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Joint Legislative Committee on Emergency Management and Senate Committee on Insurance

Informational Hearing

DROUGHT, CLIMATE CHANGE AND FIRE: HOW IS THE CALIFORNIA HOMEOWNERS' INSURANCE MARKET RESPONDING?

Tuesday March 20, 2018
Room 112

Summary

The Senate Committee on Insurance held an informational hearing on March 9, 2016 titled "Preparing for Global Warming and Drought: State of the Homeowners' Insurance Market." That hearing generally found that the homeowners' insurance market had not yet suffered significant disruption as a result of the ongoing drought, despite serious fires the preceding year in Lake, Sonoma, Napa and Butte counties. At the time, the Valley fire of 2015, which caused at least \$1.5 billion in damage and killed four people, was the third most destructive wildfire in the State's history based on the number of structures lost (2,000 structures and 1,300 homes), and fifth costliest based on insured losses of approximately \$1 billion. In 2017, however, California experienced the largest and most destructive wildfire season in its history. Nearly 9,000 wildfires tore through the state, burning 1.2 million acres of land, destroying more than 10,800 structures—more than the previous nine years combined--and killing at least 46 people. In addition, mudslides following and resulting from the Thomas fire in Santa Barbara County destroyed or damaged more than 400 homes and killed at least another 21. Insured fire losses for 2017 exceed \$11 billion. The National Interagency Fire Center's Predictive Outlook for 2018 for the first time is forecasting above normal large fire potential due to the persistence of dry fuels, frequent offshore winds and generally unfavorable weather. Assumptions about urban areas previously not thought subject to extreme fire risk such as Santa Rosa are now open to reexamination. As a result, some homeowners are facing rapidly rising premiums, non-renewal or cancellation of their policies, and greater difficulty in obtaining homeowners' insurance coverage.

The intent of this hearing is to examine the current state of the residential insurance market, whether homeowners are adequately insured against the growing threat of major fires, the impact of rising premiums on existing homeowners and the real estate market, and whether the Fair Access to Insurance Requirements Plan (FAIR Plan) and the surplus line market are able to fill gaps in the homeowners' insurance market. Are California homeowners and homebuyers able to find—and afford--adequate protection for their largest asset?

Background

After a year of above normal rainfall, California is again facing drought conditions in large areas of the state, while residential areas continue to expand into traditionally high risk fire areas—called the wildland urban interface (WUI). Perhaps of more concern, the area of the Tubbs fire in Napa and Sonoma—now the state's most destructive and third deadliest fire--was not previously thought to be an extreme fire zone. The chance of a major fire in the state that damages or destroys large numbers of homes, or whole communities is growing.

California consistently ranks number one in the top 10 most wildfire prone states, with more than two million households at high or extreme fire risk. Until last year, the most destructive fire in California history was the Oakland Hills fire in October 1991. Its insured losses were $2.7 billion in 2016 dollars. The Tubbs fire in Napa and Sonoma counties alone produced losses that are almost double the losses of the Oakland fire, and total 2017 insured losses in northern California could exceed $9 billion. The Thomas fire in Ventura and Santa Barbara counties was the largest fire in state history, burning 282,000 acres in December—generally considered outside of fire season. In 2003 in Southern California multiple fires destroyed or damaged more than 2,800 structures in San Diego, San Bernardino, Ventura, and Los Angeles Counties. The two costliest were the Cedar Fire and the Old Fire—each led to almost identical insured losses of about $1.4 billion[1]. The 2015 Valley fire in northern California has now been downgraded to the fourth most destructive wildfire in state history based on the number of structures lost (2,000 structures and 1,300 homes), and sixth costliest based on insured losses. Thirteen of the top 20 most destructive fires in California history happened in the last 15 years, and eight in just the past five years. It is typical for about half the losses from a wildfire to be uninsured, including damage to public roads and utilities.

A Risk Management Solutions and ImageCat, Inc. analysis published in 2008 found that from 1997 to 2007, close to 1,350 structures burned on average each year, with an estimated annual insured loss of some $490 million – nearly twice the long-term average. That analysis pales in

[1] All losses calculated in 2014 dollars

comparison to 2017 and was done prior to four years of extreme drought. While on average less than 10 percent of the burnt areas in the U.S. are in California, historically around 70 percent of the total insured losses are from properties in southern California. The counties between Santa Barbara and San Diego house some 60 percent of the Californian population who have been hit by wildfires, but it should be noted again that the state's two costliest fires have been in northern California.

