

REPORT OF EXAMINATION  
OF THE

CALIFORNIA INSURANCE  
GUARANTEE ASSOCIATION

AS OF  
JUNE 30, 2011

A handwritten signature in black ink that reads "Dave Jones". The signature is written in a cursive style with a large, looping initial "D".

Insurance Commissioner

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Los Angeles, California  
June 1, 2012

Honorable Dave Jones  
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 its primary location of its books and records, 101 North Brand Boulevard, Suite 600, Glendale, California 91203.

**SCOPE OF EXAMINATION**

The previous examination of the Association was made as of June 30, 2008. This examination covers the period from July 1, 2008 through June 30, 2011. The examination was conducted in accordance with the National Association of Insurance Commissioners' Financial Condition Examiners' Handbook. The Handbook requires the planning and performance of the examination to evaluate the Association's financial condition, to identify prospective risks, and to obtain information about the Association, including corporate governance, identification and assessment of inherent risks, and the evaluation of the system controls and procedures used to mitigate those risks. The examination also included an assessment of the principles used and the significant estimates made by management, as well as an evaluation of the overall financial statement presentation. All accounts and activities of the Association were considered in accordance with the risk-focused examination process. The examination also included a review and analysis of the Association's projected cash flows through 2021.

In response to the findings of an independent consultant who was hired in 2007 by the Association's management to conduct a review of internal controls, the California Insurance Commissioner ordered a separate operational review. The Operational Review Public Report was issued on July 23, 2009; a summation of the more significant recommendations depicted therein and the Association's action plan in response to each such recommendation are referenced in this report under the caption "Operational Review Findings."

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: fidelity bonds and other insurance; pensions and insurance plans; and loss experience.

### SUBSEQUENT EVENTS

On October 2, 2011, the Governor of California signed Senate Bill 712 which extends the Association's borrowing authority for bonds issued to provide funds for covered claim obligations for workers' compensation claims, as specified, to January 1, 2023.

### 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 the Guarantee Act (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 from policyholders.

The Association has been in a deficit position, which coincides with the influx of workers' compensation insolvencies, since 2001.

### MANAGEMENT AND CONTROL

Management of the Association is vested in a thirteen-member board of governors (board), eleven of which are appointed by the California Insurance Commissioner, and one member each is appointed by the President pro Tempore of the California State Senate and the Speaker of the California State Assembly. Nine members shall be member insurers and 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.

A listing of the members of the board and principal officers serving at June 30, 2011 follows:

#### Governors

<u>Name</u>	<u>Principal Business Affiliation</u>
Tom Ault (1)	Lawyers' Mutual Insurance Company
John Boyle	Inter-Insurance Exchange of the Automobile Club of Southern California
Glen Brown	Fu-Gen, Inc.
Stephen Festa	Secretary and Treasurer-California Insurance Guarantee Association Employers Insurance Group
Bruce Friedberg	Fireman's Fund Insurance Company
Scott Hauge (2)	Vice Chairman-California Insurance Guarantee Association

<u>Name</u>	<u>Principal Business Affiliation</u>
	CAL Insurance Associates
Laszlo G. Heredy (3)	Mid-Century Insurance Company
Paul Mattera	Liberty Mutual Insurance Company
Thomas Rowe (4)	California State Compensation Insurance Fund
James M. Sevey (5)	Chairman-California Insurance Guarantee Association California Casualty Insurance Group
William Vainisi	Allstate Insurance Company
Harry Wilson	CPF Health Benefits Trust
Thomas Wilson	Monterey Peninsula Surgery Center LLC

#### Principal Officers

<u>Name</u>	<u>Title</u>
Wayne Wilson	Executive Director
John G. Horner	Deputy Executive Director
Richard L. Hurd	Director of Finance
Hal Fedora	Director of Audit

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(1) Mr. Ault retired from Lawyers Mutual Insurance Company and was replaced by Mr. Gary Davis, who was appointed to the board on 12/19/11.

(2) Mr. Hauge's appointment, which was served at the pleasure of the President Pro Tem of the California State Senate, was terminated effective 3/20/12. He was replaced by Mr. George Woolverton, who was appointed on 4/5/12.

(3) Mr. James Westerman was appointed on 12/19/11 to replace Mr. Heredy, who retired from Mid-Century Insurance Company. Effective 4/23/12, Mr. Ceglar, representing Mid-Century Insurance Company, was appointed to replace Mr. Westerman for the remainder of the three-year term ending 12/31/14.

(4) Mr. Rowe was replaced by Mr. Dan Sevilla of the California State Compensation Insurance Fund on 1/10/12.

(5) As of 12/31/12, the three-year term of the California Casualty Insurance Group expired. Mr. Sevey retired from the Company. The member insurer's seat remains vacant as of the date of this report.

