

REPORT OF EXAMINATION
OF
PORTUGUESE FRATERNAL SOCIETY
OF AMERICA

AS OF
DECEMBER 31, 2010

Participating State
and Zone:

California

Filed November 28, 2011

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San Francisco, California
October 11, 2011

Honorable Joseph Torti, III
Chairman of the NAIC Financial
Condition Subcommittee
Superintendent of Business Regulation
Division of Insurance
Cranston, Rhode Island

Honorable Linda S. Hall
Secretary, Zone IV-Western
Director of Insurance
Alaska Department of Insurance
Anchorage, Alaska

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

Dear Chairman, Secretary, and Commissioner:

Pursuant to your instructions, an examination was made of the

PORTUGUESE FRATERNAL SOCIETY OF AMERICA

(hereinafter also referred to as the Society) at its home office located at 1120 E. 14th Street, San Leandro, California, 94577.

SCOPE OF EXAMINATION

The previous examination of the Society was made as of December 31, 2005. This examination covers the period from January 1, 2006 through December 31, 2010. 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 Society's financial condition, to identify prospective risks, and to obtain information about the Society, 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 Society were considered in accordance with the risk-focused examination process.

The Society has no affiliates or subsidiaries and no other states were involved in this examination.

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

SUBSEQUENT EVENTS

The Society's mortgage loan impairment as of June 30, 2011 was determined to be \$643,702. This impairment is not expected to affect surplus because the Society increased its valuation allowance by \$700,000 as of December 31, 2010.

SOCIETY HISTORY

Effective January 1, 2010, the Society became the surviving entity in a four way merger with Irmandade do Divono Espirito Santo (I.D.E.S.); Sociedade do Espirito Santo (S.E.S.); and the União Portuguesa Protectora do Estado da California (U.P.P.E.C.). As a result of the merger, the Society changed its name from Uniao Portuguesa do Estado da California (U.P.E.C.) to the Portuguese Fraternal Society of America. The merger was recommended by the California Department of Insurance (CDI) due to the financial difficulties and the uncertainty of each party's ability to continue as a going concern independently.

The Society's Articles of Incorporation were amended in November of 2009 to reflect the new name and the change in the supreme governing body. The CDI consented to the merger and the

name change on December 31, 2009. The CDI approved the issuance of an Amended Certificate of Authority reflecting the Society's new name on December 9, 2010.

The Society is a not-for-profit corporation formed, organized, and incorporated under the Fraternal Benefit Society Laws of the State of California for the sole mutual benefit of its members and their beneficiaries. The Society operates on the lodge system, with ritualistic ceremonies and a representative form of government.

MANAGEMENT AND CONTROL

The Society underwent significant restructuring as a result of the merger noted in the Society History section. The Board of Directors became the supreme governing body of the Society under the laws of the State of California. Prior to January 1, 2010, the Supreme Council was the supreme governing body. The Supreme Council is now responsible for coordination and promotion of fraternal, social, cultural, charitable, and membership activities of the Society and no longer has supervision or authority regarding the business affairs of the Society. A Chief Executive Officer position was created and the previous position of Supreme Executive Secretary/Treasurer was separated into two positions: Executive Secretary and Executive Treasurer. Additionally, the number of Company employees increased from 5 to 12.

Management of the Society is vested in a nine-member Board of Directors that is elected annually. As of December 31, 2010, the directors and principal officers were as follows:

Directors

Name and Residence

John A.R. Salvador
Patterson, California

Gary C. Meyer
Tracy, California

Principal Business Affiliation

Funeral Counselor and Office Manager
Hillview Funeral Chapels

Information Systems Technician
CVS Caremark Corporation

Name and Residence

Marie Kelly-Barreiro
Turlock, California

Donald J. Valadao
San Diego, California

Antoinette F. Duarte
Elk Grove, CA

James S. Cave
Berkeley, California

Odette Pinheiro
Santa Barbara, California

Geraldine E. Alves
Los Banos, California

Duane S. Oliveira
Benicia, California

Principal Business Affiliation

Owner
Marie B. Kelly & Associates

Controller
Cement Cutting Inc.

