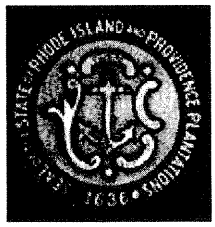


Report on the Zone Association Examination

of

AFFILIATED FM INSURANCE COMPANY

Johnston, Rhode Island

as of

December 31, 2008

State of Rhode Island

Department of Business Regulation

Insurance Division

STATE OF RHODE ISLAND
DEPARTMENT OF BUSINESS REGULATION
Insurance Division

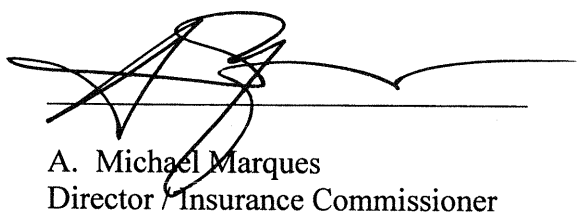
DIRECTOR'S ORDER

The attached Report of Examination as of December 31, 2008, of the condition and affairs of **AFFILIATED FM INSURANCE COMPANY**, was recently completed by duly qualified examiners, pursuant to the provisions of the Rhode Island General Laws.

Due consideration has been given to the comments of the examiners regarding the operation of the Company and its financial condition, as reflected in the report.

It is therefore ORDERED that said Report be, and it is hereby, adopted and filed and made an official record of this Department as of this date.

DEPARTMENT OF BUSINESS REGULATION



A. Michael Marques
Director / Insurance Commissioner

ORDER # 10-057

DATED: 04-19-2010

TABLE OF CONTENTS

	Page
Salutation	1
Scope of Examination	2
History	3
Holding Company System	
Registration Under Insurance Holding Company Act	5
Organizational Structure	6
Intercompany Agreements	7
Plan of Operation	8
Territory	9
Management	
Stockholders	9
Board of Directors	10
Officers	14
Compensation of Directors, Committee Members and Officers	14
Conflict of Interest	15
Employee Benefits	15
Fidelity Bond and Other Insurance	15
Reinsurance	
Ceded	16
Intercompany Reinsurance	18
Information Systems and Controls	20
Financial Statements	
Comparative Statement of Assets, Liabilities and Surplus	23-24
Statement of Income	25
Capital and Surplus Account	26
Reconciliation of Surplus	27
Analysis of Assets	28
Assets	
Bonds	29
Net Deferred Tax Asset	31
Receivable From Parent, Subsidiaries and Affiliates	31

TABLE OF CONTENTS (cont.)

	Page
Liabilities	
Losses and Loss Adjustment Expenses	32
Net Adjustments in Assets and Liabilities Due to Foreign Exchange Rates	34
Capital and Surplus	34
Summary of Recommendations	35
Subsequent Events	36
Conclusion	37

February 10, 2010

Honorable Alfred W. Gross
Chair, NAIC Financial Condition Committee
Virginia State Corporation Commission
Bureau of Insurance
PO Box 1157
Richmond, VA 23218

Honorable Thomas R. Sullivan, Commissioner
Chair, Northeastern Zone
Connecticut Insurance Department
PO Box 816
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Honorable A. Michael Marques
Insurance Commissioner
Department of Business Regulation
Insurance Division
1511 Pontiac Avenue
Cranston, Rhode Island 02920

Commissioners:

In compliance with instructions and pursuant to the General Laws of the State of Rhode Island, an examination has been made as of December 31, 2008, of the financial condition and affairs of the

AFFILIATED FM INSURANCE COMPANY

hereinafter referred to as "Affiliated FM" or the "Company," incorporated under the laws of the State of Rhode Island as a stock company. The examination was conducted at the main administrative office of the Company, located at 1301 Atwood Avenue, Johnston, Rhode Island.

SCOPE OF EXAMINATION

The Company was last examined as of December 31, 2004, under the Association Plan of Examination of the National Association of Insurance Commissioners (NAIC), by the Insurance Division of the Department of Business Regulation of the State of Rhode Island.

The present examination, also performed by the Insurance Division of the State of Rhode Island, in compliance with the General Laws of this State, covered the intervening four-year period ended December 31, 2008.

At December 31, 2008, FMIC Holdings, Inc., a wholly owned subsidiary of Factory Mutual Insurance Company (FMIC), owned 100% of Affiliated FM's outstanding common stock and 65.5% of its outstanding preferred stock. Appalachian Insurance Company (Appalachian) owned the remaining 34.5% of the preferred stock. Examinations of both FMIC and Appalachian, the common stock of which is also 100% owned by FMIC Holdings, Inc., were conducted concurrently with this examination, with reports thereon submitted under separate cover. Both FMIC and Appalachian are chartered by the State of Rhode Island, and are located in Johnston, Rhode Island.

This examination consisted of a verification and evaluation on a test basis, of assets and liabilities, as reported by the Company in its 2008 Annual Statement. Verification procedures were also applied to cash receipts and disbursements, policy and claim transactions, and other matters as deemed appropriate during the period intervening since the last examination. Transactions subsequent to December 31, 2008 were reviewed where deemed necessary.

The Company instructed their independent accounting firm to make available for review, all workpapers concerning procedures followed, tests performed, information obtained, and conclusions reached pertinent to the firm's audit of the Company's financial statements for the

year ended December 31, 2008. The workpapers of the independent accounting firm were reviewed in order to ascertain the extent to which procedures were employed to determine compliance with statutory guidelines. To the extent possible, these workpapers and analyses were utilized to supplement the examination process.

In accordance with a resolution adopted by the National Association of Insurance Commissioners requiring electronic data processing auditing on all Association Examinations, the Rhode Island Insurance Division utilized audit software in an effort to assist in the overall examination of the Company. The use of the audit software facilitated the examination process by providing for the direct retrieval of information from the Company's data processing systems, which was then verified to source documentation.

HISTORY

The Company was chartered by an Act of the General Assembly of the State of Rhode Island at its January 1949 session. The charter was amended in 1969, 1975, 1980, 1988, and 1994.

Prior to July 1, 1971, Affiliated FM was owned by the Associated Factory Mutual Insurance Companies, which consisted of Allendale Mutual Insurance Company (then named MFB Mutual Insurance Company), Arkwright-Boston Manufacturers Mutual Insurance Company, Philadelphia Manufacturers Mutual Insurance Company (which has since merged with Arkwright-Boston) and Protection Mutual Insurance Company. On July 1, 1971, Allendale Associates, Inc. a wholly owned subsidiary of Allendale Mutual Insurance Company acquired the capital stock of Affiliated FM that was owned by Allendale and Arkwright-Boston. Further acquisitions in 1974 and 1977 from Protection Mutual and Philadelphia Manufacturers resulted in Allendale Associates, Inc. attaining 100% ownership of the 30,000 shares of Affiliated FM's outstanding common stock. Finally, on July 1, 1999, Allendale Associates, Inc. changed its name to FMIC Holdings Inc. The name change was the result of the three remaining factory

mutual companies (Allendale Mutual Insurance Company, Arkwright Mutual Insurance Company, and Protection Mutual Insurance Company) merging into Allendale, with Allendale subsequently changing its name to Factory Mutual Insurance Company. The group currently operates under the name FM Global.

