

REPORT OF EXAMINATION
OF THE

CALIFORNIA INSURANCE
GUARANTEE ASSOCIATION

AS OF
JUNE 30, 2008

Filed November 24, 2009

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Los Angeles, California
July 24, 2009

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

CALIFORNIA INSURANCE GUARANTEE ASSOCIATION

(hereinafter also referred to as the Association) at the primary location of its books and records, 700 North Brand Boulevard, Suite 1400, Glendale, California 91203.

SCOPE OF EXAMINATION

The previous examination of the Association was made as of June 30, 2005. This examination covers the period from July 1, 2005 through June 30, 2008. The examination included a review of the Association's practices and procedures, an examination of management records, tests and analyses of detailed transactions, and an evaluation of the assets and a determination of liabilities as of June 30, 2008, as deemed necessary under the circumstances. The examination also included a review and analysis of the Association's projected cash flows through 2017.

The California Insurance Commissioner ordered a separate operational review of the Association due to numerous findings relating to the Association's internal controls and related issues noted in a report by a consultant hired by the Association dated February 20, 2008. A separate detailed report covering the operational review was issued on July 23, 2009.

This Examination Report includes some of the significant findings from the operational review and are captioned "Operational Review Findings." This Examination Report also includes some of the actions taken by the Association to address its internal control deficiencies, which are included in the Association's Process Improvement Plan. The Association has indicated that it will be providing an action plan to the California Department of Insurance regarding the "Operational Review Findings" as deemed appropriate by its board of governors.

In addition to those items specifically commented upon in this report, other phases of the Association's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers' and employees' welfare and pension plans; and loss experience.

SUBSEQUENT EVENTS

Subsequent to the examination date of June 30, 2008, the Association received approximately \$48 million in advances from liquidators from various insolvencies, the largest of which was \$44 million from the liquidator of PAULA Insurance Company.

ASSOCIATION HISTORY

The Association was created by California legislation in 1969 to establish a fund from which insureds could obtain financial and legal assistance in the event their insurers became insolvent. The Association was organized pursuant to, and operates in accordance with, California Insurance Code (CIC), Division 1, Part 2, Article 14.2, Section 1063. In addition, the Association functions pursuant to a Plan of Operation approved by the California Department of Insurance. The purpose of the Association is to provide against loss arising from the failure of an insolvent insurer to discharge its obligations under its insurance policies. The Association is a statutory entity that depends on CIC Sections 1063-1063.77 for its existence and for a definition of the scope of its powers, duties and protections. The Association issues no policies, collects no premiums, makes no profits, and assumes no contractual obligations to the insureds.

MANAGEMENT AND CONTROL

The Association is managed by a board of governors (board), composed of thirteen members. Nine of the members shall be member insurers, each of which is appointed by the California Insurance Commissioner (Commissioner). The nine members must be representative, as nearly as possible, of the classes of insurance and of the kinds of insurers covered by California Insurance Code Section 1063. At least five member insurers of the board must be from domestic insurers. At least three member insurers must be from stock insurers, and at least three must be from non-stock insurers. In case of a vacancy on the board, the Commissioner shall appoint a member insurer to fill the unexpired term.

In addition to the nine member insurers, the membership shall also include one public member appointed by the President pro Tempore of the Senate, one public member appointed by the Speaker of the Assembly, one business member appointed by the Commissioner, and one labor member appointed by the Commissioner.

A listing of the governors and principal officers serving on June 30, 2008 follows:

Governors

| <u>Name</u> | <u>Principal Business Affiliation</u> |
|-------------------|--|
| Robert Balgenorth | State Building & Construction Trades Council of California |
| John Boyle | Inter-Insurance Exchange of the Automobile Club |
| Robert Chick | Lawyers Mutual Insurance Company |
| Ron Coble | Farmers Insurance Group |
| Kathleen Dubia | Chubb Insurance Company |
| Janet Frank | State Compensation Insurance Fund |

| <u>Name</u> | <u>Principal Business Affiliation</u> |
|-----------------|--|
| Scott Hauge | CAL Insurance & Associates |
| Daniel Jacobson | Jacobson & Associates |
| Felix Mantilla | Secretary – California Insurance Guarantee Association Allstate Insurance Company |
| Thomas Rudder | Liberty Mutual Insurance Company |
| James Sevey | Vice Chair - California Insurance Guarantee Association California Casualty Insurance Group |
| Linda Smith | Chair - California Insurance Guarantee Association Preferred Employers Insurance Company |

The public member appointment by the Speaker of the State Assembly is vacant.

