Informational Hearing
The California FAIR Plan
Wednesday, March 8, 2023
1:30pm
State Capitol, Room 437

What is the California FAIR Plan?

The California FAIR Plan – "Fair Access to Insurance Requirements" – is an "association" of all licensed insurance companies by the California Department of Insurance (CDI)) that provides basic property insurance in California. It was created in 1968, following urban disturbances, notably the Watts Riots in Los Angeles.

What is the purpose of the California FAIR Plan?

"To assure stability……
To assure the availability……
To encourage maximum use…..
To provide for equitable distribution among admitted insurers of the responsibility for insuring qualified property for which basic property insurance cannot be obtained through the normal insurance market." (CA Ins. Code 10090)

Simply stated, the purpose of the FAIR Plan is to be the "insurer of last resort" for "basic" property insurance in the event of a market failure. At inception, that was essentially urban commercial property. Ultimately, it has expanded to include homeowners' insurance anywhere in the state, provided that the insurance "cannot be obtained" in the normal manner in the market. The FAIR Plan is not intended to compete with the voluntary market.

The FAIR Plan was established to ensure that urban property owners, mostly businesses, would have "fair access" to the property insurance necessary to continue to operate in a market that insurers viewed as too risky to cover. That risk evaluation resulted in a substantial market withdrawal by insurers from the urban property market. Despite its initial creation as an urban/business "insurer of last resort," the FAIR Plan expanded to provide coverage in "designated" brush fire regions of the state. It operated fairly well in this manner until the mid-1990's, when, as a consequence of the genuine homeowners' insurance crisis that followed the Northridge earthquake in 1994, the entire state was designated as the appropriate FAIR Plan coverage region.

FAIR Plan policies are capped at $3.3 million for residential properties and $8.4 million for commercial properties. Both these caps were increased by the Insurance Commissioner in 2020 for residential and 2021 for commercial.

By statute, the FAIR Plan policy is not as broad as traditional homeowners' policies, it is nonetheless a fully sound and guaranteed policy that satisfies lenders' security requirements and protects the property against the primary risk factor faced by homeowners which is fire. Other

coverages are readily available in the market (typically through the purchase of a "difference-in-conditions" or "DIC" policy), which provides wraparound coverage that, coupled with a FAIR Plan policy, results in the same protection provided by a standard homeowner's policy. Because the FAIR plan's role is to provide coverage when the regular market won't, it is not the role of the FAIR Plan to provide DIC policies when there is a healthy market for those policies.

"Rates for the FAIR Plan shall not be excessive, inadequate, or unfairly discriminatory, and shall be actuarially sound so that premiums are adequate to cover expected losses, expenses and taxes, and shall reflect investment income of the plan." (CA Ins. Code 10100.2)

The Role of the FAIR PLAN

The current role of the FAIR Plan is largely a result of the aftermath to the 1994 Northridge earthquake and more recently, wildfires. A brief review of California's experience in the mid-1990's in comparison with today's current market conditions is helpful in evaluating the extent of the current problems and the efficacy of *existing* solutions.

Just as the wildfire losses have shaken the insurance industry's confidence in its prior assessment of the scale of wildfire risk, the Northridge earthquake generated a comparable re-evaluation with respect to earthquake risk in California. The market response was predictable. As long as state law mandated insurers to write earthquake insurance for any homeowners' insurance policyholder who chose to buy it, insurers would simply not write new homeowners' policies.

In the absence of a statewide coverage area for the FAIR Plan, the homeowners' insurance market for new policies virtually collapsed, and there was a serious and immediate risk of widespread non-renewals of existing policies. Escrows on home sales were failing for lack of available insurance (not merely insurance that prospective buyers found to be more expensive than had historically been the case). There was a complete lack of availability of homeowners' insurance to be purchased at any price.

The administrative/legislative response was essentially two-fold. Administratively, the FAIR Plan was expanded to statewide, thereby ensuring access to essential coverage so that the state's real estate market would not collapse. Legislatively, the California Earthquake Authority (CEA) was established to address earthquake insurance in a manner that would enable a recovery of the basic homeowners' insurance market. Both of these efforts succeeded. [1]

There are several lessons to be drawn from the 1990's crisis:

1) It is very difficult to mandate that insurers write policies that their risk analysis shows to be unmanageable. This remains true either because the aggregate risk posed is too great or because existing rate structures do not permit insurers to charge adequate premium based on

[1] It bears mentioning that for the portion of the market that did not join the CEA, earthquake insurance rates increased shortly after the Northridge quake in excess of 50% across the state – and higher in high risk regions. Part of the 1990's "new normal" with respect to earthquake insurance was significantly higher costs for consumers.

the risk created by issuing the policies.

