

REPORT OF EXAMINATION
OF THE
FIRST AMERICAN SPECIALTY
INSURANCE COMPANY

AS OF
DECEMBER 31, 2019

Insurance Commissioner

A handwritten signature in blue ink, appearing to read "P. DeLoe", is positioned to the right of the "Insurance Commissioner" text.

FILED ON May 12, 2021

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION	1
COMPANY HISTORY:	2
Capitalization	2
Capital Contribution	3
MANAGEMENT AND CONTROL:.....	3
Management Agreements.....	5
TERRITORY AND PLAN OF OPERATION.....	6
LOSS EXPERIENCE.....	6
REINSURANCE:	7
Assumed.....	7
Ceded	7
FINANCIAL STATEMENTS:	9
Statement of Financial Condition as of December 31, 2019.....	10
Underwriting and Investment Exhibit for the Year Ended December 31, 2019	11
Reconciliation of Surplus as Regards to Policyholders from December 31, 2015 through December 31, 2019.....	12
COMMENTS ON FINANCIAL STATEMENT ITEMS:.....	13
Losses and Loss Adjustment Expenses	13
SUBSEQUENT EVENTS	13
SUMMARY OF COMMENTS AND RECOMMENDATIONS:	14
Current Report of Examination	14
Previous Report of Examination	14
ACKNOWLEDGMENT	16

Los Angeles, California
April 28, 2021

Honorable Ricardo Lara
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). The Company's home office is 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, 2015. This examination covered the period from January 1, 2016 through December 31, 2019.

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 Title Insurance Company of the First American Title Group. It was conducted concurrently with other insurance entities in the holding company group, including First American Title Insurance Company, First American Title Insurance Company of Louisiana, First American Property and Casualty Insurance Company, First American Specialty Insurance Company, First American Title Guaranty Company, and Ohio Bar Title Insurance Company. The following states participated on the examination: California, Louisiana, Ohio, and Texas.

COMPANY HISTORY

Capitalization

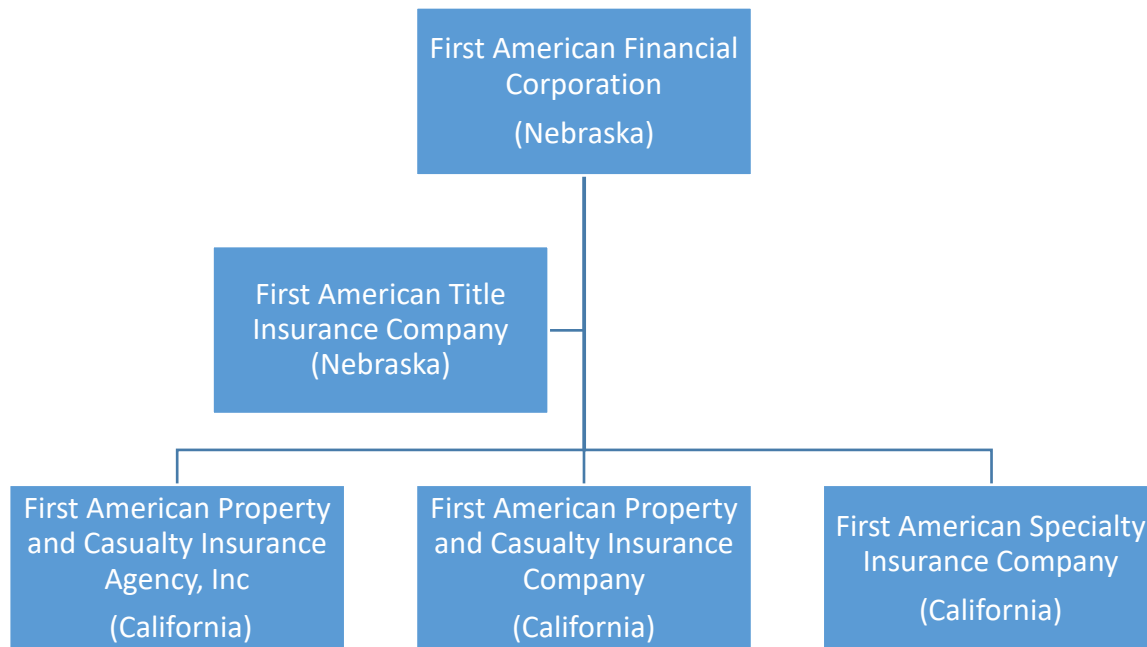
The Company has 100,000 shares of \$50 par value common stock authorized, with 40,000 original shares issued and outstanding. In 2017, to cover the substantial loss incurred in that year, the Company received a capital infusion of \$6.0 million from its parent, First American Financial Corporation (FAFC), by issuing an additional 20,000 common shares (\$50 per share, 60,000 shares issued and outstanding).

