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INFORMATIONAL HEARING

OVERVIEW OF INSURANCE AND INSURANCE REGULATION

Wednesday, April 3, 2019
State Capitol, Room 113
10 a.m. – 12 p.m.

BACKGROUND

Insurance is complex and intimidating; it may be difficult to understand, purchase, and use. But almost everybody needs it. This tension drives the need for careful oversight and has made insurance one of the most highly regulated industries. Federal law shifts most of that responsibility to the states. State law determines what an insurer can charge, how an insurer can spend or invest, what the insurer can say, and directs many other activities related to consumer protection. To do this, California delegates to several entities the authority and responsibility of protecting consumers. The purpose of this hearing is to provide an overview of the roles of entities under the jurisdiction of this committee. This open dialogue will help prepare the committee and stakeholders to confront the insurance market's challenges as they arise and protect the interests of California's policyholders.

The California Department of Insurance plays the central role in assuring that insurers have the resources to pay claims and that they treat consumers fairly. Other entities serve as a failsafe. Guarantee associations cover claims when an insurer becomes insolvent. Entities such as the California Earthquake Authority, California Fair Access to Insurance Requirements Plan, Surplus Lines Association, and State Compensation Insurance Fund play critical roles in making sure consumers have access to coverage that that may be otherwise hard-to-get or unavailable.

California Department of Insurance

The California Department of Insurance (CDI) regulates more than 1,300 insurers that together write more than $310 billion in premium annually, the fourth largest insurance market in the world. It also oversees more than 410,000 licensees, including insurance producers (agents and brokers), independent adjusters, public adjusters, and others. With a budget of $289.4 million (FY 18-19), CDI employs analysts, attorneys, administrative law judges, public safety officers, and others.

The Insurance Commissioner directs the department, sets priorities and policies, makes final decisions on administrative actions, and adopts regulations. It is one of the few statutory offices where prosecutorial and executive, quasi-judicial, and quasi-legislative powers are vested in a single individual (as opposed to a board or commission). Proposition 103, approved by the voters in 1988, converted the office from a position appointed by the Governor to a statewide elected official. Insurance Commissioner Ricardo Lara, elected in November 2018, previously served in the State Senate and as a member of this committee.

To accomplish its consumer protection mission, CDI maintains specialized units to carry out its core functions, including:

- *Issuing certificates of authority and licenses.* CDI issues certificates of authority that allow an insurer to legally offer insurance products in this state; these insurers comprise the "admitted market." It also licenses agents, brokers, independent adjusters, public adjusters, and others who are involved in insurance transactions.

- *Enforcing California's insurance laws.* CDI enforces California's insurance laws by accepting complaints from consumers and others, conducting examinations of insurers, investigating complaints, and prosecuting disciplinary actions. The Commissioner makes final decisions in administrative actions subject to review by California courts. Additionally, the department operates several programs, funded through assessments on insurance policies, to investigate insurance fraud committed by consumers, service providers (such as medical care providers), and others; those programs also fund, in part, prosecutions of those cases by local district attorneys.

- *Reviewing insurance rates.* Under Proposition 103, the Commissioner must approve insurance rates for most types of property and casualty insurance policies before an insurer may use them, including auto, homeowners, and commercial. The Rate Regulation Branch reviews rates, but an insurer's petition for approval of rates may be subject to a public hearing where members of the public may object (third-party challengers are known as "intervenors"). Hearings are held by administrative law judges employed by CDI and assigned to the Administrative Hearing Bureau who will propose decisions to the Commissioner. CDI also reviews and approves rates for long-term care insurers, but those rates do not fall under Proposition 103.

- *Reviewing policy forms.* The Policy Approval Bureau reviews some policy forms (templates used to issue policies) and insurance advertising material for compliance with

California law. The types of insurance that require form approval include supplemental life insurance benefits; variable life insurance and annuities; health, dental, and vision insurance; credit insurance; long term care insurance; and workers' compensation insurance.

- *Overseeing the financial condition of insurers.* Insurers must have an adequate net worth and reserves to pay anticipated claims based on the risks insured. An insurer has limited "underwriting capacity," that is the total amount of coverage an insurer can offer based on its assets, reserves, and risk transfer agreements (such as reinsurance where another insurer, a reinsurer, assumes some of an insurer's liability). The Financial Surveillance Branch uses financial exams, both routine and for cause, to confirm compliance with California law governing an insurer's financial health and make sure that the insurer does not exceed its capacity.

