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Attorneys for Applicant
STATE FARM GENERAL INSURANCE COMPANY

BEFORE THE INSURANCE COMMISSIONER

OF THE STATE OF CALIFORNIA

In the Matter of the Rate Applications of STATE FARM GENERAL INSURANCE COMPANY, Applicant.	File Nos. PA-2024-00011, PA-2024-00012, PA-2024-00013 **DECLARATION OF DAVID APPEL**

I. INTRODUCTIONS AND QUALIFICATIONS

1. My name is David Appel, and I am retired from my former position as Principal and Director of Economics Consulting at Milliman, Inc. While I am retired, I am consulting with State Farm General Insurance Company (SFG) in this matter in my personal capacity.

2. I have a B.A. degree in economics from Brooklyn College, City University of New York, and M.A. and Ph.D. degrees in economics from Rutgers University. After completing my graduate education and serving as an instructor and Assistant Professor at Rutgers University, I joined the National Council on Compensation Insurance (NCCI), the nation's largest statistical, research, and ratemaking organization serving the workers compensation insurance industry. I joined NCCI as Research Economist in 1980 and held progressively responsible positions, finally becoming Vice President in charge of Research beginning July 1985. In 1989, I left NCCI to establish the Economics Consulting practice for Milliman in its New York office. I became a Principal with the firm in 1991 and served on its Board of Directors from 2003 through 2006.

3. Throughout my professional career, I have participated in a variety of academic and business activities related to insurance. I have served two three-year terms as an elected member of the Board of Directors of the American Risk and Insurance Association, the leading learned society of insurance academics; I have been a member of the editorial board of the Journal of Insurance Regulation, the official research publication of the National Association of Insurance Commissioners; and I have acted as a peer referee for a number of scholarly journals in economics and insurance. I also served for twelve years as an Adjunct Professor of Economics at Rutgers University.

4. My curriculum vitae, listing my refereed publications and expert testimony, is included as Exhibit SFG-DA-1 to this Declaration.

5. In addition to my academic and professional experience, I have also frequently served as an expert witness in insurance rate proceedings or insurance related civil litigation. During the course of my career I have testified in well over 100 such matters, including at least 25 in the state of California. My testimony has covered a wide variety of issues, including such diverse topics as

the impact of economic and demographic facts on insurance costs; the use of econometric and statistical models in insurance forecasting; and the use of modern financial theory in developing insurance prices. This testimony has covered most of the major lines of property casualty insurance, including automobile, homeowners, workers compensation, medical malpractice, reinsurance, and title insurance. In addition, I have served as an arbitrator on more than 25 occasions, as a member of the Panel of Neutrals of the AAA and a Certified Arbitrator and Umpire with ARIAS, the international insurance and reinsurance arbitration society.

6. Potentially of most relevance here, I testified for SFG in the California rate hearing in PA-2015-00004 in which, ultimately, the California Court of Appeal upheld SFG's position that the ratemaking formula must use SFG's actual portfolio in calculating the investment income offset to determine rate need. That was the principal subject of my testimony in the administrative proceeding, presented through the "confiscation variance." In my preparation and presentation in that prior case I gained significant knowledge about SFG.

7. I am being compensated for my work in this matter at my standard hourly rate of $750. My compensation does not depend in any way on the opinions I express or the outcome of this case.

II. NATURE OF ASSIGNMENT AND SUMMARY OF OPINIONS

8. SFG has asked that I review various documents in connection with the Request for Emergency Interim Rate submitted to the Commissioner on February 3, 2025, and to provide my opinions on whether the requested interim rate increase is reasonable and justified. Specifically, I was asked to review the Final Two Party Stipulation dated February 7, 2025; Consumer Watchdog's Objections To CDI And State Farm's Two-Way Stipulation To Interim Rate, dated March 24, 2025; various letters exchanged between SFG, Consumer Watchdog (CW) and Commissioner Lara; and such other materials as I found necessary to form my opinions in this matter.

9. I am aware that there are a number of issues that are in dispute in this case, however I have been asked to focus my attention on questions related to SFG's economic and financial condition. In particular, I was asked to do the following:

a. Provide an overview of SFG's financial results over the past decade, based on publicly available information, to better understand how SFG has arrived at its current financial condition.

b. Assess the regulatory and market implications of SFG's current surplus position.

c. Respond to allegations raised by CW in connection with SFG's purchase of reinsurance and its behavior in the market.

d. Provide an opinion as to whether it would be reasonable for the Commissioner to approve the Proposed Stipulation in this matter.

10. My findings regarding these issues are as follows:

a. SFG's current financial condition is characterized by a dangerously low level of surplus that is the result of a decade of sustained underwriting losses in California. Over the years 2015 – 2024, SFG suffered underwriting losses of over $5.2 billion, and even after all investment income and tax benefits, had total operating losses of almost $2.8 billion. This led to a decline in surplus over that 10-year period of almost $2.7 billion; an increase in SFG's premium to surplus ratio from .48 to 3.03; a decrease in its risk based capital (RBC) ratio to 150%, and a reduction in its Best's rating from A to B.

b. The implications of this deterioration in financial condition are severe. Most importantly, absent a significant improvement in its surplus position, SFG could be in danger of insolvency if another significant catastrophe event were to occur. Aside from that risk, SFG's premium to surplus ratio in excess of 3.0 causes it to fail the first IRIS ratio test, and its RBC ratio of 150% places it in the Company Action Level under the NAIC's RBC rules. Further, if SFG suffers another ratings downgrade, its policies may no longer be eligible to insure collateral for mortgages under the rules established by FNMA and FHLMC (colloquially known as "Fannie May" and "Freddie Mac").

