RUDMOSE & NOLLER ADVISORS, LLC
INSURANCE REGULATORY SERVICES

CALIFORNIA DEPARTMENT OF INSURANCE

Operational Assessment Report

California FAIR Plan Association

June 15, 2022

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The Honorable Ricardo Lara
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner Lara:

In accordance with your instructions, Rudmose & Noller Advisors, LLC ("RNA") was appointed as Special Examiner for the California Department of Insurance ("Department") pursuant to authorities contained in California Insurance Code §733 and 734. As part of the appointment, RNA completed an operational assessment of the California FAIR Plan Association ("FAIR Plan") to assess its operational and financial challenges as a result of the growth in insurance policies-in-force, which has resulted in much higher claims and transaction volumes.

Executive Summary

Created by the Governor and California State Legislature, the FAIR Plan is comprised of the admitted insurers licensed in California to provide basic property insurance for homes and businesses when coverage options are not available in the voluntary market, in accordance with California statutes. Recent wildfires and related claims have resulted in a significant increase in non-renewals in the voluntary market and, accordingly, consequential growth in insurance policies issued by the FAIR Plan. As reflected in the Department's press release of December 20, 2021, the number of FAIR Plan policies-in-force was 241,466. As of December 31, 2021, according to the President's Report to the Governing Committee dated February 10, 2022, there were 248,361 such property policies-in-force compared to 126,854 such property policies as of April 30, 2018, an increase of 95.7% over that period. Similarly, the FAIR Plan's staff increased to 133 people as of December 31, 2021 from 53 people as of April 30, 2018. This rapid growth in policies-in-force has resulted in much higher claims and transaction volumes, and notable operational and financial challenges for the FAIR Plan. As a result, the Department engaged RNA to conduct an assessment of the FAIR Plan's financial and operational management practices. The assessment was completed through a review of FAIR Plan documents, publicly-available information, and interviews of management.

This report contains significant findings and recommendations, and recommended best practices in the following seven operational areas:

- Governance, Plan of Operation, and Enterprise Risk Management ("ERM")
- Capital and Liquidity Management
- Financial Oversight and Reporting
- Underwriting and Rating
- Claim Processing and Reserving
- Reinsurance Adequacy
- Customer Service Policies and Procedures

Introduction and Scope

Created by the Governor and California State Legislature, the FAIR Plan is comprised of the admitted insurers licensed in California to provide property insurance for homes and businesses available in two areas of the state: (1) specified brush/wildfire areas, and (2) specific urban areas (Division I) designated by the Insurance Commissioner ("Commissioner") of the Department.

A Business Owner's Program ("BOP") (Division II) has been offered by the FAIR Plan since October 1, 1994. BOP offers coverage to small and medium-sized business operators, who have difficulty obtaining property and liability insurance in the voluntary insurance market. The FAIR Plan is a joint reinsurance association formed by licensed insurers and established to provide insurance coverage to risks that would otherwise not be able to obtain coverage through voluntary markets. Effective May 30, 2001, the

Commissioner expanded the FAIR Plan's area of operation statewide. Also, the Commissioner must approve the Plan of Operation of the FAIR Plan.

In accordance with California insurance statutes, all private insurance companies licensed to write fire, allied lines, homeowners, commercial multi-peril, and earthquake coverages are required to participate in the FAIR Plan, and share in any profits and losses as a condition of their authority to transact insurance in California. Thus, it is a mechanism to spread risk, premiums, losses, and expenses among the participating insurers. Participating percentages are reduced proportionately by the amount that the participating insurers voluntarily write in the designated lines of business. Accounting activity is allocated to pool years, which remain open until closure is approved by the FAIR Plan's Governing Committee, and either a distribution or assessment (with the approval of the Commissioner), or capital contribution of equity (re-application to other pool years) of funds is made.

All activity conducted by the FAIR Plan is on behalf of its participating insurers. Licensed producers are not appointed agents of the FAIR Plan; however, all property and casualty producers licensed by the Department are eligible to submit applications to the FAIR Plan on behalf of their insurance clients. Consumers may also seek coverage directly from the FAIR Plan without the use of a licensed producer.

The FAIR Plan writes its own policies, collects premiums, pays claims and producer commissions, and incurs general expenses. One-year policies are issued, and premium rates are based upon the FAIR Plan's loss experience, as approved by the Department. While the FAIR Plan does not verify if applicants attempted to place a risk in the voluntary market, it does require that producers e-sign an acknowledgement that they have conducted a diligent search, as required by California Insurance Code §10093.

There have been a series of Orders issued by the Commissioner since 2019, which require changes to the FAIR Plan's Plan of Operation to effect certain aspects in its business operations. On November 14, 2019, the Commissioner issued Order 2019-2 requiring the FAIR Plan to offer consumers the ability to purchase a policy with coverages similar to those contained in an HO-3 policy, increasing policy limits to $3.3 million for all personal lines homeowners risks, including the right to pay premiums in monthly installments without fees, and requiring the right to pay premiums by credit card or electronic funds transfer without fees. The FAIR Plan did not agree with some or parts of the Commissioner’s Orders, and consequently, the FAIR Plan initiated litigation challenging the Commissioner’s Order.

On July 12, 2021, the Superior Court issued an Order, which limited the coverages that the FAIR Plan would be required to provide consumers, but upheld the Commissioner’s authority to order additional property-related coverage options not provided by the FAIR Plan. Subsequently, on September 20, 2021, the Commissioner issued Order 2021-2, as amended on November 19, 2021, again requiring the FAIR Plan to provide consumers access to additional coverages. The FAIR Plan filed suit challenging that Order. On February 10, 2022, the Superior Court denied the FAIR Plan’s request for a preliminary injunction barring enforcement of Order 2021-2, as amended, and, on March 21, 2022, the FAIR Plan filed a notice of appeal. The FAIR Plan continues to pursue litigation challenging Order 2021-2, which requires the FAIR Plan to offer personal lines coverage related to the insured property for accidental discharge or overflow of water or steam, premises liability, incidental workers’ compensation, theft, falling objects, weight of ice, snow, or sleet, freezing, and loss of use, including coverage for additional living expenses.

