Informational Hearing

PREPARING FOR GLOBAL WARMING AND DROUGHT: STATE OF THE HOMEOWNERS' INSURANCE MARKET

Wednesday March 9, 2016
Room 112

Summary

According to the United States Environmental Protection Agency, every 2°F increase in global average temperature is expected to result in 5-15% reductions in crop yields, 3-10% increases in rainfall during heavy precipitation events, and 200-400% increases in areas burned by wildfires in the western U.S. Nonetheless, most public policy discussion has focused on mitigation, water supply, water quality and air quality impacts. The purpose of this hearing is to examine the impact of climate change, drought and growing wildfire risk on the homeowners' insurance market, and homeowners' and homebuyers' ability to adequately protect their largest asset or to purchase a home.

In 2013, California ranked number one in the top 10 most wildfire prone states, and that year California was home to seven of the top ten most costly fires in United States in history. The Valley (Lake, Sonoma and Napa counties) and Butte (Amador and Calaveras counties) fires of 2015 would give California nine out of the 10 most costly fires. According to the most recent data, the Valley fire, which caused at least $1.5 billion in damage and killed four people, was the third most destructive wildfire in the State's history based on the number of structures lost (2,000 structures and 1,300 homes), and fifth costliest based on insured losses, currently estimated at between $700 million and $925 million. The Butte fire was the seventh most damaging wildfire,

causing two deaths, at least $450 million in damages and up to $300 million in insured losses. Tremendous efforts by CalFire, and luck, prevented potentially even worse fires in the highest risk areas of southern California in 2015.

California is facing record drought conditions at the same time that residential areas have been expanding into traditionally high risk fire areas—called the wildland urban interface (WUI). The chances of a major fire that damages or destroys large numbers of homes, or whole communities is growing at the same time that some insurers are exiting the homeowners' insurance market for such high risk properties and others are scaling back their exposure to such risk. Some homeowners in these areas are facing rapidly rising premiums, non-renewal or cancellation of their policies, and greater difficulty in obtaining insurance coverage. At the same time, the Fair Access to Insurance Requirements (FAIR Plan), California's statutorily created "insurer of last resort," reports it has not seen an increase in the number of homeowners' policies it has issued.

The intent of this hearing is to examine the current state of the residential insurance market, whether homeowners are adequately insured against the growing threat of major fires, the impact of rising premiums on existing homeowners and the real estate market, and the growing role of the surplus lines market in filling gaps in the homeowners' insurance market. Is there more insurance companies and the Legislature could or should be doing to increase community readiness and preparedness for major fires in residential communities?

Background

In 2013, California ranked number one in the top 10 most wildfire prone states, and that year California was home to seven of the top ten most costly fires in the United States in history[1]. The Valley (Lake, Sonoma and Napa counties) and Butte (Amador and Calaveras counties) fires of 2015 would give California nine out of the 10 most costly fires. According to the most recent data available, the Valley fire, which caused at least $1.5 billion in damage and killed four people, was the third most destructive wildfire in the State's history based on the number of structures lost (2,000 structures and 1,300 homes), and fifth costliest based on insured losses, currently estimated at between $700 million and $925 million. The Butte fire was the seventh most damaging wildfire, causing two deaths, at least $450 million in damages and up to $300 million in insured losses.

The most destructive fire in California to date was the Oakland Hills fire in October 1991. Its insured losses were $2.9 billion in 2014 dollars. Southern California was scorched by more than 12 separate wildfires in October and early November 2003. Together, they destroyed or damaged more than 2,800 structures in San Diego, San Bernardino, Ventura, and Los Angeles Counties. The two costliest were the Cedar Fire and the Old Fire—each led to almost identical insured

[1] According to the Insurance Information Institute

losses of about $1.4 billion[2]. In October 2007, Southern California was hit particularly hard again by an outbreak of wildfires that resulted in the destruction of more than 3,000 buildings. In 2008, fire destroyed more than 1,000 properties, with insured losses of more than $800 million. The insured losses do not include those who were uninsured, or damage to public roads and utilities. According to one estimate, it is typical for about half the losses from a wildfire to be uninsured.

