Report

of the

Examination of

Spring Grove Mutual Insurance Company

Brodhead, Wisconsin

As of December 31, 2012

TABLE OF CONTENTS

Page

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

May 20, 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:

SPRING GROVE MUTUAL INSURANCE COMPANY
Brodhead, Wisconsin

and the following report thereon is respectfully submitted:

I. INTRODUCTION

The previous examination of Spring Grove 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 was organized as a town mutual insurance company on January 5, 1875, under the provisions of the then existing Wisconsin Statutes. The original name of the company was the Mutual Fire Insurance Company of the Town of Spring Grove, Decatur, and Albany. Subsequent amendments to the company's articles and bylaws changed the company's name to that presently used.

During the period under examination, there were no amendments to the articles of incorporation or 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:

Dane	Rock
Green	Walworth
Lafayette	

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 a term of one year with premiums payable on the advance premium basis. The company also charges a policy fee equal to $30 for farmowners and commercial business and $25 for homeowners business. Additionally, the company charges installment fees for each payment of premium in the amount of $10 for semiannually and quarterly payments and $3 for monthly payments.

Business of the company is acquired through two agents, both of whom are directors of the company. Agents are presently compensated for their services as follows:

Type of Policy	**Compensation**
New business	15%
Renewals	10

Nearly all of the losses are adjusted by a commercial adjusting firm. Losses may be adjusted by the company's agents. If adjusted by an agent, losses in excess of $500 must be approved by the board of directors. Agents receive $25 for each loss adjusted plus $0.55 per mile for 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 board of directors meets monthly to approve all losses before payment is made, make investment decisions, and review inspection reports.

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

Name	Principal Occupation	Residence	Expiry
Judy Albright	Town Clerk	Orfordville, WI	2016
James Beutel *	Farmer	Brodhead, WI	2016
Roger Brugger	Farmer	Monticello, WI	2014
Thomas Ten Eyck	Retired Farmer	Brodhead, WI	2015
Nick Faessler	Farmer	Juda, WI	2015
Geraldine Lee	Farmer/Tax Accountant	Brodhead, WI	2014
Terry Regenold	Farmer	Brodhead, WI	2014
Laura Usher *	Office Manager/Agent	Brodhead, WI	2015
Lorraine Williams	Retired Farmer	Monroe, WI	2016

Directors who are also agents are identified with an asterisk.

Members of the board currently receive $35 for a partial-day meeting and $85 for an all-day meeting attended plus $0.55 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*
Lorraine Williams	President	$ 1,540
James Beutel	Vice President	12,110
Geraldine Lee	Secretary/Treasurer	5,000
Laura Usher	Office Manager	49,905

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

Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. The company does not currently have any separate committees of the board. The entire board of directors acts as the adjusting and investment committees.

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	$122,303	363	$ (61,768)	$1,237,557	$1,115,993
2011	110,005	353	(150,236)	1,326,424	1,201,206
2010	123,543	358	(2,506)	1,436,852	1,314,323
2009	110,287	358	(12,010)	1,402,069	1,287,515
2008	108,910	370	(48,435)	1,417,631	1,306,789
2007	97,630	383	(18,498)	1,513,317	1,409,559

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 Net	Writings Ratios Gross
2012	$290,891	$126,879	$1,115,993	11%	26%
2011	275,798	117,011	1,201,206	10	23
2010	275,468	130,204	1,314,323	10	21
2009	272,075	106,990	1,287,515	8	21
2008	278,332	105,531	1,306,789	8	21
2007	285,844	99,838	1,409,559	7	20

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	$108,027	$107,790	$122,303	88%	85%	173%
2011	138,996	107,983	110,005	126	92	219
2010	58,307	109,417	123,543	47	84	131
2009	68,438	96,468	110,287	62	90	152
2008	118,777	87,903	108,910	109	83	192
2007	83,780	92,875	97,630	86	93	179

The company reported a net loss in all five years under examination. During the period under examination, the company’s admitted assets decreased by 18%, net premiums written increased by 27%, and surplus decreased by 21%.

The small amount of policyholders in combination with a high percentage of business ceded results in a relatively low volume of net premium written. This has led to the company having a very high expense ratio which has contributed to the decrease in admitted assets and surplus mentioned above. The company also reported high loss ratios in 2008, 2011, and 2012. The large loss ratios were caused by a few exceptionally large losses in these years, as well as additional losses due to wind and hail damage.

