



CALIFORNIA EARTHQUAKE AUTHORITY

ANNUAL REPORT TO THE LEGISLATURE AND INSURANCE COMMISSIONER ON CEA PROGRAM OPERATIONS Report Covering Calendar Year 2012

(Insurance Code section 10089.13, subdivision (a))

Brief Background: California Earthquake Authority

The California Earthquake Authority (CEA) was formed through legislation in 1995 and 1996 to address an insurance-availability crisis that followed the 1994 Northridge earthquake. After that earthquake, many homeowners found it difficult, and in some cases impossible, to find basic homeowners insurance. Many others were faced with the prospect of having their homeowners insurance non-renewed as insurance companies tried to shed their exposure to earthquake risk. Because state law requires insurers to offer earthquake insurance to their applicants and holders of residential policies, the insurers' retreat from the California market resulted in an availability crisis for both homeowners and earthquake insurance. The California Department of Insurance ("CDI") reported in the summer of 1996, at the height of the crisis, that 95 percent of the homeowners insurance market had either stopped, or severely restricted, sales of new homeowners policies.

After the CEA began operations on December 2, 1996, the recovery of the California homeowners-insurance market was dramatic and swift. A Department of Insurance report noted that at the peak of the availability crisis, 82 insurers had restricted the sale of new homeowners policies—by contrast, by October 1997 only three insurers were restricting the sale of new policies.

The CEA is the largest earthquake insurer in California, with over 65% of the residential-earthquake-insurance market; CEA participating insurers are responsible for almost 80% of California's residential property insurance.

Current Market Conditions

California's Residential Property Insurance Market

The CDI year-end-2012 data once again indicate an increase in policy numbers in the statewide residential property insurance market: In 2012, over 10.6 million policies were sold compared to the previous year's 10.2 million. (*See Attachment A: California Department of Insurance, Summary of 2012 Residential & Commercial Market Totals.*)

Statewide totals, for all insurers that write residential property insurance in California:

- *Residential Homeowners (Dwelling) Policies* totaled 6,257,580
- *Residential Condominium Unit Policies* totaled 773,276
- *Manufactured Home (including Mobilehome) Policies* totaled 258,824
- *Rental Policies* totaled 1,566,390
- *Dwelling Fire Policies* totaled 1,708,631

California's Residential Earthquake Insurance Market – 2012

Based on the total number of residential earthquake insurance policies written in 2012, CEA and non-CEA companies together accounted for 1.12 million earthquake policies statewide, down from 2011's 1.23 million.

CEA Earthquake Response in 2012

Fortunately for Californians, there were no catastrophic earthquakes in 2012. Even so, the CEA and its participating insurers responded to and investigated 166 CEA earthquake claims through the year.

The largest earthquake in 2012 was a 5.3 Richter magnitude epicentered near Brawley, California, on August 26, 2012. This earthquake generated 18 CEA claims, and the CEA was able to pay two of them. The remainder of claims reported had minor damage that was less than their policy deductible. During 2012, the CEA also paid two smaller claims from other earthquakes.

On each of the 166 claims, policyholders received a free investigation of their reported damages and in many cases, a free engineering report to determine the cause of their damage.

While the CEA did not have any large earthquakes to respond to in 2012, the CEA knows that a major earthquake could strike at any moment, so annually the CEA engages its participating insurance companies in different kinds of earthquake drills, including data-transmission tests, in-person earthquake response drills, and claim-handling training.

CEA Operational Developments in 2012

CEA Policy Growth

The CEA ended 2012 with 841,503 policies-in-force, which represents a 2.51% increase compared to year-end 2011. Most of the increase was attributable to adding Nationwide Mutual Insurance Company (Nationwide) as a CEA participating insurer. Nationwide transferred its residential earthquake-insurance book of business to the CEA by November 2012.

Implementation of Rate and Coverage Changes

On January 1, 2012, the CEA implemented a 12.5% average statewide rate decrease.

New scientific information supported the rate reduction, as the CEA incorporated lower estimated average annual losses into its rate calculations. It's important to note that different

policyholders saw their rates increase or decrease, depending on CEA product, location of the insured risk, and the application of all other rating factors.

