

REPORT OF EXAMINATION
OF THE
BUSINESS ALLIANCE INSURANCE COMPANY
AS OF
DECEMBER 31, 2016

Filed On June 8, 2018

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION	1
COMPANY HISTORY	2
MANAGEMENT AND CONTROL:.....	2
Intercompany Agreement.....	4
TERRITORY AND PLAN OF OPERATION.....	4
REINSURANCE:	5
Assumed.....	5
Ceded	5
FINANCIAL STATEMENTS:	6
Statement of Financial Condition as of December 31, 2016.....	7
Underwriting and Investment Exhibit for the Year Ended December 31, 2016	8
Reconciliation of Surplus as Regards Policyholders from December 31, 2012 through December 31, 2016.....	9
COMMENTS ON FINANCIAL STATEMENT ITEMS:.....	10
Bonds, Preferred Stocks, Common Stocks, Cash and Short-Term Investments	10
Losses and Loss Adjustment Expenses	11
Unearned Premiums	11
Advance Premiums.....	11
SUBSEQUENT EVENTS	12
SUMMARY OF COMMENTS AND RECOMMENDATIONS:	13
Current Report of Examination	13
Previous Report of Examination	13
ACKNOWLEDGMENT	16

San Francisco, California
May 29, 2018

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

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

BUSINESS ALLIANCE INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 400 Oyster Point Boulevard, Suite 327, South San Francisco, California 94080.

SCOPE OF EXAMINATION

We have performed our single-state examination of the Company. The previous examination of the Company was as of December 31, 2012. This examination covered the period of 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 the Company's financial condition, assess corporate governance, identify current and prospective risks, and evaluate system controls and procedures used to mitigate those risks. The examination also included identifying and evaluating significant risks that could cause the Company'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 includes assessing significant estimates made by management and evaluating management's compliance with Statutory Accounting Principles. The examination does not attest to the fair presentation of the financial statements included herein. If, during the course of the examination, an adjustment is identified, the impact of such adjustment will be documented separately following the Company's financial statements.

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

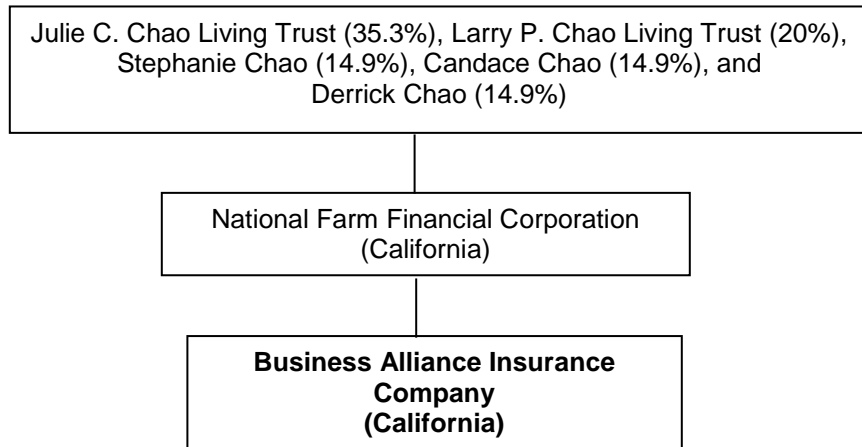
COMPANY HISTORY

The Company was incorporated on November 12, 1996 under the laws of the State of California and commenced business on September 15, 1997. The Company is authorized to issue 100,000 shares of common stock with a par value of \$100 per share. As of December 31, 2016, there were 26,000 shares outstanding.

In 2015, the Company paid ordinary cash dividends of \$500,000 to its parent, National Farm Financial Corporation (NFFC). In 2017, the Company paid extraordinary cash dividends of \$5 million to NFFC after receiving approval from the California Department of Insurance.

MANAGEMENT AND CONTROL

The Company is a wholly owned subsidiary of National Farm Financial Corporation (NFFC), which is owned and controlled by the Chao Family. The following organizational chart depicts the Company's relationship within the holding company system at December 31, 2016 (all ownership is 100% unless otherwise indicated):



A four-member board of directors, who are elected annually, oversee the business and affairs of the Company. Following are members of the board and principal officers of the Company serving at December 31, 2016:

Directors

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
Julie C. Chao Hillsborough, California	Chief Financial Officer and Treasurer Business Alliance Insurance Company
Stephanie D. Chao, M.D. Hillsborough, California	Physician/Surgeon Stanford University Medical Center
Robert T. Kingsley Davis, California	Chief Executive Officer and Secretary Business Alliance Insurance Company
Roger H. Platten Dyersville, Iowa	President and Head of Claims Business Alliance Insurance Company

Principal Officers

<u>Name</u>	<u>Title</u>
Robert T. Kingsley	Chief Executive Officer and Secretary

Name

Julie C. Chao
Roger H. Platten

Title

Chief Financial Officer and Treasurer
President and Head of Claims

Intercompany Agreement

Effective September 5, 1997, the Company entered into a broker agreement with Larry P. Chao Insurance Services, a California insurance agency owned by Larry P. Chao, the trustee of the Larry P. Chao Living Trust that owns 20% of NFFC. Under the terms of the agreement, Larry P. Chao Insurance Services is authorized to solicit and submit insurance applications and proposals for the classes and lines of business written by the Company. The Commissioner's Order Granting Exemption Letter dated September 10, 1997 exempted this agreement from the prohibitions of California Insurance Code Section 1101(a).

