income | | 8,854 |
| | | |
| Net income before federal and foreign income taxes | | 404,616 |
| Federal and foreign income taxes incurred | | 130,790 |
| | | |
| Net Income | | $ 273,826 |

**Farmington Mutual Insurance Company**
**Cash Flow**
**For the Year 2015**

| | | | |
|---|---|---|---|
| Premiums collected net of reinsurance | | | $1,117,399 |
| Net investment income | | | 67,480 |
| Miscellaneous income | | | 8,854 |
| Total | | | 1,193,733 |
| Benefit- and loss-related payments | | $ 424,139 | |
| Commissions, expenses paid, and aggregate write-ins for deductions | | 458,585 | |
| Federal and foreign income taxes paid | | 91,518 | |
| Total deductions | | | 974,242 |
| Net cash from operations | | | 219,491 |
| | | | |
| Proceeds from investments sold, matured, or repaid: | | | |
| Bonds | $ 426,127 | | |
| Stocks | 2,257,534 | | |
| Total investment proceeds | | 2,683,661 | |
| Cost of investments acquired (long-term only): | | | |
| Bonds | 978,756 | | |
| Stocks | 1,830,888 | | |
| Real estate | 11,281 | | |
| Total investments acquired | | 2,820,925 | |
| Net cash consumed by investments | | | (137,264) |
| | | | |
| Cash from financing and miscellaneous sources: | | | |
| Other cash provided (applied) | | 2,135 | |
| Net cash from financing and miscellaneous sources | | | 2,135 |
| | | | |
| **Reconciliation:** | | | |
| Net change in cash, cash equivalents, and short-term investments | | | 84,362 |
| Cash, cash equivalents, and short-term investments: | | | |
| Beginning of year | | | 918,909 |
| | | | |
| End of Year | | | $1,003,271 |

**Farmington Mutual Insurance Company**
**Compulsory and Security Surplus Calculation**
**December 31, 2015**

| | | |
|---|---|---|
| Assets | | $7,948,506 |
| Less security surplus of insurance subsidiaries | | |
| Less liabilities | | 1,511,559 |
| Adjusted surplus | | 6,436,947 |
| Annual premium: | | |
| Lines other than accident and health | $1,114,355 | |
| Factor | 20% | |
| Compulsory surplus (subject to a minimum of $2 million) | | 2,000,000 |
| Compulsory Surplus Excess (or Deficit) | | $4,436,947 |
| Adjusted surplus (from above) | | $6,436,947 |
| Security surplus: (140% of compulsory surplus, factor reduced 1% for each $33 million in premium written in excess of $10 million, with a minimum factor of 110%) | | 2,800,000 |
| Security Surplus Excess (or Deficit) | | $3,636,947 |

**Farmington Mutual Insurance Company**
**Analysis of Surplus**
**For the Five-Year Period Ending December 31, 2015**

The following schedule details items affecting surplus during the period under examination as reported by the company in its filed annual statements:

| | **2015** | **2014** | **2013** | **2012** | **2011** |
|---|---|---|---|---|---|
| Surplus, beginning of year | $6,067,042 | $5,472,476 | $4,866,746 | $4,949,192 | $5,141,772 |
| Net income | 273,826 | 140,385 | 379,950 | 261,371 | (123,947) |
| Change in net unrealized capital gains/losses | 73,398 | 473,772 | 228,169 | (251,386) | (70,526) |
| Change in net deferred income tax | 22,340 | (19,060) | (19,953) | (97,139) | 17,130 |
| Change in nonadmitted assets | 341 | (531) | 17,564 | 4,708 | (15,237) |
| Surplus, End of Year | $6,436,947 | $6,067,042 | $5,472,476 | $4,866,746 | $4,949,192 |

**Farmington Mutual Insurance Company**
**Insurance Regulatory Information System**
**For the Five-Year Period Ending December 31, 2015**

The company's NAIC Insurance Regulatory Information System (IRIS) results for the period under examination are summarized below. IRIS is a collection of analytical solvency tools and databases designed to provide state insurance departments with an integrated approach to screening and analyzing the financial condition of insurers, and the IRIS Ratio Application generates key financial ratio results based on financial information obtained from insurers' statutory annual financial statements. Unusual IRIS results are denoted with asterisks and discussed below the table.

| | Ratio | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|---|
| #1 | Gross Premium to Surplus | 25.0% | 26.0% | 30.0% | 34.0% | 32.0% |
| #2 | Net Premium to Surplus | 17.0 | 18.0 | 21.0 | 23.0 | 21.0 |
| #3 | Change in Net Premiums Written | 1.0 | -3.0 | 0.0 | 7.0 | 2.0 |
| #4 | Surplus Aid to Surplus | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| #5 | Two-Year Overall Operating Ratio | 81.0 | 76.0 | 63.0 | 92.0 | 99.0 |
| #6 | Investment Yield | 0.9 * | 1.3 * | 1.0 * | 1.6 * | 1.4 * |
| #7 | Gross Change in Surplus | 0.9 | 11.0 | 12.0 | -2.0 | -4.0 |
| #8 | Change in Adjusted Surplus | 6.0 | 11.0 | 12.0 | -2.0 | -4.0 |
| #9 | Liabilities to Liquid Assets | 15.0 | 16.0 | 17.0 | 19.0 | 22.0 |
| #10 | Agents' Balances to Surplus | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| #11 | One-Year Reserve Development to Surplus | 0.0 | 0.0 | -1.0 | -2.0 | 1.0 |
| #12 | Two-Year Reserve Development to Surplus | 0.0 | -1.0 | -2.0 | 0.0 | -2.0 |
| #13 | Estimated Current Reserve Deficiency to Surplus | 0.0 | -1.0 | 3.0 | 4.0 | -5.0 |

The company's only exceptional IRIS result relates to the company's investment yield, which was outside of the NAIC defined usual range for each year under examination. The table below provides the "usual" investment yield ranges for the industry, for each year under examination, in comparison with the company's exceptionally low investment yield values.

