CALIFORNIA EARTHQUAKE AUTHORITY

ANNUAL REPORT TO THE LEGISLATURE AND INSURANCE COMMISSIONER ON CEA PROGRAM OPERATIONS
Report Covering Calendar Year 2011
(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

<u>Residential Property Insurance Market</u>
The CDI year-end-2011 data once again indicate an increase in policy numbers in the statewide residential property insurance market: In 2011, over 10 million policies were sold compared to the previous year's 9.6 million. (*See Attachment A: California Department of Insurance, Summary of 2011 Residential & Commercial Market Totals*.)

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

- *Residential Homeowners (Dwelling) Policies* totaled 6,196,262
- *Residential Condominium Unit Policies* totaled 720,356
- *Manufactured Home (Mobilehome) Policies* totaled 260,083
- *Rental Policies* totaled 1,394,478
- *Dwelling Fire Policies* totaled 1,626,305

Earthquake Insurance Market – 2011
Based on the total number of residential earthquake insurance policies written in 2011, CEA and non-CEA companies together accounted for 1.23 million earthquake policies statewide.

CEA Earthquake Response in 2011

The CEA paid $31,538 on earthquake-insurance claims in 2011—the year was a quiet one for California earthquakes, and the USGS (United States Geological Survey) did not record any California earthquakes with a Richter Magnitude higher than 5.0. Although there were no large damaging earthquakes in California during 2011, there were of course many smaller earthquakes, with a Richter Magnitude of 4.9 or lower.

The CEA regularly receives claims from CEA policyholders who have felt small earthquakes and ask that their homes be inspected for earthquake damage; in 2011, the CEA received 203 such claims. Each claim is fully investigated by or on behalf of a CEA participating insurance company, and when necessary, an engineer is used to determine the cause of reported damage.

The CEA policy is designed to assist homeowners with the kind of damage one might expect from larger earthquakes. Although limited claim payments were made in 2011, each property that was the subject of a CEA earthquake-insurance claim received a thorough inspection, and the policyholders benefited from any expert reports that were generated.

CEA Operational Developments in 2011

CEA Policy Growth

The CEA ended 2011 with 820,932 policies-in-force, which represents a 1.19% increase compared to year-end 2010.

The increase was attributable to a notable increase in consumer interest in residential earthquake insurance following the 9.0 Magnitude earthquake and tsunami in Honshu, Japan, on March 11, 2011. That event triggered the CEA's largest organic growth in policies-in-force during the period from March 11, 2011, through June 30, 2011.

In addition, 2011 CEA policy growth included the addition of Nationwide Group as a CEA participating insurer. Nationwide began writing CEA residential earthquake insurance on November 15, 2011.

Approval of Rate and Coverage Changes

On July 13, 2011, the CDI approved CEA's request for a 12.5% average statewide rate decrease, beginning with new and renewal policies that became effective on and after January 1, 2012. That rate change was a result of a reduction in the estimated average annual loss, as derived from new scientific information. Given that the rate decrease is expressed as an average statewide rate impact, individual policyholders may see their rates increase or decrease, depending on CEA product, location of the risk, and other rating factors.

The CDI also approved the CEA's application to use new editions of the CEA policy forms, which incorporate new coverage enhancements and refinements in coverage, definitions, and policy language. Of note, the new edition of the CEA "Basic Earthquake Policy—Homeowners" includes enhancements and refinements in coverage, most notably, "Other Coverages" has been broadened to include $1,500 in coverage (not subject to any deductible) for emergency repairs to protect covered property from further damage, secure the residence, or restore habitability after an earthquake.

In addition, a new $25,000-limit option was introduced for Coverage D – Loss of Use (covering additional living expenses, post-earthquake) in response to consumer feedback.

Approval of New Product

On July 13, 2011, the CDI also approved the new "Homeowners Choice" product, which available to consumers beginning July 1, 2012. The Choice product offers consumers more coverages and delivers more immediate policy benefits after an earthquake for those who own a house or a manufactured home (mobilehome).

The "Homeowners Choice" policy includes:

- The option to purchase only Coverage A – Dwelling and Coverage B – Extensions to Dwelling, with an option to purchase, in addition, Coverage C – Personal Property or Coverage D – Loss of Use, or both.
- Separate deductibles for Coverage A – Dwelling and Coverage C – Personal Property. A separate deductible option of 15% or 10% is available for each coverage. The Coverage C – Personal Property deductible is waived if the Coverage A – Dwelling deductible is met for covered structural property.

By offering more choice in coverage options, consumers are empowered to manage their residential earthquake insurance premium—these features enhance availability and affordability.

