

**COMBINED  
MANAGEMENT'S DISCUSSION AND ANALYSIS**

Prepared for the

***Farmers Insurance  
Exchange***

And its Affiliated Property and Casualty Insurers

**2018**

NAIC GROUP CODE: 0069

NAIC COMPANY CODE: 21652



**FARMERS INSURANCE EXCHANGE**  
**And its Affiliated Property and Casualty Insurers**

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The accompanying MD&A consists of the following affiliated insurance companies,

<u>Name of Company</u>	<u>NAIC code</u>	<u>State of Domicile</u>
Farmers Insurance Exchange	21652	California
Fire Insurance Exchange	21660	California
Truck Insurance Exchange	21709	California
American Pacific Insurance Company, Inc.	10805	Hawaii
Bristol West Casualty Insurance Company	11034	Ohio
Bristol West Insurance Company	19658	Ohio
Bristol West Preferred Insurance Company	12774	Michigan
Civic Property And Casualty Company	10315	California
Coast National Insurance Company	25089	California
Exact Property And Casualty Company	10318	California
Farmers Insurance Company Of Arizona	21598	Arizona
Farmers Insurance Company Of Idaho	21601	Idaho
Farmers Insurance Company Of Oregon	21636	Oregon
Farmers Insurance Company Of Washington	21644	Washington
Farmers Insurance Company, Inc.	21628	Kansas
Farmers Insurance Hawaii, Inc.	28487	Hawaii
Farmers Insurance Of Columbus, Inc.	36889	Ohio
Farmers New Century Insurance Company	10806	Illinois
Farmers Reinsurance Company	10873	California
Farmers Specialty Insurance Company	43699	Michigan
Farmers Texas County Mutual Insurance Company	24392	Texas
Foremost County Mutual Insurance Company	29254	Texas
Foremost Insurance Company Grand Rapids, Michigan	11185	Michigan
Foremost Lloyds Of Texas	41688	Texas
Foremost Property And Casualty Insurance Company	11800	Michigan
Foremost Signature Insurance Company	41513	Michigan
Illinois Farmers Insurance Company	21679	Illinois
Mid-Century Insurance Company	21687	California
Mid-Century Insurance Company Of Texas	28673	Texas
Neighborhood Spirit Property And Casualty Company	10317	California
Security National Insurance Company	33120	Florida
Texas Farmers Insurance Company	21695	Texas
21St Century Advantage Insurance Company	25232	Minnesota
21St Century Assurance Company	44245	Delaware
21St Century Auto Insurance Company Of New Jersey	10184	New Jersey
21St Century Casualty Company	36404	California
21St Century Centennial Insurance Company	34789	Pennsylvania
21St Century Indemnity Insurance Company	43974	Pennsylvania
21St Century Insurance Company	12963	California
21St Century Insurance Company Of The Southwest	10245	Texas
21St Century North America Insurance Company	32220	New York
21St Century Pacific Insurance Company	23795	Colorado
21St Century Pinnacle Insurance Company	10710	New Jersey
21St Century Preferred Insurance Company	22225	Pennsylvania
21St Century Premier Insurance Company	20796	Pennsylvania

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**GENERAL INFORMATION**

**Basis of Combination and Corporate Structure**

The accompanying Management's Discussion and Analysis ("MD&A") of Statutory Financial Condition and Results of Operations as of December 31, 2018 has been prepared on a combined basis for the Farmers Insurance Exchange ("FIE") and its Affiliated Property and Casualty Insurers (collectively, "Farmers") and consists of all the companies listed on Page 2 of the accompanying MD&A statement.

FIE and certain members of Farmers participate in an intercompany reinsurance agreement (the "Intercompany Program"), with FIE as the lead company, pursuant to which each participant assumes a proportionate share of Farmers' results from FIE based on their respective participation percentages (see also Note 26 of the annual statement). FIE is also a participant in various other reinsurance contracts with affiliates, which occur prior to the Intercompany Program. Since these insurers are part of a consolidated group that utilizes 100% intercompany reinsurance or pooling agreements, regulatory approval was obtained to prepare a combined MD&A. Accordingly, the combined results of Farmers have been analyzed in this MD&A.

**OVERVIEW**

**Background** – Farmers operates in all 50 states, with the states of California, Texas and Washington accounting for nearly 50% of Farmers' total direct premiums written. Farmers offers a variety of personal automobile, personal property, business insurance, and personal lines specialty products. The automobile insurance products include liability insurance, uninsured/underinsured motorists, no-fault or personal injury protection, collision and comprehensive coverages. Farmers' personal property business is primarily comprised of single-family homeowners' policies. In addition to homeowners' policies, a variety of other policies are offered including comprehensive personal liability, residential landlord, residential fire, condominium, and renters.

Farmers' business insurance targets select markets for small and medium-sized commercial accounts, including automotive trades, artisans and service contractors, wholesale and distribution, habitational, restaurants, retail and service, commercial real estate, workers' compensation insurance for work-related injury, illness, or death, and commercial auto insurance protection for Uber and their independent contractor drivers while engaging in official company ridesharing activities in the states of Georgia and Pennsylvania.

The majority of Farmers' policies are marketed through a captive agency force, mainly in the western and mid-western United States. Independent agents are primarily used to distribute specialty and small business products. Farmers also markets mobile home and recreational vehicle products through the Foremost brand name using Farmers' exclusive agents, independent agents, and direct sales representatives throughout the country.

