

REPORT OF EXAMINATION
OF THE
CALIFORNIA EARTHQUAKE AUTHORITY
AS OF
DECEMBER 31, 2013

A handwritten signature in black ink that reads "Dave Jones". The signature is written in a cursive, flowing style.

Insurance Commissioner

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San Francisco, California
May 7, 2015

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

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

CALIFORNIA EARTHQUAKE AUTHORITY

(hereinafter referred to as the CEA) at its home office located at 801 K Street, Sacramento, California 95814.

SCOPE OF EXAMINATION

We have performed our examination of the CEA. The previous examination of the CEA was made as of December 31, 2009. This examination covers the period from January 1, 2010 through December 31, 2013. 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 CEA's financial condition, to identify prospective risks, and to obtain information about the CEA, 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 CEA 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 CEA's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; pensions, and insurance plans; growth of the CEA; loss experience; and accounts and records.

SUBSEQUENT EVENTS

New Participating Insurers

On August 28, 2014, the Governing Board approved Hyundai Marine and Fire Insurance (Hyundai) as a participating insurer with the CEA. Hyundai is anticipated to begin writing earthquake policies in May 2015.

California Assembly Bill 2064 (AB 2064)

AB 2064 was signed into law by the Governor on September 18, 2014. The bill updates and improves the delivery of information to California homeowners and renters about earthquake insurance options. Specifically, this legislation replaces the existing periodic mandatory offer of earthquake insurance with a new, plain-English letter and a solicitation to apply for CEA earthquake insurance. The bill also requires the CEA's participating insurers to provide annually CEA-created and produced marketing documents to each of their residential property insureds. The above changes are effective January 1, 2016.

AB 2064 also raises the cap on CEA operating expenses from 3 percent to 6 percent of premium income and includes language to define operating expenses that are subject to the cap. This part of the bill is effective January 1, 2015.

Revenue Bonds

The CEA issued a series of revenue bonds with a market value of approximately \$350 million in November of 2014. The issuance is made pursuant to CIC Section 10089.10(b) and is comprised of three serial bonds: 2-year Series Bond issued at \$40 million with a 1.194% interest rate; 3-year Series Bond issued at \$60 million with a 1.824% interest rate; and 5-year Series Bonds issued at \$250 million with a 2.805% interest rate.

Rate Filing and New Policy Coverages

On December 17, 2014, the CEA's Governing Board approved a new rate and form application that included the following changes:

- 10% statewide average rate change
- Expanded coverage, limit, and deductible options
- Enhanced hazard reduction discount rules
- Added new limitations

The above rate and form application was submitted to the California Department of Insurance on December 18, 2014 and was approved on April 23, 2015. The targeted implementation of all proposed changes is for policies with new or renewal effective dates of January 1, 2016, or later.

CEA HISTORY

The CEA was created pursuant to California Insurance Code (CIC) Section 10089.6 in 1995 to transact insurance in California as necessary to sell policies of basic residential earthquake insurance in the manner set forth in CIC Sections 10089.26 through 10089.28, and commenced operations in December 1996.

Previously, under CIC Section 10089.7(h)(1) the total number of people, subject to civil service provisions, the CEA could employ was limited to 25. On June 27, 2013, the Governor approved Senate Bill 71 which amended CIC Section 10089.7(h)(1) and removed the limit on the number of people, subject to civil service provisions, that the CEA can employ.

MANAGEMENT AND CONTROL

Pursuant to California Insurance Code (CIC) Section 10089.7(a), the CEA is governed by a three-member Governing Board consisting of the Governor, the State Treasurer, and the Insurance Commissioner, each of whom may name designees to serve as board members in their place. The Speaker of the Assembly and the Chairperson of the Senate Rules Committee serve as nonvoting, ex officio members of the Governing Board, and may name designees to serve in their place.

CIC Section 10089.7(c) provides that the Governing Board shall have the power to conduct the affairs of the CEA, and may perform all acts necessary or convenient in the exercise of that power.

A listing of the members of the Governing Board and principal officers serving on December 31, 2013 follows:

Governing Board

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
Edmund G. Brown, Jr. Oakland, California	Governor State of California
William W. Lockyer ^(A) Hayward, California	Treasurer State of California
Dave E. Jones Sacramento, California	Insurance Commissioner State of California

Governing Board (continued)

John Pérez* ^(B)
Los Angeles, California

Speaker of the Assembly
State of California

Darrell S. Steinberg* ^(C)
Sacramento, California

Chairman of the Senate Rules Committee
State of California

**Non-voting members*

^(A) Effective January 5, 2015, John Chiang replaced William W. Lockyer as the State Treasurer.

