March 1, 2023

To:
Honorable Lisa Calderon, Chair
Honorable Bill Essayli, Vice Chair
Members, Assembly Insurance Committee

RE: March 8, 2023, Assembly Insurance Committee Informational Hearing:
The California Fair Plan

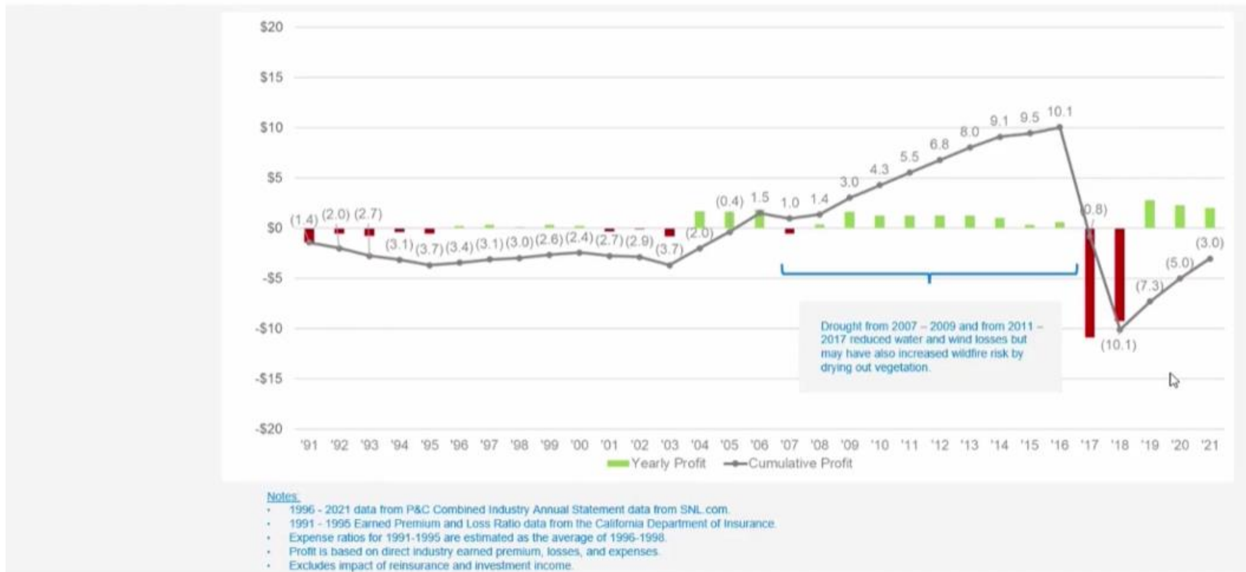
The Personal Insurance Federation of California (PIFC), the American Property Casualty Insurance Association (APCIA), the National Association of Mutual Insurance Companies (NAMIC), and the Pacific Association of Domestic Insurers (PADIC), collectively known as the "trades" respectfully submit these comments in connection with the Assembly Insurance Committee Informational Hearing regarding the *California FAIR Plan*. Collectively our members serve more than 90% of the homeowners' insurance market in California.

We greatly appreciate the Legislature's interest in this important issue and the opportunity to provide insights from the insurance industry's perspective. We believe that a healthy and competitive insurance market provides Californians a sense of security and peace of mind, encourages loss mitigation, increases overall prosperity, and makes people more aware of the reality of risks and their consequences through information and pricing signals.

The Source of the Problem

Of the 20 most destructive wildfires in California's recorded history, 13 have occurred since 2017. Together, these 13 fires caused tremendous damage, destroying nearly 40,000 structures, taking 148 lives, and charring millions of acres. In particular, the 2017 and 2018 wildfire seasons were the most destructive and costly in California history. As can be seen in the chart below, the losses from the 2017 and 2018 wildfire seasons wiped out nearly two times the combined underwriting profits for California homeowners' insurers for the prior 26 years –

putting California insurers' cumulative results at roughly $3 billion of losses in the years between 1991 and 2021.[1]



(Milliman 2023)

It is the nature of a catastrophe-prone line of business to have several profitable years with a few years of large losses. To attract capital to support insuring catastrophe prone properties, the expected gains must be adequate to absorb the occasional very large loss. Unfortunately, this has not been true for California property insurers since 2018 when loss expectations changed for the worse.