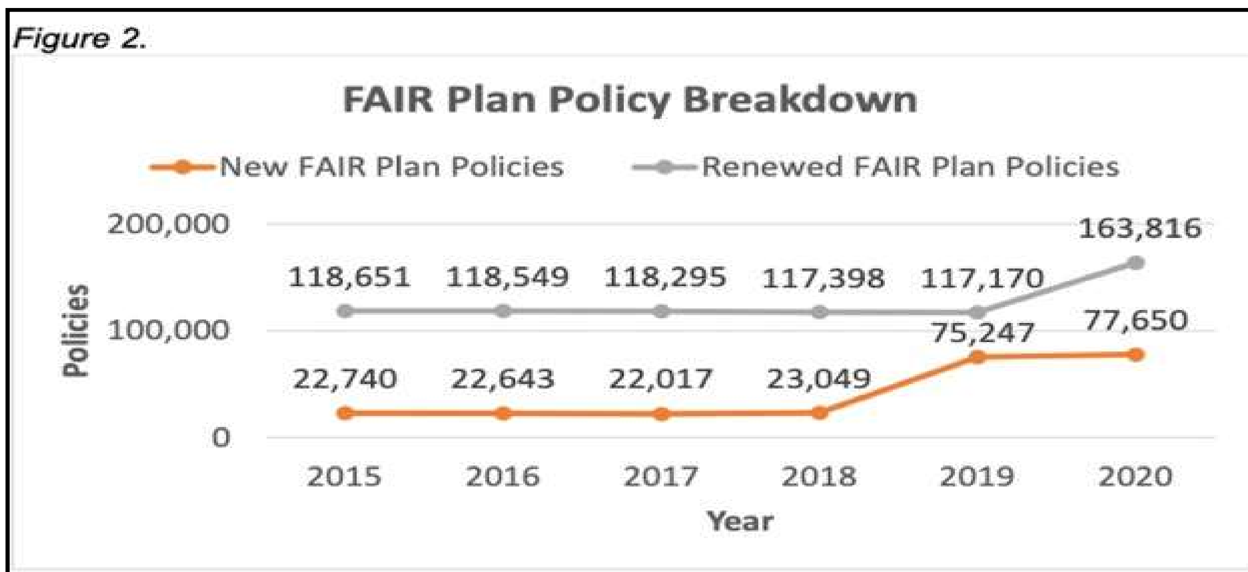
2) There was credible evidence that insurers were delaying a more drastic market withdrawal across the state, absent administrative/legislative action to address the crisis.

3) The primary administrative tool (expansion of the FAIR Plan statewide) both served its immediate purpose, and in the years since.

FAIR Plan Clearinghouse

The FAIR Plan clearinghouse was created in 2021. Statute puts the onerous on the FAIR Plan to develop the clearinghouse program with these goals: reduce the concentration of policies and push the use of the regular insurance market; lower the quantity of policies in the FAIR Plan; and provide the insurers the ability to take on additional business. The intent of the program is to get FAIR Plan policyholders back into the admitted market. The policies in the clearinghouse are initially limited to the admitted market for the first 30 days, at which point nonadmitted insurers may also participate by offering a homeowners policy to someone in the FAIR Plan.

FAIR Plan Market Activity



(California Department of Insurance, Dec. 20, 2021)

Policyholders continue to face challenges obtaining residential property insurance. While the number of new FAIR plan policies rose slightly in 2020, the number of renewed FAIR plan policies also increased at a sharper rate. According to CDI, 98% of Californians obtain residential insurance through traditional insurance companies. Data shows in 2020, the FAIR Plan renewed 163,816 policies and provided 77,750 new policies. An increase in 46,646 renewed policies, and 2,403 new policies from the previous year.