New CEA Participating Insurers

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 successful applications were conditioned on payment by each insurer of up to five annual risk-capital surcharges, as required in Insurance Code sec. 10089.16(d). The surcharge is in addition to the standard capital contribution and any assessment obligations.

Nationwide officially 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 or after November 15, 2011.

MetDirect has delayed implementation because of a change in their related business plans.

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 or after December 1, 2008.

Safeco was the first insurer to apply to become a CEA participating insurer since passage of Insurance Code sec. 10089.16(d), which became effective July 1, 2008. As part of the CEA-participating-insurer 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 (CEA-contractor) EQECAT computer 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 CEA's analysis of Safeco's earthquake insurance risk profile, on June 28, 2008, the CEA 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 capital contribution and any assessment obligations.

Under the law, the Board must calculate the first 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 calculation and impose the resulting surcharge. 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. Certain penalties and interest can be imposed, 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 first annual risk-capital surcharge in the amount of $1,700,000, which represented the increased cost of providing capacity to insure Safeco's excess earthquake-insurance risk. Safeco paid the surcharge in February 2011.

In accordance with the law, CEA staff analyzed Safeco's earthquake-insurance risk profile as of December 31, 2010, and determined that Safeco's earthquake-insurance risk profile was substantially similar to the CEA's average risk profile for a CEA book of business of similar size — leading CEA staff to recommend, and the Board to concur, that Safeco be relieved of further obligation to pay annual risk-capital surcharges.

CEA Supported Research Projects

Because California law requires the CEA to base its rates on the best scientific information, the CEA continued its commitment to supporting research that promotes the ongoing development of science that is relevant to CEA operations. In recent years, the CEA supported research on a Uniform California Earthquake Rupture Forecast (UCERF), 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, EQECAT, updated its model to incorporate the results of UCERF. Because EQECAT added these authoritative results to 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, USGS used UCERF in development of new hazard maps.

In 2009, CEA staff identified two new research projects — Uniform California Earthquake Rupture Forecast, Version 3 (UCERF3), and Near-Source Ground Motion Characterization (NGA–West 2)—which the CEA Governing Board approved for support and funding.

As with previous CEA-funded research, these projects represent the CEA's ongoing need and commitment to advancing the evolution of earthquake science that supports the loss-modeling on which the CEA and its rate-setting methodologies are highly dependent. The UCERF3 and NGA-West 2 projects are continuation 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 2011, both the UCERF3 and NGA-West 2 projects remained on target for completion.

New Insurance Director

On November 1, 2011, Mitchell D. Ziemer joined the CEA as Insurance Director. Mitch is a 27 year veteran of the property and casualty insurance industry.

Mitch most recently served as Property Product Manager for Fireman's Fund Insurance Companies where he was employed for 27 years—at Fireman's Fund, he also held positions as Audit & Compliance Manager and has demonstrated creativity in product development. Of note, he managed development and implementation of nationwide strategic and tactical business plans to support Fireman Fund's well publicized "Green Upgrade." In addition, Mitch was a member of, and has chaired, the California F.A.I.R. Plan Governing Committee.

Mitch is a graduate of the University of Wisconsin at Milwaukee, where he received a Bachelor of Arts and Social Sciences degree in Economics.

Communications

In August 2010, CEA's Governing Board approved investing up to $5 million (less than one percent of the CEA's 2011 premium revenue) to support a first-time, annualized, new-policy-sales Marketing Value Program (MVP) for 2011, developed to:

- Attract new CEA policyholders;
- Retain existing CEA policyholders;
- Generate media impressions; and
- Produce a return-on-investment that helps build CEA's capital.

Though CEA's unique structure still offers financial and logistical challenges in the sale of its policies through its participating insurers, all year-end 2011 metrics to evaluate program effectiveness programming revealed upward-facing trends. The CEA expects the number of MVP-registered agents to increase annually as MVP awareness grows.

In 2011, CEA policies-in-force increased by about 1 percent, resulting in the highest CEA policy-count since 2001.

- Total number of agents registered in MVP increased by 73% (compared to 2010)
- MVP agent training increased by 128% (compared to 2010)
  - In person and Webinars +132%.
  - Online +119%.
  - Average class size +58%.
  - 95.5% of survey respondents want to participate in future MVP efforts:
    - 92.5% will recommend MVP participation to co-workers and colleagues.
    - 43.3% of respondents reported an increase in quotes and sales through MVP.
    - 71% said earthquake preparedness kits were a good tool appreciated by clients.
- In addition, CEA trained 1,074 claim adjusters as part of its annual commitment to ensuring that its policyholder claims are adjusted promptly, fairly, and consistently.