Pursuant to the authority contained in the California Insurance Code §733 and 734, RNA was appointed as a Special Examiner regarding the affairs of the FAIR Plan on September 29, 2021. This is the first such assessment of the FAIR Plan conducted by the Department. In addition to completing the operational assessment, RNA was also engaged to assist the Department’s Field Examination Division in conducting its full-scope financial examination of the FAIR Plan as of and for the three-year period ended September 30, 2020. RNA reviewed additional financial information and assessed other matters occurring subsequent to September 30, 2020, through the date of report, as deemed appropriate. The purpose of the operational assessment is to evaluate the FAIR Plan's operational effectiveness, and identify strengths and opportunities for improvement in a thorough, comprehensive, and objective review. All operational activities supporting the FAIR Plan's scope of administrative, underwriting, claims, and policyholder service functions were considered in the review, including its budgeting, financial reporting, and liquidity and capital resources. The operational assessment should be seen as developmental with the goal of continuous improvement of services, processes, and operational performance. Additional information technology recommendations were made to the FAIR Plan, but are not included in this report.

RNA relied on written documentation, and oral and written representations provided by the FAIR Plan's Governing Committee Chairperson, Officers, and management. To the extent inaccuracies exist in documents or analyses provided to us that we read or analyzed, there could be inaccuracies in the information presented herein. The sufficiency of the work we performed was set forth by the Department, and the scope of that work is solely the responsibility of the Department. The following describes our assessments and recommendations based on the analyses and procedures described herein.

Procedures Performed

RNA performed assessment procedures focused on seven operational areas as follows:

- Governance, Plan of Operation, and ERM
- Capital and Liquidity Management
- Financial Oversight and Reporting
- Underwriting and Rating
- Claim Processing and Reserving
- Reinsurance Adequacy
- Customer Service Policies and Procedures

RNA interviewed Denise Pavlov, Chairperson of the Governing Committee, who has been in this role since November 2021, but has been a member of the Governing Committee since June 2018. In addition, RNA interviewed the following Officers of the FAIR Plan:

Name	Title
Anneliese Jivan	President (resigned February 28, 2022)
Victoria Roach	President (effective March 1, 2022) previously, Vice President – Underwriting, Product, and Human Resources
Peter Ducich	Vice President – Underwriting & Product
Cesar Flores	Vice President – Information Systems
Kornel Heard	Vice President – Operations
Estee Natale	Vice President – Claims
Jinal Patel	Vice President – Finance

RNA reviewed numerous documents obtained from the FAIR Plan including Governing Committee and Subcommittee minutes; conflict of interest statements for Governing Committee members; management reports and presentations provided to the Governing Committee; the Plan (most recently revised May 31, 2019); audited financial statements; periodic budget, financial and operational reports prepared by management; written investment policies; the Assessment Policy and Pool Close Policy dated August 2019; reinsurance analyses prepared by AON plc ("Aon"); actuarial analyses prepared by Milliman, Inc. ("Milliman"); staff organization charts; documentation of various policies, procedures, guidelines, and manuals related to the underwriting, policyholder service, and claims functions; various third-party service provider contracts; employee training materials related to fraud; and FAIR Plan reports provided to Property Insurance Plan Service Office, Inc. ("PIPSO"), a national organization supported by the FAIR Plans (also known as "residual market facilities") throughout the United States. In addition, we obtained publicly-available information from the Department, other state insurance departments, other states' FAIR Plans and residual market facilities, and PIPSO.

RNA performed independent analyses and comparisons to other FAIR Plans or residual market facilities[1] of similar size based upon publicly-available information, and our experience with best practices in the insurance industry. While the nature and extent of claims, and the specific catastrophic risks residual market facilities may differ from the those in the FAIR Plan, the other residual market facilities are similar in that they are the insurers-of-last-resort within their markets, and are critical for ensuring sufficient and available insurance coverage for consumers. The following are our significant findings and recommendations, and recommended best practices.

Operational Assessments by Functional Area

Governance, Plan of Operation, and ERM

Governing Committee Members

California Insurance Code § 10094 and the Plan of Operation as referenced in California Insurance Code §10095 require that the Governing Committee of the FAIR Plan include nine voting members, who are elected annually from member companies, and who will serve for one year, or until successors are elected. Not more than one participating insurer within a holding company may serve on the Governing Committee. The Plan of Operation also indicates that Governing Committee member elections are to be held in accordance with premiums written during the second preceding calendar year as disclosed in the members' Annual Statements filed with the Department.

Additionally, four non-voting members are appointed by the Governor for an indefinite term including one representative of insurance agents, one representative of insurance brokers, one representative of surplus line brokers, and one representative of the public.

California Insurance Code §10095 indicates that the Plan of Operation is subject to approval by the Department and continuing review, including the Department's ability to

[1] Louisiana Citizens Property Insurance Corporation, North Carolina Joint Underwriting Association, Texas FAIR Plan, and Texas Windstorm Insurance Association.

revoke its approval. In such cases, the FAIR Plan must submit a revised Plan of Operation within 30 days. If the FAIR Plan fails to do so, or if the revised Plan of Operation is unacceptable, the Department must promulgate a new Plan of Operation.

The Plan of Operation indicates that all members of the Governing Committee must execute a non-disclosure agreement, subject to the approval of the Department, agreeing to "maintain the confidentiality of (1) any pending or anticipated litigation, and any matters falling within the attorney-client privilege, to the extent that confidentiality is required for the attorney to exercise his/her ethical duties as a lawyer, and, (2) any matter involving employment, termination, terms and conditions of employment, evaluation, promotion, or disciplining of any prospective or current Association (i.e. FAIR Plan) employee or contractor."