| | NAIC "usual" range: | | |
|---|---|---|---|
| Year | Upper Limit | Lower Limit | Company Value |
| 2015 | 6.5 | 3 | 0.9 |
| 2014 | 6.5 | 3 | 1.3 |
| 2013 | 6.5 | 3 | 1.0 |
| 2012 | 6.5 | 3 | 1.6 |
| 2011 | 6.5 | 3 | 1.4 |

It has become commonplace for property and casualty companies to fall below this lower limit in recent years because of the historically low market interest rate environment. However, in addition to historically low interest rates, in 2015 investment expenses of $52,069 reduced gross investment income of $122,484 by 42.5%. Over the period covered by the examination, investment expenses have averaged approximately 38% of gross investment income, as depicted in the table below.

| Year | Gross Investment Income | Investment Expenses | Percent |
|---|---|---|---|
| 2015 | 122,484 | 52,069 | 42.5% |
| 2014 | 144,882 | 52,150 | 36.0 |
| 2013 | 110,312 | 45,087 | 40.9 |
| 2012 | 132,095 | 37,544 | 34.0 |
| 2011 | 133,625 | 46,505 | 34.8 |

**Growth of Farmington Mutual Insurance Company**

| Year | Admitted Assets | Liabilities | Surplus as Regards Policyholders | Net Income |
|---|---|---|---|---|
| 2015 | $7,948,506 | $1,511,559 | $6,436,947 | $ 273,872 |
| 2014 | 7,589,700 | 1,522,658 | 6,067,042 | 140,385 |
| 2013 | 6,952,775 | 1,480,299 | 5,472,476 | 379,950 |
| 2012 | 6,415,723 | 1,548,977 | 4,866,746 | 261,371 |
| 2011 | 6,659,266 | 1,710,074 | 4,949,192 | (123,947) |
| 2010 | 6,735,610 | 1,593,838 | 5,141,772 | 177,977 |

| Year | Gross Premium Written | Net Premium Written | Premium Earned | Loss and LAE Ratio | Expense Ratio | Combined Ratio |
|---|---|---|---|---|---|---|
| 2015 | $1,609,212 | $1,114,355 | $1,125,078 | 37.6% | 38.4% | 76.0% |
| 2014 | 1,601,369 | 1,103,524 | 1,155,981 | 63.8 | 35.6 | 99.4 |
| 2013 | 1,640,816 | 1,142,664 | 1,159,500 | 30.1 | 37.2 | 67.3 |
| 2012 | 1,653,435 | 1,139,288 | 1,089,862 | 37.1 | 37.1 | 74.2 |
| 2011 | 1,574,913 | 1,062,818 | 1,091,615 | 90.1 | 34.5 | 124.6 |
| 2010 | 1,575,466 | 1,037,947 | 1,054,532 | 55.7 | 33.4 | 89.1 |

Surplus and admitted assets increased overall during the period under examination, despite declining in 2011 and 2012 primarily due to losses incurred from storm events in 2011 and unrealized capital losses of $251,000 in 2012. Surplus as of December 31, 2015, increased approximately 25% since 2010 primarily as a result of cumulative underwriting profits of $640,000 and net investment income and net unrealized capital gains over the same period totaling $1,092,000. One-third of these positive investment results were attributable to Wisconsin Reinsurance Corporation (WRC) and NAMIC Insurance Company, Inc., results totaling $356,000, comprised of cumulative unrealized gains of $266,000 and WRC dividends of $90,000.

The company's gross premium written and net premium written to surplus ratios have averaged about 0.29 to 1 and 0.20 to 1, respectively, over the period under examination. Gross premiums written increased 2% over the period under examination, with the increase due primarily to rate and insured value increases. The company had 1,939 policyholders at the beginning of the examination period and 1,690 at the end of the examination period, a decrease of 13%.

The expense ratio increased from 33.4% to 38.4% during the period under examination, with an average of 36.6%. The increase in 2015 to 38.4% (from 35.6% for 2014) was primarily due to a retirement payment of $18,670 to a former agent.

The company's average combined ratio (net of reinsurance) during the period under examination was 88.3%, which reflects the 124.6% combined ratio in 2011 (due to high storm-related losses that year). The average combined ratio for the last four years of the examination period was 79%, evidencing profitable underwriting results during that four-year period.

**Reconciliation of Surplus per Examination**

The following schedule is a reconciliation of surplus as regards policyholders between that reported by the company and as determined by this examination:

| | Increase | Decrease | |
|---|---|---|---|
| Surplus December 31, 2015, per annual statement | | | $6,436,947 |
| Cash | $0 | $(174,789) | |
| Bonds | 0 | (144,068) | |
| Common stocks | 0 | (26,238) | |
| Investment income due and accrued | 0 | (638) | |
| Net increase or (decrease) | $0 | $(345,713) | (345,713) |
| Surplus December 31, 2015, Per Examination | | | $6,091,234 |

For more information on this adjustment, please refer to the section of this report entitled "Summary of Current Examination Results."

**Examination Reclassifications**

No reclassifications were made as a result of the examination.

## VI. SUMMARY OF EXAMINATION RESULTS

### Compliance with Prior Examination Report Recommendations

There were 10 specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

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

   Action—Noncompliance; see comments in the "Summary of Current Examination Results."

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

   Action—Noncompliance; see comments in the "Summary of Current Examination Results."

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

   Action—Partial compliance; see comments in the "Summary of Current Examination Results."

4. Underwriting—It is suggested that for new business the company create an inspection checklist or guide for the inspection of each class of business the company writes.

   Action—Compliance.

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

   Action—Noncompliance; see comments in the "Summary of Current Examination Results."

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

Action—Noncompliance; see comments in the “Summary of Current Examination Results.”

7. Investments—It is recommended that the company report the correct NAIC designation that corresponds with equivalent ratings from NAIC acceptable rating organizations in accordance with the NAIC’s SVO Purposes and Procedures Manual.

   Action—Noncompliance; see comments in the “Summary of Current Examination Results.”

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

   Action—Compliance.

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

   Action—Noncompliance; see comments in the “Summary of Current Examination Results.”

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

    Action—Compliance.