### Management Agreements

Authorization for the direct management of the Association's investment portfolio has been granted to two separate investment management firms, Payden & Rydel and Western Asset Management Company. Both agreements have been in effect for over 15 years. Each firm is responsible for the management of a designated segment of the Association's investment portfolio. Within the confines of the Association's codified guidelines, each investment management firm has authority to execute transactions without prior consultation with the Association's management.

### Third Party Administrators

The majority of the Association's workers compensation claims are administered by third-party administrators (TPAs). As of June 30, 2011, there are three TPAs under contract: Broadspire, Sedgewick, and Intercare Holdings Insurance Services, Inc. Under limited circumstances, the Association has the right to cancel the contracts. Fees paid to the TPAs are based on the number of claims filed. Some of the claims handling fees were 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.

### Operational Review Findings

The following is a summation of the significant findings and recommendations depicted in the Operational Review Public Report and the Association's action plan in response to each such recommendation:

### Board Representation and Participation

Recommendation 1: Each Board member insurer should submit a written designation to the Association and the California Insurance Commissioner specifically naming the company's

individual Board representative. Member insurers should commit to attending all Board meetings and meetings of committees of which they are members.

Action Plan in Response to Recommendation 1: Since the representative proposed by the company is subjected to a review process by the California Department of Insurance, it was the decision of the Board that submitting the name of the representative to the Association was not necessary. It was further agreed that member insurers should commit to attending all Board meetings and meetings of committees of which they are members. A Board attendance policy was adopted at the November 10, 2009 meeting.

Recommendation 2: Insurers should be required to make formal written appointments of alternates to represent the company in the absence or departure from employment of the primary Board designee. It is recommended that each member designate one alternate.

Action Plan in Response to Recommendation 2: The Board decided not to implement the above referenced recommendation. It was decided that the individual Board member should be at liberty to designate an alternate on an as needed basis.

Recommendation 3: The Board should work with the Insurance Commissioner to facilitate recruitment of new members to fill existing or anticipated vacancies in order to provide new perspectives and expertise.

Action Plan in Response to Recommendation 3: It has been confirmed that this recommendation is already in practice.

Recommendation 4: When Board vacancies arise, the Board should assist the California Insurance Commissioner in the recruitment of new members.

Action Plan in Response to Recommendation 4: It has been confirmed that this recommendation is already in practice.

Recommendation 5: The Association should provide all new Board and committee members with formal orientation training and a policy and procedure manual.

Action Plan in Response to Recommendation 5: The above referenced recommendation has been implemented.

### Board Policy Governance

Recommendation 1: The Association should conduct a comparative analysis of the policy governance model of other similar non-profits entities such as other guarantee associations, which focus on governance of “ends” and not “means” versus the governance model currently used by the Association to determine potential enhancements to its current governance model.

Action Plan in Response to Recommendation 1: The Association prepared and distributed a survey to be shared with other guarantee associations on governance and oversight issues employed by those entities. The Association's management has represented that the survey results indicate that the Association's corporate governance practices surpassed that of similar entities.

Recommendation 2: The Board should hold an annual strategic planning session, in which strategic objectives are set and evaluated.

Action Plan in Response to Recommendation 2: The Board determined that the development of a concise annual plan, as opposed to a strategic plan, was appropriate which include a budget in summary form.

Recommendation 3: The Board should go beyond a traditional advisory role and engage in high level corporate governance and oversight, including: approval of a corporate philosophy, strategic plan, and mission; review and approval of an annual budget, business plan, risk assessment plan, financial objectives, and material transactions; monitor corporate performance against the budget, business and strategic plan; and granting authority to management for matters not reserved for the Board.

Action Plan in Response to Recommendation 3: The Board decided not to implement the above referenced recommendation. The inherent associated uncertainties engendered by the Association's dictated statutory function of paying covered claims of insolvent member companies precludes implementation of the recommendation.

#### Documentation of Governance and Board Policies

Recommendation 1: The Board should improve its governance documentation and record-keeping. Minutes of the Board and committee meetings should be transcribed in more detail with greater description of the discussions of the agenda items, actions taken, and votes of each member. Motions should clearly identify the individual making the motions, seconds, and the results of the vote.

Action Plan in Response to Recommendation 1: Upon review of the Board and committee minutes, it has been confirmed that the Association is currently in compliance with the above referenced recommendations.

Recommendation 2: Board and committee agendas should be more descriptive of items to be presented and actions to be taken. Agenda items should include staff or consultant recommendations with a written analysis supporting the recommendations.

Action Plan in Response to Recommendation 2: Upon review of documentation depicting Board and committee agendas, it has been confirmed that the Association is currently in compliance with the above referenced recommendations.

Recommendation 3: Resolutions should be used for all major Board actions and should be maintained in a formal resolution binder. Such resolutions should be used for actions which in the past would have been taken by regular Board actions and referenced in Board minutes.