Capital Contribution

On March 1, 2021, the California Department of Insurance approved the reporting of a \$12,000,000 capital contribution from First American Financial Corporation (FAFC) to be recognized as Type I subsequent admitted asset receivable in its December 31, 2020 Annual Statement, pursuant to Statement of Statutory Accounting Principles No.72.

MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of First American Financial Corporation, a Nebraska corporation. The following abridged organizational chart depicts the Company's relationship within the holding company system. All ownership is 100%:



Management of the Company is vested in a six-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2019 follows:

Directors

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
Scott Jeffrey Callender Lake Forest, California	Chief Operating Officer First American Property and Casualty Insurance Company First American Specialty Insurance Company
Larry Milton Davidson Santa Ana, California	President First American Property and Casualty Insurance Company First American Specialty Insurance Company
Dennis Joseph Gilmore Santa Ana, California	Chief Executive Officer First American Financial Corporation
Richard Louis Leza Jr. Dove Canyon, California	Chief Financial Officer First American Property and Casualty Insurance Company First American Specialty Insurance Company
Jeffrey Scott Robinson ^(a) Santa Ana, California	Corporate Deputy General Counsel First American Financial Corporation
Mark Edward Seaton Santa Ana, California	Chief Financial Officer First American Financial Corporation

Principal Officers

<u>Name</u>	<u>Title</u>
Larry Milton Davidson	President
Zachary James Zaharek	Secretary
Richard Louis Leza Jr.	Chief Financial Officer and Treasurer
Scott Jeffrey Callender	Vice President, Chief Operating Officer
Cynthia Carter	Vice President Operations/Underwriting
Kenneth David DeGiorgio	Executive Vice President
Mathew Hugh McCreddie	Vice President, Treasurer
Valerie Peterson	Vice President, Claims
Jeffrey Scott Robinson ^(a)	Vice President
James Hoggs Rogers	Vice President, Chief Investment Officer

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

- (a) On April 20, 2020, Jeffrey Scott Robinson was replaced by Greg L. Smith on the Company's board of directors. Mr. Robinson also was replaced by Greg L. Smith as Vice President.

Management Agreements

Tax Reimbursement Agreement: Effective June 1, 2015, the Company entered into a Federal Tax Sharing Agreement with its parent, First American Financial Corporation, and 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 each member 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 thirty days after such refund is received from the IRS or notification of the proper amount due. The federal income tax liability paid/(recovered) by the Company for 2016, 2017, 2018, and 2019 were \$2,932,359, (\$4,834,172), (\$2,689,455), and (\$1,604,748), respectively.

Management and Services Agreement: The Company and its affiliates are parties to a Management and Services Agreement with First American Title Insurance Company (FATICO). In August 2014, FATICO re-domesticated from California to Nebraska. The agreement was amended, effective March 6, 2015, to reflect the change in the state of domicile of the Company to the state of Nebraska. The agreement was approved by the CDI on August 18, 2015. FATICO will provide services to its affiliates that include, but are not limited to, accounting and auditing; title plant and policy production; information technology; other functional support services as further defined in the service agreement. Services and use of facilities provided by FATICO to affiliates is based on actual cost without a profit factor being built into that cost. The cost or expense for services by FATICO allocated to the affiliates shall be paid by the affiliates to FATICO within thirty days after the end of each calendar quarter. Expenses are allocated in accordance with a method in conformity with Statement of Statutory Accounting Principles (SSAP) No.70 of the National Association of Insurance Commissioners Accounting Practices and