The Governing Committee members serving as of December 15, 2021 are as follows:

Name	Company	Representing
Voting Members		
Denise Pavlov, Chairperson	TOPA Insurance Group	At-large insurance companies
Janine Graff	Liberty Mutual Insurance Company	At-large insurance companies
Kyle Belvill	California Casualty Group	Association of California Insurance Companies
Meggan Conner	The Hartford	At-large insurance companies
Nicole Forziati	State Farm Insurance	At-large insurance companies
Michael Mohamed	Interinsurance Exchange of the Automobile Club	Other Non-Stock Insurers
Jeff Sauls	Farmers Insurance Group	Other Non-Stock Insurers
Michael Schalk	Allstate Insurance Company	Other Stock Insurers
Cedric Snow	CSAA Insurance Group	At-large insurance companies

Name	Company	Representing
Non-voting Members		
Mark Buell	N/A	Public via the Department
Irene Sabourin	Hub International	Insurance Agents
Donna Bacarti	AmWINS Access Insurance Services	Surplus Lines Insurers
Javier Rodriguez	RISCO Insurance Services, Inc.	Insurance Brokers

Designated liaisons for the Department for attendance at Governing Committee meetings are as follows:

Edward Cimini – Senior Casualty Actuary, Rate Regulation Branch, Rate Actuarial Office
Risa Salat-Kolm – Senior Staff Counsel, Legal Branch, Enforcement Bureau
Daniel Wade – Senior Staff Counsel, Legal Branch, Rate Enforcement Bureau

Governing Committee Authorities and Duties

The Plan of Operation indicates that the Chairperson of the Governing Committee shall appoint a Nominating Committee consisting of not less than three voting members for election at the annual meeting.

The Plan of Operation notes that the Governing Committee may establish Subcommittees to address items within their respective charters, which are to be approved by the Governing Committee annually at a meeting when the Department's representative is present. The Subcommittees authorized by the Plan of Operation are the Underwriting Subcommittee, Claims Subcommittee, Accounting Subcommittee, Investment Subcommittee, Nominating Subcommittee, Reinsurance Subcommittee, and the Executive Subcommittee. Each Subcommittee shall include at least one non-voting member of the Governing Committee. Also, the Plan of Operation specifically states that "only the Executive Subcommittee may exercise delegated authority from the Governing Committee." The Executive Subcommittee shall include the non-voting member of the Governing Committee described in California Insurance Code §10094 as the public's representative. Accordingly, each of the above Subcommittees have been established by the Governing Committee.

The Committee has authority to appoint a Manager, and such other personnel, to execute the FAIR Plan's business. The Manager shall prepare an operating budget, which shall be approved by the Governing Committee. Further, the Plan of Operation requires that the Governing Committee provide a written report on operations annually to the members and the Department. Also, the Governing Committee is required to obtain periodic reports from entities completing inspections, and provide such reports to the Department.

<u>Meetings</u>

The Governing Committee is required to have an annual meeting to elect the voting members with 20 days' advance written notice of the annual meeting with the related agenda provided to all participants, including the Department. The Department is permitted to attend all Governing Committee and Subcommittee meetings except for any portion of a Governing Committee or Executive Subcommittee meeting called to discuss pending or anticipated litigation, matters falling within the attorney-client privilege, or any matter involving employment, termination, terms and conditions of employment, evaluation, promotion, or disciplining of any prospective or current FAIR Plan employee or contractor. A majority of the voting and at least one non-voting member of the Committee constitutes a quorum.

A special meeting may be called by the Governing Committee, or upon the written request to the Governing Committee by a minimum of ten insurers. Voting at the special meeting is on a weighted basis in accordance with each insurer's premiums written. The FAIR Plan is to provide notice to the Department and the non-voting members of the special meeting with attendance permitted by the non-voting members and the Department. Also, the Governing Committee is to meet annually with the FAIR Plan's independent auditors, and all findings and any reports of the independent auditors are to be provided to the Department. In recent years, the Governing Committee has met at least three times a year, with six meetings held in 2021.

Strategic and operational planning is driven by the FAIR Plan's Officers in consultation with legal counsel, as appropriate, with status reports, such as the President's Report, to the Governing Committee. The Plan of Operation requires that the Governing Committee provide a written report on operations annually to the members and the Department. The President's Report is generally provided to the Governing Committee three times a year, but has limited operational information. Such information primarily includes policies-in-force, claims outstanding and in litigation, cash-on-hand, staffing levels, compliance with the customer service goals of providing rating quotes within three business days or less, and call abandonment rate metrics.

The examiners observe the accuracy of financial information within the President's Report could be improved. For example, the most recent President's Report dated February 10, 2022 states "as of December 31, 2021, the FAIR Plan had $155 million in cash and investments less loss and loss adjustment expense ("LAE") reserves of $111.6 million, for a net capital amount of $43.4 million." The September 30, 2021 audited financial statements indicated that the FAIR Plan had a $332.3 million accumulated deficit at that date, which is the FAIR Plan's net capital position at that date. Thus, it would be more accurate to describe this financial metric in the President's Report as cash less case loss and LAE reserves, or another term describing a measure of short-term expected liquidity.

Also, the Plan of Operation requires the Governing Committee to obtain periodic reports from entities completing inspections and provide such reports to the Department. Based on our review of the meeting minutes and discussion with management, we see no evidence that such reports were presented to the Governing Committee, or provided to the Department.