Action Plan in Response to Recommendation 3: The Board decided not to implement the above referenced recommendation. If it is deemed critical that a separate binder of resolutions be maintained, management has indicated that it can readily be accomplished.

Recommendation 4: The Association should begin preparing for compliance with the new requirement for open meetings pursuant to Senate Bill SB1467, Chapter 407, Statutes of 2007-08, effective January 1, 2009. The Board should be trained by legal counsel on how to conduct meetings pursuant to California Insurance Code (CIC) Section 1063.17.

Action Plan in Response to Recommendation 4: The Association's Plan of Operation was amended to incorporate procedures for compliance with CIC Section 1063.17.

Recommendation 5: Minutes of committee meetings should be kept, with actions and recommendations clearly detailed. Attendees should be identified in the minutes.

Action Plan in Response to Recommendation 5: Upon review, it has been confirmed that the above referenced recommendation has been implemented.

### Committee Structure

Recommendation 1: A new committee structure should be established, with the following standing and ad hoc committees: executive, audit, finance and investment, claims, and nominating.

Action Plan in Response to Recommendation 1: It was the decision of the Board to have a committee structure comprised of three committees: executive, audit and finance, and investment. The Board decided not to establish a claims and nominating committee.

Recommendation 2: The responsibilities and authorities of all committees should be specified in the Association's Plan of Operation.

Action Plan in Response to Recommendation 2: Upon review, it has been confirmed that the responsibilities and authorities of all committees are now specified in the Association's Plan of Operation.

Recommendation 3: Membership and/or participation of non-Board members should be allowed on certain committees. These committees should be filled with at least one or two Board members and should include experts in certain disciplines.

Action Plan in Response to Recommendation 3: The Association's Plan of Operation was amended to allow non-Board members to serve on the committees.

### Legal Representation

Recommendation 1: The Board should retain a general legal counsel. This counsel should report directly to the Board.

Action Plan in Response to Recommendation 1: The Board concluded that the Board itself does not have the need for a separate general legal counsel.

Recommendation 2: A cost-benefit analysis should be performed on whether the position of general legal counsel should be an employee or on a contract basis with an individual in a legal firm experienced with public or private non-profit clients.

Action Plan in Response to Recommendation 2: Management concluded that the matters identified as responsibilities of the general legal counsel did not justify a full time in-house employee and the associated costs that would be created.

### Management and Vendor Oversight

Recommendation 1: The Board should develop management performance and accountability measures.

Action Plan in Response to Recommendation 1: As described in the action plan in response to a prior recommendation, the Association has developed a concise annual plan including a budget in summary form. Management has represented that this annual plan and budget serve as a benchmark for evaluating management's performance and accountability.

Recommendation 2: The Board should require an annual written report from management to the Board on all major activities that includes specific accountability measures.

Action Plan in Response to Recommendation 2: The Board determined that it will not require an annual written report from management on all major activities that includes specific accountability measures. Rather, management will be directed to create a power point presentation to be presented to the Board highlighting the results attained compared to the expectations outlined in the annual plan.

Recommendation 3: Management should require that all major service providers prepare annual stewardship reports.

Action Plan in Response to Recommendation 3: The Board determined that management should report to the Board, a summary of the findings contained in the annual stewardship reports presented to the Association's management by its service providers.

### Budget Process and Development

Recommendation 1: The Board, through the finance and investment committee, should review, approve, and adopt an annual operating budget of projected revenues and expenses for the fiscal year.

Action Plan in Response to Recommendation 1: The Board concluded that it is not practical for the Association to produce a budget to project revenues. Management has represented that the inherent uncertainty surrounding recoveries and distributions made by liquidators makes the projection of revenues and the resulting comparison of budgeted revenues to actual revenues to be a difficult if not impossible task.

Recommendation 2: The Board should receive a comparison of budgeted revenues and expenditures to actual results in conjunction with the presentation of the quarterly internal financial statements.

Action Plan in Response to Recommendation 2: Comparisons are now prepared on a quarterly basis.

### Workers' Compensation Bill Review Analysis

Recommendation 1: The Association's Purchasing Policy should include a specific process for management and, when appropriate, Board review and approval of all vendor contracts.

Action Plan in Response to Recommendation 1: This recommendation has been implemented.

Recommendation 2: Unless cost savings (or other operational efficiencies) are provided, the Association should pursue future bill review contracts separate from the third-party administrator (TPA) contracts and with companies not associated with the TPA providing administration services. Documentation of projected savings on any future bundled contracts should be provided to the Board as part of its approval process.

Action Plan in Response to Recommendation 2: This recommendation has been implemented.

Recommendation 3: All current TPA and bill review contracts should be reviewed to determine if the contracts encompass all services currently provided by each vendor as well as to verify the accuracy and acceptance of all billing rates.