As urban development continues to encroach on the wilderness fringes and ongoing drought increases wildfire risk in areas not previously at high or extreme risk, the problem of major wildfires destroying hundreds or thousands of properties is likely to increase in the future. Recent data suggests that more than two million homes in California are currently located in high or extreme fire risk zones. Los Angeles County has the highest number of homes in high or extreme risk at more than 440,000. Although they have significantly smaller populations, more than 80% of the homes in Alpine, Mariposa, Trinity and Tuolumne counties are classified as being at high or extreme risk. The massive Tubbs fire was in an area not previously thought to be at high risk and will lead to a reexamination of fire risk assumptions throughout the state.

In addition to population expansion in the WUI, drought has caused a major tree die off in the Sierras and foothills, literally adding fuel to the fire. Governor Brown in October 2015 declared a state of emergency and created a Tree Mortality Task Force composed of state, county and local officials and other stakeholders to identify areas of the State that represent high hazard zones for wildfire and falling trees with a goal of protecting the public health and safety by undertaking efforts to remove dead or dying trees that threaten power lines, roads and other evacuation corridors, critical community infrastructure, and other existing structures. For homeowners, the dead trees present an additional risk and barrier to insurance. It can cost anywhere from hundreds to many thousands of dollars each to remove dead trees from private property, and disposal of the trees presents additional problems.

State of the Homeowners' Insurance Market: Availability vs. Affordability

There are more than 100 insurers admitted to provide homeowners' insurance coverage in California, down from close to 200 in 1990. The number of companies operating in the state declined dramatically from 2001 to 2005, but remained relatively stable until 2015 when several companies again left the market. State Farm remains the largest in the state, with approximately 20% of the homeowners' insurance market and more than $1.5 billion in premiums in 2016, followed by Farmers Insurance at 16% and more than $1.2 billion in premiums, and the Auto Clubs of Northern and Southern California (although operated separately) are third with just over 13% market share and just over $1 billion in premiums. [2] Although these are big names with which most homeowners are familiar, many companies do not advertise on television, and many are available only through an insurance broker. There are at least 40 little known insurers with less than a 1% market share operating in the state.

California requires prior approval of insurance rates based on past loss experience data of the company filing the rate application, generally based on an average of up to 20 years for homeowners' insurance. Rates are required to be actuarially sound, and to not be inadequate,

[2] Based on California Department of Insurance data for 2016 (by insurance group)

excessive or unfairly discriminatory. Rates are expected to reflect the risk, so rates can be neither too high nor too low to ensure the financial stability and solvency of the insurer. The requirement that insurers use past loss data over a long period in the rate-setting process can make it difficult for rates to reflect dramatic changes in risk profile over a short period of time—or projected catastrophe modeling--such as caused by the recent drought, bark beetles and the unexpected death of millions of trees in the foothills and mountains of California and other western states.

Insurers complain they have to file rate plans based on past loss experience, but essentially have to prepare for the possibility that losses such as 2017 will happen each year. As noted earlier, experts are now predicting that catastrophic wildfires will increase in both frequency and severity for the foreseeable future. If insurance companies cannot collect enough premiums to cover such catastrophic losses, with a profit, they will almost certainly exit the market. At the same time, to date 1991 was the only year when insurer losses exceeded premiums paid in. Loss ratios (share of earned premium to losses incurred) for homeowners' insurance since 1991 have averaged approximately 60%, and generally remain lower than for automobile insurance which has a loss ratio average of 63%. However, losses in homeowners insurance can swing widely from year to year, unlike relatively constant losses in auto insurance. The loss ratio averaged 74% for the 2003 fire year. For some of the smaller companies in the homeowners' insurance market, loss ratios have varied more widely. Even large companies can experience higher losses in concentrated catastrophic events like the Tubbs fire depending on a particular insurer's penetration of a regional market.

That said, premiums in WUI areas have also increased since the fires of 2003 as insurers now have access to much more accurate data and risk analyses to determine their willingness to offer insurance and how to price it within their existing approved rate structure. Insurers have access to "brush mapping" programs brimming with data from the California Department of Forestry and Fire Protection (CalFire), the U.S. Forest Service, and the National Oceanic and Atmospheric Administration. This data more accurately predicts how a fire might sweep across a neighborhood based on the property's slope, brush composition, local wind patterns, clearance between structures, access and defensibility for fire suppression, and building materials. Insurance companies also utilize the ratings of a community's fire suppression system to determine rates and whether an area is too high risk.