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
Effective date:	January 1, 2013
Termination provisions:	90-day notice

The coverages provided under this treaty are summarized as follows:

1.	Type of contract:	Class A - Casualty Quota Share Reinsurance
	Lines reinsured:	All business classified as casualty business
	Company's retention:	The company shall cede on a quota share basis 100% of the company's business
	Coverage:	100% of each and every loss occurring on the business covered by this contract, including loss adjustment expenses. Coverage is subject to maximum policy limits of $1,000,000 per occurrence, in any combination of bodily injury and property damage liability; $25,000 for medical payments per person, $25,000 per accident.
	Reinsurance premium:	100% of the net written premium
	Commission:	15%
2.	Type of contract:	Class B First Surplus Reinsurance
	Lines reinsured:	All property business written by the company
	Company's retention:	$250,000 per ceded risk or at least 50% on a pro rata basis per ceded risk when the company's net retention is $250,000 or less in respect to a risk
	Coverage:	Up to $800,000 on a pro rata basis when the company's net retention is $250,000 or more in respect to a risk. When the company's net retention is $250,000 or less in respect to a risk, the company may cede on a pro rata basis and the reinsurer shall accept up to 50% of reinsurance of such risk.
	Reinsurance premium:	Pro rata share of all premiums and fees charged by the company corresponding to the amount of each risk ceded
	Ceding commission:	15%, plus 15% profit commission

3.	Type of contract:	Class C-1 First Per Risk Excess of Loss
	Lines reinsured:	All property business written by the company
	Company's retention:	$40,000 per occurrence
	Coverage:	100% of any loss, including loss adjustment expense, in excess of $40,000, subject to a limit of liability to the reinsurer of $70,000
	Reinsurance premium:	Based on experience over the past four years with load factor of 125% Minimum rate: 6% of current net premiums written Maximum rate: 15% of current net premiums written Current rate: 8.10% Premium deposit: $14,341
4.	Type of contract:	Class C-2 Second Per Risk Excess of Loss
	Lines reinsured:	All property business written by the company
	Company's retention:	$110,000
	Coverage:	100% of any loss, including loss adjustment expense, in excess of $110,000, subject to a limit of liability to the reinsurer of $140,000
	Reinsurance premium:	4.75% of the company's current net premiums written in respect to the business covered Premium deposit: $8,410
5.	Type of contract:	Class D/E Stop Loss Reinsurance
	Lines reinsured:	All business written by the company
	Company's retention:	75% of net written premium
	Coverage:	100% of the amount by which the aggregate of the company's losses, including loss adjustment expenses exceed the retention with a limit of 50% of NWP (losses from 75% to 125% of NWP). Estimated attachment point is $132,784.
	Reinsurance premium:	Minimum rate: 6.5% of the current net written premiums Maximum rate: 11% of the current net written premiums Current rate: 6.5% Premium deposit: $11,508
6.	Type of contract:	Class D/E 2 Stop Loss Reinsurance
	Lines reinsured:	All business written by the company
	Company's retention:	125% of net written premium

Coverage:	100% of the amount by which the aggregate of the company’s losses, including loss adjustment expenses, exceed the retention
Reinsurance premium:	Minimum rate: 4% of the current net written premiums Premium deposit: $7,082

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."

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

Assets	Ledger	Nonledger	Not Admitted	Net Admitted
Cash on hand	$ 50	$	$	$ 50
Cash in checking	21,018			21,018
Cash deposited at interest	328,325			328,325
Bonds	347,803			347,803
Stocks and mutual fund investments	444,970			444,970
Real estate	34,889			34,889
Premiums, agents' balances and installments:				
In course of collection	2,902			2,902
Deferred and not yet due	19,630			19,630
Investment income accrued		4,108		4,108
Reinsurance recoverable on paid losses and LAE	784			784
Electronic data processing equipment	808			808
Other expense-related assets:				
Reinsurance commission receivable	470			470
Other nonexpense-related assets:				
Securities receivable	31,800			31,800
Furniture and fixtures	2,366		2,366	
Totals	$1,235,815	$4,108	$2,366	$1,237,557