c. CW has alleged that SFG's distressed financial condition is "self-inflicted," citing its reinsurance arrangements with its parent, State Farm Mutual Automobile Insurance Company (SFMAIC), and its behavior in the market with respect to rate requests. There is nothing unreasonable about SFG's purchase of reinsurance from SFMAIC – to the contrary, SFMAIC provides reinsurance capacity that would likely be unavailable to SFG in the traditional reinsurance market, which is a significant benefit to the company. In addition, CW has provided no meaningful evidence about the cost of SFG's reinsurance; the analysis of 10 years of reinsurance results is of no value in assessing the cost of a catastrophe reinsurance program as, among other things, it is simply too short a period of time.

d. As far as market behavior, CW claims that SFG intentionally elected to file for inadequate rates in order to capture market share and "dominate the market," and alleges that such behavior may amount to "predatory pricing." However, CW provides no evidence in support of those allegations, beyond citation of a newspaper article from the Wall Street Journal. As a matter of fact, SFG's market share today is actually slightly lower than it was in 2015. Furthermore, the pattern of rate increases requested by SFG (normally 6.9%, regardless of the actual rate indication) is consistent with the behavior of many California insurers, and reflects the unique circumstance surrounding the rate approval process under Proposition 103.

e. It is my opinion that the interim rate increase is not only reasonable and justified, but in fact is critical to the health of SFG and the California homeowners insurance market. SFG currently underwrites almost 20% of all California homeowners insurance; obviously, if the company were to become financially impaired such that it could no longer serve the needs of California consumers, the ability of the market to absorb that business would be in serious doubt. In addition, the interim rate increase poses no risk to policyholders: the stipulation incudes terms that require SFG to pay refunds to policyholder if the interim rates proposed in this filing are determined to be excessive. In light of SFG's current financial condition, the benefits to the market and the absence of risk to policyholders, it seems obvious that the interim rate increase should be approved and implemented as soon as possible.

f. In the remainder of this report I discuss the research and analyses I conducted that form the foundations of these conclusions.

III. SFG'S FINANCIAL RESULTS: 2015 – 2024

11. In its February 26, 2025 letter to Commissioner Lara,[1] CW makes the following statements regarding SFG's financial condition.

> Despite SFG's claim that "rate levels have been insufficient to result in any material surplus growth", it must be taken into account that rate levels are not the only (and arguably not the primary) means of generating surplus. SFG should have received positive net gains from their reinsurance contracts in accident years 2017 and 2018, and subrogation amounts corresponding to those accident years should have primarily benefited SFG, not their main reinsurer SFMAIC.

12. These statements reflect a fundamental misunderstanding of the basic economics of insurance. Rate levels, and the premiums they produce, *are* normally the primary means of generating surplus growth in insurance. Insurance rates are supposed to include a profit provision that provides the insurer with a fair and reasonable return on capital, and in general, if insurers earn that fair return and retain the earnings in the firm, that will provide surplus growth sufficient to meet the growing needs of the company. And since there are really only two sources of income for insurers – premiums (or more accurately underwriting income) and investment income – and since investment income is a relatively insignificant consideration in the homeowners line – it stands to reason that premiums are the main source of income and thus surplus growth. In fact, it is hard to understand what CW means when it states that "rate levels are not the only (and arguably not the primary) means of generating surplus." I can think of no other sources of income that would be the primary means of generating surplus.

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[1] Submitted as Exhibit SFG-DA-2 for convenience.

13. CW then points to SFG's reinsurance as a concern. While it is true that in some years reinsurance recoveries may exceed reinsurance costs, in a long run equilibrium reinsurance costs must exceed recoveries. Since primary insurers transfer risk to reinsurers, and that risk transfer has a cost, the price of reinsurance must not only include expected reinsurer losses (i.e., recoveries), but also must provide for reinsurer expenses and the cost of reinsurer capital. This implies that in the long run there is a positive net cost of reinsurance, which is equal to the difference between reinsurance premiums paid and expected recoveries. Thus, the fact that reinsurance costs exceeded recoveries is not, in itself, a cause for concern.

14. In the final paragraph of its February 26, 2025 letter CW also says:

> Further, surplus is not the first line of defense for an insurer's claims payments—it's the amount left over after liabilities (including reserves) are subtracted from assets. Surplus acts as a backstop in the event that reserves, reinsurance, and subrogation recoveries are not sufficient to pay the entirety of claim amounts. If SFG's surplus position is tenuous, it is imperative to fully understand why the company's loss reserves, reinsurance arrangements, and subrogation recoveries were insufficient to the point that surplus was continually depleted over a period of years.

15. It is true that as an accounting matter, surplus is the difference between assets and liabilities (including reserves). However when considering the role of surplus as a backstop, it is incorrect for CW to say that, "Surplus acts as a backstop in the event *reserves, reinsurance, and subrogation recoveries* are not sufficient to pay the entirety of claim amounts." (Emphasis added). In reality, surplus acts as a backstop in the event that *premiums (plus investment income*), *reinsurance and subrogation recoveries*, are not sufficient to pay the entirety of claim amounts *and all related expenses*.

