

REPORT OF EXAMINATION
OF THE
FIRST AMERICAN SPECIALTY
INSURANCE COMPANY
AS OF
DECEMBER 31, 2015

Filed on January 13, 2017

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Los Angeles, California
November 21, 2016

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

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

FIRST AMERICAN SPECIALTY INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 4 First American Way, Santa Ana, California 92707.

SCOPE OF EXAMINATION

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

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

All accounts and activities of the Company were considered in accordance with the risk-

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

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

This was a coordinated examination with Nebraska as the lead state of the First American Financial Corporation (FAFC) group. FAFC has two subgroups, title and property and casualty, of which the Company is included in the property and casualty subgroup. This examination was conducted concurrently with other insurance entities within FAFC including its affiliate First American Property and Casualty Insurance Company. The following states participated on the examination: Louisiana and Texas.

COMPANY HISTORY

The Company, formerly known as Five Star Insurance Company (FSIC), was incorporated under the laws of the state of California on August 1, 1986 and commenced business on May 18, 1987. On October 19, 2000, FSIC changed its name to First American Specialty Insurance Company subsequent to the acquisition of its parent company, Five Star Holdings, Inc. (FS Holdings), by First American Corporation (FAC) in November 1999.

Pursuant to an Agreement and Plan of Merger dated May 13, 2009, FAC merged FS Holdings into itself. As a result, the Company became a direct wholly-owned subsidiary

of FAC. Effective June 1, 2010, FAC was reorganized into two independent public companies, First American Financial Corporation (FAFC) and CoreLogic, Incorporated. At that time, the Company became a wholly-owned subsidiary of FAFC.

Capitalization

The Company has 100,000 shares of \$50 par value common stock authorized, with 40,000 shares issued and outstanding. The Company has no preferred stock authorized, issued or outstanding.

Surplus Adjustments: Paid In

FAFC contributed \$400,000 in 2014 and \$175,000 in 2015 in cash to the Company. The effect of the contributions was a surplus paid-in adjustment in the Company's policyholder surplus.

Dividends

In September 2011, the Company paid an ordinary cash dividend to FAFC totaling \$12,000,000. The CDI approved this transaction in September 2011.

In September 2012, the Company paid an ordinary cash dividend to FAFC totaling \$7,700,000. The CDI approved this transaction in August 2012.

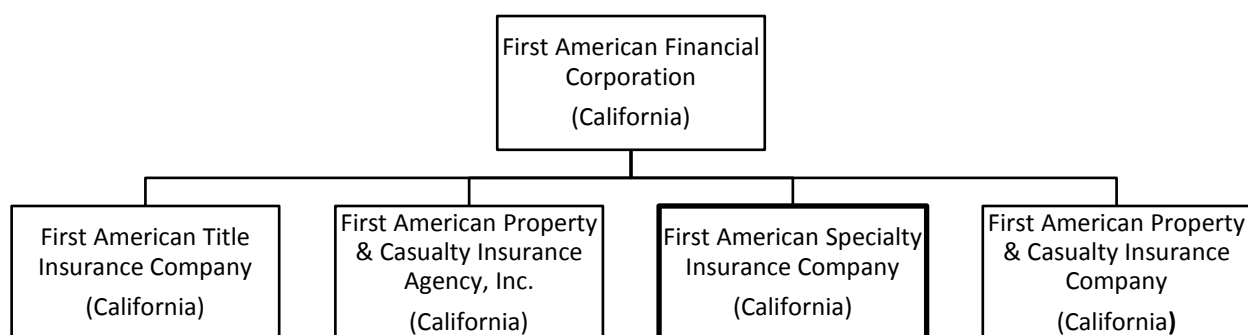
In September 2013, the Company paid an ordinary cash dividend to FAFC totaling \$3,000,000. The CDI approved this transaction in September 2013.

In September 2014, the Company paid an ordinary cash dividend to FAFC totaling \$1,600,000. The CDI approved this transaction in September 2014.

In October 2015, the Company paid an ordinary cash dividend to FAFC totaling \$2,400,000. The CDI approved this transaction in October 2015.

