CALIFORNIA EARTHQUAKE AUTHORITY

ANNUAL REPORT TO THE LEGISLATURE AND INSURANCE COMMISSIONER ON PROGRAM OPERATIONS

Report Covering Calendar Year 2010

(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

Residential Property Insurance Market

California Department of Insurance (CDI) year-end-2010 data once again indicates an increase in policy numbers in the statewide residential property insurance market: In 2010, over 9.6 million policies were sold compared to the previous year's 9.5 million. (*See Attachment A: California Department of Insurance, Summary of 2010 Residential & Commercial Market Totals*.)

The following totals are statewide, for all insurers writing residential property insurance in California:

- *Residential Homeowners (Dwelling) Policies* totaled 6,075,092
- *Residential Condominium Unit Policies* totaled 685,533
- *Manufactured Home (Mobilehome) Policies* totaled 264,402
- *Rental Policies* totaled 1,241,952
- *Dwelling Fire Policies* totaled 1,386,480

Earthquake Insurance Market – 2010
Based on the total number of residential earthquake insurance policies written in 2010, CEA and non-CEA companies together accounted for 1.14 million earthquake policies statewide.

CEA Earthquake Response in 2010

The CEA and its participating insurers responded to 371 policyholder claims in 2010, resulting in payments of $68,320. The year 2010 had the largest number of CEA claims since 2003, when the San Simeon earthquake struck California's Central Coast.

On January 9, 2010, California started the year with a 6.5 earthquake, epicentered in the Pacific Ocean some 22 miles off the Northern California coast. Ferndale and Eureka were the closest cities to the epicenter, and while many people reported having felt the earthquake, there was very little new earthquake damage to homes, primarily because of their substantial distance from the epicenter. The CEA received 27 claims and was able to make two payments totaling $22,214.

On April 4, 2010, there was a 7.2 earthquake in Mexico, 30 miles south of the California town of Calexico. The CEA received 164 claims from this earthquake (CEA insures only properties located in California but does not restrict claim payments based on the location of earthquakes outside California's borders). Most of the $46,166 CEA paid in claims from this earthquake was on account of damage to manufactured homes ("mobilehomes") close to the border. The earthquake was widely felt throughout San Diego and Imperial counties, and most claims were from insureds who were seeking an inspection of their homes. These inspections were completed by CEA participating insurers; because of the substantial distance from the epicenter to the claimants' homes, it was determined that any new (covered) earthquake damage was minor and did not clear the CEA insurance-policy deductible.

California experienced a large number of small earthquakes in 2010 that generated the remainder of the CEA's claims. The CEA regularly receives claims from CEA policyholders who have felt small earthquakes and want their homes inspected for earthquake damage. Each claim is fully investigated by a CEA participating insurance company, and when necessary, an engineer is used to determine the cause of all new damage. For all such claims reported in 2010, the damage (mainly cracks) were determined to be minor and non-structural, or caused by other than earthquake shaking.

CEA Operational Developments in 2010

CEA Policy Growth

The CEA ended 2010 with 811,317 policies-in-force, which represents a 1.38% increase in policy count compared to year-end 2009.

It is the CEA's view that the increase was attributable to a notable increase in consumer interest in residential earthquake insurance, which was triggered by the following series of significant events:

- January 9, 2010—6.5 Magnitude earthquake
    - 43km (27 miles) W of Ferndale, CA, Humboldt County
- January 12, 2010—7.0 Magnitude earthquake
    - 25km (15 miles) WSW of Port-au-Prince, Haiti
- February 27, 2010—8.8 Magnitude earthquake
    - 100km (60 miles) NNW of Chillan, Chile
- April 4, 2010—7.2 Magnitude earthquake
    - 17km (11 miles) WSW from Guadalupe Victoria, Baja California, Mexico

The CEA experienced its largest organic growth in policies-in-force during the period beginning February 2010 and ending May 2010. Many of the gains achieved in the first half of 2010, however, were lost in the second half as the frequency of earthquakes dropped off and consumers began reconsidering their insurance-purchase options.