- *Conservation and liquidation of insolvent insurers.* When an insurer no longer has the assets to pay its liabilities, including claims, it may be declared insolvent and placed under a receivership. The Commissioner may take over the insurer and "conserve" its assets while it is determined whether the insurer can be rehabilitated. An insurer that cannot be rehabilitated will be liquidated. Liquidation involves terminating an insurer's business by canceling all cancelable policies, selling company assets, and paying claims and other debts and liabilities. The Commissioner works through the Conservation and Liquidation Office to perform these functions and serves as a fiduciary for the benefit of all claimants, subject to supervision by the court.

- *Collecting and Reporting Market-related Data and Information.* The Statistical Analysis Division implements numerous data collection and reporting requirements regarding the insurance market. These reports measure the amount of insurance sold by insurers and their market share, identify "underserved" communities, and other market assessments. Many of these reports are based on periodic "data calls," that is demands for data or information required by statute or regulation.

In addition to its core consumer protection functions, CDI also administers, facilitates, and oversees programs designed to further public or social policy goals.

- *Low-Cost Automobile Insurance Program.* California's Low Cost Automobile Insurance Program (Low-Cost Auto) was established in 1999 to provide low-income eligible drivers with affordable liability insurance. A Low-Cost Auto policy provides an exception to the normal limits required under the law and offers coverages of $10,000 for bodily injury per person, up to $20,000 per accident, and $3,000 for property damage. The California Automobile Assigned Risk Plan works closely with CDI to administer the program. CDI reports that 121,753 Californians have received insurance through the program since its inception and that 16,749 policies were in place at the end of 2017.

- *California Organized Investment Network.* The California Organized Investment Network (COIN) works to increase insurance industry investment in underserved and rural California communities by implementing a data call for large insurers on qualifying investments that offer environmental and social benefits. COIN also acts as a liaison between insurers and community organizations, and as a clearinghouse of community development investment information.

- *Insurance Diversity Initiative.* CDI operates several programs to increase diversity in insurance leadership and in the insurance market. These efforts have include a Diversity Task Force that conducts outreach, pursues partnerships, and hosts events. CDI also uses surveys and data calls to collect insurers' diversity efforts and track results, including the Diverse Supplier Survey and the Governing Board Diversity Survey (for the last three years, CDI has combined these surveys into the Multistate Insurance Diversity Survey and administered them on behalf of some other states as well).

- *Climate Change Mitigation Programs.* CDI has been engaged in several activities designed to address risks posed by climate change, including the multistate Climate Risk Discloser Survey requiring insurers to disclose, among other things, its climate change policy, the process for assessing climate change risks, and the effect climate change has on its investment portfolio. CDI also administers the Climate Risk Carbon Initiative that requires large insurers to report climate-related investments, such as those in thermal coal and the energy sector, and provides analysis on the long-term feasibility of those investments. (The COIN survey also requires insurers to disclose "green" investments.)

Guarantee Associations

Guarantee associations serve as an important failsafe by covering claims of insolvent insurers, up to a limit, made by California residents. Insurers in the same or similar lines are required to be members and will contribute funds to pay for those claims when necessary.

Coverage terms determine how the guarantee association approaches these liabilities. Claims arising from shorter-term policies, such as an annual basis, including health and homeowner's insurance policies, are easier and quicker to calculate and resolve. Some types of insurance, such as long-term care or workers' compensation insurance, may have indefinite obligations that last for decades.

But coverage is not unlimited and costs will ultimately be passed on to policyholders. The type of insurance and other factors determine the coverage cap. When available estate assets and income are inadequate, the association must assess its members to make up the difference. Assessment amounts are proportionate to each member's market share but are also capped on an annual basis. The number and size of participating members defines the capacity of the guarantee association. Large assessments may be broken down and spread over a number of years and most insurers may recoup payments through a surcharge on its policyholders.

California Insurance Guarantee Association. All insurers writing property and casualty insurance in California are required to be members of California Insurance Guarantee Association (CIGA). These include property, liability, and workers' compensation insurers. CIGA does not issue policies, charge premiums, or make a profit. Its 13-member board administers the fund based on assessments and may issue bonds to pay covered claims in the event of a natural disaster, subject to approval by CDI.

CIGA processes mostly workers compensation claims, many of which can arise from insolvencies that occurred decades earlier. Less common are claims for auto insurance coverage with two recent auto insurance insolvencies, one in 2016 and one last year. Insolvencies resulting from residential property claims are rarer, but last year, Merced Property and Casualty Company (Merced) went into liquidation as a result of the 2018 Camp Fire. With assets of only \$23 million and claims topping as much as \$64 million, Merced became the only insurer to face insolvency because of wildfire in 2018. According to CIGA, policyholders are protected up to \$500,000 per policy for each coverage subject to the limits established by the policy. CIGA does not expect to issues an assessment for the Merced insolvency.