16. The changes from the CW statement shown in italics reflect an extremely important distinction. Reserves (specifically loss reserves) are simply an accounting entry that reflects the best estimate of the cost of claims that are yet to be paid. But reserves are not cash that can be used to pay the claims - the funding for those costs has to come from somewhere, and that is primarily from premiums (and to a much lesser extent from investment income, especially for the homeowners line of business).

17. That much said, I agree with CW that it is imperative to understand why the company's surplus was continually depleted over a period of years. In order to provide some high level insight into that question, I compiled data from SFG's statutory Annual Statements, which is displayed in the Table below.

State Farm General Insurance Company

Financial Results 2015 - 2024

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Year	Net Written Premium	Net Underwriting Gain (Loss)	Net Income after Tax	Policyholder Surplus	Change in Surplus	Return on Surplus (Note 3)	Premium to Surplus Ratio = (2) / (5)	Risk Based Capital (RBC) Ratio
2024	$3,148,741,849	($589,384,079)	($318,877,238)	$1,038,181,027	($304,047,618)	-26.8%	3.03	150%
2023	2,786,794,345	(1,066,061,315)	(880,385,978)	1,342,228,645	(895,957,401)	-49.2%	2.08	228%
2022	2,908,433,485	(241,162,295)	(98,367,504)	2,238,186,046	(62,687,940)	-4.3%	1.30	464%
2021	2,488,417,667	(23,664,894)	159,756,996	2,300,873,986	156,279,315	7.2%	1.08	501%
2020	2,168,449,146	(564,665,828)	(379,935,387)	2,144,594,671	(407,698,962)	-16.2%	1.01	462%
2019	2,015,577,376	(53,653,640)	108,202,531	2,552,293,633	89,376,542	4.3%	0.79	539%
2018	1,871,835,585	(1,100,598,171)	(719,371,054)	2,462,917,091	(723,943,305)	-25.5%	0.76	465%
2017	1,781,578,646	(1,566,864,366)	(836,909,724)	3,186,860,396	(889,165,160)	-23.0%	0.56	644%
2016	1,930,664,252	(64,838,368)	128,664,293	4,076,025,556	84,818,676	3.2%	0.47	2302%
2015	1,904,166,244	(7,147,750)	174,024,998	3,991,206,880	170,003,173	4.5%	0.48	2467%
Total	$23,004,658,595	($5,278,040,706)	($2,663,198,067)	$25,333,367,931	($2,783,022,680)	-10.5%		

Notes:
1. S&P Market Intelligence - Annual Statement of Five-Year Historical Data, retrieved March 27, 2025, containing data as of December 31, 2024, https://www.capitaliq.spglobal.com/web/client?auth=inherit#insurance/select-a-page.
2. All amounts in dollars.
3. (7) = (4) / 2-Year average of (5). 2014 policyholder surplus was $3,821,203,707.

See Table 1.

18. This table displays data from the Five Year History Page of SFG's 2024 and 2019 Annual Statements, and contains high level financial information that can shed light on why the company's surplus position has deteriorated over time. To begin, note in col. (1) that SFG's premium has grown from $1.9 billion to $3.1 billion over the past decade, or at an annual rate of about 5.7%. However, as shown in col. (2), over that same time period, the company sustained underwriting losses of over $5.2 billion, or an average of over $520 million per year. Importantly, those losses were not only in catastrophe years, but in each and every year during the decade.

19. As mentioned above, insurers do earn investment income, and can avail themselves of tax benefits when they sustain operating losses. These after-tax and including investment income results are shown in col. (3) – Net Income after Tax; as can be seen, in four of the years investment income and tax benefits were sufficient to offset underwriting losses and produce a

modest operating profit, but in six of the years the total return, including all sources of income, was negative. Overall, SFG suffered almost $2.7 billion of operating losses over the past decade, or an average of almost $270 million per year.

20. Also of note are the data contained in col. (5), Change in Policyholders Surplus. This shows the year-to-year changes in surplus recorded on SFG's books. As can be seen, the total reduction in surplus over the entire decade was approximately $2.8 billion while the operating loss was $2.7 billion. Moreover, in each year the change in surplus was virtually identical to the net income after tax. This demonstrates clearly why SFG's surplus declined by around 75% (from almost $4.0 billion to around $1.0 billion) over the decade – it was the result of persistent losses related to its insurance operations in the state of California.

21. This pattern, in which SFG's surplus grows (or declines) by the company's net income, is not new. When I testified during the 2015 rate case, my pre-filed rebuttal testimony included a chart that showed that over the then prior 15 years (2000 – 2014) SFG had earned net income of $3.2 billion, and had an increase in surplus of $3.2 billion. The past 10 years simply continues that pattern – SFG's surplus depends upon the results of its insurance operations.

22. CW asserts that a significant factor in SFG's surplus decline is the purchase of reinsurance from its affiliate, SFMAIC: for example, they state "in each of the ten years from 2015‒2024, insurance was disadvantageous to State Farm but beneficial to its parent—resulting in a total decapitalization of State Farm to its multistate parent to the tune of nearly $3 billion."

23. There is no dispute that SFG has incurred net reinsurance costs over the 10 years ending in 2024, by virtue of its purchase of a prudent catastrophe reinsurance program. However, that does not explain SFG's surplus decline, nor does it negate the value of that reinsurance (acknowledging the fact that its costs exceeded recoveries). Indeed, as I discussed earlier, it is expected that on average reinsurance costs will exceed recoveries (because the price of reinsurance must include expected recoveries along with reinsurer expenses and capital costs).

