

REPORT OF EXAMINATION  
OF THE  
PACIFIC SPECIALTY INSURANCE COMPANY  
AS OF  
DECEMBER 31, 2016

Filed on May 7, 2018

## TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION .....	1
COMPANY HISTORY: .....	2
Capitalization .....	3
Dividends Paid to Parent .....	3
MANAGEMENT AND CONTROL:.....	4
Management Agreements.....	7
TERRITORY AND PLAN OF OPERATION.....	9
REINSURANCE: .....	10
Assumed.....	10
Ceded .....	11
ACCOUNTS AND RECORDS:.....	12
Information Systems Controls.....	12
Annual Statement Instructions.....	13
Notice to the Board of Prior Examination Report .....	13
Board Review and Approval of Investments .....	13
Annual Information Statement .....	14
Unclaimed Property .....	14
Conflict of Interest.....	14
FINANCIAL STATEMENTS: .....	16
Statement of Financial Condition as of December 31, 2016.....	17
Underwriting and Investment Exhibit for the Year Ended December 31, 2016 .....	18
Reconciliation of Surplus as Regards Policyholders from December 31, 2012 through December 31, 2016.....	19
COMMENTS ON FINANCIAL STATEMENT ITEMS:.....	20
Losses and Loss Adjustment Expenses .....	20
SUBSEQUENT EVENTS .....	20
SUMMARY OF COMMENTS AND RECOMMENDATIONS: .....	21
Current Report of Examination .....	21
Previous Report of Examination .....	22
ACKNOWLEDGMENT .....	24

San Francisco, California  
March 19, 2018

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

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

PACIFIC SPECIALTY INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 2200 Geng Road, Suite 200, Palo Alto, California 94303.

SCOPE OF EXAMINATION

We have performed our multi-state examination of the Company. The previous examination of the Company was as of December 31, 2012. This examination covered the period from January 1, 2013 through December 31, 2016.

The examination was conducted in accordance with the National Association of Insurance Commissioners *Financial Condition Examiners Handbook (Handbook)*. The Handbook requires the planning and performance of the examination to evaluate the Company's financial condition, assess corporate governance, identify current and prospective risks, and evaluate system controls and procedures used to mitigate those risks. An examination also includes identifying and evaluating significant risks that could cause an insurer's surplus to be materially misstated, both currently and prospectively.

All accounts and activities of the Company were considered in accordance with the risk-

focused examination process. This may include 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 might 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 the Company.

This was a coordinated examination with California as the lead state. It was conducted concurrently with the Company's subsidiary, Pacific Specialty Property and Casualty Company, a Texas domiciled insurer. Texas Department of Insurance participated in this group examination.

### COMPANY HISTORY

The Company is a wholly-owned subsidiary of Western Service Contract Corporation (WSCC), a California corporation. The Company obtained its Certificate of Authority in December 1989 and commenced business in January 1990. This holding company group has been reorganized since the prior examination. The changes are as follows:

Effective February 14, 2013, two affiliates, Pacific Loan Administrators and Rockridge Finance Corporation, and two subsidiaries, Haven Avenue Investments, Inc., and Haven Avenue Properties, Inc. were dissolved.

In 2014, WSCC and its affiliate, The McGraw Company (TMC), dba McGraw Insurance Services, repurchased the shares of WSCC and TMC from Ann Morrical, one of the

ultimate controlling stockholders. As a result, Ms. Morrical ceased to be one of the three ultimate controlling persons of the Company. Ms. Morrical filed a notice of her proposed divestiture of control of the Company with the California Department of Insurance (CDI), pursuant to California Insurance Code (CIC) Section 1215.2(h), and received a non-disapproval letter issued on May 7, 2014 from the CDI. Since then, all of the issued and outstanding shares of WSCC and TMC are owned equally by John M. McGraw and Michael J. McGraw.

On December 23, 2014, McGraw Insurance Inc. (MII), an S Corporation, was formed in Delaware by the two surviving stockholders. Effective June 1, 2015, TMC was merged into MII. Also on December 23, 2015, a new entity, McGraw Insurance Services L.P. (MISLP), was formed to serve as the general agent of the Company and its subsidiary, Pacific Specialty Property and Casualty Company. MISLP is 99.9% owned by MII and 0.1% owned by WSCC.

On March 24, 2016, Western Service Leasing LLC (WSL) was formed for the purpose of managing any interest in real or personal property including business aircraft. WSL is directly owned by the Company's affiliate, MISLP.

