CALIFORNIA EARTHQUAKE AUTHORITY
GOVERNING BOARD MEETING
MINUTES

Thursday, October 27, 2011
1:00 p.m.

Location: CalSTRS Headquarters Building
Board Room
100 Waterfront Place
West Sacramento, California

Members of the Governing Board in attendance:
Pedro Reyes, designee of Governor Jerry Brown
Grant Boyken, designee of State Treasurer Bill Lockyer
Reid McClaran, designee of Insurance Commissioner Dave Jones
Chris Schultz, designee of Insurance Commissioner Dave Jones
Deborah Doty, designee of Speaker of the Assembly John Pérez
Dietrich Stroeh, designee of Chair of the Senate Rules Committee Darrell Steinberg

Members of the CEA Staff in attendance:
Glenn Pomeroy, Chief Executive Officer
Tim Richison, Chief Financial Officer
Bob Stewart, Chief Operations Officer
Chris Nance, Chief Communications Officer
Shawna Ackerman, Chief Actuary
Janiele Maffei, Chief Mitigation Officer
Susan Pitton, Governing Board and Advisory Panel Liaison
Aeky Summerell, Senior Counsel

Also present:
John Forney, Raymond James, Inc. (Independent Financial Advisor to CEA)
Marc Gallo, PricewaterhouseCoopers

1. **The meeting was called to order at 1:00 p.m. A quorum was established.**

2. **Consideration and approval of the minutes of the August 25, 2011, and October 7, 2011, Governing Board meetings.**

   MOTION: Mr. Boyken moved approval of the August 25, 2011, and October 7, 2011, Governing Board minutes; seconded by Mr. McClaran. Motion passed unanimously.

3. **Executive Report by Chief Executive Officer Glenn Pomeroy; assisted by CEA executive staff, Mr. Pomeroy's report will include an update for the Board on federal and state legislative activities of interest to the CEA.**

- Mr. Pomeroy began by noting the devastating earthquake that had recently occurred in Turkey, with a death toll standing at 500. Turkey has a public earthquake-insurance program, but in eastern Turkey—the epicenter's location—the take-up rate was reported as very low—roughly between 2% and 10%. In addition to the loss of human life, the economic loss will be substantial.

- Recent, more minor earthquakes in Berkeley and Truckee serve to remind us that we live every day in earthquake country.

- Mr. Pomeroy recognized CEA Chief Financial Officer Tim Richison for his having put in place a CEA reinsurance program for 2012. Mr. Pomeroy noted that Mr. Richison had met the challenge of devising a program that CEA could afford, and which also represented good value for policyholders. Mr. Pomeroy said Mr. Richison is one of the global experts in the management and understanding of earthquake risk transfer. Mr. Pomeroy also thanked the broker team for their assistance to CEA staff and the reinsurers from around the world that provide the CEA with reinsurance capacity.

- CEA staff is pursuing federal legislation—the Earthquake Insurance Affordability Act—which would allow the CEA to replace certain portions of its risk-transfer layers with the certainty of a committed federal guarantee that CEA could borrow stated amounts in the private debt markets, post-earthquake and only if needed. Mr. Pomeroy emphasized that CEA's efforts in support of the EIAA translate to any negative feelings towards the reinsurance industry—to the contrary, the CEA simply needs to acquire additional sources of risk transfer and financing, and prudently diversify its risk-transfer portfolio to expand its program and make its coverage more available to more Californians.

  Senators Feinstein and Boxer introduced Senate Bill 637 in the Senate, thus introducing the concept of the EIAA. An identical bill has now been introduced in the House of Representatives by (Southern California) Representative John Campbell, with co-sponsors Rep. Jerry Lewis and Rep. Ken Calvert. It is a bipartisan measure, which itself is welcome in the present political climate.

  The official list of EIAA supporters has grown since the last CEA Board meeting: It now includes the Automobile Club of Southern California, as well as the American Red Cross, the California Association of Realtors, the Mayor of Oakland, and many more.

- The Department of Insurance ("CDI") has approved a number of changes to CEA's policy forms, which will go into effect in 2012—changes include an overall, statewide rate reduction of 12½%, to take effect January 1, 2012. This morning the CDI communicated that the second piece of the CEA's rate and form filing—the Homeowners Choice product implementation—now has an official implementation date of July 1, 2012.

