

REPORT OF EXAMINATION
OF THE
EXPLORER INSURANCE COMPANY
AS OF
DECEMBER 31, 2012

Filed June 20, 2014

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Los Angeles, 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

EXPLORER INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 11455 El Camino Real, San Diego, California 92130.

SCOPE OF EXAMINATION

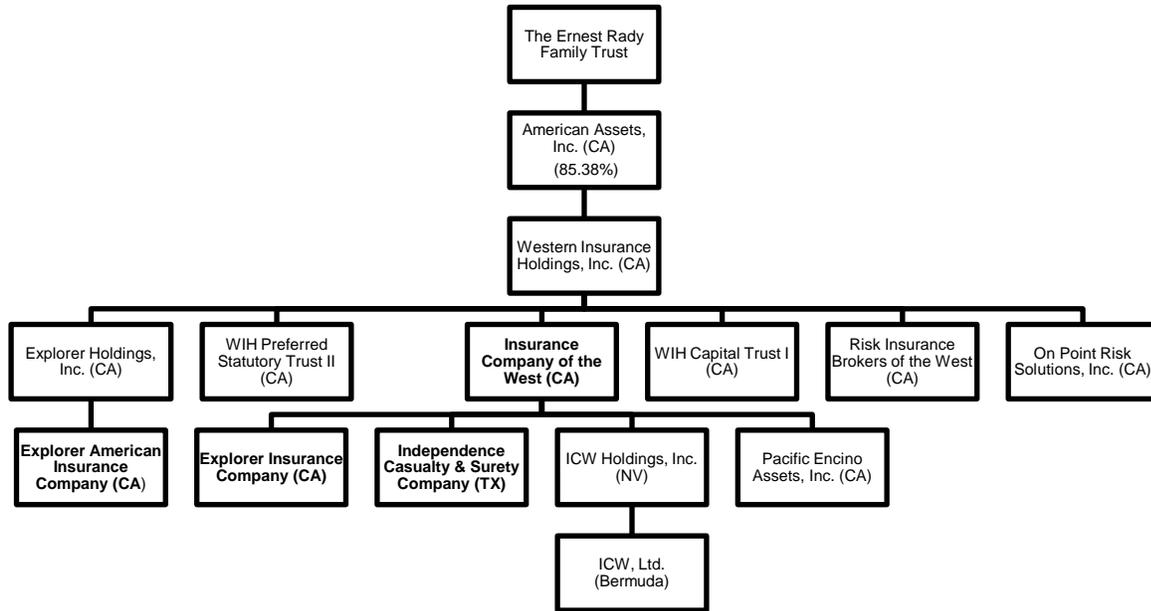
We have performed our multi-state examination of the Company. The previous examination of the Company was made as of December 31, 2009. This examination covers the period from January 1, 2010 through December 31, 2012. The examination was conducted in accordance with the National Association of Insurance Commissioners Financial Condition Examiners Handbook. The Handbook requires the planning and performance of the examination to evaluate the Company's financial condition, to identify prospective risks, and to obtain information about the Company, 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 Company were considered in accordance with the risk-focused examination process.

The examination was a coordinated examination and was conducted concurrently with the examination of other insurance entities in the holding company group, including Insurance Company of the West (California), Independence Casualty and Surety Company (Texas), and Explorer American Insurance Company (California). California served as the lead state.

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

MANAGEMENT AND CONTROL

Ultimate control of the Company is maintained by the Ernest S. Rady Family Trust. The following organizational chart depicts the Company's relationship within the holding company system (all ownership is 100%, unless otherwise noted):



*Remaining ownership of Western Insurance Holdings, Inc. is held by the Ernest S. Rady Trust (10.82%), Company Officers (2.1%), and Stock Purchase and Saving Plan (1.7%).