Homeowners are required to conduct a diligent search of the private market for new coverage before resorting to the FAIR Plan. After receiving a non-renewal notice, some homeowners will

find coverage from the private market in the course of that diligent search -- information provided by the FAIR Plan supports the inference that coverage from the regular market is available in many areas. However, where there are significant increases in FAIR Plan policy counts, it is a sound assumption that there has been an increase in the number of non-renewal notices sent to homeowners.

Surplus Lines

Both the FAIR Plan and surplus lines (nonadmitted) are considered the secondary insurance market. Surplus line insurers are those admitted to sell insurance in another state but not directly in California. Surplus lines are intended to also be a last resort because most often these policies are more expensive than the admitted market. California currently works with 132 surplus line carriers.

What is homeowners' insurance?

A typical homeowner's policy will protect against a variety of property and casualty losses, with each type of loss typically having a separate coverage limit. Unlike a FAIR Plan policy which typically only covers losses due to a fire. Dwelling coverage (referred to as "Coverage A") pays for damage to or destruction of the dwelling itself. Damage to or destruction of other structures on the property, such as fences and freestanding garages (referred to as "Coverage B"), is considered separately from the dwelling loss. Damage or destruction to personal property such as furniture, clothes, appliances, and electronics (referred to as "Coverage C") is also separated out from dwelling coverage. Standard policies also cover additional living expenses (referred to as "ALE"), such as temporary housing, while a home is replaced or repaired. A homeowners' insurance policy also typically covers losses due to theft or vandalism, as well as providing liability protection in the event the homeowner is sued as a result of an event associated with the property. Some risks, such as earthquake and flood, are not covered by a standard homeowner's policy (separate coverages are available for those risks). To the extent that a policyholder has not selected coverage limits sufficient to rebuild or repair the home, the homeowner is responsible for the remaining expense.

There are a few basic types of homeowner's insurance policies available in the market:

- **Actual Cash Value** – This type of policy provides for the cost to repair or replace the home (less depreciation) and caps the coverage based on the estimated normal cost of rebuilding.

- **Replacement Cost** – This type of policy provides for the cost to repair or replace the home (without depreciation) and caps the coverage provided based on the estimated normal cost of replacement.

- **Extended Replacement Cost** – Like the replacement cost policy, this type of policy provides for the cost to repair or replace the home (without depreciation) up to the estimated replacement cost, but provides additional coverage should the cost of replacement exceed the dwelling limit. This additional coverage typically increases the dwelling coverage limit by 25% - 50%.

- **Guaranteed Replacement Cost** – This type of policy does not have a limit on the dwelling coverage (although premium is charged based on the estimated normal replacement cost). Very few insurers sell this type of policy, as the open-ended expense due to "demand surge" in the aftermath of a major catastrophe is highly volatile and unpredictable.

- **Stated Value** – This type of policy provides coverage for a predetermined amount in the event of a loss. Stated value policies are commonly used to cover mobilehomes.

Most policies require a deductible, which is an amount the policyholder is responsible for before coverage applies. Limits, deductibles, and exclusions are ways to define both the scope of coverage provided by the policy and the risk borne by the homeowner (sometimes referred to as "risk retention" or "self-insurance"). Risk retention provisions are included to eliminate/reduce small value claims for losses easily borne by the homeowner, and to provide a financial incentive to the homeowner to take responsibility for protecting the property. The less risk transferred to the insurer (higher deductibles and lower limits), the lower the premium charged for the policy. However, lower premium (and the associated reduced coverage) increases what the homeowner may have to pay out-of-pocket.

Policies may also provide code upgrade coverage (typically with an additional premium charged) to pay for costs of rebuilding based on updated building codes that have been adopted since the home was originally built. It's estimated that code upgrades for a home built before the early 2000s can drive up construction costs by as much as 20%.

Some insurers offer to increase the limit annually based on inflation and/or the increased cost of rebuilding. The premium charged will reflect the increased coverage. These mechanisms are designed to prevent the value of the Coverage A limit from eroding over time, but these increases may not suffice when the cost of rebuilding increases dramatically after a catastrophe.

How does insurance pricing work?

Since the major wildfires across California, homeowners in the wildland urban interface (WUI) continue to face insurance rate increases. There have also been reports of homeowners being "unable" to obtain insurance, non-renewals, and cancellations. Each of these "reports" deserves thoughtful consideration in light of market reality which has substantially driven California's rate regulation system and the premium structures it creates.

