2012 Management's Discussion and Analysis

FARMERS UNION MUTUAL INSURANCE COMPANY

Great Falls, Montana

NAIC Company Code: 28436

Supplement to the Statutory Annual Statement

For year ended December 31, 2012

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Introduction

This discussion provides an assessment by management of the current financial position, results of operations, cash flow, liquidity and changes in financial position for Farmers Union Mutual Insurance Company (FUMICo). FUMICo is a mutual insurance company domiciled in the State of Montana with its home office in Great Falls, Montana. FUMICo is a multi-line carrier underwriting personal/farm and commercial property and casualty coverages in Montana. FUMICo is also authorized to conduct business in the State of Idaho however has no business written in that State. FUMICo upholds unlicensed authorized reinsurer status in the State of Wisconsin. Information presented in this discussion supplements the financial statements, schedules and exhibits in the 2012 annual Statement.

While being a single state writer, FUMICo considers its geographical location to be a unique blend of exposure and risk. The square miles covered by the state of Montana is 145,587, while the square mile area for the nine states of New Jersey, New York, Pennsylvania, Massachusetts, Maryland, Delaware, Connecticut, New Hampshire and Vermont is 144,179 square miles. The tremendous geographical region of Montana allows for a variety of weather related exposures and a correspondingly large spread of risk.

Financial Position

ASSETS	2012	2011
Bonds	$34,491,521	$32,353,060
Preferred Stocks	129,520	246,560
Common Stocks	3,779,796	5,645,228
Real Estate	1,637,022	1,620,137
Cash	2,124,894	1,463,104
Short-term Investments	2,867,544	2,192,966
Premium Balances	2,579,443	3,207,617
Reinsurance Recoverable	432,206	601,583
Interest, Dividends and Real Estate	139,401	195,224

Income Due and Accrued

Financial Position (Cont.)

ASSETS	2012	2011
Current Federal Income Tax Recoverable	468,297	589,210
Net Deferred Tax Asset	1,198,136	895,210
Receivables from Affiliates	352,502	337,046
Pension Asset	166,273	187,058
Total Assets	$50,366,555	$49,534,004

LIABILITIES	2012	2011
Losses	$6,904,025	$5,297,533
Loss Adjusting Expense	3,550,092	3,580,580
Unearned Premiums	9,112,578	8,570,116
Federal Income Taxes	0	374,638
Ceded Reinsurance Premiums Payable	62,545	(161,623)
Funds Held by Company under Reinsurance Treaties	100,457	158,703
Provision for Reinsurance	0	41,062
Additional Minimum Pension Liability	2,142,690	2,024,844
Other Liabilities	475,140	611,028
Total Liabilities	$22,347,527	$20,496,882
SURPLUS AS REGARDS POLICYHOLDERS	$28,019,028	$29,037,122
TOTAL LIABILITIES AND SURPLUS	$50,366,555	$49,534,004

The 2012 year can best be described as an extremely disappointing year for our corporate results. As we watch our new production flourish and our overall premium grow, the underwriting results, loss ratio, and the expense ratio were higher than anticipated, ending with a combined ratio of 122%. We lagged the industry average by several points. The net underwriting results reflected the storm activity, the wild fires in southern Montana and a series of Homeowners fire losses and one large commercial fire loss. Even the strong performance of the investment income portfolio was unable to cover the negative underwriting results and the additional pension liability we experienced in 2012. The bottom line result for 2012 recorded a net loss of $768,768 for the year. Policyholder surplus decreased by $1,018,094 (3.51%) from year-end 2011 and stands at $28,019,028 which is still a very strong financial position for FUMICo. This is only the third decrease in surplus the Company has recognized since 2002. Collectively the 2012 and 2011 decrease to surplus equates to 3.38% whereas the prior two year (2010/2009) collective total represents a 20.80% increase to policyholder surplus. Corrective action is being taken to address all aspects of expense issues within the Company.

ASSETS

Total assets at year end 2012 increased by $832,551 or 1.68% to $50,366,555. This is the first time in history the Company has reached $50 million in Net Admitted Assets. This followed a 2011 increase of $3,233,891 bringing year end 2011 to $49,534,004 from $46,300,113 at year end 2010. The 2012 increase in assets is primarily due to positive cash flow from operations of $718,719 and a positive change in cash and short-term investments of $1,336,369. In whole, cash and invested assets increased $1,509,242 or 3.47% over 2011. Prior year cash and invested assets reflected an increase of $1,326,067 or 3.14% over 2010. This string of annual growth in cash and invested assets continues to be due to the increased funds available for investment as a result of positive cash flow and increased investment income.

FUMICo's investment framework consists mainly of high quality fixed income assets comprised of certificates of deposit, money market funds, government and government agency obligations, preferred securities, corporate bonds, municipal bonds and affiliate common stock. Investments in bonds increased by $2,138,461 primarily as a result of principal payoffs on our book of Government National Mortgage Association Real Estate Mortgage Investment

Conduits (Ginnie Mae Remics) and a reduction in common stock holdings of $1,865,432. The Company received proceeds from numerous bonds that matured or were called throughout 2012 on its Corporate Bond, Municipal Bond and Certificate of Deposit holdings. The proceeds from these investments were reinvested into fixed income securities of high quality (NAIC classes 1 and 2) with laddered maturity dates. Investments in preferred stock and common stock decreased by $1,982,472 as the Company made a conscious effort to reduce its equity exposure in 2012.
Real estate owned by the Company increased by a net of $16,885 during 2012 due to $127,664 expended for capital improvements and depreciation expense of $110,779. Farmers Union Mutual Insurance Company does not purchase real estate for investment purposes and current investments in real estate are limited to property occupied by the Company. The Company and its subsidiary Montana Farmers Union Insurance Agency, Inc. occupy approximately 50% of the total home office building space with the remaining 50% being tenant occupied.