A Risk Management Solutions and ImageCat, Inc. analysis published in 2008 found that from 1997 to 2007, close to 1,350 structures burned on average each year, with an estimated annual insured loss of some $490 million – nearly twice the long-term average. That analysis was done prior to four years of extreme drought. Moreover, while on average, less than 10 percent of the burnt areas in the U.S. are in California, around 70 percent of the total insured losses are from properties in Southern California. The counties between Santa Barbara and San Diego house some 60 percent of the Californian population who have been especially hard hit by wildfires. Despite the damage done by the Valley and Butte fires, losses could have been significantly worse if fires in southern California had not been contained before they destroyed whole communities like the fires of 2003 and 2007, or worse.

As urban development continues to encroach on the wilderness fringes, and ongoing drought increases wildfire risk in areas not previously at high or extreme risk, the problem of major wildfires destroying hundreds or thousands of properties is likely to increase in the future. Recent data suggests that more than two million homes in California are currently located in high or extreme fire risk zones. Los Angeles County has the highest number of homes in high or extreme risk at more than 440,000. Although they have significantly smaller populations, more than 80% of the homes in Alpine, Mariposa, Trinity and Tuolumne counties are classified as being at high or extreme risk.

Not only has population expanded into the WUI, the drought has caused a major tree die off in the Sierras and foothills, literally adding fuel to the fire. Governor Brown in October 2015 declared a state of emergency and created a Tree Mortality Task Force composed of state, county and local officials and other stakeholders to identify areas of the State that represent high hazard zones for wildfire and falling trees with a goal of protecting the public health and safety by undertaking efforts to remove dead or dying trees that threaten power lines, roads and other evacuation corridors, critical community infrastructure, and other existing structures. For homeowners, the dead trees present an additional risk and barrier to insurance. It can cost anywhere from hundreds to many thousands of dollars to remove dead trees from private property, and disposal of the trees presents an additional problem that the state is still grappling with.

State of the Homeowners' Insurance Market: Availability vs. Affordability

There are more than 100 insurers admitted to provide homeowners' insurance coverage in California. State Farm is the largest, with approximately 20% of the market, followed by Farmers Insurance with almost 15%.[3] Although Allstate Insurance is third, the company stopped

[2] All losses calculated in 2014 dollars
[3] Based on California Department of Insurance data for 2014

issuing new homeowners' insurance policies in California in 2007, describing the state as "catastrophe prone…".

California requires prior approval of insurance rates based on past loss experience data of the company filing the rate application, generally based on an average of up to 20 years for homeowners' insurance. This can make it difficult for rates to reflect dramatic changes in risk profile—or projected catastrophe modeling--such as caused by the recent drought, and the unexpected death of millions of trees in the foothills and mountains of California and other western states.

Insurers complain they have to file rates based on past experience, but essentially have to prepare for the possibility that such catastrophic losses will happen each year. As noted earlier, experts are now predicting that catastrophic wildfires will increase in both frequency and severity for the foreseeable future. If insurance companies cannot collect enough premium to cover such catastrophic losses, with a profit, they will almost certainly exit the market for these products.

A common practice for insurers offering catastrophic insurance coverage is the use of reinsurance to take on greater risk, while shifting some of the risk off their own books. California, however, is one of three states (the others are Washington and Alaska) where insurers are prohibited from including the net cost of reinsurance in their rates, except for earthquake coverage and medical malpractice.

For some of the smaller companies in the homeowners' insurance market, loss ratios (share of earned premium to losses incurred) have varied widely, but for the past six years the major insurers' loss ratios for homeowners insurance have generally stayed in the range of 41%-53%s—years without any catastrophic fires that resulted in billion dollar losses. This compares to a loss ratio average of 63% for auto insurance, and 55.5% across all lines of insurance. However, losses in homeowners insurance can swing widely from year to year, unlike relatively constant losses in auto insurance. Losses spiked for the major carriers in 2003 and 2007, the last years when major fires destroyed thousands of homes in southern California. That said, premiums in WUI areas have also increased since the fires of 2003 as insurers have been able to rely on more detailed loss data in their rate filings.

Insurers now have access to much more accurate data and risk analyses to determine their willingness to offer insurance and how to price it. Insurers have access to "brush mapping" programs--brimming with data from the California Department of Forestry and Fire Protection (CalFire), the U.S. Forest Service, and the National Oceanic and Atmospheric Administration--which accurately predict how a fire might sweep across a neighborhood based on the property's slope, brush composition, local wind patterns, clearance between structures, access and defensibility for fire suppression, and building materials. Insurance companies also utilize the ratings of a community's fire suppression system to determine rates and whether an area is too high risk.