Principal Officers

| <u>Name</u> | <u>Title</u> |
|-----------------|---|
| Wayne Wilson | Executive Director |
| Richard L. Hurd | Director of Finance |
| Hal Fedora | Director of Internal Audit and Information Technology |

Third Party Administrators

The Association has agreements with various third-party administrators (TPAs) to primarily administer workers' compensation claims of insolvent companies until those claims are closed. The Association has the right to cancel these contracts under limited circumstances. Fees paid to the TPAs under these contracts are based on the number of claims filed. Some of the claims handling fees are paid at the inception of the agreements, whereas other contract fees are paid on a monthly or annual cycle based on the number of open claims. The TPAs have the authority to issue claim

payments up to \$25,000. Claim payments in excess of \$25,000 require the approval of the Association's management.

The claims administered by these TPAs as of June 30, 2008 comprise a material amount of the outstanding claims of the Association. As of June 30, 2008 the Association had reduced the number of TPAs handling claims from nine TPAs noted in the prior examination to the following: Broadspire, Cambridge Integrated Services Group, Inc. and Intercare Holdings Insurance Services, Inc.

Operational Review Findings

The Operational Review Report noted the following significant findings and recommendations:

Board of Governors

- (1) The current committee structure was determined to be inadequate for an organization the size and complexity of the Association.
- (2) The operational review report recommended that each member insurer designate a specific board member and alternate, and the Association should provide training for Board and committee members.
- (3) The Board should expand its traditional advisory role and engage in high level corporate governance and oversight including the review and approval of the annual budget, business plan, and the monitoring of the corporate performance and the business and strategic plan.

Internal Audit

- (1) The scope of authority of the Internal Audit (IA) Department and reporting relationships are not formally defined.
- (2) The Board has not given specific guidance for the scope of the IA Department.
- (3) The current scope of the internal audit activities does not include any of the operations of the Association itself, except for internal in-house claims functions.

- (4) The Association should develop a Board approved charter describing the scope of authority of the IA Department. The charter should require that the IA Department report directly to the Board or an audit committee.

Third Party Administrators

- (1) Third party administrator (TPA) agreements reviewed were incomplete, lacking effective dates, and were not signed by all parties.
- (2) No documentation was provided to memorialize any dissolution of contractual agreements between the Association and the various TPAs who were no longer handling the Association's claims.
- (3) The Association should develop a consistent contract process to include a review of the initial contract with standardized review intervals, and a standardized method by which a contract would be terminated.
- (4) The Association has an ongoing audit program in place to monitor and control the policies and procedures that its TPAs must adhere to. In addition to monitoring TPAs from its home office, the Association placed compliance representatives on site at the TPA locations. However, the operational review report concluded that the Association's pre-July 2007 audit process did not adequately evaluate the technical abilities and contract compliance of those administering workers' compensation benefits. The claims auditing process has significantly improved over time, and was revised in late 2007 to include expectations as well as measurable results.
- (5) For the purpose of assuring that the TPAs are administering benefits in a statutory and timely manner, the Association should make use of the resources provided by the State Audit Unit annual reports, Field Claims Bureau Referrals, and the California Department of Insurance consumer complaints listing.

Process Improvement Plan

To address noted internal control deficiencies, the Association implemented a Process Improvement Plan which included the following provisions that address many of the significant findings noted in the previous sections:

- (1) Address the control weaknesses identified in the Association's utilization of vendors by implementing a review process for all significant contracts by the Director of Finance and the Executive Director as well as soliciting input from legal counsel.
- (2) Develop a formalized procurement policy.

