

EXHIBIT A

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15
16 BEFORE THE INSURANCE COMMISSIONER
17 OF THE STATE OF CALIFORNIA

18 In the Matter of the Rate Application of,

19
20 State Farm General Insurance
21 Company,

22 Applicant.
23

FILE NO.: PA-2015-00004

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

24
25 CONDITIONALLY FILED UNDER SEAL
26 CONFIDENTIAL, UNREDACTED VERSION
27
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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
27 revision took effect in May 16, 2008.

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 “The results of State Farm Stress Test demonstrate State
7 Farm Mutual Automobile Insurance Company and its affiliates (State Farm) is
8 well-positioned to remain financially strong, even under extreme stresses from
9 catastrophes and changes in market and economic conditions”⁵⁸ and “State Farm
10 Fire and Casualty Company, State Farm Mutual Automobile Insurance Company
11 (SFMAIC) and State Farm General Insurance Company remain well capitalized
12 in most stress scenarios”.⁵⁹
- 13 • In the twenty Stress Test Scenarios run by State Farm, SFGIC falls into a
14 “concern” level only once.⁶⁰ That one instance is an extremely unfavorable
15 scenario involving multiple adverse events.⁶¹ However, even in that scenario,

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
insurers operating within their respective states.” Exh. 718-2.

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

23 ⁵⁹ Exh. 719-3.

24 ⁶⁰ Exh. 720-1 (The range used for a concern level is a Surplus/Net Written Premium Ratio of
25 1.00 or less, but greater than 0.50.) (Exhibit 720 is selected pages of a document produced by
26 State Farm in discovery).

27 ⁶¹ That event is referred to as “C3: Economic Stress with Inflation, Equity Event, and All
28 Insurance Operations Stressed Events”. The description given for that event is:

1 SFGIC would have an acceptable premium to surplus ratio that easily falls within
2 the range of the NAIC IRIS ratios. Furthermore, SFGIC tends to perform better
3 than most of the other State Farm companies in the various stress tests.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
7 “The Economic Stress with Inflation scenario is combined with the following stresses:
8 Multiple P&C Catastrophes in four P&C affiliates: 1-in-100 year catastrophe losses in
9 2015 and 1-in-250 year catastrophe losses in 2017.
10 Loss ratio deterioration in C2 is replaced with loss ratio deterioration of 20 ppt in P&C
11 affiliates throughout the scenario period due to inflation.
12 At least a 50% decline in the equity market in 2015 with no recovery.
13 A \$2 billion loss against SFMAIC stemming from an operational loss event in 2015.
14 Increased credit spreads reduce the return on the State Farm non-treasury fixed income
15 investment portfolio by 7.22%.
16 Fixed income default loss rate of 0.50% period and annual fixed income impairments of
17 0.50% over the scenario.
18 1-in-250 catastrophic mortality year in 2015.”

19 Exh. 720-3.

20 The Economic Stress with Inflation scenario is described as follows:

21 “The Economic Stress with Inflation scenario assumes interest rates increase approximately 200-
22 400 bps. Real interest rates stay low, and the increase is due entirely due to annual inflation of
23 approximately 5% in 2015, which increases to 7% and 9% in 2016 and 2017, respectively.
24 Equities increase approximately 3% annually. The unemployment rate increases to
25 approximately 10.0% in 2015. The increase in inflation causes loss ratio deterioration of 5 ppt in
26 2015, 7 ppt in 2016, and 9 ppt in 2017.”

27 Exh. 720-2.

28 ⁶² See Exh. 720-1.

⁶³ Exhibit 8-0045.

⁶⁴ Risk based capital is one measure used by the NAIC to monitor the financial condition of insurance companies. When the ratio of the Total Adjusted Capital is below 2.00 times its Authorized Control Level Risk-Based Capital level, that triggers increased regulatory scrutiny of an insurance company. The NAIC has stated the following on this “Risk-Based Capital (RBC) is a method of measuring the minimum amount of capital appropriate for a reporting entity to support its overall business operations in consideration of its size and risk profile. RBC limits the 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

- 1 • A. M. Best has said the following about SFGIC “The ratings and outlooks reflect
2 State Farm General Insurance Company’s (SFGIC) strong risk-adjusted
3 capitalization, excellent overall operating performance and superior business
4 profile as a strategic member of State Farm Group”⁶⁵ and

5 Enterprise risk management (ERM) within State Farm is sophisticated and
6 appears to be more advanced than the average personal lines insurer in the U.S.
7 ERM promotes effective risk management which improves the ability of State
8 Farm to meet strategic objectives. It provides a framework for risk management
9 activities and promotes a risk management culture. ERM aggregates and reports
10 on enterprise risks to help inform strategic and operational planning and assist
11 leaders in ensuring State Farm maintains capital commensurate with its risk
12 exposure. It is endorsed by leadership and the Board of Directors and influenced
13 by associates at every level.