^(B) Effective May 12, 2014, Toni G. Atkins replaced John Pérez as the Speaker of the Assembly.

^(C) Effective December 17, 2014, Kevin de León replaced Darrell S. Steinberg as the Chairman of the Senate Rules Committee.

Principal Officers

Name

Title

Glenn Pomeroy

Chief Executive Officer

Timothy Richison

Chief Financial Officer

Robert Stewart

Chief Operations Officer

Todd Coombes

Chief Information Officer

Christopher Nance

Chief Communications Officer

Janiele Maffei

Chief Mitigation Officer

Insurer Participation Agreements

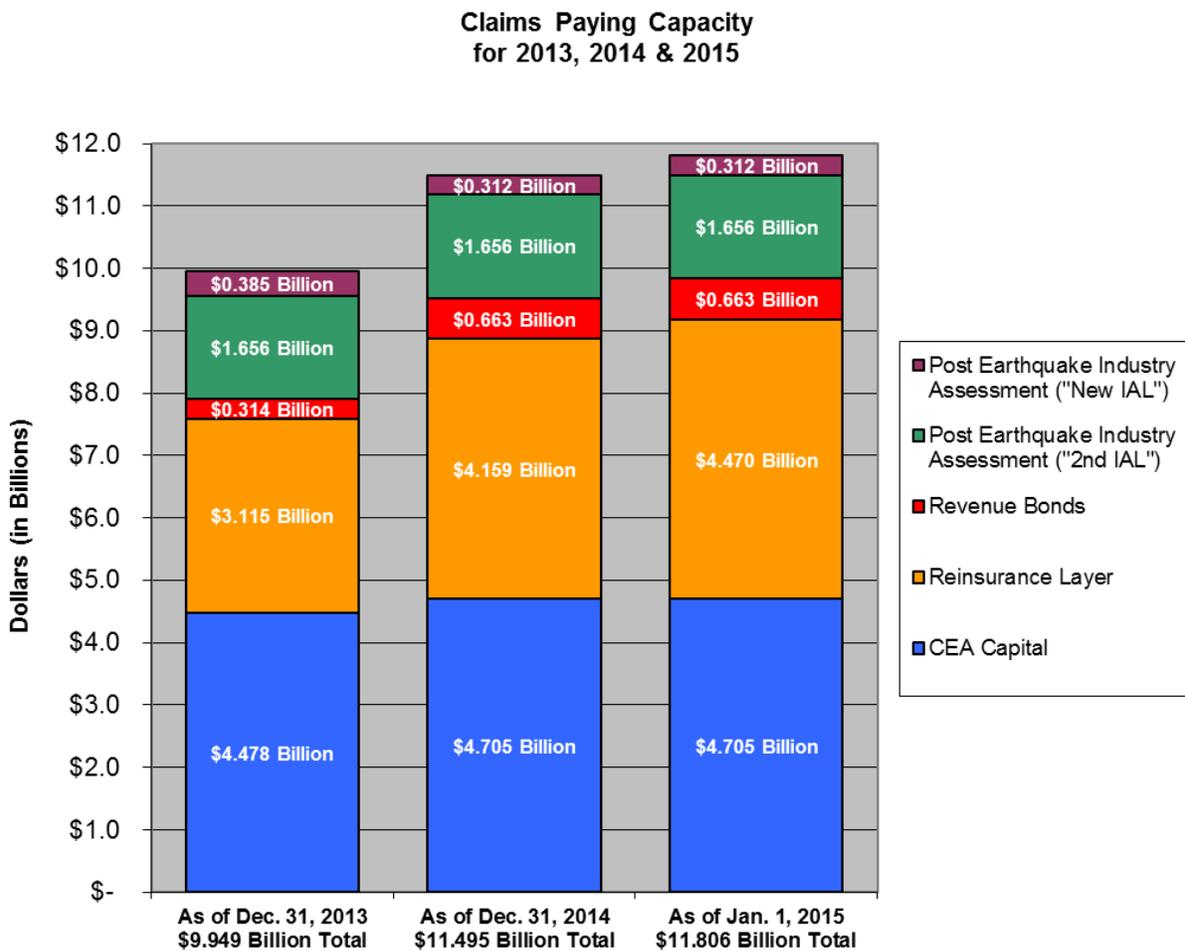
Services are performed on behalf of the CEA by the participating insurers pursuant to the terms of the Insurer Participation Agreements signed by the CEA and each participating insurer. These services include policy administration and claims settlement. Refer to the "TERRITORY AND PLAN OF OPERATION" section for more information on the participating insurers.