## Summary of Current Examination Results

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

## Conflict of Interest

In accordance with a directive of the Commissioner of Insurance, each company is required to establish a procedure for the disclosure to its board of directors of any material interest or affiliation on the part of its officers, directors, or key employees that conflict, or are 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. All conflict of interest statements over the period under examination were reviewed. It was noted that some board members did not disclose as conflicts the fact that they are appointed agents for other insurance companies. A director who is appointed as an agent for a competing insurance company has a conflict of interest; therefore, such appointment should be disclosed as a conflict and the specific companies should be listed on the conflict of interest statement. It is again recommended that the company's officers, directors, or key employees annually disclose all potential conflicts with their respective duties with the company.

## Business Continuity Plan

A business continuity plan identifies steps to be performed in case the company loses a key employee, is not able to access its computer, information on its computer is lost, or the office building is destroyed, to name a few contingencies. The company has not established a formal written disaster recovery plan or key employee succession plan. The lack of a formalized key employee succession plan affected the company and this examination due to the recent passing of the former long-term manager of the company and demonstrated the urgency to establish such a plan. However, both the interim manager and the recently hired permanent manager have performed admirably despite the lack of a formalized succession plan and documented operating procedures. A future unexpected loss of the manager or administrative employee would be difficult for the company, given the lack of planning and documentation. It is again recommended that the company develop a comprehensive disaster recovery plan that would clearly identify what would be done in cases where it is not able to access its computers, the office building is destroyed or if a key employee is lost. All critical company procedures, including licensing, underwriting, adjusting, cash receipts and disbursements, agent management, reinsurance, and investment oversight and approval must be documented. The company should prepare a formalized succession plan, including specific job duties and responsibilities and detailed procedures manuals, for the company manager and the administrative employee. The plan should include specific details for short-term and long-term resolution of the loss of one or both employees.

**Unclaimed Funds**

The company does not have a procedure to track outstanding checks and report escheats to the state. Current company practice is to void and reissue checks that have been outstanding for six months, on a continuous six-month cycle. Long-term outstanding checks are handled the same way (i.e., reissued every six months). Because of this procedure, the examiners were not able to determine the original issue date of one of the stale checks. It was noted that the company does not have a written escheat policy under which unclaimed funds are tracked and remitted to the Wisconsin Department of Revenue in compliance with ch. 177, Wis. Stat. (Uniform Unclaimed Property Act). It is recommended that the company develop, and the board adopt, a written escheat policy and the policy should address: (1) the company's procedures relating to stale-dated checks (sufficient to ensure compliance with the requirements of ch. 177, Wis. Stat.); and (2) the establishment and maintenance of an escheat liability account (to hold stale-dated checks outstanding for over one year).

**Agent Contract**

The agency contract in force during the exam period and through the first succeeding year, 2016, lacked provisions for both a right of first refusal for the transfer of in force business and a requirement that agents carry E&O coverage.

It was noted that the agency contract that was implemented starting January 1, 2017, included a good faith clause, a provision that the company has right of first refusal for transfer of in force business, and a provision requiring that agents carry E&O coverage.  The company has obtained executed updated agency agreements for 2017 from all agents and has also obtained policy declaration pages evidencing agent's E&O coverage.

**Underwriting**

The company does not apply underwriting procedures in a consistent manner, and most new business is not subject to external professional underwriting inspection.  Applications for new business submitted with photographs of the risk are not required to have an underwriting inspection performed by an external professional inspection firm but are subject to underwriting qualification and approval by the company manager.  For applications submitted without photographs, an underwriting inspection performed by an external professional underwriting inspection service is required, and underwriting risk acceptance is based upon the underwriting inspection report.  During the examination, it was noted that most new applications are not subject to professional underwriting inspections, and that 30% of policy files sampled did not contain photographs of the risk.  It was also noted that the company does not have a written policy for the consistent inspection of renewal business, such as every three years.

For new business, it is again recommended that the company develop and the board approve consistent procedures to obtain an inspection if an agent's application submission is incomplete or does not contain adequate information on which to base underwriting decisions, to be applied on a consistent basis for all agents.  Professional underwriting inspections for all new risks is an industry best practice.

For renewal business, it was previously recommended that the company promptly adopt criteria to determine the priority of risks to be inspected, a checklist or guide for the inspection of each class of business, and a procedure to ensure that information from the inspection report is evaluated and underwritten before the statutory deadlines for notices of nonrenewal or changes in coverage to the policyholder.  It was also recommended that the company track inspection results, report the results to the board of directors, use the results to plan for future inspections, and that the company consistently follow its inspection criteria when deciding which policies to inspect. The company could not demonstrate compliance with either recommendation, despite the board's agreement to carry out both at the end of the last examination.

For renewal business, it is again recommended that the company promptly adopt criteria that determines the priority of which risks are to be inspected, a checklist or guide for the inspection of each class of business the company writes (homeowner's, farmowner's, mobile home, etc.), and a procedure to ensure that information from the inspection report is evaluated and underwritten before the statutory deadlines for notices of nonrenewal or changes in coverage to the policyholder, pursuant to s. 631.36 (4) and (5), Wis. Stat. It is again recommended that the company track inspection results, report the results to the board of directors, and use the results to plan for future inspections, and that the company consistently follow its inspection criteria when deciding which policies to inspect. During discussions with the board of directors, the directors mentioned that the board had adopted a policy for inspecting renewal properties at some time in the recent past. However, the company was unable to provide a written copy of the policy and therefore could not demonstrate that the policy was being followed and that renewal inspections were performed pursuant to that policy; therefore, the recommendation is repeated.

**Claims Adjusting**

The company's stated policy is to utilize outside adjusting firms for all claims; however, it was noted that this policy was not consistently followed during the period under examination. Certain claims were adjusted by either the company's manager or one of the company's director/agents. In many cases, directors adjusted claims for losses covered by policies for which they were also the agent, which is a conflict of interest for the director. Some of the claims that were adjusted by a manager or director were for less complex adjustments for scheduled property loss claims, whereas other scheduled property loss claims were sent to outside adjusters. During the examination, all claims adjusted during 2015 were analyzed. It was noted that 15% of all claims were not adjusted by an outside adjusting firm. It is recommended that the company consistently abide by company policy for using outside adjustors for all claims or revise the policy to address adjustments of scheduled property and/or less complex claims by specified in-house individuals, with due consideration of conflict of interest issues.

