

REPORT OF EXAMINATION
OF THE
STATE COMPENSATION INSURANCE FUND
AS OF
DECEMBER 31, 2016

Filed on April 20, 2018

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San Francisco, California
March 20, 2018

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

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

STATE COMPENSATION INSURANCE FUND

(hereinafter referred to as State Fund) at its regional office located at 1010 Vaquero Circle, Vacaville, California 95688. State Fund's home office is located at 333 Bush Street, 8th Floor, San Francisco, California 94104.

SCOPE OF EXAMINATION

We have performed our single-state examination of State Fund. The previous examination of State Fund was made as of December 31, 2012. This examination covers the period from January 1, 2013 through December 31, 2016.

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 State Fund'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 State Fund 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 State Fund's financial statements.

This examination report includes findings of fact and general information about State Fund 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 State Fund.

STATE FUND HISTORY

State Fund is a public enterprise fund whose organization and powers are defined by California Insurance Code (CIC) Sections 11770 through 11805. Concurrently with the enactment of the first compulsory workers' compensation laws in California, State Fund was established by the California Legislature in 1914 to provide an available market for workers' compensation insurance to employers located in California.

Effective January 1, 2013, Senate Bill (SB) 1513 was approved by the Governor on September 30, 2012 and was enacted into law under California Insurance Code (CIC) Section 11797. SB 1513 allows State Fund, until January 1, 2025, to invest or reinvest an aggregated maximum of twenty percent of moneys in excess of the admitted assets over the liabilities and required reserves in the investments allowed pursuant to CIC Sections 1191, 1192.4, 1192.6, 1192.10, 1194.7, and 1198. It also requires the California Department of Insurance to submit to the Legislature by January 31, 2019, a report that assesses the benefit and risk of State Fund's equities investment history by measuring

the volatility and total return of State Fund's investment portfolio with and without equities. The report is to be submitted pursuant to Government Code Section 9795.

MANAGEMENT AND CONTROL

Pursuant to California Insurance Code Section 11770, the Board of Directors of State Fund is composed of eleven appointed, voting members and one ex-officio, nonvoting member. Nine of the board members (including the chairperson) are appointed by the Governor, of which one appointed member must be from organized labor. One member is appointed by the Speaker of the Assembly and also must represent organized labor. The eleventh member is appointed by the Senate Committee on Rules and must have been a policyholder of State Fund, or an officer or employee of a policyholder, for one year immediately preceding the appointment, and must continue in this status during the period of his or her membership. The Director of Industrial Relations is a non-voting ex-officio member of the Board, and is not counted for quorum or any other purposes. All board members, other than the Director of Industrial Relations, serves for a period of five years until the appointment and qualification of their successors.

Following are the directors and principal officers of State Fund serving at December 31, 2016:

Board of Directors

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
Christine Baker Berkeley, California	Director Department of Industrial Relations
Robin L. Baker Berkeley, California	Emerita University of California, Berkeley
Sheryl A. Chalupa, Chair Bakersfield, California	President and Chief Executive Officer Goodwill Industries of South Central California
Daniel M. Curtin Carmichael, California	Director California Conference of Carpenters

Board of Directors (continued)

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
Marvin P. Kropke Brea, California	Business Manager International Brotherhood of Electrical Workers (IBEW) Local Union 11
Senator Michael J. Machado Linden, California	Retired
Lawrence E. Mulryan San Rafael, California	Retired
Jack L. Neureuter Geyserville, California	Retired
Steven L. Rank Roseville, California	Executive Director Safety & Health Ironworkers International (International Association of Bridge, Structural, Ornamental and Reinforcing Iron Workers)
Thomas E. Rankin Berkeley, California	Vice President California Alliance for Retired Americans
Scott K. Reid Placerville, California	Director Economic and Statistical Research Bureau Franchise Tax Board
William M. Zachry San Carlos, California	Senior Fellow Sedgwick Institute

Principal Officers

<u>Name</u>	<u>Position</u>
Vernon L. Steiner	President and Chief Executive Officer
Peter A. Guastamachio	Chief Financial Officer and Chief Investment Officer
Kenneth R. Van Laar	Chief Risk Officer
Richard J. Law	Chief Operating Officer
Marjorie Hutchings	Chief Information Officer

Principal Officers (Continued)

<u>Name</u>	<u>Position</u>
Margie Lariviere	General Counsel
Stephen P. Hunckler	Chief Claims Operations Officer
Dante Robinson	Chief of Internal Affairs
Andreas Acker	Executive Vice President and Chief Administrative Officer
Jennifer Vargen	Executive Vice President of Public Affairs
Darlyn Regan	Executive Vice President of Enterprise Project Management