### Capitalization

The Company is authorized to issue 100,000 shares of common stock. As of December 31, 2016, the Company reported \$3,500,000 in common capital stock, which is comprised of 12,000 issued and outstanding shares with a par value of \$291.67 per share. The Company reported \$11,384,419 in gross paid-in and contributed surplus. There were no changes to the common capital stock or the gross paid-in and contributed surplus during the examination period.

### Dividends Paid to Parent

The Company paid the following dividends to its immediate parent, WSCC, during the examination period:

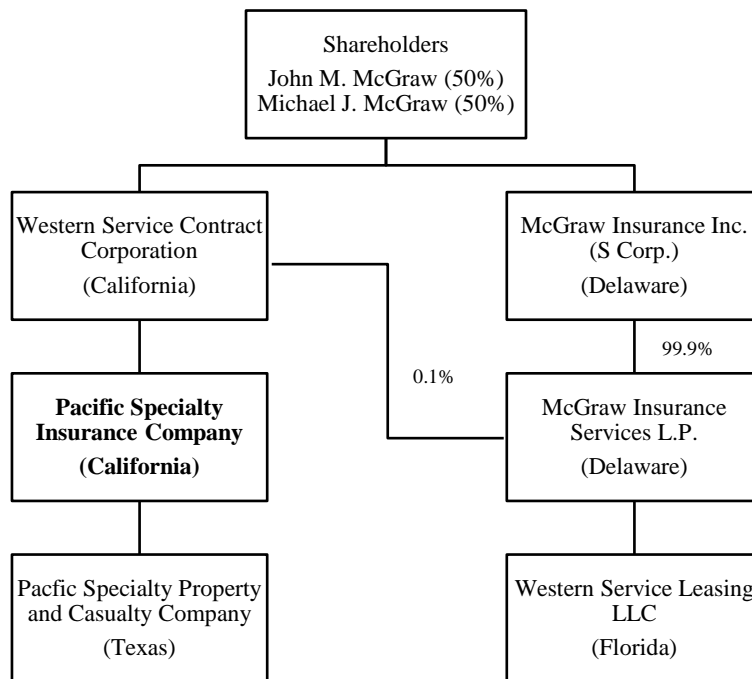
- On March 16, 2013, the Company paid an ordinary cash dividend to WSCC in the amount of \$5,000,000. The Company provided proper notification to the CDI on February 14, 2013 pursuant to CIC Section 1215.4(f).
- On May 13, 2014, the Company paid an extraordinary cash dividend to WSCC totaling \$90,000,000. A prior notice was filed with the CDI on April 1, 2014 pursuant to CIC Section 1215.5(g). The request was approved by the CDI on May 7, 2014.
- In 2015, the Company distributed \$3,815,711 dividend-in-kind (software-related assets) to WSCC; however, the Company did not timely file a notice with the CDI until October 24, 2016, in accordance with CIC Section 1215.4(f).
- In 2016, the Company declared \$11,000,000 dividend including \$8,000,000 in cash and \$3,000,000 as a dividend-in-kind (software-related assets) to WSCC, which was approved by the Board on December 2, 2016. The Company did not timely file a notice with the CDI until December 21, 2016, in accordance with CIC Section 1215.4(f). It was also noted that the Company distributed \$6,500,000 of the \$8,000,000 cash dividend and \$3,000,000 dividend-in-kind before the required 10 business days after receipt by the CDI, not in compliance with CIC Section 1215.4(f).

It is recommended that the Company timely report and pay all future ordinary dividends and other distributions to shareholders in accordance with CIC Section 1215.4(f).

#### MANAGEMENT AND CONTROL

The Company is wholly-owned by Western Service Contract Corporation (WSCC), a

privately owned company and insurance holding company incorporated in California. The Company has one direct subsidiary, Pacific Specialty Property and Casualty Company (PSPCC). The holding company group is ultimately controlled and equally owned by two individuals, John M. McGraw and Michael J. McGraw. The following organizational chart depicts the interrelationship of the entities within the holding company system at December 31, 2016. All ownership is 100% unless otherwise indicated.