The FAIR Plan implemented a clearinghouse program, effective June 5, 2021 in accordance with California Insurance Code §10095(i) to assist in depopulating risks from the FAIR Plan to the voluntary market. The FAIR Plan also asks policyholders, at least annually, to shop the market, and reminds producers of their obligation to conduct a diligent search of the insurance market. The Governing Committee has not directed the staff to prepare any strategic plan, formal environmental, social, and governance assessment, or formal ERM plan to assist the Governing Committee in identifying and quantifying the FAIR Plan's strategies and key prospective risks. However, the FAIR Plan notes that it purchases reinsurance and seeks premium rate increases when it believes that market conditions require.

The Plan of Operation requires the Governing Committee annually to approve the Subcommittee charters at a meeting at which the Department representative is present. For the years 2018, 2019, and 2021, the Governing Committee minutes do not reflect approval of the Subcommittee charters. The FAIR Plan's Claim Subcommittee did not meet in 2020 or 2021. Also, historically, Executive Subcommittee meetings are not documented with meeting minutes.

The Governing Committee Chairperson indicated that succession planning has been completed at the Officer level and will be expanded to the next level down, and includes identification of individuals, who could replace departing staff, and development of a training program for such staff over a one-to-three-year period.

When comparing publicly-available information about the FAIR Plan and public access to FAIR Plan Governing Committee and Subcommittee meetings to those of other FAIR Plans or residual market facilities of similar size, the available financial results, operational and statistical data, reinsurance coverage, strategic and depopulation plans, and governance processes lack transparency as follows:

Public Access and Available Information	Financial Results & Auditor's Report	Operational and Statistical Data	Reinsurance Coverage
FAIR Plan	No	No	No
Louisiana Citizens	Yes	Yes	Yes
North Carolina JUA	Yes	Yes	Yes
Texas FAIR Plan	Yes	Yes	Yes
Texas Windstorm	Yes	Yes	Yes

Public Access and Available Information	Strategic/ Depopulation Plan	Governing Committee Meetings	Governing Committee Minutes
FAIR Plan	No	No	No
Louisiana Citizens	Yes	Yes	Yes
North Carolina JUA	No	Yes	No
Texas FAIR Plan	No	Yes	Yes
Texas Windstorm	Yes	Yes	Yes

Governance, Plan of Operation, and ERM Significant Findings and Recommendations

- The Governing Committee has not adopted a strategic or ERM plan. The FAIR Plan should develop a three-to-five-year strategic plan to address the FAIR Plan's financial and operating goals and needs, providing the board and management a defined strategy and direction to make decisions and allocate FAIR Plan resources.
- The FAIR Plan has not adopted a formal environmental, social, and governance assessment. The FAIR Plan should establish transparent environmental, social, and governance criteria for its operations under the direction and ongoing monitoring of the Governance Committee, or a specifically-designated Subcommittee. Areas for focus, among others, could be enhancing customer and community resilience from the effects of climate change, encouraging and incentivizing fire prevention and risk mitigation, and advancing diversity, equity and inclusion among its staff and vendors.
- We did not see evidence that inspection reports were presented to the Governing Committee or provided to the Department. Also, for the years 2018, 2019, and 2021, the Governing Committee minutes do not reflect approval of the Subcommittee charters. The FAIR Plan should ensure and monitor Governing Committee compliance with Plan of Operation requirements related to inspection

reports, approval of Subcommittee charters, and general governance requirements.

- The FAIR Plan implemented an initial clearinghouse program in June 2021. The FAIR Plan should continue to enhance and expand the clearinghouse program to assist in depopulating risks as required by statute. It may be useful to consider other action steps to encourage the replacement of FAIR Plan coverage with voluntary market coverage, similar to actions contained in other states' residual market depopulation plans. For example, the FAIR Plan may consider a consumer education initiative presenting current market issues, the clearinghouse program, and its advantages to consumers.
- Based on the governance issues identified herein, the FAIR Plan should hire a general counsel or senior legal staff, or contract with experienced legal staff to ensure compliance with the FAIR Plan's obligations under the Plan of Operation, and implementation of governance policies and procedures.
- Based on some inaccurate financial information contained in the President's Report, the FAIR Plan should improve the accuracy of financial information contained within the President's Report related to the net capital position, which is more accurately a measure of short-term expected liquidity, rather than member equity (deficit).
- Minutes of Executive Subcommittee meetings are not prepared. The FAIR Plan should establish a policy and practice to document all Executive Subcommittee meetings with appropriate meeting minutes.
- The FAIR Plan's Claim Subcommittee did not meet in 2020 or 2021. The FAIR Plan should ensure periodic and timely oversight by the Governing Committee and Subcommittees related to implementation of operational changes. If there are time constraints, it might be useful to reorganize the governance committees for efficiency and effectiveness.
- The FAIR Plan provides very little public information about its Governing Committee and Subcommittee meetings, financial results, operational and statistical data, reinsurance coverage, strategic and depopulation plans, and

governance processes. The FAIR Plan should provide enhanced transparency and information to the general public to strengthen public awareness and accountability including the following:

- FAIR Plan governance processes including Governing Committee and Subcommittee access, agendas, and minutes
- Financial reporting and annual audited financial statements
- Annual report discussing the year in review, governance updates, statutory authorities, reinsurance coverage, rate information, catastrophe response plans, strategic plans, depopulation efforts, and initiatives to enhance and improve policyholder service and related metrics
- Reports filed with PIPSO, such as the semi-annual Report of Property Insurance Plan Coverage, including new and renewal business statistics and claims statistics.

Governance, Plan of Operation, and ERM Recommended Best Practices

- The FAIR Plan should consider implementing an internal audit function, using either employee staff, or a contracted firm, or a combination, to independently assess and strengthen the key operational areas. In addition, independent quality assurance functions could be enhanced or established in these operational areas.
- The FAIR Plan should consider developing a staff ERM function to assist in identifying and quantifying longer-term prospective risks and mitigation efforts.
- The FAIR Plan should consider further developing and formalizing succession planning for executive and senior staff and establishing action steps for staff development, so that the staff is better prepared for potential higher-level roles.

