CALIFORNIA EARTHQUAKE AUTHORITY
GOVERNING BOARD MEETING
MINUTES

Thursday, December 9, 2010
1:00 P.M.

Location: Joe Serna, Jr., Cal/EPA Headquarters Building
1001 I Street, Sierra Hearing Room
Sacramento, California

Members of the Governing Board in attendance:
J. Clark Kelso, designee of Governor Arnold Schwarzenegger
Grant Boyken, designee of State Treasurer Bill Lockyer
Peter Conlin, designee of Insurance Commissioner Steve Poizner
Dietrich Stroeh, designee of Chair of the Senate Rules Committee Darrell Steinberg

Members of the CEA Staff in attendance:
Glenn Pomeroy, Chief Executive Officer (via teleconference)
Tim Richison, Chief Financial Officer
Bob Stewart, Chief Operations Officer
Chris Nance, Director, Communications and External Affairs
Shawna Ackerman, Chief Actuary
Michael Melavic, Director, Information Services
Susan Pitton, Governing Board and Advisory Panel Liaison
Danny Marshall, General Counsel

Also Present:
Tony Samer, Protiviti, Inc.
David Zocchetti, Chief Counsel and Legislative Director, California Emergency Management Agency

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 October 28, 2010, Governing Board meeting.**

   MOTION: Mr. Boyken moved approval of the October 28, 2010, Governing Board minutes; seconded by Mr. Conlin. Motion passed unanimously.

3. Chief Executive Officer Glenn Pomeroy will present an executive report.

Mr. Pomeroy reported on a recent trip that a team from CEA took in November to New Zealand. On September 4, 2010, the city of Christchurch was rocked by a magnitude 7.1 earthquake. Property damage was horrific, but the city experienced no loss of life. The CEA team met with national and local officials and NZ insurance-industry personnel to learn how the community was managing the situation.

In New Zealand, homeowners policies include earthquake coverage from NZ's Earthquake Commission (EQC). The EQC's coverage is limited, up to about $100,000. It is extremely affordable at about $50/year.

The EQC has a small staff, and with no connection with New Zealand insurance companies and their professional staffs, had to build up an adjusting force quickly to deal with more than 150,000 claims. EQC had decided very early in the adjusting process to undertake actual reconstruction rather than writing checks for damage.

A huge amount of the damage in Christchurch was caused by liquefaction. There was also classic "X damage," in which an entire building goes one way and then the other, literally producing X-shaped cracks throughout walls of buildings.

People in Christchurch are experiencing stress from living in temporary housing, and there is a lack of available contractors for immediate reconstruction. To cope with the situation the mayor and EQC officials have held regular town-hall meetings to listen to concerns and field questions. At one meeting that CEA staff attended, the mayor informed the crowd that in California—a state very much like New Zealand in terms of earthquake risk—most people don't have earthquake insurance—in fact, 90% don't have it. The crowd responded with an audible gasp.

The CEA team could see that New Zealand is in a far better situation because homes are insured. Far greater penetration of earthquake insurance means that the city of Christchurch is going to recover.

The trip reinforced CEA's view that it must push to try to make earthquake insurance more available in California. The team also brought back information on better mapping techniques, fast-track claim-review processes, and internal management of information after an event.

In response to a question from Chairperson Kelso, Mr. Richison stated that the total earthquake loss to Christchurch will be about $2.5 billion. He noted that a major difference between EQC and CEA is that EQC has an unlimited federal guarantee. Mr. Marshall commented that the federal guarantee is the key to reducing the cost of providing insurance to the people.

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

- Mr. Richison stated that CEA's available capital at the end of October was over $3.6 billion.
- Actual cash and investments are over $4.1 billion.
- Mr. Richison noted that in New Zealand, the Earthquake Commission has most of its fund in non-tradable federal-government securities; the government is the sole source of redemption.
- As of October 31, 2010, CEA claim-paying capacity is $9.7 billion, corresponding to approximately 1-in-570 years.
- There are no augmentations to the mitigation budget.
- CEA's investment portfolio consists of long-term U.S. Treasuries, short-term U.S. Treasuries, and government agencies.

5. Mr. Richison will present and seek Board approval of the proposed CEA reinsurance program for 2011.

Mr. Richison explained that the present item represents completion of the 2011 reinsurance program that staff presented at the August 2010 Board meeting. That presentation noted an option in proposed reinsurance Contracts 3 and 4, to take up additional reinsurance, if needed, to replace the capacity lost through the New Industry Assessment Layer roll-off slated for April 1, 2011—about $287 million.