Management Agreement

State Fund has a master agreement with the California Department of Human Resources to adjust workers' compensation claims and process the payments related to state employees' injuries. State Fund pays compensation benefits to the injured workers and medical benefits to the health providers. The state agencies reimburse State Fund for compensation and medical benefits paid, plus the cost of adjusting. State Fund bills annual service fees for processing these claims on a full cost recovery basis. State Fund records a receivable for these reimbursements under "Due from adjusting contracts." All state agencies make deposits in a trust account that is held by State Fund for future bills and are reported under "Amounts held in trust liability."

TERRITORY AND PLAN OF OPERATION

State Fund is authorized only to transact workers' compensation insurance business, including liability under the United States Longshoremen's and Harbor Workers' Compensation Act in the State of California. It is a quasi-government entity organized to insure California businesses that are unable to obtain coverage from private insurers. Its operations are funded from collections of policy premiums and returns from investments, and most of its employees are civil service employees. State Fund's liabilities are not

guaranteed by the State of California; however, the benefits to injured workers insured by State Fund are backed by the California Insurance Guaranty Association.

Business is written on a direct basis and through its broker distribution channel. State Fund's home office is located in San Francisco, California and has regional offices located throughout California. The day-to-day operations and majority of its employees are located in Pleasanton and Vacaville, California. As of December 31, 2016, State Fund reported \$1.6 billion in total direct premiums written and is the largest workers' compensation insurer in California with a market share of 12.4%.

REINSURANCE

Assumed

State Fund assumes a small amount of workers' compensation insurance business written by Zurich America Insurance Company covering the employees located outside of California that are employed by State Fund's policyholders pursuant to California Insurance Code Section 11780.5(2). During 2016, reinsurance assumed was only \$251,000.

Ceded

The following is a summary of the principal reinsurance agreements in-force as of December 31, 2016:

Type of Contract	Line(s) of Business	Reinsurer(s) and Participation	State Fund's Retention	Reinsurer's Limits
All Perils (excluding Terrorism)				
Multi-Year Catastrophe Bond Earthquake Coverage	Workers' Compensation and Employers' Liability Business	<u>Unauthorized</u> Golden State Re II Ltd	\$100 million ultimate net loss each trigger event	\$250 million excess of \$100 million ultimate net loss each trigger event

Type of Contract	Line(s) of Business	Reinsurer(s) and Participation	State Fund's Retention	Reinsurer's Limits
Multi-Year Workers' Compensation Excess of Loss	Workers' Compensation and Employers' Liability Business	<u>Authorized</u> Munich Reinsurance America, Inc (50.00%) <u>Unauthorized</u> Munchener Ruckversicherungs AG (50.00%)	\$350 million ultimate net loss each loss occurrence	\$50 million excess of \$350 million ultimate net loss each loss occurrence, subject to a limit of \$100 million for all loss occurrences during each contract year
Workers' Compensation Excess of Loss	Workers' Compensation and Employers' Liability Business	<u>Authorized</u> Arch Reinsurance Company (16.00%) Lloyd's of London (19.70%) Various reinsurers (34.02%) <u>Unauthorized</u> Everest Reinsurance (Bermuda) Ltd (10.00%) Various reinsurers (20.28%)	\$400 million ultimate net loss each loss occurrence	\$250 million excess of \$400 million ultimate net loss each loss occurrence, subject to a limit of \$500 million for all loss occurrences during the contract term
Terrorism (including nuclear, biological, chemical or radiological)				
Terrorism Excess of Loss*	Workers' Compensation and Employers' Liability Business	<u>Authorized</u> Arch Reinsurance Company (11.00%) Lloyd's of London (44.99%) Various reinsurers (29.61%) <u>Unauthorized</u> Various reinsurers (14.40%)	\$100 million ultimate net loss each loss occurrence	\$235 million excess of \$100 million ultimate net loss each loss occurrence \$235 million term limit

*State Fund is covered under the Federal Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) up to \$393 million in excess of \$324 million ultimate net loss. TRIPRA covers 84% and State Fund retains 16% of the ultimate net loss.