CEA's role in promoting the Great California ShakeOut, which attracted 8.6 million participants in 2011, has grown in significance each year. CEA support for the ShakeOut in 2011 included earthquake-preparedness public-service announcements by news talent from two television networks in four markets, and celebrities such as Ryan Seacrest (from "American Idol") and Mario Lopez (from "Extra"), to promote both the CEA and the ShakeOut.

CEA's collaboration results from 2008 through 2011 include:

- Delivering 175 million impressions statewide through paid media
- Distributing news releases, media advisories, and public service announcements
- Coordinating statewide media spokespersons and a media database
- Hosting five press availabilities for preparedness stakeholders
- Delivering about 6 million impressions through in-store merchandising displays
- Distributing more than 2.5 million pieces of direct mail in English, Spanish, and Chinese
- Hosted information booths at ethnic-community festivals
- Sponsoring Preparedness Team at community events, statewide
- Distributing about 25,000 preparedness starter kits to consumers

Residential Mitigation Program Development

The CEA's enabling legislation directs the CEA Governing Board to set aside each year five percent of CEA's investment income (up to 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.

The CEA has completed cornerstones to establish a statewide residential-retrofit program, including:

- Collection of mitigation-experts' input
- Creation of a mitigation-program concept
- Reference in the State Multi-Hazard Mitigation Program
- Support of the adoption of a first-ever California Building Code for the seismic retrofitting of residential structures by the State of California
- Hiring a Chief Mitigation Officer ("CMO") - Janiele Maffei joined the CEA as CMO on May 9, 2011.
- Forming a Joint Powers Authority ("JPA") with the California Emergency Management Agency — (then) Cal EMA Acting Secretary Mike Dayton and CEA CEO Glenn Pomeroy signed the Joint Exercise of Powers Agreement on August 16, 2011.
- The first JPA board meeting was held on October 4, 2011.

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 2011, the CEA redeemed $31,500,000 in outstanding bonds and therefore at year-end 2011 had $157,300,000 in revenue bonds outstanding.

<u>Financial Stability Ratings</u>
During 2011, CEA continued its "A-Minus (Excellent)" rating from 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."

Attachment A: California Department of Insurance Summary: 2011 Residential & Commercial Market Totals

EARTHQUAKE PREMIUM AND POLICY COUNT DATA CALL

SUMMARY OF 2011 RESIDENTIAL & COMMERCIAL MARKET TOTALS

2011 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* **	5,559,970,554	7,829,934	2,003,816,890,276	$ 710.09	$ 2.77	76.78%	604,468,163	804,737	286,941,375,296	$ 751.14	$ 2.11	65.50%	10.28%
Total Residential Mkt (Excluding CEA)	2,105,214,508	2,367,550	1,054,937,094,109	$ 889.20	$ 2.00	23.22%	384,276,399	423,951	193,828,042,470	$ 906.42	$ 1.98	34.50%	17.91%
Total Residential Mkt (Including CEA)	7,665,185,063	10,197,484	3,058,753,984,385	$ 751.67	$ 2.51	100.00%	988,744,562	1,228,688	480,769,417,766	$ 804.72	$ 2.06	100.00%	12.05%
Total Homeowners Market	6,123,997,294	6,196,262	2,543,809,412,151	$ 988.34	$ 2.41	60.76%	872,968,329	815,914	442,140,702,409	$ 1,069.93	$ 1.97	66.41%	13.17%
Total Rental Market	283,341,416	1,394,478	44,621,401,630	$ 203.19	$ 6.35	13.67%	9,367,961	81,614	2,109,370,385	$ 114.78	$ 4.44	6.64%	5.85%
Total Condominium Market	306,441,952	720,356	41,152,115,357	$ 425.40	$ 7.45	7.06%	47,924,661	206,952	7,218,523,687	$ 231.57	$ 6.64	16.84%	28.73%
Total Dwelling Fire Market	810,990,609	1,626,305	408,742,775,910	$ 498.67	$ 1.98	15.95%	50,706,733	82,924	25,198,296,696	$ 611.48	$ 2.01	6.75%	5.10%
Total Mobilehome Market	140,413,791	260,083	20,428,279,338	$ 539.88	$ 6.87	2.55%	7,776,878	41,284	4,102,524,590	$ 188.38	$ 1.90	3.36%	15.87%
Total Residential Mkt (Including CEA)	7,665,185,063	10,197,484	3,058,753,984,385	$ 751.67	$ 2.51	100.00%	988,744,562	1,228,688	480,769,417,766	$ 804.72	$ 2.06	100.00%	12.05%
California FAIR Plan	56,596,064	132,292	38,652,120,403	$ 427.81	$ 1.46	8.13%	4,723,633	5,426	2,267,357,139	$ 870.56	$ 2.08	6.54%	4.10%
Total Dwelling Fire (Excluding CA FAIR Plan)	754,394,545	1,494,013	370,090,655,507	$ 504.95	$ 2.04	91.87%	45,983,100	77,498	22,930,939,557	$ 593.35	$ 2.01	93.46%	5.19%
Total Dwelling Fire Market	810,990,609	1,626,305	408,742,775,910	$ 498.67	$ 1.98	100.00%	50,706,733	82,924	25,198,296,696	$ 611.48	$ 2.01	100.00%	5.10%

