

REPORT OF EXAMINATION  
OF THE  
FIRST AMERICAN HOME BUYERS  
PROTECTION CORPORATION  
AS OF  
DECEMBER 31, 2015

Filed on April 20, 2017

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Los Angeles, California  
January 18, 2017

Honorable Dave Jones  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

FIRST AMERICAN HOME BUYERS PROTECTION CORPORATION

(hereinafter also referred to as the Company) at its home office located at 8521 Fallbrook Avenue, Suite 340, West Hills, California 91304.

SCOPE OF EXAMINATION

We have performed our multi-state examination of the Company. The previous examination of the Company was as of December 31, 2010. This examination covered the period from January 1, 2011 through December 31, 2015.

The examination was conducted in accordance with the National Association of Insurance Commissioners *Financial Condition Examiners Handbook (Handbook)*. The Handbook requires the planning and performance of the examination to evaluate the Company's financial condition, assess corporate governance, identify current and prospective risks, and evaluate system controls and procedures used to mitigate those risks. An examination also includes identifying and evaluating significant risks that could cause an insurer's surplus to be materially misstated both currently and prospectively.

All accounts and activities of the Company were considered in accordance with the risk-focused examination process. This may include assessing significant estimates made by management and evaluating management's compliance with Statutory Accounting Principles. The examination does not attest to the fair presentation of the financial statements included herein. If, during the course of the examination, an adjustment is identified, the impact of such adjustment will be documented separately following the Company's financial statements.

This examination report includes findings of fact and general information about the Company and its financial condition. There might be other items identified during the examination that, due to their nature (e.g., subjective conclusions, proprietary information, etc.), were not included within the examination report but separately communicated to other regulators and/or the Company.

### COMPANY HISTORY

The Company was incorporated in the state of California on February 8, 1984 and began transacting home warranty business on March 31, 1984.

On May 1, 2012, the Company's wholly-owned subsidiary, Alliance Home Warranty Inc., (AHW) was merged into the Company. AHW was no longer actively writing contracts, so the Company determined that there were no benefits derived from the resources expended to maintain the subsidiary. The California Department of Insurance (CDI) consented to the merger.

On September 28, 2012, the Company's then parent, First American Title Insurance Company (FATIC), transferred control of the Company via a stock dividend of 100% of the issued and outstanding shares of the Company to First American Financial Corporation (FAFC). As a result of this transaction, FAFC became the parent of the Company.

## Dividends

On November 21, 2011, the Company applied to pay an extraordinary cash dividend to its then parent, (FATIC), totaling \$13,656,179. The Company did not receive a disapproval letter from the California Department of Insurance (CDI) within the 30-day period and the dividend was paid on December 27, 2011, pursuant to California Insurance Code Section (CICS) 1215.5 (g).

On September 21, 2012, the Company paid an extraordinary non-cash dividend in the form of promissory notes totaling \$38,878,422 to its then parent, FATIC. The CDI approved this transaction on September 18, 2012, pursuant to CICS 1215.5 (g).

On November 4, 2013, the Company filed its application to pay an ordinary cash dividend to its parent, First American Financial Corporation (FAFC), in the amount of \$19,800,000. The dividend was paid on November 26, 2013.

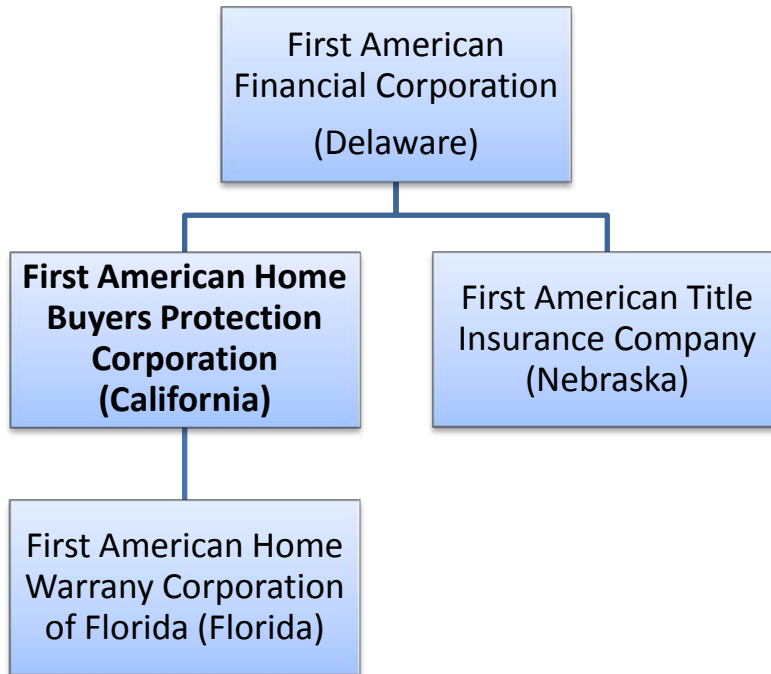
On September 30, 2014, the Company paid an extraordinary cash dividend to its parent, FAFC, in the amount of \$18,288,000. The CDI approved this transaction pursuant to CICS 1215.5 (g) on September 29, 2014.