24. To show that the cost of reinsurance is not the predominant source of SFG's surplus decline, consider this hypothetical. Imagine that SFG had purchased the same reinsurance from a

third party but paid only half the net cost, such that instead of $3 billion in outflow to the reinsurer over the decade it was only $1.5 billion. (I am not suggesting that SFG's reinsurance program *could* have been purchased at a lower price, but rather am illustrating that the net cost of reinsurance does not explain SFG's financial condition.) Under this hypothetical, SFG would have earned $1.5 billion more during the period, but that additional income would have been subject to tax, resulting in additional net income to the company of slightly less than $1.2 billion. This would obviously have been insufficient to offset the overall operating loss of almost $2.7 billion, or to eliminate the drain on surplus.

25. One other thing to note from col. (7) of the Table is SFG's return on surplus. As can be seen, the average return on surplus over the entire 10 year period was -10.5%, and in no year was it even as high as the target return that would be allowed under the California ratemaking regulations. That is what best explains SFG's surplus decline over time.

IV. REGULATORY AND MARKET IMPLICATIONS OF SFG'S SURPLUS DECLINE

26. I now turn to the regulatory and market implications of that surplus depletion. From a regulatory perspective, when an insurer's surplus falls below "acceptable" levels, the insurer can become the subject of greater regulatory scrutiny, and, in extreme situations, may be subject to receivership. From a market perspective, if the company's surplus and financial stability ratings decline sufficiently, their insurance may not be acceptable collateral to support a mortgage; under such circumstances the company could be effectively out of business. These are both important considerations in connection with the proposed interim rate increase.

27. As to the regulatory implications, perhaps the most important responsibility of an insurance regulator is to provide financial oversight and solvency monitoring of insurers under their supervision. To do so they rely on various tools to assist in identifying insurers who may be in adverse financial condition. Two of those tools are the Insurance Regulatory Information System (IRIS) and Risk Based Capital (RBC) tests.

28. To explain very briefly, the IRIS tests were introduced 50 years ago, and were among the first formal methods regulators adopted to monitor insurer solvency. They were designed to be an early warning system which would allow regulators to identify potentially troubled insurers, who could be then be accorded additional oversight. There are 13 such tests, all of which are based on data from the insurer's statutory annual statements, and for each of the ratios the NAIC promulgates a range of "usual" values. If an insurer's value falls outside the range it is deemed unusual.

29. While each of the ratios is important, the one that is most frequently cited is the insurer's net written premium to surplus ratio (or P/S ratio), which is a measure of the insurance exposure retained by the insurer (based on net premium) compared to the insurer's capacity to absorb risk (measured by its level of surplus.) For that ratio values above 3.0 are deemed to be unusual.

30. RBC is an additional and very important measure in the regulator's solvency monitoring toolkit. Instead of simply calculating ratios based on annual statement data, RBC attempts to more precisely quantify each insurer's exposure due to a variety of underlying risks, including asset, credit, underwriting, reserve, catastrophe and operational risks. Each specific source of risk is quantified, and then an amount of capital, termed the Authorized Control Level (ACL) RBC, is determined. The ACL RBC is the minimum amount of capital an insurer must hold before a regulator is authorized to take control of the company.

31. It is obvious that if a company's surplus falls to the ACL level of capital, that company is in a very serious financial condition, worthy of strict regulatory oversight and potential control. That is the reason why most insurers maintain levels of surplus that are many multiples of their ACL level of risk based capital. In fact, the NAIC promulgates four levels of potential control over insurers, based on the ratio of a company's actual (or what is called adjusted) capital to its ACL risk based capital. The levels are as follows:

a. CAL, or company action level, if the ratio of Adjusted Capital to ACL RBC is between 150 and 200%; the company may be required to file an action plan to reduce risk or increase capital.

b. RAL, or regulatory action level, if the ratio of Adjusted Capital to ACL RBC is between 100 and 150%; the regulator may be empowered to intervene more directly in the company's operations.

c. ACL, or authorized control level, if the ratio of Adjusted Capital to ACL RBC is between 70 and 100%; the regulator has the authority to take control of the company if necessary.

d. MCL, or mandatory control level, if the ratio of Adjusted Capital to ACL RBC is between 0 and 70%; the regulator has the authority to take control of the company if necessary.

32. Table 1 below (as reproduced in paragraph 17) entitled Financial Results 2015 – 2024 displays these two important solvency monitoring metrics – the P/S ratio and the RBC ratio – for SFG during the period from 2015 to 2024.

State Farm General Insurance Company

Financial Results 2015 - 2024

(1) Year	(2) Net Written Premium	(3) Net Underwriting Gain (Loss)	(4) Net Income after Tax	(5) Policyholder Surplus	(6) Change in Surplus	(7) Return on Surplus (Note 3)	(8) Premium to Surplus Ratio = (2) / (5)	(9) Risk Based Capital (RBC) Ratio
2024	$3,148,741,849	($589,384,079)	($318,877,238)	$1,038,181,027	($304,047,618)	-26.8%	3.03	150%
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Total	$23,004,658,595	($5,278,040,706)	($2,663,198,067)	$25,333,367,931	($2,783,022,680)	-10.5%		

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2. All amounts in dollars.
3. (7) = (4) / 2-Year average of (5). 2014 policyholder surplus was $3,821,203,707.

