REPORT OF EXAMINATION
OF THE
STATE COMPENSATION INSURANCE FUND
AS OF
DECEMBER 31, 2012

Filed May 27, 2014

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San Francisco, California
March 27, 2014

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 also referred to as the Fund) at one of its regional offices located at 1010 Vaquero Circle, Vacaville, California 95688. The Fund's statutory 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 the Fund. The previous examination of the Fund was made as of December 31, 2009. This examination covers the period from January 1, 2010 through December 31, 2012. 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 Fund's financial condition, to identify prospective risks, and to obtain information about the Fund, 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, and management's compliance with Statutory Accounting Principles and Annual Statement instructions. All accounts and activities of the Fund were considered in accordance with the risk-focused examination process.

In addition to those items specifically commented upon in this report, other phases of the Fund's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; pensions, stock ownership and insurance plans; salary, wages and benefits; loss experience; and statutory deposits.

SUMMARY OF SIGNIFICANT FINDINGS AND SUBSEQUENT EVENTS

On September 13, 2013, Assembly Bill (AB) 1394 was signed into law by the Governor with an effective date of January 1, 2014. AB 1394 authorizes the Fund to have four additional exempt positions and establishes the Fund as a quasi-state agency for the purpose of transacting workers' compensation insurance both competitively in the market and as the insurer of last resort for California businesses that require coverage but cannot obtain that coverage from private insurers. As a result of AB 1394, Section 11785 of the California Insurance Code was amended to read as follows:

> "11785. (a) The board of directors shall appoint a president, a chief financial officer, a chief operating officer, a chief information technology officer, a chief investment officer, a chief risk officer, a general counsel, a chief medical officer, a chief actuarial officer, a chief claims operations officer, and a chief of internal affairs. The board of directors shall set the salary for each position. These positions shall not be subject to otherwise applicable provisions of the Government Code and the Public Contract Code, and for those purposes the fund shall not be considered a state agency or other public entity. The president shall manage and conduct the business and affairs of the fund under the general direction and subject to the approval of the board of directors, and shall perform other duties as the board of directors prescribes."

On November 15, 2013, the board of directors accepted the resignations of Thomas E. Rowe, President and Chief Executive Officer, and Dan J. Sevilla, Jr., Chief Financial Officer. On the same day, the board appointed Carol R. Newman, General Counsel, as Interim President and Peter A. Guastamachio, Chief Investment Officer, as Interim Chief Financial Officer.

THE FUND HISTORY

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

During the examination period, the Fund has undergone an unprecedented amount of change. Starting in December 2010, the Fund implemented a consolidation plan to reduce its real estate footprint statewide and to geographically restructure its operations to serve California more efficiently. One of the key measures to reduce operating costs involved the elimination of a significant number of positions. To accomplish this plan, the Fund announced the possibility of layoffs.

In October 2011, the Fund sold its home office location at 1275 Market Street, San Francisco, California, and transferred the majority of the home office employees to other offices in Pleasanton, Vacaville, and Sacramento, California. The Fund recorded a realized gain of $24.6 million on the sale. After the sale of its home office building, the Fund moved its statutory home office to a leased space located at 333 Bush Street, San Francisco, California. The Fund's senior executives as well as its finance, investment, and actuarial operations remained in San Francisco, California. All other administrative and managerial functions were reallocated to regional offices located in Vacaville and Pleasanton, California.

The Fund also closed other regional offices and consolidated regional claims and underwriting functions into central locations located in California. The Monterey Park, Pleasanton, Santa Ana, Fresno, and Sacramento regional offices handle both claims and underwriting. The Riverside, Redding, Stockton, Bakersfield, Eureka, and Rohnert Park regional offices handle claims and the Vacaville regional office handles underwriting. The threat of layoffs and the changes in office locations resulted in a large

number of workers retiring early, leaving for other state agencies, or other companies. The reduction in employees due to attrition allowed for the Fund to cancel the layoff plan. The Fund went from 7,660 full time employees as of December 31, 2009, down to 4,589 full time employees by December 31, 2012.