An additional $50 million purchase of reinsurance is required to bring CEA financial strength to the required 1-in-500-year level.

Mr. Marshall explained the corresponding resolution for the agenda item. Staff recommended that the Board authorize $50 billion in additional reinsurance for the 2011 CEA reinsurance program.

MOTION: Mr. Conlin moved to authorize the reinsurance contracts and to immediately bind it, pursuant to the authorizing resolution; seconded by Mr. Boyken. Motion passed unanimously.

6. Chief Actuary Shawna Ackerman will seek Board approval of the method for calculating an annual risk-capital surcharge for those new CEA participating insurers that are subject to such a surcharge.

Ms. Ackerman presented a proposed method for an annual risk-capital-surcharge calculation, which applies to certain new CEA participating insurers. The calculation is required by amendments to the CEA law effective in July 2008, and any resulting surcharge is designed to account for any increased risk-financing costs attributable to a new participating insurer's risk profile—that is, if the Board determines that a new participating insurer's risk profile may raise the CEA's risk profile, then that new participating insurer can be subject to this surcharge.

Ms. Ackerman explained that her approach to the proposed calculation method would essentially convert the words of the statute to a mathematical process and formula.

Chairperson Kelso asked Mr. Marshall whether the proposed method complied with the statutory requirements; Mr. Marshall replied that the method (1) appeared appropriate to the statutory provision it was intended to implement and (2) should operate uniformly for all new participating insurers where a risk surcharge is appropriate.

MOTION: Mr. Boyken moved to approve the resolution, seconded by Mr. Conlin. Motion passed unanimously.

7. **Ms. Ackerman will seek Board approval of the first annual risk-capital surcharge for CEA participating insurer *Safeco Insurance Company of America.***

Ms. Ackerman reported that the item took the method approved by the Board in the previous item and applied it to Safeco's insurance portfolio as brought to the CEA, starting in 2009.

With application of the newly approved methodology, Safeco's first annual risk-capital surcharge is $1.7 million; Safeco may also be subject to the surcharge based on its 12-1-2010 portfolio. Mr. Marshall noted that the written resolution appears to capture the appropriate surcharge calculation, consistent with the Board-approved calculation method.

MOTION: Mr. Conlin moved to approve the resolution, seconded by Mr. Boyken. Motion passed unanimously.

8. Chief Operations Officer Bob Stewart will seek Board approval to proceed with a contract amendment with *Protiviti Inc.*, supporting the ongoing development, implementation, and maintenance of a comprehensive and sustainable information-services environment that is able to meet all CEA legal, regulatory and audit requirements.

In seeking the Board's approval to amend the CEA-Protiviti contract, Mr. Stewart discussed in detail why staff believed the amendment was needed.

At its August meeting, the Board was briefed on the results of the annual independent audit of the CEA's (2009) financial statements. The audit report included a management comment letter, which pointed to material weaknesses in the CEA's internal controls and pointed out material risks within CEA information services, which if unaddressed could lead to a qualified audit.

Since the next audit is scheduled for November 2011, staff determined that the most appropriate action would be to contract immediately with a firm that had skills and resources to help in completing a remediation plan by September 2011. The CEA identified Protiviti as the best vendor choice.

Mike Melavic, Director of Information Services at CEA, provided further details on the Protiviti action plan:

1. Phase 1 was the development of a strategy and a roadmap.
2. Phase 2 was the establishment of a Program Management Office (PMO) and the execution of the roadmap to bring CEA IS to an “audit readiness” state.
3. Phase 3 was process optimization.

For Phase 1, Protiviti established a baseline for CEA IS regarding policies, procedures, and resources, interviewing CEA staff and management and analyzing the 2009 audit review. From all of this information, the project group developed a baseline of where CEA IS is today.

Protiviti developed a roadmap to illustrate the work to be accomplished; provide a schedule of milestones and other deliverables; and track project progress.

Tony Samer, Managing Director of Protiviti, continued:

Phase 2 had three primary objectives:

1. Establish a PMO to help manage and drive the myriad of initiatives.
2. Design the initiatives to formalize, stabilize, and mature IT processes and practices.
3. Prepare the evidence, making it clearly demonstrable to external auditors and management that the processes and controls are in place and operating effectively.

In conjunction with CEA management, the project group had identified five key initiatives to address in 2011:

1. Establish an IS governance foundation.
2. Mature CEA’s ability to recover in the event of a major disaster or business continuity catastrophic event.
3. Ensure that the CEA is better prepared to manage and maintain its IS environment.
4. Improve IS security and privacy.
5. Improve the application environment and controls.

