CEA Background Paper
November 2021

Introduction
The California Earthquake Authority (CEA) is a not-for-profit entity that offers residential earthquake insurance to the policyholders of our participating insurers. CEA is not a state agency, and its earthquake insurance obligations are not financially backed by the State of California. The premiums collected from CEA policyholders must be adequate to cover the insured risk the CEA assumes from our policyholders, and CEA is required by law to charge actuarially sound rates utilizing "best available science."

Today CEA offers its policyholders coverage options far beyond the minimum coverage levels required by state law, and has more than enough to pay out claims to cover losses if the most destructive earthquake in California's history were to reoccur today (i.e., the Great 1906 San Francisco Earthquake). However, due to rising home rebuilding costs and other factors, the annual cost of the average CEA policy is projected to nearly double over the next five years unless certain modifications are made to CEA's coverage offerings and/or financial structure.

This background paper provides historical information about CEA's formation and structure, outlines a number of financial challenges currently facing the organization, and describes a number of potential programmatic changes CEA's Governing Board will be considering in the months ahead. The purpose of this paper is to solicit input from all CEA stakeholders, as well as members of the public regarding various steps under review as CEA strives to continue to provide valuable earthquake coverage at stable rates, while having the financial strength necessary to pay policyholder claims in the wake of a catastrophic earthquake.

CEA: Established in the Wake of the 1994 Northridge Earthquake
Since the early 1980s, the State of California has imposed a statutory requirement on residential insurers to offer coverage for loss or damage caused by the peril of earthquakes to their customers who purchase a homeowners policy. This is generally referred to as the "mandatory offer" law.

In 1994, California was hit by the second most catastrophic earthquake in the state's history. The Northridge earthquake caused approximately $40 billion (1994 dollars) in property damage—roughly $20 billion of which was residential damage. In the wake of massive insured losses, most residential insurance carriers drastically cut back the amount of *homeowners* insurance they were willing to write to avoid the corresponding obligation to offer earthquake coverage. The state's homeowners insurance market essentially shut down, threatening the state's residential real estate market as well.

To respond to this growing crisis, the Legislature established the California Earthquake Authority, enabling those insurers who wished to participate in the capitalization and support of CEA ("participating insurers") to remain in the homeowners market and satisfy their mandatory offer requirement by offering a CEA earthquake policy—on which CEA bears the financial risk of loss or damage from the peril of earthquakes. CEA continues to perform this vital function to this day.

CEA Today
The core features of CEA remain as initially established:

- CEA is not a state agency, but rather is referred to in the enabling statute as a "public instrumentality of the state."
- CEA operates on a not-for-profit basis and is exempt from taxation at both the state and federal levels.
- CEA is not a part of the state budget. It was initially capitalized by its participating insurers and is funded through premiums collected from CEA policyholders. The State's support of CEA (a prerequisite for CEA's exemption from federal taxation) comes in the form of its public management (the Governing Board) and the statutory provision allowing CEA to deposit premium tax it collects into its own capital account rather than into the State treasury.
- The voting members of the Governing Board are the Governor, Insurance Commissioner and State Treasurer. The Speaker of the Assembly and the Chair of the Senate Rules Committee serve as ex officio non-voting members.
- CEA operates as a "take-all-comers" insurer. Any residential policyholder insured by a CEA participating insurer has guaranteed access to the purchase of a CEA policy covering loss or damage from future earthquakes (i.e., a CEA policy does not cover loss or damage from ongoing earthquake events or prior earthquakes).

While the basic components of CEA remain unchanged, CEA has grown and evolved significantly over time.