Procedures Manual. Payments made to FATICO for 2016, 2017, 2018, and 2019, were \$3,745,959, \$4,670,163, \$4,332,129, and \$4,674,024, respectively.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2019, the Company was licensed to transact multiple lines of property and casualty insurance business in the following states: California, Arizona, Nevada, New York, Oregon, Utah, and Washington and writes surplus line business in Florida. The Company offers primarily homeowner and dwelling fire insurance marketed through an affiliated general agent, First American Property and Casualty Insurance Agency, Inc., and through a network of independent agents and brokers. In 2019, the Company had \$47.1 million in direct premiums written. The majority of the direct premium was written in the states of California \$34.5 million (73%) and Arizona \$8.9 million (19%). Subsequently, in the first quarter of 2021, the Company notified the California Department of Insurance its intention of withdrawing from writing business in all states by entering Renewal Right Agreements with Liberty Mutual Insurance Company and Heritage Insurance Holdings, Inc. Detail of the Renewal Right Agreements will be discussed in the “Subsequent Events” section.

LOSS EXPERIENCE

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

Year	Net Underwriting Income or (Loss)	Net Income or (Loss)	Surplus
2016	\$ 4,894,428	\$ 5,770,631	\$55,643,423
2017	\$ (18,358,651)	\$ (9,079,903)	\$49,827,865
2018	\$ (17,040,764)	\$ (10,442,322)	\$32,916,837
2019	\$ (9,691,809)	\$ (1,345,071)	\$30,041,351

Year	Net Underwriting Income or (Loss)	Net Income or (Loss)	Surplus
2020	\$ (20,557,348)	\$ (6,987,135)	\$ 28,846,569

The Company experienced net underwriting losses and net losses for the last four years under the examination. The underwriting results of the Company were primarily attributable to adverse development on the losses and losses adjustment expenses, which were largely driven by the wildfires throughout California and rainstorms across the west coast during the examination period. The adverse development continued into the year 2020 and resulted in a significant decrease in reported surplus.

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, 2019:

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 Lloyds Syndicates	\$5 million per occurrence	\$15 million excess \$5 million, Ultimate Net Loss in respect of each Loss Occurrence
Second Layer	Various authorized and unauthorized domestic foreign and alien companies led Lloyds Syndicates	\$20 million per occurrence	\$20 million excess \$20 million, Ultimate Net Loss in respect of each Loss Occurrence
Third Layer	Various authorized and unauthorized domestic foreign and alien companies led Lloyds Syndicates	\$40 million per occurrence	\$60 million excess \$40 million, Ultimate Net Loss in respect of each Loss Occurrence

Line of Business and Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Limit
Fourth Layer	Various authorized and unauthorized domestic foreign and alien companies led Lloyds Syndicates	\$100 million per occurrence	\$10 million excess \$100 million, Ultimate Net Loss in respect of each Loss Occurrence
<u>Quota Share and Excess of loss on Personal Umbrella Liability</u>	General Re Corp-Authorized	10% of first \$2,000,000 each occurrence of Net Loss	(a) 90% of the policy limits up to and including \$2,000,000 each occurrence of Net Loss sustained by the Company; plus (b) 100% of Net Loss sustained by the Company in excess of the first \$2,000,000 each occurrence up to and including \$5,000,000 each occurrence
<u>Quota Share and Excess of loss on Personal Umbrella Liability</u>	Various unauthorized companies	5% of first \$1,000,000 each occurrence of Net Loss	(a) 95% of the policy limits up to and including \$1,000,000 each occurrence of Net Loss sustained by the Company; plus (b) 100% of Net Loss sustained by the Company in excess of the first \$1,000,000 each occurrence up to and including \$4,000,000 each occurrence
<u>Facultative</u>	General Re Corp-Authorized	\$1.75 million	\$5.75M in all risk per occurrence; \$18M in all occurrences
<u>Residential Earthquake Quota Share</u>	Palomar Specialty Insurance Company- Authorized	\$0	100% of earthquake shock under stand-alone residential earthquake policies (including earthquake endorsements to the Company's personal lines policies).