The seven members of the Board of Directors 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

Name and Location

Principal Business Affiliation

John K. Chu<sup>(a)</sup>

President and Chief Executive Officer

<u>Name and Location</u>	<u>Principal Business Affiliation</u>
San Mateo, California	Pacific Specialty Insurance Company
Carleen M. Driscoll <sup>(a)</sup> San Mateo, California	General Counsel and Secretary Pacific Specialty Insurance Company
Kevin J. Kendrick San Francisco, California	Business Advisor Self Employed
John M. McGraw <sup>(b)</sup> Las Vegas, Nevada	Shareholder Western Service Contract Corporation
Michael J. McGraw Palm Beach Gardens, Florida	Shareholder Western Service Contract Corporation
Robert C. Olsman <sup>(a)</sup> Ambler, Pennsylvania	Partner Intrepid Brokerage Services LLC
Dianne B. Snedaker <sup>(a)</sup> Marin, California	Chief Marketing Officer First Republic Bank

#### Principal Officers

<u>Name</u>	<u>Position</u>
John K. Chu <sup>(c)</sup>	President and Chief Executive Officer
Carleen M. Driscoll <sup>(d)</sup>	General Counsel and Secretary
Patrick J. Persse <sup>(e)</sup>	Chief Financial Officer
Stann M. Rose <sup>(f)</sup>	Senior Vice President, Claims
Cindy K. Roth <sup>(g)</sup>	Senior Vice President, Sales
William H. Guthrie <sup>(h)</sup>	Senior Vice President and Chief Risk Officer
Susan Valencia <sup>(i)</sup>	Senior Vice President, Underwriting
Jim P. Lee <sup>(j)</sup>	Vice President and Chief Information Officer
Nicola J. Tidwell <sup>(k)</sup>	Vice President, Human Resources
Melissa K. Kaufman <sup>(l)</sup>	Vice President, Product Development

The following changes in management and Board occurred subsequent to the examination date:

(a) Effective April 25, 2017, these four directors were released and John V. McGraw, Jr.



- (known as Jack McGraw) was added to the Board.
- (b) Effective April 25, 2017, John M. McGraw was appointed as the Chair of the Board.
  - (c) Effective April 24, 2017, John K. Chu resigned as the President and Chief Executive Officer (CEO), and was replaced by Michael J. McGraw.
  - (d) Effective June 30, 2017, Carleen M. Driscoll resigned as the General Counsel (GC) and Secretary, and was replaced by Kara L. Holzwarth, effective September 19, 2017.
  - (e) Effective August 24, 2017, Patrick J. Persse resigned as Chief Financial Officer (CFO). The Company hired an interim CFO, Stephen L. Kolakowski from September 29, 2017 through December 20, 2017. Paul J. Cash was appointed as CFO, effective January 3, 2018.
  - (f) Effective August 1, 2017, Stann M. Rose resigned as Senior Vice President (VP) of Claims, and was replaced by Cory Candelario, effective August 2, 2017.
  - (g) Effective May 24, 2017, Cindy K. Roth resigned as Senior VP of Sales, and was replaced by Michael Budnyk, effective June 12, 2017.
  - (h) Effective January 5, 2017, William H. Guthrie retired as Senior VP and Chief Risk Officer. The Chief Risk Officer's duties have been absorbed by the GC and CFO.
  - (i) Effective January 5, 2017, Susan Valencia retired as Senior VP of Underwriting. After her resignation, the underwriting function was overseen by Product Development Department until Andrew Childs was hired as VP of Underwriting and Customer Service on May 15, 2017.
  - (j) Effective August 14, 2017, Jim P. Lee resigned as VP and Chief Information Officer (CIO). The CIO's job duties were absorbed by the new Chief Operating Officer (COO), Kevin J. Judice, until Jai Shankar was hired as CIO on October 13, 2017.
  - (k) Effective January 5, 2017, the position of VP of Human Resources was eliminated and the job duties have been absorbed by the GC.
  - (l) Effective August 4, 2017, Melissa K. Kaufman resigned as VP of Product Development and was replaced by Nathan Edwards on the same day.

### Management Agreements

General Agency Agreement: Effective September 1, 1995, the Company and its affiliate, The McGraw Company (TMC), a licensed agent, entered into the General Agency Agreement, whereby TMC shall perform all underwriting, filing/rating, sales and administrative services as a general agent. The Agreement was not filed with the California Department of Insurance (CDI) until September 20, 2011. The Company filed a Second Amendment to the Agreement, effective March 1, 2012. Both the Agreement and the Amendment were approved by the CDI on November 26, 2013. As part of the restructuring in 2015, the Company, TMC, and McGraw Insurance Services L.P. (MISLP), a newly created entity, entered into a Joinder to General Agency Agreement to add MISLP as a party to the Agreement, so that TMC could transfer its operations to MISLP once it is fully licensed in all jurisdictions that TMC was licensed. TMC was subsequently terminated from the Agreement and MISLP has been the exclusive

general agency for the Company. The CDI approved the Joinder on January 20, 2015 pursuant to California Insurance Code (CIC) Section 1215.5(b)(4). The commissions paid by the Company for services under this Agreement were: \$58,528,173 in 2013, \$65,169,360 in 2014, \$65,722,842 in 2015, and \$68,386,167 in 2016.