LIABILITIES

Loss and loss expense reserves are stated at the Company's estimate of the ultimate cost, net of ceded reinsurance, of settling all incurred but unpaid claims. Loss and loss expense reserves are not discounted. Salvage and subrogation recoveries are not anticipated when setting loss reserves. Reserve levels have been reviewed internally, as well as by an independent actuarial firm and have been determined to make a reasonable provision for unpaid loss and loss expenses. Activity with respect to net loss and loss expense reserves for the years 2012 and 2011 are displayed below:

(Amounts in 000)	2012	2011
Unpaid losses and LAE at beginning of year	8,878	$7,174
Losses and LAE incurred in current year:		
For current year losses and LAE (Schedule P – Part 1)	$11,393	$9,426
For prior year losses and LAE	790	224
Income Statement Amounts	$12,183	$9,650
Losses and LAE paid in current year:		
For current year losses and LAE (Schedule P – Part 1)	$6,878	$5,546
For prior year losses and LAE	3,729	2,400
Underwriting Exhibits Paid Amounts	$10,607	$7,946

Unpaid losses and LAE at end of year	$10,454	$8,878

FUMICo historically has not experienced any significant adverse development of loss and loss expense reserves estimates.

Loss adjusting expense reserves decreased $30,488 during 2012. This follows a decrease to LAE reserves of $33,422 during 2011. The 2012 decrease is attributed to a reduction in reserves for defense and cost containment expenses for small contractor claims in the Commercial Multiple Peril line of business.

Due to the increased premium writings by the Company in 2012, Unearned Premium Reserve increased by 6.33% from $8,570,116 at year end 2011 to $9,112,578 at year end 2012, compared to a 2.01% decrease in 2011 and a 5.27% decrease in 2010. Net Premiums Written during the year increased by 6.04% from $14,533,921 at year end 2011 to $15,412,239 at year end 2012.

Under statutory accounting, premiums are booked as written and 100% unearned at the inception of the policy. The Company utilizes the monthly pro-rata method of calculating unearned premium. This method assumes that, on the average, the same amount of business is written each day of any month so that the mean will be the middle of the month.

FUMICo's reinsurance program has been consistent over the past few years. Schedule F – Part 9 reflects a net amount recoverable from reinsurers of $5,547,980. The Company did not record a Statutory Provision for Reinsurance in 2012 as all reinsurance ceded to unauthorized reinsurers was covered by collateral. FUMICo cedes 92.6% of its total ceded premium (Schedule F, Part 3) to authorized reinsurers.

During 2012 the Company recorded an addition to its minimum pension liability of $117,846 bringing the total liability recorded to $2,142,690. Although the financial markets made a nice rebound at December 31, 2012, the pension actuaries reduced the Discount Rate and the Expected Long-term Rate of Return on Plan Assets to more closely reflect the interest rates currently available in the marketplace. A pension asset of $1,896,674 was recorded by the Company in 2012 of which $1,730,401 is reflected as a non-admitted asset leaving $166,273 as an admitted asset.

CAPITAL AND SURPLUS ACCOUNTS

A Net Loss of $768,768 and an overall negative change in the surplus accounts of $249,326 led to a 2012 decrease in Policyholder's Surplus of $1,018,094 or 3.51% as compared to a 0.13% surplus decrease in 2011. The components of these changes are as follows:

Capital and Surplus Accounts	2012	2011
Surplus as Regards Policyholders (Previous year)	$29,037,122	$29,074,275
Gains and (Losses) in Surplus		
Net income	(768,768)	1,878,765
Net unrealized capital gains (losses)	(526,835)	(1,123,718)
Change in deferred income tax	302,925	1,046,598
Change in nonadmitted assets	82,781	(8,865)
Change in provision for reinsurance	41,062	(8,907)
Pension asset (liability) adjustment	(149,259)	(1,821,026)
Change in surplus for the year	(1,018,094)	(37,153)
Surplus as regards policyholders (Current year)	$28,019,028	$29,037,122

An unrealized valuation decrease from un-affiliated common stock of ($400,922) and an unrealized increase from un-affiliated preferred stock of $2,960 were recorded during the year. An unrealized valuation decrease of ($151,126) was recorded on affiliated common stock. An unrealized valuation increase of $22,253 was recorded on bonds. In total, ($526,835) was recorded for unrealized valuation decreases from investments for 2012.

In conformity with the NAIC model regulation and formula adopted by the Montana Insurance Department, the Company calculated its Risk-Based Capital (RBC) requirement as of year-end. The results as of year-end are as follows:

Risk-Based Capital	2012	2011
Total adjusted capital (TAC)	28,019,028	29,037,122
Authorized control level risk-based capital	1,846,480	1,769,449

The authorized control level RBC is equal to 50% of the RBC requirement. The Company's TAC of $28,019,028, compared with its RBC requirement of

$3,692,960 is well above the required minimum and is in line with industry results.

