REPORT OF EXAMINATION

OF THE

CALIFORNIA EARTHQUAKE AUTHORITY

AS OF

DECEMBER 31, 2017

Insurance Commissioner

FILED JUN 05 2019

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San Francisco, California
May 20, 2019

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

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

CALIFORNIA EARTHQUAKE AUTHORITY

(hereinafter also referred to as the CEA) at its home office located at 801 K Street, Sacramento, California 95814.

SCOPE OF EXAMINATION

We have performed our examination of the CEA. The previous examination of the CEA was as of December 31, 2013. This examination covered the period from January 1, 2014 through December 31, 2017.

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 CEA'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 the CEA's surplus to be materially misstated both currently and prospectively.

All accounts and activities of the CEA were considered in accordance with the risk-focused examination process. This includes 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 CEA's financial statements.

This examination report includes findings of fact and general information about the CEA and its financial condition. There may 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 CEA.

CEA HISTORY

The CEA was created in 1996 pursuant to California Insurance Code (CIC) Section 10089.6 to transact insurance in California as necessary to sell residential earthquake insurance in the manner set forth in CIC Sections 10089.26 through 10089.28. It commenced operations in December 1996.

MANAGEMENT AND CONTROL

Pursuant to California Insurance Code (CIC) Section 10089.7(a), the CEA is governed by a three-member Governing Board consisting of the Governor, the State Treasurer, and the Insurance Commissioner, each of whom may name designees to serve as board members in their place. The Speaker of the Assembly and the Chairperson of the Senate Rules Committee serve as nonvoting, ex officio members of the Governing Board, and may name designees to serve in their place.

CIC Section 10089.7(c) provides that the Governing Board shall have the power to conduct the affairs of the CEA, and may perform all acts necessary or convenient in the exercise of that power.

A listing of the members of the Governing Board and principal officers serving on December 31, 2017 follows:

Governing Board

Name and Location	Principal Business Affiliation
Edmund G. Brown [(A)] Oakland, California	Governor State of California
John Chiang [(A)] Sacramento, California	Treasurer State of California
Dave E. Jones [(A)] Sacramento, California	Insurance Commissioner State of California
Anthony Rendon* Los Angeles, California	Speaker of the Assembly State of California
Kevin A. Leon* Los Angeles, California	Chairman of the Senate Rules Committee State of California

**Non-voting members*

Principal Officers

Name	Position
Glenn Pomeroy	Chief Executive Officer
Timothy Richison [(B)]	Chief Financial Officer
Todd Coombes [(C)]	Chief Information Officer
Christopher Nance	Chief Communications Officer
Janiele Maffei	Chief Mitigation Officer
Shawna Ackerman	Chief Actuary
Kellie Schneider	Chief Operations Officer

The following changes in management and the Board occurred subsequent to the examination date:

(A) Effective January 7, 2019, Gavin Newsom replaced Edmund G. Brown as the State Governor; Fiona Ma replaced John Chiang as the State Treasurer; and Ricardo Lara replaced Dave Jones as the Insurance Commissioner.

(B) Effective January 31, 2019, Timothy Richison retired as Chief Financial Officer. Thomas Hanzel was hired as a replacement, effective February 27, 2019.
(C) Effective February 28, 2019, Todd Coombes resigned as Chief Information Officer. The position is currently vacant.

