CALIFORNIA EARTHQUAKE AUTHORITY
GOVERNING BOARD MEETING
MINUTES

Thursday, February 24, 2011
1:00 P.M.

Location: CalSTRS Headquarters Building
100 Waterfront Place, Board Room – E-124
West Sacramento, California

Board members in attendance:
J. Clark Kelso, designee of Governor Jerry Brown
Grant Boyken, designee of State Treasurer Bill Lockyer
Dave Jones, Insurance Commissioner
Bruce Patton, designee of Insurance Commissioner Dave Jones
Dietrich Stroeh, designee of Chair of the Senate Rules Committee Darrell Steinberg

Members of the CEA staff in attendance:
Glenn Pomeroy, Chief Executive Officer
Tim Richison, Chief Financial Officer
Bob Stewart, Chief Operations Officer
Chris Nance, Chief Communications Officer
Shawna Ackerman, Chief Actuary
Susan Pitton, Governing Board and Advisory Panel Liaison
Danny Marshall, General Counsel

Also present:
Anne Sheehan, designee of Governor Jerry Brown
John Forney, Raymond James, Inc.

1. The meeting was called to order at 1:04 p.m. A quorum was established.

- Ms. Sheehan welcomed the group to the new CalSTRS building. She noted that it was exciting to broadcast the meeting live over the Internet; this was in keeping with CalSTRS' commitment to bring government to the people. She expressed the hope that CEA would hold future meetings in the building.

- Mr. Kelso welcomed Insurance Commissioner Dave Jones.

2. Consideration and approval of the minutes of the December 9, 2010, Governing Board meeting.

MOTION: Mr. Boyken moved approval of the December 9, 2010, Governing Board minutes; seconded by Mr. Jones. Motion passed unanimously.

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

Mr. Pomeroy presented the Executive Report. Highlights are below.

- A capital markets initiative will be discussed.
- A rate reduction and policy enhancement will also be discussed, bringing a 12.5% rate reduction across all CEA policyholders, on average.
- CEA has been pursuing an initiative in Congress to seek a public-policy solution to CEA's over-reliance on reinsurance as risk transfer.
- No items are currently pending before the state Legislature. Staff will be working to address the staffing limitation that slows CEA's ability to accomplish a number of initiatives.
- Last session the Legislature passed a bill calling for the creation of a new executive position at CEA: a Chief Mitigation Officer ("CMO"). Staff has selected the search firm Sequence and hopes to have a CMO on board as soon as possible.
- The CEA's 2011 marketing campaign, approved by the Board late last year, is launching today. The program consists of three flights, with advertising in newspapers and on radio, TV, and the Web, and direct mail from agents to their customers. Agents must complete the CEA training course before receiving free marketing materials. For the final and third flight, agents must demonstrate that they have sold three new policies.
- CEA's most recent independent audit indicated opportunities for improving controls over CEA's internal IS processes. Late last year, the Board approved engaging a firm to lead a process-improvement effort, with work continuing throughout 2011—that process is up and running.
- Last November, CEA staff members visited Christchurch, New Zealand, to meet with the New Zealand Earthquake Commission ("EQC"), and to study in particular how EQC was dealing with the huge influx of claims from the September 4, 2010, earthquake. Then came the damaging second Christchurch earthquake on Tuesday, February 22, 2011. Although the latter quake released far less energy than the first, the epicenter was closer to the city's center and the rupture depth closer to the surface of the earth, so it caused much more damage than the September 2010 event. The property loss from the two quakes is staggering, and a huge amount of liquefaction occurred throughout the city.

- The EQC will be dealing with over 200,000 claims over the coming months. In November 2010, Christchurch Mayor Bob Parker noted that Christchurch's chance of recovery may be greater than had a similar even occurred in California, because virtually everyone in New Zealand has earthquake insurance.

  The CEA can take from this tragedy the inspiration to increase the takeup rate in California beyond the 10% or 12% that it is today.

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

Highlights of the financial report are as follows.