Allocation of Overhead Charges Agreement: Effective January 1, 2007, the Company entered into the Allocation of Overhead Charges Agreement with TMC. Under this Agreement, TMC charged the Company an allocation of overhead costs paid by TMC on its behalf. Costs include office space, supplies, salaries, advertisement, and other overhead expenses. Allocation is based on time studies of actual costs incurred. The Agreement was approved by the CDI on March 28, 2007. As a result of the 2015 re-organization, the Company proposed to reassign the party to this Agreement from TMC to MISLP, effective June 1, 2015. However, the "Assignment" was not timely filed with the CDI until June 14, 2017, in accordance with CIC Section 1215.5(b)(4). It is recommended that the Company timely file future assignments, modifications or amendments to its management agreements with the CDI in accordance with CIC Section 1215.5(b)(4). The fees incurred by the Company for services under this Agreement were: \$1,395,635 in 2013, \$1,480,457 in 2014, \$2,510,114 in 2015, and \$2,209,002 in 2016.

Tax Allocation Agreement: Effective January 1, 2006, the Company entered into the Tax Allocation Agreement with its parent, WSCC and affiliates. The allocation of the tax liability is based on the taxable income as a percentage of the consolidated taxable income. Members are reimbursed for net operating losses and other tax credits upon the tax savings realized when the loss or credit is utilized. Tax liability is limited to the amount each party would pay as though a separate income tax return was filed. This Agreement was approved by the CDI on February 8, 2007, pursuant to CIC Section 1215.5(b)(4). Subsequently, the Company's subsidiary, Pacific Specialty Property Casualty Company, was added to the Agreement, effective September 9, 2008. The Company did not properly notify the CDI of the modification to the Agreement as required by CIC Section 1215.5(b)(4). It is recommended that the Company properly

notify the CDI of the modification, effective September 9, 2008, in accordance with CIC Section 1215.5(b)(4).

**Service Contract Reimbursement Policy:** Effective October 14, 2008, the Company issued the Service Contract Reimbursement Policy to WSCC to provide contractual liability coverage for service contracts issued by WSCC in the event WSCC is unable to meet its obligations under the service contracts. WSCC issues service contracts for motorcycles, watercrafts, snowmobiles, and other mechanical breakdown coverages, and pays \$5 per service contract to the Company for this coverage. A rate filing was submitted to the CDI for this policy on March 6, 2001. Under this Policy, the Company received payment of \$139,145 in 2013, \$160,360 in 2014, \$130,810 in 2015, and \$160,360 in 2016.

**Services and Expense Allocation Agreement:** During the course of examination, it was noted that the Company paid \$3,600,490 in 2016 to its parent, WSCC, for expenses incurred on behalf of the Company relating to policy and claims management software and executive payroll. However, there was no written agreement for such arrangement as required by CIC Section 1215.5(b)(4). In response to this finding, the Company entered into the Services and Expense Allocation Agreement with WSCC, and submitted a Form D application to the CDI on June 14, 2017. The filing is pending review. It is recommended that the Company implement policies and procedures to ensure future compliance with CIC Section 1215.5(b)(4).

### TERRITORY AND PLAN OF OPERATION

The Company's main operation is located at the holding company's headquarters in Palo Alto, California. The functions performed there include accounting, legal, human resources, information technology, and product management. The underwriting and customer service functions are located in Anaheim, California; and the claims function is located in Rancho Cordova, California.

As of December 31, 2016, the Company was licensed in 50 states and the District of Columbia. The Company primarily writes homeowners multiple-peril, automobile, motorcycle, personal watercraft, boat, commercial multiple-peril, comprehensive personal liability, motor-home, preferred homeowners, preferred private automobile, and stand-alone earthquake insurance policies. The homeowners multiple-peril (83.1%), earthquake (5.9%), other liabilities – occurrence (3.8%), other private passenger automobile liability (3.6%), and automobile physical damage (2.7%) lines account for 99.1% of the direct writings of the Company.