During and subsequent to the examination period, the Fund has experienced a significant amount of turnover in its senior executive, exempt positions. The changes in the exempt positions are noted in the Management and Control section of this Report of Examination.

MANAGEMENT AND CONTROL

Pursuant to California Insurance Code Section 11770, the board of directors (board) of the Fund is composed of eleven members, nine of whom are appointed by the Governor, including the Chairperson and one of whom shall be from organized labor. One member is appointed by the Speaker of the Assembly (this member also represents organized labor). One member is appointed by the Senate Committee on Rules. The Director of Industrial Relations is an ex-officio, non-voting member of the board, and is not counted as a member of the board for quorum purposes or any other purpose. Following the initial terms of office, the subsequent terms of the members of the board, other than the Director of Industrial Relations, are five years, and they hold office until the appointment of their successors.

A listing of the directors and principal officers as of December 31, 2012, follows:

Directors

Name and Location	Principal Business Affiliation
Christine Baker Berkeley, California	Chief Deputy Director and Acting Director Department of Industrial Relations

Directors (continued)

Name and Location	Principal Business Affiliation
Sheryl A. Chalupa [(a)(b)] Bakersfield, California	President and Chief Executive Officer Goodwill Industries of South Central California
Daniel M. Curtin Carmichael, California	Director California Conference of Carpenters
Donald E. Garcia [(b)] Tustin Ranch, California	President and Chief Executive Officer Pinnacle Consulting Group
Senator Michael J. Machado Linden, California	Retired
Lawrence E. Mulryan [(a)(b)] San Rafael, California	Retired Chairman of the Board
Francis E. Quinlan [(b)] Corona del Mar, California	Of Counsel Newmeyer & Dillion, LLP
Steven L. Rank [(b)] Roseville, California	Western Region Director Ironworker Management Progressive Action Cooperative Trust (I.M.P.A.C.T.)
Thomas E. Rankin Berkeley, California	Treasurer California Alliance for Retired Americans
Scott K. Reid Placerville, California	CEA III Economic and Statistical Research Bureau - Franchise Tax Board
William M. Zachry [(b)] San Carlos, California	Vice President, Risk Management Safeway Inc.

Principal Officers

Name	Title
Thomas E. Rowe [(c)(e)]	President and Chief Executive Officer
Dan J. Sevilla, Jr. [(d)(e)]	Chief Financial Officer
Carol R. Newman [(e)]	General Counsel
Peter A. Guastamachio [(e)]	Chief Investment Officer
Kenneth R. Van Laar [(c)]	Chief Risk Officer
Beatriz Sanchez [(f)]	Interim Chief Operating Officer
Marjorie Hutchings [(g)]	Chief Information Officer
Andreas Acker	Senior Vice President and Chief Administrative Officer
Brian D. Watson [(h)]	Senior Vice President of Government and Business Affairs
Darlyn Regan [(i)]	Executive Vice President of Field Operations
Jennifer Vargen	Senior Vice President of Marketing and Communications

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

[(a)] Jeannie Cain, former Chairman of the board, left the board on December 31, 2010. Her term expired January 15, 2010, however, she remained on the board until a replacement was named. Lawrence E. Mulryan was elected as Chairman of the board effective December 31, 2010. On March 7, 2014, Sheryl A. Chalupa replaced Lawrence E. Mulryan, as Chairperson of the board. Lawrence E. Mulryan remained a member of the board.

[(b)] In March 2013, the Governor announced the appointment of Robin Baker, Director of Research at the University of California, Berkeley Center for Occupational and Environmental Health, and Marvin Kropke, Business Manager and Financial Secretary for Local 11 of the International Brotherhood of Electrical Workers, to the board. Marvin Kropke replaced Don Garcia whose term had expired and was not reappointed by the Governor. In January 2014, the Governor announced the reappointments of Sheryl A. Chalupa and William M. Zachry. The Governor also announced the appointment of Jack Neureuter to replace Francis E. Quinlan whose term expired January 15, 2014. Both Lawrence E. Mulryan's and Steven L. Rank's terms expired effective January 15, 2014, however, they have not been replaced and continue to serve on the board.