Several factors have led to the increase in severe wildfire events over the past few years. Climate change along with population shift toward the wildland-urban interface (WUI) areas have contributed to an increase in the impacts of wildfires. Fortunately, more focus is being placed on ways that consumers can prevent or mitigate damage to their homes when these events occur. Mitigation and prevention measures, both on an individual and community basis, have been shown to reduce wildfire risk. In fact, new *Mitigation in Rating Plans and Wildfire Risk Models* regulations were recently adopted by the California Department of Insurance (CDI) that require insurers to take specified mitigation actions into account for purposes of pricing and wildfire risk scores.

Additional Tools Needed

Commissioner Lara's administration has worked diligently to stabilize the homeowners' insurance market in California, especially with respect to wildfire. For example, the CDI has

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[1] Eric Xu, Cody Webb, David D. Evans. Wildfire catastrophe models could spark the chances California needs. *Milliman (2019).*

steadily approved homeowners rate filings that incentivize insurers to recognize the value of mitigation efforts taken by individual homeowners and communities – actions that have a positive impact on the health of the homeowners' market.

However, there are some challenges associated with the 35-year-old rules and regulations that were developed before the advent of climate change impacts, smartphones, or the internet, but still govern California's insurance market today. The core problem is that the current rules do not properly recognize the impact climate change poses to California properties, and they include elements that discourage insurers from increasing availability of coverage for properties in wildfire exposed areas. As these rules work against the broader policies that the Commissioner has been implementing, changes to these rules would significantly help fix what troubles the property insurance market.

Specifically, the California homeowners' insurance market has fallen into a capacity crisis due to a restricted ability to price wildfire risk and significant uncertainty regarding the approval of rate filings. As a result, many carriers who wish to serve California are instead reducing new business capacity and non-renewing wildfire-exposed properties because they cannot receive appropriate returns. Some carriers are leaving the California market altogether. Unfortunately, this capacity crisis is leaving some customers without access to traditional insurance coverage.

Pricing Restrictions

A major contributor to the capacity crisis is the challenge insurers face in generating an appropriate return for catastrophe-exposed properties. In particular, the current regulatory misalignments are related to the expected wildfire losses, the net cost of reinsurance, and generating an appropriate return on capital. The following pricing restrictions in California's regulations prevent insurers from expanding property insurance capacity for homeowners in wildfire-risk areas of California:

- *Net Cost of Reinsurance*

CCR §2644.25 restricts ratemaking to be on a direct basis with no consideration of reinsurance for homeowners' insurance. However, every insurer uses reinsurance to spread California wildfire risk around the globe. California's current pricing rules create a fiction that homeowners' insurers do not use reinsurance. This is inconsistent with existing rules that recognize the usage of reinsurance in other catastrophic classes of business. For instance, the California Earthquake Authority (CEA) is allowed to build its rates with recognition of its actual reinsurance costs. This unequal treatment for homeowners' insurers does not make sense, creates a mismatch between actual costs and permitted rates, and contributes greatly to the current market crisis.

The cost of capital to spread risk has climbed significantly following natural catastrophe losses in recent years. Insurers are facing higher reinsurance prices for less coverage, increased retention, and tighter terms. Market analysts have noted *"[t]he last time we saw this level of capital dislocation was during the 2008-2009 global financial crisis. At the same time, the sector is experiencing its most acute, cyclical price increases since the 2001-2006 period if not before."* The global rate-on-line index, which tracks the year-over-year change in price for reinsurance, rose an average of 37% - the largest year-over-year increase since 1992. Data has indicated reinsurance rate increases in the U.S. ranged from 15% to 25% for programs that are loss-free and not exposed to catastrophes, and up to 45% to 100% for programs with catastrophe loss histories.

Reinsurance cost increases are creating significant pressure on property insurers across the U.S. However, these impacts are significantly amplified in California since the net cost of reinsurance is not a permitted expense in the California prior approval regulations, and reinsurance must be paid for from allowable profits or else the insurer will non-renew the riskiest properties in its portfolio to reduce its reinsurance costs.