On December 5, 2014, the Company paid an extraordinary cash dividend to its parent, FAFC, in the amount of \$22,000,000. The CDI approved this transaction pursuant to CICS 1215.5 (g) on December 2, 2014.

On October 16, 2015, the Company paid an extraordinary cash dividend to its parent, FAFC, in the amount of \$26,772,000. The CDI approved this transaction pursuant to CICS 1215.5 (g) on September 22, 2015.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which First American Financial Corporation is the ultimate controlling entity. Following is an abridged organizational chart. (All ownership is 100%).



The six members of the board of directors, who are elected annually, manage the business and affairs of the Company. Following are members of the board and principal officers of the Company serving at December 31, 2015:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Larry Davidson Dana Point, California	Chairman of the Board and Chief Executive Officer First American Home Buyers Protection Corporation
Jeffrey Powell Santa Rosa, California	President First American Home Buyers Protection Corporation
Dennis Gilmore Corona Del Mar, California	Chief Executive Officer First American Financial Corporation
Jeffrey S. Robinson Lake Forest, California	Deputy General Counsel First American Financial Corporation
Gerald Bumbaugh Santa Monica, California	Chief Financial Officer First American Home Buyers Protection Corporation
Mark Seaton Newport Beach, California	Executive Vice President and Chief Financial Officer First American Financial Corporation

Principal Officers

<u>Name</u>	<u>Title</u>
Larry Davidson	Chief Executive Officer
Jeffrey Powell	President
Gerald Bumbaugh	Chief Financial Officer and Vice President
Eric Gleason	Chief Information Officer and Vice President
Patrick Hogan	Chief Operations Officer
Carla Roupe	Vice President, Controller and Treasurer

<u>Name</u>	<u>Title</u>
Tracy Berger	Senior Vice President, Sales
Barry Miles	Executive Vice President, Operations
Helen Hayden	Secretary

### Corporate Records

During the examination, it was noted that the Company failed to adhere to its By-Laws regarding the required number of directors. A review of the Company's By-Laws disclosed that the number of directors shall be eight. A review of the number of directors as of December 31, 2015 noted the Company only had six directors. During the course of the examination, the Company amended its By-Laws so its actual number of directors is now in compliance.

### Management Agreements

Federal Tax Sharing Agreement: On June 26, 2012, a notice of a material transaction was submitted on behalf of the Company to the California Department of Insurance (CDI) for a proposed Federal Tax Sharing Agreement with its parent, First American Financial Corporation (FAFC), and other specified affiliates within the holding company system. After certain issues raised by the CDI were satisfactorily addressed, an amended agreement was submitted, and the CDI approved this agreement on August 23, 2012.

On May 15, 2015, the Company submitted an amended Federal Tax Sharing Agreement to the CDI. The amendment added FAFC as the appointed agent, attorney-in-fact, and tax matters partner/member to the agreement. The agreement is still under review by the CDI. During the examination period, the Company paid federal taxes of \$5,127,979, \$10,710,000, \$9,869,710, \$14,887,553, and \$14,431,825 in 2011, 2012, 2013, 2014, and 2015, respectively.



