

Excerpt: **Financial Information**



## FINANCIAL INFORMATION ▾

Investment Report	31
Management's Statement on Internal Control Over Financial Reporting	34
Report of Independent Auditors	35
Consolidated Balance Sheets	36
Consolidated Statements of Operations	37
Consolidated Statements of Changes in Policyholders' Surplus	38
Consolidated Statements of Cash Flows	39
Notes to Consolidated Financial Statements	40
Management	59
Risk Management Executive Councils	60
Advisory Boards	63
Board of Directors	66

Global financial markets were very weak in 2008, as major dislocations in credit markets led to broad-based economic contraction. FM Global's investment positions and rate of return by asset class are shown on page 33. Primarily reflecting the decline in global stock markets, the Company's invested assets declined by 21.13 percent in 2008 to end the period at \$7.6 billion<sup>†</sup>.

As shown in the exhibit on page 33, returns on the aggregate of actively managed assets were negative 20.48 percent versus a benchmark return of negative 16.61 percent. The benchmark is based on a predetermined weighting of stock and bond indices. The shortfall of FM Global relative to the benchmark can be attributed roughly evenly to an overweight position in stocks and underperformance in fixed income.

Turning first to fixed income, the investment-grade taxable portfolio had a total return of 3.47 percent versus the benchmark at 5.37 percent. This reflected a heavier weighting of U.S. Treasury securities in the benchmark during a period in which a pronounced movement of funds to the safety of U.S. debt caused Treasury bonds to substantially outperform all other high-quality fixed-income securities. Importantly, FM Global has had de minimis exposure to debt instruments that came to be characterized as "toxic securities," such as securitized subprime mortgages. Though FM Global's high-grade taxable portfolio trailed the index, peer group analysis indicates performance exceeded the median bond manager in this asset class.

FM Global's municipal bond portfolio, which is managed externally by Standish Mellon, produced a return of 3.95 percent versus 6.59 percent for the index. Standish Mellon's expertise and historic value-added from credit analysis of municipal securities was overwhelmed by investors seeking safety over yield in this market, not unlike the risk aversion that took place in taxable bonds. This same risk aversion resulted in FM Global's high-yield bond portfolio, managed by Goldman Sachs, returning a negative 25.18 percent in 2008, versus the benchmark in this market segment returning negative 26.11 percent.

Turning to equities, the combined stock portfolio return was a negative 38.47 percent compared with the benchmark of negative 38.28 percent. Approximately 80 percent of total equities is an internally managed, diversified portfolio of mid- to large-size U.S.-based companies, which returned negative 36.96 percent. For the remaining 20 percent of equities, FM Global utilizes outside managers with mandates in subclasses, including small capitalization stocks and international securities. International equities, in particular, were weak in U.S. dollar terms in 2008, with FM Global's portfolios returning negative 48.25 percent. These large negative returns from equity markets, combined with an equity weight that averaged approximately 5 percent over benchmark, caused the large decline in invested assets for the year. Looking forward, the base case expectation of most investment professionals is that gradual stabilization in global economies will produce a meaningful recovery in equities over the intermediate to longer term. FM Global maintains a significant exposure to stocks (37.2 percent at year-end) reflective of the Company's longer-term investment horizon for this asset class.

<sup>†</sup> All financial figures reported in U.S. dollars.

In addition to providing functional support to FM Global's business operations, the real estate group manages 2.7 million ft.<sup>2</sup> (251,000 m<sup>2</sup>) of investment properties. These real property assets provide an additional element of portfolio diversification. They also provide a cost-effective approach in meeting FM Global's ongoing real estate needs, while enhancing the value of its properties. For 2008, commercial properties produced \$60.3 million in revenue and \$16.8 million in cash flow.

† All financial figures reported in U.S. dollars.

Rates of Return – 2008	Portfolio	Benchmark
Total portfolio*	-20.48%	-16.61% <sup>1</sup>
Fixed-income		
Investment-grade taxable bonds	3.47%	5.37% <sup>2</sup>
Municipal bonds**	3.95%	6.59% <sup>3</sup>
High-yield bonds	-25.18%	-26.11% <sup>4</sup>
Equities		
Internal portfolio	-38.47%	-38.28% <sup>5</sup>
External portfolios		
U.S. portfolios	-44.39%	-33.80% <sup>6</sup>
International portfolios	-48.25%	-43.38% <sup>7</sup>

<sup>1</sup> Weighted S&P 500 Plus Global Stock Index, Lehman Index, T Bill

<sup>2</sup> Custom Barclays Index

<sup>3</sup> Barclays Muni 2-12 Year

<sup>4</sup> Merrill Lynch U.S. High-Yield Master II Constrained Index

<sup>5</sup> S&P 500 Index (85%) plus MSCI All World ex. U.S. (15%)

<sup>6</sup> Russell 2000 Index

<sup>7</sup> MSCI EAFE Index

\*The investment returns exclude returns on assets that are held in Canada to comply with Canadian insurance regulations. This is done because the investments reflect regulatory requirements rather than being the result of investment considerations. Canadian assets approximated 7.0 percent of total assets at year-end.

\*\*Taxable equivalent return.

Pretax Contribution to Surplus (In Millions) †	2008	2007
Investment income	\$ 317.6	\$307.5
Realized (losses)/gains	(819.7)	336.4
Unrealized (losses)/gains	\$(1,062.8)	69.2
	<u>\$(1,564.8)</u>	<u>\$713.1</u>

As of December 31 Holdings (In Millions) †	2008		2007	
	Total	Percentage	Total	Percentage
Equities	\$2,832.0	37.2%	\$4,727.0	49.0%
Taxable bonds	2,710.0	35.6	3,235.0	33.5
Municipal bonds	1,012.0	13.3	941.0	9.7
Short-term funds	799.0	10.5	504.0	5.2
Partnerships and alternative investments	262.0	3.4	248.0	2.6
	<u>\$7,615.0</u>	<u>100.0%</u>	<u>\$9,655.0</u>	<u>100.0%</u>

† All financial figures reported in U.S. dollars.