There is a difference between insurance "rates" and the "premium" a particular homeowner pays to their insurer. In insurance regulatory parlance, "rate" means the average price to be paid by customers that will generate an adequate amount of money required to cover the insurer's

anticipated expenses and make a reasonable rate of return.[2] The "premium" that any particular homeowner pays is the result of the approved "rating plan" or "class plan" that uses a series of positive and negative factors to determine that actual price paid. This class plan spreads the cost required to cover insurer's losses, expenses, and return (all defined by CDI regulations) among the insurer's policyholders based on a set of factors also approved by CDI. Allocating premium within these rules is essentially a zero-sum game where a factor that reduces the premium charged in one area must be offset by a factor that increases the premium charged in another area. When those factors result in an insurer charging premium inadequate to pay the losses associated with a category of homes, that gap must be filled by higher premiums charged for categories of homes with lower losses.

Pooling risks through insurance mechanisms creates the possibility, in fact a likelihood of, creating subsidies. In its most basic operation, insurance literally "subsidizes" those with losses with the premiums paid by those without losses. That is not the sense in which the term is used here. Rather, it is used in a broader sense. Determining how risk will be priced and how groups of insureds will be assembled to share that risk will create some financial incentives and disincentives. Financial incentives and disincentives are not determinative of individual behavior, but they do influence behavior that is not limited only to the insurance market. Thoughtful consideration of how the incentives/disincentives are created by the rules imposed for pricing risk (rating) and for assembling insureds (underwriting) create subsidies and those subsidies can either support or undermine the insurance market, as well as broad public policy goals.

In the admitted market, this subsidy factor is even more pronounced than it has been with respect to the FAIR Plan, and as a result, homeowners in the WUI are not merely experiencing a "new normal" but also losing a long-term discounted price that was far below the actual cost of providing insurance in the WUI. This point needs to be clearly understood, *the premiums historically paid by homeowners in the WUI have already been substantially subsidized by low-risk policyholders*. Actions to reduce this subsidy will cause WUI premiums to rise independent of any consideration of the "new normal" and the billions of dollars in recent losses. Each of these factors will inflate property insurance cost in the coming years for all homeowners, but the increases born by homeowners in lower risk areas would be reduced to the degree that the current subsidy to the WUI is reduced.

Insurers point to two regulations adopted by CDI as contributing to the underpricing of policies in WUI. First, and most surprising, the rate regulation system *precludes* counting actual and proven reinsurance expenses as legitimate costs that can be built into the rate base.[3] It's widely accepted that insurers need to buy reinsurance to guard against catastrophic losses that may exceed expected losses. This is, now, especially true with respect to policies that cover homes in the WUI, and reinsurance prices have been rising in the face of substantial losses reinsurers have experienced in recent years. Thus insurers are bearing increasing reinsurance costs without

[2] Pursuant to Proposition 103, and the current regulations adopted by the Department of Insurance, an admitted insurer cannot charge a rate before it has been approved by the Insurance Commissioner, and that rate is set at the constitutionally minimum that can be imposed without resulting in a "taking" that would violate the United States constitution's "Takings Clause".

[3] See California Code of Regulations, Title 10, Section 2644.25.

being able to recover those costs through premium. Insurers argue that the current rate regulation system inherently underprices premiums in high risk areas. Second, the rate regulation rules *prohibit* the use of even the most sophisticated forward-looking risk modelling tools.[4] Rather, the rules require a retrospective look at historical losses. Insurers argue that if, in fact, we are facing a "new normal" with wildfires, limiting rate regulation analysis to historical losses inherently underestimates the risk, and results in underpricing. It is an unpopular and uncomfortable truth that price and availability go hand in hand. If insurers are facing underpriced premiums in high risk areas, their willingness to issue or renew policies in these areas will be low or non-existent.

In addition to potential pricing concerns, large market share companies are also reconsidering the mix of risks presented by their current policyholders. The losses in recent years and the reality that this likely represents a "new normal" does require most insurers (particularly those with a large piece of the market) to reconsider if their policyholders are over-concentrated in high risk areas. Concentration of risk is an essential consideration when selling homeowner's insurance.

