

SFG-VW-18

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17 **BEFORE THE INSURANCE COMMISSIONER**
18 **OF THE STATE OF CALIFORNIA**

19 In the Matter of the Rate Application of,

20 State Farm General Insurance
21 Company,

22 Applicant.

FILE NO.: PA-2015-00004

**PRE-FILED DIRECT TESTIMONY OF
ALLAN I. SCHWARTZ**

23
24
25 **PUBLIC - REDACTED VERSION**
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PRE-FILED DIRECT TESTIMONY OF ALLAN I. SCHWARTZ

FILED

OCT 19 2015

ADMINISTRATIVE HEARING BUREAU

ORIGINAL

1 A previous SFGIC filing pooled the experience of various State Farm companies by
2 using countrywide data for evaluating the following items: home/auto discount, solid fuel
3 appliance charge, premium changes to optional coverages and amount of insurance changes.⁴⁸
4

5 Q. SFGIC alleges that it has its own investment strategy. Do you have any response to that?

6 A. Yes.

7 [REDACTED]
8 [REDACTED]
9 [REDACTED]
10 [REDACTED]
11 [REDACTED]
12 [REDACTED]
13 [REDACTED]
14 [REDACTED]
15

16 Q. Can you summarize your testimony regarding SFGIC's request for a leverage variance?

17 A. Yes.

18 Yes. Based upon the previous discussion of the SFGIC testimony on this issue, it is clear
19 that SFGIC has not shown that it has a mix of business that presents investment risks higher than
20 the risks that are typical of the line as a whole.
21

22 **V – SFGIC DID NOT SUPPORT THE**
23 **REQUESTED CONSTITUTIONAL VARIANCE**
24

25 Q. What does the applicable regulation state with regard to the constitutional variance?
26

27 ⁴⁸ SERFF Tracking #: SFMA-127378383, CDI Filing #: 11-7257, Company Tracking #: HO-
28 27986; Filing Memorandum, Items III C, E, F and V B.

1 A. The applicable regulation states the following regarding the constitutional variance. (10
2 CCR § 2644.27(f)(9))

3 § 2644.27. Variance Request

4 ...
5 (f) The following are the valid bases for requesting a variance:

6 ...
7 (9) That the maximum permitted earned premium would be confiscatory
8 as applied. This is the constitutionally mandated variance articulated in
9 20th Century v. Garamendi (1994) 8 Cal.4th 216 which is an end result
10 test applied to the enterprise as a whole. Use of this variance requires a
11 hearing pursuant to 2646.4.

12 Q. Did you examine whether SFGIC has suffered any deep financial hardship or an inability
13 to operate based upon the enterprise as a whole?

14 A. Yes.

15 Q. What analysis did you do regarding whether SFGIC has suffered any deep financial
16 hardship?

17 A. I examined the profits of SFGIC resulting from California homeowners insurance. These
18 are summarized in the following table.

19 SFGIC Calendar Year Homeowners Historical Profits
20 (Amounts in Millions)

| | Net Income | Earned | Net Income as |
|-------------|------------------|----------------|---------------------|
| <u>Year</u> | <u>(Pre Tax)</u> | <u>Premium</u> | <u>a Percent of</u> |
| | | | <u>Premium</u> |
| 2010 | \$215.1 | \$1,308.9 | 16.4% |
| 2011 | \$336.1 | \$1,381.1 | 24.3% |
| 2012 | \$291.6 | \$1,422.1 | 20.5% |
| 2013 | \$346.9 | \$1,434.2 | 24.2% |

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| | | | | | | |
|---|-----------|-----------|-----------|-----------|-------|-------|
| 1 | 2010 | \$244.4 | \$1,821.4 | \$2,234.7 | 13.4% | |
| 2 | 2011 | \$346.1 | \$1,912.0 | \$2,478.8 | 18.1% | 10.9% |
| 3 | 2012 | \$268.2 | \$1,956.2 | \$2,817.9 | 13.7% | 13.7% |
| 4 | 2013 | \$379.9 | \$1,968.9 | \$3,101.9 | 19.3% | 10.1% |
| 5 | 2014 | \$352.2 | \$1,898.7 | \$3,452.6 | 18.5% | 11.3% |
| 6 | Combined | \$1,590.9 | \$9,557.1 | | 16.6% | 11.5% |
| 7 | / Average | | | | | |

Source: Exhibit 8-0045, 8-0057, Appel PDT page 9

These values demonstrate that SFGIC has been very profitable on an all lines countrywide basis, earning nearly \$1.6 billion in net income (after tax) over the last five years.