Secretary and Treasurer
Duarte Family Dairy Inc

Personal Financial Representative
Allstate Financial Services

Administrative Secretary II
Allan Hancock College

Clerk
City of Los Banos

Owner
Oliveira Law Firm

Principal Officers

Name

Timothy L. Borges
Helen D. Vieira
Isolete F. Gracio

Title

Chief Executive Officer
Executive Treasurer
Executive Secretary

Code of Conduct

The Society has procedures in place for the completion and review of the Code of Conduct statements, also known as conflict of interest statements, but the procedures were not performed yearly. It is recommended that the Society implement procedures to annually obtain and review completed Code of Conduct statements for all directors and key employees.

CORPORATE RECORDS

The Society was not in compliance with California Insurance Code (CIC) Section 735, which requires the Society to inform the board of directors at its next regularly scheduled meeting of every examination report received from the California Department of Insurance. It is recommended the Society comply with CIC Section 735 and inform its board of such receipt.

TERRITORY AND PLAN OF OPERATION

The Society operates under the lodge system as described under Division 2, Part 2, Chapter 10, of the California Insurance Code. The Society was licensed to transact life, annuity and disability business in the States of California and Nevada. The Society has 121 subordinate councils in California, four subordinate councils in Nevada, one subordinate council in Massachusetts and one subordinate council in Rhode Island. The Society states that it is in the process of obtaining licenses in Massachusetts and Rhode Island. All operating functions are performed at the Society's home office in San Leandro, California.

There are four classes of members: benefit, social, youth, and honorary. Benefit members are persons of age 16 or older, insured by the Society and are allowed participate in all rights and privileges granted by the laws of the Society including voting at council meetings and on corporate matters. Social members are those who apply for social membership through the subordinate council and are only entitled to participate in the social activities of the local subordinate council. Youth at any age through 15 may join, but do not have voting rights in the Society's management until they reach age 16. Honorary members are persons considered of great distinction to the Society.

The Society's products are offered through one full time agent and 17 independent agents. In 2010, 99.96% of premiums and annuity considerations, totaling \$5,664,524, were written in California. This total includes \$2,061,416 (36.3%) of life insurance premiums, \$3,589,109 (63.3%) of annuity premiums and a small amount of accident and health premiums.

During our review of operations, we noted the Society did not have a documented strategic plan. As a result of the California Department of Insurance recommended January 1, 2010 merger and past financial difficulties as noted in the Society History section, it is recommended that the Society prepare a written 5-year strategic plan with forecasts, budgets and yearly updates.

REINSURANCE

Assumed

The Society did not assume any reinsurance during the examination period

Ceded

Effective January 1, 2002, the Society reinsured its whole life business with Optimum Re Insurance Company (Optimum Re) of Dallas, Texas an admitted insurer in California, on an automatic yearly renewable term basis. Automatic reinsurance applies to the Society's products subject to certain conditions. The Society's maximum retention on individual life is \$50,000. Waiver of premiums and accidental death benefit are not reinsured under this agreement. Also on January 1, 2002, the Society entered into a coinsurance agreement with Optimum Re covering its 10 and 20 year non-renewable level-term plans. The Society's maximum retention limit is \$50,000. The Society may submit all business not eligible for automatic coverage to Optimum Re on a facultative basis. Waiver of premiums and accidental death benefit are not reinsured under this agreement.

ACCOUNTS AND RECORDS

During the course of the examination, it was noted that "Schedule F – Death Claim Resisted or Compromised" was inadvertently excluded from the Annual Statement exhibits and that inaccurate data was contained in the following: Exhibit 5, Aggregate Reserve for Life Contracts, Exhibit 8 – Contract claims for life and accident and health contracts; and other Annual

Statement schedules. Additionally, due to unrecorded and incorrect closing entries, a prior period examination adjustment of \$179,286 was made to the December 31, 2009 surplus. It is recommended the Society exercise due care when preparing the annual statements and maintain adequate financial statement documentation to support all reported information.