Capital and Liquidity Management

The FAIR Plan does not have a formal capital management or liquidity management plan. A Member Company and Assessment Policy dated August 2019 indicates that following a catastrophe, the FAIR Plan will determine whether an assessment of members should be levied based on cash inflows and outflows. The determination will be initially reviewed by the Accounting Subcommittee, which will recommend any such assessment to the Governing Committee, which will make the final determination. Any assessments would be reported to the Department for approval. Despite multiple catastrophes, no such assessments have been levied since approximately 1994. Instead, pool years, once determined to be complete in accordance with the Pool Year Closure and Distribution Policy (dated January 1988 for Division I, and April 1998 for Division II), have been closed with any distributable amounts applied to other pooled years' deficits in accordance with each members' pool percentage for that year. The Division I pool years are normally left open for approximately 42 months with periodic review by the Accounting Subcommittee to determine whether the pool year should be closed. Recommendations by the Accounting Committee for pool year closing are presented to the Governing Committee for final approval. The Division II pool years are normally left open for approximately 66 months with similar periodic reviews and Accounting Subcommittee approval. The FAIR Plan assessed members $260.0 million in 1994 and 1995, and since then, the FAIR Plan has distributed approximately $438.4 million to members when pool years were closed.

Based on RNA's review of Governing Committee minutes of June 23, 2020, it appears the FAIR Plan's previous policy and practice was to consider the reinsurance retention plus $15 million to cover four months of expenses as a benchmark for determining liquidity needs and potential assessments. Additionally, due to the cost of reinsurance and the FAIR Plan's recent claim experience, aggregate excess of loss reinsurance retentions have grown rapidly and significantly in recent years as shown below.

Reinsurance Coverage Period	Aggregate Excess of Loss Retention	Occurrence Deductible
February 15, 2020 to March 1, 2021	$250 million	$10 million
March 1, 2021 to March 1, 2022	$300 million	$10 million
March 1, 2022 to March 1, 2023	$400 million	$10 million

For the March 1, 2021 to March 1, 2022 coverage period, two excess of loss contracts for single catastrophes were placed. The retention for any one occurrence was $125 million, and including the aggregate retention, the total reinsurance coverage was $1.1 billion. For the March 1, 2022 to March 1, 2023 coverage period, a mix of aggregate and single occurrence contracts were placed, and after including the aggregate retention, the total reinsurance coverage is $1.3 billion. For financial reporting, the September 30, 2021 audited financial statements indicate cash and short-term investments are approximately $148.6 million, and the member deficit is $332.3 million. Within the member deficit, the 2020 Division I pool year deficit is $169.4 million, and the 2021 Division I pool year deficit is $218.3 million. Additionally, the FAIR Plan does not have a third-party liquidity facility in place, in the event that immediate funds are needed.

When comparing the FAIR Plan's capital and liquidity to that of other FAIR Plans or residual market facilities of similar size, the FAIR Plan's capital and liquidity and access to third-party liquidity is much lower as follows:

Capital and Liquidity	Policies - in-Force	Most Recent Year End Surplus (Deficit) (000's)	Most Recent Year Cash from Operations (000's)	Most Recent Year End Liquidity Ratio (Liabilities to Liquid Assets)	Access to Available Third-Party Liquidity Facility (000's)
FAIR Plan	248,361	($332,280)	($64,375)	276%	None
Louisiana Citizens	39,871	$134,628	($7,927)	60%	$50,000
North Carolina JUA	245,947	$21,522	$11,347	76%	$100,000
Texas FAIR Plan	66,792	$1,955	($8,608)	97%	$30,000
Texas Windstorm	193,000	($24,584)	$76,756	79%	$500,000
Average of Four Comparable Entities	136,380	$33,380	$17,892	78%	$170,000

Capital and Liquidity Management Significant Findings and Recommendations

- The FAIR Plan does not have a formal capital management or liquidity management plan. The FAIR Plan should develop a formal capital and liquidity plan with quantitative and qualitative benchmarks of acceptable capital and liquidity levels, and actions to be taken when such levels are breached. Such levels and actions should reasonably ensure the matching of significant deficit pool years with related assessments. The capital and liquidity plan should be regularly monitored and consistently reported to the Accounting Subcommittee and the Governing Committee. The development and adherence to the capital and liquidity plan would provide important financial information and accountability to member companies, the Department, the public, and other stakeholders such as reinsurers, vendors, and producers.
- The FAIR Plan does not have a third-party liquidity facility in the event that immediate funds are needed. The FAIR Plan should consider obtaining a third-party liquidity facility, similar to those of similarly-sized insurers, to assist in immediate payment of claims in the event of one or more catastrophes. This facility would partially mitigate the potential credit risk, legal dispute risk, or slow pay risk in collections from member companies, in the event that immediate funds are necessary to pay claims.

Financial Oversight and Reporting

<u>Financial Reporting</u>

The FAIR Plan's finance department prepares separate Division I and II quarterly statutory-basis balance sheets, income statements, and member equity (deficit) activity, which are prepared approximately 30 days after the period-end for review by the Accounting Subcommittee. Beginning in the second quarter of fiscal year 2020, Milliman began preparing estimates of loss and LAE reserves including incurred but not reported ("IBNR") reserves. Milliman also prepares analyses of needed premium deficiency reserves, which were identified by the FAIR Plan's independent auditors and reported in the September 30, 3021 audited financial statements. Milliman requires approximately 45 days after the period-end to complete its reserve analyses. Thus, the due date for the FAIR Plan's financial statement reporting to the Accounting Subcommittee often does not allow adequate time for Milliman's loss and LAE reserve estimates to be reported in the most recent period's quarterly financial statements. Members receive quarterly financial reporting based on PIPSO reporting guidelines including premium and loss statistical reports, catastrophe losses, number of claims outstanding, underwriting ratios, and reinsurance information. The FAIR Plan provides its annual audited financial statements to the Department.