MANAGEMENT AND CONTROL

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



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

Directors

Name and Location

Principal Business Affiliation

James J. Court
Santa Ana, California

Chairman and President
First American Specialty Insurance
Company

Larry M. Davidson
Santa Ana, California

Chief Operating Officer, Specialized
Division
First American Financial Corporation

Name and Location

Principal Business Affiliation

Dennis J. Gilmore
Santa Ana, California

Chief Executive Officer, Specialized
Division
First American Financial Corporation

George J. Grupp
Santa Ana, California

Executive Vice President
First American Specialty Insurance
Company

Jeffrey S. Robinson
Santa Ana, California

Corporate Deputy General Counsel
First American Financial Corporation

Mark E. Seaton
Santa Ana, California

Executive Vice President, Chief Financial
Officer
First American Financial Corporation.

Principal Officers

Name

Title

James J. Court
George J. Grupp ^(a)

President and Chairman
Executive Vice President, Chief
Financial Officer, and Treasurer

Ted S. Misogas ^(b)

Vice President, Secretary, Controller,
and Assistant Treasurer

Hugh M. McCreddie
James H. Rogers

Vice President and Treasurer
Vice President and Chief Investment
Officer

Brian M. Schepperle
Robert D. Dalton
Scott J. Callender
Cheryl F. Silverman
Mark D. McGrane

Vice President – Chief Information Officer
Vice President – Claims
Vice President – Escrow/Direct
Vice President – Operations
Vice President – Product Management
and Underwriting

James V. Boxdell, II
Hieu Le
Petty Nguyen
Teri L. Pierce

Assistant Treasurer
Assistant Treasurer
Assistant Treasurer
Assistant Treasurer

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

(a) Retired on May 6, 2016 and was replaced by Ted S. Misogas.

(b) Replaced the retired George J. Grupp as the Chief Financial Officer on May 9, 2016. The Controller position will be filled in January 2017.

Management Agreements

Federal Tax Sharing Agreement: Effective June 1, 2015, the Company entered into a Federal Tax Sharing Agreement with its parent, FAFC, which was approved by the California Department of Insurance (CDI) on May 21, 2015. Under the terms of this agreement, the tax liability of the Company will be computed as if it filed a separate stand-alone return. The costs associated with the services are limited to actual costs incurred. Any additional tax payable or refund due will be settled within 30 days after such refund is received from the Internal Revenue Service or notification of the proper amount received. The amount due from the Company for 2015 is \$2,219,353

Affiliated Companies Service Agreement: Effective December 31, 2012, an Affiliated Companies Service Agreement was executed with its affiliate, First American Title Insurance Company (FATIC), and was approved by the CDI on October 17, 2012. Under the terms of this agreement, FATIC will provide the following services: Accounting and Auditing, Information Technology, and Other Functional Support Services. The costs associated with the services are limited to actual costs incurred. The amounts paid by the Company were \$0, \$0, \$0, and \$627,780 for 2012, 2013, 2014, and 2015, respectively.

Agency Agreement: Effective and approved by the CDI on July 30, 2012, an Agency Agreement was executed between the Company and its affiliate, First American Property & Casualty Insurance Agency (FAPCIA). This agreement replaced a similar agreement dated January 1, 2009. Under the terms of the agreement FAPCIA underwrites policies on behalf of the Company. The Company collects premiums directly from customers and pays commissions to FAPCIA monthly based on cash collections. The Company pays FAPCIA a commission of 15% for flood and 17% for all other lines of business. The amounts paid by the Company were \$631,090, \$786,899, \$954,740, and \$83,790 for 2012, 2013, 2014, and 2015, respectively.

Corporate Records

California Insurance Code (CIC) Section 735 states that the Company must inform the board members of the receipt of the examination report. The board should be informed of the report both in the form first formally prepared by the examiners and in the form as finally settled and officially filed by the Commissioner. The board must also enter that fact in the board minutes. A review of the board minutes disclosed that neither the officially filed nor the formally prepared draft by the examiner was presented to the board. It is recommended that the Company implement procedures to ensure future compliance with CIC Section 735.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2015, the Company was licensed to transact property and casualty insurance business in Arizona, California, Nevada, and New York, and is eligible to write in Florida. The Company is authorized to write the following lines of business in California: Fire, Marine, Surety, Liability, Workers' Compensation, Common Carrier Liability, Burglary, Team and Vehicle, and Automobile.

The Company offers homeowner and dwelling fire insurance marketed through an affiliated general agent, First American Property & Casualty Insurance Agency, Inc., and through a network of independent agents and brokers. The Company writes 99.3% of direct written premiums in California and the remaining 0.7% in New York.