- The present phase of the IS improvement project continues to move towards its conclusion. Operational control testing has now been completed. The project is gearing up towards a final report to the CEA's external auditor, whose findings spawned the project.

- The CEA is beginning an effort to reach out to the CEA participating insurer ("PI") community to improve CEA-PI communication. CEA will sponsor and present an informational webinar every other month for all PIs who are interested. The first meeting was held successfully in September, with 65 attendees—the webinar was in session for two hours.

- The existing resolution, delegating various measures of authority to the CEA chief executive officer ("CEO"), makes clear that the Board can delegate to the CEO the duty of annual performance evaluations for the CEA's contract employees. But the practice of Board-members' involvement in conducting or approving each performance evaluation persists. Mr. Pomeroy asked the Board whether it would be comfortable confirming a clear-cut delegation to the CEO of authority for this task, and if so, whether the Board would be comfortable adding to the delegation of authority evaluations by the CEO of the new positions of Chief Actuary, Chief Mitigation Officer, and Insurance Director.

  Mr. Boyken said the Treasurer would support this step and asked that the CEA report in open session the salary, merit adjustment, and COLA of each of the non-civil-service employees. Mr. Pomeroy agreed to accomplish this.

  Mr. McClaran also assented, commenting that this task would be appropriate for the CEO, who deals with the other members of the executive team on a daily basis whereas the Board does not.

  MOTION: Mr. Boyken moved to reaffirm that the Board would follow the existing resolution delegating certain authority to the CEO, thereby confirming that the CEO would be responsible for all contract employees' periodic evaluations and contract-supported salary adjustments, and that the all, including the newest, contract employees be included in this sense of the Board. Mr. Reyes seconded. Motion carried unanimously.

- Mr. Pomeroy announced that Bruce Patton would be joining the CEA team as full-time Director of Policy Research and Special Projects.

4. Chief Financial Officer Tim Richison will present a financial report.

- Mr. Richison stated that as of the end of August 2011, the CEA's available capital to pay policyholder claims was over $3.9 billion; actual cash and investments at the same date were over $4.4 billion.

- Total CEA claim-paying capacity as of the end of August 2011 was $9.658 million, made up of available capital, risk transfer, revenue bonds, and the available post-event PI assessments.

- For 2011, CEA staff intended that by year-end 2011, CEA expenditures would be within 95% utilization of the budget, but it now appears that expenditures might be more like 85%. Several things did not happen that it was thought would occur:

  - Planned hiring did not occur.

  - Amounts allocated for a large data-management contract had not been adjusted, pre-budget, to a more appropriate level, so expenditures in that category through 2011 will appear artificially low.

  - On account of the diligence and skills of Chief Operating Officer Bob Stewart, the new lease agreement for CEA office space contained several favorable tenant-improvement and furniture allowances, which netted funds for the CEA—those amounts so credited also served to reduce CEA expenditures on rent and related things, thereby lowering budgeted expenditures.

- For the rolling twelve-month investment return we are higher than we have been for the last two years. We are trying our best, within the confines of the statutory guidelines that govern our investments, to achieve as much return as possible. About 98-99% of our investments are in U.S. treasuries, which are a fairly safe investment.

- Mr. Richison acknowledged the CEA's contracted investment managers for their hard work in trying to find legitimate extra basis points on investment return.

5. **John Forney, Managing Director, Public Finance, for Raymond James, Inc., the CEA's independent financial advisor, will brief the Board on the current state of the financial markets.**

- Mr. Forney commented that in 2011 in the financial markets, we had many weeks in which a decade's worth of events happened.

1. **Economic overview.**

First came the debt-ceiling crisis, and the Treasury did not default. Then, in August, the debt ceiling was raised again.

The forecasted federal-budget deficit for this year of 10% or so of GDP is the highest since World War II.

Mr. Forney said that the Europe's debt crisis is as much a crisis of political structure as of financial structure: for example, how can a small country like Greece, with 11 million people, threaten the very foundation of the world economy? If the European Union were a real union with cross-collateralization across countries such as we have under the federal system of the United States, there wouldn't be a debt crisis in Europe.