Along with the new rates, the CEA published a new version of each of its insurance-policy forms to incorporate coverage enhancements and refinements, and clearer definitions and policy language.

- Notably, \$1,500 that is *not subject to the policy deductible* is now available to pay for emergency repairs to protect covered property from further damage, secure the residence, or restore habitability.
- In addition, a \$25,000 limit option for additional living expenses was introduced in direct response to consumer feedback—this coverage provides for shelter and food if a policyholder and family are forced from their home on account of an earthquake. The CEA was pleased with the enthusiastic response to this new limit option, as nearly 30,000 policyholders chose the new limit.

Implementation of an Important New Product: *Homeowners Choice*

The CEA implemented its innovative “*Homeowners Choice*” product on July 1, 2012.

This new product offers consumers considerable choice through completely new options in earthquake coverage. And it delivers more immediate policy benefits after an earthquake for those who own a house or a manufactured home (mobilehome).

The new “*Homeowners Choice*” policy includes:

- The option to purchase only dwelling coverage, with an option to purchase, in addition, personal property coverage or additional living expense coverage, or both.
- A separate deductible of 15% or 10% is now available for structure coverage and personal property coverage. No longer is personal property coverage tied to the structure-coverage deductible (although in the new policy, the personal property deductible is waived altogether if the dwelling deductible is met).

By offering more choice in coverage options, consumers are much more empowered to manage their residential earthquake insurance premium, meaning that the new features enhance both availability and affordability.

Nearly 6,000 policyholders purchased the *Choice* policy between July 1, 2012, and December 31, 2012. Although it was available for only six months of the reporting period of this report, it seems clear the CEA’s *Choice* policyholders are tailoring their coverage by purchasing only the coverage they need. In addition, they are trending toward selecting lower deductibles on their personal-property coverage.

Implementation of Revised CEA Eligibility Standards and CEA Inspection Guidelines

Until 2012, the last time that the CEA *Eligibility Standards* and the CEA *Inspection Guidelines* had been published was 1999. Both documents were dated, and the CEA’s participating insurers were requesting clarification of, and revisions to, the current documents to bring them more closely in line with industry standards.

The *Inspection Guidelines* were updated to more clearly support and guide new policy submissions to the CEA, describe acceptable inspection types, and define the CEA's Hazard Reduction Discount qualification and verification requirements.

The *Eligibility Standards* were updated to more clearly explain the standards applicable to new insurance business submitted to the CEA, establish and clarify the standards for renewal insurance business, and add appropriate references to the CEA's new *Homeowners Choice* product. The CEA Governing Board approved the recommendations unanimously.

New CEA Participating Insurers

Other than the Nationwide Group's having completed its transfer of earthquake insurance business to the CEA in November 2012, there was no additional activity regarding applications to become a CEA participating insurer.

CEA-Supported Research Projects

Because California law expressly requires the CEA to base its rates on the best available scientific information, the CEA continued its commitment to supporting appropriate, cost-effective research that promotes the development of science that is relevant to CEA operations and activities.

- For example, in recent years the CEA strongly supported development of a Uniform California Earthquake Rupture Forecast (UCERF), completed in 2008. UCERF provided for the first time a uniform earthquake-fault-rupture forecast for *all* of California in a form most useful to CEA's contracted loss-modeling firms, at least one of which was able to update its model to incorporate UCERF results. With the advantage of that enhanced modeling capability, the CEA is assured that its rates and rate structure are based on uniform, statewide seismic-hazard estimates that represent the best available scientific information.
- Upon completion of the UCERF project, the United States Geological Survey (USGS) also used UCERF in development of new hazard maps.

The CEA has also supported two additional, more recent key research projects: Uniform California Earthquake Rupture Forecast, Version 3 (UCERF 3) and Near-Source Ground Motion Characterization (NGA–West 2), which the CEA Governing Board approved for supportive funding.

In March 2010, the NGA-West 2 project—directed by the Pacific Earthquake Engineering Research Center at the University of California, Berkeley, launched. Among other things, it will update ground-motion predictions to better estimate ground movement at certain magnitudes and distances from fault ruptures.