Results of Operations

Income Statement	2012	2011
Premiums Earned	$14,869,778	$14,710,110
Losses & LAE Incurred	12,183,103	9,650,429
Underwriting Expenses	6,079,856	5,821,350
Underwriting Gain (Loss)	(3,393,181)	(761,668)
Net Investment Income	1,398,306	1,514,976
Net Realized Capital Gains (Losses)	535,134	1,036,200
Income before Taxes	(1,459,741)	1,789,508
Federal Income Taxes	(690,973)	(89,257)
Net Income	($768,768)	$1,878,765
Loss Ratio	67.8%	53.6%
Loss Adjustment Expense Ratio	14.1%	12.0%
Underwriting Expense Ratio	40.9%	39.6%
Combined Ratio	122.8%	105.2%

Federal capital gains tax of $275,676 and $533,800 in the current and prior year, respectively, are reflected as reductions of net realized capital gains (losses) above. Our federal income tax liability for the recent four year period totals $15,537. Federal income tax liability (recovery) incurred for those periods, by year, are as follows: 2009 - $1,094,292; 2010 – ($298,525); 2011 – ($89,257) and 2012 – ($690,973). The significant tax liability in the year 2009 is in direct relationship to the improved underwriting results, investment income and overall results from operations during that year. For 2010, the tax recovery is a result of the underwriting loss (significantly mitigated by investment income) incurred from the current year catastrophe losses. In 2011, current income tax expense was offset by a net operating loss carryback from December 31, 2010 to 2008. In 2012, the significant federal tax recovery was again due to a loss carryback.

Company Ratios

The combined ratio expresses the sum of the costs of losses, LAE and underwriting expenses as a percentage of premiums (premiums earned for the loss and LAE ratios and premiums written for the underwriting expense ratio). The combined ratio is a recognized industry measure of underwriting performance. A ratio above 100% indicates that expenses are greater than premiums. As mentioned earlier, the Company endured higher losses than average during the 2012 year. The Company's shortfall in their combined ratio of 122.8% was mitigated by net investment income which was 9.4% of premiums earned in the current year. The combined ratio for 2011 hinged mostly on reduced earned premium and the 2010 combined ratio was significantly impacted from catastrophe losses. The Company's underwriting expense ratio increased slightly during 2012 and the Company is making a conscious effort to reduce expenses in 2013. Below is a five-year history of the Company's operating ratios:

	Combined Ratio	Loss/LAE Ratio	Underwriting Expense Ratio
2008	83.9	50.9	33.0
2009	84.1	46.9	37.2
2010	119.0	79.5	39.5
2011	105.2	65.6	39.6
2012	122.8	81.9	40.9

The ratio of Direct Written Premium to Surplus and the ratio of Net Written Premium to Surplus for the five year period 2008 to 2012 are reflected below.

Year	DWP/Surplus	NWP/Surplus
2008	0.91	0.76
2009	0.67	0.56
2010	0.58	0.50
2011	0.57	0.51
2012	0.62	0.55

Investment Income

As higher yield fixed income securities get called or mature, it is a challenge to find replacements in the current investment arena. During 2012, FUMICo's investment income decreased slightly as the Company continued to follow its conservative investment strategy of NAIC rated 1 or 2 fixed income securities. Below is a table reflecting our rate of return on invested assets over the last five years.

2008	4.36%
2009	4.43%
2010	3.69%
2011	3.58%
2012	3.34%

On January 1, 2004, Farmers Union Mutual Insurance Company acquired the issued and outstanding 403 shares of common stock of Montana Farmers Union Insurance Agency, Inc., from the Farmers Educational and Cooperative Union of America, Montana Division. Montana Farmers Union Insurance Agency, Inc. is a general agency with approximately 50 exclusive agents under agent contract to market products made available to them by Montana Farmers Union Insurance Agency, Inc. Approximately one-third of the total business written by these agents and placed through Montana Farmers Union Insurance Agency, Inc., is that of Farmers Union Mutual Insurance Company. During 2012, the Board of Directors of Montana Farmers Union Insurance Agency, Inc. declared and made payment of a dividend in the amount of $150 per share. The financial result of this action during 2012 was the payment of a dividend in the amount of $60,450 to Farmers Union Mutual Insurance Company. Montana Farmers Union Insurance Agency, Inc., is valued using the GAAP Equity Method (adjusted to statutory) and is carried as an admitted asset to the Company's common stock portfolio.

Cash Flow and Liquidity

The following table summarizes cash flow.

	2012	2011
Cash from Underwriting	($304,106)	($31,906)
Investment Income Received	1,224,544	1,256,548
Miscellaneous Income	(58,247)	(697,389)

Federal Income Taxes (Paid) Recovered	161,572	191,466
Cash Provided by Operations	1,023,762	718,719
Investment Proceeds	12,662,241	14,205,854
Investments Acquired	(12,334,734)	(13,864,743)
Total Other Cash Provided	(14,900)	(97,478)
Net Change in Cash & Short Term Investments	$1,336,369	$962,352

As discussed earlier, cash flows from operations are invested primarily in high quality fixed income assets consisting of certificates of deposit, money market funds, government and government agency obligations, preferred securities, corporate bonds and municipal bonds. These investments are held in a laddered portfolio of maturities ranging from one to thirty years.