Collectively, Farmers' is a multi-line, multi-channel (Affinity, Direct, Exclusive and Independent agents), multi-product insurance provider, whose core business is Personal Lines. Distribution primarily runs through a vast network of trusted advisors who are exclusive agents, servicing customers through thousands of professional offices across America. Farmers' most notable strengths are: an extensive distribution system (nearly 12,500 exclusive agents), size and scale, product portfolio depth and breadth, powerful and highly visible brands, common platforms and proven operating efficiency, along with a top-tier Claims organization of approximately 11,200 professionals. Farmers is a market leader, with significant scale and market share and is ranked nationally as the fourth largest Property and Casualty All lines organization (per AM Best, based on 2017 direct written premiums) in its core 29 operating states with a 4.8% market share. Gross written premiums were \$20.3 billion in 2018 with approximately 17.6 million policies.

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**BUSINESS ENVIRONMENT**

**Competition** – The business environment in the property and casualty insurance market is very competitive, involving several companies with diverse and competitive products which are offered across national and local markets. In spite of this broader industry's adverse trends, Farmers was able to increase gross premiums written by \$417.7 million, or 2.1%, between 2018 and 2017, driven by a combination of factors which encompass current economic conditions, a rising overall rate environment, the effects of rate tiering strategies and implementation of strategic programs. Farmers was able to grow target segments of the market and further position itself for profitable growth in the future.

As a result of the highly competitive nature of the industry, Farmers' claims paying ability and financial strength ratings have a significant impact on its ability to compete with other insurance companies to attract and retain policyholders. At any given time, there are approximately 2,500 P&C insurers in the U.S. P&C insurance market, but Farmers does not attempt to compete head to head with each of them nor in all market spaces. Farmers' major competitors are multiple-lines exclusive agency companies such as State Farm, Allstate, and American Family, but also include national carriers with similar models, such as Nationwide, Liberty Mutual, Berkshire Hathaway, and Progressive.

**Ratings** – Ratings are an important factor in establishing the competitive position of insurance companies. Rating agencies continue to review the financial performance and condition of all insurers, as well as reinsurance strategies, adequacy of loss reserving and their individual investment portfolios.

Each rating is subject to revision or withdrawal at any time by the assigning organization and should be evaluated independently of any other ratings.

The following table summarizes Farmers' ratings for the 2 most recent years available:

<b>Rating Agency</b>	<b>2017</b>	<b>2016</b>
AM Best Company	A (Excellent)	A (Excellent)
Standard & Poor's	A (Strong)	A (Strong)
Moody Investor Service	A2 (Good)	A2 (Good)

**Investments** - Farmers' investment policy is to maximize the total return of its investment portfolio while adhering to strict risk management guidelines protecting the interests of its policyholders, as well as safeguarding principal, and maintaining a highly liquid position to meet any funding requirements such as short-term obligations and unexpected developments that may occur. This investment strategy emphasizes long-term fundamental value in the selection of the investment mix. Diversification is achieved by maintaining a portfolio of high quality taxable and tax-exempt bonds (modified duration is around 4 years, average credit quality: Aa3), common stocks, non-redeemable preferred stocks, short-term investments, and real estate. Such portfolio management strategies include asset/liability matching, appropriate combination of fixed income and equity securities, a well-diversified portfolio, asset allocation, constant monitoring of the portfolio on a regular basis to ensure credit quality, diversification and duration parameters, and the use of professional investment advisors. Farmers' cash flow is carefully monitored and its investment program is regularly and systematically reviewed to ensure funds are available to meet Farmers' obligations, while at the same time optimizing investment returns. Investment policy is directed by Farmers' Board of Governors.

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***Guaranty Associations and Assessments*** - Farmers receives periodic assessments from certain states to reimburse policyholders and claimants of insolvent carriers. Depending on the guidelines established by each state, these assessments are either expensed, recouped from policyholders, or utilized as credits against premium taxes. Premium tax credits are realized between 3 to 10 years depending on the guidelines established by each state.

***Reinsurance*** - Farmers utilizes various reinsurance agreements to better control loss exposure, including the All Lines Quota Share agreements. Under the terms of these reinsurance agreements, the reinsurers are liable for all losses covered by such reinsurance agreements. However, the ceding insurer remains primarily liable for claims on policies issued whether or not the reinsurer meets its obligations.

***Catastrophe Reinsurance*** - On an excess of loss basis, Farmers, excluding Farmers Reinsurance, retains the first \$200 million of loss after satisfying a \$100 million annual deductible. Coverage is in place up to \$2.5 billion in all states. The Residential book in Florida has an additional coverage purchased from Florida Hurricane Catastrophe Fund, currently estimated as \$133 million excess of an \$8 million retention. On an aggregate basis, the companies have \$350 million of limit excess of \$1.35 billion retention net of the excess of loss reinsurance and \$1 million per-event deductible. A second limit of \$350 million is available after the companies retain additional \$150 million in aggregate losses net of the excess of loss reinsurance and \$1 million per-event deductible. An additional \$500 million is available through the Contingent Surplus Notes facility with the current attachment point of \$2.43 billion excluding earthquake shake. Farmers' total reinsurance program responded appropriately for the 2018 calendar year catastrophes where gross losses of \$3.2 billion were reduced via reinsurance to \$1.3 billion on a net basis. Farmers' 2017 calendar year catastrophes experienced gross losses of \$3.1 billion were reduced via reinsurance to \$1.4 billion on a net basis.

***California Earthquake Authority ("CEA")*** - Farmers also participates in the CEA, which was established by the California Legislature to provide earthquake insurance to the owners of residential property in the state of California. Insurers who elect to participate in the program are responsible for a portion of aggregate losses up to \$1.7 billion, contingent on losses exceeding a specified limit. As of March, 14, 2018, the latest date for which information is available, Farmers' residential earthquake insurance market share was 13.77%, and its respective share of this contingent liability before external reinsurance was \$228.0 million at December 31, 2018. Since the inception of the CEA, there has not been a significant earthquake in California. As such, the CEA has been able to build its capital and the continual increases in retained earnings and investment income lowers the possibility of additional assessments against the participating insurers.

