

FINANCIAL STATEMENTS  
(STATUTORY BASIS)

Federated Rural Electric Insurance Exchange  
Years Ended December 31, 2009 and 2008  
With Report of Independent Auditors

Federated Rural Electric Insurance Exchange

Financial Statements (Statutory Basis)

Years Ended December 31, 2009 and 2008

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## Report of Independent Auditors

The Board of Directors  
Federated Rural Electric Insurance Exchange

We have audited the accompanying statutory-basis balance sheets of Federated Rural Electric Insurance Exchange (the Exchange) as of December 31, 2009 and 2008, and the related statutory-basis statements of operations, changes in members' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Exchange's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Exchange's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Exchange's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 1 to the financial statements, the Exchange presents its financial statements in conformity with accounting practices prescribed or permitted by the Kansas Insurance Department, which practices differ from U.S. generally accepted accounting principles. The variances between such practices and U.S. generally accepted accounting principles also are described in Note 1. The effects on the financial statements of these variances are not reasonably determinable but are presumed to be material.

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of Federated Rural Electric Insurance Exchange at December 31, 2009 and 2008, or the results of its operations or its cash flows for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Federated Rural Electric Insurance Exchange at December 31, 2009 and 2008, and the results of its operations and its cash flows for the years then ended, in conformity with accounting practices prescribed or permitted by the Kansas Insurance Department.

*Ernst + Young LLP*

February 3, 2010

# Federated Rural Electric Insurance Exchange

## Balance Sheets (Statutory Basis)

	<b>December 31</b>	
	<b>2009</b>	<b>2008</b>
<b>Admitted assets</b>		
Cash and invested assets:		
Bonds	\$ 296,326,284	\$ 283,045,766
Preferred stocks	4,430,569	4,254,088
Common stocks	8,168,637	6,490,785
Real estate	1,171,626	1,084,115
Cash and short-term investments	15,650,974	6,509,428
Other invested assets	41,888	—
Total cash and invested assets	325,789,978	301,384,182
Uncollected premiums	10,041,499	9,700,029
Reinsurance balances recoverable	5,958,090	4,690,527
Accrued investment income	2,693,262	2,461,739
Electronic data processing equipment	206,856	170,396
Net deferred income tax asset	5,993,129	5,914,332
Federal income taxes recoverable	969,197	—
Total admitted assets	\$ 351,652,011	\$ 324,321,205

	<b>December 31</b>	
	<b>2009</b>	<b>2008</b>
<b>Liabilities and members' equity</b>		
Liabilities:		
Reserves:		
Losses and loss adjustment expense	<b>\$ 180,846,135</b>	\$ 169,074,947
Unearned premiums	<b>36,624,614</b>	35,537,038
Advance premiums	<b>10,434,622</b>	7,825,428
Total reserves	<b>227,905,371</b>	212,437,413
Accounts payable and accrued expenses	<b>10,795,790</b>	10,192,851
Ceded reinsurance premiums payable	<b>3,051,685</b>	2,981,934
Federal income taxes payable	-	167,226
Total liabilities	<b>241,752,846</b>	225,779,424
Members' equity:		
Surplus notes	<b>11,111,111</b>	11,111,111
Contributed capital	<b>24,438,870</b>	24,320,378
Unassigned surplus	<b>74,349,184</b>	63,110,292
Total members' equity	<b>109,899,165</b>	98,541,781
Total liabilities and members' equity	<b>\$ 351,652,011</b>	\$ 324,321,205

*See accompanying notes.*

# Federated Rural Electric Insurance Exchange

## Statements of Operations (Statutory Basis)

	<b>Year Ended December 31</b>	
	<b>2009</b>	<b>2008</b>
Premiums earned	<b>\$ 104,739,973</b>	\$ 105,719,542
Losses and loss adjustment expenses incurred	<b>89,742,790</b>	89,743,415
Other underwriting expenses incurred	<b>15,947,786</b>	14,334,617
Underwriting (loss) gain	<b>(950,603)</b>	1,641,510
Net investment income	<b>12,020,706</b>	12,107,953
Net realized capital gains (losses)	<b>1,012,855</b>	(2,897,705)
Other (expense) income	<b>(4,184)</b>	1,142
Income before federal income tax expense	<b>12,078,774</b>	10,852,900
Federal income tax (benefit) expense	<b>(424,929)</b>	1,552,330
Net margin	<b>\$ 12,503,703</b>	\$ 9,300,570

*See accompanying notes.*

## Federated Rural Electric Insurance Exchange

### Statements of Changes in Members' Equity (Statutory Basis)

	<b>Surplus Notes</b>	<b>Contributed Capital</b>	<b>Unassigned Surplus</b>	<b>Total Members' Equity</b>
Balance at January 1, 2008	\$ 11,111,111	\$ 24,295,086	\$ 62,201,845	\$ 97,608,042
Net margin	–	–	9,300,570	9,300,570
Members' equity distributions	–	(17,929)	(3,899,052)	(3,916,981)
Members' equity contributions	–	43,221	–	43,221
Change in net deferred income tax asset	–	–	3,788,852	3,788,852
Change in difference between cost and admitted amount of invested assets	–	–	(5,476,287)	(5,476,287)
Change in nonadmitted assets	–	–	(2,805,636)	(2,805,636)
Balance at December 31, 2008	11,111,111	24,320,378	63,110,292	98,541,781
Net margin	–	–	<b>12,503,703</b>	<b>12,503,703</b>
Members' equity distributions	–	<b>(2,836)</b>	<b>(5,292,196)</b>	<b>(5,295,032)</b>
Members' equity contributions	–	<b>121,328</b>	–	<b>121,328</b>
Change in net deferred income tax asset	–	–	<b>(1,738,145)</b>	<b>(1,738,145)</b>
Change in difference between cost and admitted amount of invested assets	–	–	<b>3,948,636</b>	<b>3,948,636</b>
Change in nonadmitted assets	–	–	<b>1,816,894</b>	<b>1,816,894</b>
Balance at December 31, 2009	<b>\$ 11,111,111</b>	<b>\$ 24,438,870</b>	<b>\$ 74,349,184</b>	<b>\$ 109,899,165</b>