While the homeowner's insurance market is generally quite competitive (dozens of insurers offer homeowner's policies in California), there is commonly a wide variation in the premium charged by different insurers for the same home. That variation has a number of causes. As noted above, rates are primarily based on the losses that the insurer is likely to bear among the homes it insures. If the insurer has a riskier group of homes, its rates will be higher. Each insurer also develops its own class plan based in part on the mix of homes it insures. Lastly, while homeowner's insurance is a fairly standard product, policy design choices made by individual insurers do have a cost impact. Some insurers offer more generous coverage for contents or ALE than others and that generosity comes at a cost.

One consequence of California's rate regulation system is that many of the large market share insurers tend to have lower prices than small market share companies simply because few small market share companies' rate applications are challenged by interveners. Interveners exert pressure to reduce requested increases (or even turn requested increases into rate reduction orders) from large market share companies. Since many of the non-renewals in the WUI are from larger market-share insurers, when homeowners in the WUI find coverage from another admitted company they are likely get that coverage from a smaller market share company with higher rates.

California Insurance Cost

As a general matter, Californians have had very low premiums for homeowner's insurance. A recent comparison of costs found that the average premium in California for a $200,000 replacement cost policy was 37th among the 50 states. The national average premium for that policy was $1288 and the average cost in California was $793 (35% lower than the national average.) For comparison purposes, the highest cost state was Florida with the same coverage costing $3575. West Virginia was the mid-point with $1288 and Hawaii was the lowest at $337.

[4] See California Code of Regulations, Title 10, Section 2644.4, subdivision (e).

While the sample limits used to generate those figures are certainly well below typical values in California, the study does highlight that California has been a low cost state for homeowner's insurance. We should expect that premium cost will increase across the state in response to the massive losses experienced in recent years, and the recognition of the "new normal" associated with climate change. However, California homeowners will continue to enjoy lower rates than many states despite these expected rate increases.

Legislative Actions

SB 30 (Lara), Chapter 614, Statutes of 2018, required the Insurance Commissioner to convene a working group to assess new and innovative investments in natural infrastructure and insurance products in light of California's worsening fire vulnerability due to climate change.

SB 824 (Lara), Chapter 616, Statutes of 2018, prohibited an insurer from canceling or refusing to renew a homeowners' insurance policy for one year from the date of a declaration of a state of emergency, as specified; and requires admitted insurers with at least $10 million in written premiums in California to biennially report to the California Department of Insurance specified fire risk information on residential property policies.

SB 894 (Dodd), Chapter 618, Statutes of 2018, required insurers to renew a residential insurance policy for at least two renewal periods (24 months); requires an insurer to grant an additional 12-month extension for a total of 36 months for additional living expense if an insured acting in good faith encounters a delay in the reconstruction process, subject to policy limits; allows an insured to combine payments for actual losses up to the policy limits for the primary dwelling and other structures, limited to the amount necessary to rebuild or replace the home if the policy limits for the dwelling are insufficient; and specifies that the payments for losses under this provision shall be full replacement value without requiring the replacement of the other structures.

SB 917 (Jackson), Chapter 620, Statutes of 2018, provides that if loss or damage results from a combination of perils, one of which is a landslide, mudslide, mudflow, or debris flow, an insurer shall provide coverage if an insured peril is the efficient proximate cause of the loss or damage and coverage would otherwise be provided for the insured peril; provides that this is declaratory of existing law.

AB 1772 (Aguiar-Curry), Chapter 627, Statutes of 2018, extends the minimum time limit for an insured to collect the full replacement cost of a loss related to a state of emergency to 36 months; requires an insurer to provide additional extensions of 6 months if the insured, acting in good faith and with due diligence, encounters a delay or delays in approvals or reconstruction of the home; and requires all policy forms issued or renewed by an insurer to be in compliance with these changes on or after July 1, 2019.

AB 1797 (Levine), Chapter 205, Statutes of 2018, requires an insurer that provides replacement cost residential property insurance to provide to the policyholder, every other year at the time of the offer to renew the policy, an estimate of the cost necessary to rebuild or replace the insured structure, with certain exceptions as specified; and takes effect on July 1, 2019.

AB 1799 (Levine), Chapter 69, Statutes of 2018, requires the complete copy of a residential insurance policy provided to an insured after a loss to include the full insurance policy, any endorsements to the policy, and the policy declarations page; and provides that if the request for a copy of the policy is a result of a loss in a state of emergency, the insurer may, upon the request of the insured, provide an electronic copy of the entire policy.