***All Lines Quota Share Agreement ("ALQS")*** - Farmers began participating in an All Lines Quota Share reinsurance agreement with Farmers Re and Zurich in 2002, which has been amended over the years with the aggregate participation ratio at 29% for 2018. Prior to this amendment, the prevailing 2017 participation ratio was 24%. (see also "Note 21C" of the 2018 Annual Statements.)

Following are the participating reinsurers in the ALQS for 2017 through 2019:

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<u>Reinsurers</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>
Swiss Reinsurance Company Limited ("Swiss Zurich")	7.0%	7.0%	7.0%
Hannover Rück SE ("Hannover Re")	7.0%	7.0%	2.0%
Munich Reinsurance America, Inc., ("Munich Re")	5.0%	5.0%	-
Transatlantic Reinsurance Company ("Trans Re")	3.5%	4.0%	1.0%
Catlin Reinsurance Switzerland Limited ("Catlin Re")	4.5%	4.0%	2.0%
Farmers Reinsurance Company ("Farmers Re")	1.0%	1.0%	-
Ariel Re Bermuda Limited ("Ariel Re")	1.0%	1.0%	4.0%
Zurich Insurance Company Limited ("Zurich")	0.0%	0.0%	8.0%
<b>Total</b>	<u><b>29.0%</b></u>	<u><b>29.0%</b></u>	<u><b>24.0%</b></u>

Based on the results for 2018 and 2017, Farmers' share of recoveries were \$3,749.9 million and \$3,129.2 million, respectively. For the years ended December 31, 2018 and 2017, Farmers' share of ceded premiums earned were \$5,605.1 million and \$4,622.7 million, respectively, while the Farmers' share of the ceding commissions was \$1,798.4 million and \$1,587.9 million for 2018 and 2017, respectively.

**Commercial Independent Agency Quota Share Reinsurance Contract ("CIAQS")** - On July 1, 2016, FIE and certain Farmers' companies entered into a quota share reinsurance agreement with Hannover Rück SE ("Hannover Re"), a third party reinsurer domiciled in Switzerland. This agreement provided for a cession of the quota share of the premiums written and the ultimate net losses sustained in all of the commercial independent agency block of business written by Farmers after the All lines quota share reinsurance agreement has been applied

The Hannover Re agreement was terminated effective January 1, 2018. Upon termination of the agreement, unearned premiums totaling \$70.1 million were transferred by Hannover Re to Farmers. In addition, Farmers remitted \$34.4 million of reinsurance commissions to Hannover Re, for acquisition expenses due to the cancellation of this commercial independent quota share reinsurance contract.

In 2017, Farmers' share of ceded premiums earned, recoveries, and ceding commissions were \$146.3 million, \$69.4 million, and \$65.0 million, respectively

**Personal Umbrella Quota Share and Excess of Loss Reinsurance Agreement ("PUQSOL")** - On January 1, 2018, FIE and certain of the Farmers Property and Casualty Companies entered into a two-year personal umbrella quota share and excess of loss reinsurance agreement with certain third party reinsurers, with General Reinsurance, as the lead reinsurer. The other subscribing reinsurers are Hannover Rück SE, Swiss America Reinsurance Corporation, and Everest Reinsurance (Bermuda) Limited, each with varying participating ratios. Under this agreement, Farmers cedes 100.0% of the personal umbrella exposure above \$500,000 for each and every loss, with all losses in excess of \$500,000 fully reinsured up to \$21.0 million. In addition, the agreement provides for the cession of 75.0% of all losses within the first \$500,000 and below. This agreement also provides for Farmers to receive a ceding commission of 41.55%. Unearned premiums totaling \$77.8 million were transferred from the Farmers Exchanges to the participating reinsurers as a result of this personal umbrella quota share reinsurance contract. In return, the subscribing reinsurers remitted \$32.3 million of reinsurance commissions to Farmers, for acquisition expenses due to this reinsurance agreement.

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***Risk-Based Capital (RBC) and NAIC ratios*** - The NAIC utilizes a risk-based capital formula intended for regulatory monitoring of property/casualty insurers. The RBC formulas establish capital requirements for four categories of risk: asset risk, insurance risk, interest rate risk and business risk. For each risk category, the capital requirement is determined by applying factors to asset, premium and reserve items, with higher factors applied to items with greater underlying risk and vice-versa. The focus of the capital rules is a risk-based formula that applies prescribed factors to various risk elements in an insurer's business and investments to develop a minimum capital requirement designed to be proportional to the amount of risk assumed by the insurer. Insurers that have less statutory capital than the RBC calculation requires are considered to have inadequate capital and are subject to varying degrees of regulatory action depending on the level of capital inadequacy. Farmers and each of its subsidiaries have capital levels that exceeded the minimum NAIC capital requirements and therefore no regulatory action under the risk-based capital rules is anticipated in both the current and near terms.

