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## Informational Hearing

### **Wildfires and Homeowners Insurance: Availability in High Risk Communities**

Wednesday, February 12, 2020  
State Capitol, Room 112

#### **Summary**

The Senate Committee on Insurance has been tracking the availability and affordability of homeowners insurance since 2016. Testimony at the May hearing last year suggested that many, if not most, consumers in high fire-risk areas were able to find alternative coverage in the standard market. But 2019 saw a surge in new policies issued by the California Fair Access to Insurance Requirements (FAIR) Plan, California's insurer of last resort, suggesting that the voluntary insurance market is no longer accommodating an increasing number of homeowners who are nonrenewed or shopping for new policies. In this sense, 2019 represents a turning point. This hearing is intended to provide an update of the state of the insurance market, take a closer look at the mechanisms that impact insurance supply, and consider options to address availability issues.

#### **I. INSURANCE MARKET UPDATE**

While most of California's market is functioning well, consumers in high fire-risk areas are facing shortages and climbing rates. Current market problems have been building up for years. In 2016, insurers were already adjusting their exposure in high risk areas after the 2013 Rim Fire and expected that "California was overdue for a large, catastrophic fire."<sup>1</sup> Still, the extensive

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<sup>1</sup> Senate Committee on Insurance, [Preparing for Global Warming and Drought: State of the Homeowners' Insurance Market](#) (March 2016).

damage caused by the 2017 and 2018 wildfires caught everyone by surprise and triggered a total paradigm shift in the way insurers view wildfire risk.

Once insurers realized they may have severely underestimated their liabilities in fire-vulnerable areas, they began readjusting their exposure by refusing to issue new policies and, for some, refusing to renew (“nonrenew”) existing policies. At least until 2019, it appears that the market has been filling those gaps and that most nonrenewed policyholders were able to find alternative coverage with a new insurer; after the CAMP FIRE FAIR Plan enrollments accelerated implying that fewer dropped customers are finding replacement coverage.

In 2018, California had 112 individual admitted insurers offering homeowners multi-peril insurance policies (usually referred to as an “HO3 form”) representing \$8.3 billion dollars.<sup>2</sup> The same year, one insurer went insolvent due to losses arising from the Camp Fire and at least one insurer is reported to have withdrawn from the market altogether because of wildfire risk.

A November 2019 analysis prepared by Milliman explains that the “\$14.70 billion of accumulated profits from 2004 to 2016 was insufficient to pay for over \$22 billion of underwriting losses from 2017 and 2018 wildfires” and that underwriting losses outstripped premium as far back as 1996.<sup>3</sup> (These figures do not account for investment income, reinsurance recoveries, or pending subrogation recoveries.)

### **Nonrenewals, Renewals, and New Policies**

Insurance access is often measured by the number of policies issued and renewed by insurers licensed or “admitted” to sell in California. In August of last year, the California Department of Insurance (CDI) published updated data on the number of policies issued, renewed, and nonrenewed. According to statewide data for 2018, insurers issued and renewed 8.5 million policies and nonrenewed 167,870 policies or about 1.96% of the total policies issued and renewed the prior year (as a rough estimate of the policies in-force at the beginning of 2018).

#### **Number of New, Renewed, and Non-Renewed Homeowners’ Policies Statewide<sup>4</sup>**

Year	New	Renewed	New & Renewed	Nonrenewed By	
				Insurer	Policyholder
<b>2018</b>	971,803	7,570,711	8,542,514	167,870	731,660
<b>2017</b>	987,036	7,558,393	8,545,429	162,048	749,470
<b>2016</b>	974,600	7,525,689	8,500,289	167,359	727,150
<b>2015</b>	954,687	7,446,707	8,401,394	174,345	718,563

But this data provides little insight into which nonrenewals were based on wildfire risk. Insurers have many reasons they might refuse to issue or renew a policy, such as prior claims or exposure

<sup>2</sup> CDI, [California P&C Premium and Loss Summary, Prop 103 Lines Only \(2018\)](#).