The Company's operations typically generate substantial positive cash flows as most premiums are received in advance of the time when claim and benefit payments are required. The positive operating cash flows we've experienced are expected to continue to meet the liquidity requirements of the Company.

FUMICo maintains a relatively liquid portfolio as 95.50% of the balance sheet value of bonds, cash and short-term investments mature within the next 10 years (Schedule D-Part 1A). As a component of Enterprise Risk Management, the Company continually monitors its investment portfolio in an effort to balance the maturity spread of its invested assets.

Losses/Catastrophe Losses

During 2012, FUMICo endured a high frequency of storm related losses but managed to avoid a single catastrophic event. During 2010, the Company endured wind/hail storm losses of the most severity since 1991. The storm in 1991 had a direct occurrence loss of $5,300,000 which equates to today's dollars of $15,500,000. The overall loss activity in 2012 resulted in an underwriting loss of $3,393,181. Of the numerous 2012 direct incurred losses, there were only six that exceeded our retention of $200,000 and none of the losses triggered our Catastrophe or our Aggregate reinsurance coverage. Below is a table summarizing the Company's occurrence losses (excess of $500,000) through December 31, 2012 and the effect of reinsurance for the years 2003 through 2012:

Date of Loss	Total Direct Incurred Losses	Reinsurance Loss (95% after retention)	Total Net Incurred Losses
6/19-21/2003	1,670,708	637,173	1,033,535
2004	None		
2005	None		
8/16-18/2006	540,658	0	540.658
6/15-17/2007	3,773,482	2,872,308	901,174
7/22-24/2008	1,323,305	544,640	778,665
2009	None		
5/2-4/2010	500,977	0	500,977
6/15-17/2010	3,212,430	2,101,808	1,110,621
6/19-21/2010*	1,585,312	0	1,585,312
6/29-7/1/2010	6,443,294	5,171,129	1,272,165
07/20-22/2011	655,061	0	655,061
06/23-25/2012	958,702	0	958,702

- No recovery on this loss as coverage of first layer was exhausted.

Premium

Tables reflecting the change in premium written, both direct and net, and the change in policyholder surplus for the years 1998 through 2012 is as follows:

Year	Direct Written Premium	% Increase/ (Decrease)	Surplus	% Increase/ (Decrease)
1998	12,218,868	-1.94%	7,002,397	7.30%
1999	11,977,582	-1.97%	6,249,657	-10.75%
2000	12,638,801	5.52%	6,344,762	1.52%
2001	13,808,735	9.26%	6,235,257	-1.73%
2002	16,575,546	20.04%	5,640,554	-9.54%
2003	20,367,135	22.87%	7,748,842	37.38%
2004	21,744,398	6.76%	10,393,437	34.13%
2005	22,359,801	2.83%	14,882,157	43.19%
2006	23,099,936	3.31%	18,906,042	27.04%
2007	22,771,591	-1.42%	22,762,026	20.40%
2008	21,998,717	-3.39%	24,106,572	5.91%
2009	18,035,474	-18.02%	29,336,848	21.70%
2010	16,804,529	-6.83%	29,074,275	-0.90%
2011	16,421,026	-2.28%	29,037,122	-0.13%
2012	17,376,909	5.82%	28,019,028	-3.51%

Year	Net Written Premium	% Increase/ (Decrease)
1998	6,531,935	-1.05%
1999	6,350,867	-2.77%
2000	7,099,715	11.79%
2001	8,094,212	14.01%
2002	13,848,394	71.09%
2003	16,914,901	22.14%
2004	18,096,962	6.99%
2005	18,754,005	3.63%
2006	19,348,126	3.17%
2007	18,812,002	-2.77%
2008	18,403,656	-2.17%
2009	16,346,605	-11.18%
2010	14,636,236	-10.46%
2011	14,533,921	-0.70%
2012	15,412,239	6.04%

For the first time in four years, the Company experienced an increase in direct written premium. The 5.82% increase comes from modest rate increases and the competitiveness of the market as we see the insurance arena industry wide begin to recover from a soft property/casualty insurance market. The Company filed for a 5.0% rate increase to our Homeowners and Farm and Ranch lines of business effective January 1, 2012. Other than a modest increase to our Umbrella rates in 2010 and an increase on our Small Contractors Commercial line of business in 2011, the Company has not filed for a rate increase since 2008; which was also to our Small Contractors Commercial line of business. The largest contributor to the Company's decrease in written premium during 2009 was the decision FUMICo made to exit the Commercial Auto line of business effective January 1, 2009. A full discussion of this decision is on page 13. The increase in premiums during 2002 through 2006 is due primarily to rate increases taken during those years, increased market share and the implementation of our "Insurance-to-Value" program. By design, rate increases had a lesser impact during 2005 and 2006. The variation in net written premium in 2000, 2001 and 2002 is due to the various retention levels on the Quota Share Reinsurance Treaty during those years and the ultimate running off of the program during the 2002 year.