The management of FM Global is responsible for establishing and maintaining adequate internal control over financial reporting and for the preparation and integrity of the accompanying financial statements and other related information in this report. The consolidated financial statements of the Company and its subsidiaries, including the footnotes, were prepared in accordance with accounting principles generally accepted in the United States of America and include judgments and estimates, which, in the opinion of management, are applied on an appropriately conservative basis. The Company maintains a system of internal and disclosure controls intended to provide reasonable assurance that assets are safeguarded from loss or material misuse, transactions are authorized and recorded properly, and that the accounting records may be relied upon for the preparation of the financial statements. This system is tested and evaluated regularly for adherence and effectiveness by the Company's staff of internal auditors.

The audit committee of the Board of Directors, which comprises directors who are not employees of the Company, meets regularly with management and the internal auditors to review the Company's financial policies and procedures, its internal control structure, the objectivity of its financial reporting, and the independence of the Company's independent public accounting firm. The internal auditors have free and direct access to the audit committee, and they meet periodically, without management present, to discuss appropriate matters.

Because of inherent limitations, a system of internal control over financial reporting may not prevent or detect misstatements and even when determined to be effective, can only provide reasonable assurance with respect to financial statement preparation and presentation.

These consolidated financial statements are subject to an evaluation of internal control over financial reporting conducted under the supervision and with the participation of management, including the chief executive officer and chief financial officer. Based on that evaluation, conducted under the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, management concluded that its internal control over financial reporting was effective as of December 31, 2008.



**Shivan S. Subramaniam**

Chairman and  
Chief Executive Officer



**Jeffrey A. Burchill**

Senior Vice President – Finance  
Chief Financial Officer

*To the Board of Directors and Policyholders of  
Factory Mutual Insurance Company and Subsidiaries*

We have audited the accompanying consolidated balance sheets of Factory Mutual Insurance Company and Subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of operations, changes in policyholders' surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company'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 Company'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 Company'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.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Factory Mutual Insurance Company and Subsidiaries at December 31, 2008 and 2007, and the consolidated results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, in 2008, the Company adopted the measurement date provisions of FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*.

Chicago, Illinois  
February 9, 2009

*Ernst + Young LLP*

CONSOLIDATED BALANCE SHEETS (IN THOUSANDS) ▷

December 31	2008	2007
<b>Assets</b>		
Investments:		
Debt securities	\$ 4,247,900	\$ 4,403,300
Equity securities:		
Common	2,827,000	4,711,600
Other securities	261,900	248,100
Real estate	272,300	213,400
<b>Total investments</b>	<b>7,609,100</b>	<b>9,576,400</b>
Cash and cash equivalents	469,100	459,600
Recoverable from reinsurers	1,348,100	1,435,400
Premium receivable	518,000	660,900
Prepaid reinsurance premium	247,300	210,000
Deferred income taxes	403,800	–
Other assets	711,200	687,800
<b>Total assets</b>	<b>\$11,306,600</b>	<b>\$13,030,100</b>
<b>Liabilities</b>		
Unpaid losses and loss adjustment expenses	\$ 3,899,600	\$ 3,756,400
Reserve for unearned premium	1,947,700	2,070,500
Current and deferred income taxes	51,200	483,900
Other liabilities	768,600	457,000
<b>Total liabilities</b>	<b>6,667,100</b>	<b>6,767,800</b>
<b>Policyholders' surplus</b>		
Accumulated other comprehensive (loss)/income	(176,500)	1,128,300
Retained earnings	4,816,000	5,134,000
<b>Total policyholders' surplus</b>	<b>4,639,500</b>	<b>6,262,300</b>
<b>Total liabilities and policyholders' surplus</b>	<b>\$11,306,600</b>	<b>\$13,030,100</b>

See accompanying notes.

◁ CONSOLIDATED STATEMENTS OF OPERATIONS (IN THOUSANDS)

Year ended December 31	2008	2007
Gross premium earned	\$ 4,586,000	\$ 4,655,100
Ceded premium earned	(1,282,200)	(1,364,700)
Net premium earned	3,303,800	3,290,400
Membership credit	(360,000)	(340,800)
Net premium earned after membership credit	<u>2,943,800</u>	<u>2,949,600</u>
Investment-related income	380,300	368,400
Fee-related income	40,700	37,800
Total revenue	<u>3,364,800</u>	<u>3,355,800</u>
Net losses and loss adjustment expenses	2,322,700	1,409,400
Insurance-related expenses	591,400	742,700
Investment-related expenses	112,400	113,900
Fee-related expenses	29,900	28,900
Total losses, loss adjustment and other expenses	<u>3,056,400</u>	<u>2,294,900</u>
Net income from operations	308,400	1,060,900
Net realized investment (losses)/gains	(819,700)	336,400
Net (loss)/income before income taxes	<u>(511,300)</u>	<u>1,397,300</u>
Income tax (benefit)/expense	(193,300)	469,500
Net (loss)/income	<u>\$ (318,000)</u>	<u>\$ 927,800</u>

See accompanying notes.