In 1975 the Company issued $100 par value 7% cumulative preferred stock in accordance with a charter amendment completed that same year.

In 1978 and 1979 the Company issued additional preferred stock, and in 1982 it accomplished a reorganization whereby one-half of the total 7% cumulative preferred stock outstanding at that time, amounting to $7,250,000, was exchanged by the holders thereof for surplus notes bearing interest at 7%. As of December 31, 2008, all remaining surplus notes have been redeemed.

The Company's preferred stock has always been issued at par. The holders of preferred stock have no voting rights and the Company may, at its discretion, redeem any such shares issued and outstanding.

To enable the Company to increase its capacity to write additional business, and to improve its surplus position, from time to time it has issued interest-bearing surplus notes. Originally issued for a one-year term, the notes contain a provision that they are automatically renewed from year to year unless the Company redeems them. The redemption may only take place, once prior written approval of the Rhode Island Department of Business Regulation is obtained.

On October 11, 1995, Allendale Associates, Inc. purchased an additional 50,000 shares of the Company's $50.00 par value common stock. This capital stock purchase received the necessary approval from the Rhode Island Insurance Division, and the Company filed the necessary amendments to its Articles of Incorporation. At December 31, 2008 FMIC Holdings, Inc. owns

all 80,000 shares of the Company's $50 par value common stock for a total of $4,000,000, and it owned 47,500 shares, or 65.5%, of the $100 par value 7% cumulative preferred stock, for a total of $4,750,000. Appalachian Insurance Company owns 25,000 shares or 34.5% of the Company's $100 par value 7% cumulative preferred stock for a total of $2,500,000.

HOLDING COMPANY SYSTEM

Registration Under Insurance Holding Company Act

Affiliated FM is a second tier subsidiary of Factory Mutual Insurance Company. FMIC filed, as required pursuant to Chapter 35 of Title 27 of the Rhode Island General Laws entitled, "Insurance Holding Company Systems," a consolidated registration statement "Form B" and "Form C" on behalf of itself and its subsidiaries, Affiliated FM Insurance Company, Appalachian Insurance Company, and FM Insurance Company, Limited.

A review of the Company's records for the period under examination indicated that the Company failed to file a timely Form D, notifying the Rhode Island Insurance Division of a new affiliated company Administrative Services Agreement. All other information required by the Registration Statements had been properly filed with the State of Rhode Island Insurance Division. Disclosure requirements such as listing "all management service contracts, and all cost sharing agreements" disclosing any dividends and other distributions to shareholders, and the existence of a consolidated tax allocation agreement, were included in the filings.

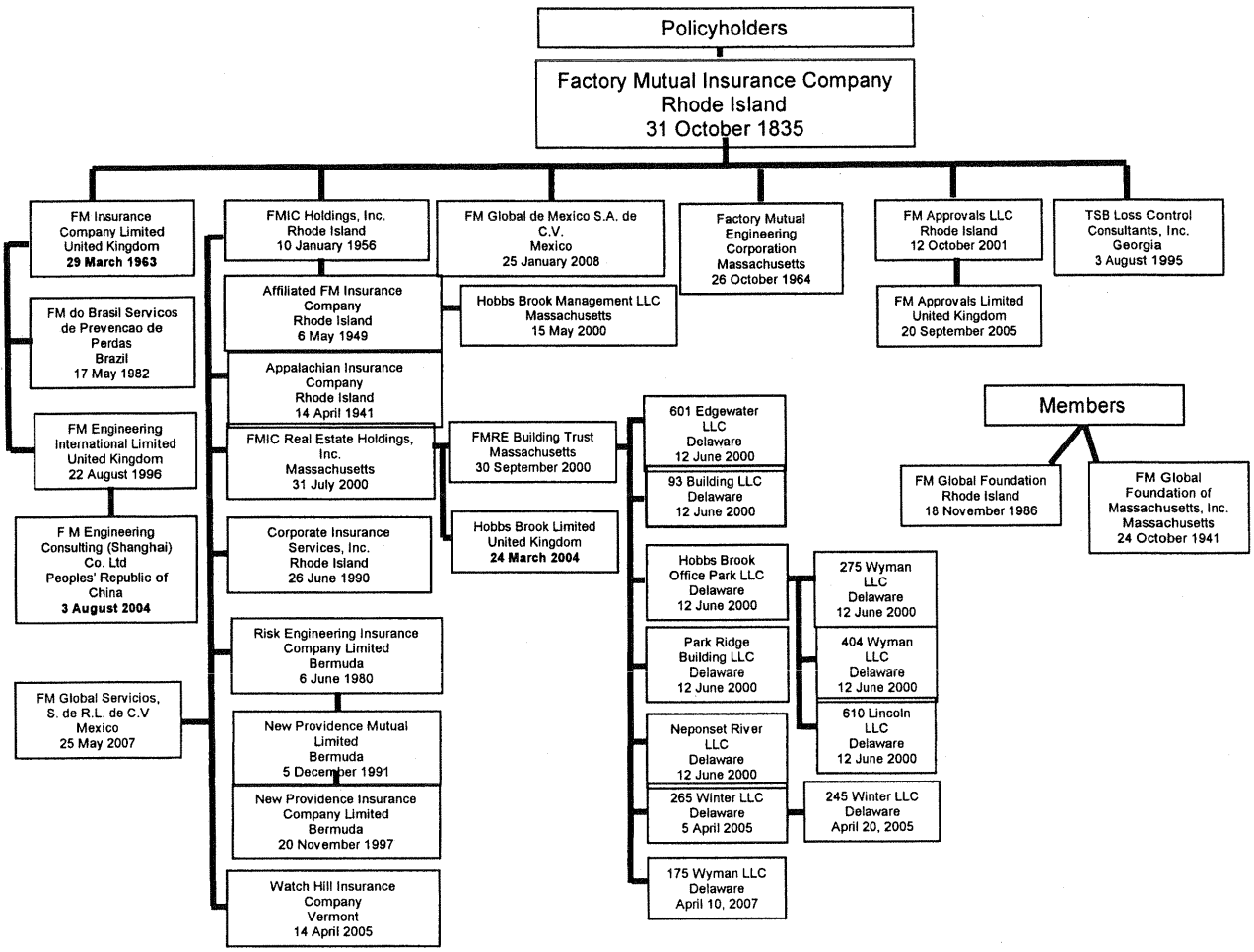
Recommendation #1

It is recommended that for any transactions and/or agreements between members of FM Global's holding company system that are subject to RI General Law Section 27-35-4, that the Company notify the Rhode Island Insurance Division at least 30 days prior to entering into the transaction and/or agreement and furnish the required information on Form D in accordance with Regulation 17, Section 20.

Organizational Structure

Schedule Y, *"Information Concerning Activities of Insurer Members of a Holding Company Group"* of the Company's 2008 Annual Statement was reviewed and found to be complete.