Effective January 1, 2013, the Company has filed for a 9.0% rate increase on both Farm and Ranch dwellings and outbuildings and Homeowners dwellings and outbuildings. Also effective January 1, 2013, the Company filed for a 20.0% rate increase on its Carpentry NOC (Small Contractors) line of business.

This increase on Carpentry NOC is needed due to the continued high volume of legal expenses associated with this class of business.

The change in policyholder count from 2004 through December 31, 2012 is as follows:

LINE OF BUSINESS	2012	2011	2010	2009	2008	2007	2006	2005	2004
HOMEOWNERS	6,448	6,349	6,527	6,889	7,668	8,263	8,485	8,698	9,009
MOBILE HO	0	0	0	0	0	0	0	0	27
DWELLING	908	900	898	967	1,108	1,192	1,213	1,281	1,293
FARM & RANCH	2,712	2,730	2,824	2,915	3,181	3.361	3,452	3,542	3,697
FARM LIABILITY	2,520	2,501	2,564	2,634	2,855	3,001	3,107	3,164	3,326
COMMERCIAL FIRE	112	119	114	137	152	165	175	188	189
COMMERCIAL PKG	1,705	1,655	1,695	1,847	2,178	2,427	2,498	2,294	2,164
BUSINESSOWNERS	1,119	1,071	1,073	1,125	1,238	1,294	1,301	1,272	1,314
COMM IN MARINE	64	66	69	82	96	100	109	116	131
GENERAL LIABILITY	276	267	245	250	248	246	231	228	221
COMMERCIAL UMB	82	74	73	82	84	85	73	61	58
PERSONAL UMB	186	171	161	149	153	136	123	118	117
FARM UMB	222	224	237	230	263	265	261	235	237
COMMERCIAL AUTO	0	0	0	49	377	486	573	579	638
GARAGEOWNERS	32	31	30	34	41	48	51	54	54
Total	16,386	16,158	16,510	17,390	19,642	21,069	21,652	21,830	22,475
CHG FROM PRIOR YR	228	(352)	(880)	(2,252)	(1,427)	(583	(178)	(645)	(694)
% CHANGE	1.41%	-2.13%	-5.06%	-11.47%	-6.77%	-2.69%	-0.82%	-2.87%	-3.00%

The renewal offer/acceptance by our insureds has continued to remain in the mid ninetieth percentile. Our renewal offer/acceptance rate was 96.83% in 2012, 95.86% in 2011, 95.52% in 2010, 94.19% in 2009 and 94.96% in 2008. The overall Company retention has also remained consistent. In 2012 our retention was 90.35%, 89.18% in 2011, 88.49% in 2010, 82.97% in 2009 and 87.07% in 2008.

Average premium per policy has increased 0.29% between 2006 and 2012. A chart detailing average premium per policy by year for this seven year period, by line of business, follows:

Line of Business	2012	2011	2010	2009	2008	2007	2006
Businessowners	1,953	2,003	2,019	1,996	2,057	1,994	1,916
Commercial Multi Peril	2,023	2,036	2,106	2,173	2,264	1,956	1,878
Commercial Fire	1,426	1,570	1,446	1,339	1,480	1,327	1,436
Inland Marine	487	502	442	431	461	468	413
Commercial Auto	0	0	0	2,822	3,843	4,019	4,076
Garageowners	1,736	1,597	1,560	1,520	1,450	1,317	1,392
General Liability	368	384	423	443	455	496	557

Commercial Umbrella	1,206	1,309	1,430	1,409	1,249	1,119	1,095
Farm & Ranch	1,650	1,512	1,485	1,464	1,470	1,425	1,380
Homeowners	860	810	803	808	797	765	746
Dwelling	471	465	464	459	474	443	428
Farm Liability	291	287	287	336	455	352	350
Farm Umbrella	651	671	689	653	681	684	679
Personal Umbrella	292	267	267	261	263	261	258
Average	1,066	1,027	1,028	1,049	1,119	1,080	1,063

For reasons outlined below, in our corporate analysis assessing enterprise risk management, we identified the financial exposure with our commercial automobile program as exceeding our appetite for risk. This resulted in the following action:

Farmers Union Mutual Insurance Company made the decision to exit the Commercial Automobile line of business during 2009. Our decision was based solely on prior rulings made by the Montana Supreme Court in regard to the permitted stacking of UM/UIM policy limits. Montana Supreme Court case rulings have allowed for the policy limits from multiple vehicles covered under one commercial policy to be aggregated (stacked) and applied to the incident of a single vehicle in the covered fleet. In spite of Montana legislative attempts to eliminate the stacking of policy limits, in our judgment, the Montana Supreme Court lacks predictability as to where they will come down on this issue in the future. This uncertainty results in this action.

To offset for the reduction in written premium due to the expiring Commercial Auto program, Farmers Union Mutual Insurance Company entered into a Quota Share Reinsurance Contract with National Farmers Union Property and Casualty Company (NFUIC), a member of the QBE insurance family, effective January 1, 2009.

NFUIC shall cede, and Farmers Union Mutual Insurance Company shall accept as reinsurance premium, a 10.00% share of all subject Private Passenger and Commercial Auto business written with NFUIC. This Contract shall apply to policies issued to insureds located within the territorial limits of the State of Montana only. FUMICo shall pay to NFUIC FUMICo's quota share of losses under the policies and loss adjustment expenses covered under the contract, subject to a maximum casualty business recovery, exclusive of loss adjustment expenses, of $101,000 per policy as respects any one occurrence. This represents a significant reduction in our corporate financial exposure from the automobile line of business.