See Table 1.

33. As can be seen in col. (8), the P/S ratio has increased from .48 (reflecting a very safe, well capitalized business) to 3.03, which is outside the usual range for the IRIS test, and reflects a

relatively weak level of capitalization (especially for a company writing property insurance in a catastrophe prone jurisdiction).

34. The data on the RBC ratio (col. (9)) is even more startling. In 2015 SFG's RBC ratio was 2467% - a level of capital almost 25 times the minimum amount required. However, that was before the NAIC implemented a catastrophe risk charge effective with 2017 reporting, a change which increased the required capital (and hence reduced the RBC ratio) for companies with significant catastrophe exposure. Because of that change comparing 2015 to 2025 would not be apples to apples - which is evident when observing the large shift in ACL from 2016 to 2017 shown in SFG's 5 year historical data. However, years 2017 and beyond are comparable, and as is evident from the data, SFG's ratio declined during those years from 644% to 150%. This value at year end 2024 put SFG into the CAL level, and just on the cusp of the RAL level of regulatory control. Furthermore, after the recent fires that RBC ratio will decline even further due to SFG's own exposure as well as their exposure to FAIR plan losses.

35. To see how extraordinary this is, consider the below Table showing RBC ratios for all property casualty insurers over the period from 2018 to 2024.

RBC Ratios for All Property Casualty Insurance Companies: 2018 - 2024

	RBC Level	YR2024	YR2023	YR2022	YR2021	YR2020	YR2019	YR2018
# OF COMPANIES WITH RBC RATIO > 10000%		407	395	378	364	542	4	525
# OF COMPANIES WITH RBC RATIO > 1,000 & < 10,000%		909	949	1,007	1,037	832	836	836
# OF COMPANIES WITH RBC RATIO > 500 & < 1,000%		599	628	611	634	620	627	682
# OF COMPANIES WITH RBC RATIO > 300 & < 500%		379	423	380	359			
# OF COMPANIES WITH RBC RATIO > 250 & < 300%		39	55	55	46			
# OF COMPANIES WITH RBC RATIO < 500% >250%						418	420	409
# OF COMPANIES WITH RBC RATIO > 200 & < 250%		34	45	37	36	23	29	35
# OF COMPANIES WITH RBC RATIO > 150 & < 200%	CAL level	12	17	27	8	15	9	14
# OF COMPANIES WITH RBC RATIO > 100 & < 150%	RAL level	11	14	7	3	4	8	11
# OF COMPANIES WITH RBC RATIO > 70 & < 100%	ACL level	3	4	3	6	3	2	1
# OF COMPANIES WITH RBC RATIO < 200 & <> 0%	MCL level	5	16	17	18	20	19	22
# OF COMPANIES WITH RBC RATIO OF ZERO		0	0		0			
TOTAL COMPANIES		2,398	2,546	2,522	2,511	2,477	1,954	2,535
TOTAL ADJUSTED CAPITAL (TAC)		1,336,631,353	1,305,188,051,389	1,211,723,945,518	1,295,396,441,237	1,147,914,269,354	1,073,407,595,862	931,224,541,048
AUTHORIZED CONTROL LEVEL RBC (ACL)		211,804,915	225,770,759,221	206,730,000,454	209,812,119,487	186,945,420,616	171,329,036,103	151,112,834,048
AGGREGATE RBC %		631%	578%	586%	617%	614%	627%	616%
MEDIAN RBC %		1159%	1097%	1145%	1167%			
# OF COMPANIES WITH RBC RATIO >500		1,915	1,972	1,996	2,035	1,994	1,467	2,043
% OF COMPANIES WITH RBC RATIO >500		79.9%	77.5%	79.1%	81.0%	80.5%	75.1%	80.6%
# OF COMPANIES WITH RBC RATIO < 200 & <> 0%		31	51	54	35	42	38	48
% OF COMPANIES WITH RBC RATIO < 200 & <> 0%		1.3%	2.0%	2.1%	1.4%	1.7%	1.9%	1.9%

Source: 2018 - 2023, NAIC Financial database - summary exhibit
2024, compiloation of S&P data

See Table 2.

36. As is evident, the vast majority of insurers have RBC ratios far in excess of the ACL level. For example, in every year at least 75% - 80% of insurers had RBC ratios above 500%. More important, in no year did more than 2.1% of insurers had RBC ratios below the CAL, and only 1% - 1.5% had ratios below the RAL. For the largest insurer in the largest state in the country to have an RBC ratio at the regulatory action level (RAL) is in my experience unprecedented.

37. It is not only the prospect of regulatory oversight that may result from SFG's financial condition that is of concern. Perhaps even more significant are the potential market disruptions that would arise if SFG were to become financially impaired even further or have its financial strength ratings reduced.

38. It is widely agreed that the California homeowners insurance market is in a state of crisis; in recent years, and particularly after the LA fires, insurers have been unwilling to continue bearing the risk of homeowners' exposure in the state. As a consequence, insurers have withdrawn and the FAIR plan (the market of last resort) has grown to unsustainable proportions. (Between 2021 and 2024, FAIR plan policy counts almost doubled, to more than half a million, and insured exposure more than tripled to over $500 billion.)[2] Were SFG to be unable to continue writing its share of the market (almost 20%) that would place over 1 million additional homeowners policies on the market in search of coverage. It is highly unlikely that other insurers, or the FAIR plan, could absorb such a shock.