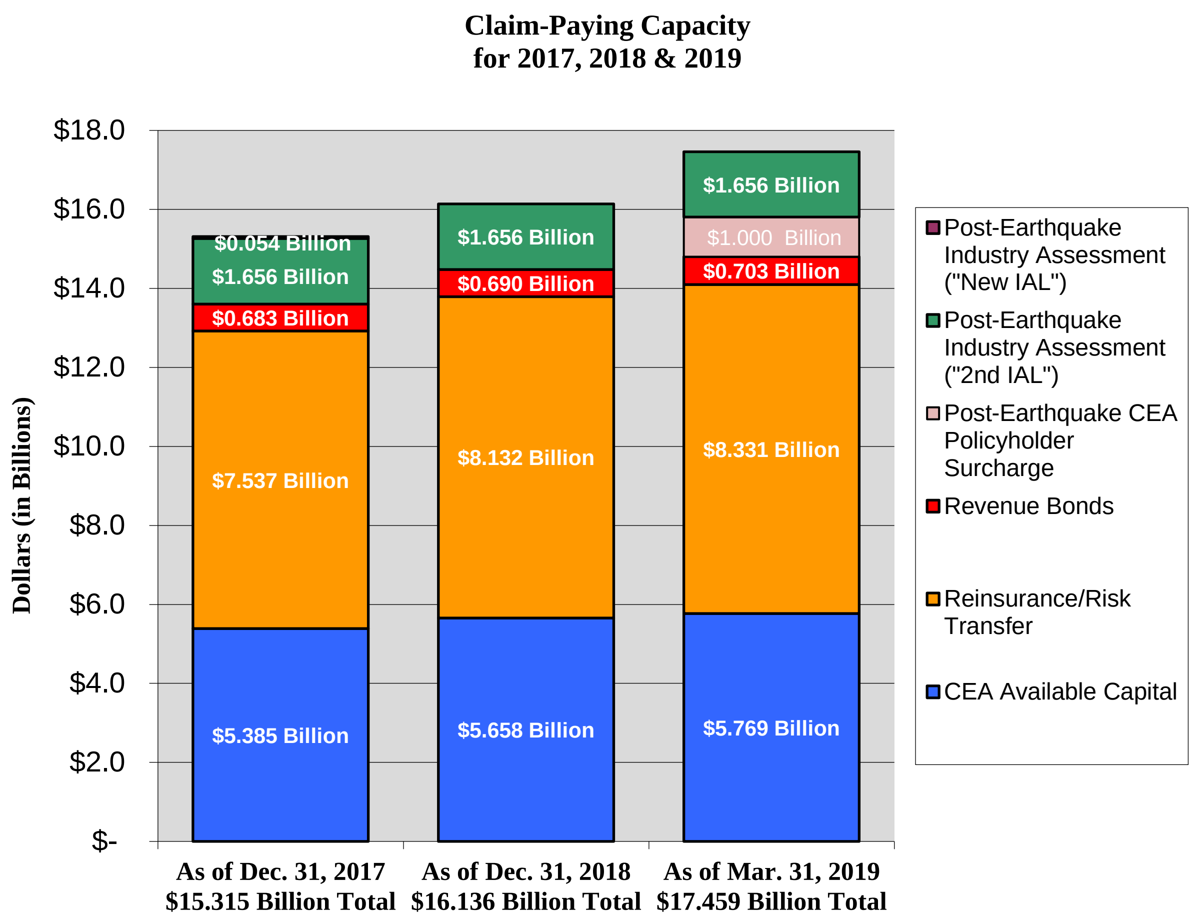
Insurer Participation Agreements

Services are performed on behalf of the CEA by the participating insurers pursuant to the terms of the Insurer Participation Agreements signed by the CEA and each participating insurer. These services include policy administration and claims settlement. Refer to the "TERRITORY AND PLAN OF OPERATION" section for more information on the participating insurers.

CLAIM-PAYING CAPACITY

As of December 31, 2017, the CEA reported a total claim-paying capacity of $15.315 billion. The CEA's claim-paying capacity comes from CEA's available capital ($5.385 billion), reinsurance/risk transfer ($7.537 billion), revenue bonds ($683 million), post-earthquake industry assessments under California Insurance Code (CIC) Section 10089.30 ($1.656 billion), and post-earthquake industry assessments under CIC Section 10089.31 ($54 million).

As of December 31, 2018, the CEA's claim-paying capacity increased to $16.136 billion. The increase is primarily due to increases in available capital and reinsurance coverage. However, the post-earthquake industry assessments under CIC Section 10089.31 was reduced to zero as of April 1, 2018, pursuant to CIC Section 10089.33(b)(1). As of March 31, 2019, the claim-paying capacity increased to $17.459 billion. The increase is mainly attributed to the addition of a $1 billion Post-Earthquake CEA Policyholder Surcharge layer (Please refer to the "Post-Earthquake CEA Policyholder Surcharge" section below for more information). A chart illustrating the sources of the claim-paying capacity for 2017, 2018 and 2019 is shown below:



Revenue Bonds

CIC Section 10089.10(b) authorizes the CEA, through the Treasurer, to enter capital market contracts for the purpose of expanding CEA's capacity and achieving maximum capacity for writing earthquake coverage. In 2006, the CEA issued $315 million in revenue bonds pursuant to CIC Section 10089.10(b). The 2006 revenue bonds matured on July 1, 2016.

On November 6, 2014, the CEA issued Series 2014 revenue bonds totaling $350 million. The issuance is comprised of three serial bonds: 2-year Series Bond issued at $40 million with a 1.194% interest rate, 3-year Series Bond issued at $60 million with a 1.824% interest rate, and 5-year Series Bonds issued at $250 million with a 2.805% interest rate. The $40 million and $100 million bonds matured in 2016 and 2017, respectively. The outstanding principal on the remaining bond issue was $210 million as of December 31, 2017.