Additionally, the NAIC has established 13 financial ratios for property-casualty insurers to assist state insurance departments in their oversight of the financial condition of licensed U.S. insurance companies operating in their respective states. The NAIC's Insurance Regulatory Information System ("IRIS") calculates these ratios based on information submitted by insurers on an annual basis and shares the information with applicable state insurance departments. Each ratio has an established "usual range" of results and assists state insurance departments in executing their statutory mandate to oversee the financial condition of insurance companies. A ratio falling outside the usual range of IRIS ratios is not considered a failing result; rather unusual values are viewed as part of the regulatory early monitoring system. Generally, an insurance company will be subject to regulatory scrutiny and may be subject to regulatory action if four or more of the ratios fall outside the usual range. Out of the 46 Farmers' companies, four companies had four ratios that were outside the usual range. All of these four companies are non-pooled entities with relatively small investment portfolios which normally triggers unusual values in the investment yield and related ratios. Overall, Farmers does not anticipate regulatory action for each of the companies with four values outside the usual range.

Farmers' management conducted an assessment of the effectiveness of internal controls over financial reporting as of December 31, 2018. No significant deficiencies or material weaknesses were identified upon the completion of management's assessments.

***Litigation*** - Certain of Farmers' companies are defendants in lawsuits arising in the normal course of business, which are in various stages of development. Some of these matters seek punitive as well as compensatory damages. While it is not possible to predict the outcome of these matters with certainty, management believes that their ultimate disposition will not have a material effect on Farmers' financial position or results of operations. In addition, certain of Farmers' companies are, from time to time, involved as parties in various governmental and administrative proceedings.

**FORWARD-LOOKING STATEMENTS**

All statements, trend analysis and other information contained in this MD&A and elsewhere (such as press releases, presentations by Farmers, or its management or oral statements) relative to markets for Farmers' products and trends in Farmers' operations or financial results, as well as other statements including words such as "anticipate," "believe," "plan," "estimate," "expect," "intend" and other similar expressions, constitute forward-looking statements.

Forward-looking statements are based on Farmers' current expectations and assumptions regarding economic, competitive and legislative developments. Because forward-looking statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict. They have been made based upon management's expectations and beliefs concerning future developments and their potential effect upon Farmers. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors which may cause actual results to be materially different from those contemplated by the forward-looking statements.



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There are several current key business initiatives at Farmers that support its business strategy, all of which are in their early stages, with focus primarily on customers, agents, products, claims, marketing, and technology, among others.

On agents and products, Farmers has undertaken numerous initiatives to increase market penetration in an effort to drive growth. One strategy is to raise the national awareness of Farmers' products and ongoing training of the Farmers' agents through advertising campaigns, particularly in new markets outside of the core 29 states, where Farmers has high potential for growth. Management recognizes that Farmers can only succeed if its agents succeed as well. Farmers provides their agents with training, business coaching and marketing assistance through numerous programs designed to help their agents succeed and grow their agencies. Farmers recently expanded its exclusive agent force into five Eastern states.

With respect to products, Farmers continues to review the portfolio of its products relative to competitors and to incorporate added features to meet the needs of its diverse policyholders. Major products developments anticipated to be launched in the current year include the completion of the rollout of Signal by Farmers®, our auto telematics program, in most states, the launch of an updated renter and condo product (i.e. Smart Plan Renter/Condo) and deployment of connected home pilots. In the auto lines, the Farmers Smart Plan Auto<sup>SM</sup> product, continues to offer customers a highly competitive product that provides positive customer experience and also simplifies the sales process for agents and customers. This new product continues to use pricing sophistication to achieve profitability by introducing more segmentation to remain competitive and introduces product and systems enhancements designed to meet the identified needs of Confident Planners. Management believes that the new auto product will improve Farmers' competitive position and customer retention. Similarly, in the homeowners area, the highly competitive Farmers Smart Plan Home<sup>SM</sup> product offer customers new product features designed to meet the identified needs of Confident Planners.

In the Business Insurance segment, the plans for the near term are focused on modest new business growth reflecting softer market conditions in Workers Compensation and Commercial Multi-Peril. For Commercial Auto, this update includes new factors, new discounts, and improved segmentation. For Workers Compensation, we are introducing tiering to our rating plan where possible and revising our commission schedules. Throughout 2019, Farmers anticipates additional product adjustments, including but not limited to, rules and forms.

With respect to the Foremost Farmers Specialty area, the immediate plans are directed on continued moderate new business growth, coupled with stable policy growth reflecting Farmers' focus in selected personal lines market niches.

Regarding Bristol West, Farmers expects retention to continue to improve and to add to profitability growth and the immediate plan is to hold rates steady. In addition, Farmers plans to continue to increase the usage of its mobile app used to do physical damage appraisals for claims and to also invest in its digital strategy with particular emphasis on our mobile self service capabilities that is expected to improve the ease-of-use for both customers and agents, while also lowering overall operating costs. Additionally, Farmers is at the advance stage to launch a new commercial auto product by year end. This anticipated "light/local" product will be targeted primarily at landscapers, artisans, among others.

In the 21st Century area, the near term plans include a focus on pricing and profitable growth. In the state of California, recent rate increases position 21st Century to increase marketing efforts targeting standard and preferred risks. Continued focus on underwriting classification integrity will help in achieving loss ratio goals. Due to corporate restructuring, 21st Century is no longer offering new business outside of California and Hawaii.

Concurrent with these initiatives, Farmers plans to expand its new startup program ("Toggle") into more states in 2019. Toggle offers affordable, customizable coverages and unique offerings direct to consumers and is currently available in eleven states: Colorado, Illinois, Indiana, Iowa, Kansas, Minnesota, Missouri, Ohio, Utah, Virginia and Wisconsin. Toggle was launched in October 2018, and is an innovative, urban insurance brand aimed at today's renter.