Direct premiums written during 2016 totaled \$219.6 million. Of the direct premiums written, \$173.9 million (79.2%) was written in California, \$12.3 (5.6%) was written in Texas, \$9.2 million (4.2%) was written in Connecticut, and \$24.2 million (11%) was written in remaining states and the District of Columbia.

The Company utilizes a multiple distribution platform to market their products through McGraw Insurance Services L.P. (MISLP), an affiliated general agent. The Company's motorcycle and personal watercraft policies are also offered through dealers possessing insurance licenses. Other distribution channels include direct, independent agents, and brokers. In 2016, approximately \$108.2 million (48.8%) of business was distributed by Ivantage Select Agency, Inc., an affiliate of Allstate Insurance Company; \$97.9 million (44.3%) was generated by independent agencies and brokers; \$10 million (4.5%) was produced by Farmers; and \$5.1 million (2.4%) was written by other distributors.

## REINSURANCE

### Assumed

The Company assumed 90% of premiums written by its subsidiary, Pacific Specialty Property and Casualty Company (PSPCC), pursuant to their 90% quota share contract, effective January 1, 2009. The Company pays PSPCC a commission rate of 35% on the premiums assumed. In 2016, PSPCC ceded \$2.9 million premiums to the Company.

## Ceded

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

<b>Type of Contract and Lines of Business</b>	<b>Reinsurer(s) and Participation</b>	<b>Company's Retention</b>	<b>Reinsurer's Limits</b>
Residential Earthquake (EQ) Quota Share  <i>Earthquake line of business</i>	Active Underwriter and Others Lloyd's Syndicate No. 4242 (Zone A 100%, Zone B 50%, Zone C 100%, Zone D 100%, Zone E 100%, All other Zones 100%, and All Legacy EQ Policies 100%) - Authorized Novae Syndicates Limited on behalf of Lloyd's Syndicate No. 2007 (Zone B 50%) - Authorized	None	100% quota share on all California Stand-Alone earthquake business
Quota Share for non-California property and stand-alone earthquake	3 authorized reinsurers: Munich Reinsurance America, Inc. (12.75%) SCOR Reinsurance Company (12.25%) Swiss Reinsurance America Corporation (10%)	65% of \$50 million	35% of \$50 million
Per-risk multi-line Excess of Loss  Applies to both Property and Casualty losses	8 authorized reinsurers. Percentages vary by layer.	1 <sup>st</sup> Layer: \$750,000  2 <sup>nd</sup> Layer: \$2.5 million  3 <sup>rd</sup> Layer: \$3.5 million	1st Layer: \$1.75 million xs of \$750,000  2 <sup>nd</sup> Layer: \$1 million xs of \$2.5 million  3 <sup>rd</sup> Layer: \$5 million xs of \$3.5 million
Property Catastrophe Excess of Loss  <i>Property business</i>	Various domestic, foreign and alien reinsurers both authorized and unauthorized. Percentages vary by layer.	1st Layer: \$5 million  2nd Layer: \$20 million  3rd Layer: \$40 million  4 <sup>th</sup> Layer: \$100 million	1st Layer: \$15 million xs of \$5 million  2nd Layer: \$20 million xs of \$20 million  3rd Layer: \$60 million xs of \$40 million  Fourth Layer: \$10 million xs of \$100 million
Reinstatement Premium Protection Contracts  Supplement to the	Hannover Ruck SE - Authorized	None	100% (the reinsurer shall be liable to pay the reinstatement premium obligations under the original contract.)

<b>Type of Contract and Lines of Business</b>	<b>Reinsurer(s) and Participation</b>	<b>Company's Retention</b>	<b>Reinsurer's Limits</b>
Contract above Shared Limit Top and Aggregate Excess of Loss Reinsurance Contract	Authorized Reinsurer: Everest Reinsurance Company (15%) Hannover Ruck SE (50%)	Section A: \$110 million	Section A: \$10 million xs of \$110 million
Supplements to Property Catastrophe Excess of Loss Reinsurance Contract	Unauthorized Reinsurers: Poseidon Re Ltd (28.089%) American Standard Insurance Company of Wisconsin (5%) Rubik Reinsurance, LTD. (1.911%)	Section B: \$7.5 million in the aggregate with \$300,000 deductible each loss occurrence	Section B: \$10 million xs of \$7.5 million in the Aggregate (Subject to \$300,000 Deductible)

## ACCOUNTS AND RECORDS

### Information Systems Controls

During the course of the examination, a review was made of the Company's general controls over its information systems. As a result of this review, several findings related to the Company's information security practices and controls were noted. These findings were presented to the Company along with recommendations to strengthen its controls. It is recommended that the Company evaluate the recommendations and make appropriate changes to strengthen its information system controls.