39. Whether or not SFG is in imminent danger of insolvency, the prospect that it could be impaired in its ability to serve California policyholders is not remote and is a very real concern. In addition to the protection it offers, one of the most important features of a homeowners insurance policy is that it insures the mortgage collateral underlying the majority of homes. In order for an insurer's policy to be eligible to insure this collateral, however, the company's financial strength ratings must meet certain minimum standards. Those standards are established by the two major government agencies that purchase and securitize mortgages (FNMA, or Fannie Mae, and FHLMC, or Freddie Mac), and they are often followed by the banks that make the loans in the

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[2] California Fair Plan, *Key Statistics & Data*, https://www.cfpnet.com/key-statistics-data/ (last accessed April 1, 2025).

first place. If an insurer falls below these standards, such that its policies cannot insure mortgage collateral, that insurer could be effectively out of business.

40. The standards established by FNMA and FHLMC allow an insurer to rely on financial strength ratings from any of four rating agencies – AM Best, S&P, Demotech and Kroll – however in my experience the first two, Best's and S&P, are the ratings most large insurers rely upon for homeowners policies. For FNMA the minimum financial strength rating from AM Best is B, and from S&P it is BBB. For FHLMC the minimum rating from AM Best is B+, and from S&P it is BBB.

41. SFG's financial strength rating from AM Best declined to a level of B as of the first quarter of 2024, so it has already fallen below the minimum FHLMC requirement, and just barely meets the FNMA standard.[3] And while SFG's S&P rating remains at AA, S&P has placed SFG on CreditWatch with negative implications, suggesting SFG's current rating could be in jeopardy.[4] Were SFG's S&P rating to decline below BBB such a change could jeopardize the stability of the entire California homeowners market.

42. Consider what could happen if SFG ratings declined to the point where its insurance could not be used to insure mortgage collateral, and hence it was unable to serve many of its over 1 million homeowners policyholders in California. According to the U.S. Census Bureau, approximately 68% of the housing units in California have mortgages.[5] Assuming 68% of SFG's policyholders have mortgages, that amounts to more than 680,000 policies that would have to find alternative insurance coverage. I am not confident that the California market, in its current state, could absorb that shock.

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3 This information is included in the February 7, 2025 communication to the Commissioner setting forth the stipulation between CDI and SFG supporting an emergency interim rate. For convenience, the published rating is included as Exhibit SFG-DA-3.

4 The S&P credit watch announcement was included in correspondence with the Commissioner, and is included as Exhibit SFG-DA-4 for the ALJ's convenience.

5 U.S. Census Bureau, B25081 Mortgage Status Chart, https://data.census.gov/table/ACSDT5Y2022.B25081?g=040XX00US06 (last accessed April 1, 2025).

43. Before leaving the subject of SFG's ratings, it is instructive to review what both AM Best and S&P said in their recent press releases regarding SFG. In March 2024, in a release entitled "AM Best Downgrades Credit Ratings of State Farm General Insurance Company," Best stated the following:[6]

> **AM Best** has downgraded the Financial Strength Rating (FSR) to B (Fair) from A (Excellent) and the Long-Term Issuer Credit Rating (Long-Term ICR) to "bb+" (Fair) from "a" (Excellent) of State Farm General Insurance Company (State Farm General) (Bloomington, IL). The outlook of the FSR has been revised to stable from negative, while the outlook of the Long-Term ICR is negative. The Credit Ratings (ratings) reflect State Farm General's balance sheet strength, which AM Best assesses as weak, as well as its marginal operating performance, neutral business profile and appropriate enterprise risk management (ERM). The ratings also reflect lift, as defined within Best's Credit Rating Methodology, from its parent, State Farm Mutual Automobile Insurance Company. The rating downgrades reflect continued deterioration in State Farm General's policyholder surplus at Dec. 31, 2023, which resulted in a corresponding decline in overall risk-adjusted capitalization, as measured by Best's Capital Adequacy Ratio (BCAR), and weakening balance sheet metrics. A contributing factor to this decline was sharp increases in claim severity affecting the company's umbrella and commercial multi-peril lines of business.
>
> The continuation of the negative outlook on the Long-Term ICR reflects the uncertainty of the company's ability to stabilize and strengthen its risk-adjusted capitalization given ongoing challenges regarding profitability and internal capital generation, trending adverse reserve development occurring on prior accident years, and the challenging regulatory environment within California's marketplace that have constrained the ability of State Farm General (as well as its industry peers) to increase premium rates in a timely fashion. While management is taking corrective actions to stabilize its balance sheet strength, these actions will need time to gain positive traction over the intermediate term.

44. On February 25, 2025 S&P issued a press release entitled "State Farm General Insurance Co. 'AA' Ratings Placed On CreditWatch Negative On Weakening Capital Position," which in summary said "We have placed our 'AA' financial strength and issuer credit ratings of SFGI on CreditWatch with negative implications."[7] In their discussion of the rationale for this decision, S&P had these comments:

> Our rating action on SFGI reflects the company's weak underwriting performance over the past five years (2019-2023), continued underperformance in 2024, and the potential earnings pressure in 2025, largely from the recent California wildfires which lead to

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[6] *See* Exhibit SFG-DA-3. Also available at https://news.ambest.com/pr/PressContent.aspx?altsrc=2&refnum=34559 (last accessed April 2, 2025).