The five members of the board of directors, who are elected annually, manage the business and affairs of the Company. Following are members of the board and principal officers of the Company serving at December 31, 2012:

Directors

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
Bernard M. Feldman Del Mar, California	Director Explorer Insurance Company
R. Steven Marshall Petaluma, California	Senior Vice President Explorer Insurance Company
Kevin M. Prior San Diego, California	President and Chief Executive Officer Explorer Insurance Company
Ernest S. Rady La Jolla, California	Chairman of Board Explorer Insurance Company
Fariborz Rostamian Solana Beach, California	Vice President and Controller Explorer Insurance Company

Principal Officers

<u>Name</u>	<u>Title</u>
Kevin M. Prior	President and Chief Executive Officer
David G. Hoppen	Senior Vice President
R. Steven Marshall	Senior Vice President
Fariborz Rostamian	Vice President and Controller
Mary E. Cannon	Secretary
Sheryl M. Hadlen	Vice President
Susan L. Karlan	Vice President

Management Agreements

Tax Allocation Agreement: Since January 1, 1996, the Company and its affiliates have been parties to a Tax Allocation Agreement with its ultimate parent, American Assets, Inc. Allocation of taxes is based upon separate return calculations with current credit for net losses. This agreement did not require prior approval by the California Department of Insurance (CDI), as it was executed prior to January 1, 1997. The Company paid/recovered the following taxes during the examination period:

<u>Year</u>	<u>Amount</u>
2010	\$ 396,913
2011	\$ (295,726)
2012	\$ <u>(109,573)</u>
Total	\$ (8,386)

Investment Management Agreement: Effective January 1, 2007, Western Insurance Holdings, Inc. (WIHI) entered into an Investment Management Agreement with non-insurance affiliate American Assets Investment Management, LLC. Under the terms of the agreement, WIHI appointed American Assets Investment Management, LLC as its Investment Manager to provide investment advisory services for WIHI's investment portfolio, including its insurance subsidiaries. The services performed by American Investment Management, LLC are subject to the direction and control of the Company's board of directors and/or appointed investment committee. Investment management fees incurred were \$1,684,000; \$1,962,000; and \$1,831,000; for 2010; 2011; and 2012, respectively. All investment management fees were paid by WIHI and paid to American Assets Investment Management, LLC under the terms of this agreement.

The Investment Management Agreement was not disclosed in the Company's Annual Holding Company Registration Statement and the CDI has no record of approval. It is recommended that the Company disclose this agreement in its Annual Holding Company Registration Statement Form B in accordance with California Insurance Code Section (CICS) 1215.4(b), and submit the agreement to the CDI for approval in accordance with CICS 1215.5(b)(4).

Management Services Agreement

The Company engages in recurring transactions including but not limited to the following: accounting, actuarial, auditing, actuarial, finance, taxes, claims management, information technology, loss control, investments, human resources, and underwriting, etc. with related parties (Insurance Company of the West and Independence Surety and Casualty Company), for which there is no formal written agreement to clearly identify the parties involved, cost basis of incurred expenses or fees, and timely settlement for

amounts owed.

It is recommended the Company ensure that all transactions between related parties are covered in the form of a written agreement. It is also recommended that the Company prepare a written management services agreement that provides and clearly identifies the entity providing services, the nature of the services provided and a listing of the entities that are parties to the agreement. Furthermore, the agreement should set forth appropriate methods to allocate costs between parties for services rendered and to provide for timely settlements of amounts owed. Lastly, the agreement should be written in accordance with CICS 1215.5 and submitted to the CDI for approval in accordance with CICS 1215.5(b)(4).

TERRITORY AND PLAN OF OPERATION

As of December 31, 2012, the Company was licensed and authorized to write various property and casualty lines of insurance in the following 17 states:

Arizona	Idaho	Montana	Pennsylvania
California	Illinois	Nevada	Texas
Colorado	Indiana	New Mexico	Utah
Florida	Iowa	Oregon	Washington
Hawaii			

The Company specializes in nonstandard private passenger automobile liability and physical damage coverages. During 2012, the Company wrote \$75.6 million of direct premiums. Of the total direct written premium, \$71.1 million (94%) was written in California; \$3.2 million (4%) was written in Nevada; and \$1.3 million (2%) was written in Illinois. Business is produced through independent agents.