<sup>3</sup> Sheri Scott, FCAS, MAA, CSPA, Reshaping insurance to solve California’s wildfire insurance availability issue, Milliman (November 2019), p. 1.

<sup>4</sup> CDI, [Number of New, Renewed, and Non-Renewed Homeowners’ Policies \(2019\)](#).

to civil liability (think dog bite). Since the data only goes back to 2015, there is no baseline to compare current trends to before insurers began accelerating nonrenewals.

CDI does provide some breakdown of policies covering risks located in a State Responsibility Area (SRA). In 2018 in the SRA, insurers issued or renewed about 4.3 million policies and nonrenewed 88,187 or 2.04% of the policies issued and renewed in 2017. Throughout the four years tracked, SRA policies represented 50.4% of new and issued policies and 53% of total nonrenewals.

Policyholders tend to nonrenew policies at a much higher rate than insurers. Reasons for nonrenewal could include death and the sale of the home. In 2018, consumers statewide terminated 731,660 policies representing about 81% of all policies that were not renewed that year; in the SRA, insured's initiated 375,388 nonrenewals at the same ratio.

Although there are some up-and-down trends in the nonrenewal activity, the data does not track the number of consumers who applied but were never able to obtain coverage, nor does it track those policyholders who were picked up by another insurer. Because of these limitations, inferences about the available insurance supply must be drawn by looking at other data, such as the number of homeowners who rely on the "last resort" options.

- In order to slow-down nonrenewals in the state's most vulnerable areas, existing law provides some temporary relief for wildfire victims, and those living in impacted areas. SB 824 (Lara), Chapter 616, Statutes of 2018, requires insurers to renew policies in areas impacted by a disaster for at least one year, as specified. SB 894 (Dodd), Chapter 618, Statutes of 2018, requires insurers to renew policies for at least 24 months, if the property suffered a total loss in a declared disaster. Last year, the Governor triggered SB 824 protections in several areas by declaring fire-impacted areas a disaster; those protections now extend to more than 1 million homeowners. The Insurance Commissioner also asked insurers to voluntarily renew policies in the rest of the state.

### **The Nonadmitted and Residual Market**

When standard coverage, policies offered by admitted insurers in the "voluntary" market is hard to come by, consumers may seek coverage in the nonadmitted market through surplus line insurers or the "residual" market through the FAIR Plan. But these options are more expensive and generally viewed as less preferable. Because these options are usually more expensive and usually not recommended unless necessary, growth suggests a lack of preferable choices.

Surplus Line Policies. Surplus line insurers are not licensed or "admitted" to sell insurance in California. In order to place insurance with a surplus line insurer, most consumers must go through a surplus line broker because, in part, they are not subject to CDI regulation and lack many of California's consumer protections. They do play an important role in the market by offering a source for hard-to-get coverage and provide flexibility during changing market conditions. According to the Surplus Line Association, 2019 homeowners premium in California totaled \$232 million from 46,479 transactions. Although surplus line coverage represents a very small portion of the market, premium rose significantly over 2018 by about \$122 million, although total transactions were actually slightly down from 49,281 in 2018. This trend is

consistent with surplus line markets nationally. There is some evidence that rates are increasing and that surplus line carriers are covering higher value homes.

The FAIR Plan. The FAIR Plan ensures that nearly every California consumer has access to homeowners insurance. It has very limited discretion to deny an application or nonrenew an existing policy. Still policies are not designed to replace standard coverage, are expensive and offer slim benefits.