Liabilities and Surplus

Net unpaid losses	$ 4,602
Unpaid loss adjustment expenses	500
Commissions payable	2,253
Fire department dues payable	119
Unearned premiums	81,763
Reinsurance payable	14,085
Amounts withheld for the account of others	1,673
Payroll taxes payable (employer's portion)	185
Other liabilities:	
Expense-related:	
Accounts payable	627
Accrued property taxes	2,130
Nonexpense-related:	
Premiums received in advance	13,627
Total liabilities	121,564
Policyholders' surplus	1,115,993
Total Liabilities and Surplus	$1,237,557

Spring Grove Mutual Insurance Company
Statement of Operations
For the Year 2012

Net premiums and assessments earned		$122,303
Deduct:		
Net losses incurred	$ 93,309	
Net loss adjustment expenses incurred	14,718	
Net other underwriting expenses incurred	105,878	
Total losses and expenses incurred		213,905
Net underwriting gain (loss)		(91,602)
Net investment income:		
Net investment income earned	28,874	
Net realized capital gains (losses)	(74)	
Total investment gain (loss)		28,800
Other income (expense):		
Miscellaneous income (expense)		1,034
Net Income (Loss)		$ (61,768)

Spring Grove 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	$1,201,206	$1,314,323	$1,287,515	$1,306,789	$1,409,559
Net income	(61,768)	(150,236)	(2,506)	(12,010)	(48,435)
Net unrealized capital gain or (loss)	(24,083)	40,123	27,311	(5,261)	(54,335)
Change in nonadmitted assets	638	(3,004)	2,003	(2,003)	0
Surplus, End of Year	$1,115,993	$1,201,206	$1,314,323	$1,287,515	$1,306,789

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.

IV. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

Comments and recommendations contained in the last examination report and the action taken on them by the company are as follows:

1. Corporate Records—It is again recommended that the company include detailed information in the minutes of the board of directors meetings concerning significant business and financial decisions regarding the company.

   Action—Compliance.

2. Reinsurance Recoverable on Paid Losses and LAE—It is recommended that the company carefully review all reports provided by the CPA in developing the annual statement to avoid unnecessary re-filing of the annual statement or misstatements of assets, liabilities, and surplus.

   Action—Compliance.

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 has 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."

Upon review of the company's 2012 annual statement, it was noticed that the company did not accurately disclose the manager position and salary as directed by the Town Mutual Annual Statement Instructions and pursuant to s. 611.63 (4), Wis. Stat. The company has two managerial positions—Company Manager and Office Manager. The Company Manager position is held by the person who is also secretary and treasurer and is responsible for duties corresponding to these offices, such as review of financial documents and signing of company checks. The Company Manager does not have regular office hours. The Office Manager position is held by a director of the company who is responsible for the vast majority of day-to-day operations of the company including administrative, underwriting, and claim adjusting duties. The Office Manager has regular office hours and was paid $33,780 in 2012. The company disclosed the Company Manager position but not the Office Manager position and compensation in its 2012 annual statement. All town mutual insurers are required to disclose in the annual statement the executive officers and compensation paid to such officers. According to s. 611.63 (4), Wis. Stat., "The amount of all direct and indirect remuneration for services, including retirement and other deferred compensation benefits and stock options, paid or accrued each year for the benefit of each director and each officer and employee whose remuneration exceeds an amount established by the commissioner, and for all directors and officers as a group shall be included in the annual report made to the commissioner." It is recommended that the company accurately disclose the manager position and salary as directed by the Town Mutual Annual Statement Instructions and s. 611.63 (4), Wis. Stat.

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	$ 100,000
Worker's compensation:	
Employee injury	Statutory
Employee liability:	
Each accident	100,000
Each employee	100,000
Policy limit	500,000
Professional liability and directors and officers liability	1,000,000
Business owners:	
Commercial liability	1,000,000
Building and personal property	400,400
Insurance agents and brokers professional liability	1,000,000

Underwriting

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

The company does not have a formal inspection procedure for both new and renewal business. It is recommended that the company establish a formal inspection procedure for new and renewal business, whereby a sampling of new applications and of renewal business is inspected by committee members independent of the risk under consideration.

Claims Adjusting

The company has an adjusting committee consisting of at least three directors as required by s. 612.13 (4), Wis. Stat.

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 not audited annually by an outside public accounting firm. The company is exempt from the annual audit due to its size.