14 The objectives of the ERM program are to; maintain a risk governance structure
15 that facilitates communication across business units and considers the relationship
16 among risks; promote a risk management culture that includes the appropriate
17 identification, analysis, treatment, monitoring, and reporting of risk; provide a
18 framework that aligns with sound risk management practices, enabling effective
19 identification, analysis, treatment, monitoring, and reporting of risks as well as
20 capitalization on opportunities; provide a framework for integrating risk
21 considerations into operations, strategic decision-making, and capital planning;
22 and utilize information obtained through risk management activities and financial
23 risk modeling to analyze, understand, and report on enterprise risk.⁶⁶

24 Q. Is A. M. Best an accepted source for evaluating the financial condition of insurance
25 companies?

26 A. Yes it is. In fact, State Farm Mutual cites its A. M. Best rating on its website as support
27 for financial strength and claims paying ability.⁶⁷

28 addition, RBC is not designed to be used as a stand-alone tool in determining financial solvency
of an insurance company; rather it is one of the tools that give regulators legal authority to take
control of an insurance company.”

http://www.naic.org/cipr_topics/topic_risk_based_capital.htm.

⁶⁵ Exh. 711-1.

⁶⁶ Exh. 711-3.

⁶⁷ Exh. 721-1.

EXHIBIT B

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STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE

PUBLIC HEARING
IN RE: STATE FARM RATE APPLICATION
PA-2015-00004
SAN FRANCISCO, CALIFORNIA
FRIDAY, NOVEMBER 20, 2015
VOLUME V, PAGES 1007-1228

CORRECTED TRANSCRIPT DECEMBER 9, 2015

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STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE

PUBLIC HEARING
IN RE: STATE FARM RATE APPLICATION
PA-2015-00004
SAN FRANCISCO, CALIFORNIA
FRIDAY, NOVEMBER 20, 2015

Proceedings taken at California Department of
Insurance, 45 Fremont Street, 22nd Floor, San Francisco,
94104, before John Larsen, Administrative Law Judge,
commencing at 9:00 a.m., November 20, 2015, before
Carrie Hewardine, RDR, CSR No. 4579.

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1 BY MR. SHEPARD:

2 Q Just a few more topics, Mr. Schwartz.

3 I want you to turn your attention now to
4 page 31 of your prefiled direct testimony. And this is
5 in a section of your prefiled -- well, I won't
6 characterize it. I'd just ask you to turn to page 31,
7 which is part of an answer that begins on page 29 to a
8 question: "Can you comment on the issue of the financial
9 integrity of State Farm General."

10 Do you see that?

11 A Yes.

12 Q And at Footnote 64 and the accompanying text,
13 on page 31, you say: "State Farm's total adjusted
14 capital of 3.821 billion is almost 26 times as large as
15 its authorized control level, risk-based capital level of
16 148.5 million," right?

17 A Yes.

18 Q And for that, you cite to a State Farm
19 exhibit like the annual report, I believe, Exhibit 8?

20 A Yes.

21 Q Are you aware of any restrictions on the use
22 of RBC or risk-based capital information in rate-making?

23 A I mean, if you are referring to a specific
24 California statute, umm, generally, I'm aware of it.

25 Q There's a California statute that says

1 risk-based capital information shall not be used by the
2 Commissioner for rate-making, correct?

3 A If you have the statute, I'd be happy to look
4 at it.

5 MR. FOREMAN: Your Honor, I'm going to object
6 to this line of questioning. I believe that this is
7 getting into the area of motion-to-strike questions.

8 He's -- counsel seems to be talking about
9 some prohibition, which I think would have been raised at
10 the motion-to-strike level.

11 MR. SHEPARD: I don't see why it isn't fair
12 cross-examination, Your Honor. It goes to the care with
13 which he prepared this report and presented information
14 to the Court.

15 JUDGE LARSEN: But isn't that the -- the
16 report you're talking about, isn't that for an entirely
17 different purpose, or ...

18 MR. SHEPARD: It's -- it's -- any -- it's --
19 "Risk-based capital information is not supposed to be
20 used by the Commissioner for rate-making nor considered
21 or introduced as evidence in any rate proceeding."

22 MR. FOREMAN: That's a mischaracterization of
23 the statute, Your Honor.

24 Again, I think this is -- these are questions
25 that go to the admissibility. That's to be dealt at a

1 motion -- the motion-to-strike level.

2 They moved to strike on that basis, and you
3 denied it. They moved -- or they may have. I don't know
4 if they moved to strike this, in particular.

5 But if they think it's irrelevant or
6 prohibited, they should have moved to strike it,
7 Your Honor.

8 JUDGE LARSEN: My records show that I didn't
9 strike that.

10 MR. FOREMAN: Correct.

11 JUDGE LARSEN: So just one question on that,
12 Mr. Shepard. Let's not keep --

13 MR. SHEPARD: That's fine, Your Honor, I'll
14 ask one question.

15 BY MR. SHEPARD:

16 Q You didn't check the California statutes to
17 see what you were allowed to present and what you weren't
18 allowed to present before submitting your report,
19 correct?

20 A Your statement is inaccurate.

21 Q I guess that's the only question I can ask.
22 One different question as we try to replicate
23 the material at page 15 -- I'm sorry -- page 13.

24 Did the premium values you used as weights
25 come directly from the NAIC profitability report?