The following represents an organizational chart, as of December 31, 2008, which reflects the identities and interrelationships between the Company, its parent, affiliated insurers and other members of the holding company system:



Intercompany Agreements

The following represents a summary of the primary intercompany agreements in-force between the Company and the various members of the holding company system as of December 31, 2008:

- Intercompany Tax Sharing Agreement

  Effective January 4, 2002, the Company and its affiliates entered into a tax sharing agreement whereby FMIC collects from or refunds to the subsidiaries the amount of taxes or benefits determined as if the Company and the affiliates filed separate returns, with current credit for net losses incurred to the extent those losses are included in the consolidated return. Amounts are settled within ninety (90) days of filing of the consolidated federal tax return.

- Management and Service Agreements

  Effective July 1, 2001, the Company entered into a Management and Service Agreement with FMIC. Under the terms of the agreement, FMIC provides Affiliated FM with the personnel, space, equipment and facilities necessary to conduct business. The agreement stipulates that FMIC shall be paid a monthly fee, to be paid within fifty-five (55) days after the end of the month to which it applies. The monthly fee shall be an amount determined by product line cost analysis. Effective October 1, 1982 and amended on July 1, 2001, a similar agreement was entered into between FMIC and Affiliated FM with respect to the Canadian business written by Affiliated FM.

- Intercompany Cash Management Agreement

  Effective February 21, 2003, FMIC entered into a Cash Management Agreement ("Agreement") with several affiliates, including Affiliated FM. Under the terms of the Agreement, any party ("Lender") may from time to time loan to another ("Borrower") such amounts as shall be determined and mutually agreed upon by and between the Lender and Borrower, provided that the Lender at all times shall maintain sufficient cash amounts for normal working requirements. All loans made under the Agreement are made on an unsecured basis and at no time shall the aggregate amount of loans

outstanding among all parties exceed $150,000,000. Under the terms of the Agreement, interest on any loaned money shall be payable at an annual rate equal to the simple average of the weekly ninety-day U.S. Treasury Bill rates appearing in the Federal Reserve Data section of the *Wall Street Journal*. The settlement terms require that outstanding balances of principal and accrued interest shall be due and payable no later than sixty days following the last day of each calendar quarter. Lender may demand any part or all funds loaned under the Agreement by giving three-(3) business days notice to the Borrower.

PLAN OF OPERATION

Affiliated FM Insurance Company, a member of the FM Global Group, specializes in providing commercial property insurance for the middle market segment of business and industry. It provides innovative products and services designed to protect assets, improve operating reliability, reduce the overall cost of risk and maintain the profits and market share of its clients.

Affiliated FM products and services are delivered through a select network of agents and brokers on a global basis. The company is committed to developing strong long term relationships with its brokers and clients through superior property underwriting knowledge, expertise and products, customized property loss prevention engineering programs, responsive and efficient services in a highly automated environment, and prompt, professional, flexible and fair claims services.

With offices in North America, Europe and Australia, Affiliated FM is well positioned to support middle market clients as they expand their worldwide reach, providing tailored underwriting and loss prevention engineering solutions for facilities around the world.

Market conditions have been competitive in the middle market sector for the past several years, due to excellent industry performance and premium levels continued decline throughout 2008.

Loss experience, however, deteriorated due to a spate of natural catastrophe and individual risk losses and this, exacerbated by the global financial meltdown, sent industry results into decline. Insurance and reinsurance pricing levels are expected to stabilize in 2009.

Looking to the future, Affiliated FM will continue to differentiate itself in the market place by creating value for its broker partners and clients. This is demonstrated through a strong focus on new product development tailored to the specific needs of target market segments as well as professional, flexible and responsive service to meet broker partner and client evolving needs.

TERRITORY

A review of certificates of authority or compliance in effect at December 31, 2008, verified that the Company was licensed to transact business in all states, as well as the District of Columbia, the Virgin Islands, and Puerto Rico. The Company is also licensed by the Dominion of Canada, all provinces thereof, and the Northwest Territories.

In 2004, approximately 51% of the Company's direct premiums written were derived from the following five jurisdictions: California (14.6%); Canada (14.1%); New York (8.6%); Washington (7.8%) and Texas (5.9%).

MANAGEMENT

Stockholders

The bylaws, as amended, provide that the annual meeting of the Company shall be held at the principal offices of the Company, or at such other place as may be stated in the notice of the meeting, at 9:00 a.m. on the second Thursday of April in each year. Special meetings shall be called at any time by the Chairman of the Board, the Chairman of the Executive Committee, or the President, or by request in writing addressed to the Secretary by any five Directors.

At all meetings of the shareholders, the presence, in person or by proxy, of one-fifth of the shareholders shall be necessary to constitute a quorum. The vote of a smaller number of shareholders may adjourn the meetings from time to time. When a quorum is present at any meeting, all questions except amendments to the bylaws shall be decided by a majority vote of those present in person or by proxy.

Board of Directors

The Charter provides that the management of the business and affairs of the Company shall be vested in a Board of Directors, the number of which shall be fixed from time to time by the bylaws. At the annual meeting of the Company, Directors shall be elected by the shareholders, each for a term of three years, to succeed that class of Directors whose term then expires. In case of any increase in the number of Directors, one-third of the additional number shall be elected for the then unexpired portion of the term of those Directors whose term expires in the year in which the increase is made; one-third for the unexpired portion of the term of those Directors whose term expires in the year following that in which such increase is made, and one-third for the unexpired portion of the term of those Directors whose term expires in the second year next after that in which such increase is made. All Directors shall serve until their successors are elected and qualified.

The bylaws provide that the number of Directors shall be set at up to twenty-one unless and until a different number shall be determined by action of the Board. If the Board of Directors shall decrease the number of Directors, such decrease shall not be effective with respect to terms of Directors then holding office until the expiration of each such Directors term.

Directors shall be elected as prescribed by the charter of the Company. The Directors may fill any vacancy in their own body occurring between annual meetings. Any vacancy existing at the time of the annual meeting may be filled by the shareholders at said meeting. The person chosen

to fill any vacancy shall hold office for the unexpired term of the class in which such vacancy exists.

A majority vote of the Directors in attendance at any meeting shall, in the presence of a quorum, decide its action.

A quorum of the Board of Directors shall consist of a majority, and a majority vote of the Directors in attendance at any meeting of the Board of Directors shall, in the presence of a quorum, decide its action. Less than a quorum of the Board of Directors may adjourn the meeting from time to time. When a meeting is adjourned to a specific time and place, notice of the adjourned meeting need not be given.

The membership of the Board, together with the principal business or professional affiliation of each Director was as follows at December 31, 2008:

David B. Burritt	Vice President and Chief Financial Officer Caterpillar, Incorporated
Walter J. Galvin	Executive Vice President and Chief Financial Officer Emerson Electric Company
Mary L. Howell	Executive Vice President Textron, Inc.
John A. Luke, Jr.	Chairman and Chief Executive Officer MeadWestvaco Corporation
Gracia C. Martore	Executive Vice President and Chief Financial Officer Gannett Company, Incorporated
Robert J. O'Toole	Chairman and Chief Financial Officer (Retired) A.O. Smith Corporation

David Pulman	President Global Manufacturing and Supply GlaxoSmithKline
Elisabeth M. Struckell	Vice President/Business Development PepsiCo
Shivan S. Subramaniam	President and Chief Executive Officer Factory Mutual Insurance Company
James C. Thyen	President and Chief Executive Officer Kimball International, Inc.
Alfred J. Verrecchia	President and Chief Executive Officer Hasbro, Inc.