Mr. Samer added that the CEA needed its process and controls in place about a full calendar quarter before the fourth-quarter-2011 audit.

Late in the third quarter 2011, Protiviti expected to support CEA in doing Operational Control Testing. Protiviti also expected to support CEA in responding to the audit findings, and to clarify and ensure that the testing and results adequately represent the current state of the environment.

Mr. Samer touched on the key deliverables and accomplishments for the organization. Protiviti expected to fully analyze the organizational structure and roles within CEA IS to assure that roles are properly designed and organized. It also expected to assess and identify risks and the appropriate controls for them. Policy standards and procedures will be a big part of the initiative in formalizing it and moving it forward.

Mr. Stewart noted that in terms of IS controls, the process is like a start-up: The project group is creating documentation that has not existed until now and is doing so in a short timeframe.

Mr. Pomeroy stated that staff could place a Protiviti discussion and update item on the Agenda of each 2011 Board meeting.

Mr. Boyken pointed out that Treasurer Lockyer was concerned about another type of risk: that of going forward in entering a large contract without a competitive bid process to ensure the necessary cost, quality, and fit.

Mr. Marshall responded that the CEA's default position for procurements was competitive procurements, but if certain criteria are met, then CEA procedures allow sole-source procurement as a legitimate way to procure services, and the CEA's sole-source criteria are taken directly from the State contracting manual. Mr. Marshall noted that he had reviewed copies of the formal sole-source request and justification that was approved by the CEO in September for this contractor. The project was exigent – it demanded immediate attention – and for that reason the exigent circumstance criterion was determined to have been met.

MOTION: Mr. Conlin moved to approve the resolution; seconded by Mr. Kelso. Motion carried, approved two to one (ayes, Governor and Insurance Commissioner; no, State Treasurer).
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9. Mr. Pomeroy will present the 2011 CEA Business Implementation Plan for Board consideration and approval.

(combined with)

10. In support of the 2011 Business Implementation Plan, Mr. Pomeroy and Mr. Richison will present the proposed 2011 CEA budget for Board consideration and approval.

Mr. Pomeroy stated that the document represents an effort to organize the main activities of the organization to reaffirm what CEA is all about and to lay out a roadmap of how it will continue to meet its mission.

He made brief statements about the goals:

- Goal 1: Provide excellent customer service. CEA's mechanism is ready to go under Dan Dyce's leadership.

- Goal 2: The ability to pay covered claims. Mr. Pomeroy expressed the hope that 2011 represents the year that the CEA successfully is able to move at least a portion of its risk-transfer into the capital markets.

- Goal 3: Encourage more Californians to make informed decisions. The Board has already approved a robust marketing plan for next year.

- Goal 4: Mitigation. 2010 has been a very successful year in terms of ramping up CEA's ability to start moving in the mitigation area in 2011.

- Goal 5: Mission effectiveness. In approving Item #8, the Board just took a huge step in terms of allowing CEA to bolster its IS resources, processes, and controls.

Mr. Pomeroy submitted the budget to the Board, while noting that it is an insurance-operations budget only. The mitigation program would be handled separately, at the next Board meeting.

He projected that actual expenditures for 2010 would come in at about $9.5 million, or 90% of the amount approved. Because of a variety of factors, both within and outside of CEA's control, CEA did not spend all of the budgeted funds. But CEA was at 90% of budget, rather than the historical 60%. This meant that the CEA budget-preparation process had been properly redialed and now better reflected anticipated conditions.

The proposed 2011 budget called for an operating expense level of $12.3 million. During 2010, the Board had approved new and important initiatives, and approved additional spending. And clearly, the Board had intended the new, approved initiatives to become a part of ongoing CEA operations. For example, the Board approved hiring a full-time Chief Actuary and authorized funds to obtain additional staffing to bolster its IS capabilities.

With the budget, Mr. Pomeroy proposed to build modestly on current capabilities in three key areas:

- Communication and external affairs. The addition of a marketing and media assistant was needed to support expansion in media outreach. The addition of a professional writer would facilitate increased emphasis on marketing for the launch of the mitigation program in 2011.

- Legal and compliance. CEA's model is an outsource operation that has a huge worldwide financial footprint, but operates with minimal internal staff. A new slot was proposed for staff counsel. Each of the three main business departments would then have a dedicated internal legal expertise assigned to it.

- Operations. A new position of Insurance Director is proposed, who would take responsibility for staff and line functions for product development, pricing, policy services, claims services, underwriting, and the all-important coordination of and with participating insurers.