Information Systems Controls

A review was made of the Society's general controls over its information systems. As a result of this review, moderate risk findings were noted in IT disaster recover/contingency planning, data and logical access security, and program changes. These findings were presented to the Society along with recommendations to strengthen its controls. The Society should evaluate the recommendations and make appropriate changes to strengthen its information system controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2010

Summary of Operations and Surplus Account for the Year Ended December 31, 2010

Reconciliation of Surplus from December 31, 2005 through December 31, 2010

Reconciliation of Examination Changes as of December 31, 2010

Statement of Financial Condition
as of December 31, 2010

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 67,079,085	\$	\$ 67,079,085	(1)
Stocks				
Preferred stocks	5,911,345		5,911,345	
Common stocks	2,664,108		2,664,108	
Mortgage loans on real estate				
First liens	16,129,842	259,676	15,870,166	(2)
Real estate				
Properties occupied by the company	217,170		217,170	
Properties held for the production of income	2,110,612		2,110,612	
Cash and short-term investments	4,182,967		4,182,967	
Contract loans	278,568		278,568	
Investment income due and accrued	1,007,115		1,007,115	
Premiums and considerations:				
Deferred premiums, agents' balances and installments booked but deferred and not yet due (EBUB)	7,175		7,175	
Electronic data processing equipment and software	115,303	115,303		
Aggregate write-ins for other than invested assets	<u>26,538</u>	<u>26,538</u>		
Total assets	<u>\$ 99,729,828</u>	<u>\$ 401,517</u>	<u>\$ 99,328,311</u>	
 <u>Liabilities, Surplus and Other Funds</u>				
Aggregate reserve for life certificates and contracts			\$ 86,636,037	(3)
Aggregate reserve for accident and health contracts			295,317	(3)
Liability for deposit-type contracts			1,860,366	
Contract claims - Life			189,099	
Premiums and annuity considerations received in advance			178,140	
Contract liabilities not included elsewhere:				
Interest maintenance reserve			1,263,763	
General expenses due or accrued			180,492	
Amounts withheld or retained by society as agent or trustee			36,466	
Miscellaneous liabilities:				
Asset valuation reserve			2,097,525	
Aggregate write-ins for liabilities			<u>43,641</u>	
Total liabilities			92,780,846	
Unassigned funds (surplus)		<u>\$ 6,547,465</u>		
Surplus			<u>6,547,465</u>	(4)
Total liabilities, surplus and other funds			<u>\$ 99,328,311</u>	

Summary of Operations and Surplus Account
for the Year Ended December 31, 2010

<u>Summary of Operations</u>		<u>Note</u>
Premiums and annuity considerations	\$ 5,332,578	
Net investment income	4,955,500	
Amortization of interest maintenance reserve	69,668	
Aggregate write-ins for miscellaneous income	<u>48,566</u>	
Total	<u>10,406,312</u>	
Deduct:		
Death benefits	674,191	
Matured endowments	53,835	
Annuity benefits	3,008,185	
Surrender benefits	865,991	
Interest on deposit-type contract funds	2,568,301	
Increase in aggregate reserve for life and accident and health certificates and contracts	(729,472)	
Commissions on premiums and annuity considerations	71,772	
General insurance expenses and fraternal expenses	2,970,499	
Insurance taxes, licenses and fees	<u>97,368</u>	
Total	<u>9,580,670</u>	
Net realized capital losses	<u>(643,331)</u>	
Net income	<u>\$ 182,311</u>	

<u>Surplus Account</u>		
Surplus, December 31, 2009	\$ 6,082,422	(4)
Net gain	182,311	
Change in net unrealized capital gains	77,028	
Change in nonadmitted assets and related items	444,793	
Change in asset valuation reserve	<u>(239,089)</u>	
Net change in surplus for the year	<u>465,043</u>	
Surplus, December 31, 2010	<u>\$ 6,547,465</u>	

Reconciliation of Surplus
from December 31, 2005 through December 31, 2010

Surplus, December 31, 2005, per Examination			\$ 9,594,838
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net loss	\$	\$ 781,600	
Change in net unrealized capital losses		2,637,270	
Change in net unrealized foreign exchange capital loss		110,024	
Change in nonadmitted assets	929,241		
Aggregate write-ins for gains in surplus	482,174		
Change in asset valuation reserve	<u> </u>	<u>929,894</u>	
Total gain and losses in surplus	<u>\$ 1,411,415</u>	<u>\$ 4,458,788</u>	
Net decrease in surplus for the examination period			<u>(3,047,373)</u>
Surplus, December 31, 2010, per Examination			<u>\$ 6,547,465</u>