Action Plan in Response to Recommendation 3: This recommendation has been implemented.

## Third Party Claims Administration Procurement and Contracts

Recommendation 1: The Association should develop standardized fees and payment schedules, along with measurable performance standards and expectations that should be coordinated with during the audit process.

Action Plan in Response to Recommendation 1: This recommendation has been implemented.

Recommendation 2: The Association should develop a consistent contracting process to include a review of the initial contract with standardized review intervals. This process should also document a standardized method by which a contract would be terminated.

Action Plan in Response to Recommendation 2: This recommendation has been implemented.

Recommendation 3: The Association should review and evaluate the basis and process for the consolidation and related costs associated with the transition of cradle to grave contracts.

Action Plan in Response to Recommendation 3: Currently, the Association has only one cradle to grave contracts. The Association has no plans to terminate this contract because of the associated increased costs. As the Association has no plans to consolidate this contract to monthly fee or other fee basis contract, it does not see the need to evaluate the basis and process for such a consolidation.

## Internal Audit

Recommendation 1: The Association should develop a comprehensive policy describing the scope of authority of the Internal Audit Department. This policy should require that the Department report directly to the Board or an audit committee.

Action Plan in Response to Recommendation 1: The above referenced recommendation has been implemented.

Recommendation 2: The Board should authorize development of a comprehensive internal audit process that includes developing an Internal Audit Activity Charter, Audit Committee Charter, Internal Audit Manual, audit process, and reporting process.

Action Plan in Response to Recommendation 2: The above referenced recommendation has been implemented.

## Workers' Compensation Audit Analysis

Recommendation 1: The Association should utilize existing resources such as the State Audit Unit annual reports, Field Claims Bureau Referrals and Department of Insurance complaints to determine appropriate areas of review, with a focus on the Association vision of assuring “that the Association Claim Department staff and Third Party Administrators are administering benefits statutorily and in a timely manner.”

Action Plan to Response to Recommendation 1: The Association has represented that it is in compliance with the above referenced recommendation

Recommendation 2: The audit categories should be evaluated on a yearly basis with a focus on industry expectations and contract compliance. Continued review of the target scores and their impact to the overall Association program should be conducted at least annually

Action Plan in Response to Recommendation 2: The Association has represented that it is in compliance with the above referenced recommendation.

## Information Technology General Controls Assessment

Recommendation 1: The Association should develop and implement an Information Technology (IT) Strategic Plan to ensure IT initiatives comply with governance requirements that potentially impact the organization's goals and responsibility to the public by management and the Board.

Action Plan in Response to Recommendation 1: The Association's IT Steering Committee approved the above referenced recommendation.

Recommendation 2: The Association should develop and implement a formal annual IT budget.

Action Plan in Response to Recommendation 2: The IT budget is a component of the Association's overall budget.

## Legal Contract Review

Recommendation 1: The Association should assign a designated person(s) to focus on the current legal contract review process to continually monitor their agreements to ensure that they have been properly executed, that the required insurance/indemnity protection has been secured prior to the beginning of the work or service (and continuously maintained), and that any conflict of interest situations are disclosed and either approved or waived.

Action Plan in Response to Recommendation 1: The Association has purchased contract management software and has entered information on its various vendor contracts. The system is configured to generate a message to the Association's Treasurer with regard to each contract in

advance of contract anniversaries that will trigger annual contract reviews for the items noted in the recommendation.

Recommendation 2: The Association should develop a model services agreement with clear and unambiguous language regarding legal execution, termination, indemnification/hold harmless protection, transfer of risk techniques, insurance requirements, and conflict of interest situations. Since the failure to provide evidence of insurance coverage is, by contract, a material breach of the agreement, this will give the Association leverage to negotiate, monitor, track and enforce agreements with outside vendor/contractors.

Action Plan in Response to Recommendation 2: The Association has developed a model contract for Third Party Administrator (TPA) services that include the items noted in this recommendation and has utilized it in its two most recent TPA contracting endeavors.

Recommendation 3: All agreements must clearly specify the "effective date" that services are to begin, the exact insurance limits and protection required for each loss exposure, and that any actual or perceived conflict of interest situations are addressed prior to the effective date of the agreement(s).

Action Plan in Response to Recommendation 3: This recommendation has been implemented.

### Financial Statement and General Ledger Analysis

Recommendation 1: The Association should disclose the following additional information in its quarterly internal financial statements and such statements should be formally accepted by the Board of Governors.

- a. Material claims and administrative expenses that mirror those presented in the annual operating budget;
- b. Actual revenue and expense results compared to the annual operating budget and percentage of the budget expended; and
- c. Narrative explanation of material budget variances.

The Association should also disclose material claims and administrative expenses in its annual audited financial statements.

Action Plan in Response to Recommendation 1: This recommendation has been implemented.