All of the Company's automobile business is managed from the Santa Clarita branch office. Previously, the Company maintained an office in Orlando, but that office was closed when the Company stopped writing business in Florida in 2011.

REINSURANCE

Intercompany Reinsurance Pooling Agreement

The Company is party to an intercompany reinsurance pooling agreement with its parent company, Insurance Company of the West (ICW), and its affiliate, Independence Casualty and Surety Company (Independence). Under the terms of this agreement dated December 31, 1995, the Company and Independence cede 100% of their written premiums to their parent, ICW. ICW, in turn, retrocedes a 15% and a 1.5% pro rata portion of premiums, losses and expenses to the Company and Independence, respectively. The following table illustrates each participant's pooled share as of December 31, 2012:

<u>Company</u>	<u>State of Domicile</u>	<u>Pooling Share</u>
Insurance Company of the West	CA	83.5%
Explorer Insurance Company	CA	15.0%
Independence Casualty and Surety Company	TX	<u>1.5%</u>
Pool Total:		<u><u>100.0%</u></u>

The agreement provides that receivable and payable balances are to be settled within 30 days of the receipt of the monthly report.

Assumed

Assumed business is limited to the Company's participation in the aforementioned intercompany reinsurance pooling agreement.

Ceded

Ceded business is limited to the Company's participation in the aforementioned intercompany reinsurance pooling agreement.

ACCOUNTS AND RECORDS

Derivatives

The Company incorrectly reported a liability pertinent to the Company's written call options on the line caption "Payable for Securities". It is recommended that the Company report balances (i.e. either asset or liability) pertinent to the Company's written call options on the line caption "Derivatives" in accordance with the National Association of Insurance Commissioners Property & Casualty Annual Statement Instructions.

Premium Receivable/Commission Payable Balances

The Company incorrectly reported "Uncollected premiums and agents' balances in course of collection" net of commissions payable. It is recommended that the Company not offset receivables and payables or report balances net of each other, unless a valid right to offset exists in accordance with Statement of Statutory Accounting Principles Number 64.

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

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 82,018,025	\$	\$ 82,018,025	
Preferred stocks	9,332,933	373,050	8,959,883	
Common stocks	9,530,608		9,530,608	
Cash and short-term investments	32,605,686		32,605,686	
Receivable for securities	10,168		10,168	
Investment income due and accrued	758,409		758,409	
Premiums and agents' balances in course of collection	2,871,414	4,254	2,867,160	
Premiums, agents' balances and installments booked but deferred and not yet due (including \$570,464 earned but unbilled premiums)	26,218,138		26,218,138	
Amount recoverable from reinsurers	2,244,150		2,244,150	
Net deferred tax asset	4,768,508	1,098,026	3,670,482	
Guaranty funds receivable or on deposit	284,166		284,166	
Receivables from parent, subsidiaries and affiliates	270,844		270,844	
Aggregate write-ins for other than invested assets	<u>432,657</u>		<u>432,657</u>	
 Total assets	 <u>\$ 171,345,706</u>	 <u>\$ 1,475,330</u>	 <u>\$ 169,870,376</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses and loss adjustment expenses			\$ 84,986,099	(1)
Commissions payable, contingent commissions and other similar charges			960,634	
Other expenses			89,921	
Current federal income taxes (including \$0 on realized capital gains (losses))			1,514,621	
Unearned premiums			12,086,420	
Ceded reinsurance premiums payable			22,608,141	
Drafts outstanding			13,432	
Payable for securities			3,476	
Aggregate write-ins for liabilities			<u>329,390</u>	
 Total liabilities			 122,592,134	
Common capital stock	\$ 2,600,000			
Gross paid-in and contributed surplus		8,070,835		
Unassigned funds (surplus)		<u>36,607,407</u>		
Surplus as regards policyholders			<u>47,278,242</u>	
 Total liabilities, surplus and other funds			 <u>\$ 169,870,376</u>	

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

Statement of Income

Underwriting Income

Premiums earned		\$ 65,009,251
Deductions:		
Losses and loss expenses incurred	\$ 46,373,374	
Other underwriting expenses incurred	<u>17,636,533</u>	
Total underwriting deductions		<u>64,009,907</u>
Net underwriting gain		999,345