CONSOLIDATED STATEMENTS OF CHANGES IN POLICYHOLDERS' SURPLUS (IN THOUSANDS) ▷

Year ended December 31	2008	2007
Policyholders' surplus at beginning of year	\$ 6,262,300	\$5,155,700
Effect of changing measurement date pursuant to FASB Statement No. 158, net of income tax benefit of \$1,600	(2,900)	—
Adjusted policyholders' surplus at beginning of year	6,259,400	5,155,700
Comprehensive (loss)/income:		
Net (loss)/income	(318,000)	927,800
Other comprehensive (loss)/income:		
(Decrease)/increase in net unrealized appreciation on investments in debt and equity securities, net of income tax (benefit)/expense (2008: \$(374,000); 2007: \$23,700)	(688,800)	45,500
Change in benefit plan assets and liabilities, net of income tax (benefit)/expense (2008: \$(188,100); 2007: \$36,000)	(349,400)	66,900
(Decrease)/increase in foreign currency translation adjustment, net of income tax (benefit)/expense (2008: \$(25,600); 2007: \$15,600)	(263,700)	66,400
Total comprehensive (loss)/income	<u>\$(1,619,900)</u>	<u>1,106,600</u>
Policyholders' surplus at end of year	<u>\$ 4,639,500</u>	<u>\$6,262,300</u>

See accompanying notes.

◀ CONSOLIDATED STATEMENTS OF CASH FLOWS (IN THOUSANDS)

Year ended December 31	2008	2007
<b>Operating activities</b>		
Net (loss)/income	\$ (318,000)	\$ 927,800
Adjustments to reconcile net (loss)/income to net cash provided by operating activities:		
Decrease in premium receivable	142,900	31,000
(Decrease)/increase in reserves for unearned premium	(122,800)	77,300
Increase/(decrease) in unpaid losses and loss adjustment expenses	143,200	(381,500)
Decrease in recoverable from reinsurers	87,300	379,600
Change in current and deferred income taxes	(316,000)	(14,800)
Net realized investment losses/(gains)	819,700	(336,400)
Increase in prepaid reinsurance premium	(37,300)	(43,800)
Other	(104,500)	(20,100)
Net cash provided by operating activities	<u>294,500</u>	<u>619,100</u>
<b>Investing activities</b>		
Net (purchases)/sales of short-term investments	(321,200)	232,400
Purchases of debt and equity securities	(2,228,600)	(3,071,800)
Sales and maturities of debt and equity securities	2,395,800	2,421,800
Capital expenditures	(127,600)	(79,400)
Other	(3,400)	(2,600)
Net cash used in investing activities	<u>(285,000)</u>	<u>(499,600)</u>
<b>Financing activities</b>		
Repayment of debt	—	(36,600)
Net cash used in financing activities	<u>—</u>	<u>(36,600)</u>
Increase in cash and cash equivalents	<u>9,500</u>	<u>82,900</u>
Cash and cash equivalents at beginning of year	459,600	376,700
Cash and cash equivalents at end of year	<u>\$ 469,100</u>	<u>\$ 459,600</u>

See accompanying notes.

## **Note 1.** Significant Accounting Policies

### ***Basis of Presentation***

The consolidated financial statements are stated in U.S. dollars and have been prepared on the basis of accounting principles generally accepted in the United States, which differ in some respects from statutory accounting practices prescribed or permitted by the State of Rhode Island and Providence Plantations, Department of Business Regulation, Insurance Division. On the basis of statutory accounting practices, consolidated policyholders' surplus was \$4,734,200 and \$5,771,100 at December 31, 2008 and 2007, respectively; net (loss)/income for the respective years then ended was \$(558,000) and \$953,500.

The process of preparing financial statements in conformity with accounting principles generally accepted in the United States requires the use of management's estimates and assumptions regarding certain types of assets, liabilities, revenues and expenses. Such estimates primarily relate to unsettled transactions and events as of the date of the financial statements. Accordingly, upon settlement, actual results may differ from estimated amounts.

The Company provides comprehensive lines of property coverage and supporting services for industrial and institutional properties throughout the world.

### ***Principles of Consolidation***

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions were eliminated in consolidation.

### ***Reclassification***

Certain amounts reported in the 2007 financial statements and disclosures have been reclassified to conform to the 2008 presentation.

### ***Cash and Cash Equivalents***

Cash equivalents consist of various sweep accounts with a maturity of less than 90 days at acquisition.

**Note 1.** Significant Accounting Policies (continued)**Investments**

Management determines the appropriate classification of debt securities at the time of purchase. All common stocks and debt securities are classified as available-for-sale and are stated at fair value based on information provided by independent outside valuation services.

The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, or in the case of asset-backed securities, over the estimated life of the security adjusted for anticipated prepayments. This amortization and accretion is included in investment-related income. For asset-backed fixed maturity securities, the Company recognizes income using a constant effective yield based on anticipated prepayments over the economic life of the security. The asset-backed portfolio is accounted for under the retrospective method, and prepayment assumptions are based on market expectations. When actual prepayments differ significantly from anticipated prepayments, the effective yield is recalculated to reflect actual payments to date and anticipated future payments, and any resulting adjustment is included in net investment income.

Other securities consist primarily of partnerships and alternative investments, which are accounted for under the equity method. As a result of the timing of the receipt of valuation data from the investment managers, these investments are reported on a three-month lag. Changes in the Company's equity in the net assets of these investments are included in income as realized investment gains or losses.

The cost of securities sold is based upon the specific identification method. Unrealized appreciation or depreciation of available-for-sale debt and equity securities, net of tax, is reported directly in policyholders' surplus.

Impairments in value deemed to be other than temporary are reported as a component of net realized investment gains or losses. Securities are reviewed for both quantitative and qualitative considerations in the calculation of impairments.

**Income Taxes**

The Company files consolidated U.S. and foreign income tax returns as required by law. The income tax expense is based upon pretax income reported in the consolidated financial statements. Deferred income taxes are provided, when appropriate, for the effects of temporary differences in reporting income and expenses for tax and financial reporting purposes, for unrealized appreciation or depreciation of investments, for pension and postretirement liabilities and for foreign currency translations.

**Note 1.** Significant Accounting Policies *(continued)*

***Deferred Costs***

Premium taxes and commissions, the principal business acquisition costs, are deferred to the extent recoverable and are amortized over the period during which the related premium is earned. Deferred costs are included in other assets.