**Reinsurance**

The review of the company's ten largest risks revealed that the company does not use facultative reinsurance for its larger property risks. For the period under examination, the company retained the first $125,000 of property losses for each risk, after which it was protected on the next $875,000 by three layers of excess of loss reinsurance. For losses in excess of $1,000,000 the company was again responsible for the amount over $1,000,000 until the excess of loss aggregate coverage applied at the attachment point of 75% of annual net premium, which was $1,117,601 in 2015. By not ceding risks in excess of $1,000,000 to the reinsurer under the Class B or the facultative program, the company was taking the risk that a large claim could adversely affect its future reinsurance rates. The company noted that this risk was mitigated by geographic separation of risks within each of the largest policies.

The company’s reinsurance program was substantially strengthened in 2017. Excess of loss coverage was doubled to a combined limit of $2,000,000 per loss, with retention of $125,000 per occurrence. The 2017 program also includes aggregate excess of loss coverage for losses in excess of 70% of net written premium, with an estimated attachment point of $1,135,820. The strengthening of the reinsurance program, combined with geographic separation of the insured properties for the company’s largest farm risks, eliminates the need for a recommendation for facultative reinsurance at this time.

**Corporate Records**

The Report on Executive Compensation filed with this office for year-end 2015 was reviewed to verify that the report included all compensation provided to employees or directors during 2015. Examiners reviewed the company’s records regarding the report. It was noted that the company did not include compensation paid to directors who were also agents of the company for performing claim adjusting services on behalf of the company. According to s. 611.63 (4), Wis. Stat., companies are to report to the Commissioner, on an annual basis, all direct and indirect remuneration for services paid or accrued each year for the benefit of each director and each officer and employee whose remuneration exceeds the amount established by the Commissioner. The compensation paid to directors for all services provided to the company, including adjusting services, should have been reported. This is a repeat recommendation; however, the prior exam recommendation noted that the company was not properly reporting contributions to employee benefit plans. The current examination determined that the company is now properly reporting contributions to employee benefit plans as “All Other Compensation” in the Report on Executive Compensation. However, because the current examination determined that the company did not properly report compensation paid to directors for adjusting services in the Report on Executive Compensation, this recommendation is repeated. It is again recommended that the company report all remuneration paid to or accrued on behalf of employees or directors for those individuals whose remuneration meets the requirements to be reported to the Commissioner in accordance with s. 611.63, Wis. Stat.

**Investments**

The company has two employees, a general manager and an administrator, and relies on its board of directors to oversee the company’s investment functions. All members of the board of directors are members of the company’s Investment Committee.

Pursuant to s. 611.51 (6), Wis. Stat., the board of directors is required to manage the business and affairs of the insurer, including investment activities. The examination found that the company does not have a board-approved investment policy. It is recommended that the board develop an investment policy and submit it to this office for approval within six months of the adoption of this report; the investment policy should take into consideration the company’s investment objectives, metrics that will be used to evaluate the performance of the portfolio, allowable asset classes, investment limitations, prohibited investments, investment processes/controls, cash management, and investment roles and responsibilities.

In addition, it is recommended that the board establish and document internal controls to ensure that the provisions of the investment policy are properly enforced and submit the documented internal controls to this office within six months after the adoption of this report;

the internal controls should consider the resources necessary to properly oversee and enforce the provisions of the investment policy.

The examination found that the company does not have an investment management agreement with its current investment advisor. After the company prepares and adopts an appropriate investment policy, as described in the previous paragraph, the investment management agreement should also be updated to reflect the standards set forth in the newly adopted investment policy. In addition, the investment management agreement should be executed and agreed to by the investment advisor.

When establishing the provisions of the investment management agreement, the company should consider whether there are appropriate provisions to adequately address the selection of investments in accordance with the company's investment policy, authority for transactions, reporting of investment transactions (including explanatory supporting documentation upon request such as prospectuses), conflicts of interest, and calculation of fees. These considerations should include the following best practices:

a. Selection of Investments: The investment management agreement should set clear guidelines with respect to the selection of appropriate investments for the company's investment portfolio. This should include specific reference to the insurer's investment policy.

b. Authority for Transactions: The investment management agreement should address the level of discretionary authority that will be given to the investment advisor in executing transactions on behalf of the company.

c. Conflicts of Interest: The investment management agreement should clearly articulate the manner in which conflicts of interest (or potential conflicts of interest) should be addressed. [This is an important protection against an investment advisor's biases as a result of business arrangements (e.g., referral relationships, affiliate product offerings, etc.) that may interfere with the proper execution of the investment strategy. For example, investment advisors may have affiliates or business partners that offer investment options or services that should be available to the insurer but should not be given preferential treatment if competitor products or services are determined to be a better fit for the company's investment strategy.]

d. Fiduciary Responsibility: Language provided in the investment management agreement should acknowledge the investment advisor's role as a fiduciary in advising the insurer. [This is an important legal distinction that may help to protect the insurer's interests in the advisor's execution of the insurer's investment strategy.]

e. Calculation of Fees: It is important that the manner in which fees are calculated is well defined in the investment management agreement (this is critical to the evaluation of the advisor's performance). [For example, if the advisory fee is computed based on volume of transactions, it would be important for management to closely review the frequency of trades to help avoid excessive charges.]

f. Review of Performance: The investment management agreement should include consideration of information that will be provided to the company to permit the company to perform adequate review of the advisor's performance and execution of the company's investment strategy.

It is recommended that the company update the investment management agreement to conform to the company's revised investment policy in accordance with s. 611.51 (6), Wis. Stat., present the draft agreement to this office for approval within six months of the adoption of this report, and require the investment advisor to sign, and agree to abide by, such agreement. The updated agreement should incorporate the best practice considerations and include a provision requiring that securities trades will occur at the firm with the best available execution price and not require that they are executed by any specific firm or firms.