Post-Earthquake CEA Policyholder Surcharge

In 2019, a new $1 billion Post-Earthquake CEA Policyholder Surcharge layer was added to the CEA's claim-paying capacity. This new layer was added through the passage of Assembly Bill No. 2927 (AB 2927), which the California Legislature adopted and the Governor signed on September 27, 2018. Effective on January 1, 2019, AB 2927 amended CIC Sections 10089.23 and 10089.29 by providing a mechanism for the CEA to more readily access $1 billion of claim-paying capacity from standby CEA-policyholder surcharge debt. CIC Section 10089.29 authorizes the CEA to issue and sell investment grade revenue bonds or secure other debt financing, or both, in amounts not to exceed $1 billion, plus related costs if claims and claim expenses incurred by the authority from an earthquake event exhaust the total of the following: (A) The authority's available capital; (B) The maximum amount of all contributions of initial operating capital made by participating insurers pursuant to Section 10089.15, and assessments levied and paid pursuant to Section 10089.23; (C) All reinsurance actually available and under contract to the authority; and (D) All risk transfer provided and any other capital committed through capital market contracts that is actually under contract to the authority from private capital markets. The CEA is authorized to surcharge annually all CEA policyholders up to 20 percent of each policyholder's annual earthquake insurance policy premium to repay the bonded indebtedness or other debt incurred by the CEA pursuant to CIC Section 10089.29.

Post-Earthquake Industry Assessments

As of December 31, 2017, the CEA had two layers of post-earthquake industry assessments (IAL): $1.656 billion under CIC Section 10089.30 (2nd IAL) and $54 million under CIC Section 10089.31 (New IAL). The CEA is authorized to levy assessments under the 2nd IAL if claims and claim expenses paid by the CEA due to earthquake events that commence on or after December 1, 2008, exhaust the total of the available capital, the maximum amount of all insurer capital contributions and assessments, all reinsurance actually available and under contract, and all capital committed and actually available from the private capital markets. The total amount of all assessments levied on participating insurers for the 2nd IAL cannot exceed $2 billion. Per CIC Section 10089.31, beginning on December 1, 2008, the CEA is authorized to levy assessments under the New IAL up to $1.78 billion under similar conditions once the participating insurers' assessments under CIC Section 10089.23 are exhausted on December 1, 2008. Amounts available for assessment under the 2nd IAL and New IAL are subject to reduction. Pursuant to CIC Section 10089.33(a), the 2nd IAL is subject to annual reductions once the CEA's available capital reaches $6 billion. In addition, pursuant to CIC Section 10089.33(b)(1), effective April 1, 2010, and on each April 1st thereafter, the New IAL is subject to both a five percent annual reduction and a reduction in an amount equal to the retained earnings differential. As of April 1, 2018, the amount available for assessment under the New IAL was reduced to zero due to the aforementioned reductions.

EARTHQUAKE LOSS MITIGATION FUND

Pursuant to California Insurance Code (CIC) Section 10089.37, the CEA is permitted to set aside in each calendar year an amount equal to 5 percent of investment income accruing on the CEA's invested funds, or $5 million, whichever is less, if deemed actuarially sound by a consulting actuary employed for, or hired by the CEA, to be maintained as a sub-account in the California Earthquake Authority Fund. The CEA shall use those funds to fund the establishment and operation of an Earthquake Loss Mitigation Fund. Per CIC Section 10089.38, the Earthquake Loss Mitigation Fund may be applied to supply grants and loans or loan guarantees to dwelling owners who wish to retrofit their homes to protect against earthquake damage.

The following table illustrates the amounts set aside pursuant to CIC Section 10089.37 during the examination period:

Year	Loss Mitigation Fund
2017	$5,000,000
2016	2,140,441
2015	1,268,767
2014	1,064,575

TERRITORY AND PLAN OF OPERATION

The CEA is authorized to write residential earthquake insurance in the state of California pursuant to California Insurance Code (CIC) Section 10089.6(a). Earthquake insurance policies are available for homeowners, condominium owners, mobile homeowners, and renters in California.