Certain pre-rental and other expenses incurred by the Company's real estate limited liability corporation subsidiaries are deferred and amortized over the lives of the various tenant leases. Expenses relating to the origination of long-term debt are deferred and amortized over the life of the debt.

***Premises and Equipment***

Premises and equipment are stated at cost, and depreciation is provided on a straight-line basis over the estimated useful lives of the respective assets. Upon retirement or sale, the cost of the assets disposed of and their related accumulated depreciation are removed from the accounts, and any resulting gain or loss is recognized in income. The net book value of the Company's investments in land and buildings is included in real estate, whereas the remaining net book value of the Company's occupied land and buildings, furniture, fixtures and equipment is included in other assets.

***Unpaid Losses and Loss Adjustment Expenses***

Liabilities for unpaid losses and loss adjustment expenses are based on case estimates or on reports from ceding companies. Estimates of incurred-but-not-reported (IBNR) reserves are based on historical experience and management analysis.

Although the above-described amounts are based on estimates, management believes recorded liabilities for unpaid losses and loss adjustment expenses are adequate to cover the ultimate settlement cost of losses incurred. These estimates are continually reviewed and adjustments to such estimates are reflected in current operations.

***Premium***

The Company issues term premium policies. The term premium is earned on a pro-rata basis over the life of the policy.

**Note 1. Significant Accounting Policies (continued)*****Adoption of FASB Statements No. 157 and No. 159***

On January 1, 2008, the Company adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, which defines fair value, provides a framework for measuring fair value, and expands the disclosures required for assets measured at fair value. The adoption of SFAS 157 did not have a significant impact on the Company's financial position or results of operations. The additional disclosures required are in Note 3.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which provides companies with an option to report selected financial assets and liabilities at fair value, with the changes in fair value recognized in earnings at each subsequent reporting date. SFAS 159 became effective for the Company on January 1, 2008. The Company chose not to elect the fair value option under SFAS 159 for any of its financial assets or financial liabilities in the current year.

***Adoption of Measurement Date Provisions of SFAS No. 158***

Beginning in 2008, SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* requires an employer to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position. As a result, the Company changed the measurement date for its pension and postretirement benefit plans from September 30 to December 31.

The Company elected the alternative transition method, whereby it transitioned to a year-end measurement date using earlier measurements determined for year-end reporting as of December 31, 2007. Use of the earlier measurements required the Company to project the net periodic benefit cost for the 15 month period from the earlier measurement date through December 31, 2008. The net periodic benefit cost for the transition period was prorated, with an adjustment made to beginning retained earnings for the cost associated with the transition period. Also, changes in fair value of plan assets and benefit obligations during the transition period were recognized in other comprehensive income. Application of this provision resulted in a decrease of \$2,900, net of tax, to policyholders' surplus and an increase of \$2,000, net of tax, to accumulated other comprehensive income.

***Recent Accounting Pronouncements***

In June 2006, the FASB issued FASB Interpretation (FIN) 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, or expected to be taken, in a tax return. During 2008, the FASB deferred the required implementation date of FIN 48 for non-public companies to fiscal years beginning after December 15, 2008. The Company is required to adopt this interpretation in 2009 and is currently evaluating the new standard to determine the effect of adoption on the financial statements.

**Note 1.** Significant Accounting Policies *(continued)*

***Reinsurance***

In the normal course of business, the Company seeks to reduce losses that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk with other insurance enterprises.

Reinsurance premium and losses and loss adjustment expenses ceded under these arrangements are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contract.

***Retirement Income Plans and Postretirement Benefit Plans Other than Pensions***

Noncontributory retirement income plans cover substantially all employees. The Company's funding policy is generally to contribute the net periodic pension cost each year, as determined pursuant to SFAS No. 87, *Employers' Accounting for Pensions*. However, the contribution for any year will not be less than the minimum required contribution, nor greater than the maximum tax-deductible contribution.

The Company provides certain health care and life insurance benefits for retired employees and their dependents. The plan is contributory, with retiree contributions adjusted annually, and contains other cost-sharing features, such as deductibles and coinsurance. Current service and interest costs of postretirement health care and life insurance benefits are expensed on an accrual basis.

***Investment- and Fee-Related Income***

Investment-related income primarily consists of interest and dividends from the Company's investment portfolio and income from leased office space, which is earned as services are provided, or over the term of applicable leases. Fee-related income primarily consists of fees for ancillary services.

**Note 2. Investments*****Debt and Equity Securities***

The following is a summary of securities at December 31, 2008:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities:				
U.S. Treasury securities and obligations				
of U.S. government agencies	\$ 210,000	\$ 34,000	\$ —	\$ 244,000
Obligations of states and political subdivisions	1,017,500	13,600	(33,200)	997,900
Asset-backed securities	1,148,200	27,400	(38,400)	1,137,200
U.S. corporate securities	1,378,800	11,700	(58,100)	1,332,400
Foreign government securities	300,900	12,200	(1,100)	312,000
Other debt securities	232,800	1,200	(9,600)	224,400
Total debt securities	4,288,200	100,100	(140,400)	4,247,900
Equity securities	2,164,000	727,400	(64,400)	2,827,000
Total debt and equity securities	<u>\$6,452,200</u>	<u>\$827,500</u>	<u>\$(204,800)</u>	<u>\$7,074,900</u>

The following is a summary of securities at December 31, 2007:

	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities:				
U.S. Treasury securities and obligations				
of U.S. government agencies	\$ 510,900	\$ 21,300	\$ (300)	\$ 531,900
Obligations of states and political subdivisions	933,900	9,500	(5,300)	938,100
Asset-backed securities	1,258,800	13,400	(8,100)	1,264,100
U.S. corporate securities	1,059,800	13,100	(12,800)	1,060,100
Foreign government securities	376,700	5,300	(800)	381,200
Other debt securities	231,300	600	(4,000)	227,900
Total debt securities	4,371,400	63,200	(31,300)	4,403,300
Equity securities	3,058,000	1,727,600	(74,000)	4,711,600
Total debt and equity securities	<u>\$7,429,400</u>	<u>\$1,790,800</u>	<u>\$(105,300)</u>	<u>\$9,114,900</u>

**Note 2.** Investments (continued)

During the years ended December 31, 2008 and 2007, proceeds from the sale of debt and equity securities were \$2,321,600 and \$2,377,300, respectively. The gross realized gains/(losses) on such sales totaled \$201,500 and \$(305,700), respectively, in 2008 and \$396,000 and \$(31,000), respectively, in 2007.