While the bylaws make no reference to a mandatory retirement age for Directors, at a meeting of the Board of Directors on March 7, 1979, it was voted to establish a policy that no Director could be elected for a new term following attainment of age 68. Subsequent to the merger, this policy was reaffirmed in the July 13-14, 1999 Board of Directors' minutes. The foregoing policy was still in force at December 31, 2008.

The bylaws authorize the Board of Directors to set the compensation of its members. The Board voted to pay its members, other than salaried officers of the Company, an annual retainer of $67,000, plus a fee of $4,500 for each Board meeting attended. Directors are also reimbursed for travel expenses incurred. This compensation is paid only by FMIC, and is for services rendered to all related entities of FM Global.

During 1986, the Company adopted a retirement plan for outside Directors. The plan provides benefits to outside Directors who voluntarily retire at age 60 or later, having completed five or more years of Board service. The plan is an unfunded plan and benefits are paid solely from the general assets of the Company. Prospectively, the plan was discontinued in 1999, although it continues to pay benefits to directors who became eligible prior to its discontinuance. Also in

1986, the Company adopted a deferred compensation plan for outside Directors. The Board of Directors amended the plan on December 13, 1989, and again in Year 2000. The plan allows each outside Director the option to defer a portion or all compensation. The interest crediting rate is equal to the average long-term (30-year) Treasury bond rate for the quarter plus 3%. The interest earned along with all costs associated in administering the plan is borne by the Company.

The bylaws, as amended, provide that the Board of Directors shall elect an executive committee and a finance committee to which certain powers and responsibilities may be delegated. The bylaws also provide that the Board may elect from their own number, any other Committees they deem advisable, and may delegate to such Committees authority to exercise the powers of the Board with respect to the duties of the Committee. Committees elected by the Board of Directors consisted of the following at December 31, 2008:

Executive Committee	Finance Committee
Shivan S. Subramaniam, Chairman	Walter J. Galvin, Chairman
Walter J. Galvin	David Pulman
John A. Luke, Jr.	Elisabeth Struckell
Robert J. O'Toole	Shivan S. Subramaniam
	James C. Thyen

Compensation Committee	Audit Committee
John A. Luke, Jr., Chairman	Robert J. O'Toole, Chairman
Mary L. Howell	David B. Burritt
Robert J. O'Toole	Gracia C. Martore
Alfred J. Verrecchia	

The records of meetings of the Stockholders, Board of Directors, and Committees were reviewed. Matters of regulatory significance are commented on throughout this report where deemed necessary.

Officers

Specified executive officers that include officers with the rank of Senior Vice President or higher, are elected by the Board of Directors. The Chief Executive Officer may appoint or remove officers below the rank of executive officer. The executive officers serving at December 31, 2008 were as follows:

Shivan S. Subramaniam	Chairman and Chief Executive Officer
Ruud H. Bosman	Executive Vice President
Brian J. Hurley	Executive Vice President
Bret N. Ahnell	Senior Vice President
Geraldo L. Alonso	Senior Vice President
Carol G. Barton	Senior Vice President
Perry R. Brazeau	Senior Vice President
Jeffrey A. Burchill	Senior Vice President
Kenneth W. Davey	Senior Vice President
Rodney C. Fisher	Senior Vice President
Jonathan W. Hall	Senior Vice President
Christopher Johnson	Senior Vice President
Paul E. LaFleche	Senior Vice President
Thomas A. Lawson	Senior Vice President
Jeanne R. Lieb	Senior Vice President
William A. Mekrut	Vice President and Treasurer
John J. Pomeroy	Senior Vice President and Secretary
Enzo Rebula	Senior Vice President
Michael R. Turner	Senior Vice President

COMPENSATION OF DIRECTORS, COMMITTEE MEMBERS AND OFFICERS

All Directors, committee members and officers of Affiliated FM hold similar positions with its parent company, Factory Mutual Insurance Company. The resolutions of the Compensation Committee of FMIC with respect to compensation of its Directors, committee members and officers contain the provision that all compensation thereby authorized is for service to all units of FMIC. Thus, there is no additional compensation for service to any of FMIC's subsidiaries.

CONFLICT OF INTEREST

During the period covered by this examination, there was in effect a "Statement of Policy Relative to Business Conduct" (Statement of Policy), with accompanying guidelines applicable to Directors, officers, and professional and managerial employees.

The Statement of Policy stipulates that each Director, officer, member of management and key employee will conduct his or her affairs so that any conflict between personal or outside interests and Company interests will be avoided. Also, any conduct that might adversely affect an employee's judgment or which might be perceived to have such an effect is to be avoided. FM Global requires each individual to annually review the Statement of Policy and confirm his or her review and compliance via electronic response to the Corporate Secretary. If a potential or actual conflict exists, the employee is required to formally notify the General Counsel of the Company in a confidential manner.

The conflict of interest statements submitted by the Directors, officers and key employees during the period under examination were requested. Each Director, officer and key employee confirmed electronically that they reviewed and accepted the FM Global Statement of Policy. No apparent conflicts of interest were noted on the statements that were reviewed.

EMPLOYEE BENEFITS

The Company had no salaried employees. All services necessary for the functioning of the Company were provided by employees of FMIC.

FIDELITY BOND AND OTHER INSURANCE

As of the examination date, the Company was a participant on a financial institution bond, with its affiliates, issued by St. Paul Fire and Marine Insurance Company. The bond provided coverage with a single loss limit of $25,000,000, and a single loss deductible of $500,000. This

coverage exceeded the minimum suggested by the National Association of Insurance Commissioners for the holding company group. The coverage provided protection for the companies against loss resulting from dishonest or fraudulent acts committed by employees or officers. The bond also covered loss caused by larceny, robbery, burglary, theft, misplacement, mysterious unexplainable disappearance and damage thereto, loss of or damage to furnishings, fixtures, supplies or equipment, loss resulting directly from a fraudulent entry of data into or changes to electronic data or computer programs within the Company's computer system. Also covered is loss caused by forgery or alteration of negotiable instruments and loss resulting directly from the receipt of any counterfeit securities. The bond included coverage for securities on deposit with government officials and those in trust and custodian accounts. This coverage was written by a company authorized to transact business in Rhode Island.

The Company also maintains insurance coverage for comprehensive general liability; directors, officers and employees' professional liability; fire and allied coverage's on real and personal property; liability coverage's for both owned and non-owned automobiles; liquor liability; aircraft liability; registered mail; workers' compensation and employers' liability; agents' and brokers' errors and omissions; and pension and welfare fund fiduciary responsibility.

REINSURANCE

Ceded

At December 31, 2008, the Company had the following principal reinsurance treaties in force:

- Property Lines (Surplus Treaty)

The Company had a surplus treaty covering risks classified as Property (excluding war, nuclear, assumed treaty and casualty classes of business) with the following limit of coverage:

CRT (Core Reinsurance Treaty)	$130,000,000

- MCT (Maximum Capacity Treaty)

This is a cessions treaty. It is used on the Company's best of class business. It is used on a location basis within the reinsurance line setting structure when reinsurance is needed above the Company's generated maximum net capacity for these risks. The risk limit is $300M per cession. It is used on an excess of loss basis. This treaty excludes war, nuclear, assumed treaty, casualty, flood and earth movement, but includes fire following.