California Life and Health Insurance Guarantee Association. Claims related to insolvent life and disability insurers, including annuities, health, long-term care, and disability income insurance clams (but not including health plans regulated by the Department of Managed Health Care) are guaranteed by the California Life and Health Insurance Guarantee Association (CLHIGA). CLHIGA was formed in 1994 when the separate life and health guaranty associations merged. CLHIGA assesses its members when assets and income are inadequate to pay claims. CLHIGA has an account for life insurers pay into one to cover life insurance policies and annuities, and a health account for disability insurers, including health, disability income, and long-term care insurers to pay into. The assessment for each member is proportionate to its market share, capped on an annual basis, and spread over a number of years. As health insurers transition their products to managed care plans not subject to assessment (such as an HMO plan), CLHIGA's capacity to cover long term care insurance and health insurance continues to dwindle. In 2011, CLHIGA enjoyed a capacity of about \$381 million; in 2016, that capacity dropped to \$299 million. Since inception, CLHIGA has paid \$1.1 billion in 39 separate insolvencies.

Since CLHIGA covers permanent life and long-term care insurance that do not expire, it may have to step into the shoes of the insolvent insurer. The association will either arrange to transfer liabilities to a healthy insurer or assume, settle, and pay the claims itself. Unlike CIGA, it cannot simply cancel or refuse to renew a permanent policy. This also means CLHIGA may have to collect premium to pay for those claims and ask for rate increases when justified.

In 2017, Penn Treaty Network America Insurance Company ("Penn Treaty"), a Pennsylvania-domiciled long-term care insurer, was placed in liquidation. It was estimated that Penn Treaty had up to \$4 billion in liabilities and only \$700 million in assets. CLHIGA is responsible for claims up to a maximum of \$560,929. Estimates show that California policyholders will ultimately pay \$400 million in surcharges related to the Penn Treaty insolvency over the next several decades in order to ensure that the approximately 8,000 Penn Treaty policyholders in California will have their claims covered.

Alternative Sources of Property Coverage

Property insurance coverage not only protects the insured from a loss, but also facilitates the purchase of property. Home purchasers must obtain insurance coverage in order to secure a mortgage. A lack of access to insurance can have a significant impact on the housing market and other areas of the economy.

Insurance can become hard to come by when the risks of simultaneous large losses dramatically increase. One way insurers limit their exposure is to exclude or cap certain perils, such as damage from an earthquake. Another way is to limit losses that may occur at the same time by restricting the amount of coverage offered in any one area. (For this reason, some property insurers are refusing to issue or renew some policies in high-fire risk areas.) When consumers face a lack of access to affordable coverage, the Legislature has responded by establishing alternative methods of obtaining coverage.

California Earthquake Authority. The 1994 Northridge earthquake killed 57 people, injured 1,500, and damaged tens of thousands of structures. It also caused over $25 billion in damages and $49 billion in economic losses. At the time, insurers were required to offer earthquake coverage and the losses left many insurers overexposed. As insures threatened to withdraw from the market, the Legislature created the California Earthquake Authority (CEA) in 1996 as a privately financed and publicly managed entity that offers catastrophic residential earthquake insurance to homeowners, renters, condo owners, and mobile home owners (it does not offer commercial policies). The CEA currently has more than $17 billion in claims-paying capacity, over 1 million policyholders, and 25 participating insurers. Allowing insurers who join the CEA to shift earthquake risk off their books kept insurers in the homeowners insurance market, but has not addressed the fact that California consumers (and businesses) have severely underinsured its earthquake risk—only about 11% of California homeowners purchase earthquake insurance.

In order to better adapt to the potential for massive losses, the CEA has a multilayered mechanism to fund the payment of claims; once one layer is exhausted, the next layer is triggered. The first layer is the available capital built up through policyholder premium and other income. The second layer includes risk-transfer mechanisms such as reinsurance and catastrophe bonds. The third layer is funded through revenue bonds. The two remaining layers involve assessments on other types of insurance policies issued by participating insurers. Under its original structure, CEA could assess insurers $2.2 billion if a loss exceeded CEA's capital. When that agreement expired in 2008, the Legislature granted the CEA the authority to assess participating insurers with a new layer. This second assessment layer is the least exposed to earthquake losses, but primary insurers may choose to purchase reinsurance to mitigate their exposure to an industry assessment.