[(c)] Douglas V. Stewart served as Interim President and Chief Executive Officer from October 2009 up to August 1, 2010 when Thomas E. Rowe was named President and Chief Executive Officer. Effective August 1, 2010, Douglas V. Stewart was named as the Chief Risk Officer and served in that capacity until he left the Fund in December 2010. Effective January 21, 2011, Kenneth R. Van Laar was named as Chief Risk Officer by the board.

(d) Jay H. Stewart, Chief Financial Officer resigned effective October 15, 2010 and was replaced by an interim Chief Financial Officer, Dan J. Sevilla, Jr.. On January 21, 2011, Dan J. Sevilla, Jr. was named as the Chief Financial Officer by the board.

(e) On November 15, 2013, the board accepted the resignations of Thomas E. Rowe, President and Chief Executive Officer, and Dan J. Sevilla, Jr., Chief Financial Officer. The board appointed Carol R. Newman, General Counsel, as Interim President and Peter A. Guastamachio, Chief Investment Officer, as Interim Chief Financial Officer and Chief Investment Officer. Lisa Stolzy was also named as acting General Counsel.

(f) Linda Hoban, Claims Operations President, retired at the end of 2010. Effective December 2, 2010, Beatriz Sanchez was named as the Executive Vice President of Field Claims and Julie Jenkinson was named Executive Vice President of Corporate Claims. Effective January 1, 2012, Julie Jenkinson was given a new assignment when Corporate Claims and Field Claims were combined and Beatriz Sanchez was named as the Executive Vice President of Claims. In the fourth quarter of 2010, James F. Neary, Vice President and Actuarial/Chief Advisor, Harrison D. Jerome, Chief Operating Officer, retired. Effective December 2, 2010, Tom Clark was named as Chief Operating Officer until he retired in November 2012, and Beatriz Sanchez was named as Interim Chief Operating Officer. In the February 15, 2013, board meeting, Beatriz Sanchez was named as the Chief Operating Officer. On November 15, 2013, Beatriz Sanchez was named as Chief Claims Operations Officer effective January 1, 2014, Dr. Dinesh Govindarao was named as Chief Medical Officer effective January 2, 2014, and Dante Robinson was named as Chief of Internal Affairs effective January 2, 2014. Effective January 1, 2014, the Chief Operating Officer position was vacant and was not filled as of the date of this report.

(g) Shaun Coyne resigned his position as Chief Information Officer effective August 31, 2012. Effective September 1, 2012, Marjorie Hutchings was named as the Chief Information Officer.

(h) Brian D. Watson was named Senior Vice President of Government and Business Affairs effective September 20, 2011. He retired on June 28, 2013.

(i) In December 2012, Darlyn Regan, Executive Vice President of Field Operations, became a member of the Executive Committee.

Management Agreements

Master Consulting Services Agreement: Effective March 1, 2012, a Master Consulting Services Agreement was executed between United States Insurance Services, Inc. (USIS) and the Fund. Under the agreement, USIS has provided individual consultants for certain management level, highly specialized, and/or technical workers' compensation insurance consulting services such as predictive analytics, internal audit, and information technology. USIS provided consultants for key positions such as the

Chief of Internal Affairs, Chief Technology Officer, and Vice President of Enterprise Procurement during the examination period.

The Fund paid a base fee and a management fee to USIS for the aforementioned services and reimburses USIS for other costs and expenses related to the engagement of the consultant.