It was also determined that the Investment Committee does not make investment decisions or approve individual investment transactions but instead merely reviews the company's investment profits or losses in the aggregate. The board delegates all investment authority to the investment advisor. Pursuant to s. 611.51 (6), Wis. Stat., the board of directors may not delegate its power or responsibilities over investments. It is recommended that the board, or a subordinate committee thereof, review all investment transactions at least quarterly, for adherence with the current investment policy, approve or disapprove the investment transactions, and maintain documentation in board minutes of the records reviewed and the board's approval or disapproval of each investment transaction, in accordance with s. 611.51 (6), Wis. Stat.

Insurance company management best practices indicate that the board should monitor compliance with the company's investment policy and investment management agreement as an integral part of the investment review and approval process and should also evaluate investment manager performance against appropriately structured and mutually agreed upon investment performance benchmarks. The investment advisor should demonstrate portfolio compliance with the terms of the investment policy, in writing, for the board's review, on a periodic basis. It is recommended that the board monitor the investment advisor's compliance with the investment policy and the investment management agreement, as well as the investment advisor's performance, on at least a quarterly basis.

Derivative investments are contracts between two or more parties whose value is based on an agreed-upon underlying financial asset, index, or security. Common derivatives include futures contracts and options contracts. During the examination's review of investment transactions, it was noted that the company had purchased several securities which were comprised primarily of derivative instruments, including the following:

- Invesco PowerShares DB Gold Short ETN, designed to provide investors a way to take a short or leveraged view on the performance of gold and designed to be purchased by investors who want to profit on gold's decline. This speculative investment provides concentrated exposure to notional positions in gold futures contracts.
- ProShares Short S&P 500 ETF, designed to earn the inverse of the daily performance of the S&P 500. Common uses for inverse exposure include helping to hedge against market declines and seeking to profit from market declines. The fund does not seek to achieve its stated investment objective over a period of time greater than a single day. This speculative fund invests in derivatives including futures contracts.
- ProShares Short Russell 2000 ETF, designed to earn the inverse of the daily performance of the Russell 2000. Common uses for inverse exposure include helping to hedge against market declines and seeking to profit from market declines. The fund does not seek to achieve its stated investment objective over a period of time greater than a single day. This speculative fund invests in derivatives including futures contracts.

Pursuant to s. 620.23 (5), Wis. Stat., this office may treat the proportional share of assets owned through a mutual fund or investment company as if they were owned directly by the insurance company. Domestic insurers may not invest in derivatives unless the company has adopted a derivatives use plan, as defined in s. Ins 6.20 (8) (o), Wis. Adm. Code, which has been approved by this office. The company's board has not approved a derivative use plan, nor have they submitted such a plan to the Commissioner; therefore, these are not permitted investments for this company.

**Investment Reporting**

The examination team reviewed the company's investment schedules to determine if its investments were reported in accordance with the NAIC Annual Statement Instructions - Property and Casualty and Statements of Statutory Accounting Principles (SSAP). This review found numerous examples of incorrect reporting of transactions and preparation of the annual statement.

It was noted that a long-term transaction involving 311 shares and a short-term transaction involving 308 shares of iShares Russell 1000 Growth ETF were combined and reported in aggregate on Schedule D - Part 4 (i.e., long-term securities sold) as a 619 share long-term transaction. According to the annual statement instructions for Schedule D - Part 5, all securities that were both purchased and sold during the current reporting year should be reported on Schedule D - Part 5. The short-term portion of the transaction involved 308 shares of the iShares Russell 1000 Growth ETF, purchased March 2, 2015, for $31,079 and sold on June 10, 2015, for $30,989. Correct reporting is to report two separate transactions, the long-term portion on Schedule D - Part 4 and the short-term portion on Schedule D - Part 5.

It was also noted that long-term transactions involving 1,901 shares and a short-term transaction involving 1,219 shares of PowerShares DB US Dollar Bullish Index Fund were combined and reported in aggregate on Schedule D - Part 4, as a 3,120 share long-term transaction. As noted above, all securities that were both purchased and sold during the current reporting year should be reported on Schedule D - Part 5. The short-term portion of the transaction involved 1,219 shares of the PowerShares DB US Dollar Bullish Index Fund, purchased June 10, 2015, for $30,273 and sold on August 31, 2015, for $30,495. Correct reporting is to report the sale as two separate transactions, the long-term portion on Schedule D - Part 4 and the short-term portion on Schedule D - Part 5.

It was also noted that one long-term transaction and four short-term transactions involving a SPDR Health Care Select Sector ETF were aggregated and reported in aggregate on Schedule D - Part 4 as a 1,285 share long-term transaction with a reported cost of $90,962 and a reported sales price of $90,715. As noted above, all securities that were both purchased and sold during the current reporting year should be reported on Schedule D - Part 5. The four short-term transactions involved 851 shares that were purchased and sold in 2015. Correct reporting would be to report five separate transactions, the long-term transaction of 434 shares on Schedule D - Part 4 and the four short-term transactions separately on Schedule D - Part 5.

It was also noted that three long-term transactions and one short-term transaction involving a SPDR Consumer Staples Select Sector ETF were aggregated and reported in aggregate on Schedule D - Part 4 as a 935 share long-term transaction with a reported cost of $43,104 and a reported sales price of $45,449. As noted above, all securities that were both purchased and sold during the current reporting year should be reported on Schedule D - Part 5. The short-term transaction involved 318 shares that were purchased and sold in 2015. Correct reporting would be to report four separate transactions, the long-term transactions of 617 shares on Schedule D - Part 4 and the short-term transaction separately on Schedule D - Part 5.

The investment review also revealed that three short-term transactions involving a total of 672 shares of SPDR S&P Insurance ETF were combined and reported in the aggregate on Schedule D - Part 5 as one transaction of 439 shares. According to the annual statement instructions for Schedule D - Part 5, reporting entities should track information separately for securities purchased in different lots rather than using some type of averaging for the issue in aggregate. These short-term transactions should have been reported as three separate transactions:

- 233 shares purchased January 5, 2015, for $15,209 and sold on February 2, 2015, for $14,687.
- 15 shares purchased June 10, 2015, for $1,033 and sold on August 31, 2015, for $1,026.
- 424 shares purchased June 10, 2015, for $29,212 and sold on October 5, 2015, for $29,071.