The goals of the NGA-West 2 project include improving the estimates of the level and the degree of uncertainty of future near-source ground motions. This information can provide valuable information to engineers, loss modelers, and those interested in current construction and mitigating existing buildings and infrastructure. The NGA-West 2 team has significantly expanded the number of ground shaking recordings in its database from about 10,000 records (in the original NGA) to approximately 57,000 in NGA-West 2.

The CEA contracts with the University of Southern California and its seismic-research arm, the Southern California Earthquake Center, to update the earthquake-rupture-forecast report, UCERF 2, that underlies the 2008 USGS National Seismic Hazard Maps—these are maps that building codes are based on. A rupture forecast states probabilities about the locations, occurrence rates, and magnitude of future fault ruptures. The updated UCERF 3 would address several issues not covered in UCERF 2—the work began in January 2010 and should be completed in the near future with the help of the California Geological Survey and the USGS.

Integrated with NGA-West 2, UCERF 3 will provide the latest science to support a quantitative understanding of the earthquake hazard in California. It should prove vital for first responders, emergency preparedness stakeholders, and the entire mitigation community.

Risk Capital Surcharge - Insurance Code Section 10089.16(d)

Nationwide Mutual is a participating insurer of the CEA. It began offering CEA earthquake-insurance policies effective on and after November 15, 2011.

As part of the CEA participating-insurer application process, and as required by law, Nationwide submitted to the CEA policy data for its earthquake-insurance book of business. The data was modeled to permit CEA staff to complete an “earthquake-insurance risk profile.” That profile indicates the current likelihood and magnitude of additional CEA losses on account of insuring Nationwide’s CEA book of business during its first full year of CEA participation.

Based on Nationwide’s earthquake-insurance risk profile and the CEA staff recommendation, the Governing Board on April 29, 2010, unanimously approved Nationwide’s participation application, conditioned on Nationwide’s paying up to five annual risk-capital surcharges in addition to its required capital contribution and any required loss assessments.

The risk surcharge is re-assessed (based on a Board-approved recalculation method) each year after its imposition. Once the insurer’s risk profile becomes substantially similar to the CEA’s average risk profile, the Board must relieve the insurer of further obligation to pay a surcharge.

CEA staff re-analyzed Nationwide’s earthquake-insurance risk profile as of December 31, 2012, and determined that—as of that date—Nationwide’s earthquake insurance risk profile was substantially similar to the CEA’s average risk profile for a CEA book of business of similar size. CEA staff therefore recommended that the Board relieve Nationwide of further obligation to pay annual risk-capital surcharges. The CEA Governing Board approved unanimously.

Communications

In 2010 and 2011, the CEA developed the Marketing Value Program (MVP), designed to attract new policyholders, retain existing policyholders, generate meaningful media impressions, and produce a return-on-investment to help build CEA capital. The CEA refined its marketing program in 2012, using new and renewal-business policy data to increase homeowners policies-in-force based on acquisition and retention industry standards. The CEA also introduced a pilot renters-insurance marketing program.

Now in its second year, the 2012 MVP featured an improved statewide media campaign that used programming that resulted in a more user-friendly, accessible format for agents. Also in 2012, the CEA used research results to support a year-round online marketing program focused exclusively on encouraging people considering earthquake insurance to contact their insurance agent and purchase a CEA policy. Four different online campaigns were produced as digital static, Flash, and rich-media ads. This program exceeded expectations by:

- Pacing ahead of projections in message delivery, delivering over 317 million impressions.
- Increasing CEA Web-site visits from 81,000 visitors May-September 2011 to 373,000 visitors during the same period in 2012, producing 269,000 visitors.
- Delivering 32 million impressions through a Facebook™ ad.
- CEA Web-site visitors produced by CEA's online marketing programs spending about two minutes per visit (2:04 for homebuyers/1:52 for renters).
- Producing, for the first time in CEA history, more CEA Web-site traffic from consumers considering earthquake insurance than from agents using the premium calculator.

CEA's role in promoting the Great California ShakeOut, which attracted 8.6 million participants in 2011, has grown in significance each year. In 2012, the CEA and the American Red Cross joined forces to create the *Traveling Red Table*™ to promote the ShakeOut. The total ShakeOut registration exceeded 9.3 million Californians.