- As of December 31, cash and investments were over $4.2 billion. The amount available to pay claims was over $3.7 billion. Reinsurance was $3.1 billion.

- The reinsurance capacity is less than it was for 2010. There is no change to the revenue bonds and the insurer-assessment layers.

- The 2010 budget shows that the CEA spent 86.5% of the 2010 budget.

- Although CEA's investment managers have strived to find financially secure commercial-paper securities, CEA's investments remain primarily in U.S. Treasuries. Staff continues to work with CEA investment managers to find opportunities for yield than the U.S. Treasury market.

In response to a question from Mr. Kelso, Mr. Richison stated that the 2011 budget planning target is to have over a 95% expenditure rate.

5. Mr. Richison will seek Board authorization to set the CEA participating insurer's respective maximum-earthquake-loss-funding-assessment levels, effective April 1, 2011.

Mr. Richison stated that setting maximum-earthquake-loss-funding-assessment levels for CEA participating insurers is done each year. The so-called New Industry Assessment Layer rolls off annually according to a formula established by the passage of Senate Bill 430 in 2007; after this year's roll-off and as of April 1, 2011, the New Industry Assessment Layer will be just over $804 million.

The Second Industry Assessment Layer also is subject to roll-off, which would commence upon CEA's having $6 billion or more of capital.

The respective contingent obligations of CEA participating insurers in the two assessment layers is determined each year based on each company's CEA market share, as shown by the CEA premium written by each insurer.

In response to a query from Mr. Kelso, Mr. Richison and Mr. Marshall confirmed that this year's New Industry Assessment Layer calculation complied with statutory requirements.

Mr. Pomeroy pointed out that, despite a notation on the financial report that could indicate the contrary, all materials under discussion in fact had been fully reviewed by Mr. Richison.

MOTION: Mr. Jones moved to approve the New Industry Assessment roll-off calculation amounts, adopting the market share information provided in Attachment B, and to direct CEA staff to so notify each participating insurer of its maximum assessment liability as of April 30, 2011; seconded by Mr. Boyken. Motion passed unanimously.

6. Mr. Richison will seek Board approval to continue work on a transformer-reinsurance option to augment CEA claim-paying capacity for 2011-2014.

Mr. Richison noted that staff has been working on exploring additional sources of risk transfer to diversify the CEA's claim-paying capacity. "Transformer-reinsurance" would allow the CEA's risk to be passed to the capital markets, which in turn would result in lower cost.

Mr. Richison explained the differences between the CEA's traditional reinsurance and the new proposed transformer reinsurance.

- The proposed transformer reinsurance is a reinsurance contract that has collateral posted for 100% of the reinsurance-contract limit.
- The reinsurer would transfer the risk to the capital markets through a transaction called a catastrophe bond.
- In the transaction under consideration, the CEA would seek multi-year, fully collateralized reinsurance contracts.
- The proposed transformer reinsurance contract would help CEA's survivability.
- The proposed transformer reinsurance transaction would be in a relatively small amount—$150 million—but this type of transaction has the potential to grow to as much as one billion dollars in risk-transfer capacity over a five-year period.

At the present Board meeting, staff is proposing a new rate filing that will include new products. The CEA must be able to finance these proposed new products. Also, reinsurers are going to start looking at how much reinsurance they provide individual programs, especially after the New Zealand earthquake.

Mr. Richison explained that the proposed transformer reinsurance transactions will involve two contracts, a reinsurance agreement and a collateral-control agreement. In addition, he explained the aggregate-loss basis of the reinsurance contract and the features of the collateral-control agreement that provides full financial security for CEA.

John Forney of Raymond James and Associates, independent financial advisor to the CEA, gave his firm's perspective on the risks and benefits of the proposed transformer reinsurance transaction. He began by offering the perspective that the primary risk the CEA faces, other than an earthquake, is over-reliance on traditional reinsurance for its risk transfer and claim-paying capacity.