*See accompanying notes.*

# Federated Rural Electric Insurance Exchange

## Statements of Cash Flows (Statutory Basis)

	<b>Year Ended December 31</b>	
	<b>2009</b>	<b>2008</b>
<b>Cash from operations</b>		
Premiums collected, net of reinsurance	\$ <b>105,555,783</b>	\$ 106,784,960
Net investment income received	<b>13,256,823</b>	12,934,019
Miscellaneous income	<b>582,017</b>	561,490
Benefit and loss-related payments	<b>(79,239,165)</b>	(81,854,687)
Commissions and expenses paid	<b>(15,986,371)</b>	(13,690,676)
Federal income taxes paid	<b>(711,494)</b>	(97,309)
Net cash from operations	<b>23,457,593</b>	24,637,797
<b>Cash from investments</b>		
Proceeds from investments sold, matured, or repaid:		
Bonds	<b>79,488,527</b>	60,477,919
Stocks	<b>3,996,633</b>	3,736,560
Total investment proceeds	<b>83,485,160</b>	64,214,479
Cost of investments acquired:		
Bonds	<b>(92,242,073)</b>	(71,924,695)
Stocks	<b>(2,642,543)</b>	(17,706,851)
Real estate	<b>(200,193)</b>	(101,862)
Total investments acquired	<b>(95,084,809)</b>	(89,733,408)
Net cash used in investments	<b>(11,599,649)</b>	(25,518,929)
<b>Cash from financing and miscellaneous sources</b>		
Members' equity contributions	<b>121,328</b>	43,221
Members' equity distributions	<b>(5,295,032)</b>	(3,916,981)
Other cash provided (used)	<b>2,457,306</b>	(3,475,011)
Net cash used in financing and miscellaneous sources	<b>(2,716,398)</b>	(7,348,771)
Net increase (decrease) in cash and short-term investments	<b>9,141,546</b>	(8,229,903)
Cash and short-term investments:		
Beginning of year	<b>6,509,428</b>	14,739,331
End of year	<b>\$ 15,650,974</b>	\$ 6,509,428

*See accompanying notes.*

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (Statutory Basis)

December 31, 2009

### **1. Nature of Operations and Significant Accounting Policies**

#### **Nature of Operations**

Federated Rural Electric Insurance Exchange (the Exchange) is a reciprocal insurer domiciled in Kansas. As a reciprocal insurer, the Exchange is the result of the mutual exchange of insurance contracts among subscribers in an unincorporated association through an attorney-in-fact having authority to obligate each subscriber both as insured and insurer. The Exchange writes commercial property and casualty insurance coverage to rural electric and telephone systems and their affiliates. At December 31, 2009, the Exchange insures 810 rural electric and telephone systems in 42 states.

Federated Rural Electric Management Corp. (FREMC), a Kansas nonstock membership corporation, serves as the Exchange's attorney-in-fact. The members of FREMC are the members of its Board of Directors, which is composed of the same individuals that serve on the Exchange's Board of Directors. As attorney-in-fact, FREMC provides management services to the Exchange for a fee not to exceed 20% of gross written premium and other income. The Exchange has recorded management fee expense of \$10,781,000 and \$9,668,000 during 2009 and 2008, respectively, which is reported within other underwriting expenses incurred. The Exchange accrued a payable related to this agreement of \$116,000 and \$25,000 at December 31, 2009 and 2008, respectively. The Exchange unconditionally guarantees the performance of FREMC.

#### **Use of Estimates**

The preparation of financial statements of insurance companies requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

#### **Basis of Presentation**

The accompanying financial statements of the Exchange have been prepared in conformity with accounting practices prescribed or permitted by the Kansas Insurance Department.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

*(Statutory Basis)*

### **1. Nature of Operations and Significant Accounting Policies (continued)**

The Kansas Insurance Department recognizes only statutory-basis accounting practices prescribed or permitted by the State of Kansas for determining and reporting the financial condition and results of operations of an insurance company, for determining its solvency under the Kansas Insurance Law. The *Accounting Practices and Procedures Manual* of the National Association of Insurance Commissioners (NAIC) has been adopted as a component of prescribed or permitted practices by the State of Kansas. The Kansas Commissioner of Insurance has the right to permit or prescribe specific practices that deviate from those set forth in the NAIC's *Accounting Practices and Procedures Manual*. The Exchange has not applied any deviations from the NAIC's *Accounting Practices and Procedures Manual* in the preparation of the financial statements included herein.

Accounting practices prescribed or permitted by the Kansas Insurance Department vary from accounting principles generally accepted in the United States (GAAP). The more significant variances from GAAP are as follows:

#### *Investments*

For statutory purposes, investments in bonds and mandatory redeemable preferred stocks are reported at amortized cost or market value based on their rating by the NAIC; for GAAP, such fixed maturity investments would be designated at purchase as either held-to-maturity, trading, or available-for-sale. Held-to-maturity fixed investments would be reported at amortized cost, and the remaining fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in operations for those designated as trading and as a separate component of members' equity for those designated as available-for-sale. If it is determined that a decline in fair value is other-than-temporary, for GAAP, unrealized losses are bifurcated between credit and non-credit related impairments. Credit related impairments are recognized in earnings, while non-credit related impairments are reported as a component of members' equity. For statutory purposes, other-than-temporary impairments are treated as realized losses.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued) (Statutory Basis)

### 1. Nature of Operations and Significant Accounting Policies (continued)

All single-class and multiclass mortgage-backed securities (e.g., CMOs) are adjusted for the effects of changes in prepayment assumptions on the related accretion of discount or amortization of premium of such securities using the retrospective method. If it is determined that a decline in fair value is other-than-temporary, the cost basis of the security is written down to the estimated future cash flows discounted to the effective interest rate of the security. For GAAP purposes, all securities, purchased or retained, that represent beneficial interests in securitized assets (e.g., CMO, CBO, CDO, CLO, MBS, and ABS securities), other than high-credit-quality securities, are adjusted using the prospective method when there is a change in estimated future cash flows. If it is determined that a decline in fair value is other than temporary, the cost basis of the security is written down to the discounted fair value. For those securities in which an other-than-temporary impairment is identified, the impairment losses are bifurcated between credit and non-credit related impairments. If high-credit-quality securities are adjusted, the retrospective method is used.

Investments in real estate are reported net of related obligations for statutory purposes rather than on a gross basis for GAAP. Real estate owned and occupied by the Exchange is included in investments for statutory purposes rather than reported for GAAP as an operating asset, and investment income and operating expenses include rent for the Exchange's occupancy of those properties.

Changes between cost and admitted asset investment amounts are credited or charged directly to members' equity for statutory purposes. There is no admitted asset investment valuation concept under GAAP.

#### *Policy Acquisition Costs*

The costs of acquiring and renewing business are expensed when incurred for statutory purposes. Under GAAP, such costs, to the extent recoverable, would be deferred and amortized over the effective period of the related insurance policies.

#### *Furniture and Equipment*

The cost of furniture and equipment purchased during the year is charged to expense for statutory purposes rather than capitalized and depreciated over the estimated useful life of the asset for GAAP.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

(Statutory Basis)

### 1. Nature of Operations and Significant Accounting Policies (continued)

#### *Nonadmitted Assets*

Certain assets designated as “nonadmitted assets,” principally a portion of deferred income tax assets, prepaid expenses, and other assets not specifically identified as an admitted asset within the NAIC’s *Accounting Practices and Procedures Manual* are excluded from the accompanying balance sheets and are charged directly to members’ equity for statutory purposes. These assets aggregated approximately \$6,007,000 and \$7,823,000 at December 31, 2009 and 2008, respectively. Under GAAP, such assets are included in the balance sheets.

#### *Reinsurance*

Reserves for losses and loss adjustment expenses and unearned premiums ceded to reinsurers have been reported as reductions of the related reserves for statutory purposes rather than as assets, as would be required under GAAP.

Commissions allowed by reinsurers on business ceded are reported as income when received for statutory purposes rather than being deferred and amortized with deferred policy acquisition costs for GAAP.