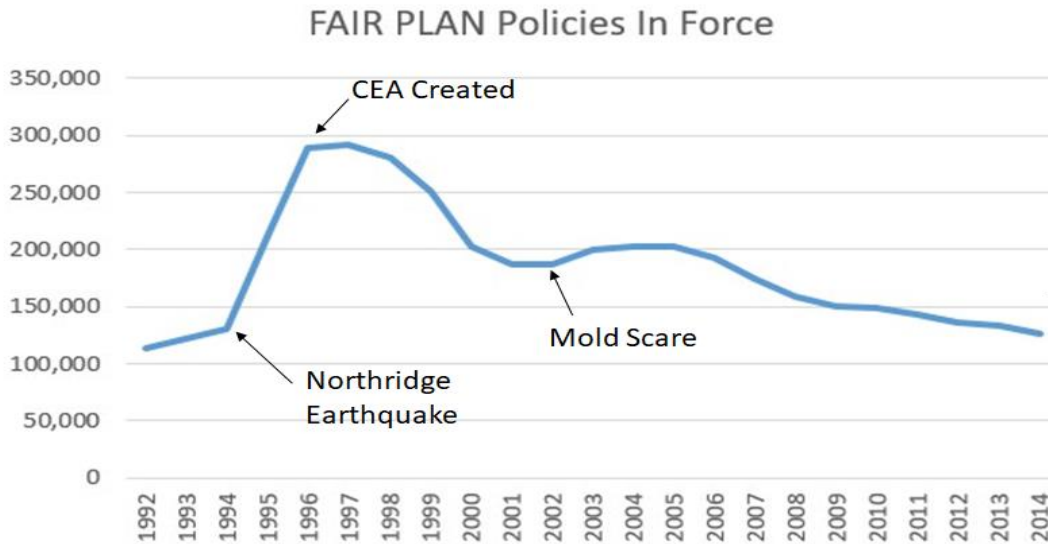
All insurers admitted to write property insurance in California are required to be members of the FAIR Plan and are subject to an assessment when its liabilities exceed assets. Residential policies are currently capped at \$1.5 million for all coverages making it a less viable option for homes with higher values. More than half of FAIR Plan policies are written for less than \$500,000 and only 14% of policies are for over \$1 million.

Prior to 2019, total FAIR Plan policies in force remained relatively flat. The FAIR Plan only issued 89,248 new policies for 2015 to 2018, representing a mere 13.29% of 671,322 nonrenewals reported for the same period. This suggests that most nonrenewed policyholders were able to find replacement coverage elsewhere. In fact, FAIR Plan policies in-force statewide fell from 127,000 in February 2014 to 123,000 in February 2018.

However, different areas are showing significant differences in enrollment. From 2015 to 2018, just over half of all nonrenewals in the state occurred in Los Angeles, Riverside, San Diego, San Bernardino, and Orange Counties. Those same counties accounted for nearly 80% of the FAIR Plan's new business. Some communities have particularly high levels. Most of San Bernardino's FAIR Plan business covers properties in the county's mountain communities. These communities represent the FAIR Plan's highest concentration of risks; one fire could result in as much as \$1 billion in losses and likely trigger an insurance industry assessment.

FAIR Plan enrollments began accelerating after the Camp Fire. In November 2018, the FAIR Plan had 122,310 policies in force, just 6 fewer than the previous month. As of January 2020, the FAIR Plan reports 179,263 policies in-force representing a growth of 55,606 policies from January 2019. Before the surge began, the FAIR Plan would typically write around 2,000 new policies per month. Since December 2018, new business has steadily increased and FAIR wrote 8,927 policies in October 2019. Moreover, the average policy limit has increased 17%, suggesting owners of more expensive homes in wildfire risk areas are turning to the FAIR Plan.

Still, FAIR Plan enrollment only represents a fraction of the homes in high or very high fire risk areas and enrollment is far below record levels. The insurance crisis following the 1994 Northridge earthquake caused FAIR Plan rolls to add almost 170,000 policies over just a few years, swelling our last resort plan from 121,776 policyholders to 291,617 by 1997 (139% increase). As insurers paid out on massive losses, 82 insurers restricted the sale of *new* policies. As a result, the FAIR Plan grew substantially, topping out at 291,617 policies in 1997 just after the creation of the CEA. Once the CEA was formed, participating insurers reopened their books and by October 1997 only three insurers were still restricting the sale of new policies. As the market recovered, some insurers responded to a surge in mold claims by refusing to write new policies, causing a bump in enrollment, but the declining trend returned a few years later.



