

REPORT OF EXAMINATION
OF THE
QUALITAS INSURANCE COMPANY
AS OF
DECEMBER 31, 2018

Filed on May 19, 2020

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION	1
COMPANY HISTORY:	2
Capitalization	2
MANAGEMENT AND CONTROL:.....	3
Management Agreements.....	5
TERRITORY AND PLAN OF OPERATION.....	6
LOSS EXPERIENCE.....	7
REINSURANCE:	7
Assumed.....	7
Ceded	7
ACCOUNT AND RECORDS:	8
Financial Statements	8
FINANCIAL STATEMENTS:	9
Statement of Financial Condition as of December 31, 2018	10
Underwriting and Investment Exhibit for the Year Ended December 31, 2018	11
Reconciliation of Surplus as Regards to Policyholders from December 31, 2015 through December 31, 2018	12
COMMENTS ON FINANCIAL STATEMENT ITEMS.....	13
SUBSEQUENT EVENTS:	13
Capitalization	13
Federal and State Income Tax Sharing Agreement.....	13
COVID-19 Pandemic	14
SUMMARY OF COMMENTS AND RECOMMENDATIONS:	14
Current Report of Examination	14
Previous Report of Examination	14
ACKNOWLEDGMENT	16

Los Angeles, California
May 08, 2020

Honorable Ricardo Lara
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

QUALITAS INSURANCE COMPANY

(hereinafter also referred to as the Company). Its statutory home office and primary location of its books and records is located at 101 West Broadway, Suite 1270, San Diego, California 92101.

SCOPE OF EXAMINATION

We have performed our multi-state examination of the Company. The previous examination of the Company was made as of December 31, 2014. This examination covers the period from January 1, 2015 through December 31, 2018.

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. The 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 on November 10, 1982, under the laws of the state of California, and commenced transacting property and casualty business on January 1, 1984. In June 1999, the Company was acquired by Trinity Universal Insurance Company (TUIC). The Company was then acquired by Qualitas Financial Services, Inc., a Delaware company, a wholly-owned subsidiary of Qualitas Controladora, S.A.B de C.V. (QC), a financial holding company and ultimate controlling entity based in Mexico in March 2014. QC is a publicly-traded stock company on the Mexican Stock Exchange. On March 25, 2014, the California Department of Insurance (CDI) approved the Company's name change from Valley Insurance Company to Qualitas Insurance Company.

Capitalization

On March 14, 2014, the parent company, Qualitas Financial Services, Inc. (QFS), made a commitment to the California Department of Insurance that it would ensure, commit, and maintain the total statutory capital and surplus of the Company at no less than \$15