CLAIMS PAYING CAPACITY

As of December 31, 2013 the CEA reported a total claims paying capacity of \$9.949 billion. The CEA's claims paying capacity comes from the CEA's available capital (\$4.478

billion), reinsurance coverage (\$3.115 billion), revenue bonds (\$0.314 billion), post-earthquake industry assessments under California Insurance Code (CIC) Section 10089.30 (\$1.656 billion), and post-earthquake industry assessments under CIC Section 10089.31 (\$0.385 billion).

As of December 31, 2014, the CEA's claim-paying capacity increased to \$11.495 billion. The increase is primarily due to increases in the CEA's available capital, reinsurance coverage and revenue bonds. A chart illustrating the sources of the claims paying capacity for 2013, 2014 and 2015 is shown below:



Revenue Bonds

CIC Section 10089.10(b) authorizes the CEA, through the Treasurer, to enter capital market contracts for the purpose of expanding CEA's capacity and achieving maximum capacity for writing earthquake coverage. In 2006, the CEA issued \$315 million in revenue bonds pursuant to CIC Section 10089.10(b), of which \$94.5 million in principal was outstanding as of December 31, 2013. The 2006 revenue bonds will mature on July 1, 2016.

In November 2014, the CEA issued \$350 million in revenue bonds. The issuance is comprised of three serial bonds that mature in 2016, 2017, and 2019. Refer to the "SUBSEQUENT EVENTS" section for more information.

Post-Earthquake Industry Assessments

The CEA is authorized to levy assessments on participating insurers if claims and claim expenses paid by the CEA due to earthquake events exhaust the total of the available capital, reinsurance, policyholder assessments, and proceeds from debt financing. These assessments are authorized pursuant to CIC Sections 10089.30 (2nd IAL) and 10089.31 (New IAL). Assessments levied under the 2nd IAL shall not exceed \$2 billion and assessments levied under the New IAL shall not exceed \$1.78 billion. The amounts available for assessment under both industry assessment layers are subject to periodic reduction as described in CIC Section 10089.30 and 10089.13. At December 31, 2013, the amount available for assessment under the 2nd IAL was \$1.656 billion and under the New IAL was \$0.385 billion.

EARTHQUAKE LOSS MITIGATION FUND

Pursuant to California Insurance Code (CIC) Section 10089.37, the CEA is to set aside in each calendar year an amount equal to 5 percent of investment income accruing on the CEA's invested funds, or \$5 million, whichever is less, if deemed actuarially sound

by a consulting actuary employed for, or hired by the CEA, to be maintained as a sub-account in the California Earthquake Authority Fund. The CEA shall use those funds to fund the establishment and operation of an Earthquake Loss Mitigation Fund. CIC Section 10089.38 states that the Earthquake Loss Mitigation Fund may be applied by supply grants and loans or loan guarantees to dwelling owners who wish to retrofit their homes to protect against earthquake losses.

The following table illustrates the amounts set aside pursuant to CIC Section 10089.37 during the examination period:

<u>Year</u>	<u>Loss Mitigation Fund Contribution</u>
2013	\$1,238,300
2012	1,584,672
2011	2,019,253
2010	2,772,498

TERRITORY AND PLAN OF OPERATION

The CEA is authorized to write residential earthquake insurance in California pursuant to California Insurance Code (CIC) Section 10089.6(a). Earthquake insurance policies are available for homeowners, condominium unit owners, mobilehome owners, and renters in California.

The CEA offers two earthquake products for both homeowners and mobilehome owners: Standard Homeowners and Homeowners Choice. Standard Homeowners bundles all the coverages into one package: home (dwelling), personal property, building code upgrades, loss of use and emergency repairs (subject to exclusions and deductibles). Coverages, except for loss of use, are subject to the dwelling deductible. Homeowners Choice offers coverage for dwelling, building code upgrades and emergency repairs. There are two optional coverages: personal property (contents) which has a separate, lower deductible, and loss of use which has no deductible.