California Insurance Code (CIC) Section 734 provides that every company or person from whom information is sought, and its officers, directors, employees, and agents, shall provide to the examiners appointed pursuant to this article, timely, convenient, and free access at all reasonable hours at its offices to all books, records, accounts, papers, documents, and any or all computer or other recordings relating to the property, assets, business, and affairs of the company being examined. During the information technology (IT) controls review portion of this examination, the examiners encountered significant delays in obtaining the information and documents that were requested to complete the IT controls review timely. As such, the Company was not in compliance with CIC Section 734. It is recommended that the Company inform its officers, directors,

employees, and agents regarding the requirements of CIC Section 734 to ensure future compliance.

#### Annual Statement Instructions

Pursuant to the National Association of Insurance Commissioners (NAIC) Annual Statement Instructions, the Appointed Actuary must report to the Company's Board of Directors or the Audit Committee each year on the items within the scope of the Actuarial Opinion; and the minutes of the Board of Directors shall indicate as such. During the course of the examination, it was noted that the Appointed Actuary did not report to the Board of Directors or the Audit Committee those items within the scope of the Actuarial Opinion; nor was there indication in the Board minutes that such report by the Appointed Actuary was made. It is recommended that the Company implement appropriate procedures to ensure that its Appointed Actuary report to the Board of Directors or the Audit Committee each year on the items within the scope of the Actuarial Opinion; and that such reporting is documented in the minutes of the Board of Directors or Audit Committee.

#### Notice to the Board of Prior Examination Report

Pursuant to CIC Section 735, the Company is required to inform the Board members of the receipt of the examination report; both in the form first formally prepared by the examiners, and in the form officially filed by the Commissioner and document these facts within the Board minutes. A review of the Board minutes disclosed that the Company did not make the required references. It is recommended that the Company implement procedures to ensure future compliance with CIC Section 735.

#### Board Review and Approval of Investments

The Company's Board actions regarding the authorization and approval of investments did not satisfy the requirements of CIC Sections 1200 and 1201. Some of the

Company's minutes failed to document the authorization or approval of its investments in accordance with CIC Section 1200. In addition, it was noted for certain period, specific references to amounts, facts and the values of the securities were not included as required under CIC Section 1201. It is recommended that the Company implement procedures to ensure future compliance with CIC Sections 1200 and 1201.

#### Annual Information Statement

An Annual Information Statement is required to be filed with the California Department of Insurance (CDI) annually in order to establish the Company's continuing qualification to hold a California Certification of Authority. The Company is responsible for providing updated information in the Annual Information Statement filed with the CDI. It was noted that the Company amended and restated its Bylaws, effective June 21, 2016. However, such information was not reflected in their filed 2016 Annual Information Statement. It is recommended that the Company provide updated and accurate information in the Annual Information Statement filings.

#### Unclaimed Property

The Company does not have written procedures related to unclaimed property. In addition, the Company was unable to provide documentation to evidence that unclaimed property was reported and/or remitted to the State Controller's Office (SCO) for stale dated checks, in accordance with California Unclaimed Property Law (Code of Civil Procedure, Title 10, Chapter 7, Article 1-7) and Regulations (California Administrative Code, Title 2, Subchapter 8, Article 1-5). It is recommended that the Company adopt formal procedures to identify, report and/or remit escheatable items with the SCO in accordance with the California Unclaimed Property Law and Regulations.

#### Conflict of Interest Statements



The Company has established a written code of ethics; however, it was noted that some of the conflict of interest statements were not properly completed and some statements were not available for review. It is recommended that the Company establish policies and procedures to ensure that all directors and officers complete annual conflict of interest statements and properly file them for review in accordance with the Company's Policy Guide Conflict of Interest.

## FINANCIAL STATEMENTS

The following financial statements are based on the statutory financial statements filed by the Company with the California Department of Insurance for the period ending December 31, 2016. The accompanying comments to the amounts reported in the financial statements should be considered an integral part of the financial statements. No adjustments were made to the financial statements as a result of the examination.