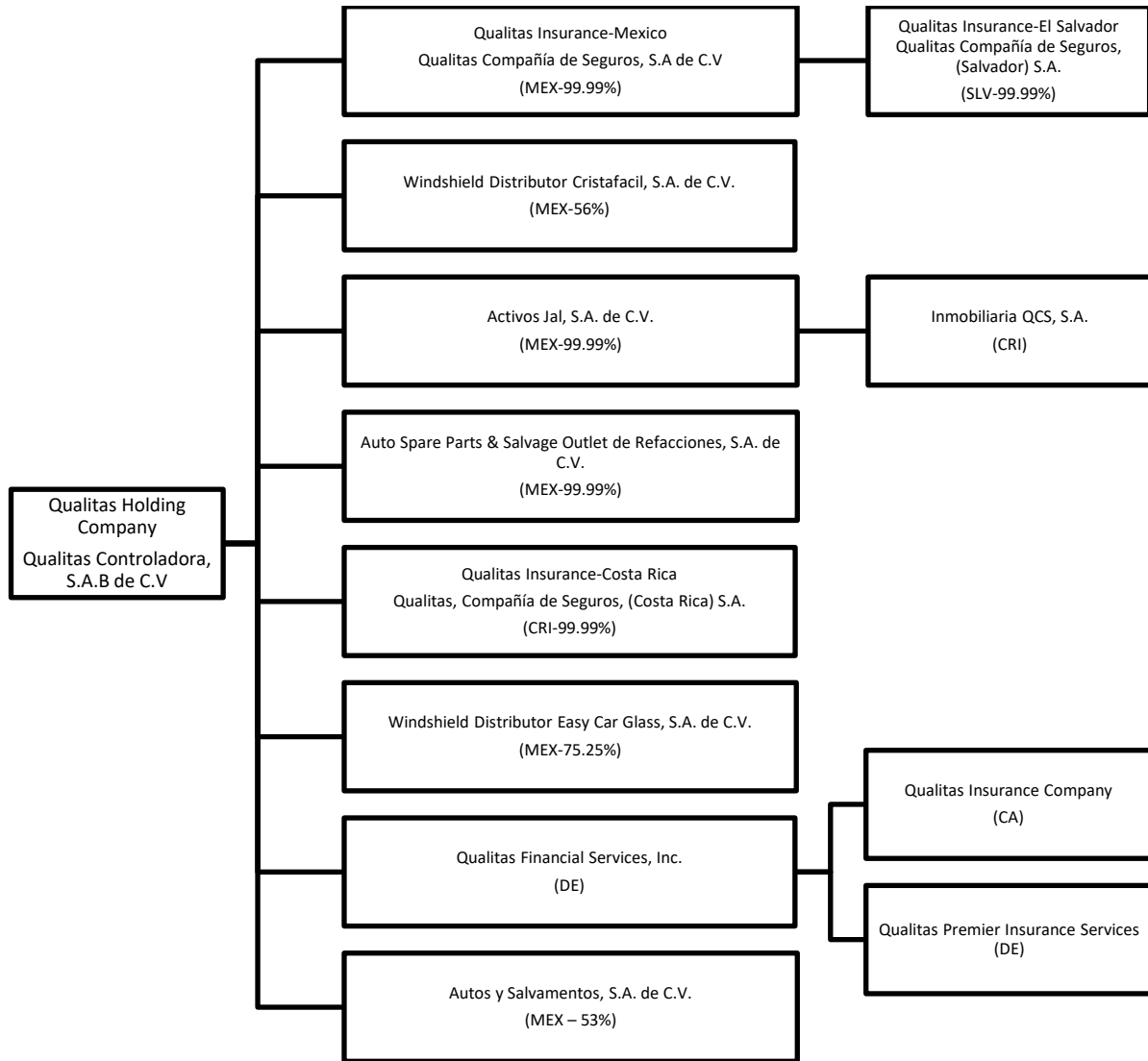
million dollars for a period of five (5) years following the acquisition date of the Company. The capital contributions in 2018 was made to allow for the elimination of the non-favorable quota share treaty. The following capital contributions from QFS were made to the Company:

<u>Year</u>	<u>Type</u>	<u>Capital Contribution</u>
2015	Cash	\$ 4,843,968
2016	Cash	600,000
2017	Cash	2,200,000
2018	Surplus Note	6,000,000

On October 1, 2018, the Company received \$6,000,000 from QFS, under the terms of a Surplus Note Agreement. Under the terms of the agreement, interest is accrued at a rate of 3.5% per annum. All principal and interest payments must be made from the Company's surplus funds with the prior written approval of the Insurance Commissioner, in accordance with the California Insurance Code Section 1315. The note matures on September 31, 2028. The agreement was approved by the California Department of Insurance on September 10, 2018.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which Qualitas Controladora, S.A.B. de C.V. is the ultimate controlling entity. The following organizational chart depicts the Company's relationship within the holding company system at December 31, 2018. All ownership is 100.0% unless otherwise indicated.



The five members of the Board of Directors, who are elected annually and oversee the business and affairs of the Company. Following are members of the Board and principal officers of the Company serving at December 31, 2018:

Directors

Name and Location

Joaquin Brockman-Lozano
Mexico D.F., Mexico

Principal Business Affiliation

Chairman of the Board and Chief
Executive Officer
Qualitas Compañía de Seguros, S.A.
de C.V.