Additionally, more than 54 million impressions were generated through those efforts. CEA supported the ShakeOut in 2012 through earthquake-preparedness public-service announcements by news talent from local stations, as well as public officials including Los Angeles Mayor Antonio Villaraigosa.

In 2012, CEA also joined forces with the American Red Cross to create the *Get Prepared, California!* auction during Earthquake Preparedness Month, which was promoted on www.GetPreparedCalifornia.org, where more than 104 million impressions were generated and over \$180,000 was raised to benefit the Red Cross.

CEA's collaboration results from 2008 through 2012 include:

- Delivering 333 million impressions statewide through paid media
- Distributing news releases, media advisories, and public service announcements
- Coordinating statewide media spokespersons and a media database
- Hosting seven press availabilities for preparedness stakeholders
- Delivering about 6 million impressions through in-store merchandising displays
- Distributing more than 5.2 million pieces of direct mail in English, Spanish, and Chinese
- Hosting information booths at ethnic-community festivals
- Sponsoring a "preparedness team" at community events, statewide
- Distributing about 34,000 preparedness starter kits to consumers and agents

For 2012 programming, the CEA earned a PR News Corporate Social Responsibility Award (Nonprofit/Corporate Partnership category) at the National Press Club, two awards from the International Association of Business Communicators (Overall Communications Program and Special Event categories), a PR Daily Award (Best Cause-Related Marketing in the Branding

and Marketing category), and three Awards of Excellence (Corporate Social Responsibility, TV Spot or Campaign and Total Sales/Marketing/Branding Campaign categories) from the Insurance Marketing and Communications Association.

Mitigation Program Development

The CEA's enabling legislation directs the CEA Governing Board to set aside annually five percent of the CEA's investment income (as long as the set-aside is actuarially sound and up to a limit of five million dollars) to be used for activities that mitigate seismic risks of vulnerable residential structures in California. This includes programs to provide financial assistance to those who mitigate their homes against seismic risk.

In 2012 the CEA mitigation program coordinated projects and objectives into three focus areas:

- **Guidelines Development**
 - Current guidelines, adopted into California's existing building code through CEA efforts in 2010, addresses only one type of seismic retrofit of single family dwellings. More guidelines are needed to provide direction for additional types of seismic retrofits necessary for other homes that are vulnerable to damage from seismic activity.
 - In September 2012, the CEA held a workshop to bring together earthquake and mitigation experts and researchers to discuss the need and process to establish these additional guidelines.
 - The CEA and the Federal Emergency Management Agency (FEMA) are joining forces to develop Comprehensive Guidelines for the Evaluation and Retrofit of Single-Family Dwellings (up to 4 units).

- **Mitigation Research**
 - Earthquake insurance premium discounts for bolting a foundation, bracing a cripple wall, and strapping a water heater are currently at 5%.
 - Any increase in this discount depends on credible research into loss and damage reduction from specified seismic retrofits.
 - Current research is limited on the effectiveness of seismic retrofits on raised foundation, cripple wall, single-family dwellings.
 - To address these research needs and gaps, the CEA will fund research into the effectiveness of specified retrofits, using numerical modeling, component testing, and possibly shake-table testing of seismically strengthened and un-strengthened single-family dwellings.

- **Incentive Program**
 - Through the joint powers authority the CEA has entered into with the Governor's Office of Emergency Services, the JPA's operations arm (the California Residential Mitigation Program (CRMP)) developed and refined an outline and rules for a statewide mitigation-incentive program, including:
 - Identifying ZIP Codes in Oakland and Los Angeles with houses meeting current building-code specifications (houses with a raised foundation and with a cripple wall that is four feet or less in height).

- Promulgating Requests for Qualifications for contractors to develop and manage elements of the program (marketing, Web site, program evaluation, site inspection, and quality control).
- Hiring a Program Manager who is responsible for oversight and day-to-day management of daily program operations, including contract management.

Financial Report

In 2006, the CEA issued \$315,000,000 in investment-grade revenue bonds, marking the CEA's first entry into the debt markets. During 2012, the CEA redeemed \$31,500,000 in outstanding bonds, and therefore at year-end 2012 the CEA had \$126,000,000 in revenue bonds outstanding.