- CEA's not-for-profit and tax-exempt status allows it to charge lower overall rates than a private insurer (i.e., CEA rates are lower on average). However, there are many instances where a private insurer may offer lower rates and more attractive coverage features to an individual prospective policyholder.
- Today CEA insures more than 1.1 million residences in California, about 10% of the homes in the state. In certain high-risk zones, CEA insures 20% - 30% of the homes in the area.
- CEA is by far the largest writer of earthquake insurance in the United States in terms of premium written.
    - In the United States, CEA's earthquake business is more than double that of the number two writer.
    - In California only, CEA is larger than the next nine writers of earthquake insurance combined.
- Total property value insured by CEA is over $590 billion. CEA has lowered policyholder rates 5 times during our 25-year history by a cumulative total of 39% since inception.
- CEA encourages people to explore ways to reduce their premium by considering a seismic retrofit of their home. A discount of up to 25% is available for properly retrofitted houses. A manufactured home (mobile home) that has an earthquake resistance bracing system qualifies for a discount of 21%.

- CEA accounts for 67% of the residential earthquake policies in the state.
- CEA is the largest buyer of catastrophe reinsurance in the United States, and the second largest in the world.
- CEA's book of business is made up of the following types of policies:
  - Homeowners: 79%
  - Condo unit owners: 11%
  - Renters: 7%
  - Mobilehome owners: 3%
- CEA has a total of $19.7 Billion in claim-paying capacity as of July 31, 2021. This amount is equal to a "1 in 400 Year Return Period," which means there is a 1-in-400 chance (a 0.25% probability) that CEA will not have enough capacity to pay 100% of its covered claims, in a given year, in which case claims would be paid on a pro rata basis.
- To meet a 1-in-400-year benchmark this year, CEA purchased $9.6 Billion in reinsurance—risk transfer purchased from both the traditional reinsurance market as well as from the capital markets.
- CEA's risk transfer will cost about $500 Million this year, close to 60% of the amount of premium received from CEA policyholders.

Current Rate of Growth in Claim-Paying Capacity is Not Sustainable

The CEA book of "in-force" policies had been relatively constant for the first 20 years of CEA's operation. In 2016, CEA significantly expanded coverage options and increased its sales and outreach activities, and over the next several years a number of highly visible natural catastrophes in California and elsewhere contributed to a substantial increase in consumer interest in earthquake insurance.

The amount of claim-paying capacity required to support this increase in CEA's policies and exposure has also risen sharply over the last several years, increasing by 64% since 2016.

Unfortunately, due to accelerating exposure growth, tightening of reinsurance capacity at current rate levels, increasing cost of risk transfer/reinsurance as a percentage of direct earned premium, and upcoming catastrophe model updates to incorporate new scientific findings, CEA now faces potentially unsustainable strain on its claim-paying capacity. At the current pace of claim-paying capacity growth, CEA will need to purchase more than $6 billion of additional risk transfer within the next five years. Over that same period of time, CEA rates will need to increase by about 60% to cover the additional risk transfer costs if no other actions are taken. When anticipated reconstruction cost inflation is factored in, the annual premium on the average CEA policy will nearly double over the next five years unless affirmative steps are taken this year.

Strategic Options Under Consideration

In striving to keep CEA policyholder rates stable, CEA is considering a number of reform possibilities.

CEA coverage options: CEA offers a base residential earthquake policy to homeowners, which includes coverage for the insured dwelling and limited coverage for contents and additional living expenses if the home or mobile home is uninhabitable due to an earthquake. These are the minimum coverages that are required by law to be offered to the buyer of a residential insurance policy, and together they are referred to as the “mini-policy.” CEA also offers policies to condominium unit owners and renters. For an additional premium, CEA policyholders can significantly increase insured limits on contents and for loss of use, and can choose a lower or higher deductible other than the 15% deductible contained in the mini-policy. These additional coverage options are contributing to the escalating cost of all CEA policies, even for those who do not choose the more expensive additional coverages.