- ECT (Excess Capacity Treaty)

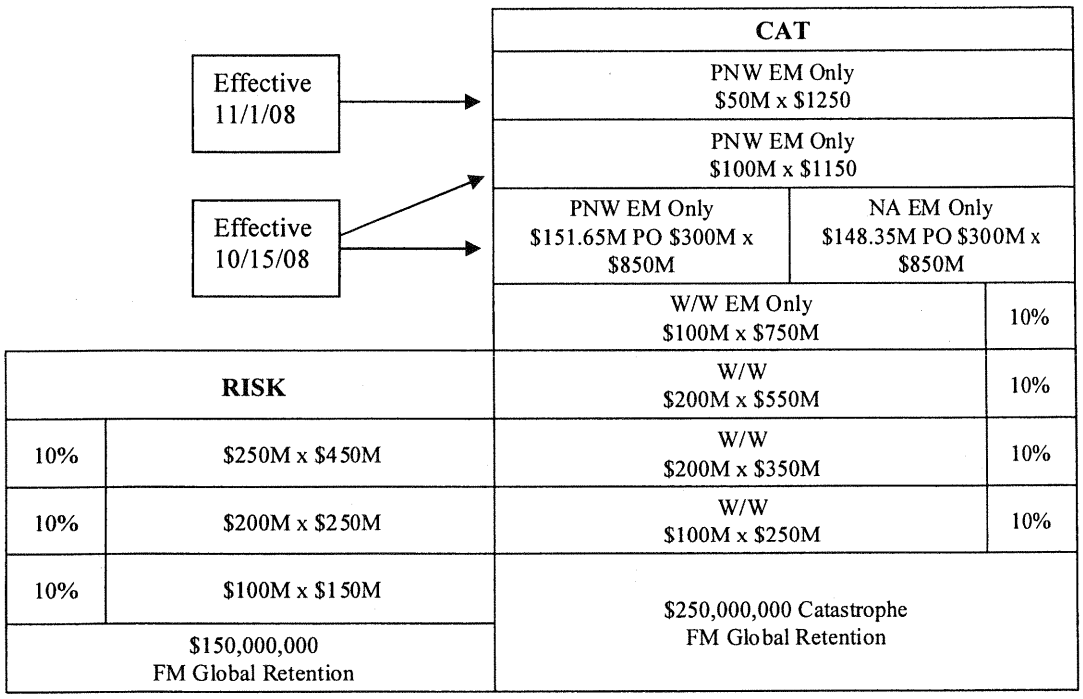
This is a cessions treaty. It is used on a location basis within the reinsurance line setting structure when reinsurance is needed above the Company's generated net capacity. The risk limit is $175M per cession. It is used on an excess of loss basis. This treaty excludes war, nuclear, assumed treaty, casualty, flood and earth movement.

- Excess Catastrophe

The Company and its affiliates have a joint protection program known as the "Factory Mutual Insurance Company (FMIC) Per Risk and Catastrophe Program" providing per risk and catastrophe reinsurance. The business covered under this program relates to all of the property and boiler and machinery business of FMIC, Appalachian and Affiliated FM (excluding war, nuclear, assumed treaty and casualty classes of business). The limit and retention on each layer at December 31, 2008 was as follows:

Excess of Loss Reinsurance Program

7/1/2008 - 6/30/2009



- Ocean Marine Cargo

The Company had three layers of an excess of loss treaty, which provided coverage up to a maximum of $25,000,000 excess of $5,000,000.

Intercompany Reinsurance

The Company participates in a Tripartite Quota Share Pooling Agreement and a Property Per Risk Excess of Loss Treaty with FMIC and Appalachian. The Tripartite Quota Share Pooling Agreement which became effective on January 1, 1982, is an agreement in which the Company and its affiliates agreed to pool all earned premiums, incurred losses, loss adjustment expenses and underwriting expenses. The pooling percentages, amended as of January 1, 2005 are FMIC - 86%, Affiliated FM - 12% and Appalachian - 2%. The percentages approximate the policyholders' surplus of each Company to the combined surplus for the three companies. The agreement was canceled and a new agreement took effect as of December 31, 2008, changing the

settlement provision from 20 days after quarter-end to 60 days after quarter-end. The pooling percentages remain unchanged in the current agreement.

The Company also participates in a Bipartite Quota Share Pooling Agreement with FMIC. The Bipartite Quota Share Pooling Agreement which became effective on January 1, 1993, is an agreement in which the Company and FMIC agreed to pool all earned premiums, incurred losses, loss adjustment expenses and underwriting expenses. The pooling percentages, amended as of January 1, 2004 are FMIC - 81% and Affiliated FM - 19%. The agreement was canceled and a new agreement took effect as of December 31, 2008, changing the settlement provision from 20 days after quarter-end to 60 days after quarter-end. The pooling percentages remain unchanged in the current agreement.

Beginning in 2003, the Company changed the way the pooling amounts were allocated among the three participants. That being, prior to 2003 FMIC and Affiliated FM would first pool their Canadian activity (premiums, losses, and expenses) under the Bipartite Quota Share Pooling Agreement. The remaining activity (U.S. premiums, losses, and expenses) would then be allocated in accordance with the Tripartite Quota Share Pooling Agreement. Under this arrangement, Appalachian Insurance Company would only be allocated U.S. premiums, losses, and expenses. Then beginning in 2003, the Company determined that Tripartite Quota Share Pooling Agreement would takes precedence over the Bipartite Quota Share Pooling Agreement, whereby all premiums, losses, and expenses subject to the Tripartite Quota Share Pooling Agreement would be allocated to the three participating entities regardless whether it was U.S. or Canadian business. This now had the effect of allocating Canadian business to Appalachian Insurance Company who was not a party to the Bipartite Quota Share Pooling Agreement.

Recommendation #2

It is recommended that the Company notify the Rhode Island Insurance Division of any changes in the reporting of inter-company pooling activity and provide a detailed effect of the changes in the pooled results of the three entities.

INFORMATION SYSTEMS AND CONTROLS

In conjunction with the statutory examination of FMIC and affiliates, we performed a review of the Companies' Information Systems (IS) controls. This review included an evaluation of the completed Financial Condition Examiners Handbook, Exhibit C, Evaluation of Controls in Information Systems (IS) Questionnaire.

Our review also included procedures to obtain reasonable assurance about whether: 1) the Company's responses to Exhibit C present fairly, in all material respects, the aspects of the Company's policies and procedures that may be relevant to its internal control structure, 2) the control structure policies and procedures were suitably designed to achieve the control objectives implicit in the Questionnaire, and 3) whether those policies and procedures were complied with.

Overall, while no significant issues were discovered in the IS internal control structure, some weaknesses were noted that should be addressed by the Company.

During our review, it was noted that certain logical access controls for the following operating systems and applications do not follow industry best practices for the following reasons:

1. Windows operating system - Passwords are set to expire after 180 days, instead of the industry best practice of 90 days.
2. PeopleSoft Financials Application - Passwords are set to expire after 180 days and are not required to be a combination of letters and numbers. In addition, the application does not keep a history of passwords previously used.