In August 2011, the CEA and the Governor's Office of Emergency Services established the California Residential Mitigation Program as a joint-exercise-of-powers entity to carry out mitigation programs that assist California homeowners who wish to seismically retrofit their houses. The goal is to provide grants and other types of assistance and incentives for these mitigation efforts, including the "Earthquake Brace and Bolt" program, which provides grants of up to $3,000 for homeowners who have qualifying homes. Brace and Bolt retrofits reinforce the posts and floor joists under a wooden frame home's floor, and typically cost between $3,000 and $6,000 for single-family dwellings. This relatively small investment can prevent very high losses. The CEA estimates that there are approximately 1.6 million owner-occupied houses in California that meet Brace and Bolt's criteria, 1.2 million of which are in higher-hazard areas.

California Fair Access to Insurance Requirements Plan. The Legislature created the California Fair Access to Insurance Requirements Plan ("FAIR Plan") in 1968 following brush fires and riots in the 1960s that led many insurers to exit urban areas or neighborhoods as too risky to insure. The FAIR Plan assures that homeowners and some businesses have access to basic property insurance, and is often referred to as homeowners' "insurer of last resort." The FAIR Plan is a private association comprised of all insurers licensed to write property insurance in California, and profits and losses are shared in proportion to market share. It is not a state agency and no taxpayer funds are involved. FAIR Plan policies are actuarially sound, which may result in higher costs for limited coverage. Coverage is very limited and only applies to structure and contents; coverage for liability, theft, or water damage typically found in most policies is not available. Homeowners may purchase a "Difference in Condition" policy or other supplemental coverage from the voluntary insurance market when purchasing a FAIR Plan policy to obtain these coverages. FAIR Plan's market share declined from 2006 to 2016, but increased in 2018. As of February, 2019, the Fair Plan had 125,079 policies. Of those, approximately 72% of its policies are in urban areas, largely Los Angeles. However, effective April 1, 2019, FAIR Plan rates on dwellings will increase an average of 20.3% with another expected rate increase in 2020 driven by losses from the most recent wildfires.

Surplus Lines Association of California. Surplus lines insurance offers protections against unique, distressed, and high capacity risks, or new risks without loss history, not readily offered by California admitted insurers. Surplus lines insurers are admitted in other states, but may only sell policies in California under certain conditions. Specially licensed "surplus line brokers" follow specific procedures and file a report to issue a policy. All California-licensed surplus lines brokers are members of the Surplus Lines Association. The association reviews every surplus lines filing filed in the state and serves as an advisor to CDI.

During the 2018 reporting period (December 1, 2017, through November 30, 2018), more than 5,500 members placed 687,194 surplus lines policies totaling more than $7.6 billion in processed premiums, up slightly from 648,582 policies totaling $6.5 billion in premium in 2017. The overwhelming share of the association's business is in the commercial marketplace, but association brokers did place 49,370 California homeowners policies with surplus lines carriers last year, accounting for 1.6% of all processed surplus lines premiums in 2018. While the number of homeowners policies insured in the surplus lines market in California doubled from 2013 to 2017, the association estimates approximately only 1% of all homeowners premiums in the state go into the surplus lines marketplace. The association does note, however, an increase in the number of homeowners policies issued in fire-prone areas.

Workers' Compensation Insurance

All California employers must provide workers' compensation coverage to protect employees who are injured or disabled in the course of employment. Over 16 million employees are currently covered. Benefits cover health care costs and other services necessary to enable the injured worker to return to work, compensate those who cannot, and provide disability payments. Employers are protected against lawsuits filed by employees related to those injuries. The Department of Industrial Relations monitors the administration of claims and benefits, but CDI regulates the insurers. (The Department of Industrial Relations is generally overseen by the Labor, Public Employment, and Retirement Committee.) In 2016, employers paid workers' compensation insurance premiums totaling $17.9 billion.

The State Compensation Insurance Fund. Created by statute in 1914, the State Compensation Insurance Fund ("State Fund") serves as a workers' compensation insurer for the State as well as to ensure all employers have access to coverage. The State Fund is required to maintain enough market share to remain financially stable and provide quality services, but not compete for increased market share or make a profit. The State Fund also serves as a third-party administrator for self-insured public and private employers. State Fund is self-supported with premiums and investment income. It does not receive any financial support from the State and the State is not liable for any of its obligations. The Governor appoints nine members of the governing board, including one from organized labor, and names the chairperson; the Speaker of the Assembly appoints one member who represents organized labor; and the Senate Committee on Rules appoints one member to represent policyholders. The board also includes the Department of Industrial Relations Director as a non-voting "ex-officio" member. State Fund's market share fluctuates, with a high of 53% reported in 2000-01, to a low of 10% in 2012. In 2017, State Fund wrote $1.3 billion in premium, had investment income of $619 million, and a net income of $40 million.