The CEA offers two earthquake products for both homeowners and mobile homeowners: Standard Homeowners and Homeowners Choice. Standard Homeowners bundles all the coverages into one package: dwelling, personal property, loss of use, building code upgrade, and emergency repairs. Coverages, except for loss of use and the first $1,500 of emergency repairs, are subject to the dwelling deductible. Homeowners Choice covers dwelling, building code upgrade and emergency repairs, and also provides two optional coverages: personal property and loss of use, which has no deductible. There are two more optional coverages, exterior masonry veneer and breakables, which are available for homeowners' policies. The deductibles available on homeowners' policies are between 5% to 25% on the dwelling and personal property coverage.

For the condominium unit owners, the CEA provides the following coverages: building property, personal property, loss of use, loss assessment, building code upgrade, emergency repair, and breakables. The renters' policy covers personal property, loss of use, emergency repairs, and breakables (an optional coverage).

CEA's earthquake business is placed through its participating insurers. Pursuant to CIC Section 10089.9, each insurer participating in the CEA shall execute a contract with the

Commissioner that sets forth its rights and responsibilities as a CEA participant, and such contract shall be part of the CEA's plan of operations and shall be uniform for every participating insurer. Insurers writing in the CEA represent approximately 73 percent of California's residential property insurance market. As of the examination date, there were 21 insurers who had signed Insurer Participation Agreements with the CEA.

According to the Insurer Participation Agreements, participating insurers act as independent contractor agents on behalf of the CEA by performing policy and claims services which include underwriting, policy issuance, premium collection, and claims adjustment. Participating insurers receive a producer commission equal to 10 percent of written premium for all new and renewal CEA policies and a non-claims related operating cost reimbursement equal to 6 percent of net written premiums net of the loading for the CEA's financing costs (including, but not limited to, costs or reinsurance, capital-markets transactions, private-placement transactions, and other debt.) Participating insurers are also reimbursed for claims expenses associated with CEA's earthquake claims equal to 9 percent of the total amount of the claim paid out.

The CEA imposes an eligibility requirement for earthquake policies as follows: (1) the risk must be a qualified residential property; (2) the risk must be insured by a companion policy issued by a CEA participating insurer that will act as the servicing carrier for the earthquake policy; (3) the risk must be insured to the value of the companion policy; and (4) all prior earthquake structural damage must be repaired before an application for coverage is accepted.

Following are the direct premiums written by the CEA during the examination period:

Year	Written Premiums
2017	$690,221,789
2016	621,548,760
2015	635,955,374
2014	606,977,285

REINSURANCE

Assumed

The CEA has no assumed reinsurance.

Ceded

As of December 31, 2017, the CEA had 38 catastrophe one-year and multi-year aggregate excess of loss reinsurance treaties with various reinsurers. Most of the multi-year treaties have a single limit over a two-, three- or five-year term. There are also multi-year contracts that have the option of two limits available for two events. For the multi-year contracts, the first-year premium for the reinsurance limit is calculated on the full limit, while subsequent premiums would be calculated on the remaining limit, if there were a recoverable from the reinsurance contract. In addition, the retention is adjusted based on the contracted probability of loss on an annual basis.

Certain contracts allow for an adjustment of premium, based on the average aggregate insurance in-force and the exposure adjustment limit. There was no premium adjustment expense against the contracts as of December 31, 2017, in accordance with contract terms.

As of December 31, 2017, the ceded reinsurance provided maximum limits of $7.537 billion at varying retention points starting at $1.88 billion. CEA's five largest reinsurers based on reinsurance premiums are: Ursa Re Ltd; Swiss Reinsurance America Corporation; Poseidon Re, Ltd; Tokio Millennium Re. AG; and Munich Reinsurance America.

FINANCIAL STATEMENTS

The following financial statements are based on the statutory financial statements filed by the CEA with the California Department of Insurance for the period ending December 31, 2017. The accompanying comments to the amounts reported in the financial statements should be considered an integral part of the financial statements. No adjustments were made to the financial statements as a result of the examination.

Statement of Financial Condition as of December 31, 2017

Underwriting and Investment Exhibit for the Year Ended December 31, 2017

Reconciliation of Surplus as Regards Policyholders from December 31, 2013 through December 31, 2017