The condominium unit owners policy covers building code upgrades and emergency repair coverage with optional coverage for building property, personal property and loss of use, as well as earthquake loss assessment. The renters policy covers personal property, loss of use and emergency repairs.

The CEA's earthquake business is placed through its participating insurers. Pursuant to CIC Section 10089.9, each insurer participating in the CEA shall execute a contract with the Commissioner that sets forth its rights and responsibilities as a CEA participant, and such contract shall be part of the CEA's plan of operations and shall be uniform for every participating insurer. Insurers writing in the CEA represent approximately 80 percent of California's residential property insurance market. As of the examination date, there were 19 insurers participating in the CEA.

According to the Insurer Participation Agreements, participating insurers act as independent contractor agents on behalf of the CEA by performing policy and claims services which include underwriting, policy issuance, premium collection, and claims adjustment. Participating insurers receive a producer commission equal to 10 percent of written premium for all new and renewal CEA policies and non-claims related operating cost reimbursement equal to 6 percent of net written premiums. Participating insurers also are reimbursed for claims expenses associated with the CEA's earthquake claims equal to 9 percent of the total amount of the claim paid out.

The CEA imposes an eligibility requirement for earthquake policies as follows: (1) The risk must be a qualified residential property; (2) The risk must be insured by a companion policy issued by a CEA participating insurer that will act as the servicing carrier for the earthquake policy; (3) The risk must be insured to the value of the companion policy; and (4) All prior earthquake structural damage must be repaired before an application for coverage is accepted.

The following table is the direct premiums written during the examination period:

<u>Year</u>	<u>Written Premiums</u>
2013	\$573,959,642
2012	566,664,072
2011	614,308,227
2010	602,411,960

During the examination period, the CEA's operating expenses were capped at 3 percent of the premium income received by the CEA pursuant to CIC Section 10089.6(c). Beginning January 1, 2015, CIC Section 10089.6(c) was amended to increase the operating expense cap to 6 percent of the premium income received.

REINSURANCE

Assumed

The CEA has no assumed reinsurance.

Ceded

The CEA has multiple catastrophe aggregate excess of loss treaties with various reinsurers. As of December 31, 2013, CEA's largest reinsurers based on reinsurance premiums are: Embarcadero Re (18.9%); Swiss Reinsurance America Corporation (15.9%); Munich Reinsurance America (4.7%); SCOR Global P&C SE, Paris, Zurich Branch (4.6%); and Munchener Rueckversicherungs-Gesellschaft (3.9%).

The following table is an outline of the CEA's ceded reinsurance program as of December 31, 2013:

Contract	Reinsurers	Effective Date	Expiration Date	Retention	Limit	Amount Placed
2013 January Program	Various Reinsurers	1/1/2013	12/31/2013	\$3.4 Billion	\$4.5 Billion	\$715,595,320
2013-2014 April Program Contract 1	Various Reinsurers	4/1/2013	3/31/2014	\$5 Billion	\$6.2 Billion	\$759,900,000
2013-2015 April Program Contract 2	SCOR Global P&C SE, Paris, Zurich Branch	4/1/2013	3/31/2015	\$5 Billion	\$6.2 Billion	\$84,999,960
2013-2014 August Program Contract 1	Swiss Reinsurance America Corporation	8/1/2013	7/31/2014	\$3.4 Billion	\$4.5 Billion	\$299,999,920
2013-2014 August Program Contract 2	Various Reinsurers	8/1/2013	7/31/2014	\$4 Billion	\$4.5 Billion	\$130,000,000
2013-2015 August Program Contract 3	Various Reinsurers	8/1/2013	7/31/2015	\$4 Billion	\$4.5 Billion	\$250,000,000
2013-2014 August Program Contract 4	Hannover Ruck SE	8/1/2013	7/31/2014	\$3 Billion	\$3.3 Billion	\$24,999,000
2013-2016 May Program Contract 1	Poseidon Re Ltd	5/1/2013	4/30/2016	\$4.4 Billion	\$4.5 Billion	\$100,000,000
2013-2015 June Program Contract 1	Horseshoe Re Limited (EA0010 & OP0013)	6/1/2013	5/31/2015	\$4.6 Billion	\$4.65 Billion	\$50,000,000
2012-2015 September Program Contract 1	Allianz Global Risks US Insurance Company	9/1/2012	8/31/2015	\$4.49 Billion	\$4.59 Billion	\$100,000,000
Transformer Contract 1 (2011-I)	Embarcadero Reinsurance Ltd.	8/2/2011	8/8/2014	\$3.46 Billion	\$3.61 Billion	\$150,000,000
Transformer Contract 2 (2012-I)	Embarcadero Reinsurance Ltd.	2/7/2012	2/13/2015	\$3.045 Billion	\$3.34 Billion	\$150,000,000
Transformer Contract 3 (2012-II)	Embarcadero Reinsurance Ltd.	8/1/2012	8/7/2015	\$6.441 Billion	\$6.741 Billion	\$300,000,000