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
Wilfrido Castillo Sanchez-Mejorada ^(a) Mexico D.F., Mexico	Vice Chairman of the Board Qualitas Compañía de Seguros S.A. de C.V.
Jose Antonio Correa Etchegaray Mexico D.F., Mexico	Corporate Chief Financial Officer Qualitas Compañía de Seguros S.A. de C.V.
Eduardo Pedrero San Diego, California	President and Chief Executive Officer Qualitas Insurance Company
Andres Ruiz-Hubard ^(b) San Diego, California	Chief Financial Officer Qualitas Insurance Company

Principal Officers

<u>Name</u>	<u>Title</u>
Eduardo Pedrero	President and Chief Executive Officer
Andres Ruiz-Hubard ^(a)	Chief Financial Officer and Secretary

^(a) Mr. Wilfrido Castillo Sanchez-Mejorada, Vice Chairman of the Board, passed away and Ms. Eliane Berenice Ibarra Sevilla was elected his replacement on April 20, 2020.

^(b) On April 20, 2020, Mr. Andres Ruiz-Hubard, Director and Chief Financial Officer, retired and was replaced by Ms. Mary E. Queen as Director and Chief Financial Officer.

Management Agreements

Intercompany Affiliated Service Agreement: Effective April 1, 2018, the Company and Qualitas Premier Insurance Services (QPI) entered into an intercompany affiliated service agreement. Under the terms of the agreement, the Company agrees to make its facilities available and provide certain services to QPI, including but not limited to: data processing, equipment, business property, office space, and communication equipment. Compensation for providing services shall be limited to the actual cost incurred and will not include a profit factor. This agreement was approved by the California Department of Insurance (CDI) on February 1, 2018. For the 2018 year, the Company received \$13,626 from QPI, under the terms of the agreement.

General Agency Agreement: Effective May 25, 2017, the Company and QPI entered into a General Agency Agreement. The Company appointed QPI for lines of insurance listed within the product line authority, to countersign and deliver policies and binders of insurance, and to cancel insurance policies insured through the Company. QPI will collect all premiums due and will transmit premiums to the Company. QPI receives a commission of 19.0% of the net premium due on domestic commercial automobile liability business and 32.0% for cross-border business placed in Arizona, California, and Texas. This agreement was approved by the CDI on July 2, 2018. QPI received commissions from the Company in the amounts of \$429,840.50 and \$1,871,195.81 for the years of 2017 and 2018, respectively.

TERRITORY AND PLAN OF OPERATION

The Company's headquarters are located in San Diego, California. It is licensed in fourteen states (Arizona, California, Colorado, Idaho, Kansas, Maine, Montana, Nevada, Oklahoma, Oregon, Texas, Utah, Washington, and Wyoming). However, all of its business is written in three states: Arizona, California, and Texas. The Company does not have plans to expand writings to additional states.

It has a primary focus on the automobile market entering the United States from Mexico, writing both commercial automobile (cross-border and domestic risks) and personal automobile (cross-border and domestic risks). A large portion of the business is referred to the Company by Qualitas Compania de Seguros, S.A. de C.V. (Qualitas Insurance - Mexico), many of whose customers have a need of United States insurance for their trucks that cross into the United States. to deliver goods.

The Company was granted an insurance license from CDI on April 11, 2014, to write commercial automobile liability policies. In December 2014, the Company began offering private passenger automobile liability coverage for automobiles with Mexico license plates entering into U.S. under cross border certificates.

As of December 31, 2018, the Company wrote \$49.8 million in direct premiums; 79.7%

and 15.2% of the writings pertained to commercial automobile liability and private passenger automobile liability, respectively. Of the total direct premiums written, \$25 million (50.3%) was written in California, \$17.7 million (35.5%) was written in Texas, and \$2.9 million (5.8%) was written in Arizona.