3. PeopleSoft Human Resources application - The application does not keep a history of passwords previously used.

The deviations with the Windows operating system and the PeopleSoft Financials application also were noted during our prior examination. For these deviations, the Company responded that they would be addressed in a reasonable amount of time.

Recommendation #3

It is again recommended that logical access controls for Windows, PeopleSoft Financials, and PeopleSoft Human Resources be set to the following minimum industry best practices: 1) passwords should be set to expire after 90 days, 2) passwords should not be reused for at least 4 generations, and 3) passwords should consist of alphabetic and numeric characters.

Based on the scope of our work, and the work of other professionals (including Internal Audit and CPA workpapers), our assessment of the overall risk mitigation strategy/control related to information systems controls at the Company is STRONG for those policies and procedures that had been in place during the period of July 1, 2007 to September 12, 2008. An overall STRONG assessment conveys that the Company's Information Systems controls appropriately mitigate risks arising out of Information Systems activities.

FINANCIAL STATEMENTS

The financial condition of the Company and the results of its operations are presented in the following financial statements and exhibits:

Comparative Statement of Assets, Liabilities and Surplus
December 31, 2008 and December 31, 2004

Statement of Income
Year Ended December 31, 2008

Capital and Surplus Account
December 31, 2007 to December 31, 2008

Reconciliation of Surplus
December 31, 2004 to December 31, 2008

Analysis of Assets
December 31, 2008

AFFILIATED FM INSURANCE COMPANY
COMPARATIVE STATEMENT OF ASSETS, LIABILITIES AND SURPLUS
December 31, 2008 and December 31, 2004

ASSETS

	December 31, 2008	December 31, 2004	Increase or Decrease)
Bonds	$1,030,287,739	$703,753,642	$326,534,097
Stocks:			
Common stocks	27,914,823	20,644,022	7,270,801
Cash ($5,412,538), cash equivalents ($1,048,157), and short-term investments ($161,237,094)	156,872,713	25,134,679	131,738,034
Receivable for securities	385,535	2,659,780	(2,274,245)
Subtotals, cash and invested assets	1,215,460,810	752,192,123	463,268,687
Investment income due and accrued	12,037,826	8,419,409	3,618,417
Uncollected premiums and agents' balances in course of collection	96,379,617	90,308,002	6,071,615
Amounts recoverable from reinsurers	87,237,215	81,973,777	5,263,438
Funds held by or deposited with reinsured companies	48,861	49,078	(217)
Current federal and foreign income tax recoverable and interest thereon	6,387,393	0	6,387,393
Net deferred tax asset	25,567,000	13,255,000	12,312,000
Guaranty funds receivable or on deposit	999,638	372,113	627,525
Receivables from parent, subsidiaries and affiliates	25,196,293	0	25,196,293
Equities and deposits in pools and associations	250,000	440,149	(190,149)
Accounts receivable State Tax Refunds	372,798	0	372,798
Accounts receivable miscellaneous	1,113,732	376,871	736,861
Loss clearing	4,422,528	2,203,035	2,219,493
Total Assets	$1,475,473,711	$949,589,557	$525,884,154

AFFILIATED FM INSURANCE COMPANY
COMPARATIVE STATEMENT OF ASSETS, LIABILITIES AND SURPLUS
December 31, 2008 and December 31, 2004

LIABILITIES AND SURPLUS

	December 31, 2008	December 31, 2004	Increase Or (Decrease)
Losses	$361,473,939	$204,253,047	$157,220,892
Reinsurance payable on paid loss and loss adjustment expenses	8,452,644	2,071,357	6,381,287
Loss adjustment expenses	40,074,157	30,797,164	9,276,993
Other expenses	64,410	9,629,146	(9,564,736)
Taxes, licenses and fees	5,577,373	3,400,917	2,176,456
Current federal income taxes (including $0on realized capital gains)	26,854,293	19,728,232	7,126,061
Unearned premiums (after deducting unearned premiums for ceded reinsurance of $67,770,729)	240,806,200	183,247,603	57,558,597
Dividends declared and unpaid: policyholders	111,714	80,732	30,982
Ceded reinsurance premiums payable	68,858,522	50,649,611	18,208,911
Funds held by company under reinsurance treaties	0	2,856,755	(2,856,755)
Amounts withheld or retained by company for account of others	385,634	253,618	132,016
Remittances and items not allocated	432,801		432,801
Provision for reinsurance	4,737,877	3,197,693	1,540,184
Net adjustments in assets and liabilities due to foreign exchange rates	8,832,712	7,330,987	1,501,725
Payable to parent, subsidiaries and affiliates	0	10,094,903	(10,094,903)
Payable for securities	0	1,329,735	(1,329,735)
Miscellaneous accounts payable	8,334,644	654,090	7,680,554
Total Liabilities	774,996,920	529,575,590	245,421,330
Common capital stock	4,000,000	4,000,000	0
Preferred capital stock	7,250,000	7,250,000	0
Gross paid in and contributed surplus	270,210,662	270,210,662	0
Unassigned funds (Surplus)	419,016,129	138,553,305	280,462,824
Surplus as Regards Policyholders	700,476,791	420,013,967	280,462,824
Total Liabilities, Surplus and Other Funds	$1,475,473,711	$949,589,557	$525,884,154

AFFILIATED FM INSURANCE COMPANY
STATEMENT OF INCOME
Year Ended December 31, 2008

Underwriting Income

Premiums earned		$324,329,030
Deductions:		
Losses incurred	$233,782,441	
Loss expenses incurred	17,760,061	
Other underwriting expenses incurred	68,403,371	
Total underwriting deductions		319,945,873
Net underwriting gain (loss)		4,383,157

Investment Income

Net investment income earned	58,906,197	
Net realized capital gains (losses)	(392,101)	
Net investment gain (loss)		55,014,096

Other Income

Net gain (loss) from agents' or premium balances charged off	(296,244)	
Miscellaneous income (expense)	111,604	
Total other income		(184,640)
Net income before dividends to policyholders and before federal and foreign income taxes		59,212,613
Dividends to policyholders		308,880
Net income after dividends to policyholders but before federal and foreign income taxes		58,903,733
Federal and foreign income taxes incurred		26,000,418
Net income		$32,903,315

AFFILIATED FM INSURANCE COMPANY
CAPITAL AND SURPLUS ACCOUNT
December 31, 2007 to December 31, 2008

Surplus as regards policyholders, December 31, 2007			$675,504,916
	Gains in Surplus	Losses in Surplus	
Net income	32,903,315		
Change in net unrealized capital gains or (losses)		6,687,756	
Change in net unrealized foreign exchange capital gain (loss)		9,374,157	
Change in net deferred income tax	16,278,000		
Change in nonadmitted assets		7,644,942	
Change in provision for reinsurance		80,594	
Change in surplus notes			
Surplus adjustments: Paid in			
Dividends to stockholders		507,500	
Aggregate write-ins for gains and losses in surplus	85,509		
Total gains and losses	49,266,824	24,294,949	
Increase in surplus as regards policyholders for the year			24,971,875
Surplus as regards policyholders, December 31, 2008			$700,476,791