Last year, the Insurance Commissioner ordered the California FAIR Plan to increase its limits on residential properties to \$3 million, offer a full HO3 option, and provide charge-free financing. CDI anticipates that policyholders save on administrative costs by purchasing a single HO3 rather than FAIR Plan fire coupled with a separate wraparound policy. The FAIR Plan estimates that implementing the order will increase its expenses and will have to pass those costs on to its existing policyholders. The FAIR Plan has requested a preliminary injunction on the Commissioner’s order and a court hearing on that matter is scheduled for February 18.

The FAIR Plan is expensive and likely to get more so. Policyholders saw a 20% average rate hike last year, with lower fire-risk homes possibly seeing a 10 to 30% decrease and some high fire-risk properties seeing as much as a 69% hike. Many homeowners in these areas are on limited and fixed incomes. The affordability of the FAIR Plan and insurance in the voluntary market is primary concern for most policyholders and the Legislature. The Committee intends to hold a follow-up hearing on increasing rates and the proposed changes to the FAIR plan soon.

## II. THE MECHANICS OF INSURANCE SUPPLY

Insurance is a method of risk transfer and management. It serves a critical role in society by giving insureds assurance that they can go about their daily lives without living in fear of some horrible event taking the paycheck or the family home.

For at least two reasons, the supply of insurance *appears* limitless. It seems to exist in a virtual world unbound by the laws of physics (or economics). But, through the magic of leverage and statistics, insurers multiply a few thousand dollars into millions; an insurance policy covering a \$1 million home might only be backed up by mere thousands. Yet, the \$1 million is there when needed. These tools only create so much supply, however and is ultimately limited by insurer assets.

California’s current insurance challenges arise from a troubled supply line and an increase in demand. To make things more difficult, there is no one-stop shop. Matching supply to need

during times of shortage becomes even more difficult. To better address those troubles, a basic understanding of the components of insurance is necessary to better address those challenges.

### **The Parts of the Insurance Engine**

Insurance involves very complex mechanisms that require fine tuning and educated guesswork. Insurers use several sophisticated, mysterious and sometimes counter-intuitive tools to extract resources from a risk pool and direct them where needed most.

Risk Pooling. By definition, insurance involves risk pooling, a system of shifting large losses from the unfortunate few to the fortunate many. Pooling operates on the law of large numbers; the more exposures in the pool, the more predictable the losses. It also works more efficiently when losses are measurable and accidental. Unfortunately, pooling does not work as well for catastrophic losses which often requires some supplemental mechanism or subsidy to make insuring such high loss events feasible.

A good deal depends on the insurer's ability to estimate potential losses and apportion those losses by way of premium among risk pool members according to their individual risk. If they guess projections are wrong, there may not be enough resources to pay for the losses. When some pay more than the actual risk they bring to the pool, they cross-subsidize other pool members disadvantaging lower-risk insureds and undermining incentives for high risk insureds to avoid risky behaviors.

Underwriting. Underwriting is the process insurers use to assess the risk of an individual exposure, like a home, in order to decide whether or not to issue a policy and determine how much to charge. Underwriting is a form of eligibility analysis and serves as a gateway to the pool. Underwriting guidelines that govern the assessment are designed fit the premium to the risk, avoid cross-subsidization, and diversify risks in order to avoid overconcentration. When an insurer restricts its underwriting, it raises the eligibility criteria to make it harder for consumers to qualify and lowers the risk pool's exposure. For homeowners, this process usually considers roof type, public protection class (scoring the availability of fire suppression services), wildfire risk model score, and brush clearance. Based on the guidelines, the insurer may accept or reject an application, or offer to issue the policy on the condition that the insured perform some risk mitigation steps, such as clearing brush or home modifications.

Assets and Capacity. Insurers can only pay claims if they have adequate assets. Risk pooling requires pool members to contribute to the pool by way of insurance premium. Those contributions, i.e. "underwriting income," are based on projected losses and administrative expenses (the cost of providing the insurance). Each member must contribute enough to pay for projected losses and expenses, and preferably at a rate commensurate to their individual risk. However, underwriting income can be supplemented with investment income which gives the whole enterprise a bit, sometimes quite a bit, of wiggle room.