Doing without reinsurance reduces an insurer's ability to spread risk and provide insurance coverage to more wildfire exposed properties. Reinsurance is capital that supports additional homeowners' writings, and the homeowners that would otherwise be non-renewed are direct beneficiaries of that reinsurance capital.

Additionally, financial strength, and related financial ratings such as A.M. Best, are important because insurance at its core is a promise to make the insured whole after a loss. The insured is injured if the insurer's assets fall short of the amount needed to keep that promise. Additionally, if financial strength ratings drop below the minimum threshold, the insurer may be barred from insuring properties with federally backed mortgages, which could have serious implications for California's real estate market and consumers more broadly.

- *Use of Wildfire Catastrophe Models*

CCR §2644.5 makes it is illegal to include climate change projections in catastrophic fire insurance rates and insurers must estimate their future losses using the average historic losses for the past 20 years, which does not reflect the extensive housing growth in high-risk regions, or increased fuel load following years of drought and fire suppression strategies. Understandably, it is unlikely insurers will rush into a high-risk area to sustain huge losses, in hopes of higher rates down the road. The only exception is "fire following earthquake" losses which can be priced using catastrophe models (*CCR §2644.4*).

This disparate treatment does not make sense and is inconsistent with the actions of policymakers to ensure that climate change is adequately incorporated into the planning and financial preparedness of government agents and other stakeholders. Similarly, wildfire catastrophe models help insurers quantify the financial impact of potential future disasters by informing where future events are likely to occur and how intense they are likely to be. Similar to actions taken by the state, such climate impacts must also be reflected in insurance ratemaking for wildfire through predictive modeling.

To help illustrate these concerns, research has shown climate change intensifies the effects of droughts, as environmental conditions are hotter than they might've been just a few decades ago, which draws more moisture out of soils and vegetation, thereby worsening the drought in a positive feedback loop. This has contributed to wildfires igniting more easily and spreading more rapidly. Additionally, researchers have found climate warming has diminished the 'high-elevation flammability barrier' – the point where forests historically were too wet to burn regularly because of the lingering presence of snow. Over three decades (1984-2017), researchers found fires have advanced 252 meters uphill in Western mountains, or roughly 800 feet in elevation – which places more foothill communities throughout the state at higher risk of wildfire.

The impacts of climate change in California are increasingly apparent (e.g., drought, floods, wildfire, mudslides, hundreds of millions of dead and dying trees), and have resulted in eight of the ten costliest insured wildfire events in the world having occurred in California since 2017. Climate change is a consistent topic of policymaking in the legislature, yet insurers are required

to ignore future climate change impacts for purposes of estimating future losses to ensure fair and adequate insurance rates.

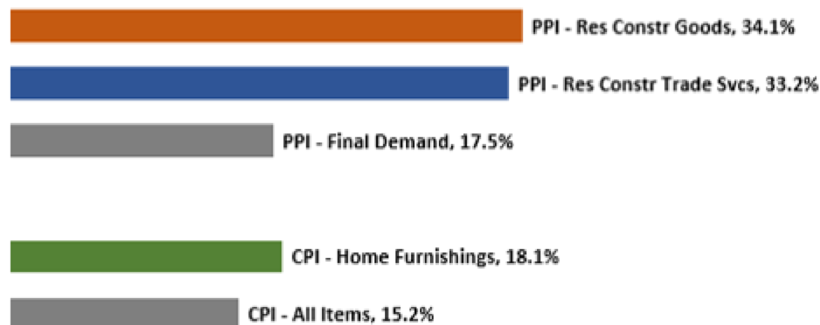
It should also be noted that California is the only state that does not allow for consideration of reinsurance costs in ratemaking and requires historical data to determine catastrophe losses as opposed to modeled data. These restrictions, which pre-date the current Insurance Commissioner, are no longer adequate to meet California's needs because they do not appropriately measure the increasing catastrophe risk. According to the most recent National Association of Insurance Commissioners (NAIC) data, the average premium in California is still about 40% lower than other states with a high risk for catastrophic events, such as Florida, Louisiana, and Texas, which underscores concerns raised by insurers of constraints in managing increasing exposure and costs.