Budgeting

Annual budgets are prepared in July-August, approved by the FAIR Plan's President, and approved by the Governing Committee in September for the fiscal year beginning October 1. The budget is separated between Division I and II. Premiums are estimated based on historical patterns, estimates of policies-in-force, and estimated average premiums including rate change impacts that are assessed to be likely. The budget process projects incurred non-catastrophe losses, paid and incurred LAE, accrual-basis commission expense, and overhead expenses. Catastrophe losses are not projected. Updated budget variance reports are provided at six, ten, and 12-month intervals with variances analyzed and reported to the Accounting Subcommittee for review. Historically, the FAIR Plan has not prepared projections of statutory-basis financial statements.

Financial Oversight and Reporting Significant Findings and Recommendations

- To effectively reflect actuarial conclusions in quarterly financial reporting, the FAIR Plan should reflect Milliman's quarterly loss, LAE, and premium deficiency reserve estimates in the concurrent quarterly financial statements, even if the FAIR Plan delays the financial reporting to member companies by a few days, to reflect the period's statutory results and financial position accurately in the quarterly financial statements.

- Based on current budgeting practices, the FAIR Plan should review the budget process, determine the objectives of the process, and consider process adjustments to ensure that it provides the Governing Committee with the most useful and intended information. If the budget is intended to estimate cash flows, then a focus on projected cash-basis impacts that include estimates of premiums received would be appropriate. Alternatively, the budget process could solely focus on cash-basis expenses if the objective is expense management. If the intent of the budget is to reflect accrual-basis statutory financial results, then more complex accounting estimates should be included in the projections such as IBNR, premium deficiency reserves, employee benefits accruals, and others. Several of these estimates would require involvement by Milliman. Also, if the FAIR Plan continues to report actual vs. budgeted results at the ten-month period, the budget process should focus on cash-basis impacts, since reserves and many accrual-basis adjustments are only estimated and recorded quarterly.
- The FAIR Plan does not report its climate-related financial risks. The FAIR Plan should begin reporting its climate-related financial risks within its annual statutory financial statements, in alignment with recently adopted NAIC guidance and the international Task Force on Climate-Related Financial Disclosures ("TCFD"). This would include the FAIR Plan's exposure to, and anticipated effects of, specific climate-related financial risks and opportunities, planned responses to the effects, and the implications of the responses on the FAIR Plan's current and future financial statements, capital, liquidity, and reinsurance availability. The TCFD has published guidance for implementation that may be helpful. https://www.fsb-tcfd.org/

Financial Oversight and Reporting Recommended Best Practices

- The Department should consider having the FAIR Plan file with the Department its quarterly statutory financial statements as prepared in accordance with the *NAIC Accounting Practices and Procedures Manual,* and filing other PIPSO quarterly reports or operational metric results provided to the Governing Committee that may be useful to the Department.

Underwriting and Rating

The FAIR Plan's policies-in-force have nearly doubled over the past three years, requiring additional underwriting staff or assistance from contractual resources to meet its customer service goals. The FAIR Plan has reviewed staffing levels and plans to hire four or five additional underwriting staff in the first half of 2022. Many lower-level underwriting staff have limited industry experience.

There have been a series of Orders issued by the Commissioner since 2019, which require changes to the Plan of Operation to effect certain aspects in its business operations. The most notable required changes expand the covered perils and policy limits offered by the FAIR Plan. Also, as a result of increased claims experience and cost of reinsurance, the FAIR Plan has made multiple rate filings for rate increases with the Department. Consistent with Department's ratemaking policy and practice for the admitted insurer market, the Department has consistently not allowed the FAIR Plan's net cost of reinsurance to be included in approved rate filings.

Underwriting and Rating Significant Findings and Recommendations

- As noted previously, the Governing Committee has not adopted a strategic plan. The FAIR Plan should develop a three-to-five-year strategic plan including an assessment of underwriting staffing or contracting needs consistent with expected growth along with depopulation efforts. The strategic plan should also assess training and development needs of newly hired staff and contractors.
- The FAIR Plan's Underwriting Manual, which includes personal lines dwelling fire and commercial property guidelines does not appear to have been updated since 2019. Examples of updates needed for recent statutory changes include revising the definition of "actual cash value" and noting the 75-day notice requirement to consumers for non-renewal actions. A proposed Commercial Underwriting Manual for commercial property risks has been drafted to be effective February 1, 2022,

and includes underwriting guidelines for newly-eligible farm risks. The FAIR Plan states that it has filed the draft Commercial Underwriting Manual with the Department for approval. The Underwriting Manual, for personal lines dwelling fire risks should be updated consistent with California law changes, changes in the Plan of Operation, and for other changes as approved by the Department. Also the revised Underwriting Manual should be submitted to the Department for review and approval. The FAIR Plan states that it plans to update the Underwriting Manual. Also, the proposed Commercial Underwriting Manual should be updated for recently increased policy limit offerings and submitted to the Department for approval.

- To improve the efficiency and effectiveness of its underwriting and policy service processes, the FAIR Plan should continue to evaluate underwriting and policy service processes and application systems. For example, premium payments are received in the FAIR Plan's mail room, scanned, and deposited the same or next day in the FAIR Plan's premium bank account. Use of a lockbox system would be more efficient, particularly with the growth in policies-in-force, and provide additional controls over premium receipts. Management states it will continue to review this issue, and that use of a lockbox system is a medium to long-term objective.