TERRITORY AND PLAN OF OPERATION

The Company is licensed to transact property and casualty insurance in the state of California. As a highly specialized niche underwriter of primarily small minority-owned businesses in California, the Company provides products that are specifically tailored to the needs of small businesses.

During 2016, the Company wrote commercial multiple peril and surety lines of business in California, which made up 81.1% and 18.9%, respectively, of the Company's total direct premiums written of \$6.7 million. The commercial multiple peril business is produced by approximately 300 independent brokers. The surety business consists of contractor license bonds produced by a single general agent.

All operations are conducted out of the Company's home office located in South San Francisco, California.

REINSURANCE

Assumed

The Company did not assume any reinsurance during the period covered by this examination.

Ceded

The following is a summary of principal reinsurance agreements inforce as of December 31, 2016:

Line of Business and Type of Contract	Authorized Reinsurer's Name	Company's Retention	Reinsurer's Limit
<u>Property and Casualty:</u>			
Multi XOL Property	Hannover Re (50%) Odyssey Re (50%)	\$300,000 each loss, each risk	\$700,000 excess of \$300,000 each loss, each risk subject to a limit of \$2.8 million each loss occurrence
Multi XOL Casualty	Hannover Re (50%) Odyssey Re (50%)	\$300,000 each loss occurrence	\$700,000 excess of \$300,000 each loss occurrence
Property Catastrophe	Hannover Re (50%) Odyssey Re (50%)	\$1,000,000 each loss occurrence	\$1,000,000 each loss occurrence, subject to a limit of \$1,500,000 each loss occurrence

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, 2016. The accompanying comments to the amounts reported in the financial statements should be considered an integral part of the financial statements. There were no adjustments 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	\$ 9,229,837	\$	\$ 9,229,837	(1)
Preferred stocks	150,267		150,267	(1)
Common stocks	1,544,385		1,544,385	(1)
Cash and short-term investments	10,349,033		10,349,033	(1)
Investment income due and accrued	97,604		97,604	
Premiums and agents' balances in course of collection	(51,550)	3,626	(55,176)	
Premiums, agents' balances and installments booked but deferred and not yet due (including \$0 earned but unbilled premiums)	1,831,944		1,831,944	
Amount recoverable from reinsurers	814,907		814,907	
Current federal and foreign income tax recoverable and interest thereon	135,538		135,538	
Net deferred tax asset	230,921	230,921		
Electronic data processing equipment and software	60,559		60,559	
Aggregate write-ins for other than invested assets	<u>128,995</u>		<u>128,995</u>	
 Total assets	 <u>\$ 24,522,440</u>	 <u>\$ 234,547</u>	 <u>\$ 24,287,893</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 2,388,840	(2)
Loss adjustment expenses			976,225	(2)
Commissions payable, contingent commissions and other similar charges			63,328	
Other expenses			162,977	
Taxes, licenses and fees			15,010	
Unearned premiums			2,709,949	(3)
Advance premiums			0	(4)
Ceded reinsurance premiums payable			313,206	
Aggregate write-ins for liabilities			<u>2,628</u>	
 Total liabilities			 6,632,163	
Common capital stock	\$ 2,600,000			
Gross paid-in and contributed surplus	5,490,240			
Unassigned funds (surplus)	<u>9,565,490</u>			
Surplus as regards policyholders			<u>17,655,730</u>	
 Total liabilities, surplus and other funds			 <u>\$ 24,287,893</u>	

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

Statement of Income

Underwriting Income

Premiums earned		\$ 5,664,048
Deductions:		
Losses incurred	\$ 2,012,797	
Losses adjustment expenses incurred	\$ 1,152,896	
Other underwriting expenses incurred	<u>2,560,371</u>	
Total underwriting deductions		<u>5,726,064</u>
Net underwriting loss		(62,016)

Investment Income

Net investment income earned	\$ 423,152	
Net realized capital losses	<u>(754)</u>	
Net investment gain		422,398