Statement of Financial Condition as of December 31, 2016

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

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

Statement of Financial Condition  
as of December 31, 2016

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 195,032,146	\$	\$ 195,032,146	
Preferred stocks	4,876,303		4,876,303	
Common stocks	5,258,894		5,258,894	
Cash and short-term investments	72,773,703		72,773,703	
Other invested assets	7,708,057		7,708,057	
Receivable for securities	763,177		763,177	
Investment income due and accrued	1,370,125		1,370,125	
Premiums and agents' balances in course of collection	6,012,373		6,012,373	
Premiums, agents' balances and installments booked but deferred and not yet due	5,357,360		5,357,360	
Amount recoverable from reinsurers	3,429,369		3,429,369	
Net deferred tax asset	14,316,012	5,023,429	9,292,583	
Electronic data processing equipment and software	17,255,771	17,255,771	0	
Furniture and equipment	540,620	540,620	0	
Receivables from parent, subsidiaries and affiliates	<u>2,318,500</u>		<u>2,318,500</u>	
 Total assets	 <u>\$ 337,012,410</u>	 <u>\$ 22,819,820</u>	 <u>\$ 314,192,590</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 48,547,890	(1)
Reinsurance payable on paid loss and loss adjustment expenses			112,274	
Loss adjustment expenses			19,324,599	(1)
Other expenses			3,834,061	
Taxes, licenses and fees			345,471	
Current federal and foreign income taxes			1,036,976	
Unearned premiums			90,897,382	
Advance premiums			5,108,528	
Dividends declared and unpaid: Stockholders			1,500,000	
Ceded reinsurance premiums payable			3,137,988	
Funds held by company under reinsurance treaties			4,681	
Provision for reinsurance			3,130	
Payable to parent, subsidiaries and affiliates			1,413,451	
Payable for securities			<u>6,900,051</u>	
 Total liabilities			 182,166,480	
Common capital stock	\$ 3,500,000			
Gross paid-in and contributed surplus		11,384,419		
Unassigned funds (surplus)		<u>117,141,693</u>		
Surplus as regards policyholders			<u>132,026,111</u>	
 Total liabilities, surplus and other funds			 <u>\$ 314,192,591</u>	

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

Statement of Income

Underwriting Income

Premiums earned		\$ 185,387,739
Deductions:		
Losses incurred	\$ 90,392,637	
Loss adjustment expenses incurred	15,692,652	
Other underwriting expenses incurred	<u>78,726,194</u>	
Total underwriting deductions		<u>184,811,484</u>
Net underwriting gain		576,255

Investment Income

Net investment income earned	\$ 6,982,357	
Net realized capital gain	<u>10,134,798</u>	
Net investment gain		17,117,155

Other Income

Finance and service charges not included in premiums	\$ <u>1,066,581</u>	
Total other income		<u>1,066,581</u>
Net income after dividends to policyholders, after capital gains tax and before federal and foreign income taxes		18,759,991
Federal and foreign income taxes incurred		<u>1,171,533</u>
Net income		<u>\$ 17,588,457</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2015		\$ 132,963,156
Net income	\$ 17,588,457	
Change in net unrealized capital losses	(1,586,304)	
Change in net deferred income tax	1,806,506	
Change in nonadmitted assets	(7,753,226)	
Change in provision for reinsurance	7,522	
Dividends to stockholders	<u>(11,000,000)</u>	
Change in surplus as regards policyholders for the year		<u>(937,046)</u>
Surplus as regards policyholders, December 31, 2016		<u>\$ 132,026,110</u>

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

Surplus as regards policyholders, December 31, 2012			\$ 184,811,148
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 60,835,143	\$	
Net unrealized capital losses		1,766,335	
Change in net deferred income tax	3,080,083		
Change in nonadmitted assets		5,115,087	
Change in provision for reinsurance		3,130	
Dividends to stockholders	<u>                    </u>	<u>109,815,711</u>	
Total gains and losses	<u>\$ 63,915,226</u>	<u>\$ 116,700,263</u>	
Net decrease in surplus as regards policyholders			<u>(52,785,037)</u>
Surplus as regards policyholders, December 31, 2016			<u>\$ 132,026,111</u>

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Losses and Loss Adjustment Expenses

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

### SUBSEQUENT EVENTS

The Company loaned \$6,000,000 to its parent, Western Service Contract Corporation (WSCC), on April 28, 2017. Due to the amount of the loan being below the statutory thresholds, the Company was not required to file Prior Notification of Transaction with the California Department of Insurance (CDI) pursuant to California Insurance Code (CIC) Section 1215.5(b)(1)(A).