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2013

Underwriting and Investment Exhibit for the Year Ended December 31, 2013

Reconciliation of Surplus as Regards Policyholders from December 31, 2009 through December 31, 2013

Statement of Financial Condition
as of December 31, 2013

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 3,851,830,002	\$	\$3,851,830,002	
Cash, cash equivalents, and short-term investments	1,141,361,188		1,141,361,188	
Investment income due & accrued	14,076,465		14,076,465	
Uncollected premiums and agents' balances in course of collection	47,776,029	7,928,771	39,847,258	(1)
Electronic data processing equipment and software	970,252		970,252	
Furniture and equipment, including health care delivery assets	46,840	46,840		
Aggregate write-ins for other than invested assets	<u>15,057,329</u>	<u>386,460</u>	<u>14,670,869</u>	
Total assets	<u>\$ 5,071,118,105</u>	<u>\$ 8,362,071</u>	<u>\$5,062,756,034</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 36,250	(2)
Loss adjustment expenses			3,263	(2)
Other expenses (excluding taxes, licenses and fees)			7,809,243	
Borrowed money and interest thereon			97,414,853	
Unearned premiums			288,464,329	
Advance premium			3,112,722	
Ceded reinsurance premiums payable			<u>384,989</u>	
Total liabilities			397,225,649	
Aggregate write-ins for special surplus funds		\$ (37,736,297)		
Gross paid-in and contributed surplus		777,394,246		
Unassigned funds (surplus)		<u>3,925,872,436</u>		
Surplus as regards policyholders			<u>4,665,530,385</u>	
Total liabilities, surplus and other funds			<u>\$5,062,756,034</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2013

Statement of Income

Notes

Underwriting Income

Premiums earned		\$ 355,987,589
Deductions:		
Losses incurred	\$ 249,407	
Loss expenses incurred	123,904	
Other underwriting expenses incurred	<u>123,647,015</u>	
Total underwriting deductions		<u>124,020,326</u>
Net underwriting gain		231,967,263

Investment Income

Net investment income earned	\$ 11,953,842	
Net realized capital gains	<u>327</u>	
Net investment gain		11,954,169

Other Income

Net gain from agents' or premium balances charged off	\$ 451,894	
Finance and service charges not included in premiums	412,957	
Aggregate write-ins for miscellaneous income	<u>51,304</u>	(1)
Total other income		<u>916,155</u>

Net income		<u>\$ 244,837,587</u>
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Capital and Surplus Account

Surplus as regards policyholders, December 31, 2012		\$ 4,408,116,393
Net income	\$ 244,837,587	
Change in nonadmitted assets	508,660	
Aggregate write-ins for gains and losses in surplus	<u>12,067,745</u>	(1)
Change in surplus as regards policyholders for the year		<u>257,413,992</u>
Surplus as regards policyholders, December 31, 2013		<u>\$ 4,665,530,385</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2009 through December 31, 2013

Surplus as regards policyholders, December 31, 2009, per Examination			\$3,498,293,003
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$1,104,705,598	\$ 0	
Change in nonadmitted assets	2,028,440		
Surplus adjustments: Paid in	26,242,000		
Aggregate write-ins for gains and losses in surplus	<u>34,261,344</u>		
Total gains and losses	<u>\$1,167,237,382</u>	<u>\$ 0</u>	
Net increase in surplus as regards policyholders			<u>1,167,237,382</u>
Surplus as regards policyholders, December 31, 2013, per Examination			<u>\$4,665,530,385</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Premiums and Agents' Balances in Course of Collection

The CEA is not in compliance with Statement of Statutory Accounting Principles (SSAP) No. 6, paragraph 7, because it does not follow the guidance when aging premiums for the purpose of nonadmitting amounts over 90 days due. The CEA's current practice is to age the premium receivable from the last date that a payment was received on the policy. SSAP No. 6, paragraph 7, requires the aging to be computed from the due date, which is defined as the policy effective date for original and deposit premiums and from the contractual due date for installment premiums. No exam adjustment was made for this finding because the amount involved is not material. It is recommended that the CEA comply with SSAP No. 6, paragraph 7. Similar comments were made in the prior examination.