REINSURANCE

Assumed

The Company does not assume reinsurance.

Ceded

The following is a summary of the principal ceded reinsurance treaties in-force as of December 31, 2015:

Line of Business and Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Limit
<u>Excess Catastrophe:</u>			
First Layer	Various authorized and unauthorized domestic, foreign and alien companies led by Lloyds Syndicates	\$5 million	\$15 million excess \$5 million, per occurrence
Second Layer	Various authorized and unauthorized domestic, foreign and alien companies led by Lloyds Syndicates	\$20 million	\$20 million excess \$20 million, per occurrence
Third Layer	Various authorized and unauthorized domestic, foreign and alien companies led by Lloyds Syndicates	\$40 million	\$60 million excess \$40 million, each and every loss/risk, per occurrence
Fourth Layer	Various authorized and unauthorized domestic, foreign and alien companies led by Lloyds Syndicates	\$100 million	\$10 million excess \$100 million, per occurrence
Fifth Layer	Various authorized and unauthorized domestic, foreign and alien companies led by Lloyds Syndicates	\$110 million	\$10 million excess \$110 million, per occurrence

Line of Business and Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Limit
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Quota Share and Excess of loss on Personal Umbrella Liability

First layer	General Re Corp - Unauthorized	10% up to \$2 million	90% up to \$2 million per occurrence 100% in excess of \$2 million per occurrence and up to \$5 million under special circumstances
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Facultative

First Layer	General Re Corp - Unauthorized	\$1.75 Million	\$5.75 million in all risk per occurrence and \$18 million in all occurrences
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ACCOUNTS AND RECORDS

During the course of the examination, a review was made of the Company's general controls over its information systems. As a result of this review, some findings were noted and were presented to the Company along with recommendations to strengthen its controls. The Company should evaluate the recommendations and make appropriate changes to strengthen its information systems controls.

FINANCIAL STATEMENTS

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

Statement of Financial Condition as of December 31, 2015

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

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

Statement of Financial Condition
as of December 31, 2015

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 70,058,283	\$	\$ 70,058,283	
Common stocks	26,570,116		26,570,116	
Cash and short-term investments	3,719,540		3,719,540	
Investment income due and accrued	675,879		675,879	
Premiums and agents' balances in course of collection	296,947	105,000	191,947	
Premiums, agents' balances and installments booked but deferred and not yet due (including \$ earned but unbilled premiums)	2,544,038		2,544,038	
Amounts recoverable from reinsurers	24,478		24,478	
Net deferred tax asset	3,555,771		3,555,771	
Electronic data processing equipment and software	381,469	381,469	0	
Furniture and equipment	55,411	55,411	0	
Receivables from parent, subsidiaries, and affiliates	1,225,778		1,225,778	
Aggregate write-ins for other than invested assets	<u>27,964,913</u>	<u>27,487,692</u>	<u>477,221</u>	
 Total assets	 <u>\$ 137,072,623</u>	 <u>\$ 28,029,572</u>	 <u>\$ 109,043,051</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses and loss adjustment expenses			\$ 19,151,106	(1)
Commissions payable, contingent commissions and other similar charges			1,519,295	
Other expenses			1,638,724	
Taxes, licenses and fees			83,664	
Current federal and foreign income taxes (including \$39,338 on realized capital gains)			910,164	
Unearned premiums			35,367,835	
Advance premiums			2,148,720	
Ceded reinsurance premiums payable			64,791	
Amounts withheld or retained by company for account of others			1,026,992	
Payable to parent, subsidiaries and affiliates			325,345	
Payable for securities			<u>110,366</u>	
 Total liabilities			 62,347,002	
 Common capital stock	 \$ 2,000,000			
Gross paid-in and contributed surplus		12,345,000		
Unassigned funds (surplus)		<u>32,351,049</u>		
Surplus as regards policyholders			<u>46,696,049</u>	
 Total liabilities, surplus and other funds			 <u>\$ 109,043,051</u>	

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

Statement of Income

Underwriting Income

Premiums earned		\$ 66,927,309
Deductions:		
Losses and loss expenses incurred	\$ 41,177,381	
Other underwriting expenses incurred	<u>22,413,204</u>	
Total underwriting deductions		<u>63,590,585</u>
Net underwriting gain		3,336,724