On November 21, 2017, the Company declared a cash dividend of \$2,000,000 to be paid to its parent, WSCC. The Company filed a dividend report with the CDI on November 30, 2017. The dividend was distributed on December 21, 2017.

On March 13, 2018, the Company declared a cash dividend of \$1,400,000 to be paid to its parent, WSCC. The Company filed a dividend report with the CDI on March 14, 2018. The dividend will be distributed on March 30, 2018.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Company History – Dividends Paid to Parent (Page 3): It is recommended that the Company timely report and pay all future ordinary dividends and other distributions to its shareholders in accordance with California Insurance Code (CIC) Section 1215.4(f).

### Management and Control – Management Agreements (Page 7):

Allocation of Overhead Charges Agreement: It is recommended that the Company timely file future assignments, modifications, amendments to its management agreements with the California Department of Insurance (CDI) in accordance with CIC Section 1215.5(b)(4).

Tax Allocation Agreement: It is recommended that that the Company properly notify the CDI of the modification, effective September 9, 2008, in accordance with CIC Section 1215.5(b)(4).

Services and Expense Allocation Agreement: It is recommended that the Company implement policies and procedures to ensure future compliance with CIC Section 1215.5(b)(4).

Accounts and Records – Information Systems Controls (Page 12): It is recommended that the Company evaluate the recommendations and make appropriate changes to strengthen its information system controls. In addition, it is recommended that the Company inform its officers, directors, employees, and agents about the requirements of CIC Section 734 to ensure future compliance.

Accounts and Records – Annual Statement Instructions (Page 12): It is recommended that the Company implement procedures to ensure that its Appointed Actuary report to

the Board of Directors or the Audit Committee each year on the items within the scope of the Actuarial Opinion; and that such reporting is documented in the minutes of the Board of Directors or Audit Committee.

Accounts and Records – Notice to the Board of Prior Examination Report (Page 13): It is recommended that the Company implement procedures to ensure future compliance with CIC Section 735.

Accounts and Records – Board Review and Approval of Investments (Page 13): It is recommended that the Company implement procedures to ensure future compliance with CIC Sections 1200 and 1201.

Accounts and Records – Annual Information Statement (Page 13): It is recommended that the Company provide updated and accurate information in the Annual Information Statement filings.

Accounts and Records – Unclaimed Property (Page 14): It is recommended that the Company adopt formal procedures to identify, report and/or remit escheatable items with the State Controller's Office in accordance with the California Unclaimed Property Law and Regulations.

Accounts and Records – Conflict of Interest (Page 14): It is recommended that the Company establish policies and procedures to ensure that all directors and officers complete annual conflict of interest statements and properly file them for review in accordance with the Company's Policy Guide Conflict of Interest.

#### Previous Report of Examination

Management and Control – Conflict of Interest and Code of Ethics (Page 11): It was noted that conflict of interest statements were not available for 2010 and 2012. It was also noted the Company had not established a written code of ethics. It was



recommended the Company implement procedures to comply with the required oversight of corporate governance and internal controls; to better preserve its corporate records; and to develop a written code of ethics which can provide guidance on handling of conflicts of interest, as well as other ethics issues. The Company has established a written code of ethics; however, it was noted that some of the conflict of interest statements were not properly completed and some of them were not available for review.

Accounts and Records – Schedule BA Holdings (Page 13) – In accordance with Statement of Statutory Accounting Principles (SSAP) Nos. 48 and 97, the Company should have non-admitted an investment on Schedule BA for Emerald Crest EData Holdings, LLC due to an audited U.S. GAAP statement not being available. It was recommended the Company non-admit the Emerald Crest EData investment on Schedule BA. This is no longer applicable since the Company does not currently hold the subject investment.

Accounts and Records – Disclosure of Contingent Commitment (Page 13) – It was noted that the Company had committed to annually contribute to the capital stock of its subsidiary, Pacific Specialty Property and Casualty Insurance Company (PSPCC) to bring PSPCC into compliance with Texas law. It was recommended the Company disclose any commitments to its subsidiary in Note 14 of the Annual Statement, Notes to Financial Statements in accordance with the Annual Statement Instructions. 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/\_\_\_\_\_

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

\_\_\_\_\_/S/\_\_\_\_\_

Kyo Chu, CFE  
Senior Insurance Examiner, Supervisor  
Department of Insurance  
State of California