Investment Income

Net investment income earned	\$ 4,458,878	
Net realized capital gain	<u>422</u>	
Net investment gain		4,459,300

Other Income

Net loss from agents' or premium balances charged off (amount recovered \$25,886 amount charged off \$1,299,405)	\$ (1,273,518)	
Finance and service charges not included in premiums	1,079,603	
Aggregate write-ins for miscellaneous income	<u>210,253</u>	
Total other income		<u>16,338</u>
Net income before dividends to policyholders, after capital gains tax and before federal and foreign income taxes		5,474,983
Dividends to policyholders		<u>164,912</u>
Net income after dividends to policyholders, after capital gains tax and before federal and foreign income taxes		5,310,071
Federal and foreign income taxes incurred		<u>1,557,016</u>
Net income		<u>\$ 3,753,055</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2011		\$ 42,730,405
Net income	\$ 3,753,056	
Change in net unrealized capital gains	553,073	
Change in net deferred income tax	383,303	
Change in nonadmitted assets	51,981	
Aggregate write-ins for losses in surplus	<u>(193,576)</u>	
Change in surplus as regards policyholders for the year		<u>4,547,837</u>
Surplus as regards policyholders, December 31, 2012		<u>\$ 47,278,242</u>

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

Surplus as regards policyholders, December 31, 2009 per Examination			\$ 41,103,789
	Gain in Surplus	Loss in Surplus	
Net income	\$ 6,112,459	\$	
Net unrealized capital gains	592,372		
Change in net deferred income tax		702,204	
Change in nonadmitted assets	895,718		
Aggregate write-ins for gains and losses in surplus	_____	723,893	
Total gains and losses	\$ 7,600,549	\$ 1,426,097	
Net increase in surplus as regards policyholders			6,174,452
Surplus as regards policyholders, December 31, 2012, per Examination			\$ 47,278,242

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Based on an analysis by a Casualty Actuary for the California Department of Insurance, the Company's loss and loss adjustment expense reserves as of December 31, 2012 were found to be reasonably stated and have been accepted for purposes of this examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management Agreements – Investment Management Agreement (Page 5): It is recommended that the Company report said agreement in its Annual Holding Company Registration Statement Form B in accordance with California Insurance Code Section (CICS) 1215.4(b), and submit the agreement to the California Department of Insurance (CDI) for approval in accordance with CICS1215.5(b)(4).

Management Agreements – Management Services Agreement (Page 5): It is recommended the Company ensure that agreements to provide services between related parties are formalized by a written agreement. It is also recommended that the Company prepare a written management services agreement that provides or clearly identifies the entity providing services, the nature of the services provided and a listing of the entities that party to the agreement. Furthermore, the agreement should set forth appropriate methods to allocate costs between parties for services rendered and provide for timely settlements of amounts owed. Lastly, the agreement should be written in accordance with CICS 1215.5 and submitted to the CDI for approval in accordance with CICS 1215.5(b)(4).

Accounts and Records – Derivatives (Page 8): It is recommended that the Company report balances (i.e. either asset or liability) pertinent to the Company's written call options on the line caption "Derivatives" in accordance with the National Association of Insurance Commissioners Property & Casualty Annual Statement Instructions.

Accounts and Records – Premium Receivable/Commission Payable Balances (Page 8): It is recommended that the Company not offset receivables and payables or report balances net of each other, unless a valid right to offset exists in accordance with Statement of Statutory Accounting Principles Number 64.

Previous Report of Examination

Accounts and Records – Information Systems Controls (Page 5): It was recommended that management review the policies and practices related to certain controls germane to the functions of business continuity planning, physical security, security and access controls and program change controls. The Company has compiled with this recommendation.

ACKNOWLEDGMENT

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

Respectfully submitted,

_____/S/_____
Joshua J. Johnson, CFE
Examiner-In-Charge
Contract Insurance Examiner
Department of Insurance
State of California