LOSS EXPERIENCE

A review of the Company's loss experience data during the examination period, disclosed a historical trend of net underwriting losses and net losses as follows:

<u>Year</u>	<u>Net Underwriting loss</u>	<u>Net Income (Loss)</u>	<u>Company Surplus</u>
2015	\$ (3,984,414)	\$ (3,518,824)	\$ 15,967,413
2016	\$ (2,690,786)	\$ (1,589,796)	\$ 15,578,600
2017	\$ (2,279,061)	\$ (969,922)	\$ 16,585,194
2018	\$ (1,049,091)	\$ 607,943	\$ 23,670,285

Since being acquired in 2014, the Company had net underwriting losses. The Company also had overall net losses until year-end 2018. The combined ratios were 99.3%, 97.8%, 112.0%, and 97.7% during the years of 2015 to 2018, respectively. In 2017, the Company experienced adverse development, due primarily to the excessive growth of the commercial automobile liability business in the accident year 2016. Costs associated with the entry into the California private passenger automobile ("PPA") market also attributed to continued poor operating performance. The Company exited the PPA market in 2018 and is currently in a run-off basis.

REINSURANCE

Assumed

The Company does not have any assumed reinsurance.

Ceded

Casualty Excess of Loss Reinsurance: the Company entered into a Casualty Excess of Loss Reinsurance with various reinsurers; Everest Reinsurance Company (authorized),

Citadel Reinsurance Company Limited (unauthorized) and Ocean International Reinsurance Company Limited (unauthorized) (collectively known as Reinsurers). The Company ceded commercial automobile liability in Arizona, California, and Texas on an excess of loss basis. For years of 2015 to 2017, the Company retained the first \$500,000 of each risk. For years ended December 31, 2018, the Company retained the first \$400,000 of each risk. Losses in excess of retention were reinsured up to \$1,000,000 per occurrence. The maximum aggregate limit under this agreement is equal to \$20,000,000. As of December 31, 2018, there were three reinsurers participating: Everest Reinsurance Company (68.0%), Citadel Reinsurance Company Limited (7.0%), and Ocean International Reinsurance Company Limited (25.0%).

Quota Share Treaty Reinsurance: the Company entered into a Quota Share Treaty Reinsurance with the Rainmaker Insurance SCC (Rainmaker) (unauthorized). The agreement applied to all losses that occurred between June 1, 2017, and June 1, 2018. The Company ceded to Rainmaker 25.0% of the unearned premium and associated ultimate net liability on the business covered with respect to Third-Party Commercial Automobile Liability, including domestic and cross-border policies in Arizona, Texas, and California written by the Company. Rainmaker indemnified the Company for losses up to \$1,000,000 each ultimate net losses, each claim, each and every insured. The agreement was terminated on June 1, 2018.

ACCOUNT AND RECORDS

Financial Statements

During the course of the examination, it was noted misstatements within the Company's filed financial statements for years 2018 and 2019 occurred. The misstatements noted included the following:

- The Company inaccurately reported closed claim counts with loss payments on a direct and assumed basis in each respective year for prior years in its 2018 and 2019 Annual Statements, Schedule P, Part 5B and 5C, Section 1;

- The Company inaccurately reported the number of claims closed on a direct and assumed basis in each respective year for prior years in its 2018 and 2019 Annual Statements, Schedule P, Part 5B and 5C, Section 3.

Upon notification of these misstatements, the Company adjusted its Schedule P Part 5B and 5C, Section 1 and Section 3, respectively, in its 2018 and 2019 Annual Statements. There is no impact and no examination adjustment required as the Company amended its Schedule P. It is recommended that the Company implement procedures to strengthen its financial reporting and accounting controls to ensure that all accounts and schedules are fairly and accurately reported within its filed financial statements.

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, 2018. There were no adjustments made to the statutory financial statements filed by the Company.