Financial Stability Ratings

During 2012, CEA remained rated "A-Minus (Excellent)" by the A. M. Best Co., with a "stable" outlook. Best's rating framework continues to recognize the CEA's "excellent risk-adjusted capitalization, financial flexibility, extensive risk modeling capabilities, sophisticated management practices, and conservative investment policy."

EARTHQUAKE PREMIUM AND POLICY COUNT DATA CALL

SUMMARY OF 2012 RESIDENTIAL & COMMERCIAL MARKET TOTALS

2012 Experience Year	Written Premiums	No. of Policies	Exposure (\$) Excluding EQ	Avg Prem Per Policy	Avg Rate Per Policy	Market Share *	EQ Premiums	No. of EQ Policies	Exposure (\$) Including CEA	Avg Prem Per Policy	Avg Rate Per Policy	Market Share *	% with EQ **
Total CEA Companies	6,017,422,228	8,511,815	2,268,820,113,035	\$ 706.95	\$ 2.65	80.57%	556,817,712	841,503	312,501,580,495	\$ 661.69	\$ 1.78	75.15%	9.89%
Total Residential Mkt (Excluding CEA)	1,834,290,249	2,052,886	720,370,575,782	\$ 893.52	\$ 2.55	19.43%	362,997,282	278,275	164,274,125,298	\$ 1,304.46	\$ 2.21	24.85%	13.56%
Total Residential Mkt (Including CEA)	7,851,712,477	10,564,701	2,989,190,688,817	\$ 743.20	\$ 2.63	100.00%	919,814,994	1,119,778	476,775,705,793	\$ 821.43	\$ 1.93	100.00%	10.60%
Total Homeowners Market	6,219,313,615	6,257,580	2,434,510,058,153	\$ 993.88	\$ 2.55	59.23%	806,530,413	774,129	430,064,221,395	\$ 1,041.86	\$ 1.88	69.13%	12.37%
Total Rental Market	322,727,806	1,566,390	52,645,230,141	\$ 206.03	\$ 6.13	14.83%	8,172,922	79,816	2,900,511,601	\$ 102.40	\$ 2.82	7.13%	5.10%
Total Condominium Market	337,233,467	773,276	43,795,238,405	\$ 436.11	\$ 7.70	7.32%	49,179,465	128,927	12,420,413,077	\$ 381.45	\$ 3.96	11.51%	16.67%
Total Dwelling Fire Market	831,392,423	1,708,631	437,642,396,508	\$ 486.58	\$ 1.90	16.17%	48,270,739	86,232	27,089,278,130	\$ 559.78	\$ 1.78	7.70%	5.05%
Total Mobilehome Market	141,045,166	258,824	20,597,765,610	\$ 544.95	\$ 6.85	2.45%	7,661,455	50,674	4,301,281,590	\$ 151.19	\$ 1.78	4.53%	19.58%
Total Residential Mkt (Including CEA)	7,851,712,477	10,564,701	2,989,190,688,817	\$ 743.20	\$ 2.63	100.00%	919,814,994	1,119,778	476,775,705,793	\$ 821.43	\$ 1.93	100.00%	10.60%
California FAIR Plan	59,685,177	127,426	38,462,666,430	\$ 468.39	\$ 1.55	7.46%	4,509,659	5,130	2,227,903,183	\$ 879.08	\$ 2.02	5.95%	4.03%
Total Dwelling Fire (Excluding C.A FAIR Plan)	771,707,246	1,581,205	399,179,730,078	\$ 488.05	\$ 1.93	92.54%	43,761,080	81,102	24,861,374,947	\$ 539.58	\$ 1.76	94.05%	5.13%
Total Dwelling Fire Market	831,392,423	1,708,631	437,642,396,508	\$ 486.58	\$ 1.90	100.00%	48,270,739	86,232	27,089,278,130	\$ 559.78	\$ 1.78	100.00%	5.05%

* Market share represents the percentage of policies to total residential market.
 ** Percent with EQ represents the percentage of policies that also have EQ coverage.