Many companies now use a product called the FireLine State Risk Report that provides a wildfire hazard score ranging from 0-30 for each property analyzed, produced by the Insurance Services Office (ISO) through Verisk Analytics. With this product, insurers know the profile of

each house rather than relying on general regional attributes or zip code. One source in a foothills community has claimed that some of the largest insurers are now refusing to write policies for homes that score higher than a 3 on the FireLine report—a standard so high no homes in these areas can meet it no matter how well prepared or protected. Given the possibility of catastrophic fires that destroy hundreds of thousands of acres and thousands of homes, insurers are not surprisingly seeking to limit their exposure to the highest risk areas, and to reduce their exposure in any areas where they might have had a concentration of policies, leading to a wave of non-renewals by some companies.

The result assures insurance company profits (or reduced losses), but homeowners come away with sticker shock. Two neighbors who would have paid roughly equivalent insurance premiums in the 1990s might now be charged premiums that vary from 50 to 100 percent more. In Tuolumne County, the 2013 Rim Fire changed many insurers' calculations about the home insurance market. It confirmed the belief that California was overdue for a large, catastrophic fire. Even though there was not a significant loss of homes or commercial structures in the Rim Fire, insurance companies started aggressively enforcing fire safety standards in annual inspections. According to some homeowners, the companies are relying on the FireLine rating, and not on the actual conditions on the ground even when verified steps have been taken to reduce a home's risk. That said, there has been little hard data on the scope of non-renewal of policies and decisions by insurers to stop offering new policies in areas of high fire risk. The CDI in December issued a data call to the major insurers to gather such data and hopefully help determine the actual scope of the problem.

- Are wildfires in California approaching the class of catastrophe similar to hurricanes and earthquakes? At what point should insurers be allowed to price for the risk of exposing that capital, and for the price of backing up that capital with reinsurance?
- Short of accepting wildly fluctuating profits and losses, what other steps could California take from a regulatory standpoint to encourage admitted insurers to offer insurance in the WUI?

Can the Surplus Lines Market Fill the Void?

Surplus lines carriers are relatively free from state insurance regulation. Policy forms and rates are unregulated, and capitalization requirements are far different from those imposed on admitted carriers. This lack of regulation is the essence of what a surplus carrier is; that is, a "free agent" able to respond to the changing market conditions and coverage needs of certain insureds. That said, there are still a few significant regulatory issues confronting surplus insurers, largely concerning the licensing of surplus brokers and the state oversight of surplus lines carriers to see that they do not write business that could go to the admitted market. This oversight is probably required because, as surplus carriers are free of assigned risk pools and guaranty fund assessments, a non-admitted carrier could potentially offer placement at a significant price advantage.

The California Department of Insurance (CDI) monitors the financial condition of surplus line insurers and maintains a list of insurers that surplus line brokers are allowed to use--the List of Approved Surplus Line Insurers, ("LASLI"). This financial monitoring is particularly important

because if the insurer were to fail (go bankrupt), there is no guaranty fund protection for the insured. A policyholder's claim on a regular insurance policy can be paid out of a state guarantee fund that all the state's regular insurance issuers contribute to in case one insurer goes bankrupt. Regular insurance carriers, also called standard or admitted carriers, must follow state regulations about how much they can charge and what risks they can and cannot cover. Surplus lines carriers don't have to follow these regulations, allowing them to take on higher or more unusual risks. Surplus lines insurance is often more expensive than regular insurance because it protects against risks that other insurers won't cover.

LASLI is a voluntary list, however, and insurers may opt off the list. As a result, there may be nonadmitted insurers that are not on LASLI but are nonetheless eligible for use by surplus line brokers, as long as the broker has determined at the time of placement that the insurer meets specific eligibility criteria. It is important to note that these insurers are generally not unable to obtain a license to operate in California. They choose to operate on an unlicensed, surplus line basis.