Recommendation 2: The Association should obtain an annual actuarial evaluation of its claim liabilities to develop estimates of its future payout of reserves and allocated and unallocated loss adjustment expenses.

Action Plan in Response to Recommendation 2: This recommendation has been implemented.

Recommendation 3: The Association Board or the Audit Committee should initiate a request for proposal for independent financial audit services prior to the commencement of the audit of the fiscal year ending June 30, 2009.

Action Plan in Response to Recommendation 3: The Association has implemented this recommendation.

Recommendation 4: The Board should formally receive and adopt the audited annual financial statements within a time frame established by the Board.

Action Plan in Response to Recommendation 4: The Association has implemented this recommendation.

### Human Resources

Recommendation 1: The Human Resources Department should develop a formally stated purpose, clearly identifying the chain of command for anticipated and potential complex situations.

Action Plan in Response to Recommendation 1: The Association has implemented this recommendation.

Recommendation 2: New job descriptions should be developed for the Human Resources Department with clear and authoritative responsibility.

Action Plan in Response to Recommendation 2: The Association has implemented this recommendation.

Recommendation 3: The Association should conduct a market-based compensation analysis to ensure that pay at all levels is competitive and reasonable within the market to attract and retain qualified employees.

Action Plan in Response to Recommendation 3: The Association has implemented this recommendation.

Recommendation 4: The Association should develop new personnel and operational policies, comprehensive in scope, that contributes to the Association's business operations and efficient management.

Action Plan in Response to Recommendation 4: The Association has implemented this recommendation.

Recommendation 5: The Association should conduct a review of current legally required practices for personnel recordkeeping and should modify any practices which are not in full compliance.

Action Plan in Response to Recommendation 5: The Association has implemented this recommendation.

Recommendation 6: Human Resources should participate in documented consultative decision making with executive management.

Action Plan in Response to Recommendation 7: The Association has implemented this recommendation.

Recommendation 7: The Association should annually evaluate its business plan, with a Human Resources review, to include areas such as recruitment strategy, benefits and compensation plan, anticipated turnover, succession planning, and workplace culture.

Action Plan in Response to Recommendation 7: The Association has implemented this recommendation.

#### Plan of Operation

The Operational Review also provided recommendations for the adoption of amendments to the Association's Plan of Operation. The Board considered each of those recommendations at its special Board meeting on October 28, 2009 and came to the decisions on those matters as described below:

#### New committee structure:

The Board agreed to adopt a new committee structure comprising of an executive committee, an audit committee, and a finance and investment committee as outlined in its discussion of Action Plan in Response to "Committee Structure" Recommendation number 1. The Board directed that management prepare Plan of Operation amendments for review by the Board at a future meeting that reflects the new committee structure.

### Specific duties and responsibilities of each committee:

The Board discussed this recommendation and felt that it was likely that the duties and responsibilities of the committees could change from time to time. The Board originally concluded that implementation of this recommendation, would perhaps necessitate frequent changes to the Plan of Operation was not feasible and directed management not to prepare or pursue plan amendments in this regard. However, the Board subsequently decided to specify the responsibilities and authorities of the committees. The Board directed that committee charters be prepared and presented to the Board for review and approval at a future meeting.

### Requirements for clear designations of Board members and alternates

The Board's decision on designations of Board members and alternates is set forth in their Action Plans in Response to "Board Representation and Participation" Recommendations 1 and 2. The Board concluded that based on their responses to Recommendations 1 and 2 as previously discussed, management should not pursue or prepare Plan of Operation amendments on designation of Board members and alternates.

### Duties of officers, including consideration of the position of Treasurer

The Board discussed amending the Plan of Operation to include clearer definitions of the posts of Chairman, Vice Chairman, and Secretary-Treasurer. It was agreed that the Plan of Operation should be revised to clearly state the duties of each of these Board positions and indicate that the chair was the primary liaison with the executive director. The Board's discussion, which included a review of how Board members moved thru officer positions within the organization, led to the conclusion that there was no need for the separate position of treasurer.

### Mission Statement reflecting the Board's governance philosophy and management accountability

The Board concluded that there was no necessity to have such a mission statement or to include one in the Plan of Operation. It was noted that Association's mission is to pay covered claims consistent with law as set forth in statute.

### Specific authority reserved to the Board

The Board determined that the Board does discuss discreet issues over which they wish to retain authority. The Board appoints an executive director who functions as a Chief Executive Officer for the Association and who has the Board's delegated authority. The Board discussion indicated that current Board policies such as the investment guidelines and the purchasing policy, by way of example define issues reserved to the Board. Accordingly, the Board concluded that there was no need to make reference to its specific authority in the Plan of Operation.