[7] *See* Exhibit SFG-DA-4. Also available at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/3328722 (last accessed April 2, 2025).

> deteriorating capital near the regulatory authorized control level (ACL). Our action also reflects our view of uncertainties related to capital support from the State Farm group, which raises concern relating to SFGI's core group status assessment. This action also considers the California Insurance Department's ambiguity around rate approval.
>
> SFGI is an operating subsidiary of State Farm Mutual (AA/ Stable) that does business exclusively in the state of California. 77% of SFGI's $3.0 billion quarter three year-to-date 2024 direct premium written were from homeowners business. This has limited SFGI's ability to achieve rate adequacy due to regulatory restrictions on personal lines. SFGI has been vigilant in taking non-rate actions to manage exposure, particularly to wildfires, but it hasn't been enough to offset the elevated severity and frequency affecting the book.
>
> Over the past five years, SFGI reported an average combined ratio of around 115.5%, with a combined ratio for the first nine months of 2024, remaining above the average at 118.0%. This was due to claims from higher catastrophe losses, further elevated by higher inflation. Because of these underwriting losses, SFGI's ACL risk-based capital ratio declined to 228% at year-end 2023, compared with 501% at year-end 2021. With the underwriting losses in 2024, along with the California wildfire losses of around $212 million, and a FAIR assessment of $400 million, the ratio is expected to decline further in 2025.
>
> SFGI has had pending rate increases since June of 2024, and has since requested an emergency interim rate increase. Given the inherent lag for earned rate to meaningfully materialize, we expect it will take at least 12 months to realize the benefits of these rate increases, if they are approved.
>
> Over this period of underperformance and capital deterioration, the State Farm group has not provided any capital support beyond reinsurance agreements to SFGI. This raises questions on the core group status of SFGI and the possibility of changing the group status to non-core. A change to the group status of SFGI could lead to a rating downgrade by multiple notches.
>
> **CreditWatch**
>
> The CreditWatch with the negative implication on SFGI is the result of weakening credit fundamentals and uncertainty about the group's willingness to provide capital support. This raises questions about SFGI's status as a core group member. We expect to resolve this action when more information is available and we're able to refine our credit profile assessment on the operating subsidiary, mainly focused on the prospective capital levels. Upon resolution of the CreditWatch listing, we could change our assessment of the group status and lower the rating by multiple notches.

45. I have reproduced these press releases in their entirety because I believe they strongly support my analysis in this matter: SFG's financial condition is a result of its California insurance operating experience and the "challenging regulatory environment" that has "constrained the ability of State Farm General (as well as its industry peers) to increase premium rates in a timely fashion" (to quote AM Best). I would also note that neither press release attributes SFG's financial condition to its purchase of reinsurance from SFMAIC, as does CW. However, in one of the few

positive statements in these documents, Best's does mention SFG's "appropriate enterprise risk management (ERM)." The purchase of reinsurance is one of the cornerstones of an enterprise risk management program, so to the extent it references reinsurance at all, Best's suggests SFG's program is reasonable and appropriate.

V. IS SFG'S FINANCIAL DISTRESS SELF INFLICTED?

46. I now turn to CW's claim that SFG's financial distress is self-inflicted. In its Objection to the Two Party Stipulation, CW states the following:[8]

> State Farm's claimed financial distress is entirely self-inflicted. For years, the insurer deliberately sold policies at unsustainably low premiums to aggressively grow its market share, ignoring repeated internal warnings about severe financial risks.... Additionally, Consumer Watchdog has submitted an analysis establishing that State Farm entered into reinsurance arrangements with its Illinois-based parent company that siphoned approximately $3 billion from its California operations directly to the parent's benefit.... Thus, the insurer's current financial dissatisfaction arises not from regulatory burdens but from potentially unlawful pricing strategies and internal self-dealing.

Here, CW asserts that SFG's financial condition is the result of two things: (1) SFG's attempts to "aggressively grow its market share" by electing to file rate increases that were less than the maximum indicated rate; and (2) SFG's reinsurance arrangements, which resulted in a net outflow of funds from the company to its reinsurers. Neither of these allegations is correct.

47. As far as filing for rate changes below the indication, and specifically filing for a 6.9% rate increase, that is a common practice amongst California insurers. The reason is obvious – under Proposition 103, if a filed rate increase for personal lines is greater than 7.0%, the Commissioner must notice a rate hearing; the Commissioner does not have the choice to approve the rate and deny an intervenor request for hearing, an option which is permitted with rate requests of 7% or less. In such a case the insurer cannot implement the rate increase until after a rate hearing. Rate hearings unavoidably consume a lengthy period of time, with hefty price tags, particularly considering that the insurer must frequently pay the intervenor's fees.

48. When there is a rate hearing with an intervenor, it has been my experience that the approval process becomes incredibly burdensome. There are frequently multiple rounds of

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[8] Submitted as Exhibit SFG-DA-5 for convenience.

discovery (which are often the subject of disputes) and potentially numerous days of hearings spread over many weeks or even months. It is not uncommon for rate filings that are the subject of such intervention to take well more than a year to get resolved. As an example, the last California hearing I was involved in was the SFG homeowners filing made in December, 2014-PA-2015-00004. While the filing was made in 2014, the ultimate decision was not finally rendered until 2022, following a published Court of Appeal decision upholding SFG's position that the ratemaking formula must use SFG's actual portfolio in calculating the investment income offset to determine rate need, and the California Supreme Court's denial of review of that decision. (I would note that during that period SFG was deprived of hundreds of millions of dollars in needed rate level, because of erroneous assumptions regarding its investment yield. Those additional funds would have gone directly to SFG's surplus, to the benefit of SFG's policyholders.)