The amortized cost and fair value of debt securities at December 31, 2008, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
Due in one year or less	\$ 621,100	\$ 619,600
Due after one year through five years	993,000	984,000
Due after five years through 10 years	1,073,000	1,070,300
Due after 10 years	452,900	436,800
	3,140,000	3,110,700
Asset-backed securities	1,148,200	1,137,200
Total debt securities	<u>\$4,288,200</u>	<u>\$4,247,900</u>

At December 31, 2008 and 2007, debt and equity securities with a carrying amount of \$17,200 were pledged as collateral to secure public deposits.

Under a securities lending program with an agent, the Company has temporarily loaned certain debt securities with a fair value of \$236,400 and \$335,000 at December 31, 2008 and 2007, respectively. Borrowers of these securities must deposit with the agent an amount of cash and/or securities equal to 102 percent of the fair value of the securities, plus interest. The Company continues to receive the interest on the loaned debt securities as a beneficial owner, and the loaned debt securities are included in the investment portfolio of the Company.

Included in the Company's debt security portfolio are securities with unrealized losses deemed to be temporary. The total unrealized loss relating to these securities was \$140,400 (fair value of \$1,471,900) at December 31, 2008, and \$31,300 (fair value of \$1,525,000) at December 31, 2007. The amount of loss that existed for 12 months or more was immaterial for both 2008 and 2007. Losses on these securities are considered temporary due to the nature of interest-rate fluctuations during 2007 and the credit market dislocation in 2008. In reaching its conclusion that these impairments are temporary, the Company considered issuer specific circumstances as well as the fact that the Company has the intent and ability to hold the securities until they recover in value or mature.

Included in the Company's equity security portfolio are securities with unrealized losses deemed to be temporary. The total unrealized loss on these securities was \$64,400 (fair value of \$316,500) at December 31, 2008, and \$74,000 (fair value of \$574,800) at December 31, 2007. The amount of loss that existed for 12 months or more was immaterial for both 2008 and 2007. These equity securities are in a range of industries and were impacted by the severe credit market dislocations and the resulting equity market downturn. In reaching its conclusion that these impairments are temporary, the Company considered the duration and severity of the decline as well as the near term prospects of the issuer. The Company believes these securities will appreciate over time.

The write-down of other-than-temporarily impaired securities included in net realized investment gains in 2008 and 2007 was \$784,300 and \$38,500, respectively.

**Note 2.** Investments (continued)**Credit Risk**

All investment transactions have credit exposure to the extent that a counterparty may default on an obligation to the Company. Credit risk is a consequence of carrying investment positions. To manage credit risk, the Company focuses on high-quality fixed-income securities, reviews the credit strength of all companies in which it invests, limits its exposure in any one investment and monitors the portfolio quality, taking into account credit ratings assigned by recognized credit-rating organizations.

**Note 3.** Fair Value

Effective January 1, 2008, the Company adopted SFAS 157, *Fair Value Measurements*, for all investments in debt and equity securities accounted for at fair value. The SFAS 157 framework requires fair value to be determined based on the exit price that would be received for an asset in the principal or most advantageous market for the asset in an orderly transaction between market participants. SFAS 157 establishes market or observable inputs as the preferred source of values, followed by assumptions based on hypothetical transactions or other unobservable inputs.

The valuation techniques required by SFAS 157 are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect market assumptions.

These two types of inputs create the following fair value hierarchy:

**Level 1** Quoted prices for identical instruments in active markets.

**Level 2** Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

**Level 3** Significant inputs to the valuation model are unobservable.

The Company retains independent pricing vendors to assist in valuing the invested assets. As part of the adoption of SFAS 157, the Company conducted a review of the primary pricing vendor, validating that the inputs used in that vendor's pricing process are deemed to be market observable as defined in the standard.

When available, the Company uses quoted market prices to determine the fair value of investment securities, and they are included in Level 1.

When quoted market prices are unavailable, the Company uses quotes from independent pricing vendors based on recent trading activity and other relevant information including market interest rate curves, referenced credit spreads and estimated prepayment rates, where applicable. These investments are included in Level 2 and are primarily comprised of fixed income securities. In infrequent circumstances, the pricing is not available from the pricing vendor, and is based on significant unobservable inputs. In those circumstances, the investment security is classified in Level 3.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS) ▷

December 31, 2008 and 2007 (continued)

### Note 3. Fair Value (continued)

The following table presents the Company's invested assets measured at fair value as of December 31, 2008:

Invested Assets, at Fair Value	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Bonds, available for sale	\$4,247,900	\$ 537,000	\$3,708,900	\$2,000
Equities, available for sale	2,827,000	2,767,300	59,700	—
Total	<u>\$7,074,900</u>	<u>\$3,304,300</u>	<u>\$3,768,600</u>	<u>\$2,000</u>

There were no material changes in Level 3 investments for the year ended December 31, 2008. There were also no material unrealized gains/(losses) for the period included in earnings for Level 3.

### Note 4. Membership Credit

The Company's Board of Directors approved a membership credit to policyholders for 2008 and 2007. Policyholders were eligible for the membership credit upon renewal of their respective 2008 and 2007 policies. The membership credit is recorded as a reduction of net premium earned.