Farmers Union Mutual Insurance Company shall allow NFUIC a 35% commission on all premiums ceded to FUMICo. NFUIC shall allow FUMICo a return commission on return premiums at the same rate.

Within 90 days following the end of each Contract Year, and annually thereafter until all losses occurring during the Contract Year are settled, a contingent commission calculation shall be prepared by NFUIC and a contingent commission, if any, shall be paid to NFUIC by FUMICo.

The business subject to the Quota Share Reinsurance Contract is business that FUMICo is completely familiar with. All of the NFUIC automobile business currently written in Montana is written by Montana Farmers Union Insurance Agency, Inc (MFUIAI). The exclusive MFUIAI agent force also writes 100% of the FUMICo business. As discussed in other areas of this MD&A, Montana Farmers Union Insurance Agency, Inc., is a totally owned subsidiary of FUMICo.

Effective September 2, 2011 Farmers Union Mutual Insurance Company was approved as a Wisconsin unlicensed authorized reinsurer. Previously, by contract, FUMICo's year-end obligations to NFUIC were required to be funded with a cash advance, Trust Agreement or Letter of Credit due to its unauthorized status in the State of Wisconsin. With the Company now having authorized status, the funding requirement of year-end outstanding loss and LAE reserves is waived.

Reinsurance Programs

The reinsurance program the Company currently has in place has been greatly simplified. For a number of years, prior to 2004, the Company held reinsurance treaties providing General Excess of Loss Reinsurance, Casualty Second Excess of Loss Reinsurance, several layers of Aggregate Excess of Loss Reinsurance and Excess Catastrophe Reinsurance. Beginning in 2004, in addition to our regular working layers, various layers of catastrophe reinsurance were purchased as well as limited aggregate excess of loss coverage. This change came about after a thorough analysis of premiums and losses. It was then determined that the move to additional occurrence protection would benefit the Company more than the multiple layers of aggregate protection the Company had in years prior. An additional consideration at the time was that the reinsurance market had changed so that aggregate coverage became less affordable and less available.

The reinsurance program in place for the 2012 year is similar in structure to the program in place during the past several years. The Company maintained its retention on a per risk basis of $200,000. The limit for property coverage under our General Excess of Loss contract is $1,300,000 excess of $200,000. This limit provides the Company blanket coverage for property values up to $1,500,000 prior to using our facultative reinsurance. The retention is $1,500,000 for Property Catastrophe Excess of Loss Reinsurance. Our catastrophe recovery limit for 2012 is 95% of $18,500,000 excess of $1,500,000. FUMICo's assumed automobile physical damage (comprehensive only) under the Quota Share Reinsurance contract with National Farmers Union is covered hereunder. The 2012 coverage provided by the Aggregate Reinsurance was 95% of 35% of Gross Net Earned Premium excess 70% of Gross Net Earned Premium. We should note that FUMICo's assumed automobile physical damage (comprehensive only) under the Quota Share Reinsurance contract with National Farmers Union is also covered hereunder. A summary of both the 2012 and 2011 reinsurance programs and the various reinsurers on our program during those years is attached to this discussion and analysis.

Additional reinsurance contracts are in place between the Company and General Reinsurance Corporation. These agreements apply to our umbrella lines of business and excess limits of property and casualty exposure. The Company's umbrella exposure is 15% of the first $1,000,000 of limits of liability, to a maximum of $150,000. All umbrella exposure in excess of $1,000,000 is ceded 100%. The Company cedes 100% of the excess limits of property and casualty exposure.

A clash cover is in place applicable to property and casualty (including umbrella) and quota share assumed that eliminates the possibility of more than one retention from a single loss.

The Company continues to carry a 100% Quota Share Reinsurance Treaty with Factory Mutual Insurance Company automatically covering Boiler and Machinery Insurance on its Businessowners policies. FUMICo has also made this extended coverage available as a voluntary option under its Homeowners and Farmowners lines of business. Traditionally, property policies have excluded the three perils covered under Boiler & Machinery policies. Those three perils are mechanical breakdown, electrical breakdown and pressure equipment breakdown. Under the treaty, Factory Mutual assumes 100% of the liability for all claims and loss adjustment expense arising out of coverage provided under Boiler and Machinery endorsements issued on Businessowners, Homeowners and Farm and Ranch policies.

For purposes of assessing exposure and catastrophic reinsurance coverage, Guy Carpenter & Co., Inc. of Pennsylvania regularly conducts a thorough catastrophe analysis for our Company. Another analysis was undertaken during the 2012 year. Company data as of August 31, 2012 was utilized along with updated industry data to conduct the catastrophe analysis. 98.1% of the modeled risks were modeled at the most precise detail level in use – street level using the risk's latitude and longitude. Guy Carpenter & Co., Inc. utilizes a software program (AIR CLASIC/2 Version 14.0) that models loss potential from the effects of atmospheric perils other than hurricane. The program analyzed the Company's property exposure portfolio against a series of probabilistic events involving loss due to severe thunderstorms (tornado and/or hail). The Company will continue to update and conduct catastrophe analyses on a regular basis as part of our catastrophe management strategy. A copy of the Catastrophe Analysis completed in November 2012, as described above, is attached to this report. Previously submitted along with earlier Management's Discussion and Analysis documents were the catastrophe analysis reports completed in those years.