An insurer's "capacity," the maximum liability an insurer can legally assume, is driven by statutory minimum capital and surplus requirements.<sup>5</sup> "Surplus" is the difference between assets

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<sup>5</sup> Ins. Code §§ 700.01, 700.02 & 700.025.

and liabilities and accrues through maximizing income and minimizing losses; it serves as a cushion when losses exceed expectations. When insurers collectively hold a large surplus, they free up underwriting and lower rates; the opposite naturally occurs after massive losses drain the surplus.

The recent insolvency of the Merced Property and Casualty Co. serves as a warning. Merced represented less than 1% of the homeowners market and, in 2017, only paid \$74,526 in losses over \$4.4 million in premium collected. While other insurers were refusing to issue new policies or renew existing policies in Paradise, Merced expanded in that area. After the Camp Fire, Merced claims exceeded \$63 million, but Merced only had \$23 million available to pay them.<sup>6</sup>

Managing Risk and Distributing Supply. Insurance isn't a monopoly and the industry is not monolithic. Individual insurers come in a variety of flavors and sizes. While they might act similarly based on market trends, there is no mastermind governing industry behavior. An insurer is responsible to manage its own risk exposure. CDI has broad authority to examine the insurer's financial health, but has not made a practice of assessing business judgments like risk concentration.

The trouble with wildfire risk, unlike the one-off single-house fire, is that covered homes in close proximity are much more likely to be lost in a single event. For this reason, an insurer must monitor and measure its exposure according to location to avoid the potential for mass simultaneous losses. The problem isn't one of policies count, but the total aggregated value of insurance coverage in an area (say \$100 million per square mile) that is vulnerable to simultaneous losses. A diversified insurer will spread insured properties across a wider geographical area to decrease the likelihood of simultaneous losses, but an insurer that does not look out for its own risk concentration risks insolvency.

In terms of delivering insurance to those in need, insurance is distributed through a variety of methods: captive agents, independent agents, brokers, and directly to the consumer. There is no invisible hand that matches an insurer with available capacity to the consumer who needs coverage. While there is plenty of supply, there is no need.

The FAIR Plan is the closest thing to a unified approach to distributing coverage. Taking advantage of that fact, Louisiana, Florida, and Maryland have created programs to move policyholders out of their version of the FAIR Plan by providing a means to transfer residual market policyholders to voluntary market insurers. This allows insurers to match extra capacity to consumers. A similar approach is proposed for California in AB 1852 (Daly) which would require the FAIR Plan to establish a clearinghouse for that purpose.

Underwriting Income and the "Catastrophic Load". Insurers do not have crystal balls; they have actuaries who use mathematics, statistics, and projections to provide carefully reasoned guesses of how likely an event will happen and how much it will cost. Those guesses are used to establish rates. If they guess correctly, the insurer enjoys a profit; if not, the insurer suffers unexpected losses. Generally, the occasional kitchen fire is fairly predictable and consistent. When developing insurance rates, the insurer will compile recent data (typically 1 to 3 years) in

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<sup>6</sup> CDI, [2018 Annual Report of the Commissioner](#), p 33.

order to estimate the amount needed to pay anticipated losses. Those losses combined with other expenses, such as operational costs, regulatory costs, and taxes, make up the expected losses and expenses that serve as the basis for the rate. However, not all losses end up costing the insurer. Under some circumstances, the insurer may recover the loss from a third party through a reinsurance contract or subrogation.

Additionally, investment income can moderate underwriting losses. Insurers earn income by investing the premium it collects. In fact, an insurer that suffers underwriting losses may still operate at an overall profit if investments perform well. On the other hand, an insurer's investment income is considered during the ratemaking to offset a portion of a potential rate hike.<sup>7</sup>

An insurer's financial health depends on accurately anticipating losses, but catastrophic losses are extraordinarily difficult to project. California uses a traditional approach to rate catastrophes often called "catastrophic loading". That process allows insurers to charge extra to compensate for extraordinary losses.<sup>8</sup> The share of premium for catastrophic losses builds up over time in order to save for a "rainy day." For this reason, catastrophic losses are separated from the regular experience data, which only looks at the last few years, and calculates the catastrophic component of the premium based on average historical losses over a period of at least 20 years.