Loss Portfolio Transfer

In August 2002, State Fund entered into a Loss Portfolio Transfer (LPT) with XL Re Ltd. (XL Re) and ACE Bermuda Insurance Ltd (ACE). Effective January 1, 2007, XL Re assumed all the rights and obligations of ACE under the LPT through an Assumption Reinsurance and Novation Agreement. The LPT covers workers' compensation losses paid after January 1, 2002 on accident years 1980 to 1998. Loss adjustment expenses, employers' liability and United States Longshoremen's and Harbor Workers' Compensation Act losses are excluded. Under the LPT agreement, State Fund retains an amount of aggregate subject losses and the reinsurers are liable for 90% share of

losses in the covered layers. The maximum amount recoverable under the reinsured layers of the agreement is 90% of \$1.45 billion. The following table is a summary of the reinsured layers of coverage:

Coverage Layers	State Fund's Retention	Reinsurer's Limits
First Layer	\$950 million of aggregate subject losses	90% of \$1.15 billion excess of \$950 million aggregate subject losses
Second Layer	\$200 million of aggregate subject losses	90% of \$300 million excess of \$2.1 billion aggregate subject losses

As of December 31, 2016, cumulative subject paid losses of \$2.2 billion exceeded the upper limit of the first layer of \$2.1 billion placed at 90%. After the \$950,000,000 State Fund's retention, total billed losses were \$1.035 billion of which \$899.7 million were collected from the reinsurers.

FINANCIAL STATEMENTS

The following financial statements are based on the statutory financial statements filed by State Fund with the California Department of Insurance for the period ending December 31, 2016. 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, 2016

Underwriting and Investment Exhibit for the Year Ended December 31, 2016

Reconciliation of Surplus as Regards Policyholders from December 31, 2012
through December 31, 2016

Statement of Financial Condition
as of December 31, 2016

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$18,904,435,531	\$	\$18,904,435,531	
Common stocks	895,418,312		895,418,312	
Real estate:				
Properties occupied by the company	244,319,436		244,319,436	
Properties held for sale	710,488		710,488	
Cash, cash equivalents and short-term investments	224,084,442		224,084,442	
Receivables for securities	35,372		35,372	
Investment income due & accrued	133,539,091		133,539,091	
Uncollected premiums and agents' balances in course of collection	176,023,102	85,420,250	90,602,852	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	151,253,708	15,125,379	136,128,329	
Amount recoverable from reinsurers	2,238,808		2,238,808	
Funds held by or deposited with reinsured companies	600,000		600,000	
Guaranty funds receivable or on deposit	30,898,325	1,224,138	29,674,187	
Electronic data processing equipment and software	10,066,975	593,562	9,473,413	
Furniture and equipment	6,890,672	6,890,672		
Aggregate write-ins for other than invested assets	<u>67,351,791</u>	<u>7,607,848</u>	<u>59,743,943</u>	
Total assets	<u>\$20,847,866,053</u>	<u>\$ 116,861,849</u>	<u>\$20,731,004,204</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses			\$11,131,545,930	(1)
Loss adjustment expenses			1,776,868,928	(1)
Commissions payable, contingent commissions and other similar charges			29,214,708	
Other expenses (excluding taxes, licenses and fees)			36,885,168	
Taxes, licenses and fees (excluding federal and foreign income taxes)			15,159,073	
Borrowed money			178,874,788	(2)
Unearned premiums			76,266,778	
Advance premium			539,215	
Policyholders dividends declared and unpaid			100,000	
Ceded reinsurance premiums payable			(1,134,696)	
Amounts withheld or retained by company for account of others			61,841,784	
Remittances and items not allocated			456,190	
Provision for reinsurance			6,476,885	
Payable for securities			94,862,858	
Aggregate write-ins for liabilities			<u>627,990,746</u>	
Total liabilities			14,035,948,355	
Aggregate write-ins for special surplus funds		\$1,560,374,593		
Unassigned funds (surplus)		<u>5,134,681,256</u>		
Surplus as regards policyholders			<u>6,695,055,849</u>	
Total liabilities, surplus and other funds			<u>\$20,731,004,204</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2016

Statement of Income

Underwriting Income

Premiums earned		\$ 1,527,223,571
Deductions:		
Losses incurred	\$ 1,130,211,278	
Loss adjustment expenses incurred	493,467,528	
Other underwriting expenses incurred	<u>381,871,225</u>	
Total underwriting deductions		<u>2,005,550,031</u>
Net underwriting loss		(478,326,460)

Investment Income

Net investment income earned	\$ 626,850,282	
Net realized capital gains	<u>69,268,684</u>	
Net investment gain		696,118,966