AFFILIATED FM INSURANCE COMPANY
RECONCILIATION OF SURPLUS
December 31, 2004 to December 31, 2008

Capital and Surplus, December, 31 2004			$420,013,967
	Gains	Losses	
Net Income	281,605,736		
Change in net unrealized capital gains or (losses) less capital gains tax		3,174,682	
Change in net unrealized foreign exchange capital gain (loss)		1,501,725	
Change in deferred income tax	18,403,000		
Change in non-admitted assets		7,099,041	
Change in provision for reinsurance		1,540,184	
Dividends to stockholders		2,030,000	
Aggregate write-ins for gains and losses in surplus		4,200,280	
Total gains and losses	300,008,736	19,545,912	
Net increase in capital and surplus			$280,462,824
Capital and Surplus, December 31, 2008			$700,476,791

AFFILIATED FM INSURANCE COMPANY
ANALYSIS OF ASSETS
December 31, 2008

	Assets	Non-admitted Assets	Net Admitted Assets
Bonds	$1,030,287,739		$1,030,287,739
Common stocks	27,914,823		27,914,823
Cash ($5,412,538), cash equivalents ($1,048,157) and short-term investments ($161,237,094)	156,872,713		156,872,713
Receivable for securities	385,535		385,535
Subtotals, cash and invested assets	1,215,460,810		1,215,460,810
Investment income due and accrued	12,037,826		12,037,826
Uncollected premiums and agents' balances in course of collection	99,555,358	3,175,741	96,379,617
Amounts recoverable from reinsurers	87,237,215		87,237,215
Funds held by or deposited with reinsured companies	48,861		48,861
Current federal and foreign income tax recoverable and interest thereon	6,387,393		6,387,393
Net deferred tax asset	28,331,000	2,764,000	25,567,000
Guaranty funds receivable or on deposit	999,638		999,638
Receivables from parent, subsidiaries, and affiliates	25,196,293		25,196,293
Equities and deposits in pools and associations	250,000		250,000
Accounts receivable State Tax Refunds	372,798		372,798
Accounts receivable miscellaneous	1,113,732		1,113,732
Loss clearing	4,422,528		4,422,528
Total Assets	$1,481,413,452	$5,939,741	$1,475,473,711

ASSETS

Bonds	$1,030,287,739

The amount stated above is the admitted value of bonds reported by the Company in its 2008 Annual Statement. The majority of bonds owned are held in accordance with two custodial agreements with third parties. All of the remaining bonds ($5,617,061) are held by various states in the form of special deposits.

The quality ratings of the bonds, as established by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners were reviewed. It was noted that 99.9% of the bond portfolio represents Class 1 or Class 2 securities which are bonds of the "highest" and "high" quality, respectively.

The book value, par value, market value, actual cost and statement value of the bond portfolio at December 31, 2008 are as follows:

Book Value	Par Value	Market Value	Actual Cost
$1,030,287,741	$1,036,205,600	$1,012,202,965	$1,036,094,025

As part of the overall review of investments, a copy of the Company's investment guidelines was requested. The Company provided a copy of the December 8, 1999 Finance Committee Minutes which document that the Committee approved an overall investment policy and investment guidelines for the FM Global Group (FMIC, Affiliated FM and Appalachian). This policy applies to the investments of each company, and there is a written breakdown of the investment categories and ranges by individual company.

Beginning in 1999, the Company entered into a Security Lending Agreement with JP Morgan. The Company appointed JP Morgan as its agent to lend securities on their behalf. Securities may be lent to any borrower listed in an approved borrowers listing. JP Morgan shall receive and hold all collateral required in a collateral account and JP Morgan is hereby authorized to invest and reinvest all or substantially all cash. The collateral requirement with respect to a given security shall be an amount equal to the then applicable percentage of 102%. If the borrower of any loan of US Securities fails to return any securities on loan to JP Morgan for the account when due, then JP Morgan shall at its expense deposit replacement securities of same issue, type, class and series to the account.

As part of the overall review of investments, a copy of the Company's security lending guidelines was requested. The guidelines have restrictions on certain securities that JP Morgan may reinvest the collateral. A few prohibited items include certain derivatives, equity securities, floating rate securities with an interest rate cap.

Beginning in 2008, in order to reduce the Risk Based Capital (RBC) charge, a company must meet certain criteria that are listed in the RBC Instruction. Based on our review, the company did not meet the first criteria listed. The criteria states: "A written plan adopted by the Board of Directors that outlines the extent to which the insurer can engage in securities lending activities and how cash collateral received will be invested." The Company did provide documentation that the Arkwright Mutual Insurance Company's (merged into FMIC in 1999) Board of Director's did approve a security lending program in the early 1990's. However, the Security Lending Program should be presented to the Company's current Board of Directors for RBC compliance.

Recommendation #4

It is recommended that the current Board of Directors adopt a written plan, which outlines the extent to which the insurer can engage in securities lending activities, and how cash collateral received will be invested.

Net Deferred Tax Asset	$25,567,000

The amount reported above is $4,942,000 greater than the amount reported by the Company in its 2008 Annual Statement. The increase was the result of the review of the CPA workpapers, which noted a difference in the admitted deferred tax asset calculation when compared to the Company's deferred tax asset calculation.

Recommendation #5

It is recommended in all future Annual Statement filings that the Company properly calculates the admitted value of the deferred tax assets.

Receivables from Parent, Subsidiaries and Affiliates	$25,196,293

The above-captioned amount, which was reported by the Company in its 2008 Annual Statement, represents the net amount due to the Company from affiliates within the FM Global holding company system. Cash settlements are intended to be made between the affiliates in accordance with the intercompany agreements.

Although the examiners have accepted the Company's reported amount, a review of subsequent activity revealed that the December 31, 2008 intercompany balances relating to the Tripartite Quota Share Agreement and the Management Service Agreement were transferred to the Intercompany Cash Management Agreement (ICMA) in January 2009. The settlement terms of the ICMA require that outstanding balances of principal and accrued interest on any loans shall be due and payable no later than sixty days following the last day of each calendar quarter.

Partial settlements were made subsequent to December 31, 2008, by applying intercompany activity against the outstanding balance. Our review of the ICMA settlement revealed that the Company settled the remaining balance sixty-five (65) days after the quarter ended. Due to the Company's settlement process we were unable to determine which intercompany balances were settled timely.

The Bipartite Quota Share Pooling Agreement (more fully described in the "Reinsurance" section) represents an amount due to a Canadian insurance affiliate. As discussed above, due to the Company's settlement process we were unable to determine which intercompany balances were settled timely.

Recommendation #6

It is recommended that the Company prepare a detailed schedule that includes all intercompany balances at the end of each quarter, and that the schedule reflects activity applied against the intercompany balances subsequent to the quarter ending. It is also recommended that the Company settle any remaining intercompany balances in accordance with the settlement provisions contained in Article 2 of the Intercompany Cash Management Agreement.

LIABILITIES

Losses and Loss Adjustment Expenses (LAE)	$401,548,096

Losses	$361,473,939
LAE	40,074,157
TOTAL	$401,548,096

The amount reported above is the same as that reported by the Company in its 2008 Annual Statement. The loss and loss adjustment expense reserves have been reviewed by Merlinos & Associates Inc. (Merlinos), consulting actuaries for the Rhode Island Insurance Division.