- (3) Review all significant relationships between the Association's TPAs and the TPAs vendors for potential conflicts.
- (4) End relationships with any vendors that present a potential conflict.
- (5) Requirement of SAS 70 reports for significant TPAs and vendors.
- (6) Cost control measures such as the replacement of unbundled bill review services where savings can be achieved.
- (7) Implementation of a new and improved Payment Recovery System for identifying duplicate payments, overpayments, and penalty reimbursements.
- (8) Implementation of legal bill review software.
- (9) Attempt to re-negotiate the bill review fees of "cradle to grave" contracts.

TERRITORY AND PLAN OF OPERATION

Insurance companies writing property and casualty insurance business in California are required to participate in the California Insurance Guarantee Association. If an admitted property and casualty insurance company becomes insolvent, the Association administers unpaid claims and assesses each property and casualty insurance company up to 1% for all lines of written premium in the appropriate category. California Insurance Code (CIC) Section 1063.145 requires all property and casualty insurance companies to surcharge policies to recover these assessments.

The Association has the responsibility to pay and discharge covered claims of insurers as of the date a member insurer's domiciliary insurance regulator declares the property and casualty insurance company insolvent and a liquidator is appointed. Covered claims primarily include the policy obligations of insolvent insurers arising from property and liability coverages (exclusive of those lines not included per CIC Section 1063.1).

The Association allocates its claim payments and costs, incurred or estimated to be incurred, to one or more of the following categories: (a) workers' compensation claims; (b) homeowners' claims, and automobile claims, which include: automobile material damage, automobile liability (both personal injury and death and property damage), medical payments and uninsured motorist claims; and (c)

claims other than workers' compensation, homeowners', and automobile. Separate premium charges (assessments) are required for each category. The premium charges for each category are used to pay the claims and costs allocated to that category.

The CIC and labor laws establish the maximum claim settlement amounts for workers' compensation claims. Claims settlement amounts for covered claims other than workers' compensation are limited to the lower of \$500,000 per claim or the policy limits.

When a property and casualty insurance company becomes insolvent, the control of its assets transfers to the state insurance liquidator in its domiciliary state. The liquidator uses the assets of the insolvent insurance company to settle the outstanding liabilities of the company. Liquidators may advance funds to the Association prior to the settlement of all outstanding debts. The Association recognizes these advances as revenue when received. The advances are utilized to discharge claims against the insolvent insurance companies. The respective liquidator can recall these advances, in whole or in part. The Association recognizes any recall of advances when notified by the respective liquidator or receiver.

To the extent that assets, including advances from liquidators, are insufficient to discharge claim obligations, there are additional premium charges when determined necessary by the Board of Governors (Board) of the Association. Conversely, to the extent that the assets exceed the ultimate cost of claim obligations for insolvent insurers, the excess fund balance, if any, will be applied to reduce future premium charges by the Association in the appropriate category.

Premium charges are accrued as of the date declared by the Board of the Association and become due from the member insurers when billed. The premium charge rate is initially based upon each member's written premiums as reflected in its most recent financial statement filed with the California Insurance Commissioner. In accordance with Assembly Bill 2007, which became effective on September 7, 2002, the maximum annual premium charge of 2% was extended until December 31, 2007; thereafter the maximum premium charge cannot exceed 1% per year.

In the event of a natural disaster, the Association, to the extent it determines necessary or desirable, may request the California Department of Insurance (CDI) to issue bonds pursuant to Article 14.25 (commencing with CIC Section 1063.50) to provide funds to pay covered claims of insolvent insurers. The Association may act as an agent of the CDI to collect premium payments levied by the CDI on its member insurers.