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 computer. 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.

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	$421,564
2.	Liabilities plus 33% of gross premiums written	95,994
3.	Liabilities plus 50% of net premiums written	63,440
4.	Amount required (greater of 1, 2, or 3)	421,564
5.	Amount of Type 1 investments as of 12/31/2012	752,437
6.	Excess or (deficiency)	$330,873

The company has sufficient Type 1 investments.

The company has been approved to hold 30% of assets in common stock, preferred stock, and convertible securities.

It was noted that the company's investment policy regarding corporate bonds is to invest in bonds rated BBB or better. However, in review of the company's investments it was found that the company made several investments in corporate bonds that were rated below BBB at the time of purchase. It is recommended that the company follow its investment policy.

ASSETS

Cash and Invested Cash **$349,393**

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

Cash in company's office	$ 50
Cash deposited in banks—checking accounts	21,018
Cash deposited in banks at interest	328,325
Total	$349,393

Cash in company's office at year-end represents the company's petty cash fund. A physical count was made by the examiners during the course of the examination and the balance reconciled to year-end.

Cash deposited in banks subject to the company's check and withdrawal consists of one account maintained at a local bank. Verification of the 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 at interest represents the aggregate of five deposits in four depositories. Deposits were verified by direct correspondence with the respective depositories and by an actual count and inspection of certificates and/or passbooks. Interest received during the year 2012 totaled $8,603 and was verified to company cash records. Rates of interest earned on cash deposits ranged from 0.35% to 2.78%. Accrued interest on cash deposits totaled $876 at year-end.

The examiners noted that the company's policy is to have two signatures on all checks written over $2,000. The examiners reviewed all cancelled checks for December 2012 and January 2013 and noted that there was a check for over $3,000 that did not have two signatures on it. It is recommended that the company follow its check signing policy and have two signatures on all checks over $2,000.

Book Value of Bonds **$347,803**

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 located in a custodial account at Community Bank and Trust.

Bonds were verified by direct confirmation from the custodian. Bond purchases and sales for the period under examination were checked to brokers' invoices and advices. Interest received during 2012 on bonds amounted to $18,890 and was traced to cash receipts records. Accrued interest of $3,232 at December 31, 2012, was checked and allowed as a nonledger asset.

During review of the company's bonds it was noted the company had a bond that was rated below BBB- that was 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 bond’s 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 (6) (c), Wis. Adm. Code. It is recommended that the company properly classify its bonds between Type 1 and Type 2 investments in accordance with Town Mutual Annual Statement Instructions.

In 2011 the company hired a new investment advisor and rapidly expanded its bond portfolio. Under the new investment advisor, the company began to invest 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 in 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 3-month US Dollar LIBOR (short-term interest rate)
- the difference between the 30-year and the 10-year constant maturity swap rate (CMS Spread)

For instance, for each interest payment on the JP Morgan Chase & Co. security, interest accrues only on days where the CMS Spread (the 30-year CMS rate minus the 10-year CMS rate) is greater than or equal to 0.00%. This means that the company would not receive interest payments on the security for the days when the CMS Spread is below 0.00%. 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. A review of the company’s variable rate corporate bond portfolio revealed that seven of the bonds had the par amounts outstanding ranging from $4,500,000 to $35,000,000.

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 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. 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. 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.

2. Board minutes did not document whether or how the board of directors approved the investment transactions made by the investment advisor. According to the company's manager, the board is provided with a copy of the investment report received from their investment advisor and the report is reviewed and discussed at the board meeting. It is recommended that the minutes clearly indicate board approval of all investment transactions pursuant to s. Ins 6.20 (6) (h), Wis. Adm. Code.

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.

Stocks and Mutual Fund Investments **$444,970**

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 bank safety deposit box or under a custodial agreement with Community Bank and Trust.

Stock certificates physically held by the company were inspected by the examiners. Stock and mutual fund purchases and sales for the period under examination were checked to brokers' invoices and advices. The company's investment in stocks and mutual funds was in conformance with Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers.

Dividends received during 2012 on stocks and mutual funds amounted to $16,302 and were traced to cash receipts records. There were no accrued dividends at December 31, 2012.

Book Value of Real Estate **$34,889**

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 home office building and land.