The next player is the agent or broker (broker). If you are an individual or company that needs insurance, the broker acts as the middleman between you and the insurer. The broker is also licensed and regulated by the state. When you tell the broker you need insurance, the broker must try to find you a policy from one of the insurers that is licensed to operate in the state and with which he or she has a relationship. There are some cases, however, (generally less than 10% of policies nationwide) where the licensed insurers will not accept a risk because it does not meet their internally established guidelines. The risk may be too big, too unusual or substandard. The surplus line broker is allowed to procure a policy for you from an insurer that is not licensed in the state. Each surplus line broker is responsible to ensure that a diligent search is made among insurers that are admitted to transact and are actually writing the particular type of insurance in this state before procuring the insurance from a nonadmitted insurer. Generally speaking this means the broker must first attempt to place the insurance with three admitted insurers who decline to issue a policy. The surplus line broker must file with the Insurance Commissioner, within 60 days of placing any insurance with a nonadmitted insurer, a written report regarding the insurance, including the name and address of the insured, verification that the insured is a home state insured, the identity of the insurer or insurers, a description of the subject and location of the risk, the amount of premium charged for the insurance, a copy of the declarations page of the policy or a copy of the surplus line broker's certificate or binder evidencing the placement of insurance, and other pertinent information that the commissioner may reasonably require.

Between 2010 and 2014, the Surplus Line Association of California reports the number of policies filed jumped 30 percent. That said the number of homeowners' policies is still quite small—approximately 24,000 statewide. The majority of those policies tend to be for high value properties or properties posing unusual risks, and whose owners can afford the generally higher premiums associated with surplus lines placed insurance.

- Are surplus lines insurers expanding into wildfire risk areas?
- Are they a viable and affordable option for average homeowners?
- Are there downsides for homeowners?

The FAIR Plan: Insurer of Last Resort

The California Fair Access to Insurance Requirements ("FAIR") Plan was created by state legislation in 1968 following brush fires and riots in the 1960's that led many insurers to exit urban areas or neighborhoods as too risky to insure. Its stated purpose is "to assure stability in the property insurance market for property located in the State of California," and to "assure the availability of basic property insurance…." It is often referred to as the homeowners' "insurer of last resort." That said, policies are actuarially sound, and can still be pricey for its more limited coverage.

The FAIR Plan is a private association based in Los Angeles comprised of all insurers licensed to write property insurance in California. All insurers admitted to sell property insurance in California must be a member of the Association. FAIR Plan profits and losses are shared by its members in direct proportion to their market share of property insurance written in California. The FAIR Plan is not a state agency and no taxpayer funds are involved.

The FAIR Plan offers a standard fire insurance policy for both the structure and contents. No coverage is provided for liability, theft or water damage typically found in most homeowners' policies. The homeowner or business generally must also purchase a "Difference in Condition" policy or other supplemental coverage from the voluntary insurance market when purchasing a FAIR Plan policy. The number of FAIR Plan dwelling policies has been steadily declining since 2006.

Nonetheless, the FAIR Plan share of the homeowners' insurance market remains very small, and it reports that it has not seen an increase of new business in WUI areas as a result of the drought and recent fires. With approximately 126,000 FAIR Plan dwelling policies in place in the state, 76% of those policies are in urban areas, largely in the Los Angeles area. Part of the lack of interest may be the unwillingness of homeowners in rural areas to pay for insurance, particularly if they are low income and/or own their property outright. Homeowners may also be unaware of the FAIR Plan option. Only 6,600 out of 90,000 agents and brokers in the state are registered to sell FAIR Plan policies, despite the lack of fees or testing to do so, and the FAIR Plan's 10% commission for new business and 8% commission for renewals. Also, brokers are only required by statute to provide homeowners looking for insurance the FAIR Plan phone number, they are not required to actually help the consumer apply for such coverage.

Until recently, applicants for FAIR Plan coverage in specific geographic areas had to provide the names of three insurance companies that had denied insurance coverage for their property in order to qualify for a FAIR Plan policy. After a review following the Valley and Butte fires, the Insurance Commissioner in January directed the FAIR Plan to make several changes to its operations, including some enhanced coverage options, eliminating the requirement that homeowners prove they were rejected three times for standard insurance policies, and giving more access to brokers registered with the FAIR Plan. Consumers seeking coverage from the FAIR Plan may also soon opt for replacement cost of contents and debris removal. Now dwelling replacement cost coverage on all eligible dwellings will be considered standard unless the consumer opts out.