Statement of Financial Condition as of December 31, 2018

Underwriting and Investment Exhibit for the Year Ended December 31, 2018

Reconciliation of Surplus as Regards Policyholders from December 31, 2015 through December 31, 2018

Statement of Financial Condition
as of December 31, 2018

<u>Assets</u>	<u>Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted_ Assets</u>	<u>Notes</u>
Bonds	\$ 76,979,368	\$	\$ 76,979,368	
Common Stocks	3,858,809		3,858,809	
Cash and short-term investments	2,628,607		2,628,607	
Investment income due and accrued	408,768		408,768	
Uncollected premiums and agents' balances in the course of collection	3,229,422		3,229,422	
Amounts recoverable from reinsurers	771,650		771,650	
Current federal and foreign income tax recoverable and interest thereon	25,000		25,000	
Net deferred tax asset	1,591,656	816,447	775,209	
Electronic data processing equipment and software	151,044	151,044	0	
Furniture and equipment	60,463	60,463	0	
Aggregate write-ins for other than invested assets	<u>43,979</u>	<u>23,045</u>	<u>20,934</u>	
Total assets	<u>\$ 89,748,766</u>	<u>\$ 1,050,999</u>	<u>\$ 88,697,767</u>	
 <u>Liabilities, Surplus, and Other Funds</u>				<u>Notes</u>
Losses			\$ 34,288,662	(1)
Loss adjustment expenses			4,198,945	(1)
Commissions payable, contingent commissions and other similar charges			909,249	
Other expenses (excluding taxes, licenses and fees)			1,073,624	
Taxes, licenses and fees (excluding federal and foreign income taxes)			135,577	
Unearned premiums			20,146,300	
Ceded reinsurance premiums payable (net of ceding commissions)			465,106	
Funds held by company under reinsurance treaties			3,696,231	
Payable for parent, subsidiaries and affiliates			23,785	
Aggregate write-ins for liabilities			<u>90,000</u>	
Total liabilities			65,027,479	
Common capital stock		\$ 3,000,000		
Surplus notes		6,000,000		
Gross paid in and contributed surplus		29,433,549		
Unassigned funds (surplus)		<u>(14,763,264)</u>		
Surplus as regards policyholders			<u>23,670,285</u>	
Total liabilities, surplus, and other funds			<u>\$ 88,697,764</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2018

Statement of Income

Underwriting Income

Premium earned		\$ 39,833,025
Deductions:		
Losses incurred	\$ 19,141,456	
Loss adjustment expenses incurred	7,108,067	
Other underwriting expenses incurred	14,792,592	
Aggregate write-ins for underwriting deductions	(160,000)	
Total underwriting deductions		<u>40,882,115</u>
Net underwriting loss		(1,049,091)

Investment Income

Net investment income earned	\$ 1,609,952	
Net realized capital losses	<u>(36,718)</u>	
Net investment gain		1,573,234

Other Income

Finance and service charges not included in premiums	<u>\$ 83,800</u>	
Total other income		<u>83,800</u>
Net income after dividends to policyholders, after capital gains tax, and before all other federal and foreign income taxes		607,943
Federal and foreign income taxes incurred		<u>0</u>
Net income		<u>\$ 607,943</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2017		\$ 16,585,192
Net income	\$ 607,943	
Change in net unrealized capital gains or (losses)	(429,757)	
Change in net deferred income tax	(27,977)	
Change in nonadmitted assets	819,456	
Change in provision for reinsurance	115,426	
Change in surplus notes	<u>6,000,000</u>	
Change in surplus as regards policyholders for the year		<u>7,085,091</u>
Surplus as regards policyholders, December 31, 2018		<u>\$ 23,670,283</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2014 through December 31, 2018