Many companies now also use private underwriting risk assessment products such as the FireLine State Risk Report that provides a wildfire hazard score ranging from 0-30 for each property analyzed, produced by the Insurance Services Office (ISO) through Verisk Analytics. With this product, insurers know the profile of each house rather than relying on general regional attributes or zip code. Critics complain that the satellite images utilized are not of sufficient resolution to adequately take into consideration mitigation measures that homeowners or communities may have taken, including brush removal and improvements such as fire resistant roofing materials and siding. One source in a foothills community has claimed that some of the largest insurers are now refusing to write policies for homes that score higher than a 3 on the FireLine report—a standard so high no homes in these areas can meet it no matter how well prepared or protected.

Given the possibility of catastrophic fires that destroy hundreds of thousands of acres and thousands of homes, some insurers not surprisingly are seeking to limit their exposure to the highest risk areas and to reduce their exposure in any areas where they might have had too high a concentration of policies, leading to non-renewals of some homeowners. According to data from the California Department of Insurance (CDI), more than 10,000 homeowners in high risk counties were non-renewed by their insurer in 2016. More than 36 thousand homeowners in those counties chose to not renew their policies, however, presumably because of steep premium increases or lower coverage reasons. The data does not detail if these homeowners subsequently found insurance with other insurers.

Two neighbors who would have paid roughly equivalent insurance premiums in the 1990s might now be charged premiums that vary from 50 to 100 percent more based on new sources of risk data and steps the homeowners may have taken, or not taken, to reduce the risk on their properties. In Tuolumne County, the 2013 Rim Fire changed many insurers' calculations about the home insurance market. It confirmed the belief that California was overdue for a large, catastrophic fire. Even though there was not a significant loss of homes or commercial structures in the Rim Fire, insurance companies started aggressively enforcing fire safety standards in annual inspections.

Few insurers offer discounts on insurance for mitigation efforts by homeowners. Many claim they already take such measures into account in their underwriting and pricing. They also argue that mitigation other than actual home reinforcement, such as brush clearance and creation of a perimeter, must be maintained to be effective or may be dependent on the actions of neighbors or others. In addition, in order to offer discounts, insurers must include sufficient data in their rate application to demonstrate the actuarial reduction in losses produced by the specific mitigation efforts for which a discount is offered. Insurers maintain that mitigation will have little impact in reducing losses in certain kinds of fires, including those driven by high winds such as in the Tubbs and Thomas fires. The fires of 2017 likely have reinforced some insurers' views that such mitigation measures provide little protection against loss with the kinds of fires the state now seems to be facing—fueled by high winds and extensive fuel build-up. In addition, insurers argue that the premiums they are able to charge are inherently inadequate because California does not allow them to include the cost of reinsurance in their rates.[3]

The mudslides and debris flow in Montecito in January following the December Thomas fire raised new issues in the homeowners' insurance discussion. Generally speaking, homeowners' insurance does not cover the perils of flood, mudslide or debris flow. However, a provision of the Insurance Code (§530) and case law requires an insurer to cover a loss whenever a covered peril (in this case fire) is the efficient proximate cause of the loss. According to information from CalFire, the scorched soil in Ventura and Santa Barbara Counties due to intense heat from the recent fires was unable to absorb the heavy rain that fell over the course of only two days and the lack of vegetation allowed for increased rates of erosion, leading to the mudslides and debris flow in Montecito.

[3] California is one of three states (the others are Washington and Alaska) where insurers are prohibited from including the net cost of reinsurance in their rates, except for earthquake coverage and medical malpractice.

On January 29, 2018 Insurance Commissioner Dave Jones issued a notice to insurers reminding them of their duty to cover the damage from the mudslides and debris flows if the fire was determined to be the efficient proximate cause of the damage, and many companies, recognizing that this was indeed the case, appear to be covering the damages.

- Short of accepting wildly fluctuating profits and losses, what other steps could California take from a regulatory standpoint to encourage admitted insurers to offer insurance in the WUI?

What Role Does the Surplus Line Market Play?

Surplus line carriers are insurers who are not "admitted" to sell insurance in California by the CDI and are relatively free from regulation, although they are regulated by another state. Policy forms and rates are unregulated by California, and capitalization requirements are far different from those imposed on admitted carriers. This lack of regulation is the essence of what a surplus line carrier is; that is, a "free agent" able to respond to the changing market conditions and coverage needs of certain insureds. That said there are still a few significant regulatory issues confronting surplus line insurers, largely concerning the licensing of surplus line brokers and the state oversight of surplus line carriers to see that they do not write business that could go to the admitted market. This oversight is required because, as surplus line carriers are free of assigned risk pools and guaranty fund assessments, a non-admitted carrier could potentially offer placement at a significant price advantage. It is important to note that these insurers are generally not unable to obtain a license to operate in California. They choose to operate on an unlicensed, surplus line basis.