Regarding the consumer-confidence crisis, conventional wisdom says we're in the midst of a long-term economic malaise, but the overwhelming body of historical data would suggest that's not true. Mr. Forney said he believed that productivity and innovation would continue.

2. **Financial-market overview.**

Mr. Forney displayed a chart of U.S. equities performance, showing that U.S. equity markets have returned approximately zero in the last 10 years.

The European debt crisis, with its major effect on U.S. markets, is costing us all money.

Mr. Forney showed a chart showing bond issuance year by year, divided into the various sectors of government, corporate, asset-backed, and mortgage-backed. It showed that bond markets have really not suffered throughout the period shown.

Mr. Forney displayed charts showing the municipal-bond market, which is where the CEA's debt would be issued, whether or not the CEA issues taxable debt. This market has been characterized by stability in the last five years.

Even with the budget and economic troubles in the state of California, the states have very good access to the markets, as do municipalities and other local governments in California. Access to municipal bond markets is not a serious concern.

The federal-funds interest rate reached an all-time low in 2008 when it went to 25 basis points. Other categories – 10-year treasury, two-year treasury, and 10-year MMD (a municipal index) –

reached all-time lows this year. The Federal Reserve says it will continue at current rates through 2013.

3. Insurance market overview.

There is good news, that all rating agencies currently rate both the reinsurance industry and the insurance industry as stable. The insurance industry is characterized by strong capitalization, but with that much capital, investors expect to earn a return—the returns have to come through premiums or investment returns.

Insurance and reinsurance companies rely largely on investment returns for their income. When investment returns are as low as they are today, the only other income factor they have is premiums, which puts upward pressure on premiums. And there has been much stress through catastrophe losses around the world that has to be made up as well.

All insurers and reinsurers use models to predict future losses. Those models can change dramatically (most often related to hurricane, not earthquake).

With all this capital and all this pressure on returns in that capital, it means the equity markets are very negative on the value of the companies that ply their trade in these markets, especially those exposed to catastrophe risk.

The shares of major publicly traded reinsurers are currently priced well below book value at 77%. The insurance companies want to continue to operate and write business, but these low valuations put pressure on them to do something for shareholders to bring the values back up—this can include buying back stock, merging, or raising premiums, but companies going undervalued at these kinds of levels are not sustainable.

- The CEA is in many ways the gold standard of state-sponsored catastrophe insurance providers. Its operating model could be described as dynamically conservative and analytical.

- Its investment policy is appropriately conservative. We wish there were more than $22 million of income on the financial statements on a $4 billion portfolio. But the return for the CEA is not the motive – liquidity and being able to pay claims in a timely manner are the motives. [The Raymond James firm] has worked with Mr. Richison and the seven investment managers this year, within the confines of the investment policy, to get the returns appropriately up a bit.

- Risk transfer means one thing for the CEA: to diversify sources of risk transfer, both among reinsurers and across sources of reinsurance and risk transfer. The CEA's recent transformer deal was a huge step forward and opened up a whole new market of diversified source of risk transfer, enhancing the CEA's sustainability.

- Even with increasing sustainability, the need for diversification, buildup of capital, a significant amount of reinsurance and assessments on insurers, the reinsurer scenario exists with its pressure on capitalization and the equity markets. The CEA must push for things like the bill, now called the EIAA, in Washington—it would not only reduce the cost of earthquake insurance to consumers in California, but it would provide another, welcome source of risk transfer and capital.

- A potential increase in selective use of revenue bonds would also be good for diversification and sustainability.

Mr. Boyken inquired about "tweaking" the portfolio. Mr. Forney described modernizing the investment policy. This would involve consideration of introduction of agencies in addition to treasuries in some of the portfolios, and also the ability to use money market funds for overnight sweeps. Mr. Reyes noted that the CEA's statutory limitations cause it to remain conservative.

Mr. Richison added that under Governmental Code 16430, the CEA is not allowed to use money markets. That forces the CEA to very careful about having any extra cash left over at the end of a day. As much as possible, the investment manager must make investments in lots. That also puts pressure on the amount of available return.

6. Mr. Richison will present for Board approval the CEA's proposed 2012 risk-transfer program.

- Mr. Richison showed the CEA's projected financial structure and claim-paying capacity for 2012. The risk transfer of $3.12 billion is the amount indicated for CEA to have available at the beginning of 2012.