TERRITORY AND PLAN OF OPERATION

The Fund is authorized to write workers' compensation insurance, including liability under the United States Longshoremen's and Harbor Workers' Compensation Act (USL&H) in the State of California. The Fund insures the temporary workers' compensation exposures in other states for California employers insured by the Fund. The Fund also adjusts claims as a third party administrator (TPA) for self-insured public and private employers. Its largest TPA client is the State of California.

The Fund's predominant source of business was its broker distribution channel. The number of authorized brokers during the examination period was as follows: 4,657 in 2010, 4,694 in 2011, and 4,509 in 2012. Effective January 1, 2013, the Fund changed its broker distribution model to the "Access State Fund" program. In order for a broker to continue a direct relationship with the Fund, the broker had to generate paid premiums in excess of $100,000 in one of the past three years directly with the Fund. As a result of the distribution model change, the Fund terminated the contracts of 3,328 brokers, effective January 1, 2013.

Under the new model, the brokers who do not qualify for a direct contract can still produce business through two authorized partners, RIC Insurance General Agency, Inc. based in Santa Rosa, California, and Arthur J. Gallagher & Co. Insurance Brokers of California Inc. based in San Francisco, California. The Fund did not permit sub-producing or wholesaling activity under its direct contracts. The Fund no longer contracted with brokerage clusters as a single entity. Only cluster members who have

met the qualification threshold of $100,000 in paid premium can be offered a direct contract with the Fund.

GROWTH OF THE FUND

The Fund's market share has been steadily declining from a high of 53% of the market in 2003 to a low of 10% in 2012. The following schedule reflects the net premiums written, net underwriting losses, and surplus as regards policyholder as reported by the Fund from 2009 to 2012, along with the Fund's market share:

	Net Premiums Written	Surplus as Regards Policyholders	Net Underwriting Losses	Market Share
2009	$1,252,241,223	$5,248,888,706	($722,850,853)	18.6%
2010	1,121,494,225	5,466,363,287	(644,625,593)	16.0%
2011	995,346,055	5,662,692,152	(580,131,546)	12.9%
2012	887,629,146	6,011,868,861	(333,521,066)	10.0%

A soft market along with increased competition resulted in a substantial decline in premium volume and market share. The steady decrease in market share since 2003 has created challenges for the Fund in managing its overall expense and overhead structure. The Fund’s consolidation plan (previously mentioned in the Fund History section) has allowed the Fund to realize some cost savings which resulted in the decreased underwriting losses since 2009. The Fund’s net investment gains have more than offset the underwriting losses experienced by the Fund which allow the Fund to report net income in each year during examination.

REINSURANCE

Assumed

The Fund had no significant assumed premium written during the period covered by this examination and had no significant liability for assumed losses or loss adjustment expenses as of December 31, 2012.

Ceded

Natural Catastrophe Excess of Loss: In 2012, the Fund maintained a per occurrence reinsurance cover of $450,000,000 excess of a $100,000,000 retention for earthquake and $300,000,000 retention for all other perils (excluding terrorism). The first $200,000,000 of earthquake coverage was provided by a catastrophe bond with a single coverage limit over a three-year term which began in 2012 with loss payments triggered by modeled losses to the Fund portfolio and not actual losses. The following is a summary of the reinsurers:

Reinsurers	Authorized/ Unauthorized	Participation
Swiss Reinsurance America	Authorized	15.00%
Munich Reinsurance America, Inc.	Authorized	12.48%
Münchener Rüeckversicherungs-Gesellschaft	Unauthorized	12.48%
Everest Reinsurance (Bermuda) Limited, Bermuda	Unauthorized	10.00%
Reinsurers with less than 10% participation (24 Total)	Both	50.04%
		100.00%