Surplus as regards policyholders, December 31, 2014				\$ 14,943,422
	Gain in Surplus	Loss in Surplus		
Net losses	\$	\$	5,470,599	
Change in net unrealized capital losses			151,489	
Change in net deferred income tax	1,591,656			
Change in nonadmitted assets			987,546	
Change in provision for reinsurance	100,869			
Change in surplus notes	6,000,000			
Surplus adjustment: Paid-in	<u>7,643,968</u>			
Total gains and losses	<u>\$ 15,336,493</u>	<u>\$ 6,609,634</u>		
Net increase in surplus as regards policyholders				<u>8,726,859</u>
Surplus as regards policyholders, December 31, 2018				<u>\$ 23,670,281</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The December 31, 2018 reserves and related actuarial loss and loss adjustment expense reserves were evaluated by an assigned California Department of Insurance (CDI) actuary. Based on the analysis performed, the Company's loss and loss adjustment expense reserves were found to be reasonably stated, and have been accepted for purposes of this examination.

SUBSEQUENT EVENTS

Capitalization:

In 2019, the parent company, Qualitas Financial Services, Inc. (QFS), made a capital contribution of \$5,000,000 to allow for growth of the Company.

Federal and State Income Tax Sharing Agreement:

Effective September 1, 2019, the Company entered a Federal and State Income Tax Sharing Agreement with Qualitas Financial Services, Inc. (Parent), and Qualitas Premier Insurance Services (QPI) (QPI and the Company are collectively referred to as the Affiliates). The agreement authorizes the filing of a consolidated federal and state income tax returns (FSIT) and establishing the method of settlement of tax payments and refunds between the member parties. The Parent shall have the sole and exclusive responsibility for the preparation and filing of all consolidated FSIT returns. Affiliates will pay the Parent the amount of regular income tax they would pay to the Taxing Authority (or receive from the Parent any refund they would receive from the Tax Authority) as if they were separate companies filing separate FSIT returns and were not part of a consolidated group. This agreement was approved by the California Department of Insurance on January 14, 2020.

COVID-19 Pandemic:

On April 13, 2020, Insurance Commissioner Ricardo Lara issued Bulletin 2020-3 (Bulletin) ordering insurers to return current March and April insurance premiums to all adversely impacted California policyholders to provide much needed financial relief during the COVID-19 Pandemic. The Bulletin relates to lines of business where the measure of risk may have become substantially overstated as a result of the pandemic, including private passenger automobile and commercial automobile liability. Companies may comply with the premium refund order by providing a premium credit, reduction, return of premium, or other appropriate premium adjustment no later than 120 days after April 13, 2020.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Accounts and Record – Financial Statements (Page 9): The Company inaccurately reported closed claim counts in its 2018 and 2019 Annual Statements, Schedule P, Part 5B and 5C, Section 1 and 3. It is recommended that the Company implement procedures to strengthen its financial reporting and accounting controls to ensure that all accounts and schedules are fairly and accurately reported within its filed financial statements.

Previous Report of Examination

Management and Control – Corporate Records: Management and Control - Corporate Records: It was recommended that the Company hold regular board and shareholder meetings as stated in their Bylaws in order to disclose, document, and approve significant events and transactions. It was also recommended that they comply with the investment related reporting requirements of California Insurance Code (CIC) Sections 1200 and 1201. The Company is now in compliance.

Management and Control – Management Agreements – Commercial Agency Agreement: It was recommended that the Company submit the inter-company agreement to the

California Department of Insurance (CDI) for approval in compliance with CIC Section 1215.5(b)(4). The Company is now in compliance.

Accounts and Records – Information Systems Control: It was recommended that the Company make the appropriate change in order to strengthen its general information system control. The Company has made improvements to its general information system control.

Accounts and Records – Vehicle Fraud Assessment: It was recommended that the Company correct its vehicle fraud assessment procedures to ensure the compliance with California Code of Regulation, Title 10, Chapter 5, Subchapter 9, Article 4, Section 2698.62(b). The recording and reporting of the vehicle fraud assessment procedures are accurately calculated during the current examination period.

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/ _____

Tzuwen Meyer, CFE
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California

/S/ _____

Anjanette Briggs, CFE
Senior Insurance Examiner, Supervisor
Department of Insurance
State of California