The CDI monitors the financial condition of surplus line insurers and maintains a list of insurers that surplus line brokers are allowed to use--the List of Approved Surplus Line Insurers, ("LASLI"). This financial monitoring is particularly important because if the insurer were to fail (go bankrupt), there is no guaranty fund protection for the insured. A policyholder's claim on a regular insurance policy can be paid out of a state guarantee fund that all the state's regular insurance issuers contribute to in case one insurer goes bankrupt. Admitted insurance carriers must follow state regulations about how much they can charge and what risks they can and cannot cover. Surplus lines carriers don't have to follow these regulations, allowing them to take on higher or more unusual risks. Surplus line insurance is often more expensive than regular insurance because it protects against risks that other insurers won't cover. According to the Surplus Line Association, approximately 24,000 homes in California had insurance policies through the surplus line market in 2017, although most of those policies were for homes valued at $500,000 or higher. Although still just a small fraction of the homeowners' insurance market, that number is more than double the surplus line policies issued in California in 2013.

The next player for a homeowner seeking this kind of insurance is the insurance agent or broker (broker). If you are an individual or company (much more likely) that needs insurance, the broker acts as the middleman between you and the insurer. The broker is also licensed and regulated by the state. When you tell the broker you need insurance, the broker must try to find you a policy from one of the insurers that is admitted to operate in the state and with which he or she has a relationship. There are some cases, however, (generally less than 10% of policies nationwide) where admitted insurers will not accept a risk because it does not meet their internally established guidelines. The risk may be too big, too unusual or substandard. The surplus line broker is then allowed to procure a policy for you from an insurer that is not licensed in the state. Each surplus line broker is responsible to ensure that a diligent search is made among insurers that are admitted to transact and are actually writing the particular type of insurance in this state before procuring the insurance from a nonadmitted insurer. Generally speaking this means the broker must first attempt to place the insurance with three admitted insurers who decline to issue a policy. The surplus line broker must file with the Insurance Commissioner, within 60 days of placing any insurance with a nonadmitted insurer, a written report regarding the insurance, including the name and address of the insured, verification that the insured is a home state insured, the identity of the insurer or insurers, a description of the subject and location of the risk, the amount of premium charged for the insurance, a copy of the declarations page of the policy or a copy of the surplus line broker's certificate or binder evidencing the placement of insurance, and other pertinent information that the commissioner may reasonably require.

- Are surplus lines insurers expanding into wildfire risk areas?
- Are they a viable and affordable option for average homeowners?
- Are there downsides for homeowners?

<u>The FAIR Plan: Insurer of Last Resort</u>

The FAIR Plan was created by state legislation in 1968 following brush fires and riots in the 1960's that led many insurers to exit urban areas or neighborhoods, primarily in Los Angeles, as too risky to insure. Its stated purpose is "to assure stability in the property insurance market for property located in the State of California," and to "assure the availability of basic property insurance…." It is often referred to as the homeowners' "insurer of last resort." That said, policies are actuarially sound, and can still be pricey for its more limited coverage. The FAIR Plan offers a standard fire insurance policy for both the structure and contents but no coverage is provided for liability, theft or water damage typically found in most homeowners' policies. The homeowner or business generally must also purchase a "Difference in Condition" policy or other supplemental coverage from the voluntary insurance market when purchasing a FAIR Plan policy.

Organized as a private association based in Los Angeles, the FAIR Plan is comprised of all insurers admitted to write property insurance in California. FAIR Plan profits and losses are shared by its members in direct proportion to their market share of property insurance written in California. The FAIR Plan is not a state agency and no taxpayer funds are involved.

The FAIR Plan's share of the homeowners' insurance market remains very small, and it reports it has seen only a slight increase of new business in WUI areas as a result of the drought and recent fires. With approximately 126,000 FAIR Plan dwelling policies in place in the state, 76% of those policies are in urban areas, largely in the Los Angeles. Part of the lack of interest may be the unwillingness of homeowners to pay the high price for insurance, particularly if they are low income and/or own their property outright, or because of the more limited coverage it provides. Homeowners may also be unaware of the FAIR Plan option. Only 6,600 out of 90,000 agents and brokers in the state are registered to sell FAIR Plan policies, despite the lack of fees or testing to do so, and the FAIR Plan's 10% commission for new business and 8% commission for renewals. Until recently, insurance agents and brokers who transact homeowners' insurance had no duty to help a homeowner obtain coverage through the FAIR Plan. Legislation enacted in 2016 (SB 1302 McGuire, Chap. 543, Stats. of 2016) now requires insurance agents and brokers to assist homeowners seeking insurance through the FAIR Plan by helping them submit an application for coverage, connecting them with a broker who is registered to place insurance with the FAIR Plan, or providing them with the FAIR Plan's website and toll-free number.