Reconciliation of Examination Changes
as of December 31, 2010

	<u>Per</u> <u>Company</u>	<u>Per</u> <u>Examination</u>	<u>Surplus</u> <u>Increase</u> <u>(Decrease)</u>	<u>Notes</u>
<u>Assets</u>				
Mortgage loans on real estate	\$ 16,129,842	\$ 15,870,166	\$ (259,676)	(2)
Net decrease to surplus			(259,676)	
Surplus, December 31, 2010, per Company			<u>6,807,141</u>	
Surplus, December 31, 2010, per Examination			<u>\$ 6,547,465</u>	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Bonds

The Society had \$12,070,049 in securities held with its only investment advisor and broker Morgan Stanley, at December 31, 2010. Morgan Stanley is not a qualified custodian under California Insurance Code (CIC) Section 1104.9(b). It is recommended the Society deposit its securities with a qualified custodian pursuant to CIC Section 1104.9 and discontinue its practice of depositing securities with its investment broker.

The Society does not have an investment advisory agreement with its sole investment advisor and broker, Morgan Stanley. Guidelines set forth by the California Department of Insurance (CDI) consider the investment function to be basic elements of an insurance business and require a written agreement when the function is delegated to an entity other than the insurance company itself. It is recommended that the Society draft an investment advisory agreement with Morgan Stanley in accordance with CDI advisory, management, and service agreement guidelines.

(2) Mortgage Loans on Real Estate

The Society reported a balance of \$16,129,842 for first lien mortgage loans on real estate. In accordance with Statement of Statutory Accounting Principles (SSAP) No. 37, paragraph 16, mortgage loans for which foreclosure is probable shall be considered permanently impaired. Our examination determined the permanent impairment of this asset, due to foreclosures, totaled \$259,676. It is recommended the Society record a permanent write down of this asset of \$259,676.

- (3) Aggregate Reserve for Life Certificates and Contracts
- (3) Aggregate Reserve for Accident and Health Contracts

Based on an analysis by a Life Actuary for the California Department of Insurance, the Society's aggregate reserves for life and accident and health contracts as of December 31, 2010 were found to be reasonably stated and have been accepted for purposes of this examination.

(4) Surplus

The December 31, 2009 surplus was restated from \$5,903,136 to \$6,082,422. In its financial statement closing of December 2009, Irmandade do Divono Espirito Santo (I.D.E.S.), one of the three societies merged into the Society at January 1, 2010, recorded an incorrect value for its common stock and failed to record the sale of a bond and the realized gain associated with the sale. As a result, the net income and surplus in the I.D.E.S. 2009 Annual Statement was understated by \$179,286. SSAP No. 3 requires the restatement of the prior years' Annual Statement amounts as if the merger had occurred as of January 1 of the prior year. Because the Society did not restate and present the corrected prior year's amounts per SSAP No. 3, the December 31, 2009 surplus was adjusted by \$179,286. It is recommended the Society exercise due care when preparing the annual statements and maintain adequate financial statement documentation to support all reported information.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Code of Conduct (Page 4): It is recommended that the Society implement procedures to annually obtain and review completed Conflict of Conduct statements for all directors and key employees on an annual basis.

Corporate Records (Page 5): It is recommended the Society comply with California Insurance Code (CIC) Section 735 and inform its board of such receipt of examination reports.

Territory and Plan of Operation (Page 5): It is recommended that the Society prepare a written 5-year strategic plan with forecasts, budgets and yearly updates.

Accounts and Records (Page 6): It is recommended the Society exercise due care when preparing the annual statements and maintain adequate financial statement documentation to support all reported information.

Accounts and Records – Information Systems Control (Page 7): It is recommended the Society evaluate the general control recommendations and make appropriate changes to strengthen its information system controls.

Comments on Financial Statement Items - Bonds (Page 12): It is recommended the Society deposit its securities with a qualified custodian pursuant to CIC Section 1104.9 and discontinue its practice of depositing securities with its investment broker.

Comments on Financial Statement Items - Bonds (Page 12): It is recommended that the Society draft an investment advisory agreement with Morgan Stanley in accordance with California Department of Insurance advisory, management, and service agreement guidelines.

Comments on Financial Statement Items - Surplus (Page 13): It is recommended the Society exercise due care when preparing the annual statements and maintain adequate financial statement documentation to support all reported information.

Previous Report of Examination

None.

ACKNOWLEDGEMENT

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/_____

Sandra Bailey, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California