### Note 5. Reinsurance

The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk to minimize its exposure to significant losses from reinsurer insolvencies. While such evaluations minimize the Company's exposure, the ultimate collection of reinsurance recoverables depends on the financial soundness of the individual reinsurers. Generally, the reinsurance contracts do not relieve the Company from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company; consequently, allowances are established for amounts deemed uncollectible.

The effect of reinsurance on written premium is as follows:

Year ended December 31	2008	2007
Gross written premium	\$ 4,463,200	\$ 4,732,500
Ceded written premium	(1,185,400)	(1,422,000)
Net written premium	<u>\$ 3,277,800</u>	<u>\$ 3,310,500</u>

Ceded losses incurred for the years ended December 31, 2008 and 2007, were \$723,600 and \$343,300, respectively.

**Note 6.** Unpaid Losses and Loss Adjustment Expenses

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

Year ended December 31	2008	2007
Net balance at January 1	\$2,530,400	\$2,559,100
Net incurred related to:		
Current year	2,774,700	1,504,200
Prior year	(452,000)	(94,800)
Total incurred	<u>2,322,700</u>	<u>1,409,400</u>
Paid related to:		
Current year	1,344,600	465,300
Prior year	791,000	972,800
Total paid	<u>2,135,600</u>	<u>1,438,100</u>
Net balance at December 31	<u>\$2,717,500</u>	<u>\$2,530,400</u>

As a result of changes in estimates of insured events related to prior years, the provision for losses and loss adjustment expenses decreased by \$452,000 and \$94,800 in 2008 and 2007, respectively. The decreases in each of these years are primarily attributable to reductions of incurred-but-not-reported (IBNR) reserves based on actual experience, and decreases on a small number of individual losses.

In establishing the liability for unpaid losses and loss adjustment expenses related to asbestos, environmental and other tort-related claims, which applies only to business that is now in runoff, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy and management can reasonably estimate the Company's liability. Liabilities have also been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed continuously. Developed case law and adequate claim history do not exist for such claims, primarily because significant uncertainty exists about the outcomes of coverage litigation and whether past claim experience will be representative of future claim experience.

The Company is the subject of various asserted and unasserted claims and lawsuits covering a wide variety of issues that arise out of the normal course of its business activities. Contingent liabilities arising from litigation and other matters are not considered material in relation to the financial position or operations of the Company.

**Note 7. Premises and Equipment**

Premises and equipment included in other assets at December 31, 2008 and 2007, are summarized as follows:

	2008	2007
Land and buildings	\$ 648,200	\$ 542,800
Furniture, fixtures and equipment	253,700	245,900
Accumulated depreciation	(379,800)	(349,800)
	<u>\$ 522,100</u>	<u>\$ 438,900</u>

**Note 8. Leases**

The Company has a sale and leaseback agreement (as amended in 1988) regarding its U.S. corporate offices building, which it has leased for a period of 25 years.

The lease is classified as an operating lease, and the Company pays all costs relating to the maintenance of the building. The lease payments fluctuate widely over the term of the lease, with larger payments later in the term; however, for financial statement purposes, rent expense is recognized on a pro-rata basis adjusted for anticipated inflation.

The lease will expire on July 31, 2009. The Company's rights to renew the lease or purchase the building expired on May 31, 2008. The Company has decided to construct a new office building on an adjacent land parcel in lieu of renewing the lease. The Company still retains the right of first offer to purchase should the landlord decide to sell the property prior to the lease expiration on July 31, 2009.

In connection with its various operating offices throughout Asia, Australia, Europe, North America and South America, the Company leases office space, automobiles and equipment. These leases are classified as operating leases.

Future minimum lease payments at December 31, 2008, under operating leases with terms of one year or more, aggregate \$122,600. The future minimum lease payments for each of the five succeeding years from 2009 to 2013 are \$41,000, \$28,500, \$21,100, \$12,100, and \$8,300, respectively.

During 2008 and 2007, rent expense for all operating leases was \$48,900 and \$52,700, respectively.

**Note 9. Income Taxes**

Current income taxes primarily represent the U.S. federal and foreign tax expense/(benefit). The most significant components of deferred tax liabilities relate to net unrealized gains on investment securities, benefit plans expense and depreciation. Deferred tax assets primarily represent the U.S. tax effects of temporary differences relating principally to discounting of unpaid losses and loss adjustment expenses, adjustments to the net reserve for unearned premium, the write-down of other-than-temporarily impaired investments and the SFAS 158 pension and postretirement surplus adjustment. The Company has established a valuation allowance for its foreign subsidiary's unrelieved foreign tax.

The components of the net deferred tax asset/(liability) at December 31, 2008 and 2007, are as follows:

	2008	2007
Total deferred tax liabilities	\$(365,400)	\$(760,100)
Total deferred tax assets	794,100	351,300
Valuation allowance	(24,900)	(21,700)
Net deferred tax assets	769,200	329,600
Net deferred tax asset (liability)	<u>\$ 403,800</u>	<u>\$(430,500)</u>

The following is the current and deferred income tax (benefit)/expense for the years ended December 31, 2008 and 2007:

	2008	2007
Current income tax expense	\$ 51,000	\$441,700
Deferred income tax (benefit)/expense	(244,300)	27,800
Total income tax (benefit)/expense	<u>\$ (193,300)</u>	<u>\$469,500</u>

The Company has not recognized a deferred tax liability for the undistributed earnings of its wholly owned foreign subsidiaries that arose in 2008 and prior years because the Company does not expect those unremitted earnings to reverse and become taxable to the Company in the foreseeable future, and the calculation of the tax is not practicable. A deferred tax liability will be recognized when the Company expects that it will recover those undistributed earnings in a taxable manner, such as through receipt of dividends or sale of the investment. As of December 31, 2008, the undistributed earnings of these subsidiaries were approximately \$62,300.

In 2008, effective income tax rates differed from current U.S. statutory rates as a result of the dividends received deduction, tax exempt income and the effect of foreign operations.