Merlinos' review of loss and loss adjustment expense reserves was primarily based on the reserve analysis performed by the Company's independent actuary (Appointed Actuary). The procedures performed by Merlinos primarily included the following:

- Validated that the Appointed Actuary's actuarial analysis addressed all of the Company's claim liabilities;
- Confirmed that the reserve calculations did not include any material computational errors;
- Confirmed that the Statement of Actuarial Opinion followed the NAIC Annual Statement Instructions;
- Reviewed the Appointed Actuary's report for qualitative issues, addressing areas of the methodology and assumptions that are to some extent, based on "actuarial judgment." These areas included the stratification of the business used in the analysis, the reserving methodology used, the factors selected based on the supporting data provided and, the selection of IBNR amounts.

In addition to the above procedures, Merlinos reviewed the principal reinsurance program currently in place for FMIC and its affiliates. Merlinos concluded that FMIC and its affiliates maintain a strong reinsurance program and that the specific excess program attaches at levels low enough to protect the Company's surplus from any single claim. Merlinos also concluded that all key reinsurance agreements in force at the examination date contain sufficient risk transfer to be classified as prospective reinsurance for statutory reporting purposes.

Based upon the procedures performed, Merlinos concluded that the loss and loss adjustment expense reserves carried by the Company at December 31, 2008 meet the requirements of the insurance laws of the State of Rhode Island; are computed in accordance with accepted loss standards and principles; and make a reasonable provision for all unpaid loss and loss adjustment expense obligations under the terms of the Company's policies and agreements.

In assisting Merlinos with the reserve analysis, the Examiners performed various procedures to verify the integrity of the Company's loss data, including completeness testing. A combination of subjective and statistical sampling techniques was used in testing the loss data.

Net Adjustments in Assets and Liabilities Due to Foreign Exchange Rates $8,832,712

The balance reported above is the same as that reported by the Company in its 2008 Annual Statement. The balance represents the difference in the exchange rate between U.S. dollars and Canadian currency rates. The difference is generated when the Company combines its Canadian operation with its U.S. operations when preparing the 2008 Annual Statement.

The foreign exchange conversion is governed under Statements of Statutory Accounting Principals (SSAP) #23. In order to qualify for a single adjustment recorded in the above Annual Statement caption, the Company must meet three conditions under Paragraph 5; 1) Canadian admitted assets must be less than 10%; 2) Canadian liabilities must be less than 10%, and; 3) Canadian net written premiums must also be less than 10%. We recalculated the amount conditions and concluded that the Canadian net written premiums exceeded the 10% criteria. Once the Company fails any of the three criteria's listed above, then the SSAP requires that the Company make the foreign currency adjustment to the individual Annual Statement lines translated into U.S. dollars.

Recommendation #7

It is recommended that the Company comply with all requirements of SSAP #23, and properly record the Canadian foreign currency adjustment when filing the Annual Statement.

CAPITAL AND SURPLUS

Capital and Surplus $700,476,791

The total capital and surplus above is the same as that reported by the Company in its 2008 Annual Statement, and consists of the following:

Common capital stock	$4,000,000
Preferred capital stock	7,250,000
Gross paid in and contributed surplus	270,210,662

Unassigned funds (surplus)	419,016,129
Surplus as regards policyholders	$700,476,791

The examiner's changes in asset and liability items resulted in a net increase of $4,942,000 in unassigned funds (surplus) as reflected in the following schedule:

Liabilities	Per Company	Per Examiner	Increase in Surplus
Net deferred tax asset	$20,625,000	$25,567,000	$4,942,000

SUMMARY OF RECOMMENDATIONS

No.	Recommendations	Page No.
1	It is recommended that for any transactions and/or agreements between members of FM Global's holding company system that are subject to RI General Law Section 27-35-4, that the Company notify the Rhode Island Insurance Division at least 30 days prior to entering into the transaction and/or agreement and furnish the required information on Form D in accordance with Regulation 17, Section 20.	5
2	It is recommended that the Company notify the Rhode Island Insurance Division of any changes in the reporting of inter-company pooling activity and provide a detailed effect of the changes in the pooled results of the three entities.	20
3	It is again recommended that logical access controls for Windows, PeopleSoft Financials, and PeopleSoft Human Resources be set to the following minimum industry best practices: 1) passwords should be set to expire after 90 days, 2) passwords should not be reused for at least 4 generations, and 3) passwords should consist of alphabetic and numeric characters.	21

4	It is recommended that the current Board of Directors adopt a written plan, which outlines the extent to which the insurer can engage in securities lending activities, and how cash collateral received will be invested.	31
5	It is recommended that in all future Annual Statement filings that the Company properly calculates the admitted value of the deferred tax assets.	31
6	It is recommended that the Company prepare a detailed schedule that includes all intercompany balances at the end of each quarter, and that the schedule reflects activity applied against the intercompany balances subsequent to the quarter ending. It is also recommended that the Company settle any remaining intercompany balances in accordance with the settlement provisions contained in Article 2 of the Intercompany Cash Management Agreement.	32
7	It is recommended that the Company comply with all requirements of SSAP #23, and properly record the Canadian foreign currency adjustment when filing the Annual Statement.	34

SUBSEQUENT EVENTS

The Company terminated the Bipartite Quota Share Pooling Agreement effective at 12:01a.m. 1 January, 2009. The termination of the agreement was documented in Addendum No. 1, signed December 30, 2009 (364 days after the agreement termination). The signing of the Addendum corresponded with the examiners request for documentation that the agreement had been terminated in 2009. With regard to communicating the termination of this agreement to the Rhode Island Insurance Division (Division), the Company failed to notify the Division of the termination when filing the March 31, 2009, June 30, 2009, or the September 30, 2009 Comprehensive Quarterly Analysis (CQA) with the Division.

Regarding the carried reserves for Discontinued Lines of Business, the Company performed an analysis of the carried reserves for asbestos, environmental and other mass torts, and concluded that reserves should be strengthened by approximately $20.0 million (net) for December 31, 2009 Annual Statement reporting.

CONCLUSION

We have applied verification procedures to the data contained in this report using both subjective and statistical sampling techniques as deemed appropriate. While sampling techniques do not give complete assurance that all errors and irregularities will be detected, those that were detected during the course of this examination have been disclosed in this report. We were not informed of, and did not become aware of any other error or irregularity which could have a material effect on the financial condition of the company as presented in this report.

Assisting in the examination with the undersigned were Theodore J. Hurley, CPE, CPA, Insurance Examiner-In-Charge, Gianfranco Monaco, CISA, Principal Insurance Examiner EDP & Automated Systems, Debra Almeida, CFE, Senior Insurance Examiner, and Douglas Fowler, Insurance Examiner of the Rhode Island Insurance Division. Acknowledgment is also made of the assistance rendered by Merlinos' & Associates, Inc.; the Rhode Island Insurance Division's consulting actuaries.

Respectfully submitted,

Louis A Gabriele, Jr. CFE, CPA
Insurance Examiner-in-Charge
State of Rhode Island
Northeastern Zone, NAIC