Affiliated Companies Service Agreement: On December 31, 2010, First American Title Insurance Company (FATIC) executed an Affiliated Companies Service Agreement (Service Agreement) to provide services to its affiliates, including the Company. Under the terms of the agreement, FATIC provides the following services: accounting and auditing; information technology and other functional support services. At the request of the CDI to amend the Service Agreement to include an interest provision, FATIC filed an amended Service Agreement including, an interest provision with a proposed effective date of December 31, 2012. The CDI granted its approval of the Service Agreement on December 17, 2012.

On September 29, 2015, the Company submitted a notice to the CDI of a proposed updated Affiliated Companies Service Agreement which served to add its affiliates, First American Property & Casualty Insurance Company and First American Specialty Insurance Company. The updated Service Agreement was approved by the CDI on October 29, 2015.

FATIC and its affiliates agree that the compensation for services and use of facilities are provided on an actual cost basis. During the examination period, no service fees were paid during the years 2011 through 2014. In 2015, the Company paid service fees of \$1,912,262 to FATIC under the agreement.

#### Investment Management Agreements

Investment Management Agreement: A portion of the investment portfolio of the Company is managed by Guggenheim Partners Investment Management, LLC (GPIM), an unaffiliated company. Under the terms of the agreement, GPIM manages a trading account and performs management and other duties in accordance with the investment guidelines. The manager shall be paid a quarterly fee based on the assets in the account.

Investment Management Agreement: A portion of the investment portfolio of the Company is managed by Wells Capital Management (WCM), an unaffiliated company. Under the terms of the agreement, WCM has the discretion to direct the purchase, sale,

exchange and/or transfer of securities in the account consistent with the Company's investment guidelines. Fees are based on the market value of the assets.

### TERRITORY AND PLAN OF OPERATION

The Company's home protection business provides service contracts that cover residential systems, such as heating and air conditioning, and certain appliances against failures that occur as the result of normal usage during the coverage period. Coverage is typically for one year and is renewable annually at the option of the contract holder and upon the Company's approval. The home protection contracts are initially sold as part of a residential home purchase transaction. Coverage and pricing typically vary by geographic region and renewal premiums may be paid under a number of different options. In addition, under the contract, the holder is responsible for a service fee for each trade call. First-year contracts are primarily marketed through real estate brokers and agents, and the Company increasingly markets directly to consumers.

The Company currently is licensed in all states except Florida, where its subsidiary, First American Home Warranty Corporation of Florida, writes home protection business. In addition, the Company is licensed in the District of Columbia.

Home protection contract renewals represent approximately 56% of the Company's premium revenue. In 2015, the Company wrote \$260.9 million of direct premiums. Of this amount, \$94.0 million (36.0%) was written in California; \$48.7 million (18.7%) was written in Texas; \$14.6 million (5.6%) was written in Arizona; and \$103.6 million (39.7%) was written in the remaining states, and the District of Columbia.

### REINSURANCE

The Company does not have reinsurance assumed or ceded.

## FINANCIAL STATEMENTS

The following financial statements are based on the statutory financial statements filed by the Company with the California Department of Insurance and present the financial condition of the Company for the period ending December 31, 2015. The accompanying comments to the amounts reported in the annual statements should be considered an integral part of the financial statements. There were no examination adjustments made to surplus as a result of the examination.

Statement of Financial Condition as of December 31, 2015

Underwriting and Investment Exhibit for the Year Ended December 31, 2015

Reconciliation of Surplus as Regards Contractholders from December 31, 2010  
through December 31, 2015

Statement of Financial Condition  
as of December 31, 2015

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 101,856,474	\$ (200,293)	\$ 102,056,767	
Common stocks	22,627,636		22,627,636	
Real estate, less encumbrances	5,141,666		5,141,666	
Cash, cash equivalents and short-term investments	8,689,948	(46)	8,689,994	
Home protection contract fees receivable	59,964,538		59,964,538	
Federal income tax recoverable	2,269,253		2,269,253	
Electronic data processing equipment	18,367,376	16,964,201	1,403,175	
Interest, dividends and real estate income due and accrued	894,448		894,448	
Other assets	<u>11,852,517</u>	<u>11,852,517</u>	<u>                    </u>	
Total assets	<u>\$ 231,663,856</u>	<u>\$ 28,616,379</u>	<u>\$ 203,047,477</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Claims adjusted & unpaid or in process of adjustment			\$ 13,607,818	(1)
Claims service expenses			175,000	
Other expenses			8,191,938	
Taxes, licenses and fees			941,705	
Unearned home protection contract fees			110,398,191	
Deposits held escheat			565,153	
Intercompany			423,053	
Accounts receivable - securities			(114,750)	
Rebates			<u>(72,446)</u>	
Total liabilities			134,115,662	
Common capital stock		\$ 1,947,700		
Gross paid-in and contributed surplus		1,480,500		
Unassigned funds (surplus)		<u>65,503,615</u>		
Surplus as regards contractholders			<u>68,931,815</u>	
Total liabilities, surplus and other funds			<u>\$ 203,047,477</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2015