<u>New Chief Actuary</u>

Shawna Ackerman, FCAS, MAAA, joined the CEA on October 1, 2010, as the CEA's Chief Actuary.

A veteran of some 20 years in the property and casualty insurance industry and with California's insurance commissioner, Ms. Ackerman's diverse work experience and outstanding credentials match perfectly with the CEA's needs. Ms. Ackerman is uniquely qualified for this critical role on the CEA's executive-management team, having served as the CEA's independent consulting actuary for over ten years.

For the seven years before she joined the CEA, Ms. Ackerman served as a principal and consulting actuary at Pinnacle Actuarial Resources, Inc., where she acted as an independent advisor to insurance companies (and to the CEA), state and local governmental entities, and trade associations on actuarial matters for all lines of property and casualty insurance. Her responsibilities included evaluations of the liabilities of insurance companies, financial modeling, and rate-level studies. In addition, Ms. Ackerman has provided testimony in legislative and regulatory hearings, including three contested rate hearings regarding California residential earthquake insurance and the use of commercial-earthquake-model output.

Ms. Ackerman began her career as an actuary at the California Department of Insurance (CDI), where she served for nine years. While at the CDI, she advanced through the ranks to Senior Casualty Actuary while pursuing and attaining her professional designations as a Fellow of the Casualty Actuarial Society (CAS) and a Member of the American Academy of Actuaries (AAA), which she attained in 1996 and 1998, respectively.

<u>New CEA Participating Insurers</u>

In 2010, the CEA Governing Board approved applications from Nationwide Group and Metropolitan Direct Property and Casualty Insurance Company ("MetDirect") to become CEA participating insurers. The Governing Board unanimously approved the applications, conditioned on payment by each insurer of up to five annual risk capital surcharges as provided by Insurance Code sec. 10089.16(d) (the surcharge is imposed in addition to the standard, statutory capital contributions and assessment obligations).

Nationwide plans to begin writing CEA business in November 2011.

MetDirect is targeting CEA implementation for mid-year 2012.

Risk Capital Surcharge - Insurance Code Section 10089.16(d)

Safeco Insurance Company of America ("Safeco") became a participating insurer of the California Earthquake Authority and began offering earthquake insurance coverage for California residential property through the CEA for new and renewal policies, effective on and after December 1, 2008.

Safeco was the first insurer to apply to become a CEA participating insurer since passage of Senate Bill 430 (Insurance Code sec. 10089.16(d)), which became effective July 1, 2008. As part of the CEA application process, and as required by the new law, Safeco submitted policy data to the CEA for its earthquake-insurance book of business. The data allowed the CEA staff to complete an "earthquake-insurance risk profile," using EQECAT modeling to determine the current likelihood and magnitude of additional CEA losses that would be attributable to insuring Safeco's book of earthquake-insurance business during Safeco's first full year of CEA participation.

Based on staff analysis of Safeco's earthquake-insurance risk profile, on June 28, 2008, the Governing Board unanimously approved Safeco's application, conditioned on payment by Safeco of up to five annual risk-capital surcharges in addition to the standard statutory initial capital contribution and any participating-insurer assessment obligations.

Under the law, the Board must calculate the first annual risk-capital surcharge one year after the date the new participant first placed or renewed business into the CEA; in addition, the Board must recalculate the risk-capital surcharge for each of up to four years after the first year's calculation and then impose the resulting surcharge(s) in the respective ensuing years. Once the insurer's earthquake-insurance risk profile becomes substantially similar to the CEA's average risk profile for a CEA book of business of similar size, the Board must relieve the insurer of further obligation to pay risk-capital surcharges.

The law also provides that each annual risk capital surcharge must equal the CEA's increased cost of providing or securing capacity to insure the new participant's excess earthquake insurance risk.

The law requires full payment of a noticed risk-capital surcharge within 30 days after it is requested. Penalties and interest can be imposed for non-payment, but the Board may waive the penalties and interest for good cause shown.