Summary of Pricing/Underwriting Actions

During 2012, FUMICo adopted several changes in pricing, policy forms and coverage enhancements. The changes made to each line of business are outlined below:

<u>LOB: FARM AND RANCH</u>

<u>Rate change:</u>

Effective January 1, 2012

We filed for a 5% increase on all dwelling (including mobile home) premiums (rate per $100 for perils FL and BA and forms BR, SP and SP Plus) and on Barns, Granaries, Garages and Shops insured under Coverage E-1 – FARM OUTBUILDINGS AND STRUCTURES – rate per $100 for the perils FL, BA and BR. The estimated premium income to be generated from these changes is $162,694.

<u>Territory change:</u>

Gallatin County re-assigned from Territory 5 to new Territory 12.

<u>LOB: HOMEOWNERS</u>

<u>Rate change:</u>

Effective January 1, 2012

We filed for a 5% increase on forms 1,2,3 and 5. Estimated premium income to be generated from these changes is $236,009.

<u>Territory Change:</u>

Gallatin County re-assigned from Territory 5 to new Territory 12.

<u>LOB: COMMERCIAL PROPERTY – monoline and package policy</u>

<u>New endorsement:</u>

Effective date: September 1, 2012

EXCLUSION – WINDSTORM OR HAIL LOSSES TO ROOF SURFACING
CP-1050 (09-12)

This new endorsement replaces form CP 10 50 07 88 ADDITIONAL EXCLUSIONS which was outdated and needed to be replaced.

In 2012, we revised and updated the Declarations Pages for the following Commercial lines of business:

BUSINESSOWNERS - BPD (8-12)
CPP – COMMERCIAL PACKAGE POLICY – CPD (11-12)
COMMERCIAL PROPERTY – monoline – CFD (11-12)
GENERAL LIABILITY – monoline – CGD (11-12)
COMMERCIAL INLAND MARINE – monoline – CID (11-12)

For purposes of the reader gaining a historical perspective of a variety of recent years undertakings, following are several items beyond the underwriting and pricing actions taken that were discussed and elaborated upon in earlier MD&A's.

During 2010, the Company introduced a new Home/Auto package credit. This consists of a 5% credit applied to Homeowner or Farm and Ranch dwelling premium if the insured also has an automobile insured with National Farmers Union Property & Casualty Company.

Mountain Commercial Specialists continues to perform audits on our Small Contractors book of business. Special attention is being directed toward information regarding confirmation of employees, subcontractors and the type of work the contractor is performing. This is a valuable tool for the re-underwriting and renewal process.

Originally developed in 2005, the Company's Insurance-to-Value program continued to be a strong underwriting focus during 2012. The objective of this program is to ensure property coverage is reflective of property value or replacement cost. We continue with our five year re-writes of Homeowners, Dwelling and Farm and Ranch policies where agents are required to complete an updated replacement cost estimator for the dwellings. Values are continuing to trend higher but at a much lower percentage than at the introduction of the program. Emphasis is also being placed on having the agents get an adequate limit of coverage on farm outbuildings and on farm machinery. For outbuildings, agents are focusing on the appropriate coverage limit for the condition of the property and the type of construction. For farm machinery under blanket coverage, the amount of coverage cannot be less than 80% of the estimated total value of all machinery owned by the insured. For Businessowners policies, coverage limits were automatically increased 10% in 2006 and 2007 unless reviewed by an underwriter and adjusted manually. Coverage on Commercial Package policies are being reviewed on an individual, case by case basis and coverage increased as needed. With the utilization of pricing debits and credits, significant attention can be directed on an individual risk basis. Any significant additional premiums anticipated as a result of this program was mitigated by insured selection of higher levels of deductible to help contain costs.

FUMICo originally introduced its IRPM (Individual Risk Premium Modification) rating program June 1, 2006. In response to current market conditions for the Farm and Ranch line of business, we have made several enhancements to this program over the years. The original IRPM program allowed up to a 15% debit/credit on new business only. Effective in 2009, we expanded the Farm and Ranch IRPM program to also apply to existing business at renewal date. As discussed earlier, in 2011 we expanded this program to now offer a 15 – 40% debit/credit on new and renewal Farm and Ranch business. The IRPM for Commercial Lines of business currently allows and will continue to allow up to a 40% debit/credit on new and existing business at renewal date based on the merit/quality of the risk. All IRPM debits/credits are reviewed annually.

In the Personal/Farm Lines of business an intensive review of the historical loss ratios by individual agent was undertaken. Following this review, and effective April 15, 2006, a number of rating and territory changes were made. The majority of changes were in the western part of the state. This was undertaken within the Homeowners line of business and carried over to the Farm & Ranch dwelling program that mirrors the Homeowners program. This Company writes a stand alone property only Farm & Ranch policy, and a stand alone Farm Liability policy. Our rating model for the Farm & Ranch policy has been 85% of whatever the Homeowner rate would be. This 15% is to recognize the absence of the liability coverage. Effective June 1, 2006, this factor of 15% was increased to 20% for all rating territories.
As an enhancement to our Homeowner and Farm and Ranch programs, effective April 1, 2006 an identity theft remediation benefit is being provided these policyholders. This benefit is being provided, outside the insuring agreement, under an agreement entered into with the firm, ID Resolution, LLC.