Claim Processing and Reserving

The FAIR Plan experienced the largest volume of claims in its history during the past few years. In addition to using independent contracted field adjustors, temporary contract resources are used to supplement the internal employee claims adjusting and management staff. This staffing model resulted in significant claims operational costs exceeding budgeted amounts. In fiscal year 2021, approximately $7.6 million was incurred for the use of non-field contracted adjusting staff, which included approximately 33 people. Management indicated the quality of claims handled by the non-field contract adjustors and managers was often not of good quality. This is consistent with data from the Department's Consumer Services Division indicating that FAIR Plan's consumer complaints involving claims increased significantly from 2017 to 2021. Recently, to support the increase in the volume of claims received, the FAIR Plan began hiring full-time claims staff from candidates not located in California, who are permitted to work remotely. Management states this staffing change has been very helpful in hiring qualified staff. The FAIR Plan's eventual goal is to solely use non-field employee claims staff, except during emergencies or catastrophes, if needed.

All claims estimates prepared by contracted field adjusters are completed in a third-party software application, and processed through a cloud-based companion system. The FAIR Plan automatically assigns standard case reserves amounts to newly opened claims as follows:

- Dwelling fire-$25,000
- Extended coverage/vandalism-$2,250
- Commercial fire and BOP-$48,000
- Earthquake-$14,000
- LAE-$500

Completion of quality assurance ("QA") reviews are one of the FAIR Plan's key controls over the quality and efficiency of claims handling processes. The QA reviews assess compliance with FAIR Plan policy and regulatory requirements. The FAIR Plan performs two types of QA reviews. First, for the independent field claim adjusters, their work is reviewed by a supervisor or QA reviewer from the contracting firm before the claim is submitted to the FAIR Plan. Management indicated that quality and service standards have been provided to the independent claim adjusting firms, but historically have not been included within their contracts. Second, the FAIR Plan's employee Quality File Reviewers complete QA reviews of all open claims adjusted by full-time contractual staff, and the FAIR Plan states that it will begin conducting such reviews for employee adjusters soon. Recently, the Quality File Reviewers have struggled to keep up with the increased volume of claims, but the Quality File Reviewers were able to complete the QA reviews over the non-field contract adjusters. The Quality File Reviewers also complete QA reviews on approximately 25% of open claims processed by the independent contracted field adjusters.

Claim Processing and Reserving Significant Findings and Recommendations

- As noted previously, the Governing Committee has not adopted a strategic plan. The FAIR Plan should develop a three-to-five-year strategic plan including an assessment of claims staffing or contracting needs consistent with anticipated growth in claim volume. Further, the FAIR Plan should continue to make efforts to hire sufficient employee claims staff to reduce dependency on high-cost and marginal-quality non-field contract adjusters. The strategic plan should also assess training and development needs of newly hired staff and contractors.
- The FAIR Plan's Claim Subcommittee did not meet in 2020 or 2021, although the Claims Subcommittee met in January 2022 to discuss 2021 activities. The structured oversight of the claims function appears to be lacking. The Claims Subcommittee should meet regularly and consistently and receive standard reports from the FAIR Plan's claims management related to claims operations, including compliance with standards and benchmarks for claims handling, staffing issues, results of QA reviews and other claims audits, process weaknesses or challenges, management's recommendations for improvements, and any other necessary topics. Also, the FAIR Plan should consider whether real-time reporting of claims benchmarks to the Claims Subcommittee is warranted.
- To improve the efficiency and effectiveness of its claim processes, the FAIR Plan should continue to evaluate its claims processes and application systems.

Claim Processing and Reserving Recommended Best Practices

- The case reserve amounts automatically assigned to claims have not been updated in several years. The FAIR Plan and its consulting actuary, Milliman, should evaluate and update the standard case reserve amounts based on historical and projected claim settlement values.

- The FAIR Plan's Claims Manual requires that only a member of the Governing Committee may sign a claim payment check over $1.5 million, but the staff were unsure about this requirement. The FAIR Plan should review this policy and ensure that claims staff understand this and other policies in the Claims Manual.
- The FAIR Plan should consider expanding the QA File Reviewer staff review to allow for improved claim process quality and accuracy, to provide targeted training needs indicated by the QA review results, and to assess the quality of closed claims for potential reach-back of contractual fees paid for poor quality work.
- The FAIR Plan should re-evaluate all claims contracts to ensure that meaningful quality and service standards are included in the contracts sufficient to ensure consistent high-quality performance, and with timely actions that can be taken when the work does not meet the service standards.

Reinsurance Adequacy

Because of the increasing cost of reinsurance, the FAIR Plan has elected to purchase reinsurance only at an estimated 33-year return-period for the March 1, 2021 to March 1, 2022 contract period, and at an estimated 31-year return-period for the March 1, 2022 to March 1, 2023 contract period. Other comparable residual market facilities strive for at least 100-year return-period coverage. As noted previously under the liquidity and capital management section, for the March 1, 2022 to March 1, 2023 coverage period, a mix of aggregate and single occurrence contracts were placed, and after including the $400 million aggregate retention, the total reinsurance coverage is $1.3 billion. Credit quality is managed by using reinsurers with high financial strength ratings of A- or better from A.M. Best, and the reinsurers' financial conditions are subject to continual surveillance.

The FAIR Plan relies on the advice of Aon, its reinsurance broker, to assess the availability of reinsurance and make recommendations for coverage limits. The FAIR Plan believes that its reinsurance needs are much different than a traditional market insurer, since it can assess its insurance company members to fund liquidity needs and cover losses resulting from insufficient premiums or catastrophes. However, the FAIR Plan does not have a multi-year reinsurance strategy, which subjects the FAIR Plan to increasing annual reinsurance cost volatility and availability uncertainty.