Correct reporting is to report three separate transactions, the total of which reflects the correct number of 672 shares, on Schedule D - Part 5.

It was also noted that two short-term transactions involving an SPDR S&P Retail ETF were aggregated and reported on one line on Schedule D - Part 5, as if they were one transaction, even though there were two distinct purchase dates and two distinct sale dates. Also, the aggregated transaction was reported for a total of 312 shares, when the actual number of shares sold was 473. As noted above, according to the annual statement instructions for Schedule D - Part 5, reporting entities should track information separately for securities purchased in different lots rather than using some type of averaging for the issue.

It was also noted that four short-term transactions involving an SPDR Consumer Discretionary Select Sector ETF were aggregated and reported on one line on Schedule D - Part 5, as if they were one transaction, even though there were four distinct sale dates and two distinct purchase dates. As noted above, according to the annual statement instructions for

Schedule D - Part 5, reporting entities should track information separately for securities purchased in different lots rather than using some type of averaging for the issue.

The company held securities with variable coupons linked to the 10-year U.S. Dollar Constant Maturity Swap Rate (CMS10). The bonds in question were reported on Schedule D - Part 1 with an NAIC Designation of “2FE” without any associated Bond Characteristic code. In 2015, variable coupon securities where the issuer has the right to vary the amount of periodic payments are to be reported with a bond characteristic code of 3 in column 5 of Schedule D - Part 1. The company did not report such bonds properly.

Combining short-term transactions with long-term transactions and reporting them in aggregate as long-term transactions makes it impossible for company management, directors, and insurance regulators to properly calculate investment turnover and to perform appropriate investment oversight. Combining short-term transactions with long-term transactions is also contrary to SSAP 26, paragraph 4, and SSAP 26, paragraph 5, which mandate that dispositions shall be recorded on the trade date. Combining such transactions and choosing one set of trade dates for the entire grouped transaction’s value is not permitted.

It is again recommended that the company record bond and non-affiliated common stock investment transactions, including mutual funds and exchange traded funds, other than acquiring privately placed securities, on their trade dates in accordance with SSAP 26, paragraph 4, and SSAP 30, paragraph 5, respectively.

In addition, it is recommended that: (1) the company report all long-term bonds and stocks acquired during the year and fully disposed of during the current year on Schedule D - Part 5 and reflect the correct number of shares of the securities that are sold, in accordance with NAIC Annual Statement Instructions - Property and Casualty; (2) the company track information separately for securities purchased in different lots and report the sales of such securities as separate transactions in accordance with the annual statement instructions for Schedule D - Parts 4 and 5; and (3) the company properly report variable coupon bonds by including the proper bond characteristic code in column 5 of Schedule D - Part 1.

The prior exam recommended that the company report the correct NAIC designation that corresponds with equivalent ratings from NAIC acceptable rating organizations in accordance with the NAIC's SVO Purposes and Procedures Manual. The current year exam team reviewed the investment schedules and found numerous exceptions. It was noted that the company reported eight bonds with an incorrect designation of 1FE (filing exempt), seven bonds with an incorrect designation of 2FE, and one bond with an incorrect designation of 5FE. It is again recommended that the company report the correct NAIC designation that corresponds with equivalent ratings from NAIC acceptable rating organizations, in accordance with the NAIC's SVO Purposes and Procedures Manual.

Four U.S. Treasury securities were incorrectly listed on Line 2599999 as U.S. special revenue and special assessment issuer obligations (municipals) when they should have been listed on line 0199999 as issuer obligations of the U.S. government. Also, an American Express Centurion Bank Certificate of Deposit (CD) was reported on Schedule D - Part 1 as a long-term bond when it should have been reported on Schedule E - Part 1 as cash. This brokered CD was purchased on October 15, 2015, and matured on April 7, 2016, which would cause it to be reported as cash. It is recommended that the company properly report all long-term bonds in the appropriate category of Schedule D - Part 1, including correctly reporting U.S. Treasury securities as U.S. government bonds. In addition, it is recommended that the company properly report certificates of deposit with maturity dates of one year or less from the acquisition date on Schedule E - Part 1, in accordance with the NAIC Annual Statement Instructions - Property and Casualty.

It was noted that the company failed to properly report $312,000 of Canadian investment holdings in the annual statement. Canadian bonds must be listed separately on the Summary Investment Schedule, Line 2.2, as non-U.S. securities. Foreign investment holdings must also be listed in the Schedule D - Summary by Country, where the Canadian bonds should have been reported on Line 9. Further, foreign bonds reported on Schedule D - Part 1 and foreign stocks reported on Schedule D - Part 2 should be noted as such by including the proper code in column 4. Failure to properly report Canadian and foreign securities prevents the annual statement users from accurately assessing the investment risk and makes it difficult for the board and regulators to assess compliance with statutory investment limitations. It is recommended that the company properly report foreign and Canadian bonds and stocks in the annual statement Summary Investment Schedule, Schedule D - Summary by Country, and Schedule D - Parts 1 and 2, in accordance with the NAIC Annual Statement Instructions - Property and Casualty.

**Custodial Accounts**

The examination found that the company holds stocks, bonds and cash, totaling $345,713 as of December 31, 2015, at Interactive Brokers LLC, in an account under the investment management of Cubic Financial Advisors, LLC. These securities are not held in a custodial account which meets statutory requirements. Section 610.23, Wis. Stat., requires that if an insurer does not hold securities in its own name, or in bearer form, then the securities must be kept under a custodial agreement or trust arrangement with a bank or banking and trust company. It is recommended that the company comply with s. 610.23, Wis. Stat., and immediately transfer the securities held at Interactive Brokers LLC into a proper custodial or trust arrangement with a bank or banking and trust company. The company's directors and officers stated that they did not authorize this account and that they were unaware of the existence of this account until it was discovered by examiners during the examination. Due to uncertainties about the company's ability to use the funds in the brokerage account to pay claims, it is recommended that the company nonadmit the balance of this account ($345,713 at December 31, 2015) until the company has transferred the funds into a custodial account that complies with s. 610.23, Wis. Stat.