In an effort to keep rates stable for all CEA policyholders, CEA could:

- Offer only the “mini-policy” as defined in state law, or
- Reduce the higher insured limit options for some combination of the following coverages:
    - Contents
    - Additional living expenses
    - For condominium unit owners, the coverage options for building property and loss assessment
- Discontinue offering deductibles lower than 15%
- Eliminate optional coverage for masonry veneer and breakables
- Seek legislation to place a cap on the amount of structure coverage CEA offers

Claim-Paying Capacity: An earthquake of any magnitude can occur in California at any time, and CEA must be able to pay policyholder claims following the next damaging earthquake. This is called our “claim-paying capacity.” If an earthquake occurs that exceeds the amount of claim-paying capacity on hand, CEA is required by law to pay policyholder claims on a “pro-rata” basis.

The Great 1906 San Francisco Earthquake remains the most destructive earthquake in California’s history. In the future, the probability of an earthquake occurring in any given year that would be that destructive is very low—less than one-half of 1%. Put another way, the chances of an earthquake occurring that would be as damaging as the Great 1906 San Francisco Earthquake are roughly 1 in 220.

CEA has enough claim-paying capacity for an event that only has a 1-in-400 chance of occurring (one-fourth of 1%) —an earthquake far more destructive than the 1906 San Francisco quake. However, amassing so much claim-paying capacity—for an earthquake that has an extremely low probability of occurring—is a big contributor to the cost of an earthquake insurance policy.

Another reform consideration under review would be to lower CEA’s claim-paying capacity to some level that has greater than a 1-in-400 chance of occurring—a 1-in-250-year event or a 1-in-300-year event, for example. Such a change would result in a less expensive CEA policy, but one that would have a greater likelihood of a pro-rata payout following a *massive* catastrophe. However, CEA also has received suggestions to create “second event” claims-paying capacity to increase CEA’s sustainability following a large catastrophic event.

Retain the Amount of Claim-Paying Capacity Currently Provided by Participating Insurers: By law, companies that participate in CEA maintain a certain amount of responsibility for providing a measure of claim-paying capacity following a massive event. Initially, this "Industry Assessment Layer" amounted to $3.6 billion of CEA's claim-paying capacity, but this responsibility was designed to "roll off" over time, and the total now stands at $1.7 billion. Unfortunately, if this contingent responsibility continues to disappear as originally contemplated, this amount will need to be replaced by purchasing more risk transfer—which will put even further pressure on the need to raise policyholder rates.

Another possible reform consideration would be to seek legislative changes necessary to preserve the Industry Assessment Layer at its current level, and potentially create an index feature so the amount grows over time in proportion to future CEA policyholder growth.

Encourage Greater Private Sector Engagement in the Residential Earthquake Insurance Market in California: While CEA writes approximately two-thirds of the residential earthquake policies in California, several private sector companies split the remaining one-third. Because CEA is a not-for-profit enterprise and is not concerned about its market share, CEA does not consider the other earthquake writers to be competitors. And yet, for most of the life of the organization, CEA participating insurers have been operating under the assumption that they are not allowed to place earthquake policies with non-CEA companies. Such a prohibition does not exist. By encouraging financially strong private insurance companies to write more earthquake insurance, the number of earthquake-insured homes in California could grow without contributing to further pressure on CEA's claim-paying capacity.

CEA is considering an industry-wide bulletin that would advise all CEA participating insurers that they are not restricted from placing business with other carriers.

Public Backstop: Of all the state-established natural catastrophe insurance providers in the United States, CEA is the only such organization that does not receive financial backing for the risk it undertakes. (The state's only financial support comes in the form of a statutory provision allowing CEA to deposit premium tax dollars into its own capital account rather than into the State treasury). In the absence of a public financial backstop, CEA policyholders must pay a premium sufficient to cover nearly the entire cost of maintaining enough claim-paying capacity for a massive earthquake.

From time to time, the Legislature has considered, and rejected, creating some sort of public backstop that otherwise would help CEA insure more homes at more stable rates. There is a finite limit to the amount of risk CEA policyholders can undertake alone. Some form of public backstop would be necessary to keep rates stable if recent CEA growth trends continue throughout the next decade.