Statement of Financial Condition
as of December 31, 2017

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$ 5,866,073,138	$	$5,866,073,138	
Cash, cash equivalents, and short-term investments	499,083,236		499,083,236	
Receivables for securities	98,223,089		98,223,089	
Investment income due & accrued	21,920,430		21,920,430	
Uncollected premiums and agents' balances in course of collection	52,358,844	7,278,392	45,080,452	
Furniture and equipment, including health care delivery assets	269,494	269,494	0	
Aggregate write-ins for other than invested assets	925,322	922,177	3,145	
Total assets	$ 6,538,853,553	$ 8,470,063	$6,530,383,490	
Liabilities, Surplus and Other Funds				
Losses			$ 87,132	(1)
Loss adjustment expenses			7,842	(1)
Other expenses (excluding taxes, licenses and fees)			11,551,849	
Borrowed money and interest thereon			212,945,250	
Unearned premiums			352,793,330	
Advance premium			1,189,062	
Ceded reinsurance premiums payable			(22,931,150)	
Payable for securities			32,727,818	
Total liabilities			588,371,133	
Aggregate write-ins for special surplus funds		$ (47,210,081)		
Gross paid in and contributed surplus		777,394,246		
Unassigned funds (surplus)		5,211,828,192		
Surplus as regards policyholders			5,942,012,357	
Total liabilities, surplus and other funds			$6,530,383,490	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2017

Statement of Income

Underwriting Income		
Premiums earned		$ 334,814,921
Deductions:		
Losses and loss expenses incurred	$ (84,914)	
Other underwriting expenses incurred	156,034,480	
Aggregate write-ins for underwriting deductions	292,686	
Total underwriting deductions		156,242,252
Net underwriting gain		178,572,669
Investment Income		
Net investment income earned	$ 72,259,897	
Net realized capital gain	14,385	
Net investment gain		72,274,282
Other Income		
Net gain from agents' or premium balances charged off (amount recovered $980,148 amount charged off $0)	$ 980,148	
Finance and service charges not included in premiums	422,642	
Aggregate write-ins for miscellaneous income	50,329	
Total other income		1,453,119
Net income		$ 252,300,070

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2016		$5,676,077,757
Net income	$ 252,300,070	
Change in nonadmitted assets	2,020,701	
Aggregate write-ins for gains in surplus	11,613,830	
Change in surplus as regards policyholders for the year		265,934,601
Surplus as regards policyholders, December 31, 2017		$5,942,012,358

Reconciliation of Surplus as Regards Policyholders from December 31, 2013 through December 31, 2017

	Gain in Surplus	Loss in Surplus	
Surplus as regards policyholders, December 31, 2013 per Examination			$4,665,530,386
Net income	$1,225,168,574	$	
Change in nonadmitted assets		107,992	
Aggregate write-ins for gains and losses in surplus	51,421,390		
Total gains and losses	$1,276,589,964	$ 107,992	
Net increase in surplus as regards policyholders			1,276,481,972
Surplus as regards policyholders, December 31, 2017 per Examination			$5,942,012,358

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The CEA only writes residential earthquake insurance. The CEA has only paid out approximately $8.8 million in losses and loss adjustment expenses (LAE) since its inception. The CEA's net paid losses and LAE were approximately $4.1 million for the examination period due to the La Habra and Napa earthquakes in 2014, which were magnitude 5.1 and 6.0, respectively. Given that no other significant earthquakes have occurred in California since 2014, the reported loss and LAE reserves of $94,974 as of December 31, 2017 are deemed reasonable.

SUBSEQUENT EVENTS

New Participating Insurers

On March 14, 2018, the CEA's Governing Board approved Amica Mutual Insurance Company (Amica) as a new participating insurer with an effective date of August 1, 2018. Pursuant to California Insurance Code Section 10089.15, each insurer that elects to participate in the CEA is required to contribute operating capital to the CEA. Amica was required to contribute $13,272,000 in one lump sum or in twelve equal monthly installments of $1,106,000 payable on the first day of each calendar month starting in August 2018. Amica chose to pay in installments, and the CEA received five monthly payments totaling $5,530,000 during the year ended December 31, 2018.

Rate and Form Filing

The CEA submitted a rate and form application with the California Department of Insurance (CDI) on February 2, 2018, and the CDI approved the application on November 29, 2018. The rate and form filing was made to introduce new rating factors, apply an enhanced hazard mitigation discount to qualifying CEA homeowners' policies, and change some rating territories. The net result in the filing is a decrease in the CEA's statewide average rates. The approved rate and form will apply to new and renewal business on and after July 1, 2019.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

None.

Previous Report of Examination

Comment on Financial Statement Items - Premiums and Agents' Balances in Course of Collection (Page 15): It was again recommended that the CEA comply with Statement of Statutory Accounting Principles (SSAP) No. 6, paragraphs 7 and 10. The CEA has complied with this recommendation.

ACKNOWLEDGMENT

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

Respectfully submitted,

Mei Gu, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California

Ber Van, CFE, ACS, CISA
Bureau Chief,
Department of Insurance,
State of California