#### *Deferred Income Taxes*

For statutory purposes, deferred income tax assets or liabilities are computed based on the difference between the financial statement and income tax bases of assets and liabilities using the enacted marginal tax rates. Changes in deferred income tax assets and liabilities are recorded directly to members’ equity. Deferred income tax assets are limited to (1) the amount of federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year, plus (2) the lesser of the remaining gross deferred income tax assets expected to be realized within one year of the balance sheet date or 10% of members’ equity excluding any net deferred income tax assets, electronic data processing equipment and operating software, and any net positive goodwill, plus (3) the amount of remaining gross deferred income tax assets that can be offset against existing gross deferred income tax liabilities. The remaining deferred income tax assets are nonadmitted. Deferred income taxes do not include amounts for state taxes. Under GAAP, state taxes are included in the computation of deferred

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

*(Statutory Basis)*

### **1. Nature of Operations and Significant Accounting Policies (continued)**

income taxes, a deferred income tax asset is recorded for the amount of gross deferred income tax assets expected to be realized in future years. Additionally, for GAAP, the change in deferred income tax assets or liabilities is generally allocated between operations and the change in accumulated other comprehensive income.

#### *Surplus Notes*

Surplus notes are reported as members' equity for statutory purposes rather than as liabilities for GAAP. For statutory purposes, interest on surplus notes is charged to earnings as a reduction in net investment income when approved for payment by the Kansas Insurance Department. For GAAP, such interest is accrued over the period the surplus note is outstanding, and amounts are reported as a separate component of operations.

#### *Premiums*

Premiums in the course of collection are recorded net of reinsurance premiums for statutory purposes rather than as gross amounts, as would be required under GAAP.

#### *Guaranty Fund and Other Assessments*

A liability for guaranty fund assessments (net of certain offsets depending on state rules) is accrued after an insolvency has occurred regardless of whether the assessment is based on premiums written before or after the insolvency. Under GAAP, the assessment recognized is typically accrued when premiums are written because the assessment generally is based on prospective premium writings.

#### *Statement of Cash Flows*

Cash and short-term investments in the statement of cash flows for statutory purposes represent cash balances and investments with initial maturities of one year or less. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with initial maturities of three months or less. Further, GAAP would require a reconciliation of net income to net cash provided by operating activities.

The effects of the foregoing variances from GAAP on the accompanying statutory-basis financial statements have not been determined but are presumed to be material.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued) (Statutory Basis)

### 1. Nature of Operations and Significant Accounting Policies (continued)

Other significant accounting practices follow.

#### Investments

Bonds, preferred stocks, common stocks, and short-term investments are stated at values prescribed by the NAIC as follows:

Bonds not backed by other loans are principally stated at amortized cost using the interest method. Bonds designated by the NAIC as Class 3 through Class 6 are reported at the lower of cost or market value as determined by the Securities Valuation Office of the NAIC (SVO), and any unrealized capital loss is reported in members' equity without any adjustment for federal income taxes.

Single-class and multiclass mortgage-backed/asset-backed securities are valued at amortized cost using the interest method including anticipated prepayments. Prepayment assumptions are obtained from dealer surveys or internal estimates and are based on the current interest rate and economic environment. The retrospective adjustment method is used to value all such securities.

Redeemable preferred stocks, which have characteristics of debt securities and are rated as high quality or better, are reported at cost or amortized cost. All other redeemable preferred stocks are reported at the lower of cost, amortized cost, or market value. Nonredeemable preferred stocks are reported at market value or lower of cost or market value as determined by the SVO, and the related net unrealized capital gains or losses are reported in members' equity with any adjustment for federal income taxes separately reported.

Common stocks are reported at market value as determined by the SVO, and the related net unrealized capital gains (losses) are reported in members' equity with any adjustment for federal income taxes separately reported.

Short-term investments include investments with remaining maturities of one year or less at the time of acquisition and are principally stated at cost or amortized cost.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

(Statutory Basis)

### 1. Nature of Operations and Significant Accounting Policies (continued)

The carrying amounts of all investments are reviewed on an ongoing basis for credit deterioration. If this review indicates a decline in fair value that is other-than-temporary, the carrying amount of the investment is reduced to its fair value, and a specific write-down is taken. Such reductions in carrying amount are recognized as realized capital losses in the statements of operations. For loan-backed and structured securities, other-than-temporary losses are bifurcated between credit and non-credit related losses. Credit related losses are recognized in operations. Non-credit related losses are reflected as an adjustment to members' equity. Realized capital gains and losses are determined using the specific identification basis.

Interest income is recognized on an accrual basis. Dividends are recorded on the ex-dividend date. The Exchange generally does not accrue income on investments when there is evidence of default or another indication that such amounts will not be collected.

#### Real Estate and Electronic Data Processing Equipment

Real estate and electronic data processing equipment are stated on the basis of cost less allowances for depreciation. Depreciation is computed by the straight-line method using the following estimated lives:

Real estate:	
Building	30 years
Building improvements	20 years
Electronic data processing equipment	3 years

Allowances for depreciation are as follows:

	December 31	
	2009	2008
	<i>(In Thousands)</i>	
Real estate	\$ 1,716	\$ 1,603
Electronic data processing equipment	858	861

Depreciation expense charged to operations in 2009 and 2008 was \$228,000 and \$209,000, respectively.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

*(Statutory Basis)*

### **1. Nature of Operations and Significant Accounting Policies (continued)**

#### **Members' Equity**

The allocation of net margin to members' equity accounts and distributions of equity from members' equity accounts are determined by the Board of Directors. Discontinued subscribers are paid the balance of their members' equity account after a reasonable determination of their final members' equity balance is made. This determination is based upon loss development of the relatively long tail lines of business written by the Exchange. During 2009, approximately \$3,000 was paid to discontinued subscribers, and at December 31, 2009, amounts reported as unassigned surplus that are associated with discontinued subscribers totaled approximately \$1,978,000.

Certain direct entries to unassigned surplus are not allocated to individual members' equity accounts. These amounts totaled \$(553,000) and \$(4,502,000) at December 31, 2009 and 2008, respectively, and were comprised of unrealized losses on investments (including the American Mutual Reinsurance Company (AMRECO) surplus drafts in 2008) and nonadmitted assets, reduced by the deferred income tax asset.

#### **Losses and Loss Adjustment Expense Reserves**

Loss and loss adjustment expense reserves represent management's best estimate of the ultimate net cost of all reported and unreported losses incurred through December 31. The Exchange does not discount loss and loss adjustment expense reserves except for certain permanent long-term disability claims related to workers' compensation coverages, which are discounted using rates approved by the Kansas Insurance Department. The reserves for unpaid losses and loss adjustment expenses are estimated using individual case basis valuations and statistical analyses. Those estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes the reserves for losses and loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

The Exchange's major lines of business are characterized by low claims frequency, but with potential for high severity. The reserves are subject to considerable uncertainty due to the potential severity of the claims, the uncertain legal climate, and the difficulty in estimating additional claims to be reported. These factors create a high degree of variability in reserve estimates.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

*(Statutory Basis)*

### **1. Nature of Operations and Significant Accounting Policies (continued)**

#### **Reinsurance**

Prospective reinsurance premiums, losses, and loss adjustment expenses are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts.