Inflation

Significant increases in costs due to inflation also continue to be a top insurance industry challenge. Inflation and supply chain delays have substantially increased the costs and timeframes needed to rebuild homes and repair cars. Insurance claims inflation inputs like materials and labor prices, which are especially relevant to home repair and rebuilding costs, remain higher than the Consumer Price Index that measures the average change in prices paid by urban consumers for a basket of goods and services.

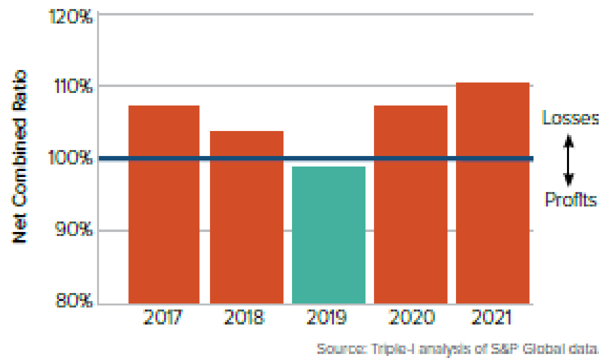
Cost Indicators, Home Insurance

Price Index Changes, Jan 2020 through Dec 2022

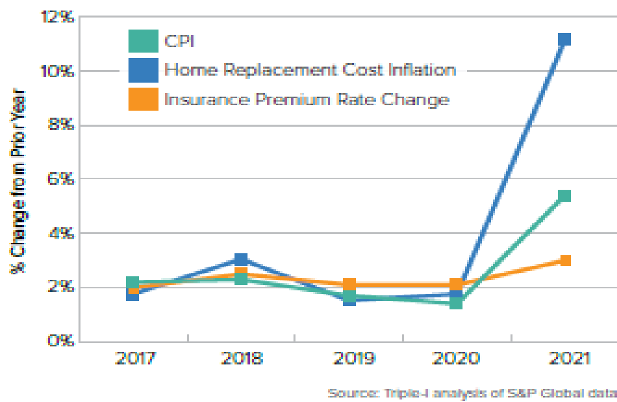


Source: U.S. Bureau of Labor Statistics | fred.stlouisfed.org (data ending Dec 2022)
Producer Price Index by Commodity: Inputs to Industries: Net Inputs to Single Family Residential Construction, Services and Goods.
Data not seasonally adjusted. Data as of Jan 18, 2023.

Any business needs to make a reasonable profit. Insurers' underwriting profitability is measured by a "combined ratio", which is calculated by dividing the sum of claim-related losses and expenses by earned premium. A combined ratio under 100 percent indicates a profit. A ratio above 100 percent indicates a loss. The charts below show how unprofitable homeowners' coverage has been for insurers in recent years and compare homeowners' insurance premium rate changes with CPI and home replacement cost inflation.



Long-term maintenance of an unprofitable product line is not a sustainable business model. When insurers cannot reflect the current cost of losses through premium increases, these costs must be paid from their policyholder surplus – funds that insurers are required to maintain to keep their promises to pay future claims. When policyholder surplus approaches defined regulatory thresholds, insurers must raise rates, reduce exposure, or risk insolvency.



As recent trends, such as inflation, climate impacts and population shift into disaster prone locales, predate the pandemic and are unlikely to go away, homeowners' insurance premium rates will need to keep pace with the change in costs in the years ahead.

FAIR Plan Impacts

Given the challenges insurers face in California in generating appropriate returns for catastrophe-exposed properties, many have made choices that make it difficult for customers to find coverage in the admitted market. Therefore, they must seek coverage in the California FAIR Plan Association (FAIR Plan), which was established in 1968 following the riots and brush fires of the 1960s. Currently, the FAIR Plan provides access to basic property coverage when it is needed, ensuring that all Californians, including those who live in areas threatened by wildfire, have access to fire coverage.

We are sensitive to the fact that more Californians have turned to the FAIR Plan as wildfires have devastated California and some insurers have pulled back from these markets. However, it is very important to remember that, unlike traditional insurers, the goal of the FAIR Plan is attrition not growth. For most homeowners, the FAIR Plan is intended to be a temporary safety net – there to support them until coverage offered by a traditional carrier becomes available.