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 **$2,902**

This asset represents the amounts due from agents or policyholders which are not in excess of 90 days past due at year-end. A review of detailed premium records verified the accuracy of this asset.

Premiums Deferred and Not Yet Due **$19,630**

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 verified the accuracy of this asset.

Investment Income Accrued **$4,108**

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

Cash at Interest	$ 876
Bonds	3,232
Total	$4,108

Reinsurance Recoverable on Paid Losses and LAE **$784**

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.

Electronic Data Processing Equipment **$808**

The above balance consists of computer hardware and operating system software, net of depreciation as of December 31, 2012. A review of receipts and other documentation verified the balance. Non-operating system software was properly nonadmitted.

Reinsurance Commission Receivable **$470**

The above asset represents the amount of reinsurance commissions that the company expected to receive as of December 31, 2012, based on the profitability of the business ceded under its 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 $2,366 of office furniture owned by the company at December 31, 2012. In accordance with annual statement requirements, this amount has been reported as nonadmitted asset, thus the balance shown above is $0.

Securities Receivable **$31,800**

The company had a year-end securities receivable balance due to having a certificate of deposit (CD) that had matured near year-end and the company had yet to decide where to reinvest the proceeds. Subsequent to year-end, the proceeds were reinvested in another CD.

LIABILITIES AND SURPLUS

Net Unpaid Losses **$4,602**

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. To the actual paid loss figure was added an estimated amount for 2012 and prior losses remaining unpaid at the time of the examination. 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	$6,668	$6,000	$668
Less: Reinsurance recoverable on unpaid losses	2,066	2,066	
Net Unpaid Losses	$4,602	$3,934	$668

The above difference of $668 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 **$500**

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 an estimate based on a review of open claims.

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 **$2,253**

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

Fire Department Dues Payable **$119**

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 **$81,763**

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 **$14,085**

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.

Amounts Withheld for the Account of Others **$1,673**

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 **$185**

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 **$627**

This liability includes estimates for bills that were received but not paid at year-end. This account includes items such as utilities, sewer, and snow removal.

Accrued Property Taxes **$2,130**

This liability represents the accrued property taxes for the company's home office and was determined to be properly stated.

Premiums Received in Advance **$13,627**

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

Spring Grove Mutual Insurance Company is a town mutual insurer with an authorized territory of five counties. The company has been in business since 1875, providing property and liability insurance to its policyholders.

The company reported a net loss in all five years under examination. During the period under examination, the company's admitted assets decreased by 18%, net premiums written increased by 27%, and surplus decreased by 21%.

The small amount of policyholders in combination with a high percentage of business ceded results in a relatively low amount of net premium written. This has contributed to the company having a very high expense ratio. This, in combination with high loss ratios in several years, has led to the above-mentioned decrease in admitted assets and surplus.

The examination did not result in any changes to surplus. The company has complied with all recommendations from the previous examination report. The current examination resulted in ten recommendations as summarized in the following section.

VI. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 14 - Corporate Records—It is recommended that the company accurately disclose the manager position and salary as directed by the Town Mutual Annual Statement Instructions and s. 611.63 (4), Wis. Stat.

2. Page 15 - Underwriting—It is recommended that the company establish a formal inspection procedure for new and renewal business, whereby a sampling of new applications and of renewal business is inspected by committee members independent of the risk under consideration.

3. Page 18 - Investment Rule Compliance—It is recommended that the company follow its investment policy.

4. Page 19 - Cash and Invested Assets—It is recommended that the company follow its check signing policy and have two signatures on all checks over $2,000.

5. Page 20 - Book Value of Bonds—It is recommended that the company properly classify its bonds between Type 1 and Type 2 investments in accordance with Town Mutual Annual Statement Instructions.

6. Page 23 - 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).

7. Page 24 - Book Value of Bonds—It is further recommended that the company divest itself of any variable rate corporate debt security 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.

8. Page 24 - Book Value of Bonds—It is recommended that the company maintain prospectuses for its current investments.

9. Page 24 - Book Value of Bonds—It is recommended that the minutes clearly indicate board approval of all investment transactions pursuant to s. Ins 6.20 (6) (h), Wis. Adm. Code.

10. Page 24 - 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.

VII. ACKNOWLEDGMENT

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

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

Respectfully submitted,

Dan Schroeder
Examiner-in-Charge