#### **Premiums**

Premiums are earned pro rata over the terms of the policies except for premium adjustments on retrospectively rated reinsurance contracts, which are recognized currently. The reserve for unearned premiums is determined on a daily pro rata basis.

Earned premiums have been reduced by \$2,645,000 and \$2,751,000 for 2009 and 2008, respectively, associated with an estimated return of premium on group retention programs. The liability for accrued estimated return of premium totaled \$3,457,000 and \$3,522,000 at December 31, 2009 and 2008, respectively.

#### **Insurance-Related Assessments**

At December 31, 2009 and 2008, the Exchange has recorded liabilities aggregating \$2,526,000 and \$2,423,000, respectively, related to secondary injury and budgetary assessments, which are included in accounts payable and accrued expenses in the balance sheets. The Exchange recognizes these liabilities when the related loss occurs.

#### **Recent Accounting Pronouncements**

Accounting Standards Codification™ 855 (ASC 855) defines subsequent events as events or transactions that occur after the balance sheet date, but before the financial statements are issued or available to be issued. It defines two types of subsequent events: recognized subsequent events, which provide additional evidence about conditions that existed at the balance sheet date, and nonrecognized subsequent events, which provide evidence about conditions that did not exist as of the balance sheet date, but arose after that date. Recognized subsequent events are required to be recognized in the financial statements, and certain nonrecognized subsequent events are

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

(Statutory Basis)

### 1. Nature of Operations and Significant Accounting Policies (continued)

required to be disclosed. ASC 855 requires entities to disclose the date through which subsequent events have been evaluated and the basis for that date. The Exchange evaluated the impact of subsequent events through February 3, 2010, representing the date at which the financial statements were issued.

In December 2009, the National Association of Insurance Commissioners revised Statement of Statutory Accounting Principles (SSAP) No. 10, *Income Taxes* (SSAP 10(R)), which provided companies the election to admit deferred tax assets expected to be realized within three years of the balance sheet date or 15% of statutory capital and surplus. The Exchange elected not to apply these provisions to its 2009 financial statements. However, SSAP 10(R) also required certain provisions, primarily recognition of a statutory valuation allowance against gross deferred tax assets when it is more likely than not that some portion of the gross deferred tax assets will not be realized. SSAP 10(R) also requires disclosures of all deferred tax assets and deferred tax liabilities by tax character (i.e., ordinary vs. capital). The Exchange adopted the required components of SSAP 10(R) for the year ended December 31, 2009. The adoption of SSAP 10(R) did not have a material impact on the financial statements.

In September 2009, the National Association of Insurance Commissioners revised SSAP No. 43, *Loan-Backed and Structured Securities* (SSAP 43(R)), to provide revised guidance on the accounting and impairment treatment for loan-backed and structured securities. Under SSAP 43(R), if it is determined that a decline in fair value is other-than-temporary, the cost basis of the security is written down to estimated future cash flows discounted to the effective rate of the security. SSAP 43(R) also requires other-than-temporary impairments to be bifurcated between credit and non-credit related losses. The Exchange adopted SSAP 43(R) for the year ended December 31, 2009. The adoption of SSAP 43(R) did not have a material impact on the financial statements.

Federated Rural Electric Insurance Exchange

Notes to Financial Statements (continued)  
(Statutory Basis)

**2. Investments**

The carrying amount and the fair value of investments in bonds are as follows:

	Carrying Amount	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<i>(In Thousands)</i>				
At December 31, 2009:				
U.S. government States and political subdivisions	\$ 1,950	\$ 115	\$ –	\$ 2,065
Corporate securities	57,071	2,220	249	59,042
Mortgage-backed securities	98,353	2,795	1,065	100,083
Convertible bonds	118,974	4,260	138	123,096
Total bonds	<u>\$ 296,326</u>	<u>\$ 11,811</u>	<u>\$ 1,477</u>	<u>\$ 306,660</u>
At December 31, 2008:				
U.S. government States and political subdivisions	\$ 1,951	\$ 195	\$ –	\$ 2,146
Corporate securities	53,527	795	787	53,535
Mortgage-backed securities	92,220	585	7,384	85,421
Convertible bonds	117,634	3,471	–	121,105
AMRECO surplus drafts (Note 4)	16,219	380	1,069	15,530
Total bonds	<u>\$ 283,046</u>	<u>\$ 5,426</u>	<u>\$ 9,240</u>	<u>\$ 279,232</u>

Fair values for bonds and preferred stocks are based on market values prescribed by the Securities Valuation Office (SVO), where available. For nonpublicly traded securities and for mortgage-backed securities where market value is not available, amortized cost is assigned as the market value by the SVO.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

*(Statutory Basis)*

### **2. Investments (continued)**

Bonds designated by the NAIC as Class 3 through Class 6 are reported at the lower of amortized cost or market value. The amortized cost of bonds at December 31, 2009 and 2008, has been reduced by \$128,000 and \$1,058,000, respectively, to derive the carrying amount of bonds in the balance sheets with respect to this handling.

In accordance with statutory accounting principles, if it is determined that a decline in the value of an investment is other than temporary, the amortized cost basis of the investment is written down to fair value, and the amount of the write-down is accounted for as a realized capital loss. The Exchange did not recognize any realized losses on bonds for declines in the value of investments that were determined to be other than temporary during 2009. An impairment charge of \$792,000 was recognized during 2008 related to two bonds where management determined the declines in value to be other than temporary.

Unrealized gains and losses on investments in preferred and common stocks are reported directly in members' equity and do not affect net margin. The cost of preferred stocks was \$4,311,000 and \$6,804,000 at December 31, 2009 and 2008, respectively. The net unrealized gains on preferred stocks at December 31, 2009, of \$120,000 consist of \$697,000 of unrealized gains and \$577,000 of unrealized losses. The net unrealized losses on preferred stocks at December 31, 2008, of \$1,810,000 consist of \$35,000 of unrealized gains and \$1,845,000 of unrealized losses.

The cost of common stocks was \$9,482,000 at December 31, 2009. The net unrealized losses on common stocks at December 31, 2009, of \$1,313,000 consist entirely of unrealized losses. The cost of common stocks was \$10,126,000 at December 31, 2008. The net unrealized losses on common stocks at December 31, 2008, of \$3,635,000 consist entirely of unrealized losses. An impairment charge of \$514,000 was recognized during 2009 related to a foreign broad market exchange traded fund (ETF). An impairment charge of \$740,000 was recognized during 2008 related to three separate preferred stocks where management determined the declines in value to be other than temporary. Management reviewed the financial condition and credit ratings of the issuers of its stock holdings and considered market conditions in general as compared to these holdings. As the Exchange has the ability and intent to hold its remaining stocks through market recovery, based on management's review, no other than temporary impairment losses have been recognized on the remaining securities.