CEA staff analyzed Safeco's earthquake insurance risk profile as of December 31, 2009, and determined that the addition of Safeco's business was more likely to produce losses for the CEA, or was likely to produce greater losses for the CEA, than would a book of existing Authority business of similar size. As a result, CEA staff recommended, and the Board concurred, that Safeco be required to pay a risk-capital surcharge in the amount of $1,700,000, which represents the increased cost of providing capacity to insure Safeco's excess earthquake-insurance risk. Safeco paid the surcharge in February 2011.

<u>CEA Supported Research Projects</u>

Because California law requires the CEA to base its rates on the best available scientific information, the CEA continued its commitment to supporting research that promotes the ongoing development of science and earthquake engineering that are relevant to CEA insurance operations and earthquake-loss mitigation activities. In recent years, the CEA supported research and development of the Uniform California Earthquake Rupture Forecast (UCERF), which was completed in 2008. UCERF provides, for the first time, a uniformly prepared earthquake-fault-rupture forecast for all of California based on an adequate time-dependent methodology. As a result of this project, the CEA's loss modeler for rate purposes, EQECAT, updated its model to incorporate the results of UCERF. Because EQECAT added these authoritative results into EQECAT's CEA earthquake model, the CEA is assured its rates and rate structure are based on uniform statewide seismic-hazard estimates that represent the best available scientific information. Upon completion of the project, the United States Geological Survey (USGS) also used UCERF in development of important new hazard maps.

In 2009, CEA staff identified two new research projects whose results would (further) aid CEA in its mission—Uniform California Earthquake Rupture Forecast, Version 3 (UCERF3), and Near-Source Ground Motion Characterization (NGA–West 2). The CEA Governing Board approved both for CEA support and funding.

As with previous CEA-funded research, these projects represent the CEA's ongoing need for and commitment to advancing the evolution of earthquake science and engineering that support the loss-modeling the CEA uses in rate-setting and other activities, including financial analysis. The UCERF3 and NGA-West 2 projects are continuations of previous research and will provide clear benefit to the CEA, its policyholders, and partners, by substantially improving the loss-modeling required for both financial analysis and ratemaking.

During 2010 and in accordance with projections, both the UCERF3 and NGA-West 2 projects remained on target for completion in 2012.

<u>Consumer and Agent Outreach</u>

In 2010, the CEA completed marketing-research studies and pilot projects necessary to earn support from its Governing Board for implementation of a first-ever annualized CEA marketing plan in 2011:

- Trained 1,386 agents – 825 in person and 561 online. CEA increased the number of agents trained annually through scheduling training sessions in targeted locations, promoting company-sponsored training sessions, and offering Webinars.

- Trained 820 claim adjusters as part of its ongoing commitment to ensure that CEA claims are adjusted promptly, fairly, and consistently.

- Completed four comprehensive marketing studies designed to complement related independent social science study recommendations produced in 2008 and 2009:
  - Market research simulated statewide CEA-policy purchase decisions according to local risks.
  - CEA policyholder research identified reasons for record net policy sales in March through April 2010.
  - CEA branding research identified a marketing story or "promise" about CEA’s purpose.
  - Message research, with co-funding sought by the CEA from the Federal Emergency Management Agency (through the California Emergency Management Agency), developed a communications roadmap depicting the decision-making thought process that would enable different earthquake-preparedness stakeholders (including the CEA) to identify a common message to effectively motivate residents to act.

- CEA worked (again) as the primary statewide marketer of the second annual Great California ShakeOut earthquake drill – helping to earn participation by more than 7.9 million Californians in all 58 counties. CEA marketing strategies from 2008 and 2009 were combined in 2010 to generate nearly 45 million paid-media impressions and distribute more than 1.2 million direct-mail pieces in English, Spanish, and Chinese through more than 2,300 CEA-participating-insurer agents.