- Staff has gone into the reinsurance marketplace and obtained commitments for reinsurance for 2012.

- A portion of CEA's reinsurance program expires at the end of December 2011, and the remaining reinsurance expires at the end of March 2012. Different expiration dates were purposely put in place so the entire CEA reinsurance program wouldn't require renewal at one time.

- Mr. Richison thanked reinsurance brokers Aon Benfield (Ralph Flum), Guy Carpenter (Andrew Bossom), and Willis Re (Doug May and Simon David) for their hard work in obtaining CEA's reinsurance.

- In the past, CEA had always secured reinsurance on a "lead-follow" market basis—on that basis, CEA would construct a reinsurance program and ask reinsurers to price it. This year, however, CEA changed tactics and linked CEA-determined, appropriate pricing with the reinsurance program needs—CEA then asked the reinsurance marketplace for authorizations for that program.

  CEA eventually changed the program and modified the pricing, slightly, because many reinsurers had changed their internal models and now look at catastrophe reinsurance pricing differently.

- The placements were geared toward the expiration of existing reinsurance cover, with proposed Program A to take effect on January 1, 2012. The brokers contacted 167 reinsurers worldwide, in 26 countries—the result was 33 reinsurers committed on Program A.

- Program A is broken into two components: traditional reinsurance and transformer reinsurance. The first components were four 12-month contracts, representing a total reinsurance limit of $1.505 billion and an average rate online of 7.13%. The total annual premium for the four contracts is just over $100 million.

  The second component of the program is the transformer reinsurance. One three-year contract is currently in place, for a transformer-reinsurance limit of $150 million.

Staff will return to the Board at its December 2011 meeting to propose another transformer-reinsurance transaction, to take effect sometime on or after January 1, 2012.

The written board resolution contains the following:

- It shows the four different Program A reinsurance contracts; the written commitments from those contracts state reinsurance limits and rates online; the reinsurance premium totals $107 million.

- It supports and meets the financial structure staff presented to the Board at its August 2011 meeting.

- It provides specific findings and authorizations by the Board.

- It cites legal authorization.

Mr. McClaran commented that the Board was encouraged by the diversification that was possible. The effect of that on the deals that Mr. Richison was able to work out by the transformer reinsurance initiative appears to have had an impact on how the CEA was able to do in the reinsurance markets.

Mr. Richison responded that they feel this mechanism is an excellent way to augment the claim-paying capacity of the CEA. If the CEA is to continue to grow, as everyone hopes it will, there must be enough suitable financing available.

Mr. Reyes confirmed with Mr. Richison that Section 5 commits the Board basically to explore possibilities. Mr. Reyes stated that he was very pleased with the proposal.

MOTION: Mr. Boyken moved to adopt the written Board resolution as drawn. Mr. McClaran seconded. Motion carried unanimously.

Item 2, to bring a recommendation to the Board at the December 2011 meeting, was incorporated in Section 5 of the Board resolution.

7. Chief Communications Officer Chris Nance will provide the Board with an update on the CEA's Marketing Value Program (MVP) and the statewide ShakeOut drill.

- Mr. Nance reported that agent training was up dramatically compared to past years. Ultimately, CEA is seeing 9,500-plus new policies sold through those agents who are participating in the program; this number is a subset of all new policies sold on behalf of CEA—it represents only those policies sold by agents participating in the program.

- From an agent perspective, 92% would recommend the CEA programming to their coworkers and colleagues. 95% want to participate in the future. Nearly half of those participating in the program report that it helps them in their work; it has increased the number of quotes and sales. Agents all like the preparedness kits that are furnished in connection with the program.

- Mr. Nance showed pictures of the direct mail pieces for the first, second, and third flights. Materials for each of the three flights were printed in Chinese, Spanish, and English.

- A key message and recurring theme in the direct mail piece was as follows:

"Preparing for the next damaging earthquake can help you survive and recover. With earthquake coverage from the CEA, you and your family will have the financial strength to get your life back to normal."