From a financial standpoint, the risks of the transformer transaction fall into three categories:

1. Risks common to all reinsurance transactions, i.e., counterparty risk.

2. Risks specific to catastrophe-bond-based reinsurance transactions.

3. Risks that are specific to the unique character of the transaction that the CEA has designed to meet its specific statutory and capital needs.

Mr. Forney explained how the transformer-reinsurance transaction has been designed to mitigate these risks. He then took questions from the Board.

He closed by highlighting firms that issued catastrophe bonds in 2010. He said there is an increasing willingness by governmental insurers to access the capital markets thru catastrophe bonds.

The bottom line on the present-day catastrophe bond market is:

- The market is small but growing.

- Big insurance companies access it routinely.

- Indemnity transactions (the CEA is seeking an indemnity transaction) are increasingly being accepted in the market.

- U.S. earthquake cat-bond deals are rare, therefore valued by the market.

- Upcoming maturities of other catastrophe bonds suggest natural demand for the type of transaction proposed.

Mr. Marshall stated that CEA's Legal and Compliance Department would advise the Board in three different areas:

1. The overarching issue of the authority of the Board and the CEA to accomplish this kind of transaction.

2. Contract law: to ensure that the contracts and ancillary documents are drawn properly and to ensure that the complexities of the transactions are properly, appropriately, and favorably captured in the documentation.

3. Securities law: underlying the proposed transformer-reinsurance transaction is an issuance of cat bonds, and in undertaking a transaction that is related to such a securities transaction, the CEA should not risk undue legal exposure and should have various risk-mitigation measures in place.

Mr. Richison spoke about the benefits proposed by the transaction.

- Discussion had often taken place on diversifying CEA's risk-transfer capacity using capital markets mechanisms.
- "Taking out the middleman" by using the proposed transformer transaction would lower the CEA's costs associated with putting in place this risk transfer.
- The multi-year reinsurance agreement would benefit the CEA.
- The reinsurance transaction would be repeatable and scalable, important to bear in mind when considering this preliminary effort.

In response to a question from Mr. Kelso, Mr. Richison supplied a timeframe for staff's future negotiations and actions.

MOTION: Mr. Boyken moved to approve the resolution before the Board; seconded by Mr. Jones. Motion passed unanimously.

7. CEA Advisory Panel Chair Wayne Coulon will provide a summary of the proceedings at the January 20, 2011, and February 14, 2011 Panel meetings.

Mr. Coulon stated that the Advisory Panel discussed the 2011 Business Implementation Plan and Panel members volunteered to be listed as a resource for many of the action items.

Mr. Coulon thanked the Governor's Office for reappointing many Panel members whose terms were expiring; they have served the CEA and the people of California well.

The Panel's Rate Subcommittee met and reviewed the proposed CEA rate filing and recommended that the Panel support the plan.

The Advisory Panel then met and voted unanimously to support the planned rate filing, including the loss-assessment provision.

The bottom line is that the rate filing would have two major benefits:

1. There is a small premium decrease overall.
2. There are a number of product enhancements in the rate filing that are very important, because they will increase the public's favorable perception of the product, likely resulting in a significantly higher uptake rate.

8. Chief Operations Officer Bob Stewart and Chief Actuary Shawna Ackerman will present for Board consideration and approval a proposed rate and form application, including related supporting documents. In a related matter, Mr. Stewart will ask the Board to support approaching the Insurance Commissioner to determine whether regulations governing CEA policy offerings should be modified to allow introduction of the newly proposed "Homeowner Choice" product.

Mr. Stewart began the presentation by focusing on the structure of the presentation.