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Other initiatives that Farmers plans to implement in 2019 and subsequent years include expanding the exclusive agent distribution of Farmers' products to states in the Eastern third of the United States. Farmers is currently writing personal auto and home in Connecticut, Georgia, Maryland, New Jersey, New York, Pennsylvania, and Florida, with future plans include expansion into South Carolina. Other programs are to improve policyholder retention and customer satisfaction by simplifying and improving the communication and service to existing customers and prospective customers. In addition, Farmers plans to replace the personal lines policy administration system ("PLA") with a new PLA system to improve product flexibility, increase speed of change, enable cross-sell capability, and lower operational costs. Additionally, Farmers is implementing plans to deliver the appropriate marketing message designed to attract the "Value Oriented" customer. Be "Smart" about your insurance and, if desired, communicate with someone (Farmers or Farmers' agent) that can provide trusted advice. In addition, as part of the ongoing growth initiatives, Farmers has implemented several incentives to customers and agents in its cross-selling programs that expanded the number of customers with two or more policies resulting in an overall increase to both policies in force and premium growth in some core personal line segments

With respect to claims, the Farmers claims team is focused on improving processes and operating structures to better serve our customers. By implementing a culture of continuous improvement, the claims team is well positioned to meet the changing expectations of our customers.

Claims training continues to develop high level training on customer service, technical excellence, and leadership. Claims focus on process and operating structures is delivering greater experience to our customers and our employees in management's commitment to and retention of Farmers customers. Management believes that having engaged, fulfilled employees are the foundation of its strategy. Farmers measures employee engagement regularly and views it as a key factor in its ability to win in the marketplace.

In general, Farmers go-to-market strategy can be summarized in two phrases: "customer centered" and "agent powered." Customer needs and experiences are two critical areas at the center of management's thinking and planning, and management recognizes that Farmers' agents are the key to the Farmers' value proposition and the main driver of success. Management has identified four key pillars to its strategy:

*Smart Customer Experience:* As we continue to improve customer experience, we want to put a special focus on designing and continuously improving every customer experience with Farmers.

*Prioritized Growth:* We want to outperform in underpenetrated lines of business and geographies – three key areas include cross-sell, engaging more agents in Business Insurance, and continuing our growth in Eastern Expansion states.

*Innovation for the Target Customer:* Using new technology in disciplined ways to evolve our business model and improve efficiency and performance.

*Larger, Stronger Agencies:* Working with our agents to generate better Net Promoter Score ("NPS"), retain longer and ensure disciplined underwriting.

The foundation for the above four pillars are:

*Innovation: Innovate our products, services and business models to meet evolving customer expectations.*

*Operational Excellence & Efficiency: Strive for continuous improvement to increase speed and reduce cost.*

*Engaged and Empowered People:* Manage succession planning across Farmers through recruitment, development, and empowering employees to deliver on Farmers strategy.

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In summary and looking ahead, in both the current year as well as in subsequent years, Farmers plans to continue to evolve toward a unified brand strategy and to provide customers with access to multiple distribution channels. This will allow Farmers to leverage financial, technology, and other resources more effectively, and provide more competitive products and services. Farmers marketing strategy includes direct sales online and through call centers responding to inbound calls, as well as the recruitment and appointment of independent contractor insurance agents who sell insurance policies throughout the state. Farmers plans to measure its success with growth in its customer targeted segment with products and services that appeal to those customers and also increase the number of products sold per household.

**FINANCIAL PERFORMANCE METRICS**

Some of the common industry metrics that were used in the evaluation and presentation of Farmers' performance are defined as follows:

**MATERIAL BALANCE SHEET CHANGES**

**ASSETS**

Farmers' total net admitted assets increased \$831.6 million to \$24,188.5 million at December 31, 2018. The following is a summary of Farmers' net admitted assets at December 31, (in millions):

	<b>2018</b>	<b>2017</b>
Bonds	\$ 16,644.4	\$ 16,117.2
Common stocks	390.2	799.9
Real estate	796.9	727.0
Cash and short-term investments	649.1	323.2
Other invested assets	<u>56.6</u>	<u>54.5</u>
Total cash and invested assets	<u>18,537.3</u>	<u>18,021.8</u>
Premiums receivable	3,339.4	3,266.4
Reinsurance recoverable on paid losses and LAE	297.9	216.7
Federal income tax recoverable	1,200.5	1,024.4
Accrued interest and dividends	134.1	127.1
Other	<u>679.4</u>	<u>700.6</u>
Total assets	<u>\$ 24,188.5</u>	<u>\$ 23,356.9</u>

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Farmers' invested asset mix at December 31, was as follows:

	2018	2017
Bonds	89.8%	89.4%
Stocks	2.1%	4.4%
Real estate	4.3%	4.0%
Cash and short-term investments	3.5%	1.8%
Other invested assets	0.3%	0.3%

**Bonds** - Bonds increased by \$527.2 million, principally due to a modest strategic shift in the investment portfolio mix toward bonds to maximize net returns while safeguarding principal and maintaining relatively highly liquid position to meet any operational liquidity and funding requirements.

Farmers invests in high quality and highly liquid bonds. At December 31, 2018, 98.4% of the bond portfolio was investment grade (NAIC Class 1 and 2), and approximately 90.5% of its bond holdings mature within the next ten years (see also "Schedule D - Part 1A" of the 2018 Combined Annual Statement). Management believes that the mix, quality, and maturity of Farmers' investment portfolio will be sufficient to meet current and future operational liquidity needs.