Q. Going on to SFGIC and its affiliated companies on an all lines countrywide basis, what values were you able to obtain regarding profits?

A. Those values are shown in the following table.

SFGIC and Its Affiliated Companies Countrywide All Lines Historical Profits
(Amounts in Billions)

| | <u>Year</u> | <u>Net Income (After Tax)</u> | <u>Earned Premium</u> | <u>Beginning Surplus</u> | <u>Net Income as a Percent of Premium</u> | <u>Annual Change in Surplus</u> |
|----|-------------|-----------------------------------|---------------------------|------------------------------|---|---|
| 20 | 2010 | \$1.266 | \$50.3 | \$58.1 | 2.5% | |
| 21 | 2011 | \$0.151 | \$51.4 | \$61.2 | 0.3% | 5.3% |
| 22 | 2012 | \$2.620 | \$52.3 | \$60.8 | 5.0% | -0.6% |
| 23 | 2013 | \$3.552 | \$54.5 | \$65.4 | 6.5% | 7.5% |
| 24 | 2014 | \$4.634 | \$56.9 | \$75.9 | 8.1% | 16.1% |

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1 Combined \$12.223 \$265.4 4.6% 6.9%
2 / Average

3 Source: Exhibit 14-0004, Exhibit 716-2
4 2011 SFMAIC Combined Annual Statement

5 These values demonstrate that SFGIC and its affiliated companies have been profitable
6 on an all lines countrywide basis, having earned over \$12 billion in net income (after tax) over
7 the last five years.

8
9 Q. Did you examine any other data regarding whether SFGIC has had an inability to operate
10 based upon the enterprise as a whole?

11 A. I examined the change in surplus for SFGIC over time. At the end of 1999, SFGIC had
12 paid in capital of \$687.5 million.⁴⁹ At the end of 2014, SFGIC has surplus of \$3.821 billion.⁵⁰
13 This is an increase of \$3.13 billion or 456%.⁵¹ On an average annual basis the increase was \$209
14 million or 12.1%.⁵²

15 The large increase in surplus over time is further evidence that SFGIC has, from an
16 actuarial and financial perspective, not suffered deep financial hardship.

17
18 Q. Do you believe it is reasonable to consider historical results like those discussed above in
19 evaluating whether SFGIC has suffered any deep financial hardship or an inability to operate
20 successfully?

21 A. Yes.

22
23
24 ⁴⁹ Larson PDT 4:4-12.

25 ⁵⁰ Exhibit 8-004.

26 ⁵¹ $456\% = [\$3.821 / \$0.6875 - 1] \times 100\%$.

27 ⁵² $12.1\% = [(\$3.821 / \$0.6875) ^ { (1/15) } - 1] \times 100\%$.

1 Q. Can you explain why?

2 A. During the historical periods, SFGIC has operated in California while the CDI rate
3 regulations have been in effect.⁵³ Hence, looking at the historical results provides useful
4 information regarding the issue of whether the CDI rate regulations as applied to SFGIC have
5 resulted in deep financial hardship or an inability to operate successfully. The actual experience
6 demonstrates that in the recent past the application of the CDI rate regulations to SFGIC has not
7 resulted in SFGIC suffering from deep financial hardship or an inability to operate successfully.
8 Therefore, it is reasonable to conclude that the application of the CDI rate regulations to SFGIC
9 in this case will also not result in SFGIC suffering from deep financial hardship or an inability to
10 operate successfully.

11

12 Q. Do you have any other reason why you believe it is reasonable to take into account past
13 results when evaluating the confiscation variance?