Income tax paid during 2008 and 2007 was \$138,000 and \$464,300, respectively. In addition, the Company received income tax refunds of \$16,500 and \$43,800 during 2008 and 2007, respectively.

**Note 10.** Retirement Income Plans and Postretirement Benefit Plans Other than Pensions

The Company sponsors a noncontributory retirement income plan covering substantially all employees. The benefits are generally based on years of service and the average of the highest consecutive 60 months of the employee's compensation within the 120 months prior to retirement. Generally, the Company's funding policy is to maintain a sufficient funded level to ensure benefit security and to vary contribution levels as appropriate to business conditions. The Company also has supplemental retirement plans that are noncontributory defined benefit plans covering certain employees.

The Company provides health care and life insurance benefits for certain retired employees and their dependents. Employees not eligible for benefits under pre-merger plan provisions, under age 30 as of January 1, 2000, or hired after January 1, 2000, are ineligible for benefits. Other employees may become eligible if they meet certain age and service requirements. The plan is contributory, with retiree contributions adjusted annually, and contains other cost-sharing features, such as deductibles and coinsurance.

SFAS 158 requires an employer to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position. As a result, the Company changed the measurement date for its pension and postretirement benefit plans from September 30 to December 31.

Obligations and funded status are as follows:

	Pension and Supplemental Benefits		Other Benefits	
	Dec. 31, 2008	Sept. 30, 2007	Dec. 31, 2008	Sept. 30, 2007
Accumulated benefit obligation	\$1,104,300	\$1,060,900	\$ —	\$ —
Fair value of plan assets	913,800	1,335,700	88,900	165,400
Benefit obligations	1,298,000	1,254,000	138,300	146,300
Funded status	<u>(384,200)</u>	81,700	<u>(49,400)</u>	19,100
Fourth-quarter contributions/(distributions)	—	500	—	(12,300)
Amount recognized, end of year	<u>\$ (384,200)</u>	<u>\$ 82,200</u>	<u>\$ (49,400)</u>	<u>\$ 6,800</u>

Amounts recognized in the statement of financial position are as follows:

	Pension and Supplemental Benefits		Other Benefits	
	Dec. 31, 2008	Sept. 30, 2007	Dec. 31, 2008	Sept. 30, 2007
Asset	\$ 500	\$150,200	\$ —	\$14,300
Liability	(384,700)	(68,000)	(49,400)	(7,500)
	<u>\$(384,200)</u>	<u>\$ 82,200</u>	<u>\$(49,400)</u>	<u>\$ 6,800</u>

**Note 10.** Retirement Income Plans and Postretirement Benefit Plans Other than Pensions (continued)

Pretax amounts included in accumulated other comprehensive income are as follows:

	Pension and Supplemental Benefits		Other Benefits	
	Dec. 31, 2008	Sept. 30, 2007	Dec. 31, 2008	Sept. 30, 2007
Net actuarial loss	\$656,200	\$167,100	\$67,900	\$12,500
Prior service cost/(credit)	11,600	14,800	(700)	(1,400)
Transition obligation	—	—	4,800	6,400
	<u>\$667,800</u>	<u>\$181,900</u>	<u>\$72,000</u>	<u>\$17,500</u>

The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension plans with an accumulated benefit obligation in excess of plan assets are as follows:

	Dec. 31, 2008	Sept. 30, 2007
Projected benefit obligation, end of year	\$1,190,300	\$68,500
Accumulated benefit obligation, end of year	1,016,100	55,400
Fair value of plan assets, end of year	815,200	—

The projected benefit obligation and fair value of plan assets for pension plans with a projected benefit obligation in excess of plan assets are as follows:

	Dec. 31, 2008	Sept. 30, 2007
Projected benefit obligation, end of year	\$1,276,700	\$64,800
Fair value of plan assets, end of year	892,000	—

**Other Changes in Plan Assets and Benefit Obligations Recognized in Other Comprehensive Income**

	Pension and Supplemental Benefits		Other Benefits	
	Dec. 31, 2008	Sept. 30, 2007	Dec. 31, 2008	Sept. 30, 2007
Current year actuarial loss/(gain)	\$495,600	\$(67,000)	\$55,500	\$(17,700)
Amortization of actuarial loss	(9,400)	(14,000)	(100)	(1,200)
Amortization of prior service (cost)/credit	(3,200)	(2,300)	700	500
Amortization of transition obligation	—	—	(1,600)	(1,300)
Total recognized in other comprehensive income	<u>483,000</u>	<u>(83,300)</u>	<u>54,500</u>	<u>(19,700)</u>
Net periodic benefit cost	20,200	35,200	1,700	4,000
Total recognized in net periodic benefit cost and other comprehensive income	<u>\$503,200</u>	<u>\$(48,100)</u>	<u>\$56,200</u>	<u>\$(15,700)</u>

**Note 10.** Retirement Income Plans and Postretirement Benefit Plans Other than Pensions (continued)

The estimated amounts that will be amortized from accumulated other comprehensive income into net periodic benefit cost in 2009 are as follows:

	Pension and Supplemental Benefits	Other Benefits
Actuarial loss	\$16,700	\$5,300
Prior service cost/(credit)	2,400	(400)
Transition obligation	—	1,300
Total	<u>\$19,100</u>	<u>\$6,200</u>

**Assumptions**

Weighted-average assumptions used to determine benefit obligations are as follows:

	Pension and Supplemental Benefits		Other Benefits	
	Dec. 31, 2008	Sept. 30, 2007	Dec. 31, 2008	Sept. 30, 2007
Discount rate	5.78%	5.74%	5.78%	5.71%
Expected return on plan assets	7.68	7.72	6.00	6.00
Rate of compensation increase	4.96	4.06	4.98	4.03

Assumed health care cost trend rates are as follows:

	Other Benefits	
	Dec. 31, 2008	Sept. 30, 2007
Health care cost trend rate:		
Initial rate	8.50%	9.00%
Ultimate rate	5.00%	5.00%
Years to ultimate	5 years	6 years

Weighted-average assumptions used to determine net periodic cost are as follows:

	Pension and Supplemental Benefits		Other Benefits	
	Dec. 31, 2008	Sept. 30, 2007	Dec. 31, 2008	Sept. 30, 2007
Discount rate	5.80%	5.74%	5.73%	5.71%
Expected long-term return on plan assets	7.68	7.72	6.00	6.00
Rate of compensation increase	4.09	4.01	4.02	4.03

**Note 10.** Retirement Income Plans and Postretirement Benefit Plans Other than Pensions (continued)

Assumed health care cost trend rates are as follows:

	Dec. 31, 2008	Other Benefits Sept. 30, 2007
Health care cost trend rate:		
Initial rate	9.00%	9.00%
Ultimate rate	5.00%	5.00%
Years to ultimate	6 years	6 years

**Pension Plan Assets**

The Company's pension plan asset allocation and target allocation are as follows:

Asset Category	Target Allocation Dec. 31, 2009	Percentage of Plan Assets	
		Dec. 31, 2008	Sept. 30, 2007
Equity securities	67%	65%	66%
Debt securities	26	27	18
Cash equivalents	3	4	13
Other	4	4	3
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>

The maturities of debt securities are as follows:

	Dec. 31, 2008	Sept. 30, 2007
Maturity range	0-50 years	0-50 years
Weighted-average maturity	6.23 years	8.72 years

**Other Postretirement Benefit Plan Assets**

The Company's other postretirement benefit plan asset allocation and target allocations are as follows:

Asset Category	Target Allocation Dec. 31, 2009	Percentage of Plan Assets	
		Dec. 31, 2008	Sept. 30, 2007
Equity securities	85%	87%	83%
Debt securities	1	1	1
Cash equivalents	14	12	15
Other	-	-	1
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>

**Note 10.** Retirement Income Plans and Postretirement Benefit Plans Other than Pensions (continued)

The maturities of debt securities are as follows:

	Dec. 31, 2008	Sept. 30, 2007
Maturity range	1-20 years	2-21 years
Weighted-average maturity	1.86 years	3.67 years

Investment policy goals are to minimize pension expense and maximize portfolio returns with acceptable return volatility. The invested assets will be managed on a long-term total return basis and measured against established benchmarks for each asset class. As equities are expected to continue to provide the highest returns of the major asset classes, exposure to equities will be emphasized. Risk management is achieved by limiting the size of asset classes and individual security positions to achieve adequate diversification. Derivatives are not used in internally managed portfolios, but are used in varying degrees in the externally managed portfolios. The plans will maintain a funded level sufficient to provide benefit security.

Expected rate of return assumptions are created based on assessments of future behavior of asset classes. As part of the process, historical relationships are considered. Using a three- to five-year outlook, estimates of numerous variables have been combined to gauge economic growth potential. Corporate profit growth is positively correlated with economic growth and equity returns are driven by profits. Debt security returns are expected to approximate their historical relationship with equities and produce somewhat lower returns with a lower level of risk.

**Cash Flows**

Employer Contributions	Pension and Supplemental Benefits	Other Benefits
2007	\$187,400	\$(3,900)
2008	45,500	(800)
2009 (expected)	33,100	(800)

Contributions by participants to the other benefit plans were \$1,900 and \$1,600 for the periods ending December 31, 2008 and September 30, 2007, respectively.

**Note 10.** Retirement Income Plans and Postretirement Benefit Plans Other than Pensions (continued)

Benefit Payments	Pension and Supplemental Benefits	Other Benefits	Other Benefits (Government Subsidy)
2007	\$41,400	\$12,400	\$1,200
2008	49,100	11,600	1,300

  

Estimated Future Payments	Pension and Supplemental Benefits	Other Benefits	Other Benefits (Government Subsidy)
2009	\$ 48,100	\$12,800	\$1,300
2010	53,100	13,200	1,400
2011	55,000	13,500	1,400
2012	59,900	13,500	1,500
2013	64,100	13,500	1,600
2014-2018	403,400	64,200	9,400

The Company also sponsors a 401(k) savings plan whereby eligible employees may elect annually to contribute from 1 percent to 50 percent of their base pay on a pretax or after-tax basis. Employee pretax contributions were limited to \$16 in 2008 and 2007. The Company matches pretax contributions up to 6 percent of the employee's base pay. Company contributions to the plan were \$13,900 in 2008 and \$12,600 in 2007.

**Note 11.** Debt

Total interest paid on debt during 2008 and 2007 was \$0 and \$1,200, respectively.

Total bank lines of credit amounted to \$102,000 and \$102,500 at December 31, 2008 and 2007, respectively. These lines include a \$100,000 line renewable in four years and the remaining lines are renewable annually. There were no outstanding balances on these lines of credit at December 31, 2008 and 2007. The lines of credit require that the Company comply with certain covenants.

**Note 12.** Components of Accumulated Other Comprehensive (Loss)/Income

The components of accumulated other comprehensive (loss)/income at December 31, 2008 and 2007, are as follows:

	2008	2007
Net unrealized appreciation in investments in debt and equity securities, (net of income tax expense of \$215,400 and \$589,400, respectively)	\$ 407,300	\$1,096,100
Pension adjustment under SFAS 158, (net of income tax benefit of \$257,900 and \$69,800, respectively)	(481,900)	(129,600)
Net foreign currency translation, (net of income tax expense of \$12,100 and \$37,700, respectively)	(101,900)	161,800
Accumulated other comprehensive (loss)/income	<u>\$(176,500)</u>	<u>\$1,128,300</u>

The reclassification adjustments for (losses) and gains recognized in net income are \$(796,700) and \$310,400 for 2008 and 2007, respectively.