The following shows the bond quality distribution at December 31, (in millions):

NAIC Designation	2018		2017	
	Statement Value	% of Total	Statement Value	% of Total
Class 1	\$ 13,759.1	82.7%	\$ 13,523.5	83.9%
Class 2	2,619.6	15.7%	2,379.1	14.8%
Class 3	171.3	1.0%	177.3	1.1%
Class 4 - 6	<u>94.5</u>	<u>0.6%</u>	<u>37.5</u>	<u>0.2%</u>
Total	<u>\$ 16,644.4</u>	<u>100.0%</u>	<u>\$ 16,117.2</u>	<u>100.0%</u>

**Stocks** - Investments in non-affiliates common stocks decreased by \$409.7 million due to a strategic shift away from stock investments and toward other investment opportunities, primarily fixed income securities. Farmers' stock investments include a portfolio of unaffiliated common stocks, affiliated common stocks, and non-redeemable preferred stocks. Management's criteria for unaffiliated stock selection consists of a core portfolio of institutional caliber equities that minimizes the risks associated with such instruments representing a mixture of both economically sensitive as well as growth-oriented companies.

**Real Estate** - Investments in real estate increased \$70.0 million mainly due to increased investment in the real estate market, which offered more attractive risk-adjusted yields.

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**Cash and Short-term Investments** - Cash and short-term investments increased \$325.9 million (see discussion under Cash Flow and Liquidity.).

**Other Invested Assets** - Other invested assets increased \$2.1 million mainly due to the acquisition of interest in certain private equity funds, joint ventures, and partnerships.

**Other Assets**

**Premiums Receivable** - Premiums receivable increased \$72.9 million primarily due to an overall modest increase in the number of policyholders on the Farmers' installment payment plan along with premium growth in home and auto.

**Reinsurance Recoverable on Paid Losses and Loss Adjustment Expenses ("LAE")** - Reinsurance recoverable on paid losses and LAE increased by \$81.2 million due to timing differences and reflects the recoverables on loss and loss adjustment expense related activities ceded to third parties under the terms of reinsurance agreements but for which funds have not yet been received at year end close.

**Federal income taxes recoverable** - Federal income taxes recoverable increased by \$176.2 million which chiefly reflects net recoveries in the current year of income tax credits established in prior years.

**Other Assets** - Other assets decreased \$21.3 million reflecting a decrease in a) the Insurance-company owned life insurance-insurance assets of \$15.5 as well as b) the Business-owned life insurance-insurance related assets of \$10.9 million, both primarily due to unfavorable market conditions. Partially offsetting these decreases were increases in equities and deposits in pools and associations \$4.2 million.

**LIABILITIES:**

The following is a summary of Farmers' total liabilities at December 31, (in millions):

	<b>2018</b>	<b>2017</b>
Losses and loss adjustment expense reserves	\$ 8,977.9	\$ 9,034.7
Reinsurance payable on paid losses and loss adj. expenses	5.9	7.0
Unearned premiums	5,708.6	5,596.0
Ceded reinsurance premiums payable	112.3	82.1
Funds held under reinsurance treaties	2,922.6	2,604.7
Other	<u>761.8</u>	<u>462.7</u>
Total liabilities	<u>\$ 18,489.2</u>	<u>\$ 17,787.2</u>

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***Loss and Loss Adjustment Expense Reserves*** – Losses and LAE reserves decreased by \$56.8 million mainly driven by the changes in the all lines quota share and favorable reserve development, principally on the workers compensation, homeowners and auto physical damage lines of insurance. This was partially offset by an increase in the other liability, private passenger auto, and commercial multiple peril lines of insurance. Farmers has maintained a history of strong reserving practices.

***Reinsurance Payable on Paid Losses and Loss Adjustment Expenses*** - Reinsurance payable on paid losses and loss adjustment expenses decreased by \$1.1 million due to relatively lower assumption of paid losses and loss adjustment expense activities by Farmers from third parties under the terms of the existing reinsurance agreements.

***Ceded Reinsurance Premiums Payable*** - Ceded reinsurance premiums payable increased \$30.2 million due to payables to third party reinsurers under terms of reinsurance agreements.

***Funds Held by Company*** - Funds held by Farmers under reinsurance treaties increased \$317.9 million principally due to the change in the ALQS agreement from 24% to 29%, which impacted the cession of unearned premium reserves and loss and loss adjustment expense reserves in 2018.

***Other Liabilities*** - Other liabilities increased \$299.1 million driven primarily by payable for securities totaling \$260.0 million, advance premium in the amount of \$27.6 million, and amounts withheld or retained by the company for account of others totaling \$27.1 million. Partially offsetting this increase was commissions payable and other expenses in the amounts of \$9.7 million and \$6.6 million, respectively.

**POLICYHOLDERS' SURPLUS:**

***Net Premiums to Surplus Ratio*** – Farmers maintains a strong surplus position relative to the risks insured. Net premium written to surplus was 2.5 to 1 at December 31, 2018 with its surplus ratio at 40.6% through December 2018. Farmers' gross leverage ratio continues to be within industry average.

***Change in Policyholders' Surplus*** – Farmers' surplus totaled \$5.7 billion at December 31, 2018, reflecting an increase of \$129.6 million.

***Risk Based Capital*** - Farmers' total adjusted capital for each member company continues to be above the risk-based capital requirements.

**LOSS RESERVES**

Farmers writes a variety of coverages whose risk factors expose Farmers' reserves to significant variability.

One such major risk factor that impacts the variability of the Farmers' reserves is changes in claims practices and technology. Farmers does not anticipate any significant adverse development on its reserves due to past or future changes.

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Another potential risk factor is catastrophes, although on a standalone basis this factor does not constitute reserve variability because it is difficult to predict the occurrence of such events with certainty. Farmers has taken steps to reduce direct catastrophe exposures and has aggressively pursued a variety of loss mitigation alternatives such as implementing coverage restrictions and limiting writings in catastrophe-prone states/regions. Farmers has implemented a catastrophe management program which management believes is appropriate given Farmers' surplus position.