Terrorism Risk Insurance Program Reauthorization Act of 2007: In addition to natural catastrophe reinsurance, the Fund was covered in 2012 for terrorist events, including nuclear, biological, chemical, and radiological events, by a combination of private reinsurance and Federal Terrorism Risk Insurance Program Reauthorization Act (TRIPRA). The Fund's retention was 20% of direct earned premium for the preceding year, therefore, for 2012 the Fund retained the first $203,000,000 of aggregate annual losses caused by terrorism. Private reinsurance provide $100,000,000 of aggregate

annual excess coverage to the level of TRIPRA retention, which is 20% of the previous year's direct earned premium, and 15% coinsurance with TRIPRA (which covers 85%) up to $2,000,000,000. TRIPRA coverage extends to an aggregate industry limit of $100,000,000,000. The Fund's maximum ultimate net loss under the private treaty is $15,000,000 for any one life in any one act of terrorism. The following is a summary of the reinsurers:

Reinsurers	Authorized/ Unauthorized	Participation
National Indemnity Company	Authorized	31.25%
Munich Reinsurance America, Inc.	Authorized	11.00%
Münchener Rüeckversicherungs-Gesellschaft	Unauthorized	11.00%
Reinsurers with less than 10% participation (20 Total)	Both	46.75%
		100.00%

Loss Portfolio Transfer: The Fund entered into a loss portfolio transfer agreement in August 2002. The contract covers workers' compensation losses only. Loss adjustment expenses, employers' liability and USL&H losses are excluded in the agreement. Under this agreement, the Fund ceded certain loss reserves relating to the accident years 1980 to 1998 to XL Capital Ltd. and ACE Ltd. In a later novation agreement, all of ACE Ltd.'s liability was transferred to XL Capital Ltd. who remains as the only reinsurer. Under the terms of the contract, the Fund retained the first $950,000,000 of losses. The reinsurance coverage is for 90% of losses in the covered layers. Initially, the reinsurers cover $1,035,000,000 of the next layer of $1,150,000,000 of losses. The Fund retains a further layer of $200,000,000 excess $2,100,000,000 with the reinsurers covering $270,000,000 of a layer of $300,000,000 excess $2,300,000,000. The Fund has the sole right to terminate the contract on or after December 31, 2008 for payment at a specified formula, but thus far has chosen not to do so. As of December 31, 2012, cumulative subject paid losses were $1,934,863,975 which exceeded the $950,000,000 retention.

As a result of this agreement, and in accordance with Statement of Statutory Principles (SSAP) No. 62, the Fund recorded a contra liability against loss reserves of

$1,035,000,000 and a retroactive reinsurance gain of $319,756,350 which was included under other income at the time of the agreement in 2002. The special surplus arising from the agreement was considered to be earned surplus and transferred to unassigned funds (surplus) when cash recoveries from the reinsurers exceed the total consideration paid by the Fund for the loss portfolio transfer. As of December 31, 2012, the contra liability against loss reserves was $528,997,447.

ACCOUNTS AND RECORDS

During the course of the examination, a review was made of the Fund's general controls over its information systems and general application controls. As a result of this review, weaknesses were noted in areas such as IT governance, logical security, computer operations and change management/systems development life cycle. These findings were presented to the Fund along with recommendations to strengthen its controls. The Fund should evaluate the recommendations and make appropriate changes to strengthen its information system controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2012

Underwriting and Investment Exhibit for the Year Ended December 31, 2012

Reconciliation of Surplus as Regards Policyholders from December 31, 2009 through December 31, 2012

Statement of Financial Condition
as of December 31, 2012

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$ 18,232,852,266	$	$18,232,852,266	
Real estate:				
Properties occupied by the company	337,388,587		337,388,587	
Properties held for sale	16,155,201		16,155,201	
Cash ($430,904,119), cash equivalents ($0) and short-term investments ($0)	430,904,119		430,904,119	
Receivable for securities	2,034,617		2,034,617	
Investment income due and accrued	151,232,120	19,300	151,212,820	
Premiums and considerations:				
Uncollected premiums and agents' balances in course of collection	72,427,158	34,128,152	38,299,006	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	59,269,408	5,926,941	53,342,467	
Reinsurance: Amount recoverable from reinsurers	3,121,552		3,121,552	
Funds held by or deposited with reinsured companies	600,000		600,000	
Guaranty funds receivable or on deposit	74,462,746	1,009,525	73,453,221	
Electronic data processing equipment and software	22,931,221	18,262,815	4,668,406	
Furniture and equipment, including health care delivery assets	20,761,639	20,761,639	0	
Aggregate write-ins for other than invested assets	91,319,392	1,234,273	90,085,119	
Total assets	$ 19,515,460,025	$ 81,342,645	$19,434,117,381	