Statement of Income

Underwriting Income

Home protection contract fees earned		\$ 249,652,042
Deductions:		
Claims incurred	\$ 138,663,508	
Claims services expenses incurred	25,093,559	
Other underwriting expenses incurred	<u>55,780,593</u>	
Total underwriting deductions		<u>219,537,660</u>
Net underwriting gain		<u>30,114,382</u>

Investment Income

Net investment income earned	\$ 2,153,584	
Net realized capital gain	<u>1,800,604</u>	
Net investment gain		3,954,188
Net income before federal income taxes		34,068,570
Federal income taxes incurred		<u>13,393,882</u>
Net income		<u>\$ 20,674,688</u>

Capital and Surplus Account

Surplus as regards contractholders, December 31, 2014		\$ 77,783,535
Net income	\$ 20,674,688	
Change in nonadmitted assets	(2,252,201)	
Dividends to stockholders	(26,772,000)	
Unrealized Loss-Common Stock	<u>(502,207)</u>	
Change in surplus as regards contractholders for the year		<u>(8,851,720)</u>
Surplus as regards contractholders, December 31, 2015		<u>\$ 68,931,815</u>

Reconciliation of Surplus as Regards Contractholders  
from December 31, 2010 through December 31, 2015

Surplus as regards contractholders, December 31, 2010			\$ 96,620,596
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 102,060,394	\$	
Change in nonadmitted assets	4,578,728		
Dividends to stockholders		139,394,601	
Alliance Home Warranty Merger	5,568,905		
Unrealized loss – common stock		<u>502,207</u>	
Total gains and losses	<u>\$ 112,208,027</u>	<u>\$ 139,896,808</u>	
Net decrease in surplus as regards policyholders			<u>(27,688,781)</u>
Surplus as regards contractholders, December 31, 2015			<u>\$ 68,931,815</u>

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Claims Adjusted and Unpaid or in Process of Adjustment

The Company does not utilize an actuary to determine reserves. Instead, the accounting department uses a model that incorporates the number of open work orders, invoices, average payment amounts, and certain assumptions, to estimate the reserve for claims adjusted and unpaid or in process of adjustment. On an annual basis, the Company performs a retrospective reserve analysis to ensure the reasonableness of the aforementioned reserving methodology. The examination team obtained and reviewed the 2014 year end reserve analysis as of 12/31/2015, and the 2015 year end reserve analysis as of 10/31/2016, respectively, and deemed the reserving methodology to be adequate.

## SUBSEQUENT EVENTS

Effective November 1, 2016, the Company submitted a request to the California Department of Insurance (CDI) to change its name from First American Home Buyers Protection Corporation to First American Home Warranty Corporation. The Company's position is that the name change will more accurately reflect its identity. In addition, customers who are familiar with the First American branding will more readily connect the new name with its product offerings. The CDI subsequently approved the name change, effective November 17, 2016.

On November 1, 2016, the Company filed its application to pay an ordinary cash dividend to First American Financial Corporation in the amount of \$16,000,000. The dividend was paid on November 21, 2016.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

None.

### Previous Report of Examination

Management and Control – Management Agreement – Tax Allocation Agreement (Page 6): It was recommended that the Company file its amended tax allocation agreement with the California Department of Insurance for approval in accordance with California Insurance Code Section 1215.5 (b) (4). The Company has complied.



ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

/S/\_\_\_\_\_

Dawson Lattimore  
Examiner-In-Charge  
Associate Insurance Examiner  
Department of Insurance  
State of California

/S/\_\_\_\_\_

Edward Aros, CFE  
Senior Insurance Examiner, Supervisor  
Department of Insurance  
State of California