Until 2016 applicants for FAIR Plan coverage in specific geographic areas had to provide the names of three insurance companies that had denied insurance coverage for their property and had to try the surplus line market in order to qualify for a FAIR Plan policy. After a review following the Valley and Butte fires, the Insurance Commissioner directed the FAIR Plan to make several changes to its operations, including some enhanced coverage options, eliminating the requirement that homeowners prove they were rejected three times for standard insurance policies, and giving more access to brokers registered with the FAIR Plan. Now dwelling replacement cost coverage on all eligible dwellings will be considered standard unless the consumer opts out.

Even if some major insurers have opted to stop writing wildfire risk and some homeowners are receiving non-renewal notices, the lack of a surge in FAIR Plan policies suggests there remain insurers willing to offer homeowner policies, possibly requiring more effort on the part of homeowners in high risk areas to shop around or use a broker to secure coverage.

- As risk increases and the traditional insurance market either increases its prices or pulls out, will the FAIR Plan see a surge in policies in the WUI? Why hasn't the FAIR Plan seen a major increase to date?
- Is the coverage offered by the FAIR Plan sufficient to allow communities to recover and rebuild after a major disaster?

An Uncertain Future

For each year that California's drought and climate change continue, the chance of widespread and devastating fires grows. More and more areas of California will likely be designated as high or extreme fire risk, with homeowners' insurers becoming even more reluctant to take on what becomes perceived as catastrophic risk, or pricing coverage outside the reach of many homeowners. If there are fire losses in the billions for several years in a row, a homeowners' insurance availability crisis could quickly roil both the insurance and real estate markets as increasing numbers of homeowners lose coverage, are unable to pay rapidly increasing premiums, or are forced to settle for the limited—but still expensive--coverage offered by the FAIR Plan. Many properties could become unsellable or unaffordable to all but the wealthiest purchasers.

California experienced such a crisis following the Northridge earthquake in 1994. The magnitude 6.7 Northridge earthquake remains the costliest natural disaster in the history of California, and the fourth largest economic loss caused by a natural disaster in the nation's history. It caused over $25 billion in damages and $49 billion in economic losses to the region and state. Prior to the Northridge earthquake, insurers dramatically underestimated the potential damage from such moderate earthquakes, and many found themselves dangerously overexposed to earthquake risk. One major insurance company with a large concentration of policies in the affected area was driven to near insolvency. Insurance rating agencies took note of this increased exposure and downgraded many companies. Because California requires all insurers offering homeowners' insurance in the state to also offer earthquake insurance, many insurers opted to stop writing homeowners insurance altogether, making it all but impossible for home buyers to obtain a mortgage. This crisis led to the creation in 1996 of the California Earthquake Authority (CEA), allowing insurers who join the CEA to shift earthquake risk off their books and to the CEA. As a result, although all homeowners must be offered earthquake insurance, only about 12% actually purchase it. Creating a separate risk pool for earthquake solved the problem in the homeowners' insurance market, but not the earthquake insurance problem.

Unlike with earthquake insurance, any homeowner with a mortgage must have homeowners' insurance covering fire. If a mortgagee drops their insurance coverage because of affordability issues, the mortgage holder could force-place insurance on the homeowner, increasing the chances of default. Although losses from wildfire are unlikely to ever reach the levels projected for major earthquakes, insurers will almost certainly try to limit their losses and increase profits by pulling out of larger and larger areas of the state if they consider the risk unacceptable or unpredictable. To ensure a healthy real estate market and preserve the largest asset most people own, homeowners insurance must be both available and affordable.

We currently do not have sufficient data to accurately assess the workings of the homeowners' insurance market in high risk areas, both as to availability and affordability. More information is needed to know how many insurers offer coverage on a county by county basis, how successful homeowners who have had their policies non-renewed have been in finding new coverage and for what price, and if we can quantify the risk reduction of specified mitigation measures, allowing reduction of premiums without jeopardizing the solvency of insurers.

Given the severity of the drought and predictions of the impact of climate change, it is time to consider whether insurers can be expected to absorb wildfire losses within a year or two without having to increase rates significantly, or whether regulatory changes and improvements in building codes, zoning changes and wildlands management can reduce the risks of catastrophic fire in a meaningful way. If several of the large homeowners' insurers should choose to dramatically reduce their exposure or exit California altogether, more dramatic action may be required, including a reexamination of the ability of insurers to incorporate reinsurance into their rates, or creation of some kind of statewide catastrophe fund funded through a surcharge on all policies across the state that could help reimburse insurers for a certain portion of extreme fire event losses.