AB 1800 (Levine), Chapter 628, Statutes of 2018, prohibits, in the event of a total loss, a residential property insurance policy from containing a provision that limits or denies payment of building code upgrade cost or replacement cost, including extended replacement cost, to the extent those costs are otherwise covered under the policy, based on the fact the insured has chosen to rebuild or purchase a home at a new location.

AB 2229 (Wood), Chapter 75, Statutes of 2018, requires a residential property insurer to disclose any fire safety discounts it offers upon offer or renewal of a homeowner's insurance policy on or after January 1, 2020.

AB 2594 (Friedman), Chapter 639, Statutes of 2018, revises the standard form fire insurance policy to extend the statute of limitations to bring suit to 24 months after the inception of the loss if the loss is related to a state of emergency.

AB 1875 (Wood), Chapter 629, Statutes of 2019, establishes the California Home Insurance Finder that will connect consumers who need residential property insurance with agents and brokers to help ensure they obtain plans and coverage that suit their specific needs and requires insurers to annually report the amount of extended replacement cost coverage to the Department of Insurance.

AB 1816 (Daly) Chapter 833, Statutes of 2019, expands the regions of the state in which an insurer can accrue "writeout credits" FAIR Plan to include areas designated by CalFire as high or very high fire risk. Also, requires the FAIR Plan to periodically provide data regarding the use of writeout credits by insurers to the Legislature, Governor, and CDI.

AB 3012 (Daly & Wood) Chapter 258, Statutes of 2020, directs the Fair Plan to implement a clearinghouse program whereby property insurers will be provided information about FAIR Plan policies, for the purpose of encouraging those insurers to offer regular private insurance to FAIR Plan policyholders.

SB 11 (Rubio) Chapter 128, Statues of 2021, authorizes the FAIR Plan to sell commercial coverage to farms.

Conclusion

To the degree we adopt policies to subsidize homeowners in high risk areas through insurance, that subsidy will be paid for by homeowners outside the high risk areas. This subsidy for homeowners in the WUI will act as any other subsidy will by tilting (ever so slightly) the economics in favor of those living in the WUI.

Finding the balance between individual responsibility (i.e., paying higher premiums and buying more insurance in high risk areas) and collective protection (i.e., spreading costs and raising premiums in low fire risk areas) is an inherently subjective endeavor. Any balance found is likely to clash with other difficult and important public policy issues, such as the availability and affordability of housing, planning and land use policy, protection of property rights, environmental protection, and climate change. Legislating in an area so interconnected greatly increases the likelihood of any policy change to generate unintended consequences – for example, retaining or increasing subsidies for homeowners in high risk areas of the state will encourage continued development in places many environmentalists argue are not appropriate for this sort of development.

Policies that shift these losses, and the cost of bearing the risk of future losses, would create incentives that sometimes support and sometimes impinge on policies being pursued to address these other issues. For example, spreading the losses widely across homeowner's insurance policies and suppressing the cost of insurance in high fire-risk areas will reduce the cost of homeownership in those high risk areas, but increase it in low risk areas. While insurance is a relatively small portion of the total cost of owning a home, for those on the margins an added insurance cost may be the difference between affording a home or not. Assessing how strong an incentive this might present and how it interacts with other policies being pursued regarding further development in the WUI, and the absolute need to build more housing units is a complex and nuanced task. By the same token, pursuing a policy that focuses insurance costs more strongly in high fire risk areas creates the opposite incentives with no less complex and nuanced implications. Any significant policy proposal in this area is based (implicitly or explicitly) on a series of value judgments regarding the relative priority of competing policy priorities and conceptions of fairness. It must also contend with the structural limitations imposed on the Legislature by Proposition 103, which effectively precludes passing bills governing rate setting for property/casualty insurance. There is great risk that legislating extensive new rules for underwriting alone (without compensating changes in rate making) would significantly disrupt a homeowners' insurance market that is effectively serving the great majority of California homeowners.

The FAIR Plan was created as a temporary safety net for policyholders. The goal is to move these policy holders back into the admitted market, hence the creation of the clearinghouse. Numbers don't lie, if the FAIR Plan continues to see an increase in policies, this means something is amiss in the admitted market. The Legislature should identify and address the inadequacies in the admitted market otherwise we will continue down the path of making the FAIR Plan the insurer of first resort rather than the insurer of last resort.