Investment Income

Net investment income earned	\$ 2,988,104	
Net realized capital gains less capital gains tax	<u>(112,395)</u>	
Net investment gain		2,875,709

Other Income

Net income from agents' or premium balances charged off	\$ 105,152	
Finance and service charges not included in income	<u>127,226</u>	
Total other income		<u>232,378</u>
Net income before dividends to policyholders, after capital gains tax and before federal and foreign income taxes		6,444,811
Federal and foreign income taxes incurred		<u>(2,219,352)</u>
Net income		<u>\$ 4,225,459</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2014		\$ 46,813,350
Net income	\$ 4,225,459	
Change in net unrealized capital losses	(901,401)	
Change in net deferred income tax	(810,377)	
Change in nonadmitted assets	454,115	
Surplus adjustments:		
Paid-in	175,000	
Dividends to stockholders	(2,400,000)	
Aggregate write-ins for losses in surplus	<u>(860,097)</u>	
Change in surplus as regards policyholders for the year		<u>(117,301)</u>
Surplus as regards policyholders, December 31, 2015		<u>\$ 46,696,049</u>

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

Surplus as regards policyholders, December 31, 2010			\$ 50,849,582
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 27,164,414	\$	
Change in unrealized capital losses		1,285,965	
Change in net deferred income tax	1,960,428		
Change in nonadmitted assets		2,499,819	
Surplus adjustments: Paid-in	575,000		
Dividends to shareholders		26,700,000	
Aggregate write-ins for losses in surplus	<u> </u>	<u>3,367,591</u>	
Total gains and losses	<u>\$ 29,699,842</u>	<u>\$ 33,853,375</u>	
Net decrease in surplus as regards policyholders			<u>(4,153,533)</u>
Surplus as regards policyholders, December 31, 2015			<u>\$ 46,696,049</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The Company's reserves were evaluated by a Casualty Actuary from the California Department of Insurance. Based on the analysis, the Company's December, 31, 2015 reserves for losses and loss adjustment expenses appear reasonable and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Corporate Records (Page 7): A review of the board minutes disclosed that neither the officially filed report of examination nor the formally prepared draft by the examiner was presented to the board. It is recommended that the Company implement procedures to ensure future compliance with California Insurance Code (CIC) Section 735.

Accounts and Records – Information System Controls (Page 9): As the result of the review of the Company's information systems controls, recommendations for improving these controls were presented to the Company. The Company should evaluate these recommendations and make appropriate changes to strengthen its controls over its information systems.

Previous Report of Examination

Management and Control – Management Agreements: Agency Agreements (Page 5): The Company failed to file the agreement with the California Department of Insurance (CDI) for approval. The Company replaced the agreement with a new Agency Agreement which was effective and approved on July 30, 2012.

Management and Control – Management Agreements: Tax Allocation Agreement (Page 5): The Company failed to file the agreement with the CDI for approval. The Company replaced the agreement with the Federal Tax Sharing Agreement approved by the CDI on May 21, 2015.

Accounts and Records (Page 7): It was recommended that the Company establish and implement procedures and quality control tests to ensure that all information contained in its detail claims listing are accurate. The Company has complied with this recommendation.

Accounts and Records (Page 7): It was recommended that the Company implement controls to identify potential errors and properly review its statutory financial statements for compliance with the National Association of Insurance Commissioners' (NAIC) Annual Statement Instructions before being submitted to the CDI. The Company has complied with this recommendation.

Comments on Financial Statement Items – Preferred Stocks (Page 12): It was recommended the Company continue to report preferred stocks with the NAIC designations 3 to 6 at the lower of cost or market. The Company no longer holds preferred stocks.

Comments on Financial Statement Items – Current federal Income Tax Recoverable and Interest Thereon (Page 12): It was recommended that tax settlements are made timely in accordance with the Tax Allocation Agreement and to non-admit any tax recoverables that are over 90 days due. The Company complied with this recommendation.

Comments on Financial Statement Items – Other Expenses (Page 12): It was recommended that the Company record advance premiums as a separate liability. The Company is in compliance.

ACKNOWLEDGMENT

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

Respectfully submitted,

/S/

Thomas Podsiadlo, CFE
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California

/S/

Grace Asuncion, CFE
Senior Insurance Examiner, Supervisor
Department of Insurance
State of California