Additionally, CIC Section 1063.70 authorizes the Association to request the issuance of bonds by the California Infrastructure and Economic Development Bank to more expeditiously and effectively provide for the payment of covered claims that arise as of result of the insolvencies of insurance companies providing workers compensation insurance. Proceeds for the sale of bonds shall be deposited into a separate account called the Workers' Compensation Bond Fund. Notwithstanding any other limits on assessments, the Association shall have authority to levy upon member insurers special bond assessments in the amount necessary to pay the principal and interest on the bonds. Any bonds issued to provide funds for covered claim obligations for workers' compensation claims shall be issued prior to January 1, 2007 in an aggregate principal amount outstanding at any one time not to exceed \$1.5 billion. As of June 30, 2008 there were \$750 million of bonds outstanding.

As of June 30, 2008, the Association is providing insolvency insurance for one hundred and twenty-six (126) insolvencies, including both active and inactive companies. Effective September 29, 2005, the Governor of California signed Assembly Bill 817 (AB817). AB817, which amends the California Insurance Code governing the operations of the Association, expands the definition of covered claims to include the obligations of an insolvent insurer to indemnify a permissible self-insured employer for its liability to pay workers' compensation benefits. However, these claims are not considered workers' compensation claims and are therefore subject to the \$500,000 per claim limit.

The Association is required to adopt a Plan of Operation. The Plan of Operation and any amendments thereto are subject to prior written approval by the Commissioner. The Association requested an amendment to its Plan of Operation effective June 3, 2008. The Association requested that the Plan of Operation be amended to (1) recognize and define the Executive Committee and the Investment

and Audit Committee, (2) and eliminate the requirement that fund borrowing must be used only to pay principal and interest on the Special Bond Assessments.

Operational Review Findings

The Association's current Plan primarily contains restatements of the California Insurance Code Section 1063 and its subsections. It is recommended that the Plan of Operation be amended to include details of the governance, management, and accountability of the Association to the Commissioner and the members of the Association as detailed in the Operational Review Report.

REINSURANCE

Reinsurance entered into by insurers prior to their insolvency is administered by the California Department of Insurance through the Conservation and Liquidation Office (CLO), and is therefore excluded from the Association's financial statements. Reinsurance recoveries made by the CLO may be advanced to the Association subject to the priority needs of the estate in liquidation. Ancillary liquidations may also have a demand on assets recoverable including reinsurance recoverable.

ACCOUNTS AND RECORDS

The financial statements presented by the Association, which are regularly audited by independent certified public accountants, are prepared on a Generally Accepted Accounting Principles (GAAP) basis with a fiscal year ending June 30th. The Association's financial statements are prepared on a conservative basis (i.e., full value of estimated California-risk reserves are established with no deduction for inuring reinsurance recoverables, no anticipation of advances from estates in liquidation, and advances are recorded only when received).

Operational Review Findings

Financial Reporting

The operational review report indicated that the Association's internal quarterly and annual audited financial statements contain only summary information on the administrative expenses incurred by the Association and such information does not provide the Board sufficient information to understand the types of expenses incurred by the Association for its operations or to review trends in expenses over time. It was recommended in the Operational Review Report that the Association disclose material claims and administrative expenses that mirror those presented in an annual operating budget, as well as budget variances and explanations.

Information Technology Controls

During the course of the operational review an evaluation was made of the Association's general controls over its information systems. It was determined that the overall Information Technology (IT) control environment is in need of improvement. The Association does not have a written IT Strategic Plan. The lack of such increases the risk of investing in IT equipment that fails to provide a sufficient return, or negatively impacts the organization.