Even if some major insurers have opted to stop writing wildfire risk and some homeowners are receiving non-renewal notices, the lack of a surge in FAIR Plan policies suggests there remain some insurers willing to offer homeowner policies, possibly requiring more effort on the part of homeowners in high risk areas to shop around to secure coverage. At the same time, however, the FAIR Plan sometimes imposes significant surcharges on homeowners in high wildfire risk areas unless the homeowner clears a significant "defensible space" around the home. This can be problematic for homeowners who cannot afford the high cost of removing large numbers of dead and dying trees from their property.

- If homeowners cannot afford such efforts resulting from the historic drought, will they be able to afford the coverage provided by the FAIR Plan?
- As risk increases and the traditional insurance market either increases its prices or pulls out, will the FAIR Plan see a surge in policies in the WUI?
- Is the more limited coverage offered by the FAIR Plan sufficient to allow communities to recover and rebuild after a major disaster?

An Uncertain Future

For each year that California's severe drought continues, the chance of widespread and devastating fires grows. More and more areas of California will likely be designated as high or extreme fire risk, with homeowners' insurers becoming even more reluctant to take on what becomes perceived as catastrophic risk. If there are fire losses in the billions for several years in a row, a homeowners' insurance availability crisis could quickly roil both the insurance and real estate markets as increasing numbers of homeowners lose coverage, are unable to pay rapidly increasing premiums, or are forced to settle for the limited—but still expensive--coverage offered by the FAIR Plan. Many properties could become unsellable or unaffordable to all but the wealthiest purchasers.

California experienced such a crisis following the Northridge earthquake in 1994. The magnitude 6.7 Northridge earthquake was the costliest natural disaster in the history of California, and the fourth largest economic loss caused by a natural disaster in the nation's history. It caused over $25 billion in damages, and $49 billion in economic losses to the region and state. Prior to the Northridge earthquake, insurers dramatically underestimated the potential damage from such moderate earthquakes, and many found themselves dangerously overexposed to earthquake risk. One major insurance company with a large concentration of policies in the affected area was driven to near insolvency. Insurance rating agencies took note of this increased exposure and downgraded many companies. Because California requires all insurers offering homeowners' insurance in the state to also offer earthquake insurance, many insurers opted to stop writing homeowners insurance altogether, making it all but impossible for home buyers to obtain a mortgage. This crisis led to the creation in 1996 of the California Earthquake Authority (CEA), allowing insurers who join the CEA to shift earthquake risk off their books and to the CEA. As a result, although all homeowners must be offered earthquake insurance, only about 11% actually purchase it. Creating a separate risk pool for earthquake solved the problem in the homeowners' insurance market, but not the earthquake insurance problem.

Unlike with earthquake insurance, any homeowner with a mortgage must have homeowners' insurance covering fire. Although losses from wildfire are unlikely to ever reach the levels projected for major earthquakes, insurers will almost certainly try to limit their losses and increase profits by pulling out of larger and larger areas of the state if they consider the risk unacceptable or unpredictable. To ensure a healthy real estate market and preserve the largest asset most people own, homeowners insurance must be both available and affordable.

Some residents of the extreme risk areas are proposing creation of a wildfire insurance pool similar to the CEA. Wildfire peril would be carved out of the basic homeowners' policy, and all homeowner policies located in high and extreme CAL FIRE severity zones would be insured for fire by the pool. Homeowners would continue to need a separate policy to cover other risks, such as liability and theft. The new wildfire pool would be heavily reliant on reinsurance, at least in its early years, and would require changes to existing regulatory rules regarding inclusion of those expenses in rates. In order to qualify for the IRS tax status needed to accumulate capital tax free like the CEA, it would also need to be structured as a quasi-state entity, even if it does not rely on state funding. What is not clear is whether such a proposal would reduce premiums for homeowners who would still have to pay actuarially sound rates for two separate policies.

Generally speaking, the homeowners' insurance market in California has been very profitable when averaged over many years. In fact, insurers had six very good years from 2009 to 2014. Even in 2003, after the fires in San Diego and San Bernardino produced $2 billion in claims, the industry ran a 96% combined ratio, which means some companies actually had some underwriting profits after paying for all those losses. Given the severity of the drought and predictions of climate change, it is time to consider whether insurers can be expected to absorb wildfire losses within a year or two without having to increase rates significantly.