Mr. Pomeroy made the final points that the proposed budget of $12.3 million was significantly lower than Board-approved budgets for 2007, 2008, and 2009. It was also nearly $6 million below the 3% statutory operating-expense cap, which for 2011 will be about $18.3 million.

In sum, the proposed budget was realistic and based squarely on current operations, with modest and well-supported adjustments CEA needs in order to increase its capabilities in key areas. The budget was also forward-looking, designed to move toward the goal of giving many more Californians access to affordable earthquake insurance protection.

MOTION: Mr. Boyken moved to approve the staff's recommendation to approve the 2011 Business Implementation Plan, seconded by Mr. Conlin. Motion passed unanimously.

MOTION: Mr. Conlin moved to approve the staff's recommended budget, seconded by Mr. Boyken. Motion passed unanimously.

11. Director of Communications and External Affairs Chris Nance will seek Board approval to permit the CEA to enter a joint powers agreement with the California Emergency Management Agency (known as "CalEMA"); the resulting joint powers authority would conduct residential-retrofit programs.

Mr. Nance began by stating that for the CEA programming to become operational on the foundations established, it must act to limit potential liabilities for it and its partner organizations, e.g., CalEMA, with which the CEA has proposed to form a joint powers authority ("JPA"). Such actions would make it easier to attract necessary federal funding.

Mr. Nance read an excerpt from the State Hazard Mitigation Plan that noted the possible formation of this JPA. The document had undergone the rigor of a federal review and then publication by California.

Mr. David Zocchetti commented favorably on the process CalEMA had gone through with CEA staff, calling it valuable and productive, as well as the substance and promise of the potential JPA.

Mr. Marshall stated that the documentary side of the JPA was both a joint exercise of powers agreement and also a business plan, which both parties wanted.

MOTION: Mr. Conlin moved to approve the resolution as presented, seconded by Mr. Boyken. Motion passed unanimously.

12. Mr. Nance will update the Board on the status of the selection process for a statewide administrator of the residential retrofit, brace, and bolt program.

(combined with)

13. Mr. Nance will seek Board approval of start-up funding for the residential retrofit, brace, and bolt program.

Mr. Nance reported that staff invited CalEMA and the California Seismic Safety Commission to participate in the evaluation of candidates. There were three proposers who responded to the RFQ, from which the evaluation panel selected two finalists.

The new position of statewide administrator will have duties that include the following:

- Establishing and maintaining a Web portal
- Managing the training, testing, and ongoing oversight of qualified contractors
- Establishing criteria for houses qualified to receive an incentive
- Verifying permitting and inspections
- Marketing the incentive to California

The two finalists estimated the proposed cost of conducting required activities from a start-up perspective at about $400K.

In seeking $500K for the purpose, staff noted several key points. CEA has the approval of the JPA. Dollars cannot be expended until CEA has the appointments for the JPA, the Chief Mitigation Officer is recruited, the statewide administrator finally is selected, and CEA has the JPA acceptance of a contract for the statewide administrator. In response to a question from Chairperson Kelso, Mr. Nance said that staff expected to have many of those items in place by late February or early March.

Mr. Marshall noted that when he drafted the resolution he included a safe haven for the Board, so that the amount could be approved and tied to the purposes set forth, but no money would be spent by CEA unless and until the CMO is hired, the JPA is established, and the Board has taken further, specific action to authorize spending.

MOTION: Mr. Boyken moved to approve the resolution to commit $500,000 of the mitigation budget to the start-up of the JPA, seconded by Mr. Conlin. Motion passed unanimously.

14. Mr. Pomeroy will present the results of his appraisal of Mr. Richison's performance under the CEA executive-performance-evaluation plan.

Mr. Pomeroy asked the Board to award a contract-supported salary merit increase for Mr. Richison, who had not received one for the previous year, and that on account of some unusual circumstances in which no COLA was requested, an appropriately recalculated COLA be provided for Mr. Richison's 2010 compensation. Mr. Pomeroy also suggested that for the upcoming year's compensation and forward, the annual COLA should be calculated based on CPI figures available for the December-to-December timeframe, regardless of when available, rather than the October-to-October interval.

Mr. Conlin noted that while he had great respect for Mr. Richison, the Insurance Commissioner would abstain on the present salary-augmentation question.

MOTION: Mr. Boyken moved that the Board approve the staff recommendation with a modification to apply the COLA for 2010, adjust the COLA-application method to allow a December-to-December look, and award a merit salary increase; seconded by Mr. Kelso. Motion carried 2-0 (ayes, Governor and Treasurer; abstain, Insurance Commissioner).

15. 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.

There was no closed session.

16. 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.

17. Adjournment.

The meeting was adjourned at 3:00 p.m.