**Custodial Agreements**

Custodial agreements of Wisconsin-domiciled companies must comply with guidelines contained in the NAIC's Financial Condition Examiners Handbook. The review of the custodial agreement with Comerica Bank revealed that the agreement does not include the suggested clauses as contained in the NAIC's Financial Condition Examiners Handbook to ensure proper controls and safeguards. The following items were missing from the agreement:

a. The custodian is obligated to indemnify the insurance company for any insurance company's loss of securities in the custodian's custody, except that, unless domiciliary state law, regulation or administrative action otherwise require a stricter standard, the custodian shall not be so obligated to the extent that such loss was caused by other than the negligence or dishonesty of the custodian.

b. In the event of a loss of the securities for which the custodian is obligated to indemnify the insurance company, the securities shall be promptly replaced or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.

c. The custodian shall not be liable for any failure to take any action required to be taken hereunder in the event and to the extent that the taking of such action is prevented or delayed by war (whether declared or not and including existing wars), revolution, insurrection, riot, civil commotion, act of God, accident, fire, explosions, stoppage of labor, strikes or other differences with employees, laws, regulations, orders or other acts of any governmental authority, or any other cause whatever beyond its reasonable control.

d. In the event that the custodian gains entry in a clearing corporation through an agent, there should be a written agreement between the custodian and the agent that the agent shall be subjected to the same liability for loss of securities as the custodian. If the agent is governed by laws that differ from the regulation of the custodian, the Commissioner of Insurance of the state of domicile may accept a standard of liability applicable to the agent that is different from the standard liability.

e. If the custodial agreement has been terminated or if 100% of the account assets in any one custody account have been withdrawn, the custodian shall provide written notification, within three business days of termination or withdrawal, to the insurer's domiciliary commissioner.

f. During regular business hours, and upon reasonable notice, an officer or employee of the insurance company, an independent accountant selected by the insurance company and a representative of an appropriate regulatory body shall be entitled to examine, on the premises of the custodian, its records relating to securities, if the custodian is given written instructions to that effect from an authorized officer of the insurance company.

g. The custodian and its agents, upon reasonable request, shall be required to send all reports which they receive from a clearing corporation, which the clearing corporation permits to be redistributed including reports prepared by the custodian's outside auditors, to the insurance company on their respective systems of internal control.

h. To the extent that certain information maintained by the custodian is relied upon by the insurance company in preparation of its annual statement and supporting schedules, the custodian agrees to maintain records sufficient to determine and verify such information.

i. The custodian shall provide, upon written request from a regulator or an authorized officer of the insurance company, the appropriate affidavits, with respect to the insurance company's securities held by the custodian.

j. The custodian shall secure and maintain insurance protection in an adequate amount.

k. The foreign bank acting as a custodian, or a U.S. custodian's foreign agent, or a foreign clearing corporation is only holding foreign securities or securities required by the foreign country in order for the insurer to do business in that country. A U.S. custodian must hold all other securities.

It is recommended that the company work with Comerica Bank to revise the custodial agreement to include the recommended provisions contained in the NAIC's Financial Condition

Examiners Handbook. The revised agreement should be executed by Comerica Bank and the company.

## VII. CONCLUSION

The company reported admitted assets of $7.9 million, liabilities of $1.5 million, and policyholders' surplus of $6.4 million for 2015. Operations for 2015 produced net income of $274,000. Over the five-year period under examination, the company's reported policyholders' surplus increased by approximately 25%, primarily due to underwriting profits and investment results. Gross premium volume decreased by 2% over the period under examination, primarily as a result of increased competition, while policy count declined by 13% to 1,690 over the same period.

The examination found numerous problems related to the company's investments, including the board not establishing a detailed investment policy, not having a current, executed investment management agreement, insufficient oversight of investment transactions, incorrect reporting of transactions in the annual statement, investing in securities which contain derivatives, and not knowing that the company used an account held by a brokerage company and not in a custodial account in violation of Wisconsin statutes. The company should adopt an investment policy that aligns with its investment strategy and objectives, is appropriate in light of the resources necessary to properly oversee and enforce the policy, and establishes clear guidelines with respect to appropriate investments for the company's investment portfolio.

The examination verified the financial condition of the company as reported in its annual statement as of December 31, 2015. The examination of FMIC resulted in 21 recommendations, 7 of which were repeated from the previous examination and 1 adjustment to surplus. The recommendations relate to establishing a business continuity plan, especially with respect to key employee succession, filing unclaimed property reports with the state of Wisconsin, underwriting inspection procedures, claims adjusting procedures, meeting filing requirements relating to executive compensation, formulation, implementation, approval, and monitoring of an appropriate investment strategy, holding investments outside of a proper custodial account, and several investment reporting errors.

## VIII. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 23 - Conflict of Interest—It is again recommended that the company's officers, directors, or key employees annually disclose all potential conflicts with their respective duties with the company.

2. Page 24 - Business Continuity Plan—It is again recommended that the company develop a comprehensive disaster recovery plan that would clearly identify what would be done in cases where it is not able to access its computers, the office building is destroyed or if a key employee is lost.

3. Page 24 - Unclaimed Funds—It is recommended that the company develop, and the board adopt, a written escheat policy and the policy should address: (1) the company's procedures relating to stale-dated checks (sufficient to ensure compliance with the requirements of ch. 177, Wis. Stat.); and (2) the establishment and maintenance of an escheat liability account (to hold stale-dated checks outstanding for over one year).

4. Page 25 - Underwriting—For new business, it is again recommended that the company develop and the board approve consistent procedures to obtain an inspection if an agent's application submission is incomplete or does not contain adequate information on which to base underwriting decisions, to be applied on a consistent basis for all agents. Professional underwriting inspections for all new risks is an industry best practice.