Also, when comparing the FAIR Plan's reinsurance coverage based on return-period years to that of other FAIR plans or residual market facilities of similar size, the FAIR Plan's reinsurance coverage is far lower, as follows:

Reinsurance Coverage	Policies-in-Force	Most Recent Reinsurance Year Return-Period in Years
FAIR Plan	248,361	31
Louisiana Citizens	39,871	302
North Carolina JUA	245,947	113
Texas FAIR Plan	66,792	100
Texas Windstorm	193,000	100
Average of Four Comparable Entities	136,380	154

Reinsurance Adequacy Significant Findings and Recommendations

- The FAIR Plan does not have a multi-year reinsurance strategy. The FAIR Plan should develop a multi-year reinsurance strategy in connection with the capital and liquidity plan. The strategy should include quantitative benchmarks of desired or optimal reinsurance protection over a multi-year period. Also, to the extent that the FAIR Plan's reinsurance return-period continues to be far lower than desired or optimal, the determination should be disclosed and supported. The reinsurance strategy should be regularly monitored and consistently reported to the Reinsurance Subcommittee and the Governing Committee.

Reinsurance Adequacy Recommended Best Practices

- The FAIR Plan should consider the use of catastrophe bonds or similar capital market solutions as alternatives to traditional reinsurance in future years as other residual market facilities have done, including two such facilities in California. Use of catastrophe bonds has advantages and disadvantages from an insurer's perspective. Catastrophe bonds generally have short maturities of three to five years, and bond payments to the insurer are dependent on the occurrence of a catastrophic event resulting in catastrophe claims exceeding a pre-determined amount. When traditional reinsurance is expensive due to recent catastrophe claims or limited capacity, use of catastrophe bonds as a form of reinsurance can be more cost effective. Also, catastrophe bonds generally provide more cost certainty to the insurer. Alternatively, in periods of financial instability or rising interest rates, the costs of such bonds may increase due to the investor's risk appetite, and the opportunity cost of forgoing safer or higher-yielding investments.

Customer Service Policies and Procedures

Since the FAIR Plan's policies-in-force have nearly doubled over the past three years, increased customer service resources are necessary to answer questions of producers and policyholders related to policy coverages, policy endorsements, billing and premium payments, and claims. The FAIR Plan has approximately 20 customer service staff to address policyholder and producer questions, and to begin processing dwelling fire endorsements. The FAIR Plan has developed a 152-page PowerPoint presentation, dated October 2021, which is used to provide training to customer service representatives, and also uses a first-notice-of-loss ("FNOL") script for claims inquiries, which is also contained in the FAIR Plan's Catastrophe Response Plan updated in February 2022.

The FAIR Plan monitors the number of business days to process dwelling fire endorsements, customer service call-time-to-answer, and the call abandonment rate. These benchmarks are periodically summarized in the President's Report as provided to the Governing Committee approximately three times per year. The benchmarks summarized in the President's Report as provided to the Governing Committee for the last five reporting dates are shown below.

Reporting Date	Dwelling Fire Endorsements Goal-3 Business Days	Average Call-Time-to-Answer Goal < 1 Minute	Call Abandonment Rate Goal <5%
September 23, 2020	1 day	Not Shown	12.99% (August 2020)
February 11, 2021	2 days	Not Shown	Not Shown
June 24, 2021	1 day	50.5%	2.22% (April 2021)
September 23, 2021	1 day	56.3%	8.12% (August 2021)
February 10, 2022	1 day	Not Shown	5.27% (December 2021)

The FAIR Plan's call abandonment rate has been high, such as 12.99% in August 2020, or 8.12% in August 2021 - often higher than the 5% goal. When comparing the FAIR Plan's employee staff based on policies-in-force to that of other FAIR Plans or residual market facilities of similar size, the FAIR Plan's staffing is far lower, as follows:

Staff Sufficiency	Policies-in-Force	Employee Staff	Policies-in-Force to Employee Staff
FAIR Plan	248,361	133	1,867
Louisiana Citizens	39,871	91	437
North Carolina JUA	245,947	144	1,708
Texas FAIR Plan	66,792	213	314
Texas Windstorm	193,000	439	440
Average of Four Comparable Entities	136,380	222	725

Customer Service Policies and Procedures Significant Findings and Recommendations

- As noted above, the FAIR Plan uses a FNOL script for claims inquiries, which is also contained in the FAIR Plan's Catastrophe Response Plan. The customer service call scripts contain suggested responses to claimants' inquiries about whether they can stay in a hotel, whether their evacuation costs are covered under their FAIR Plan policy, or whether their medical expenses are covered under their FAIR Plan policy. Each of the suggested answers note that an adjuster will answer their claim questions, and the hotel question response also indicates that fair rental value coverage is provided under the FAIR Plan policy. The FNOL script should clarify to the consumer that loss of use of the home is covered through the fair rental value policy provision, since this interpretation may be confusing to the consumer. Also, the FNOL script refers the consumer to the “specimen copy of the policy on the website”, which is not currently available on the website to the general public. Finally, the FNOL script should be reviewed by legal counsel to ensure its accuracy and adherence to industry standard fair claims practices.

- As the FAIR Plan’s staffing is lower on a per policy basis when compared to other FAIR plans or residual market facilities of similar size, the FAIR Plan should continue to consider the adequacy of the number of employee staff available to assist consumers and producers with their insurance needs. It may be appropriate to increase hiring efforts, and to develop a robust training program to ensure that the staff is capable of handling consumer and producer requests, and to assist with employee retention.

Customer Service Policies and Procedures Recommended Best Practices

- The FAIR Plan monitors the number of business days to process dwelling fire endorsements, customer service average call-time-to-answer, and the call abandonment rate. These benchmarks are periodically summarized in the President’s Report as provided to the Governing Committee. However, the reporting of these benchmarks is inconsistent. In three instances, the average call-time-to-answer was not shown. Also, measurement of the benchmark in seconds or minutes would be more informative. The FAIR Plan should provide the Governing Committee, and possibly one or more of the Subcommittees, with more frequent and informative results of customer service benchmarks, and consider whether real-time reporting of these and other benchmarks is warranted