Federated Rural Electric Insurance Exchange

Notes to Financial Statements (continued)  
(Statutory Basis)

**2. Investments (continued)**

At December 31, 2009 and 2008, the aggregate amount of gross unrealized losses and the related fair values of bonds and stocks with unrealized losses, aggregated by investment category and length of time that investment securities have been in a continuous loss position, are as follows:

	Loss More Than 12 Months		Loss Less Than 12 Months	
	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss	Fair Value
<i>(In Thousands)</i>				
At December 31, 2009:				
U.S. government	\$ -	\$ -	\$ -	\$ -
States and political subdivisions	249	8,605	-	-
Corporate securities	951	20,755	114	5,165
Mortgage-backed securities	-	-	138	14,768
Convertible bonds	25	1,122	-	-
Common stocks	1,313	8,169	-	-
Preferred stocks	336	1,892	241	822
	<u>\$ 2,874</u>	<u>\$ 40,543</u>	<u>\$ 493</u>	<u>\$ 20,755</u>
At December 31, 2008:				
U.S. government	\$ -	\$ -	\$ -	\$ -
States and political subdivisions	395	15,292	392	12,744
Corporate securities	7,367	60,403	17	6,818
Mortgage-backed securities	-	-	-	-
Convertible bonds	150	1,850	919	1,950
Common stocks	-	-	3,635	6,491
Preferred stocks	-	-	1,845	3,513
	<u>\$ 7,912</u>	<u>\$ 77,545</u>	<u>\$ 6,808</u>	<u>\$ 31,516</u>

## Federated Rural Electric Insurance Exchange

### Notes to Financial Statements (continued) (Statutory Basis)

#### 2. Investments (continued)

At December 31, 2009, the Exchange's bond portfolio includes 41 (2008 – 90) issues where the estimated fair value is below amortized cost, with individual unrealized losses ranging up to \$257,000 (2008 – \$686,000). The Exchange has reviewed the nature of declines in securities where the carrying amount has exceeded fair value for more than 12 months and concluded that they arose primarily from interest rate fluctuations. As the Exchange has the ability and intent to hold such bonds until recovery or maturity, no other-than-temporary impairment losses have been recognized on these securities.

At December 31, 2009, the Exchange held unrated or less-than-investment-grade corporate bonds of \$4,821,000, with an aggregate fair value of \$5,491,000. Those holdings amounted to 1.6% of the Exchange's investment in bonds and 1.4% of the Exchange's total admitted assets. The Exchange performs periodic evaluations of the relative credit standing of the issuers of these bonds.

The carrying amount and fair value of bonds at December 31, 2009, by contractual maturity, are as follows. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or repay obligations with or without call or prepayment penalties.

	<b>Carrying Amount</b>	<b>Fair Value</b>
<i>(In Thousands)</i>		
Years to maturity:		
One or less	\$ <b>8,951</b>	\$ 9,697
After one through five	<b>71,682</b>	76,193
After five through ten	<b>39,953</b>	41,046
After ten	<b>56,766</b>	56,628
Mortgage-backed securities	<b>118,974</b>	123,096
Total	<b>\$ 296,326</b>	\$ 306,660

Federated Rural Electric Insurance Exchange

Notes to Financial Statements (continued)  
*(Statutory Basis)*

**2. Investments (continued)**

Proceeds from sales of investments in bonds and related gross realized capital gains and losses were as follows:

	<b>Year Ended December 31</b>	
	<b>2009</b>	<b>2008</b>
<i>(In Thousands)</i>		
Proceeds from sales	\$ 35,154	\$ 20,106
Gross realized capital gains	<b>3,306</b>	699
Gross realized capital losses	<b>1,250</b>	1,053

At December 31, 2009, bonds with an admitted asset value of \$6,974,000 were on deposit with state insurance departments to satisfy regulatory requirements.

The components of real estate (all occupied by the Exchange) are summarized as follows:

	<b>December 31</b>	
	<b>2009</b>	<b>2008</b>
<i>(In Thousands)</i>		
Land	\$ 207	\$ 207
Buildings	<b>2,681</b>	2,480
Less allowances for depreciation	<b>(1,716)</b>	(1,603)
Total real estate	<b>\$ 1,172</b>	<b>\$ 1,084</b>

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued) (Statutory Basis)

### 2. Investments (continued)

Major categories of the Exchange's net investment income are summarized as follows:

	<b>Year Ended December 31</b>	
	<b>2009</b>	<b>2008</b>
	<i>(In Thousands)</i>	
<b>Income:</b>		
Bonds	\$ 13,567	\$ 12,858
Preferred stocks	314	347
Common stocks	162	157
Real estate*	216	216
Other invested assets	84	-
Cash and short-term investments	34	290
Total investment income	<b>14,377</b>	13,868
<b>Expenses:</b>		
Interest on surplus note	917	975
Depreciation	113	109
Other	1,326	676
Total investment expenses	<b>2,356</b>	1,760
Net investment income	<b>\$ 12,021</b>	\$ 12,108

\*Includes amounts for the occupancy of Exchange-owned property of \$216,000 in both 2009 and 2008.

### 3. Federal Income Taxes

The Exchange is organized as a Kansas reciprocal insurer. As a reciprocal, the Exchange is generally subject to the income tax provisions applicable to property and casualty insurance companies, which require that reserves for losses and loss adjustment expenses be discounted and the deduction for unearned premium reserves be limited to 80% of such reserves in computing taxable income. In addition, reciprocal insurance companies are allowed to deduct, within certain limits, the amount of current income allocated and credited to members' equity accounts.

## Federated Rural Electric Insurance Exchange

### Notes to Financial Statements (continued) (Statutory Basis)

#### 3. Federal Income Taxes (continued)

The components of incurred federal income tax (benefit) expense for the years ended December 31, 2009 and 2008, are as follows:

	<b>Year Ended December 31</b>	
	<b>2009</b>	<b>2008</b>
	<i>(In Thousands)</i>	
Current income tax (benefit) expense	\$ (448)	\$ 1,052
Prior year underaccrual	23	500
Federal income tax (benefit) expense	<u>\$ (425)</u>	<u>\$ 1,552</u>

The Exchange's current income tax (benefit) expense differs from the amount obtained by applying the federal statutory rate of 34% to income before federal income tax (benefit) expense as follows:

	<b>Year Ended December 31</b>	
	<b>2009</b>	<b>2008</b>
	<i>(In Thousands)</i>	
Expected federal income tax expense	\$ 4,107	\$ 3,690
Impairment loss recognized for book, not tax	175	540
Insurance liabilities	563	567
Subscriber savings account deduction	(4,251)	(3,162)
Accrued market discount	(97)	(77)
Dividends received deduction, net of proration	(84)	(113)
Tax-exempt interest	(380)	(374)
Excess capital losses over capital gains	(519)	464
AMT credit utilized	-	(358)
Other	38	(125)
Current income tax (benefit) expense	<u>\$ (448)</u>	<u>\$ 1,052</u>

Federated Rural Electric Insurance Exchange

Notes to Financial Statements (continued)  
(Statutory Basis)

**3. Federal Income Taxes (continued)**

The components of the net deferred income tax asset are as follows. The Exchange did not elect to admit deferred tax assets expected to be realized within one year of the balance sheet date or 10% of members' equity. Such election was not available in 2008.