- The CEA's TV spot reinforces the message: strength to rebuild, getting back to normal.
- CEA has learned from social scientists that, in order to be effective, CEA must be "on message," all the time. One of the greatest challenges in the past has been to find that common message.
- Social scientists also have found that most people get their preparedness information from television news anchors and reporters. Mr. Nance showed the TV spots prepared for the Sacramento, San Francisco, Los Angeles, and San Diego television markets.
- There has also been a road show through a preparedness team, a sponsorship developed through Clear Channel radio.
- Mr. Nance gave an example of the CEA's role in the ShakeOut from an earned-media perspective. Over 8.6 million people participated in the ShakeOut this year. From a news and promotion perspective, the results are becoming more and more dynamic every year.
- CEA staff has developed a ShakeOut TV PSA (public-service announcement): "Preparing today so you can get back to normal sooner after the next big one shakes."
- Mr. Nance played a recording of a ShakeOut radio spot.
- We've moved from a blank canvas three years ago to a place today that has content rich in entertainment value and relevance to California, but it is also research-based in ways that work for the CEA, as well as for partners throughout local and state government, nonprofit organizations, community leaders, and even celebrities.
- The ShakeOut remains a program that is central to CEA's marketing its products. The data speaks for itself, not only through paid and earned media, but also through direct mail and community outreach.

8. Chief Mitigation Officer Janiele Maffei will provide the Board with an update on the CEA's mitigation programming, including its participation in the California Residential Mitigation Program.

- The California Residential Mitigation Program (CRMP) was launched on October 4, 2011, the date of the first meeting of the CRMP governing board. At the meeting, a number of matters of business operation were handled, including the appointment of Ms. Maffei as Executive Director and (CEA CFO) Tim Richison as (interim) Treasurer and Auditor.
- The CRMP Board authorized negotiating a contract for a CRMP program administrator, which will be responsible for managing the retrofit program for single-family houses.
- The next meeting of the CRMP board will be held in January 2012.

9. Chief Operations Officer Bob Stewart will report on the recruitment and proposed hire of an Insurance Director and will seek Board approval for CEO Glenn Pomeroy to execute an employment contract with the candidate on behalf of the CEA.

Mr. Stewart introduced Mitch Ziemer as the lead candidate for a new CEA employee position, Insurance Director. Mr. Ziemer is a 27-year veteran of the property/casualty insurance industry. He most recently served as the product manager for Fireman's Fund Insurance Company. Mr. Stewart supplied further details of Mr. Ziemer's background, including his involvement in information technology.

Mr. Stewart requested that the Board authorize Mr. Pomeroy to execute on behalf of the CEA an employment contract with Mr. Ziemer in a form approved by the CEA's general counsel.

MOTION: Mr. Boyken moved to accept staff's recommendation to authorize the hiring of Mr. Ziemer as Insurance Director; seconded by Mr. McClaran. Motion passed unanimously.

10. REVISED: Mr. Pomeroy, assisted by representatives from PricewaterhouseCoopers (PwC), will present PwC's report on the recently completed CEA organization and staffing analysis; and, Mr. Pomeroy will request the Board's authorization to negotiate and execute a contract amendment required for PwC to proceed with continuation of its work on recommendations requiring further study supported by PwC.

Mr. Pomeroy reported that the Board would receive an overview of the 132-page PwC report, which would allow the Board and the staff more time to review and digest the report. Staff intends to develop specific recommended action steps and present them at the December Board meeting.

Mr. Pomeroy gave a brief review of the growth of the CEA since its inception in 1996. The CEA envisions a time when, on behalf of the policyholders, it would be able to centralize policy processing, to do the policy-related work more efficiently with a single system rather than with multiple systems of the CEA PIs.

The current business model requires 17 different systems be updated when the CEA implements changes—it is inefficient, ineffective, and costly.

The CEA is seeking to find a more efficient business model going forward. To that end, the Board approved a top-to-bottom organization staffing analysis by outside consultant PwC.

Mr. Marc Gallo, PwC lead consultant, summarized the report as follows.

- There were three primary objectives with which the project had begun.

  1. Determine a baseline for the current CEA organizational structure and compare that to industry-leading organizations, thereby identifying opportunities for improvement.

  2. Deliver a record that provides results of the analysis and recommendations that define a multi-functional insurance organization and its appropriate structure.

  3. Collaborate with CEA staff to develop the strategy and a tactical plan that looks forward three to five years.

- PwC consultants found that they needed to do both firsthand and secondhand research. They were on site at the CEA for roughly a two-month period, gathering information and working with the team. They also met with the CEA executives.