49. It is this type of experience that explains why SFG have filed rate increases of 7.0% or less when the indications are substantially higher. It is often more expeditious from a business perspective to take a smaller than needed rate increase that might be approved quickly, as opposed to waiting for years to get the full indication.

50. In any event, the claim that SFG's lower than indicated rate requests were part of an attempt to dominate the market, as suggested by CW, is erroneous.

51. As with much of the CW argument, there is no evidence to support this assertion. In fact, SFG did not increase its market share over the decade from 2015 to 2024: SFG' s market share stood at 19.7% in 2015 and was 19.5% in 2024, a very slight decline of 0.2 percentage points.

52. As to CW's claim that SFG's financial distress results from its reinsurance arrangements, I have already explained that on average reinsurance costs (i.e., ceded premiums) should exceed reinsurance recoveries (ceded losses), meaning that on average reinsurance should be a net cost to the primary insurer (in this case SFG). What CW seems concerned about is the price SFG paid for its reinsurance, which it contends was excessive, and the fact that a significant portion of the coverage was placed with SFMAIC. Although it is of course true that SFG purchases a significant

amount of its reinsurance from SFMAIC, I do not believe CW has provided any evidence that the price of that reinsurance was excessive.

53. In the most basic economic terms, the value of a good or service is best measured by the price people are willing to pay for it in the market. Therefore, the *prima facie* test of whether a particular price is reasonable is to compare that price to the price of equivalent goods or services in the market. That is the type of evidence that directly addresses the question of whether a price is reasonable or excessive, and CW has provided no such evidence in its documents.

54. What CW has provided is an analysis of Schedule P data for a handful of companies, showing reinsurance costs and recoveries over a period of 10 accident years. That analysis shows that during the two wildfire years, 2017 and 2018, other companies benefitted from their own reinsurance arrangements while they contend that SFG did not. On that basis alone, CW claims that SFG's reinsurance must have been overpriced.

55. I am aware that there are flaws and oversights in CW's analysis that will be addressed by other SFG witnesses. I have only two comments. First, it is impossible to validly compare the ceded loss ratios across different insurers unless you know the details of each company's reinsurance program. Different attachment points, limits and other provisions in the contracts could imply significantly different reinsurance recoveries from a given event. Therefore, SFG's ceded loss ratio for a particular year being lower than another company's is not evidence that the price of reinsurance was excessive. Second, evaluating the reasonableness of reinsurance prices by comparing ceded premium and ceded losses over a 10 year period is inappropriate for a catastrophe reinsurance program. Catastrophe reinsurance is purchased to protect against rare events that may occur only once in every 50, 100 or 200 years. It is not at all unusual that such events would not occur over a 10 year period.

56. Recent experience in California provides ample evidence of this fact. If CW were to extend its analysis three months, to include the impact of the LA fires, the picture would be completely reversed – SFG's reinsurance program over the preceding 10 years would have provided a very substantial net benefit to SFG. CW is clearly aware of this fact, since they said "State Farm

acknowledged in response to a question from Consumer Watchdog that all of the $5 billion the company claims that SFG has benefitted from its reinsurance program with State Farm Mutual came from one single event − the 2025 Los Angeles wildfires." It is not surprising in a catastrophe reinsurance program that the substantial majority of recoveries would be related to a single event.

VI. SHOULD THE COMMISSIONER APPROVE THE PROPOSED STIPULATION?

57. As mentioned at the outset, I was asked to provide an opinion as to whether it would be appropriate for the Commissioner to approve the interim rate increase requested by SFG, and as I have explained, I believe that the interim rate increase is not only reasonable and justified, but in fact is critical to the health of SFG and the California homeowners insurance market. As I discussed in this declaration, SFG's current financial condition, with its surplus depletion and concomitant financial distress, is the result of its operations in California over the past decade. The way to immediately ameliorate that situation is to grant SFG the interim rate relief requested here.

58. By granting the interim rate relief, SFG will immediately receive higher premiums that can only improve its existing surplus position. However, it will take time for those rate increases to work their way through SFG's book of business, which has been exacerbated by length of this overall rate filing process, so the impact on surplus will be delayed.

59. As I already mentioned, SFG currently underwrites almost 20% of all California homeowners insurance; obviously, if the company were to become financially impaired and unable to serve the needs of California consumers, the ability of the market to absorb that business would be in serious doubt. Approving the interim rate relief will help to avoid that eventuality.

60. In addition to these other arguments, approving the interim rate increase appears to be an obvious choice, since the increase poses no risk to policyholders. As I understand it, the stipulation incudes terms that require SFG to pay refunds to policyholders (with interest) if the interim rates proposed in this filing are determined to be excessive. In light of SFG's current financial condition, the benefits to the market and the absence of risk to policyholders, it seems obvious that the interim rate increase should be approved and implemented as soon as possible.

I declare under penalty of perjury under the laws of the State of California that the foregoing is a true and correct statement of the facts stated and my analysis of those facts and that this declaration was executed by me on April 2, 2025 at Montclair, New Jersey.

Dated: April 2, 2025