	December 31, 2009			December 31,
	Capital	Ordinary	Total	2008
Gross deferred tax assets	\$ 1,052,061	\$ 11,073,770	\$ 12,125,831	\$ 13,876,401
Valuation allowance	–	–	–	–
Adjusted gross deferred tax assets	1,052,061	11,073,770	12,125,831	13,876,401
Gross deferred tax liabilities	–	211,555	211,555	223,980
Adjusted net deferred tax asset before admission test	\$ 1,052,061	\$ 10,862,215	\$ 11,914,276	\$ 13,652,421
Admitted pursuant to SSAP 10R paragraph:				
10.a.	\$ –	\$ 1,078,416	\$ 1,078,416	\$ 1,052,331
10.b.i.	695,911	4,218,802	4,914,713	4,862,000
10.b.ii.	5,124,597	5,124,597	10,249,194	9,431,531
Lesser of 10.b.i. or ii	695,911	4,218,802	4,914,713	4,862,000
10.c.	–	211,555	211,555	223,980
Admitted deferred tax asset	695,911	5,508,773	6,204,684	6,138,311
Deferred tax liability	–	211,555	211,555	223,980
Net admitted deferred tax asset	\$ 695,911	\$ 5,297,218	\$ 5,993,129	\$ 5,914,331
Non-admitted DTA	\$ 356,150	\$ 5,564,997	\$ 5,921,147	\$ 7,738,090

Federated Rural Electric Insurance Exchange

Notes to Financial Statements (continued)

(Statutory Basis)

**3. Federal Income Taxes (continued)**

The main components of deferred income tax balances are as follows:

	<b>December 31</b>	
	<b>2009</b>	<b>2008</b>
	<i>(In Thousands)</i>	
Deferred income tax assets:		
Unearned premiums	\$ 3,200	\$ 2,949
Loss reserves	6,657	6,347
Deposit administration funds	769	734
Electronic data processing equipment	244	239
Tax capital losses in excess of book losses	603	1,220
Unrealized investment losses	449	2,211
Other	204	176
Gross deferred income tax assets	<u>12,126</u>	13,876
Nonadmitted deferred income tax asset	<u>5,921</u>	7,738
Admitted deferred income tax assets	<u>6,205</u>	6,138
Deferred income tax liability:		
Other	212	224
Total deferred income tax liability	<u>212</u>	224
Net admitted deferred income tax asset	<u>\$ 5,993</u>	<u>\$ 5,914</u>

The Exchange anticipates that in 2009, a deduction will be derived for current earnings allocated and credited to members' equity accounts as described above. However, each year this allocation is based on Board discretion and is not made without prior Board review and approval. The Exchange's current income tax expense (benefit) and deferred income tax asset calculations noted above presume that such an allocation will be made. In the event, however, that the allocation is not made, income tax expense would increase.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

*(Statutory Basis)*

### **3. Federal Income Taxes (continued)**

The Exchange's 2009 taxes were significantly reduced from those paid in 2008, due principally to non-deductible capital losses incurred in 2008 that were carried over and used in 2009. The Exchange was subject to regular taxes in 2008 of approximately \$1,052,000. These taxes are subject to recovery in the event that the Exchange incurs net operating losses within two years of the year for which such taxes were paid.

Interest and penalties related to federal income taxes are classified as tax expense on the income statement and combined with ordinary income taxes recorded during the year. The Exchange did not have any interest and penalties recorded in 2009 or 2008.

The amount of tax contingencies calculated for the Exchange as of December 31, 2009 and 2008 is not material to the Exchange's financial position. Therefore, the total amount of tax contingencies that, if recognized, would affect the effective income tax rate is immaterial.

### **4. Reinsurance**

Reserves, premiums, losses, and loss adjustment expenses are stated net of amounts related to ceded reinsurance agreements. Risks are reinsured with other companies to permit the recovery of a portion of losses and loss adjustment expenses incurred and are treated (to the extent of the reinsurance) as risks for which the Exchange is not liable; however, the Exchange remains liable to the extent that reinsuring companies cannot meet their obligations under these reinsurance contracts. Management believes that any liability arising from this contingency is unlikely. However, to limit the possibility of such losses, the Exchange evaluates the financial condition of its reinsurers and monitors concentration of credit risk. The Exchange's largest net aggregate retention under its reinsurance programs for any one risk generally is \$1,000,000.

Reinsurance assumed consists of workers' compensation coverage the Exchange provides to a self-insured association, as well as the Exchange's mandatory participation in various assigned risk pools for property, automobile, and workers' compensation coverages, of which the single largest is the National Workers' Compensation Reinsurance Pool (the Pool). Reinsurance ceded includes excess of loss, catastrophe, and facultative reinsurance on various property and casualty lines of insurance.

Federated Rural Electric Insurance Exchange

Notes to Financial Statements (continued)

(Statutory Basis)

**4. Reinsurance (continued)**

Earned premiums, incurred losses and loss adjustment expenses, and other underwriting expenses are determined by adding and deducting amounts for reinsurance assumed and ceded, respectively. The amounts added and deducted for reinsurance assumed and ceded for the years ended December 31, 2009 and 2008, are as follows:

	<b>Reinsurance Assumed</b>		<b>Reinsurance Ceded</b>	
	<b>Year Ended December 31</b>		<b>Year Ended December 31</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
	<i>(In Thousands)</i>			
Premiums earned	\$ 5,406	\$ 5,598	\$ 38,788	\$ 37,742
Premiums written	5,356	5,547	39,313	37,360
Losses and loss adjustment expenses incurred	3,433	3,569	34,505	29,430
Other underwriting expenses and commissions	767	812	3,792	4,705

The amounts for reinsurance assumed and ceded at December 31, 2009 and 2008, which have been added and deducted from liability accounts, are as follows:

	<b>Reinsurance Assumed</b>		<b>Reinsurance Ceded</b>	
	<b>December 31</b>		<b>December 31</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
	<i>(In Thousands)</i>			
Reserve for losses and loss adjustment expenses	\$ 20,028	\$ 20,727	\$ 91,296	\$ 86,743
Reserve for unearned premiums	205	254	10,164	9,639

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued) (Statutory Basis)

### 4. Reinsurance (continued)

At December 31, 2009, unsecured reinsurance recoverables exceeding 3% of members' equity were as follows:

Swiss Reinsurance America Corporation	\$ 63,894,000
Transatlantic Reinsurance Company	10,566,000
Munich Reinsurance America, Inc.	8,361,000
Endurance Reinsurance Corporation of America	7,226,000
Nationwide Mutual Reinsurance Corporation	3,754,000

The maximum amount of return commission that would be due reinsurers if all of the Exchange's reinsurance, ceded or assumed, was canceled as of December 31, 2009, would be \$1,422,000 and \$90,000 for commissions ceded and assumed, respectively.

Additional commissions or other equivalent amounts pursuant to contractual agreements of a profit-sharing nature are accrued based on the experience of the underlying business using case basis and statistical methods. Amounts receivable related to such agreements are \$421,000 and \$383,000 at December 31, 2009 and 2008, respectively.