- The consultants conducted interviews with a wide range of key CEA stakeholders, reviewed a large volume of documentation, talked to a number of people in CEA's peer group, reviewed the statutory and regulatory environment, and reviewed publicly available information such as meeting minutes.

- The consultants examined CEA's current environment and organizational structure.

- They grouped their findings and observations into a number of categories. Since one of the focuses of the project was around human capital, they looked at their observations in terms of staffing and the executive team.

- They founded the body of observations around "knowledge capital," the financial environment, statutory and regulatory considerations, executive oversight, the relationship with participating insurers, products, IT services, and data management.

- In forming its recommendations, they met with the executive team and examined the mission statement. They were impressed by the goal of protecting more homes and providing California homeowners with the strength to rebuild.

- Mr. Gallo displayed a chart showing the recommended new structure. Potentially the CEA would have direct contact with policyholders and agents, while continuing its work with the participating insurers.

- Of the 20 blanket recommendations, the consultants grouped their thoughts into three different categories: "quick hits," new business model, and the Governing Board.

- The report gives cost-impact estimates in four ranges: from $0.00 to $100,000, from $100,000 to $500,000, from $500,000 to $1 million, and over $1 million. Nonetheless, not every recommendation requires the CEA to spend money.

- With the CEA's latest rate decrease coming up in 2012, the 17 participating insurers need to make changes to their operations, IT systems, and platforms. That is a $400,000-$700,000 effort for each insurer.

  There are a number of common functions – policy administration, policy issuance, billing, etc. – that need to be performed in order to write earthquake insurance. The consultants suggested pulling those common functions into a central location.

- The third party administrator activity could be done within CEA, or it could be contracted to a third party.

- The other 19 recommendations suggest a path, challenges, advantages, disadvantages, and cost estimates.

- The important aspect of the organizational chart is for the CEA executive team to find, acquire, and train employees.

- The organizational chart recommended hiring a Chief Information Officer and employees to strengthen functional expertise.

Mr. Boyken pointed out that the survey section held disagreement in the results for Executive Staff versus Governing Board, and in many cases Governing Board versus participating insurers. He felt that going forward there is the need to have more of a dialogue about these points.

Mr. Boyken also stated that for many of the specific recommendations, the Treasurer wanted to make sure that, to the extent possible, staffing, governing, and contracting should look like a publicly managed organization.

The Treasurer's Office agreed that the 25-person cap on civil service employees doesn't make much sense, and would like to look at removing it. The Treasurer agrees with the idea of looking at centralizing some of the common functions.

On the governing issue, the Treasurer's Office agrees that expanding the number of voting members on the Board is a good idea. The Treasurer feels that it would be inappropriate to have sitting Board members choosing compensated Board members. Compensation for service on State Boards is much more the exception than the norm.

If the Board expands its numbers to two Board Members from the Assembly and the Senate, those candidates should meet certain qualifications of requirements.

The CEO's delegation and the powers reserved for the Board need to be specified, so that the CEO is accountable to the extent that the CEO should be.

Mr. McClaran commented that there was fairly broad agreement with the goals and general things that need to be accomplished, but less agreement with regard to how exactly to do it.

Mr. Reyes agreed completely with the points regarding staff. In terms of representation, he agreed that compensating Board Members would be an issue for the CEA's nonprofit status.

Mr. Stroeh commented regarding governance on the Board that it doesn't seem to make sense to have a five-person Board where two of the members are not able to vote.

The Board Members discussed the staffing cap of the CEA and its tax-exempt status, and the possibility of writing another legislative bill.

11. Staff will present for Board consideration and approval a proposed 2012 Governing Board meeting calendar.

MOTION: Mr. McClaran moved to approve the proposed calendar; seconded by Mr. Boyken. Motion passed unanimously.

12. The Board will meet in closed session to discuss personnel matters and litigation matters, as permitted by California Government Code section 11126, subdivisions (a) and (e), respectively.

The Board entered closed session at 3:04 p.m. and resumed its proceedings in open session at 3:27 p.m. The Board had nothing to report.

13. Public comment on items that do not appear on this agenda and public requests that those matters be placed on a future agenda.

There was no public comment.

14. Adjournment.

The meeting was adjourned at 3:27 p.m.