In addition, the Association has no written annual IT budget developed or approved. Accordingly, there is no way to compare budgeted and actual IT expenditures. It is recommended that the Association develop and implement an IT Strategic Plan and an IT budget.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of June 30, 2008

Statements of Income and Changes in Surplus Funds
for the Fiscal Year Ended June 30, 2008

Statements of Cash Flows
for the Fiscal Year Ended June 30, 2008

Statement of Financial Condition
as of June 30, 2008

| <u>Assets</u> | <u>June 30, 2008</u> | <u>Notes</u> |
|---|-------------------------|--------------|
| | <u>Per Examination</u> | |
| Cash and short-term investments: | | |
| Unrestricted | \$ 135,306,867 | |
| Restricted for workers' compensation claims | 39,681,074 | |
| Investments in debt securities available for sale, at fair value: | | |
| Unrestricted | 1,629,922,306 | |
| Restricted for workers' compensation claims | 199,610,583 | |
| Accrued investment income | 14,591,982 | |
| Premium charges receivables | | |
| Unrestricted | 55,099,051 | |
| Restricted for principal and interest payments on bonds payable | 64,325,434 | |
| Unamortized bond issue costs | 4,568,224 | |
| Fixed assets, net | 9,399,802 | |
| Deposits and other assets | <u>2,641,053</u> | |
| Total assets | <u>\$ 2,155,146,376</u> | |
| <u>Liabilities and Surplus Funds</u> | | |
| Reserve for claims | \$ 2,430,538,831 | (1) |
| Reserve for claim adjustment expenses | 319,448,309 | |
| Reserve for excess liquidator advances | 16,735,859 | (1) |
| Reserve for administrative expenses | 55,710,000 | |
| Claims payable | 27,520,599 | |
| Reserve for unearned premiums | 11,298,300 | |
| Assessment returns due to members | 96,206,173 | |
| Bonds payable | 767,694,997 | (2) |
| Accrued interest expense | 5,109,902 | |
| Accounts payable | <u>3,699,291</u> | |
| Total liabilities | 3,733,962,261 | |
| Surplus Funds: | | |
| Fund balance | \$(1,598,553,625) | (3) |
| Accumulated other comprehensive loss | <u>19,737,740</u> | |
| Total Surplus Funds | <u>(1,578,815,885)</u> | |
| Total liabilities and surplus funds | <u>\$ 2,155,146,376</u> | |

Statements of Income and Changes in Surplus Funds
for the Fiscal Year Ended June 30, 2008

| | <u>Fiscal Year Ended</u> <u>June 30, 2008</u> |
|---|--|
| Assessments and investment activity: | |
| Premium charges declared | \$ 54,433,662 |
| Net investment income | 86,193,582 |
| Net realized loss | (727,771) |
| Liquidator activity: | |
| Advances from liquidators | <u>272,090,849</u> |
| Total income | 411,990,322 |
| Claims activity: | |
| Claims paid | \$ (230,119,962) |
| Claim adjustment expenses paid | (74,349,735) |
| Increase in reserve for claims | <u>(18,311,937)</u> |
| | (322,781,634) |
| Policy unearned premiums activity: | |
| Unearned premiums paid | \$ (1,173,489) |
| Decrease in reserve for unearned premiums | <u>3,386,700</u> |
| | 2,213,211 |
| Administrative expense activity: | |
| Administrative expense paid | \$ (26,075,378) |
| Interest expense | (28,745,962) |
| Decrease in reserve for administrative expenses | <u>1,837,000</u> |
| | <u>(52,984,340)</u> |
| Total Expenses | (373,552,763) |
| Net income | 38,437,559 |
| Accumulated other comprehensive income | 19,737,740 |
| Surplus funds at beginning of period | <u>(1,636,991,184)</u> |
| Surplus funds at end of period | <u>\$ (1,578,815,885)</u> |