The Exchange accounts for the loss reserves assumed from the Pool on a discounted basis. At December 31, 2009, the Exchange's undiscounted reserves under the Pool totaled \$7,839,000, and discounted reserves totaled \$7,402,000. The \$437,000 difference represents the statutory discount permitted that is associated with the indemnity portion of the workers' compensation claims utilizing a 3.5% interest rate. The statutory discount on the Pool loss reserves was \$591,000 at December 31, 2008.

The Exchange was reinsured with AMRECO, who went into rehabilitation in the state of Illinois, for its primary casualty lines from January 1983 until August 1985. Subsequent to the approval of AMRECO's rehabilitation plan, AMRECO paid 49.25% of its obligations in cash and issued surplus drafts for the remaining 50.75%. Effective in 2005, the payment formula changed to 60% cash and 40% surplus drafts. During 2009 and 2008, the Exchange did not recover any money related to claims reinsured by AMRECO. The carrying amount assigned to the AMRECO surplus drafts for statutory filing purposes represented 36.7% of the AMRECO surplus drafts' face values at December 31, 2008. Changes to the difference between the face value and carrying amount of the AMRECO surplus drafts are recorded directly in members' equity. The Exchange

## Federated Rural Electric Insurance Exchange

### Notes to Financial Statements (continued)

*(Statutory Basis)*

#### **4. Reinsurance (continued)**

has historically written off loss recoverables from AMRECO due to management's expectation that AMRECO would be unable to meet its financial obligations. Any such recoveries were recorded as income when received.

In 2009, the State of Illinois approved the final distribution of the AMRECO estate assets. All AMRECO surplus drafts held by the Exchange were redeemed. The Exchange recovered approximately 53.7% of the original face value of the surplus drafts, resulting in a capital gain recorded by the Exchange of approximately \$1,926,000.

#### **5. Members' Equity**

In 1992, the Exchange issued a surplus note to the National Rural Utilities Cooperative Finance Corporation (CFC) in return for \$10,000,000 in cash and a CFC Subordinated Term Certificate with a 7.44% interest rate for \$1,111,111. The surplus note calls for the Exchange to pay, on or before December 31, 2018, the principal amount of the note and interest quarterly at an 8.75% annual rate. Any payment of interest or repayment of principal is subject to approval by the Kansas Insurance Department. Interest paid was \$917,000 and \$975,000 in 2009 and 2008, respectively. Total interest paid from inception through December 31, 2009, was \$16,507,000.

Under the terms of the surplus note, the Exchange must comply with certain financial requirements, including payment of interest on the surplus note. In the event of default, subject to the approval by the Kansas Insurance Department, CFC can declare the surplus note to be due and payable, appoint a director to the Board of Directors who would be automatically granted the number of votes necessary to constitute a majority, and/or proceed to enforce any of the rights and remedies available under applicable law and under the surplus note.

Effective January 1, 2009, the Exchange adjusted the terms of its surplus note with CFC. The maturity date is extended to December 31, 2043, and the fixed rate decreases from 8.75% to 8.25%. The Exchange also has the option to prepay, in whole or in part, the surplus note on or after January 1, 2014, upon payment of a fee equal to 0.50% of the principal amount prepaid. The interest rate paid by CFC on the \$1,111,111 subordinated term certificate associated with the surplus note is reset from 7.44% to 7.0125%.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

(Statutory Basis)

### 5. Members' Equity (continued)

The Exchange holds a commitment from CFC for the purchase of a \$10 million surplus note from the Exchange. This surplus note would allow the Exchange to increase surplus to accommodate a significant increase in underwriting activity, if needed. The surplus note would have a five-year maturity from the initial advance date. The interest rate would be equal to CFC's standard cost-based variable rate for term loans issued to Class C members. The issuance of the surplus note would require the purchase of a non-interest-bearing CFC Loan Capital Term Certificate equal to 10% of the face value of the surplus note. The financial requirements that the Exchange must comply with for this surplus note are the same as the current financial requirements contained in the 1992 surplus note. The issuance and any payments made under this agreement are subject to approval by the Kansas Insurance Department. There were no amounts outstanding under this agreement during 2009 and 2008. Effective January 1, 2009, this agreement was terminated.

Property and casualty insurance companies are subject to certain risk-based capital (RBC) requirements as specified by the NAIC. Under those requirements, the amount of capital and surplus maintained by a property/casualty insurance company is to be determined based on the various risk factors related to it. At December 31, 2009, the Exchange meets the RBC requirements.

### 6. Uncollected Premiums

Uncollected premiums are summarized as follows:

	<b>December 31</b>	
	<b>2009</b>	<b>2008</b>
	<i>(In Thousands)</i>	
Premium balances in course of collection	\$ 2,656	\$ 767
Premium balances and installments recorded but deferred and not yet due	<b>7,385</b>	8,933
	<b>\$ 10,041</b>	<b>\$ 9,700</b>

## Federated Rural Electric Insurance Exchange

### Notes to Financial Statements (continued) (Statutory Basis)

#### 7. Commitments and Contingencies

The Exchange is named as defendant in various legal actions primarily arising from claims made under insurance policies and other general corporate activities. The claims are considered by the Exchange in estimating reserves for losses and loss adjustment expenses. Exchange management believes that the resolution of these actions will not have a material adverse effect on the Exchange's financial position or results of operations.

#### 8. Losses and Loss Adjustment Expense Reserves

Activity in the liability for unpaid losses and loss adjustment expenses, net of reinsurance recoverables, is summarized as follows:

	<b>Year Ended December 31</b>	
	<b>2009</b>	<b>2008</b>
	<i>(In Thousands)</i>	
Balance at January 1	<b>\$ 169,075</b>	\$ 158,156
Incurred related to:		
Current year	<b>89,203</b>	88,654
Prior years	<b>540</b>	1,089
Total incurred	<b>89,743</b>	89,743
Paid related to:		
Current year	<b>26,085</b>	29,136
Prior years	<b>51,887</b>	49,688
Total paid	<b>77,972</b>	78,824
Balance at December 31	<b>\$ 180,846</b>	\$ 169,075

## Federated Rural Electric Insurance Exchange

### Notes to Financial Statements (continued)

*(Statutory Basis)*

#### **8. Losses and Loss Adjustment Expense Reserves (continued)**

Changes in estimates for losses occurring in prior years have increased the amount of incurred loss for the year ended December 31, 2009, by approximately \$540,000 as compared to an increase of \$1,089,000 of the incurred loss for the year ended December 31, 2008. The increase for the year ended December 31, 2009, relates primarily to unfavorable development of \$800,000 in the general liability lines of business and \$600,000 in various other lines of business. The increase in these lines of business primarily occurred in the 2006 accident year and primarily relates to an increase in estimated allocated loss adjustment expenses. Offsetting this increase was favorable development of \$900,000 in the workers' compensation and assumed workers' compensation lines of business. These lines experienced nominal favorable adjustments from multiple accident years, resulting primarily from a reduction in severity issues.