The potential for material adverse deviation from the stated loss reserves due to the risk factors identified above is not considered to be significant. The absence of other risk factors from this listing does not imply that additional factors will not be identified in the future as having been a significant influence on Farmers' reserves.

**RESULTS OF OPERATIONS**

**Underwriting Results**

Farmers' underwriting results consist of personal lines business and small business insurance. In 2018, Farmers' direct auto business before reinsurance represented 49.5% of total direct premiums written; direct homeowners' business, 26.9%; direct business insurance 9.9%, and the remaining 13.6% from other coverages.

**Profitability and Growth**

Underwriting results for 2018 produced a loss of \$201.4 million compared with a loss of \$415.3 million in 2017. This improvement over the prior year of \$213.3 million was due to favorable loss experience attributable to improved frequency and severity trends, primarily in the Auto book.

The following is a summary of Farmers' underwriting results for the years ended December 31, (amounts in millions):

	<b>2018</b>	<b>2017</b>
Net premiums written	<u>\$ 14,031.4</u>	<u>\$ 14,263.4</u>
Net premiums earned	<u>\$ 13,918.8</u>	<u>\$ 14,520.9</u>
Losses and loss adjustment expenses incurred	9,489.8	10,138.9
Other underwriting expenses incurred	<u>4,630.4</u>	<u>4,797.3</u>
Total underwriting expenses	<u>14,120.2</u>	<u>14,936.2</u>
Underwriting Loss	<u>\$ (201.4)</u>	<u>\$ (415.3)</u>
Combined ratio	101.2%	103.5%

**Net Premiums Written** – Farmers' net premiums written decreased \$232.0 million, or 1.6%, principally driven by the change in the All lines participation ratio from 24% to 29% effective December 31, 2017 and the PUQSXOL agreement effective January 1, 2019. Offsetting this decrease in net premium written was the cancellation of the CIAQS contract and higher premium per policy in Auto, Specialty, and Home books.

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**Net Premiums Earned** - Net premiums earned, which are a function of the premiums written in the current and prior periods, declined \$602.2 million primarily driven by the change in All Lines Quota Share participation from 24% to 29% and the PUQSXOL agreement. Partially offsetting this was an increase in net premiums written due to the cancellation of the CIAQS contract and increased premium per policy in the Auto, Home, and Specialty books. Rate increases and aggressive underwriting actions continue to drive up average premium per policy in these core books, but they also negatively impacted the Auto book's competitive position in the operating environment.

**Losses and Loss Adjustment Expenses Incurred** – Farmers' incurred losses and loss adjustment expenses decreased by 1.6 percentage points to 68.2% in 2018 compared to the 69.8% reported in 2017 driven primarily by the increase in ALQS agreement from 24% to 29% and the PUQSXOL agreement, which yielded a reduction in the losses retained by Farmers. Also contributing was the cancellation of the CIAQS contract and an improvement in frequency and severity trends in the Auto and Home books.

**Other Underwriting Expenses Incurred** – Farmers' underwriting expenses incurred decreased by \$167.0 million driven primarily by the change in All lines quota share agreement from 24% to 29% as well as the PUQSXOL agreement starting in January 2019 which decreased the underlying operating expenses retained by the Farmers. Partially offsetting this decrease was the cancellation of the CIAQS contract which increased the underlying operating expenses retained by the Farmers.

**Underwriting Gain or (Loss)** - In 2018, Farmers posted a net underwriting loss of \$201.4 million compared to a prior year net underwriting loss of \$415.3 million principally due to the items discussed above.

**Combined Ratio** - The year to date combined ratio of 101.2% was 2.3 percentage points below the prior year comparative of 103.5% principally due to the increase in ALQS agreement from 24% to 29% and the PUQSXOL agreement, which yielded a reduction in the losses retained by Farmers. In addition, the expense ratio in the core books decreased by 0.5 percentage points to the prior year comparative. Also contributing towards this decrease was an improvement in frequency trends in the Auto book.

**Net Investment Income Earned** – In 2018, Farmers generated net investment income of \$382.7, reflecting a increase of \$63.2 million primarily due to the relatively higher yield on the fixed income securities driven by higher interest rates as well as favorable market conditions.

Farmers maintained its asset allocation discipline of investing 2.1% of the total portfolio mainly in unaffiliated common equities and retaining approximately 89.8% in fixed-income securities, and the remaining 8.1% in real estate, cash and short-term investments and other invested assets. In 2018, invested assets continued to generate investment income and Farmers kept its exposure to interest rate risk low and credit quality high in the fixed-income portfolio. In addition, with interest rates remaining relatively low in all fixed-income sectors, Farmers plans to maintain its strategy to hold short-duration, high-quality securities.

**Capital Gains and Losses on Investments**



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Net Realized Capital Gains and Losses on sale or maturity of securities generated a net gain of \$52.0 million due to relatively higher return on certain investments that are marked to market.

*Net Unrealized Capital Gains and Losses* - Net unrealized capital losses were \$109.4 million in 2018 versus gains of \$130.9 million in 2017 and are reflective of the current economic environment.

*Other Income or Expense* - Net other expense was \$1.2 million in 2018, down \$50.0 million versus the 2017 comparative principally due to decreases in finance or service charges not in premiums, miscellaneous expenses, and interest expense on funds held.

*Gross Premiums Written* – In 2018, Farmers' core gross premiums written before the All Lines Quota Share were \$20.3 billion compared with \$19.9 billion reported in 2017. The increase was mainly driven by Uber, higher premium per vehicle in the Auto lines of business, higher premium per policy, and new business in the Homeowners lines of business, along with improved retention in the Specialty books of business.