Statements of Cash Flows
for the Fiscal Year Ended June 30, 2008

| | | <u>Fiscal Year Ended June 30, 2008</u> |
|---|-------------------|--|
| Cash flows from operating activities: | | |
| Net income | | \$ 38,437,559 |
| Adjustments to reconcile net income to net cash provided | | |
| By operating activities: | | |
| Depreciation and amortization | \$ (2,674,759) | |
| Decrease (increase) in: | | |
| Premium charges due from members | \$ 34,501,655 | |
| Accrued investment income | (2,659,318) | |
| Deposits and other assets | <u>1,774,934</u> | |
| Total | | 30,942,512 |
| Increase (decrease) in: | | |
| Reserve for claims, claim adjustment and administrative expenses | \$ 16,474,937 | |
| Claims Payable | (1,334,172) | |
| Reserves for policy unearned premiums | (3,386,700) | |
| Assessment returns due to members | 56,604,323 | |
| Accrued interest expense | (23,716) | |
| Accounts payable | 2,485,792 | |
| Loss on sale of investments, net | <u>728,673</u> | |
| Total | | <u>71,549,137</u> |
| Net cash provided by operating activities | | <u>140,929,208</u> |
| Cash flows from investing activities: | | |
| Debt securities available-for-sale: | | |
| Purchases, unrestricted | \$(1,864,416,702) | |
| Proceeds from sales, unrestricted | 1,018,191,924 | |
| Proceeds from calls or maturities, unrestricted | 641,227,275 | |
| Purchases, restricted for workers' compensation claims | (322,921,706) | |
| Proceeds from sales, restricted for workers' compensation claims | 64,022,673 | |
| Proceeds from calls or maturities, restricted for workers' compensation claims | 256,720,422 | |
| Purchase of fixed assets | <u>(167,796)</u> | |
| Net cash used in investing activities | | <u>(207,343,910)</u> |
| Increase (decrease) in cash and short-term investments | | (66,414,702) |
| Cash and short-term investments at beginning of period | | <u>241,402,643</u> |
| Cash and short-term investments at end of period | | <u>\$ 174,987,941</u> |

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Reserves for Claims and Claims Adjustment Expenses and Administrative Expenses

The Association's reserves for claims and claims adjustment expenses are primarily comprised of workers' compensation reserves associated with workers compensation carrier insolvencies. The Association's workers' compensation reserves are 90% of its total stated reserves.

The Association provided the examiners an actuarial report issued by Dale F. Ogden and Associates, (Ogden) prepared as of June 30, 2006. The Association has not obtained an actuarial report for the fiscal years ended June 30, 2007 or June 30, 2008.

The Association's external auditors issued a qualified opinion on the financial statements for the years covered by the examination period. The opinion stated in part that "the underlying claims information related to certain insolvencies was not sufficiently reliable or complete to enable the Association to estimate on a reasonable basis the reserve for claims, claim adjustment expenses and administrative expenses and the reserve for unearned premium."

An actuarial review by the California Department of Insurance of the reserves and related cash-flows was not completed due to the inability to reconcile and verify the underlying data. It is recommended that the Association obtain an annual actuarial evaluation of its claim liabilities to develop estimates of its future payout of loss reserves and loss adjustment expenses that includes a reconciliation of the underlying data.

(2) Bonds Payable

On September 30, 2003 the Governor of the State of California signed Assembly Bill 227 (AB227). AB227 enables the Association to issue up to \$1.5 billion in bonds through the California Infrastructure and Economic Development Bank. The proceeds of these bonds will be used to pay and discharge workers' compensation claims.

On August 18, 2004, the Association issued \$400 million fixed rate and \$350 million variable rate Workers' Compensation Relief Bonds. Aggregate net proceeds from the issuance of the bonds were approximately \$774.8 million.

At June 30, 2008, the carrying value of the bonds was \$767.7 million. The fair value of the Association's bonds is estimated based on quoted market prices and reporting date for similar bonds.

The long-term debt of the Association is collateralized by the special bond assessments that are paid to the Association under California Insurance Code Section 1063.74.

(3) Fund Balance and Surplus Funds

As indicated in the following schedule, the Association's workers' compensation fund balance as of June 30, 2008 indicated a deficit of \$2.3 billion (estimated \$2.3 billion excess of liabilities over assets in this category). In total, for all categories of business, the fund deficit reported by the Association was approximately \$1.6 billion.

| Category of Business | Fund Balance (deficit) as of June 30, 2008 |
|--|---|
| Automobile and Homeowners | \$ 292,533,626 |
| All Other | 422,703,385 |
| Workers' Compensation | <u>(2,313,790,636)</u> |
| Subtotals - Fund Balance (Deficit) | \$ (1,598,553,625) |
| Accumulated other comprehensive income | <u>19,737,740</u> |
| Totals – Surplus Funds | <u>\$ (1,578,815,885)</u> |