The increase for the year ended December 31, 2008, relates primarily to unfavorable development of \$1,000,000 in the workers' compensation lines of business and \$2,100,000 in the general liability lines of business. The increases in both of these lines primarily occurred in the 2005 and 2006 accident years and primarily relates to severity issues and an increase in estimated allocated loss adjustment expenses. Offsetting these increases was favorable development of \$1,600,000 in the auto liability lines of business and \$400,000 in the property lines of business, most notably from the 2004 through 2006 accident years.

The unfavorable development during 2008 within workers' compensation primarily relates to severity issues. The anticipated effect of inflation is implicitly considered when estimating liabilities for losses and loss adjustment expenses. While anticipated price increases due to inflation are considered in estimating the ultimate claim costs, the increase in average severities of claims is caused by a number of factors that vary with the individual type of policy written. Future average severities are projected based on historical trends adjusted for implemented changes in underwriting standards, policy provisions, and general economic trends. Those anticipated trends are monitored based on actual development and are modified, if necessary.

Federated Rural Electric Insurance Exchange

Notes to Financial Statements (continued)

(Statutory Basis)

**8. Losses and Loss Adjustment Expense Reserves (continued)**

The Exchange has exposure to environmental and asbestos claims related to the Superfund established by the Environmental Protection Agency arising from the sale of general liability insurance. The Exchange estimates the full impact of the environmental exposure by establishing full case basis reserves on all known losses and computing incurred but not reported losses based on previous experience. The following tables provide a reconciliation of the beginning and ending environmental and asbestos-related balances on a direct and net of reinsurance basis:

	<b>Year Ended December 31</b>	
	<b>2009</b>	<b>2008</b>
	<i>(In Thousands)</i>	
Direct:		
Reserves at beginning of year	\$ 2,661	\$ 1,818
Incurred losses and loss adjustment expenses	5,881	1,961
Claim payments for losses and loss adjustment expenses	6,056	1,118
Reserves at end of year	<u>\$ 2,486</u>	<u>\$ 2,661</u>
Net of ceded reinsurance:		
Reserves at beginning of year	\$ 2,601	\$ 1,796
Incurred losses and loss adjustment expenses	1,133	1,923
Claim payments for losses and loss adjustment expenses	1,635	1,118
Reserves at end of year	<u>\$ 2,099</u>	<u>\$ 2,601</u>

At December 31, 2009, the Exchange held bulk and incurred but not reported (IBNR) loss reserves related to environmental and asbestos coverages in the amount of \$1,718,000 and \$1,660,000 on a direct and net of ceded reinsurance basis, respectively. At December 31, 2008, the Exchange held bulk and IBNR loss reserves related to environmental and asbestos coverages in the amount of \$1,625,000 and \$1,565,000 on a direct and net of ceded reinsurance basis, respectively.

# Federated Rural Electric Insurance Exchange

## Notes to Financial Statements (continued)

(Statutory Basis)

### 8. Losses and Loss Adjustment Expense Reserves (continued)

At December 31, 2009, the Exchange held reserves for future allocated loss adjustment expenses (including coverage dispute costs) related to environmental and asbestos coverages in the amount of \$768,000 and \$439,000 on a direct and net of ceded reinsurance basis, respectively. At December 31, 2008, the Exchange held reserves for future allocated loss adjustment expenses (including coverage dispute costs) related to environmental and asbestos coverages in the amount of \$1,036,000 on a direct and net of ceded reinsurance basis.

The Exchange's reserves for loss and loss adjustment expenses are stated net of anticipated salvage and subrogation. The anticipated salvage and subrogation amounted to \$4,500,000 and \$4,200,000 at December 31, 2009 and 2008, respectively.

### 9. Fair Values of Financial Instruments

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*. SFAS No. 157 does not require any new fair value measurements; rather, it defines fair value, establishes a framework for measuring fair value, and expands disclosures regarding fair value measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). In accordance with SFAS No. 157, the Exchange groups its financial assets and liabilities measured at fair value in three levels, based on the inputs and assumptions used to determine fair value. These levels are as follows:

Level 1 – Valuations are based on unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 – Valuations are based upon quoted market prices for instruments similar to other instruments in active markets, quoted prices for instruments in inactive markets, and valuation techniques for which significant assumptions are observable in the market. Valuations are obtained from third-party pricing services or inputs that are observable or derived principally from or corroborated by observable market data.

Level 3 – Valuations of assets and liabilities are generated from techniques that use significant assumptions not observable in the market, such as option pricing models, discounted cash flow models, and spread-based models using the best information available in the circumstances.

Federated Rural Electric Insurance Exchange

Notes to Financial Statements (continued)  
(Statutory Basis)

**9. Fair Values of Financial Instruments (continued)**

The following table sets forth by level, within the fair value hierarchy, the Company's assets measured at fair value on a recurring basis as of December 31, 2009:

	Level 1	Level 2	Level 3	Total
	<i>(In Thousands)</i>			
Assets at fair value:				
Common stock	\$ 8,169	\$ –	\$ –	\$ 8,169
Total assets at fair value	\$ 8,169	\$ –	\$ –	\$ 8,169

The following table sets forth by level, within the fair value hierarchy, the Company's assets measured at fair value on a non-recurring basis as of December 31, 2009:

Description	December 31, 2009	Level 1	Level 2	Level 3	Total Gains (Losses)
Bonds	\$ 571,000	\$ –	\$ 571,000	\$ –	\$ (128,000)
Preferred stock	3,929,000	–	3,813,000	116,000	120,000

These bonds are all non-investment grade as determined by the NAIC and reflected in the NAIC ratings of 3 to 6. Accordingly, these securities are carried at the lower of cost or fair value with a charge to surplus. Preferred stocks are carried at either the unit prices as reported in the NAIC Valuations of Securities (SVO) manual or lower of cost or fair value based on their NAIC rating with a charge to surplus.

The following methods and assumptions were used by the Exchange in estimating the “fair value” disclosures for financial instruments in the accompanying financial statements and notes thereto:

**Cash, Short-Term Investments, Reinsurance Balances Recoverable, Accrued Investment Income, and Surplus Notes**

The carrying amounts reported in the accompanying balance sheets for these financial instruments approximate their fair values.

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Notes to Financial Statements (continued)  
(Statutory Basis)

**9. Fair Values of Financial Instruments (continued)**

**Investment Securities**

The fair values for fixed maturity securities are based on values prescribed by the SVO. For fixed maturity securities not actively traded, fair values are estimated using values obtained from independent pricing services or, in the case of private placements, are estimated by discounting expected future cash flows using a current market rate applicable to the yield, credit quality, and maturity of the investments. The fair values for equity securities are based on values prescribed by the SVO.

The carrying amounts and fair values of the Exchange's financial instruments at December 31 are as follows:

	2009		2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	<i>(In Thousands)</i>			
Bonds (Note 2)	\$ 296,326	\$ 306,660	\$ 283,046	\$ 279,232
Preferred stocks (Note 2)	4,431	4,869	4,254	4,254
Common stocks (Note 2)	8,169	8,169	6,491	6,491
Cash and short-term investments	15,651	15,651	6,509	6,509
Reinsurance balances recoverable	5,958	5,958	4,691	4,691
Accrued investment income	2,693	2,693	2,462	2,462
Surplus notes	11,111	11,111	11,111	11,111