### Responsibilities and authority of the Executive Director

The Board stated that the responsibilities and authority levels of the executive director are broad based and comparable to those of a chief executive officer. The Board concluded that management should prepare Plan of Operation amendments for review by the Board at a future meeting reflecting that the executive director is charged with the responsibility for overseeing the day to day operations of the organization with the power to and make crucial management decisions.

### Meeting procedures for compliance with the Open Meetings Act

During the Board's discussion of this topic, it was noted that the framework for open meetings is well defined in the statute and, in the opinion of the Board, should not be referenced in the Plan of Operation. It was noted that the Association counsel conducted a power point presentation for Board members at the February 2009 Board meeting to familiarize them with the requirements of

the act. Accordingly, the Board directed that management should not pursue or prepare Plan of Operation amendments on this topic.

#### Appointment of a general counsel by the Board with duties and responsibilities detailed

The Board concluded during its discussion of its Action Plan in Response to “Legal Representation” Recommendation number 1 described above that the appointment of a general counsel to represent the Board is not justified. Accordingly, the Board directed that management should not pursue or prepare Plan of Operation amendments.

#### Annual adoption of a budget and submission to the California Insurance Commissioner

The Board discussed this recommendation and concluded that the inclusion of a provision for the annual adoption of a budget consistent with the discussion of the appropriate scope for the budget as described in the discussion of the Action Plan in Response to “Budget Process and Development” Recommendation number 1 in the manner as outlined in the discussion of the Action Plan in Response to “Board Policy Governance” Recommendation number 2 would be appropriate and directed that management should prepare general Plan of Operation amendments for review by the Board at a future meeting. As the representatives of the Commissioner attend all Board and committee meetings and receive Board materials, the Board decided that there was no necessity to require submission of the budget to the Commissioner in the Plan of Operation.

#### Annual Reporting to the California Insurance Commissioner, members, and the California employer community

The Board discussed the nature of reporting that has historically been done. It was noted that the Association has historically prepared a report to members outlining the financial aspects of the organization’s operations. After discussion, which included reference to the fact that modern practice supports web based information dissemination, the Board directed that the Association’s

audited financial statements should be put on the Association website. The Board also directed that management should not pursue or prepare Plan of Operation amendments on this topic.

A requirement for the adoption of a strategic plan

The Board discussed whether the adoption of a strategic plan was appropriate as noted under the Action Plan in Response to “Board Policy Governance” Recommendation number 2 and concluded that an annual plan as outlined in that discussion was appropriate instead. Accordingly, the Board directed that management should not pursue or prepare Plan of Operation amendments on this topic.

A requirement for the adoption of organizational, management and service provider performance measures and evaluations

Following discussion of this topic as outlined under the Action Plan in Response to “Management and Vendor Oversight” Recommendations number 2 and 3, the Board directed management to report to the Board in summary fashion on these issues, identifying problems and corrective actions as necessary. Accordingly, the Board directed that management should not pursue or prepare Plan of Operation amendments on this topic.

A requirement for the annual review and approval by the Board of the Association’s investment policy

The Board discussed the process that had been used for development of its investment guidelines. At the conclusion of the discussion, the Board concluded that its investment guidelines should be reviewed at least annually and directed that management prepare general Plan of Operation amendments for review by the Board at a future meeting on this topic.

The Board, additionally, directed management to engage in discussions with representatives of the California Department of Insurance on other appropriate amendments or updates that would

be desirable to the Plan of Operation and to prepare proposed amendments on those topics to be presented to the Board at a future meeting.

### TERRITORY AND PLAN OF OPERATION

The purpose of the Association is to provide insolvency insurance for each member insurer and to protect policyholders against loss arising from the failure of an insolvent, admitted insurer to discharge its obligations under its insurance policies. The Association obtains funds to pay its covered claims through assessments, release of special statutory security deposits previously placed with the State of the insolvent carriers, distributions from insolvent carriers' estates and investment income.

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 court of competent jurisdiction 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 assessments 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 \$500,000 per claim or the policy limits, whichever is lower.

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, additional premium charges are assessed member insurers 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 rate of premium charges to each member is initially based on the written premium shown on the latest year's annual financial statement on file with the California Insurance Commissioner. Effective September 7, 2002, the Governor of the State of California signed Assembly Bill 2007 which amends the applicable CIC Sections governing the operations of the Association, extending the maximum annual premium charge of 2% until December 31, 2007, and thereafter shall not be more than 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 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, 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 of and interest on the bonds. Any bonds issued to provide funds covered claim obligations for workers' compensation claims shall be issued prior to January 1, 2023 in an aggregate principal amount outstanding at any one time not to exceed \$1.5 billion. Bonds outstanding totaled \$618 million at June 30, 2011.

As of June 30, 2011, the Association is providing insolvency insurance for 130 insolvent companies, including both active and inactive insurers. Effective September 29, 2005, the Governor of California signed Assembly Bill 817 (AB817). AB817, which amends the CIC Section 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 therefore, are subject to the per claim limit of \$500,000.