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, 2019. The accompanying comments to the amounts reported in the annual statements 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, 2019

Underwriting and Investment Exhibit for the Year Ended December 31, 2019

Reconciliation of Surplus as Regards Policyholders from December 31, 2015
through December 31, 2019

Statement of Financial Condition
as of December 31, 2019

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 64,453,864	\$	\$ 64,453,864	
Common stocks	9,123,642		9,123,642	
Cash and short-term investments	6,014,442		6,014,442	
Other invested assets	906,890		906,890	
Receivable for securities	624		624	
Investment income due and accrued	448,170		448,170	
Premiums and agents' balances in course of collection	131,073	63,000	68,073	
Premiums, agents' balances and installments booked but deferred and not yet due (including \$0 earned but unbilled premiums)	921,083		921,083	
Amounts recoverable from reinsurers	24,477		24,477	
Other amounts receivable under reinsurance contracts	381,661		381,661	
Net deferred tax asset	3,154,361		3,154,361	
Electronic data processing equipment and software	8,050,807	7,800,807	250,000	
Furniture and equipment	99,084	99,084	0	
Receivable from parent, subsidiaries and affiliates	3,266,333		3,266,333	
Aggregate write-ins for other than invested assets	<u>31,083,060</u>	<u>25,928,544</u>	<u>5,154,516</u>	
 Total assets	 <u>\$ 128,059,571</u>	 <u>\$ 33,891,435</u>	 <u>\$ 94,168,136</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses and loss adjustment expenses			\$ 33,018,193	(1)
Commissions payable, contingent commissions and other similar charges			994,352	
Other expenses			2,415,939	
Current federal and foreign income taxes (including \$788,464 on realized capital gains)			863,339	
Unearned premiums			21,275,910	
Advance premiums			821,099	
Ceded reinsurance premiums payable			2,270,023	
Funds held by company under reinsurance treaties			753,591	
Amounts withheld or retained by company for account of others			1,101,117	
Payable to parent, subsidiaries and affiliates			379,354	
Payable for securities			<u>233,872</u>	
 Total liabilities			 64,126,789	
Common capital stock		\$ 3,000,000		
Gross paid-in and contributed surplus		17,345,000		
Unassigned funds (surplus)		<u>9,696,347</u>		
Surplus as regards policyholders			<u>30,041,347</u>	
 Total liabilities, surplus and other funds			 <u>\$ 94,168,136</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2019

Statement of Income

Underwriting Income

Premiums earned		\$ 59,686,768
Deductions:		
Losses and loss expenses incurred	\$ 49,083,033	
Other underwriting expenses incurred	<u>20,295,543</u>	
Total underwriting deductions		<u>69,378,576</u>
Net underwriting loss		(9,691,808)

Investment Income

Net investment income earned	\$ 2,927,119	
Net realized capital gain	<u>3,754,590</u>	
Net investment gain		6,681,709

Other Income

Net loss from agents' or premium balances charged off (amount recovered \$0 amount charged off \$0)	\$ (5,921)	
Finance and service charges not included in premiums	<u>66,201</u>	
Total other income		<u>60,280</u>
Net loss before dividends to policyholders, after capital gains tax and before federal and foreign income taxes		<u>(2,949,818)</u>
Net loss after dividends to policyholders, after capital gains tax and before federal and foreign income taxes		(2,949,818)
Federal and foreign income taxes incurred		<u>(1,604,748)</u>
Net loss		<u>\$ (1,345,071)</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2018		\$ 32,916,835
Net income	\$ (1,345,071)	
Change in net unrealized capital loss	(458,773)	
Change in net deferred income tax	279,032	
Change in nonadmitted assets	(2,061,676)	
Change in provision for reinsurance	1,241,394	
Aggregate write-ins for losses in surplus	<u>(530,391)</u>	
Change in surplus as regards policyholders for the year		<u>(2,875,485)</u>
Surplus as regards policyholders, December 31, 2019		<u>\$ 30,041,350</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2015 through December 31, 2019