<u>Residential Mitigation Program Development</u>

In 2010, final program cornerstones were completed (in less than 18 months) to establish a first-ever statewide residential seismic retrofit program. The efforts positioned the CEA and its Governing Board to transition swiftly from program development to program execution in 2011.

- Established a desired CEA-program reference in the State Multi-Hazard Mitigation Plan, which is renewed every three years.

- Facilitated adoption of the first-ever California Building Code for the seismic retrofitting of existing residential structures.

- Supported passage of successful state legislation that authorized the CEA to hire a Chief Mitigation Officer (or “CMO”).

- Completed an RFQ to identify a statewide residential-seismic-retrofit-program administrator to distribute consumer financial incentives and oversee a process to verify project completion and building permits.

- Neared completion of joint exercise of powers agreement (JPA) with the California Emergency Management Agency. Earned CEA Governing Board approval for the program’s start-up funding.

Financial Report

In 2006, the CEA issued $315,000,000 in investment-grade revenue bonds, marking the CEA's first entry into the capital markets. During 2009, the CEA redeemed $31,500,000 in outstanding bonds; therefore, at the end of 2010 the CEA had $189,000,000 in revenue bonds outstanding.

Financial Stability Ratings

During 2010, CEA continued its A-Minus (Excellent) rating from the A.M. Best Co., and the rating has a "stable" outlook. As important, 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 2010 RESIDENTIAL & COMMERCIAL MARKET TOTALS

2010 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	5,267,189,316	7,312,301	1,679,014,629,928	$ 720.32	$ 3.14	75.75%	582,971,334	798,131	256,610,335,136	$ 730.42	$ 2.27	69.92%	10.91%
Total Residential Mkt (Excluding CEA)	2,115,922,490	2,341,157	1,068,308,848,001	$ 903.79	$ 1.98	24.25%	387,360,235	343,314	179,710,745,775	$ 1,128.30	$ 2.16	30.08%	14.66%
Total Residential Mkt (Including CEA)	7,383,111,807	9,653,458	2,747,323,477,929	$ 764.82	$ 2.69	100.00%	970,331,570	1,141,445	436,321,080,911	$ 850.09	$ 2.22	100.00%	11.82%
Total Homeowners Market	5,999,126,849	6,075,092	2,295,736,256,806	$ 987.50	$ 2.61	62.93%	865,291,163	836,546	406,117,439,327	$ 1,034.36	$ 2.13	73.29%	13.77%
Total Rental Market	260,973,903	1,241,952	39,811,216,048	$ 210.13	$ 6.56	12.87%	8,865,626	77,698	2,059,798,780	$ 114.10	$ 4.30	6.81%	6.26%
Total Condominium Market	292,273,973	685,533	38,037,418,606	$ 426.35	$ 7.68	7.10%	47,732,314	126,293	5,748,593,831	$ 377.95	$ 8.30	11.06%	18.42%
Total Dwelling Fire Market	692,680,085	1,386,480	353,234,329,162	$ 499.60	$ 1.96	14.36%	40,498,853	59,034	18,398,045,564	$ 686.03	$ 2.20	5.17%	4.26%
Total Mobilehome Market	138,056,997	264,402	20,504,257,308	$ 522.15	$ 6.73	2.74%	7,943,615	41,874	3,997,203,411	$ 189.70	$ 1.99	3.67%	15.84%
Total Residential Mkt (Including CEA)	7,383,111,807	9,653,458	2,747,323,477,929	$ 764.82	$ 2.69	100.00%	970,331,570	1,141,445	436,321,080,911	$ 850.09	$ 2.22	100.00%	11.82%
California FAIR Plan	56,215,333	138,207	38,751,005,465	$ 406.75	$ 1.45	9.97%	4,568,029	5,533	2,217,779,917	$ 825.60	$ 2.06	9.37%	4.00%
Total Dwelling Fire (Excluding CA FAIR Plan)	636,464,752	1,248,273	314,483,323,697	$ 509.88	$ 2.02	90.03%	35,930,824	53,501	16,180,265,647	$ 671.59	$ 2.22	90.63%	4.29%
Total Dwelling Fire Market	692,680,085	1,386,480	353,234,329,162	$ 499.60	$ 1.96	100.00%	40,498,853	59,034	18,398,045,564	$ 686.03	$ 2.20	100.00%	4.26%