Liabilities, Surplus and Other Funds				
Losses and loss adjustment expenses			$11,193,896,151	(1)
Loss adjustment expenses			1,732,627,042	(1)
Commissions payable, contingent commissions and other similar charges			22,617,713	
Other expenses			32,085,766	
Taxes, licenses and fees			11,698,514	
Unearned premiums			47,026,017	
Advance premiums			269,640	
Dividends declared and unpaid: Policyholders			131,182,126	
Ceded reinsurance premiums payable			(769,463)	
Amounts withheld or retained by company for account of others			64,677,139	
Remittances and items not allocated			2,559,367	
Provision for reinsurance			559,010	
Aggregate write-ins for liabilities			183,819,498	
Total liabilities			13,422,248,520	
Aggregate write-ins for special surplus funds		$ 1,538,274,173		
Unassigned funds (surplus)		4,473,594,688		
Surplus as regards policyholders			6,011,868,861	
Total liabilities, surplus and other funds			$19,434,117,381	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2012

Statement of Income

Underwriting Income		
Premiums earned		$ 922,634,504
Deductions:		
Losses and loss expenses incurred	$ 691,975,288	
Other underwriting expenses incurred	207,592,763	
Aggregate write-ins for underwriting deductions	356,587,519	
Total underwriting deductions		1,256,155,570
Net underwriting loss		(333,521,066)
Investment Income		
Net investment income earned	$ 759,610,261	
Net realized capital gain	42,820,661	
Net investment gain		802,430,922
Other Income		
Net loss from agents' or premium balances charged off (amount recovered $15,308,147 amount charged off $36,040,708)	$ (20,732,561)	
Aggregate write-ins for miscellaneous income	10,000,000	
Total other income		(10,732,561)
Net income before dividends to policyholders, after capital gains tax and before federal and foreign income taxes		458,177,295
Dividends to policyholders		99,500,000
Net income		$ 358,677,295

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2011		$5,662,692,152
Net income	$ 358,677,295	
Change in nonadmitted assets	(11,329,604)	
Change in provision for reinsurance	1,829,017	
Change in surplus as regards policyholders for the year		349,176,709
Surplus as regards policyholders, December 31, 2012		$6,011,868,861

Reconciliation of Surplus as Regards Policyholders
from December 31, 2009 through December 31, 2012

	Gain in Surplus	Loss in Surplus	
Surplus as regards policyholders, December 31, 2009, per Examination			$ 5,248,889,706
Net income	$ 659,331,000	$	
Change in net unrealized capital losses		4,276,280	
Change in nonadmitted assets	116,099,428	11,329,604	
Change in provision for reinsurance	7,484,134	4,329,524	
Total gains and losses	$ 782,914,563	$ 19,935,408	
Net increase in surplus as regards policyholders			762,979,155
Surplus as regards policyholders, December 31, 2012, per Examination			$ 6,011,868,861

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

A Senior Casualty Actuary with the California Department of Insurance (CDI) evaluated the loss and loss adjustment expense reserves (loss reserves) as of December 31, 2012. Based on the analyses performed the CDI has determined that the losses and loss adjustment expenses were reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

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

Previous Report of Examination

None.

ACKNOWLEDGMENT

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

Respectfully submitted,

_____

Shawn Towchik, CFE
Examiner-In-Charge
Contract Examiner
Department of Insurance
State of California