Insurers argue that traditional ratemaking methods have left them with inadequate rates for some time and that improved techniques for estimating future losses are in order. So long as insurers believe rates are inadequate, they will be less likely to expand or remain in high fire-risk areas.

### **CAT Modeling: Moving Beyond the Calculator**

Computer-driven software has greatly expanded insurers' ability to make empirically-based judgments about risk. Catastrophic models project aggregate losses by generating thousands of virtual catastrophes to calculating the range of expected damage caused. Underwriting models take information about an individual home and community to assess their vulnerability.

This hearing will look at Catastrophic or CAT models. Although models are subject to actuarial standards governing how they are used, consumer advocates note that there are no statutory standards to ensure a models accuracy or reliability in rating and underwriting of homeowners' insurance.

On the other hand, models can be difficult to regulate because they are driven, or are supposed to be driven, by science and technology; state agencies have not had good luck regulating science and technology (as the joke goes, we might still be waiting for approval of "the wheel"). Nevertheless, some oversight may be necessary to ensure that models comply with the law.

Catastrophic Modeling. CAT models are computer-driven tools used to anticipate losses under current conditions by creating virtual catastrophes, anticipating the potential damage to structures, and producing estimated losses. This gives the insurer an idea of how much

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<sup>7</sup> See 10 CCR §§ 2644.19 and 2644.20.

<sup>8</sup> 10 CCR § 2644.5.



catastrophes of various sizes and intensities will cost given the damage to covered buildings and structures. To supplement historical experience, insurers and reinsurers rely on modeling when assessing their potential risk exposure and many states allow modeling for ratemaking.

Massive catastrophes that resulted in shocking damage fueled interest in CAT modeling. Hurricane Andrew in 1992 caused over \$24.5 billion (2017 dollars) in insured losses and accelerated the use of CAT models. The 1994 Northridge Earthquake has a similar effect. Insurers realized that the traditional method for projecting losses does not account for population movements and fluctuations in construction and other costs. CAT modeling has continued to evolve as technology, engineering, and scientific understanding of catastrophic events advance. However, compared to hurricanes and earthquakes, wildfire CAT modeling is in its early adolescence.

According to the National Association of Insurance Commissioners, CAT models quantify the financial impact of a range of potential future disasters, inform users on where future events are likely to occur, estimate an events' likely intensity.<sup>9</sup> Based on the expected probability of loss, models estimate a range of *direct losses* such as damage to physical structures and contents, deaths and injuries; *indirect losses* such as loss of use, additional living expenses and business interruption; and *residual losses* including demand surge, labor delays and inflation in materials costs.

CAT models involve modules or components that work together to produce key metrics used to assess an insurer's risk exposure. The event module generates thousands of simulated catastrophic scenarios based on historical data, sometimes going back thousands of years. The intensity module determines the level of physical hazard using location-specific physical characteristics for each simulated event. The vulnerability module estimates physical damage given exposure characteristics and event intensity. When all else is calculated, the financial module measures monetary losses based on damage estimates and applies those losses according to coverage terms.

Model results provide insurers with key insights into their exposure such as the likelihood that a loss of any given size or greater will occur in a given year; the average annual loss representing the average loss of the entire set of virtual scenarios; and the annual probability that a certain loss threshold would be exceeded.

These tools are based, in part, on a good deal of educated guesses and involve many assumptions and theories. In many respects, there may be no way to determine which parts of the model may be accurate or inaccurate. Different well-designed models still produce a broad range of results that might trigger skepticism by regulators and consumer advocates. Moreover, insurers and vendors can be protective of the propriety data and infrastructure of these models which can put them at odds with transparency laws such as the California Public Records Act.