**CASH FLOW AND LIQUIDITY**

**Cash Flow**

In 2018 and 2017, Farmers generated a net change in cash and short-term investments of \$349.3 million and \$347.2 million, respectively. The principal sources of funds for the Farmers are premiums, investment income, and proceeds from the sale or maturity of investments. The principal uses of funds include the payment of claims and claim adjustment expenses, commissions and other acquisition costs, operating expenses, and the purchase of investments. The following table summarizes the net change (in millions):

	<b>2018</b>	<b>2017</b>
<b>Net Cash Flows Provided By (Used In):</b>		
Operating activities	\$ 36.3	\$ (670.8)
Investing activities	(48.1)	812.1
Financing activities	<u>361.0</u>	<u>205.9</u>
Net change in cash and short-term investments	<u>\$ 349.3</u>	<u>\$ 347.2</u>

A discussion related to the significant changes in Farmers' cash flows between 2018 and 2017 is set forth below:

*Operating Activities* – Cash inflows provided by operating activities increased \$707.1 million from (\$670.8) million in 2017 to \$36.3 million in 2018, principally due to a drop in loss related payments, commissions, and expenses paid. Partially offsetting this increase were decreases in premium collections and an increase in Federal taxes. Overall, the Farmers companies' insurance operations create liquidity by collecting and investing premiums from new and renewal business in advance of paying claims.

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**Investing Activities** - Cash flows provided by investing activities were (\$48.1) million in 2018 versus \$812.1 million in 2017. The 2018 activity mainly reflects the net outflow of funds over inflows due to relatively higher acquisition of securities.

**Financing Activities** – Cash flows provided by financing activities were \$361.1 million and \$205.9 million for the years ended December 31, 2018 and 2017, respectively. For the year ended December 31, 2018, financing activities generated an increase in cash of \$361.0 million, mainly driven by a \$317.9 increase in funds held, an additional capital contribution from Farmers Group, Inc. to Farmers Re of \$150.0 million and change in non admitted assets of \$50.2 million. Partially offsetting this increase was FIE's repayment in full of the remaining \$200.0 million of 6.15% surplus notes issued to ZNAIC on June 30, 2011 and amounts withheld or retained by company for account of others of \$27.1 million and \$15.5 million from insurance-company owned life insurance-cash value. This repayment of surplus notes was made with the approval of the California Insurance Commissioner.

**Liquidity**

**Surplus Loan Note Facility** - FIE maintains a \$500 million contingent surplus note facility with a range of bank and non-bank lenders. The facility, which was initially established in 2007, provides FIE with the ability to issue 5-year surplus notes at any time during a three-year period in the event of a specified major catastrophe loss, at a pre-agreed price. This transaction aligns with the FIE focus on preserving their long-term capital strength, even after a major catastrophic event FIE has not borrowed against the current or prior lines of credit on this facility. Fees paid by FIE for the right to access this facility were \$4.3 million and \$4.3 million at December 31, 2018 and 2017, respectively.

**SUMMARY**

Overall, Management believes that Farmers has the ability to meet all future cash requirements as they become due. As mentioned previously, Farmers invests much of its cash from operations in high quality fixed income securities. An investment mix heavily weighted toward bonds assures stable valuations. Additionally, the maturities on these investments are laddered to approximate expected payments of losses and other obligations. Farmers offers a broad product suite to consumers, including Auto, Home, Renters, Umbrella, Life, Motorcycle, Boat, and Business Insurance. Farmers sells these products with the second largest exclusive agency network in the country. Farmers has a strong brand with total brand awareness in its core 29 states and plans to further expand the brand and Farmers' products to states in the Eastern third of the country, including Florida and South Carolina. Farmers also has strong governance and a robust risk identification and management process. Farmers overall vision is to achieve market leadership by driving innovation and operational excellence to provide the best value and experience for every customer it has the privilege to serve. In pursuit of this vision, Farmers continues to adapt its strategy around its customer's needs, with goals that include but are not limited to: being the best U.S. multi-line insurance provider, and growing profitability to attract, develop, and retain top talent. Management firmly believes that these strategic goals and initiatives will continue to contribute toward Farmers overall profitability and organic surplus growth in both the short term and the long run

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**SUBSEQUENT EVENTS**

Subsequent events have been considered through March 21, 2019 for this MD&A, which were issued on March 21, 2019.

The following extraordinary dividend transactions were issued by several of the 21st Century affiliates to other 21st Century affiliates or to their parent company, the Mid-century, which is owned 80%, 10%, and 10%, by FIE, Truck, and Fire, respectively. All of these extraordinary dividend payments were made during 2019 with the approval by the respective departments of insurance where these 21st Century's subsidiaries are domiciled:

1. 21st Century North America Insurance Company received an extraordinary dividend of \$8.6 million from its affiliate, 21st Century Advantage Insurance Company.
2. 21st Century North America Insurance Company received an extraordinary dividend of \$22.3 million from its affiliate, 21st Century Superior Insurance Company.
3. Farmers Insurance Hawaii, Inc. received an extraordinary dividend of \$6.7 million from its affiliate, American Pacific Insurance Company.
4. Mid-Century Insurance Company received an extraordinary dividend of \$70.8 million from its affiliate Farmers Insurance Hawaii, Inc.
5. 21st Century Centennial Insurance Company received an extraordinary dividend of \$20.4 million from its affiliate 21st Century Auto Insurance Company of New Jersey.
6. 21st Century North America Insurance Company received an extraordinary dividend of \$24.1 million from its affiliate 21st Century Pinnacle Insurance Company.