The FAIR Plan is a syndicated fire insurance pool comprised of all insurers licensed to conduct property/casualty business in California. The FAIR Plan is not a state agency, nor is it a public entity. There is no public or taxpayer funding. All private insurance companies licensed to write fire, allied lines, homeowners, commercial multi-peril, and earthquake coverages are required to participate in the FAIR Plan and share in any profits and losses. Thus, it is a mechanism to

spread risk, premiums, losses, and expenses among the participating insurers. In short, if the FAIR Plan does not collect sufficient premiums to cover losses resulting from insufficient premiums or catastrophes, admitted market insurers are assessed to fund liquidity needs and cover those losses.

FAIR Plan Financial Stability

There are significant concerns regarding the financial stability of the FAIR Plan at its current rate levels. The FAIR Plan's total insured value (TIV) has increased from $50 billion in 2018 to over $240 billion in 2022. Over that time, inflation has significantly increased the replacement cost for fire damaged homes, yet FAIR Plan rates have not kept pace with the growing risks and potential obligations.

The September 30, 2021, audited financial statements indicated that the FAIR Plan had a $332.3 million accumulated deficit, which is the FAIR Plan's net capital position at that date. Additionally, a June 2022 CDI Operational Assessment Report indicated that when comparing the FAIR Plan's reinsurance coverage to that of other FAIR plans or residual market facilities of similar size, the FAIR Plan's reinsurance coverage is far lower, as follows:

Reinsurance Coverage	Policies-in-Force	Most Recent Reinsurance Year Return-Period in Years
FAIR Plan	***248,361***	***31***
Louisiana Citizens	39,871	302
North Carolina Joint Underwriting Association (JUA)	245,947	113
Texas FAIR Plan	66,792	100
Texas Windstorm	193,000	100
Average of Four Comparable Entities	136,380	154

With a low level of capital and liquidity, and reinsurance coverage that is far below that of similar entities, California insurers are increasingly concerned that they are exposed to an unlimited assessment to fund FAIR Plan losses that could be in the billions of dollars.

The California Insurance Guarantee Association (CIGA) can also assess insurers to pay covered claims and expenses of insolvent member insurers. However, CIGA statute (INS §1063.14) requires insurers to recoup any assessment through a policyholder premium surcharge and limits the assessment to one percent of written premiums for any category of covered claims.

Unfortunately, the FAIR Plan statute provides no such recoupment requirement. Therefore, there is no assurance that the cost of an assessment would be socialized among policyholders even if the assessment jeopardizes the solvency of the insurer.

Understanding that the FAIR Plan assessment is based on an insurers market share, it is reasonable to expect insurers to reduce their exposure to this unfunded risk by further pulling back from the California market. Additionally, the ability to treat the assessment on admitted market companies as a form of free reinsurance for the FAIR Plan becomes yet another shift of risk and cost from high-risk homeowners to those in low-risk areas and encourages population shifts into sensitive WUI areas. Thus, an unvirtuous cycle continues until the insurance market cannot bear it.

FAIR Plan Commercial Coverage

The Legislature and CDI have also raised significant concerns about the tightening market for condominium insurance, which is an issue across the U.S. but particularly in California. It is our understanding that there are several issues beyond the obvious wildfire risk that are contributing to this situation.

For example, many condominiums developments were built in the 1980's and 1990's before the imposition of the updated Chapter 7A wildfire building codes, which means they are not properly mitigated against wildfire-risk. In addition, after the Surfside condominium collapse in Florida, much more attention has been focused on the role played by the boards of the homeowner's associations (HOAs). To secure or maintain an HOA seat, board candidates/members often oppose increasing dues to fund needed maintenance because they do not want to upset unit owners who dislike paying higher HOA costs. Thus, condominiums are an increasingly risky exposure for insurers due to inadequate maintenance. This is forcing more master policy coverage into the surplus lines insurance market, which provides greater flexibility to demand mitigation and set an appropriate price for the risk.

To provide temporary relief for HOAs that are struggling with insurance challenges, a group of legislators recently requested the Insurance Commissioner to use his authority to order the FAIR Plan to expand the coverage limits for its Division I Commercial Property Program to at least *$20 million per structure* from the current level of *$8.4 million for the entire development*. This means that a development with five structures would have $100 million of FAIR Plan coverage as opposed to $8.4 million under the current limits, which is a huge increase in risk.