Highlights of Mr. Stewart's presentation included:

- The foundation of the proposal is the scientific research and consumer research earlier supported by the Board.
  - Scientific research: the CEA's loss modeler, EQECAT, has incorporated the most recent scientific information into its earthquake model to analyze the CEA's portfolio.
  - Consumer research: it is clear that consumers are looking for the CEA's product to have more value than it currently does.
- The application proposes an average 12.5% decrease statewide in CEA rates.
- It proposes the expansion of "Other Coverages" to include $1,500 in emergency-repair coverage, subject to no deductible, to protect covered property from further damage, secure the residence premises, or restore the dwelling's habitability following an earthquake.
- It proposes introducing a $25,000 limit option for Coverage D – Loss of Use, which includes additional living expense. Currently, the CEA offers $1,500, $10,000, and $15,000 limit options. Consumer feedback indicates a demand for higher limit options.
- The rate classification plan would be revised to introduce "foundation type" as a dwelling rating attribute. This would match the rate classification to engineering expectations for slab, raised, and other types of foundations.
- Four ZIP Codes in San Benito and Santa Clara counties would be reassigned to a higher-rated territory, based on their newly understood expected annual loss.
- It proposes the introduction of a minimum premium rule for each CEA product, to cover the fixed expenses necessary to issue a policy.
- It proposes a new edition of each of the CEA's policy forms, incorporating new coverage enhancements and clarifications in coverage, definitions, and policy language.

- It introduces a new homeowner product offering: Homeowners Choice. This new product would bolster product value and empower consumers with more control over their residential earthquake insurance premium. It also offers more choice in coverages and delivers more immediate policy benefits after an earthquake for those who own either a one-to-four-family dwelling or a manufactured home.

Ms. Ackerman explained the impacts to rates and ratemaking. She explained that policyholder impacts decrease by 12.5% overall, but vary considerably by individual policyholder. This is largely driven by the fact that the changes in the loss model from the scientific research done over the last several years are not uniform throughout the State.

- The last time the CEA changed its rates was in 2007, when CEA had the First Industry Assessment Layer in place. That layer is no longer available.

- The CEA has continued to grow modestly since 2007 and now requires about a billion more dollars of risk financing for 2012 relative to the amount included in the current (2007) rates.

- The reinsurance rate on line has generally gone down, from about 8.2% in 2007 to 6.7% (projected) in 2011.

- Policyholders in San Benito, Santa Clara, and Imperial Counties will see rate increases based on changes in science that more accurately reflect the risk.

Mr. Stewart and Ms. Ackerman answered questions from the Board.

Mr. Kelso noted that the proposed changes were a great step towards increasing choice for policyholders, which addresses consumer sensitivity to having choices in product offerings as opposed to rate issues only. The overall rate reduction of 12.5% is not going to transform the CEA's market penetration, but it's a good first step. This marketing complexity does provide the CEA staff with an enormous challenge.

Mr. Stewart added that because of the uniqueness of the Homeowners Choice product, it may be necessary to change regulations governing the CEA's policy offerings. Staff requested the Board's support to approach the Insurance Commissioner in that regard as well. Mr. Marshall confirmed that so doing was expressed in Section 6 of the resolution presented to the Board.

MOTION: Mr. Kelso moved to adopt the resolution to authorize the CEA staff to submit the Board-approved rate and form application to the Insurance Commissioner; seconded by Mr. Boyken. Motion passed, with Mr. Jones abstaining.

9. Mr. Richison will present a proposed first amendment to the CEA's contract-employee retirement plan and ask that the Board adopt the amendment and authorize staff to submit a determination-letter application to the Commissioner of Internal Revenue.

Mr. Richison stated that this was the formal amendment to the restated contract-employee retirement plan that the Board approved in April 2010, adding a component to allow the submission of a one-time election of 5% of the compensation of the contract-executive employee to be contributed to the retirement plan. The IRS allows this feature in such plans.

MOTION: Mr. Jones moved to approve the amendment; seconded by Mr. Boyken. Motion passed unanimously.

10. Mr. Pomeroy will ask the Board to designate one of its members to conduct, on behalf of the Board, the annual performance appraisal of the Chief Executive Officer.

Mr. Boyken volunteered to perform the appraisal, and the Board accepted his offer of service.

11. 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.

12. 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.

13. Adjournment.

The meeting was adjourned at 2:49 p.m.