The CEA's accounting for uncollectible premiums and agents' balances charged off is not in compliance with SSAP No. 6, paragraph 10. It was observed that the amount reported as uncollectible premiums and agents' balances charged off consists of the change in nonadmitted premiums and agents' balances over 90 days due only and does not include any premiums or agents' balances that were actually written off. SSAP No. 6, paragraph 10, requires that any uncollectible receivable be written off and charged to income in the period the determination is made. The change in nonadmitted agents' and premium balances over 90 days due is already included in the "Change in nonadmitted assets" line under the "Capital and Surplus Account" section of the Statement of Income and accounting for this amount as a "net gain/loss from agents' or premium balances charged off" is unnecessary. In addition, the amount that is charged off should not be added back to policyholders' surplus through the "Aggregate write-in for gains and losses in surplus" line under the "Capital and Surplus Account" section of the Statement of Income. Any amounts that are written off should be charged to income in the period the determination is made in accordance with SSAP No. 6, paragraph 10. No examination adjustment was made because the amount involved is not material. It is

recommended that the CEA comply with SSAP No. 6, paragraph 10. Similar comments were made in the prior examination.

(2) Losses and Loss Adjustment Expenses

The CEA only writes residential earthquake insurance, which has a fast reporting and payment development period. The CEA has only paid out approximately \$4.3 million in losses and loss adjustment expenses (LAE) since its inception. The CEA's net paid losses and LAE were less than \$380,000 for the examination period as no major earthquakes have occurred in CEA's territories that resulted in material insured losses. Due to the same reason, only \$39,513 loss and LAE reserves were reported as of December 31, 2013.

The CEA's financial modeling process was reviewed and analyzed with the assistance of a Casualty Actuary from the California Department of Insurance (CDI). The analysis covered three parts: 1) the quality and completeness of the CEA's exposure data, 2) the appropriateness of the CEA's use of commercial catastrophe models in monitoring and managing its exposure, and 3) the ability of the CEA to maintain its capital structure going forward. The CDI concurs that the CEA's claims paying capacity at December 31, 2013 of \$9.949 billion is adequate to cover CEA's losses from a 1-in-500 year earthquake event. The CEA has structured its reinsurance program with multiple large events in consideration such that the first layer of reinsurance has an attachment point of \$3.0 billion which is well below CEA's surplus of \$4.7 billion at December 31, 2013.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Comment on Financial Statement Items - Premiums and Agents' Balances in Course of Collection (Page 15): It is again recommended that the CEA comply with Statement of Statutory Accounting Principles (SSAP) No. 6, paragraphs 7 and 10.

Previous Report of Examination

Comments on Financial Statement Items – Premiums and Agents' Balances in Course of Collection (Page 20): It was recommended that the CEA comply with SSAP No. 6, paragraph 7 and 10. The CEA has not complied with this recommendation.

Comments on Financial Statement Items – Loss and Loss Adjustment Expenses (Page 21): It was recommended that management develop a mechanism for recapitalizing the CEA. The CEA has complied with this recommendation.

Comments on Financial Statement Items – Advance Premiums (Page 22): It was recommended that the CEA comply with SSAP No. 53, paragraph 13. The CEA has complied with SSAP No. 53, paragraph 13.

Comments on Financial Statement Items – Loss Mitigation Fund Liability (Page 22): It was recommended that the CEA accrue a liability at year end for its Loss Mitigation Fund obligation under California Insurance Code (CIC) Section 10089.37. The CEA has complied with CIC Section 10089.37.

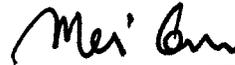
Comments on Financial Statement Items – Pro Forma Premium Taxes (Page 23): It was recommended that the CEA follow the California premium tax filing instructions when computing the pro forma premium taxes pursuant to CIC Section 10089.44 and report the pro forma premium taxes in its statutory financial statements. The pro forma

premium taxes have been properly calculated and reported in the statutory financial statements.

ACKNOWLEDGMENT

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

Respectfully submitted,



Mei Gu, CFE
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California