We understand the desire to "do something" to address rising complaints from constituents who need relief, and we greatly appreciate the recognition that such a move would only be a temporary solution that must be paired with other statewide efforts to reduce risk and increase the availability insurance in the traditional marketplace. However, in the absence of commensurate rate increases, further expanding FAIR Plan business would dramatically increase FAIR Plan risks and financial vulnerability and force insurers to make difficult decisions about their current portfolios to manage their assessment exposure.

Hopefully, we can agree that the solutions outlined below provide a more comprehensive and durable solution to our shared market crisis problems.

Opportunities to Restore a Healthy and Competitive Insurance Market

Despite the numerous challenges identified above, we believe that in partnership with the CDI and the Legislature there is an effective path forward to restore the admitted market and increase insurance availability, reliability, and sustainability in high fire-threat areas of California.

- ***Ensure Prices Reflect Risk***. The current capacity crisis is due to a restricted ability to price wildfire risk and significant uncertainty regarding the approval of rate filings. We can address this challenge by updating California's existing rules to better ensure prices reflect risk by allowing for:

    1) *The net cost of reinsurance*. Reinsurance is capital that is used to support additional property business without reducing the financial security of the insurer. The ability to recoup the net cost of a reinsurance program allows the insurer to maintain or even expand the number of policies they write.

    2) *Modern climate catastrophe models.* Instead of looking backwards, catastrophe models draw from fields like atmospheric science, environmental science, actuarial science, and engineering to forecast climate-induced risks. Catastrophe models are generally relied upon in other states as the best available science to measure risk for a variety of catastrophic perils such as hurricanes, floods, winter storms, earthquakes, and wildfires.

    3) *Increased rate filing predictability.* Process improvements that provide greater certainty about the outcome of the rate filing process would increase insurers confidence in the California market and spur the investment of time and capital necessary to sustain and grow insurance availability.

- ***Protect FAIR Plan***. The current FAIR Plan financial structure is not sustainable and incentivizes insurers to further pull back from the market. As the FAIR Plan grows and insurers must manage their exposure to an unlimited assessment, the unvirtuous cycle could spiral into a major market crisis beyond just the wildfire areas of the state. To address these concerns, we wish to work with the Legislature and CDI to accomplish the following:

    1) *Improve FAIR Plan operations*. The FAIR Plan should be properly resourced to provide great customer service, be responsive to CDI concerns, and remain financially strong enough to keep the promise to make the insured whole after a loss.

    2) *Require recoupment of assessment.* Following the CIGA model would provide greater confidence that insurers will be able to recover from a massive FAIR Plan assessment event that might otherwise jeopardize their solvency or financial strength ratings, which could broadly undermine both the insurance and housing markets.

<u>Conclusion</u>

The insurance industry is keenly aware of the market challenges our policyholders and your constituents face. We look forward to good faith discussions, among all stakeholders, that can lead to a healthy and competitive insurance market with greater insurance availability, reliability, and sustainability for all Californians.

The FAIR Plan plays a vital role in California's insurance market as the "insurer of last resort." However, the goal should be to reduce the number of policies in the FAIR Plan not grow it by expanding coverages and policy limits. Further expansion of the FAIR Plan could worsen its current financial challenges and result in the unintended consequence of pushing traditional

insurers to reduce their potential FAIR Plan assessment by decreasing the number of policies they write.

Rather than grow the FAIR Plan, we should pursue opportunities to increase the health of the traditional insurance market. With the inclusion of wildfire catastrophe models and reinsurance costs, insurers could materially re-enter the market and greatly increase insurance availability in wildfire-exposed areas and would be able to help depopulate the FAIR plan once adequate rates are approved.

These reforms to modernize California's rules and regulations would promote increased competition within the California homeowners market. However, without enhancements necessary to achieve appropriate returns, insurers will increasingly be forced to evaluate their participation and capacity in the market. This would likely involve greater consideration of non-renewals or, in some cases, the full withdrawal of their property lines from the California market. This is an outcome we strongly wish to avoid.

Thank you,

The Trades

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