14 A. Yes. In the Matter of the Rate Application of Mercury Casualty Company, PA-2009-
15 00009, the Proposed Order stated "While confiscation is determined prospectively, the
16 Commissioner may draw some limited inferences from past applications of the rate formula. For
17 example, under the Commissioner's regulatory formula, Mercury has realized profits in the
18 millions of dollars every year."⁵⁴

19

20 Q. Can you comment on the issue of the financial integrity of SFGIC?

21 A. Yes.

22 We reviewed various indicators for SFGIC, all of which demonstrate that SFGIC has a
23 high level of financial integrity. There are summarized below.

24

25

26 ⁵³ There have been some technical revisions to the rate regulations over time. The last such
revision took effect in May 16, 2008.

27

28 ⁵⁴ Exh. 702-4.

- 1 • SFGIC has received an A. M. Best Financial Strength rating of A (Excellent)
- 2 from at least 2011 to the present.⁵⁵
- 3 • SFGIC falls within the normal range of results on all thirteen of the National
- 4 Association of Insurance Commissioner's (NAIC) Insurance Regulatory
- 5 Information System (IRIS) Ratios.^{56,57}
- 6 • State Farm has stated [REDACTED]
- 7 [REDACTED]
- 8 [REDACTED]
- 9 [REDACTED]⁵⁸ and [REDACTED]
- 10 [REDACTED]
- 11 [REDACTED]
- 12 [REDACTED]⁵⁹
- 13 • [REDACTED]
- 14 [REDACTED]⁶⁰ [REDACTED]
- 15 [REDACTED]⁶¹ [REDACTED]

16 ⁵⁵ Exh. 717-1.

17 ⁵⁶ Exh. 718-5 (Exhibit 718 is selected pages from NAIC document "IRIS Ratio Results for 2014,

18 May 2015, Vol./Iss. 15-01).

19 ⁵⁷ According to the NAIC, "The NAIC Insurance Regulatory Information System (IRIS) is a

20 collection of analytical solvency tools and databases designed to provide state insurance

21 departments with an integrated approach to screening and analyzing the financial condition of

22 insurers operating within their respective states." Exh. 718-2.

23 ⁵⁸ Exh. 719-2 (Exhibit 719 is a document produced by State Farm in discovery).

24 ⁵⁹ Exh. 719-3.

25 ⁶⁰ Exh. 720-1 [REDACTED] (Exhibit 720 is selected pages of a document produced by

26 State Farm in discovery).

27 ⁶¹ [REDACTED]

28 [REDACTED]

1 [REDACTED]
2 [REDACTED]
3 [REDACTED]⁶²
4 • State Farm's Total Adjusted Capital of \$3.821 billion is almost 26 times as large
5 as its Authorized Control Level Risk-Based Capital level of \$148.5 million.^{63,64}

6 [REDACTED]
7 [REDACTED]
8 [REDACTED]
9 [REDACTED]
10 [REDACTED]
11 [REDACTED]
12 [REDACTED]
13 [REDACTED]

14 Exh. 720-3.

15 [REDACTED]
16 [REDACTED]
17 [REDACTED]
18 [REDACTED]

19 Exh. 720-2.

20 ⁶² See Exh. 720-1.

21 ⁶³ Exhibit 8-0045.

22 ⁶⁴ Risk based capital is one measure used by the NAIC to monitor the financial condition of
23 insurance companies. When the ratio of the Total Adjusted Capital is below 2.00 times its
24 Authorized Control Level Risk-Based Capital level, that triggers increased regulatory scrutiny of
25 an insurance company. The NAIC has stated the following on this "Risk-Based Capital (RBC) is
26 a method of measuring the minimum amount of capital appropriate for a reporting entity to
27 support its overall business operations in consideration of its size and risk profile. RBC limits the
28 amount of risk a company can take. It requires a company with a higher amount of risk to hold a
higher amount of capital. Capital provides a cushion to a company against insolvency. RBC is
intended to be a minimum regulatory capital standard and not necessarily the full amount of
capital that an insurer would want to hold to meet its safety and competitive objectives. In