In 1999 the Company implemented and developed an Inspection/Risk Engineering Program. Initially, all new personal lines property applications were physically inspected by locally contracted home warranty real estate inspectors. The program has developed to include review of renewal books of business of particular agents and/or locations as well as reviews of commercial property risks. This program has been additionally refined to include an evaluation of liability exposures of all inspected risks. The on-site inspectors transmit via e-mail photographs of each risk and written documentation to underwriters regarding quality of roofs, appropriateness of coverage forms, other structures on site, and various miscellaneous concerns including swimming pools, prior hail damage, woodstoves, tenancy and general quality of risk. In 2004 an additional full-time employee was hired to conduct inspections. During the 2012 year, 1,627 inspections were conducted with 325 or 19.98% of those inspections resulting in some type of underwriting action. During 2005 and 2006 the inspection program was expanded to include the inspection of farm outbuildings that are insured for Basic or Broad perils. Emphasis on this Inspection/Risk Engineering program will continue during 2013 as will the ongoing fine tuning of the program.

During 2003, the Windstorm and Hail deductible increased from $500 to $1,000 on all property policies, both personal and commercial lines. Effective January 1, 2003, all new business, whether personal or commercial lines, was written with a $1,000 Windstorm and Hail deductible. No additional changes have been implemented since 2003. With the catastrophic storms FUMICo has experienced the past several years, the financial impact of adopting this program of a split deductible was considerable.

Other Items

During 2006, Farmers Union Mutual Insurance Company became licensed in the state of Idaho. The Company has not yet written any business in Idaho and has no immediate plans of entering the Idaho market.

During 2007 the Company paid considerable attention to our Enterprise Risk Management Model (ERM). We developed our model to provide us insight into FUMICo's tolerance for risk, make us aware of the elements of risk and assist us in identifying, measuring and managing those risks. As outlined earlier in this MD&A, this evaluative process resulted in our exiting the Commercial Automobile line of business during the 2009 calendar year. We understand the elements of risk are never consistent. We continue to evaluate our ERM model and believe it will always be a work in progress.

FUMICo infrastructure changes during 2012 included moving our website onto our i5 server from the Hosting.com site. We added Secure Sockets Layer (SSL) to our website in anticipation of our customer self-service features. The SSL certificate was licensed from Verisign and includes a monthly vulnerability scan. In September we upgraded our IBM i5 server to an IBM Power 7 (P7) server.

The Information Technology (IT) department had several programming projects in 2012. One of the projects was responding to the State of Montana's request for additional rate analysis data to support our 2011 rate increases. This project tied into our anticipated project, as stated in the 2011 Management Discussion and Analysis, to reorganize and expand our statistical reporting capabilities. Mid 2012 our agents requested our system allow them to accept customer credit card and electronic payments online. Those changes went in effect on January 28, 2013. Changes in our third party credit card processor have delayed delivery of the Customer Self-Service web pages until later in 2013. The IT department was also involved in implementing rate changes to the Homeowners and Farm & Ranch lines of business effective January 1, 2013.

Looking further into 2013 the IT department is aware of the need for additional work in our statistical database as a starting point to enhancing our legacy system. Several projects directed at improving home office workflows are also on the register for 2013.

The total claims count for 2012 vs. 2011 reflected a decrease of 236. Storm claims alone decreased over prior year with an incurred number of 467 compared to 528 in 2011. Of the total claims reported in 2012, 84.6% were paid and/or reserved between $0 and $25,000, 9.6% were paid and/or reserved between $25,001 and $50,000 and the remaining 5.8% were paid and/or reserved in excess of $50,000. Legal expenses (excluding incurred but not reported) decreased in 2012 with 54.3% of total legal expense attributable to contractor claims. Salvage recoveries increased by $4,207 from $8,208 in 2011 to $12,415 in 2012. Subrogation recoveries decreased by $168,403 from $215,951in 2011 to $47, 548 in 2012.

Our Claims Department continues to use the property estimating program Xactimate, a product of Xactware Solutions, Inc., a division of ISO. We consistently upgrade to the latest version of this software as we feel this tool gives our claims staff the ability to expedite a more accurate estimate and payment to our policyholders resulting in better customer service.

As we saw the market hardened in 2012, management's intent is to continue aggressive and progressive actions to maintain loss, underwriting results and operating ratios at acceptable levels. Changes implemented and discussed in prior Management's Discussion and Analysis documents along with current information contained herein have had a favorable impact on policyholder surplus during seven of the past ten years. It is our expectation the impact of these various undertakings along with an enlarged investment portfolio will continue to favorably impact net operating results and policyholder surplus in future years.

This Management's Discussion and Analysis provides our assessment of the financial position, results of operations, cash flow and liquidity, and changes in financial position for Farmers Union Mutual Insurance Company for the year ended December 31, 2012. Representations contained herein are those of management according to the best of their information, knowledge, and belief.

Robert L. Fields

Kerri R. Bekker

President & C.E.O.

Vice President & C.F.O.,
Secretary/Treasurer

__March 28, 2013_____________
Date