5. Page 26 - Underwriting—For renewal business, it is again recommended that the company promptly adopt criteria that determines the priority of which risks are to be inspected, a checklist or guide for the inspection of each class of business the company writes (homeowner's, farmowner's, mobile home, etc.), and a procedure to ensure that information from the inspection report is evaluated and underwritten before the statutory deadlines for notices of nonrenewal or changes in coverage to the policyholder, pursuant to s. 631.36 (4) and (5), Wis. Stat. It is again recommended that the company track inspection results, report the results to the board of directors, and use the results to plan for future inspections, and that the company consistently follow its inspection criteria when deciding which policies to inspect.

6. Page 26 - Claims Adjusting—It is recommended that the company consistently abide by company policy for using outside adjustors for all claims or revise the policy to address adjustments of scheduled property and/or less complex claims by specified in-house individuals, with due consideration of conflict of interest issues.

7. Page 28 - Corporate Records—It is again recommended that the company report all remuneration paid to or accrued on behalf of employees or directors for those individuals whose remuneration meets the requirements to be reported to the Commissioner in accordance with s. 611.63, Wis. Stat.

8. Page 28 - Investments—It is recommended that the board develop an investment policy and submit it to this office for approval within six months of the adoption of this report; the investment policy should take into consideration the company's investment objectives, metrics that will be used to evaluate the performance of the portfolio, allowable asset classes, investment limitations, prohibited investments, investment processes/controls, cash management, and investment roles and responsibilities.

9. Page 28 - Investments—In addition, it is recommended that the board establish and document internal controls to ensure that the provisions of the investment policy are properly enforced and submit the documented internal controls to this office within six months after the adoption of this report; the internal controls should consider the resources necessary to properly oversee and enforce the provisions of the investment policy.

10. Page 30 - Investments—It is recommended that the company update the investment management agreement to conform to the company's revised investment policy in accordance with s. 611.51 (6), Wis. Stat., present the draft agreement to this office for approval within six months of the adoption of this report, and require the investment advisor to sign, and agree to abide by, such agreement. The updated agreement should incorporate the best practice considerations and include a provision requiring that securities trades will occur at the firm with the best available execution price and not require that they are executed by any specific firm or firms.

11. Page 30 - Investments—It is recommended that the board, or a subordinate committee thereof, review all investment transactions at least quarterly, for adherence with the current investment policy, approve or disapprove the investment transactions, and maintain documentation in board minutes of the records reviewed and the board's approval or disapproval of each investment transaction, in accordance with s. 611.51 (6), Wis. Stat.

12. Page 30 - Investments—It is recommended that the board monitor the investment advisor's compliance with the investment policy and the investment management agreement, as well as the investment advisor's performance, on at least a quarterly basis.

13. Page 31 - Investments—Comment—Domestic insurers may not invest in derivatives unless the company has adopted a derivatives use plan, as defined in s. Ins 6.20 (8) (o), Wis. Adm. Code, which has been approved by this office. The company's board has not approved a derivative use plan, nor have they submitted such a plan to the Commissioner; therefore, these are not permitted investments for this company.

14. Page 34 - Investment Reporting—It is again recommended that the company record bond and non-affiliated common stock investment transactions, including mutual funds and exchange traded funds, other than acquiring privately placed securities, on their trade dates in accordance with SSAP 26, paragraph 4, and SSAP 30, paragraph 5, respectively.

15. Page 34 - Investment Reporting—In addition, it is recommended that: (1) the company report all long-term bonds and stocks acquired during the year and fully disposed of during the current year on Schedule D - Part 5 and reflect the correct number of shares of the securities that are sold, in accordance with NAIC Annual Statement Instructions - Property and Casualty; (2) the company track information separately for securities purchased in different lots and report the sales of such securities as separate transactions in accordance with the annual statement instructions for Schedule D - Parts 4 and 5; and (3) the company properly report variable coupon bonds by including the proper bond characteristic code in column 5 of Schedule D - Part 1.

16. Page 35 - Investment Reporting—It is again recommended that the company report the correct NAIC designation that corresponds with equivalent ratings from NAIC acceptable rating organizations, in accordance with the NAIC's SVO Purposes and Procedures Manual.

17. Page 35 - Investment Reporting—It is recommended that the company properly report all long-term bonds in the appropriate category of Schedule D - Part 1, including correctly reporting U.S. Treasury securities as U.S. government bonds.

18. Page 35 - Investment Reporting—In addition, it is recommended that the company properly report certificates of deposit with maturity dates of one year or less from the acquisition date on Schedule E - Part 1, in accordance with the NAIC Annual Statement Instructions - Property and Casualty.

19. Page 36 - Investment Reporting—It is recommended that the company properly report foreign and Canadian bonds and stocks in the annual statement Summary Investment Schedule, Schedule D - Summary by Country, and Schedule D - Parts 1 and 2, in accordance with the NAIC Annual Statement Instructions - Property and Casualty.

20. Page 36 - Custodial Accounts—It is recommended that the company comply with s. 610.23, Wis. Stat., and immediately transfer the securities held at Interactive Brokers LLC into a proper custodial or trust arrangement with a bank or banking and trust company.

21. Page 36 - Custodial Accounts—Due to uncertainties about the company's ability to use the funds in the brokerage account to pay claims, it is recommended that the company nonadmit the balance of this account ($345,713 at December 31, 2015) until the company has transferred the funds into a custodial account that complies with s. 610.23, Wis. Stat.

22. Page 37 - Custodial Agreement—It is recommended that the company work with Comerica Bank to revise the custodial agreement to include the recommended provisions contained in the NAIC's Financial Condition Examiners Handbook. The revised agreement should be executed by Comerica Bank and the company.

## IX. ACKNOWLEDGMENT

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

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

| Name | Title |
|---|---|
| Adrian Jaramillo | Insurance Financial Examiner |
| Karl Albert | ACL Specialist |
| David Jensen | IT Specialist |
| Jerry DeArmond | Reserve Specialist |

Respectfully submitted,

James A. Vanden Branden
Examiner-in-Charge