### REINSURANCE

Reinsurance entered into by insurers prior to their insolvencies is administered by the California Department of Insurance, Conservation and Liquidation Office (CLO) or the domestic liquidator of a non-California domiciled company, and is therefore excluded from the Association's

financial statements. Reinsurance recoveries made by the CLO or the domestic liquidator 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 basis with the fiscal year ended 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).

### FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of June 30, 2011

Statement of Income and Changes in Surplus Funds  
for the Fiscal Year Ended June 30, 2011

Statement of Cash Flows  
for the Fiscal Years Ended June 30, 2011

Statement of Financial Condition  
as of June 30, 2011

<u>Assets</u>	<u>June 30, 2011</u> <u>Per Examination</u>	<u>Notes</u>
Cash and short-term investments:		
Unrestricted	\$ 131,978,963	
Restricted for workers' compensation claims, debt service and leases	104,976,434	
Investments in debt securities available for sale, at fair value:		
Unrestricted	2,270,600,577	
Restricted for workers' compensation claims	236,538,849	
Accrued investment income	12,552,688	
Premium charges receivables		
Unrestricted	77,858,750	
Restricted for principal and interest payments on bonds payable	83,355,391	
Unamortized bond issue costs	3,066,801	
Fixed assets, net	1,365,922	
Deposits and other assets	<u>1,098,761</u>	
 Total assets	 <u>\$ 2,923,393,136</u>	
 <u>Liabilities and Fund Deficit</u>		
Reserve for claims	\$ 3,177,393,381	(1)
Reserve for claim adjustment expenses	397,921,000	(1)
Reserve for administrative expenses	88,316,000	(1)
Book overdraft	27,168,068	
Reserve for unearned premiums	5,014,000	
Assessment returns due to members	122,969,524	
Bonds payable	617,826,623	(2)
Accrued interest expense	4,690,867	
Accounts payable	<u>7,293,498</u>	
 Total liabilities	 4,448,592,961	
 Surplus Funds:		
Fund balance	\$(1,556,462,391)	(3)
Accumulated other comprehensive gain	<u>31,262,566</u>	
 Total Surplus Funds	 <u>(1,525,199,825)</u>	
 Total liabilities and surplus funds	 <u>\$ 2,923,393,136</u>	

Statements of Income and Changes in Surplus Funds  
for the Fiscal Year Ended June 30, 2011

	<u>Fiscal Year Ended</u> <u>June 30, 2011</u>
Assessments and investment activity:	
Premium charges declared	\$ 117,275,376
Net investment income	52,464,341
Net realized gain	8,271,431
Liquidator activity:	
Advances from liquidators	<u>523,829,566</u>
Total income	701,840,714
Claims activity:	
Claims paid	\$ (142,229,608)
Claim adjustment expenses paid	(59,294,511)
Increase in reserve for claims	(78,140,174)
Increase in reserve for claim adjustment expenses	<u>(4,931,001)</u>
	(284,595,294)
Policy unearned premiums activity:	
Unearned premiums paid	(2,836,179)
Decrease in reserve for unearned premiums	<u>25,000</u>
	(2,811,179)
Administrative expense activity:	
Administrative expense paid	(30,775,183)
Interest expense	(14,563,426)
Increase in reserve for administrative expenses	<u>(7,486,000)</u>
	<u>(52,824,609)</u>
Total Expenses	(340,231,082)
Net income	361,609,632
Accumulated other comprehensive loss	(10,054,837)
Surplus funds at beginning of period	<u>(1,876,754,620)</u>
Surplus funds at end of period	<u><u>\$ (1,525,199,825)</u></u>

Statements of Cash Flows  
for the Fiscal Year Ended June 30, 2011

	Fiscal Year Ended June 30, 2011
Cash flows from operating activities:	
Net income	\$ 361,609,632
Adjustments to reconcile net income to net cash provided	
By operating activities:	
Amortization	\$ (2,320,096)
Depreciation of fixed assets	1,612,662
Loss on disposal of fixed assets	340,327
Gain on sale of investments, net	(8,271,431)
Decrease (increase) in:	
Premium charges due from members	\$ (11,610,014)
Accrued investment income	(196,800)
Deposits and other assets	<u>(436,774)</u>
Total	(20,882,126)
Increase (decrease) in:	
Reserve for claims, claim adjustment and administrative expenses	\$ 90,557,174
Book overdraft	(2,251,202)
Reserves for policy unearned premiums	(25,000)
Assessment returns due to members	28,912,067
Accrued interest expense	(810,112)
Accounts payable	<u>4,110,441</u>
Total	<u>120,493,368</u>
Net cash provided by operating activities	<u>461,220,874</u>
Cash flows from investing activities:	
Debt securities available-for-sale:	
Purchases, unrestricted	\$ (2,389,694,405)
Proceeds from sales, unrestricted	1,461,031,442
Proceeds from calls or maturities, unrestricted	592,212,062
Purchases, restricted for workers' compensation claims, debt services and leases	(302,576,247)
Proceeds from sales, restricted for workers' compensation claims and debt service	93,020,318
Proceeds from calls or maturities, restricted for workers' compensation claims and debt service	204,965,441
Purchase of fixed assets	<u>(1,462,857)</u>
Net cash used in investing activities	<u>(342,504,246)</u>
Cash flows from financing activities:	
Redemption of bonds	<u>(67,685,000)</u>
Increase (decrease) in cash and short-term investments	51,031,628
Cash and short-term investments at beginning of period	<u>185,923,769</u>
Cash and short-term investments at end of period	<u>\$ 236,955,397</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 with an actuarial report issued by Dale F. Ogden and Associates, (Ogden) prepared as of June 30, 2011.

