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Contact: Chris Nance

Phone: (916) 325-3800

California Earthquake Authority Completes Landmark Deal, Pioneering New Way to Manage and Diversify Financial Risk Posed by Natural Disasters

SACRAMENTO, Calif. – The California Earthquake Authority (CEA) today said it has completed a first-of-its-kind transaction that opens a more direct path to transfer the financial risk posed by earthquakes.

The transaction allows CEA to obtain reinsurance from the capital markets rather than solely from reinsurers. The initial \$150 million, three-year deal – the first earthquake-only catastrophe bond issued without involvement of traditional reinsurers – is intended to be a benchmark establishing a more efficient, lower-cost market for similar follow-on deals by CEA, while expanding the sources and amount of claim-paying capacity available to the CEA.

"This deal is a game-changer," said CEA Chief Executive Officer, Glenn Pomeroy. "Traditional reinsurance has been valuable for the CEA and will be going forward. But the CEA must diversify and expand its claim-paying resources. A diverse set of risk-transfer tools, which includes not only reinsurance and catastrophe bonds but also post-earthquake federal loan guarantees, will help us make earthquake insurance more affordable and more widely used."

"The costs of natural disasters today fall largely on the federal government," Pomeroy added. "But every household that is able to buy CEA earthquake insurance is a household that will depend less on federal aid in the aftermath of a big earthquake."

The CEA is the largest monoline writer of residential earthquake insurance in the United States. With over 800,000 policies in force, some \$600 million in annual premium revenue and more than \$9 billion in overall claim-paying capacity, the CEA writes 70 percent of all residential earthquake policies sold in California. Yet fewer than 12 percent of California households choose to buy earthquake insurance.

The CEA relies heavily on reinsurance, which provides \$3.1 billion out of the CEA's \$9.4 billion claim-paying capability. While reinsurance is appropriate to help CEA manage financial risks of insuring against earthquakes, it comes at a high cost. Over 14 years, CEA has paid \$2.8 billion to reinsurers, over 40 percent of its \$6 billion total premium revenue.

Under the new “transformer reinsurance” deal, the CEA entered into a reinsurance contract with Embarcadero Reinsurance, Ltd., a Bermuda-based special purpose reinsurance vehicle established for this and future CEA transactions. In a deal led by Deutsche Bank Securities, Embarcadero sold \$150 million in three-year catastrophe bonds to investors, at a floating rate of 6.6 percentage points above one-year U.S. Treasury money-market funds. Investor demand for the catastrophe bonds significantly exceeded the \$150 million issuance. The \$150 million in deal proceeds was placed in a collateral trust account, from which the CEA can draw funds if necessary to fund its actual insured losses and loss-related expenses covered by the reinsurance contract.

“This deal establishes a multi-year, repeatable method of risk transfer that's less costly than traditional reinsurance,” said Tim Richison, CEA’s chief financial officer. “We intend to be back in the marketplace every four to six months and will continue to do so as long as there is interest from investors. Using the same structure in future transactions will make it easier for investors to understand and be comfortable with the terms, and will build the investor base to increase market capacity for follow-on deals.”

CEA is also working on rate and form changes that will allow it to decrease the overall statewide average premium for CEA earthquake insurance by 12 percent while providing its policyholders with additional coverage options.

On the federal level, the CEA is working with Senators Feinstein and Boxer to support The Earthquake Insurance Affordability Act. If passed, this would authorize the CEA to access post-event federal loan guarantees and more efficiently capitalize for catastrophic earthquakes, at no cost to taxpayers. This legislation would allow the CEA to lower premiums and deductibles and would significantly reduce the post-earthquake recovery burden now borne by state and federal governments.

One unique feature of the CEA's Embarcadero deal is that it provides total indemnity for CEA's actual reinsured losses and claim expenses covered by the contract. Supposed indemnity deals often leave deal beneficiaries with substantial residual basis risk. Under the Embarcadero Re contract, CEA expects to retain zero basis risk, thus effecting a perfect risk match between its exposures and the reinsured losses.

The California Earthquake Authority is a publicly managed, privately funded organization that provides catastrophic residential earthquake insurance and encourages Californians to reduce their risk of earthquake loss. The CEA was created by the California Legislature in 1996 after most residential property insurers stopped writing earthquake insurance policies following the 1994 Northridge Earthquake. For more information, see www.earthquakeauthority.com.

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