Other Income

Finance and service charges not included in premiums	\$ 102,421	
Aggregate write-ins for miscellaneous income	<u>382,297</u>	
Total other income		<u>484,718</u>
Net income after dividends to policyholders, after capital gains tax and before federal and foreign income taxes		845,100
Federal and foreign income taxes incurred		<u>240,000</u>
Net income		<u>\$ 605,100</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2015		\$ 16,913,893
Net income	\$ 605,100	
Change in net unrealized capital gains	19,747	
Change in net deferred income tax	88,714	
Change in nonadmitted assets	28,276	
Change in surplus as regards policyholders for the year		<u>741,837</u>
Surplus as regards policyholders, December 31, 2016		<u>\$ 17,655,730</u>

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

Surplus as regards policyholders, December 31, 2012			\$ 16,387,043
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 1,831,598	\$	
Change in net unrealized capital losses		194,479	
Change in net deferred income tax	56,186		
Change in nonadmitted assets	75,382		
Dividends to stockholders	<u> </u>	<u>500,000</u>	
Total gains and losses	<u>\$ 1,963,166</u>	<u>\$ 694,479</u>	
Net increase in surplus as regards policyholders			<u>1,268,687</u>
Surplus as regards policyholders, December 31, 2016			<u>\$ 17,655,730</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Bonds, Preferred Stocks, Common Stocks, Cash and Short-Term Investments

It was observed that the investment designations assigned by the Company for fourteen bonds in its Schedule D – Part 1 were incorrect. The Company had reported all of its bonds as meeting the quality of Class 1 as designated by the National Association of Insurance Commissioners (NAIC). However, during the examination, it was noted that fourteen of these bonds were designated by the NAIC as Class 2 through 4 instead. It is recommended that the Company implement procedures to ensure that bond designations are accurately reported.

Given that the Company had reported the designations incorrectly for some bonds as noted above, this could cause the carrying value for some of those bonds to be overstated. The Statements of Statutory Accounting Principles (SSAP) No. 26, paragraph 8, requires insurers that do not maintain an Asset Valuation Reserve to report the carrying value of bonds with NAIC designations 3 to 6 at the lower of amortized cost or fair value. During the examination, it was observed that the Company had a bond which was designated by the NAIC as Class 4 but was misclassified as Class 1. In applying SSAP No. 26, paragraph 8, the examination determined that had the Company reported the designation for this bond correctly, the carrying value for this bond would have been lower because its fair value was lower than its amortized cost. As a result, the bond's value was overstated. However, since the amount involved is immaterial, no examination adjustment was made. It is recommended that the Company implement appropriate procedures to comply with SSAP No. 26, paragraph 8.

California Insurance Code (CIC) Section 1104.9(c) mandates that securities shall not be deposited in or with a qualified custodian, qualified depository, or qualified subcustodian except as authorized by an agreement between the insurer and the qualified custodian, if the agreement is satisfactory to and has been approved by the Commissioner. The Company had investments consisting of bonds, common stocks, preferred stocks, cash and short-term investments in the amount of \$4.79 million deposited with Pershing,

LLC, as of December 31, 2016. However, the Company does not have an approved custodial agreement with Pershing, LLC. It is recommended that the Company comply with CIC Section 1104.9(c).

(2) Losses and Loss Adjustment Expenses

A Casualty Actuary from the California Department of Insurance reviewed the Actuarial Report as of December 31, 2016 prepared by the Company's independent actuary and concurred with the independent actuary's conclusion that the Company's loss and loss adjustment expense reserves as of December 31, 2016 are reasonable and have been accepted for purposes of this examination.

(3) Unearned Premiums

SSAP No. 53, paragraph 8 requires insurers to use one of the following methods to compute the unearned premium reserve: daily pro rata or monthly pro rata. It was observed that the Company's computation of the unearned premium reserve for its surety premiums did not comply with SSAP No. 53, paragraph 8, because it did not use either of the above permitted methods. Rather, the Company recorded the portion of premiums not yet collected as unearned premiums. As a result, the examination noted that the unearned premium reserve was understated by an immaterial amount. No examination adjustment was made to the financial statements since the difference is immaterial. It is recommended that the Company implement procedures to ensure compliance with SSAP No. 53, paragraph 8.

(4) Advance Premiums

SSAP No. 53, paragraph 15, requires insurers to report premiums received prior to the effective date of the policies as advance premiums instead of income in the statutory financial statement. It was observed that the Company did not comply with SSAP No. 53, paragraph 15, because it included premiums received in 2016 in the amount of

\$47,000 for 2017 surety policies in the written premiums for 2016. Since the amount involved is immaterial, no examination adjustment was made. It is recommended that the Company report advance premiums in accordance with SSAP No. 53, paragraph 15.