* Market share represents the percentage of policies to total residential market.

** Percent with EQ represents the percentage of policies that also have EQ coverage.

*** Nationwide Companies are not included due to the fact that they do not participate in CEA until November 2011.

Commercial Fire	545,261,379	405,253	808,376,131,718	$1,345.48	$ 0.67	32.14%	256,829,455	29,233	114,195,928,604	$ 8,785.60	$ 2.25	34.76%	7.21%
Commercial Multiple Peril (Non-Liab.)	2,298,185,650	855,819	1,462,400,637,219	$2,685.36	$ 1.57	67.86%	70,287,831	54,860	80,100,911,990	$ 1,281.22	$ 0.88	65.24%	6.41%
Total Commercial Lines:	2,843,447,029	1,261,072	2,270,776,768,937	$2,254.79	$ 1.25	100.00%	327,117,286	84,093	194,296,840,593	$ 3,889.95	$ 1.68	100.00%	6.67%

SOURCE: California Dept. of Insurance - EQ PREMIUM POLICY COUNT DATA CALL **Date Printed: 7/11/2012**

Rate Specialist Bureau

Attachment B: 2011 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, 2011:

Assets		
	Cash on hand	$160,660,834
	Stocks or bonds	4,348,263,568
	Premiums receivable	41,893,958
	Assessments receivable	17,310,000
	Interest receivable	12,035,424
	Securities receivable	68,858,008
	Unearned ceded premium	-
	Prepaid reinsurance premiums	2,546,102
	Reinsurance premium deposit	5,029,836
	Equipment, net of depreciation	499,468
	Deferred participating-insurer commissions and operating costs	41,619,480
	Reinsurance premium receivable	131,105
	Other assets	-
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	157,500,000
	Revenue bonds Interest Payable	4,858,088
	Other debt financing	-
	Unearned premium	309,899,331
	Unearned commissions	-
	Accounts payable	3,506,928
	Securities payable	871,423
	Accrued reinsurance premium expense	1,676,612
Income		
	Premiums received	612,830,953
	Interest money received	29,803,268
	Installment fees	488,791
	Supplemental commissions	-
Expenses		
	Loss adjustment expenses paid	2,804
	Losses paid	28,734
	Participating insurer commissions	60,623,577
	Participating insurer operating costs	20,776,606
	Reinsurance broker commissions	4,800,000
	Financing expenses	11,010,368
	Reinsurance premium	200,622,675
	Other underwriting expenses	21,763,427

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, 2011.

Assets		
	Cash & Investments	$4,484,946,815
	Revenue Bond Proceeds	(316,970,531)
	Less: Debt Service	(25,590,837)
	Interest Receivable	12,035,424
	Securities Receivable	68,858,008
	Premiums Receivable	41,893,958
	Capital Contribution Receivable	17,310,000
	Other Cash-Related Assets	131,105
	Accounts Payable & Accrued Expenses	(3,506,928)
Liabilities		
	Unearned premium	229,336,955
	Securities payable	871,423
Total Available Capital		4,048,898,636
Assessments		
	Available for assessment in 1st IA layer	-
	Assessments previously made from 1st IA layer	-
	Available for assessment in 2nd IA layer	1,558,000,000
	Assessments previously made from 2nd IA layer	-
	Available for assessment in New IA layer	804,000,000
	Assessments previously made from New IA layer	-
	[IA = Industry Assessment]	
Reinsurance		
	Available in all layers	3,050,000,000
Bonds		
	Revenue bonds issued in 2006	315,000,000
	Revenue bonds outstanding 12/31/2011	157,500,000
Policyholder Surcharges		
	Surcharges assessed	-
	Surcharges outstanding	-
Capital Markets		
	Capital committed from capital markets	-
Debt		
	Line of credit available	-