For each year covered by this examination, the Association's external auditors issued a qualified opinion on the financial statements. 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."

A Casualty Actuary from the California Department of Insurance (Casualty Actuary) has opined that since the Association is an insolvency fund, the amount of loss and loss adjustment expense reserves are impractical to calculate with any degree of precision: Loss data emanating from different insurers with differing levels of data integrity create practical limits on producing loss estimates. With consideration given to the ability of the Association to issue additional bonds for funding as well as ongoing premium charges, the Casualty Actuary concluded that the Association does not require precise reserve requirements to function properly.

### (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 in fixed rate and \$350 million in variable rate Workers' Compensation Relief Bonds. Net proceeds from the issuance of the bonds were approximately \$774.8 million.

At June 30, 2011, the carrying value of the bonds was \$617.8 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 referenced in the following schedule, the Association's workers' compensation fund balance as of June 30, 2011 indicated a deficit of \$2.5 billion. In total, for all categories of business, the fund deficit reported by the Association was approximately \$1.6 billion.

<b>Category of Business</b>	<b>Fund Balance (deficit) as of June 30, 2011</b>
Workers' compensation	\$ (2,499,332,000)
Automobile and homeowners	379,930,704
All other	<u>562,938,905</u>
Total fund deficit	<u>\$ (1,556,462,391)</u>

The above depicted fund deficit results primarily from several workers' compensation insurer insolvencies. As of June 30, 2011, the deficits pertaining to the largest insolvencies were as follows:

<b>Workers' Compensation Insolvencies</b>	<b>Fund Deficits as of June 30, 2011</b>
Superior National Group	\$1,755,851,056
HIH & Great States Insurance Companies	\$ 407,896,622
Credit General Group	\$ 128,040,925
Reliance Insurance Company	\$ 405,436,714
PAULA Insurance Company	\$ 154,261,551
Legion and Villanova Insurance Company	\$ 680,363,507
Fremont Indemnity Company	\$1,508,348,556

Management has represented that it intends to fund the deficit in the workers' compensation line of business through annual assessments of premium charges to member companies, distributions from the estates of insolvent insurers, investment income, and the ability to issue bonds. To meet short-term liquidity needs, the Association may borrow from the other lines of business. However, the Association's Plan of Operation requires these borrowings from other categories to be in the form of loans which are the irrevocable obligation of the workers' compensation fund to repay, together with interest, and any such borrowings must be approved by the California Insurance Commissioner.

#### (4) Cash Flow Projections

Upon analysis, a Casualty Actuary from the California Department of Insurance has concluded that the cash flow forecasts reviewed by the Association's Board of Governors are adequate to assess the potential funding short-falls over the ten-year time horizon under which the Association evaluates its financial position.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

None.

### Previous Report of Examination

Territory and Plan of Operation – Operational Review Findings - (Page 10): It was 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 Public Report. The Association’s response to each of the recommendations calling for an amendment to the Plan of Operation is detailed in the “Plan of Operation” subheading of the “Operational Review Findings” section of this report.

Accounts and Records – Operational Review Findings – Financial Reporting – (Page 11): It was recommended in the Operational Review Public 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. This recommendation has been implemented.

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

Reserve for claims and claim adjustment expenses (Page 15): It was 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, which includes a reconciliation of the underlying data. A similar recommendation was also made in the prior examination report. The Association is now subject to an annual actuarial evaluation. Due to the lack of historical loss

experience for periods prior to the Association's involvement with each estate, the recommendation relating to the reconciliation of underlying data has not been implemented.

ACKNOWLEDGEMENT

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

Respectfully submitted,

A handwritten signature in black ink that reads "David A. Fischman". The signature is written in a cursive style with a prominent initial "D".

David A. Fischman, CFE  
Examiner-In-Charge  
Senior Insurance Examiner  
Department of Insurance  
State of California