The significant deficit as of June 30, 2008 was the result of several large insurance company insolvencies. The workers' compensation deficits for the largest insolvencies as of June 30, 2008 were as follows:

| Workers' Compensation Insolvencies | Fund deficit as of June 30, 2008 |
|---|---|
| Superior National Group | \$ 1,796,033,719 |
| HIH & Great States Insurance Companies | \$ 307,410,216 |
| Credit General Group | \$ 115,541,377 |
| Reliance Insurance Company | \$ 367,128,038 |
| PAULA Insurance Company | \$ 163,336,903 |
| Legion and Villanova | \$ 767,481,237 |
| Fremont Indemnity Company | \$ 1,031,559,362 |

(4) Cash Flow Projections

At December 31, 2008, the Association had the ability to assess a maximum one-percent surcharge on workers' compensation premiums written in California. The premium charged to any member insurer for any of the three categories or a category established by the Association shall not be more than 2% of the net direct premium written in that category in this state by that member per year, starting on January 1, 2003, until December 31, 2007, and thereafter shall be no more than 1% per year.

The Association prepared a ten-year cash flow projection (2007 through 2017) which indicates that the Association has adequate funds to pay claims assuming that it receives proceeds from the issuance of additional bonds during 2011. The cash flow analysis does not incorporate a contingency provision for new insurer insolvencies. The Association utilizes this approach due to the uncertainties related to estimating new insurer insolvencies and the related cash payout patterns which may occur as a result of new insurer insolvencies.

The examiners reviewed the Association's ten-year cash flow projections. The cash flow projections were prepared utilizing a projected payout analysis developed by an actuary as of June 20, 2006. Although the Association's cash flow projections prepared as of June 2008 appears reasonable, it

should be noted that the Association operates in a very dynamic environment and many events known and unknown can materially affect the actual cash flows of the Association's workers' compensation fund.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Territory and Plan of Operation – Operational Review Findings - (Page 10): It is recommended that the Plan of Operation be amended to include details of the governance, management and accountability of the Association to the Commissioner and the members of the Association as detailed in the Operational Review Report.

Accounts and Records – Operational Review Findings – Financial Reporting – (Page 11): It is recommended in the Operational Review Report that the Association disclose material claims and administrative expenses that mirror those presented in an annual operating budget, as well as budget variances and explanations in its quarterly and annual financial statements.

Accounts and Records - Operational Review Findings – Information Technology Controls (Page 11): The Operational Review Report recommended the Association develop and implement an Information Technology Strategic Plan and an Information Technology budget.

Reserve for claims and claim adjustment expenses (Page 15): It is recommended that the Association obtain an annual actuarial evaluation of its claim liabilities to develop estimates of its future payout of reserves and loss adjustment expenses that includes a reconciliation of the underlying data. A similar recommendation was also made in the prior examination report.

Previous Report of Examination

Summary of Significant Findings – Cash Flow Projections: (Page 3): It was recommended that the Association obtain a full and comprehensive actuarial analysis for the purpose of estimating future workers' compensation claims payments in the preparation of its cash flow analysis. The Association did not comply with this recommendation.

Management and Control – Conflict of Interest (Page 6): It was recommended that the Association provide written conflict of interest disclosure forms to be signed by employees on an annual basis rather than the more informal approach currently utilized. In response to this recommendation, the Association provided written conflict of interest agreements to be signed by management staff on an annual basis.

Reserve for claims and claim adjustment expenses (Page 17): It was recommended that the Association obtain an actuarial opinion on the workers' compensation reserves as of June 30, 2006 including a reconciliation of the underlying data and a claim payout analysis which should be utilized in its cash flow projections. The Association did not comply with this recommendation.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

 /S/

Constance J. Korte, CFE
Examiner-In-Charge
Department of Insurance
State of California