* 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	550,019,321	238,320	682,821,909,059	$2,307.90	$ 0.81	21.64%	221,875,329	27,646	77,888,483,474	$ 8,025.59	$ 2.85	25.61%	11.60%
Commercial Multiple Peril (Non-Liab.)	2,424,918,177	862,953	1,608,443,073,194	$2,810.02	$ 1.51	78.36%	99,276,224	80,300	114,843,922,078	$ 1,236.32	$ 0.86	74.39%	9.31%
Total Commercial Lines:	2,974,937,498	1,101,273	2,291,264,982,253	$2,701.36	$ 1.30	100.00%	321,151,553	107,946	192,732,405,552	$ 2,975.11	$ 1.67	100.00%	9.80%

SOURCE: California Dept. of Insurance - EQ PREMIUM POLICY COUNT DATA CALL

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Attachment A: California Department of Insurance Summary: 2010 Residential & Commercial Market Totals

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, 2010:

Assets		
	Cash on hand	$96,456,862
	Stocks or bonds	4,176,584,412
	Premiums receivable	49,595,737
	Assessments receivable	3,190,830
	Interest receivable	12,350,634
	Securities receivable	-
	Unearned ceded premium	-
	Prepaid reinsurance premiums	-
	Equipment, net of depreciation	1,413,255
	Deferred participating-insurer commissions and operating costs	40,674,396
	Reinsurance premium receivable	-
	Other assets	1,742,495
Liabilities		
	Losses due and unpaid	-
	Claims for losses resisted by the CEA	-
	Losses in the process of adjustment or suspense	-
	Reported losses	-
	Supposed losses	-
	Revenue bonds Payable	189,000,000
	Revenue bonds Interest Payable	5,829,705
	Other debt financing	-
	Unearned premium	302,862,221
	Unearned commissions	-
	Accounts payable	2,378,089
Income		
	Premiums received	604,827,689
	Interest money received	38,633,733
	Installment fees	538,907
	Supplemental commissions	-
Expenses		
	Loss adjustment expenses paid	6,195
	Losses paid	68,841
	Participating insurer commissions	59,970,221
	Participating insurer operating costs	20,567,165
	Reinsurance broker commissions	4,800,000
	Financing expenses	12,958,831
	Reinsurance premium	233,488,128
	Other underwriting expenses	19,570,601

Attachment B: 2010 Financial Statement

California Earthquake Authority: 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, 2010.

Assets		
	Cash & Investments	$4,250,371,635
	Revenue Bond Proceeds	(313,836,959)
	Less: Debt Service	(25,250,000)
	Interest Receivable	12,350,634
	Securities Receivable	-
	Premiums Receivable	49,595,737
	Capital Contribution Receivable	3,190,830
	Other Cash-Related Assets	1,742,495
	Accounts Payable & Accrued Expenses	(2,378,089)
Liabilities		
	Unearned premium	222,418,788
Total Available Capital		3,753,367,495
Assessments		
	Available for assessment in 1st IA layer	-
	Assessments previously made from 1st IA layer	-
	Available for assessment in 2nd IA layer	1,557,840,000
	Assessments previously made from 2nd IA layer	-
	Available for assessment in New IA layer	1,095,197,462
	Assessments previously made from New IA layer	-
	[IA = Industry Assessment]	
Reinsurance		
	Available in all layers	3,123,000,000
Bonds		
	Revenue bonds issued in 2006	315,000,000
	Revenue bonds outstanding 12/31/2010	189,000,000
Policyholder Surcharges		
	Surcharges assessed	-
	Surcharges outstanding	-
Capital Markets		
	Capital committed from capital markets	-
Debt		
	Line of credit available	-

Attachment C: Summary of CEA Claim-Paying Capacity