Surplus as regards policyholders, December 31, 2015				\$ 46,696,049
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>		
Net loss	\$	\$	15,096,665	
Net unrealized capital gains	527,442			
Change in net deferred income tax		1,377,282		
Change in nonadmitted assets		5,861,861		
Capital changes: paid-in	1,000,000			
Surplus adjustments: paid-in	6,000,000			
Transferred from capital		1,000,000		
Aggregate write-ins for gains and losses in surplus	<u> </u>	<u>846,333</u>		
Total gains and losses	\$ 7,527,442	\$ 24,182,141		
Net decrease in surplus as regards policyholders				<u>(16,654,699)</u>
Surplus as regards policyholders, December 31, 2019				<u>\$ 30,041,350</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

As Nebraska was the lead state, the California Department of Insurance (CDI) relied on the Nebraska Department of Insurance (NDI) Actuary to evaluate the losses and loss adjustment expense reserves as of December 31, 2019. Based on an analysis by the NDI Actuary and a peer review by Casualty Actuary from the CDI, the Company's December, 31, 2019 reserves for losses and loss adjustment expenses appear reasonable and have been accepted for purposes of this examination.

SUBSEQUENT EVENTS

On March 11, 2020, the World Health Organization declared coronavirus disease (COVID-19) pandemic. The pandemic has triggered unprecedented government mandates and health and safety measures that have significantly impacted the United States and global financial markets. The examination reviewed the potential impact of the pandemic on the Company and noted minimal impact on the Company's business operations as of the date of this report. However, significant uncertainty remains on the effect that the pandemic will have on the insurance industry, economy, and the Company at large. The California Department of Insurance (CDI) continues to closely monitor the impact of the pandemic on the Company and will take necessary action if a solvency concern arises.

On January 19, 2021, the First American Financial Corporation (FAFC) notified the CDI of its intention to enter into two Renewal Right Agreements with Liberty Mutual Insurance Company (Liberty), a Massachusetts corporation, and Heritage Insurance Holdings, Inc. (Heritage), a Delaware corporation, with an effective date of January 18, 2021. On March 9, 2021, the Company received notification from the CDI no objection to the Company moving forward with their renewal right agreement.

Under the terms of the agreements, the Company will promote and facilitate the underwriting and renewal of the in-force policies with Liberty and Heritage and completely withdraw from writing personal lines of business. In return, the Company will receive \$3.11 million in compensation for transferring the book of business from Liberty and there will not be any compensation from Heritage, as the agreement was entered as an accommodation to maximize the number of policyholders who would be afforded new policies. The policies not underwritten or renewed by Liberty and Heritage will be placed with a third-party carrier by the First American Property and Casualty Agency, Inc. The Company anticipates the transfer of business to Liberty and Heritage will be completed by year-end 2022. As a result of the business strategy changes, the Company has significantly decreased the staffing in all departments. To ensure adequate claims handling function, the Company contracted with a third-party administrator, Global Risk Solutions, Inc. (GRS), through the Company's affiliates, FATCO Holdings, LLC (FATCO). GRS will be compensated on a per claim basis. The Company will then reimburse FATCO through First American Title Insurance Company under the terms of the "Management and Services Agreement" mentioned under the "Management and Control" section.

Upon the approval of the Renewal Right Agreements and completion of the transferring of all existing business, the Company will withdraw its license from the private passenger automobile line of business in the state of California.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

None.

Previous 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. The Company has complied with this recommendation.

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. The Company has complied with this recommendation.

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,

Oseguera,
Ralph

Digitally signed by Oseguera,
Ralph
Date: 2021.05.03 15:57:26
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Ralph Oseguera, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California

Fan, Vivien

Digitally signed by Fan, Vivien
Date: 2021.05.03 16:02:19
-07'00'

Vivien Fan, CFE
Bureau Chief
Department of Insurance
State of California