SUBSEQUENT EVENTS

PSM Holding Corporation (PSM), a New York Corporation, entered into an agreement in 2005 to purchase the Company from National Farm Financial Corporation (NFFC). NFFC did not proceed with the sale. PSM (Plaintiff) brought a lawsuit against NFFC, the Company, and Larry P. Chao, the trustee of the Larry P. Chao Living Trust that owns 20% of NFFC (Defendants). PSM was awarded damages under this lawsuit and PSM took control of the Company in October 2008. In June 2010, the United States Court of Appeals for the Ninth Circuit reversed the lower court decision and PSM was subsequently ordered to return the Company to NFFC. The Company was returned to NFFC in February 2011. NFFC continued its dispute with PSM for damages suffered by the Company while owned by PSM. In December 2014, the district court ruled that NFFC and Larry P. Chao were the prevailing party in the lawsuit and as such, are entitled to reimbursement of approximately \$2.2 million in attorney's fees and \$54,000 in costs for the period prior to the appeal. PSM did not dispute and paid the Defendants those sums. However, the district court also ruled that PSM was entitled to approximately \$1.1 million to fully resolve the conflict. Both parties appealed the ruling.

On March 7, 2018, the United States Court of Appeals for the Ninth Circuit reversed the district court's order of awarding approximately \$1.1 million in restitution to PSM and denied PSM's request of rescinding the quota share agreement with the Company that was entered in 2008 and expired on January 31, 2011. As of March, 31, 2018, the reinsurance recoverable from PSM was approximately \$136,000. The Court of Appeals also reversed the district court's order of awarding Defendants \$308,000 in attorney's fees and costs for the period following the appeal. In addition, it vacated the district court's order denying the Defendants' motion to retax costs, and remanded the case for

further reconsideration. Rather than litigating further, all parties agreed to a full settlement, with no exchange of consideration. The settlement agreement was entered on April 2, 2018.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Comments on Financial Statement Items – Bonds, Preferred Stocks, Common Stocks, Cash and Short-Term Investments (Page 10): It is recommended that the Company implement procedures to ensure that bond designations are accurately reported.

It is recommended that the Company implement appropriate procedures to comply with the Statements of Statutory Accounting Principles (SSAP) No. 26, paragraph 8.

It is recommended that the Company comply with California Insurance Code Section 1104.9(c).

Comments on Financial Statement Items – Unearned Premiums (Page 11): It is recommended that the Company implement procedures to ensure compliance with SSAP No. 53, paragraph 8.

Comments on Financial Statement Items – Advance Premiums (Page 11): It is recommended that the Company report advance premiums in accordance with SSAP No. 53, paragraph 15.

Previous Report of Examination

Company History - Dividends Paid to Parent (page 3): It was recommended that the Company report all future ordinary dividends and other distributions to shareholders in

accordance with California Insurance Code (CIC) Section 1215.4(f). The Company is now in compliance.

Corporate Records (page 4): It was recommended that the Company implement procedures to ensure future compliance with CIC Section 735. The Company is now in compliance.

Fidelity Bonds and Other Insurance (page 5): It was recommended that the Company continue to maintain coverage to cover material acts of theft or dishonesty by employees in the amount recommended in the National Association of Insurance Commissioners' Financial Conditions Examiners' Handbook. The Company is now in compliance.

Accounts and Records – Information System Controls (Page 6): It was recommended that the Company evaluate the recommendations and make appropriate changes to strengthen its information systems controls. The Company has addressed some of the recommendations.

Accounts and Records – Record Retention (page 7): It was recommended that the Company maintain adequate documentation to support all financial statement accounts. This was not an issue on this examination.

Accounts and Records - Unclaimed Property (page 7): It was recommended that the Company establish a written unclaimed property policy in compliance with California Unclaimed Property Act and set up reserve for escheat liability account pending escheat of the funds to California State Controller's Office. The Company is now in compliance.

Accounts and Records - Claims Handling (page 7): It was recommended that the Company obtain and use depreciation schedules that apply depreciation based on age and condition in accordance with California Code of Regulation, Title 10, Chapter 5, Subchapter 7.5, Article I, Section 2692.9(f). The Company is in process of addressing

the recommendations.

Comments of Financial Statement Items – Uncollected Premiums and Agents’ Balances (page 12): It was recommended that the Company separately report receivables not yet due under Annual Statement line, “Deferred premiums, agents’ balances in the course of collection” in accordance with the Annual Statement Instructions. The Company is now in compliance.

It was also recommended that overdue receivables be evaluated for impairments and any receivable that are determined to be uncollectible be written off and charged to income in the period the determination is made in accordance with the Statement of Statutory Accounting Principles (SSAP) No. 6, paragraph 10. The Company is now in compliance.

Comments of Financial Statement Items - Unearned Premiums (page 12): It was recommended that the Company record written premiums and calculate unearned premiums using the effective date of the contract in accordance with SSAP No. 53, paragraph 6. The Company is now 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/_____

Sam Chiu, CFE
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California

_____/S/_____

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