Commercial Fire	356,477,808	127,185	794,987,692,578	\$ 2,802.83	\$ 0.45	14.01%	293,483,738	29,075	140,230,239,995	\$ 10,094.02	\$ 2.09	38.56%	22.86%
Commercial Multiple Peril (Non-Liab.)	2,343,904,194	780,376	1,574,576,205,838	\$ 3,003.56	\$ 1.49	85.99%	69,068,580	46,335	75,642,518,693	\$ 1,490.64	\$ 0.91	61.44%	5.94%
Total Commercial Lines:	2,700,382,002	907,561	2,369,563,898,416	\$ 2,975.43	\$ 1.14	100.00%	362,552,318	75,410	215,872,758,689	\$ 4,807.75	\$ 1.68	100.00%	8.31%

SOURCE: CDI - EQ Premium, Exposure, Policy Count Data Call

Rate Specialist Bureau

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Attachment A: California Department of Insurance Summary: 2012 Residential & Commercial Market Totals

Attachment B: 2012 Financial Statement
California Earthquake Authority: Annual Financial Report

In accordance with California Insurance Code sec. 10089.13, subdivision (b), the California Earthquake Authority reports its finances as of December 31, 2012:

Assets	
Cash on hand	\$328,884,188
Stocks or bonds	4,475,803,620
Premiums receivable	42,878,950
Assessments receivable	-
Interest receivable	14,806,316
Securities receivable	-
Unearned ceded premium	-
Prepaid reinsurance premiums	1,325,001
Transformer reinsurance premium deposit	14,634,112
Prepaid transformer maintenance premium	3,365,306
Equipment, net of depreciation	458,543
Deferred participating-insurer commissions and operating costs	39,031,916
Reinsurance premium receivable	-
Other assets	113,532
Liabilities	
Losses due and unpaid	-
Claims for losses resisted by the CEA	-
Losses in the process of adjustment or suspense	-
Reported losses	12,909
Supposed losses	-
Revenue bonds Payable	126,000,000
Revenue bonds Interest Payable	3,886,470
Other debt financing	-
Unearned premium	290,632,289
Unearned commissions	-
Accounts payable	6,000,410
Securities payable	-
Accrued reinsurance premium expense	6,068,468
Income	
Premiums received	569,235,337
Interest money received	22,703,303
Installment fees	444,984
Supplemental commissions	-
Expenses	
Loss adjustment expenses paid	5,014
Losses paid	644,207
Participating insurer commissions	58,867,335
Participating insurer operating costs	18,237,966
Reinsurance broker commissions	4,800,000
Financing expenses	9,077,731
Reinsurance premium	200,817,695
Other underwriting expenses	26,570,380

Attachment C: Summary of CEA Claim-Paying Capacity

In accordance with California Insurance Code sec. 10089.13, subdivision (c), the California Earthquake Authority reports this separate financial summary of its base-program claim-paying capacity as of December 31, 2012.

Assets		
	Cash & Investments	\$4,780,084,253
	Revenue Bond Proceeds	(314,129,302)
	Less: Debt Service	(27,874,662)
	Interest Receivable	14,806,316
	Securities Receivable	-
	Premiums Receivable	42,878,950
	Capital Contribution Receivable	-
	Other Cash-Related Assets	113,532
	Accounts Payable & Accrued Expenses	(6,000,410)
	Accrued Reinsurance Premium Expense	(6,068,468)
Liabilities		
	Unearned premium	208,717,229
	Securities payable	-
Total Available Capital		4,281,161,448
Assessments		
	Available for assessment in 1 st IA layer	1,558,000,000
	Assessments previously made from 1 st IA layer	-
	Available for assessment in 2 nd IA layer	-
	Assessments previously made from 2 nd IA layer	-
	Available for assessment in New IA layer	500,000,000
	Assessments previously made from New IA layer	-
	[IA = Industry Assessment]	
Reinsurance		
	Available in all layers	3,556,684,950
Bonds		
	Revenue bonds issued in 2006	315,000,000
	Revenue bonds outstanding 12/31/2011	126,000,000
Policyholder Surcharges		
	Surcharges assessed	-
	Surcharges outstanding	-
Capital Markets		
	Capital committed from capital markets	-
Debt		
	Line of credit available	-