Other Income

Net loss from agents' or premium balances charged off	\$ (31,457,842)	
Aggregate write-ins for miscellaneous income	<u>542,532</u>	
Total other loss		<u>(30,915,310)</u>
Net income before dividends to policyholders, after capital gains taxes and before federal and foreign income taxes		186,877,196
Dividends to policyholders		<u>(4,690,564)</u>
Net income		<u>\$ 191,567,760</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2015		\$ 6,539,438,983
Net income	\$ 191,567,760	
Change in net unrealized capital gain	39,763,073	
Change in nonadmitted assets	(25,589,006)	
Change in provision for reinsurance	(5,980,963)	
Aggregate write-ins for losses in surplus	<u>(44,143,998)</u>	
Change in surplus as regards policyholders for the year		<u>155,616,866</u>
Surplus as regards policyholders, December 31, 2016		<u>\$ 6,695,055,849</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2012 through December 31, 2016

Surplus as regards policyholders, December 31, 2012, per Examination			\$ 6,011,868,861
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 778,493,926	\$	
Change in net unrealized capital gains	132,427,125		
Change in nonadmitted assets		35,519,206	
Change in provision for reinsurance		5,917,875	
Aggregate write-ins losses in surplus	<u> </u>	<u>186,296,982</u>	
Total gains and losses	<u>\$ 910,921,051</u>	<u>\$ 227,734,063</u>	
Net increase in surplus as regards policyholders			<u>683,186,988</u>
Surplus as regards policyholders, December 31, 2016, per Examination			<u>\$ 6,695,055,849</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

A Casualty Actuary from the California Department of Insurance (CDI) evaluated the Unpaid Liability Adequacy Test and Experience Report as of December 31, 2016 prepared by State Fund's independent actuary and concurred that State Fund's losses and loss adjustment expense reserves as of December 31, 2016 were reasonable and have been accepted for purposes of this examination.

(2) Borrowed Money

Effective February 15, 2012, State Fund entered into an Advances and Security Agreement with the Federal Home Loan Bank (FHLB) of San Francisco. As a member of FHLB, State Fund has a collateralized \$1.024 billion line of credit with a maximum term of five years. The line of credit was increased to \$1.434 billion in 2016 and was reviewed by the CDI with no objection. Under this arrangement, State Fund pledged \$1.1 billion of its eligible securities to FHLB. The line of credit is utilized under the following guidelines: up to \$300 million for the five-year maturity spread program; \$700 million available for a catastrophic event with a maximum maturity of two years; and the remaining balance for daily working capital with a 90-day or 6-month maturity. As of December 31, 2016, State Fund had borrowed \$178.5 million under the line of credit with FHLB.

SUBSEQUENT EVENTS

Senate Bill (SB) 272 introduced by Senator Mendoza on February 8, 2017 was passed in the Assembly and the Senate on September 7, 2017 and September 14, 2017, respectively, and approved by the Governor, Edmund G. Brown Jr. on October 6, 2017. SB 272 authorized the State Fund Board to appoint additional executive management positions, including a Chief Underwriting Officer, a Senior Vice President of Insurance Services, an Executive Vice President of Corporate Claims, an Executive Vice President

of Strategic Planning, and a Pricing Actuary. Effective January 3, 2018, the board has appointed these five additional executive management positions pursuant to California Insurance Code Section 11785(a). The board is required to set the salary of each management position to attract talent and retain qualified individuals, and to submit salary-setting criteria and salary surveys to the California Department of Human Resources (CalHR). Under this bill, the board is required to make a report to the Legislature regarding the information submitted to CalHR and the salary and total compensation of each position appointed by the board by September 1, 2018, and subsequently on a biennial basis.

State Fund completed its periodic analyses of the adequacy of loss and loss adjustment expense (LAE) reserves for yearend 2017. These analyses indicated that loss and LAE reserves overall remain adequate but LAE reserves needed strengthening. At December 31, 2017, State Fund reallocated \$448 million in reserves on prior accident years from loss to LAE. Additionally, management's best estimate of LAE reserves indicated a further strengthening of \$217 million for an overall increase in LAE reserves of \$665 million.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

None.

Previous Report of Examination

Accounts and Records – Information Systems Controls (Page 12): As a result of the review of State Fund's information systems controls, recommendations for improving these controls were presented to State Fund. State Fund should evaluate these recommendations and make appropriate changes to strengthen its controls over its information systems. State Fund has taken steps to address the recommendations.

ACKNOWLEDGMENT

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

Respectfully submitted,

/S/ _____

Li Lim, CFE
Examiner-In-Charge
Senior Insurance Examiner, Specialist
Department of Insurance
State of California

/S/ _____

Ber Vang, CFE, AES, CISA
Senior Insurance Examiner, Supervisor
Department of Insurance
State of California