In California, historical data, rather than modeling, is primarily used for setting rates for most types of insurance, although CDI regulations expressly allow the use of models for earthquake

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<sup>9</sup> NAIC Center for Insurance Policy and Research, [Catastrophic Modeling](#) (2020).

and medical malpractice insurance.<sup>10</sup> Some experts suggest that historical experience might not be reliable for anticipating losses. Historical loss experience is based on fixed circumstances at the time of the event, including climate, building costs and population density. These circumstances cannot be adjusted to reflect new circumstances or “what if” scenarios. CAT models can incorporate adjusted assumptions, such as the potential impact of new fire mitigation standards.

The flexibility of CAT modeling is both a virtue and a vice. For the regulator, assumptions and data can be adjusted to suit a result desired by the industry, but the complexity of the model make it hard for a regulator to scrutinize it. Conversely, industry may raise concerns that CAT models, like any science-driven tool, can produce politically inconvenient results and that a publicly elected commissioner may be motivated to influence the results. Four states require review of CAT models by the insurance regulator, but of only Louisiana has an elected insurance commissioner. Florida’s Commission on Hurricane Loss Projection Methodology has an independently appointed panel of subject matter experts.

Even though California insurers may not base rates on CAT model results, insurers and reinsurers use models to assess their overall risk exposure. To the extent that CAT model projections deviate from the catastrophic load used in ratemaking, insurers may view the approved rate as inadequate to support existing or further exposure in high fire-risk areas.

Underwriting Models. A different type of model is used for underwriting. Where CAT modeling makes broad assumptions and reflects trends, underwriting models assess the specific risk of individual structures for two purposes: (1) deciding whether or not to issue the insurance policy and (2) setting premium based on an approved rate schedule and “rate differentials.” FireLine, a frequently cited example of an underwriting tool, measures individual properties for wildfire risk by weighing factors such as topography, vegetation, wind patterns, and accessibility. An insurer might refuse to insure a property with a high score or charge significantly higher premium.

While the Department does not review underwriting models when insurers use them for the purpose of determining whether or not an insurer will issue a policy, it has some oversight during the ratemaking process when insurers use those models for establishing rating differentials, i.e. how much the insurer will charge according to its approved rate schedule based on the individual risk of the home (does the home have a wood roof, lots of trees, etc.).

Although underwriting models may directly impact whether an insurer issues a policy and how much they charge, they don’t guide decisions on whether or not the insurer should reduce its overall exposure over a larger geographic area (a job better left to CAT models).

### **Reinsurance: Calling in the Backup**

Reinsurance arrangements bring in other insurers to help carry the risk load. Reinsurance is a form of “insurance for insurers” and provides a sort-of fail safe. It is a contract between two insurers where, for a price, the reinsurer “assumes” or agrees to cover the losses incurred by the “ceding” insurer. In a way, the reinsurer is back-up. Because reinsurance shifts the risk away

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<sup>10</sup> 10 CCR § 2644(e).

from the insurer, it also expands the insurer's underwriting capacity and increases the amount of coverage an insurer can legally or may be willing to offer in the market. The social benefit of reinsurance cannot merely be measured by price or reimbursed losses, but should also be considered against its function of opening up insurance supply.

Any insurer may act as a reinsurer, but there are many specialized reinsurers, and several very large reinsurers that operate internationally. Reinsurers create a web of support that dissipate and distribute catastrophic losses across international boundaries and types of catastrophes. Reinsurers also accumulate massive loss data and invest in sophisticated risk modeling. With these resources, reinsurers can provide guidance and direction to an insurer on business decisions, such as how much risk it should retain or shift, and how to draft policy coverages.

Although reinsurance agreements can work in many ways, catastrophic losses are often covered as an excess-of-loss, often based on a single exposure or aggregate losses from a single event, or the insurer's cumulative losses in a given year. Losses below that threshold are retained by the insurer and losses above will be reimbursed to a limit. In this way reinsurance helps to stabilize loss experience and moderate wild swings in losses from year-to-year.

Insurers may purchase reinsurance for several reasons, but many are related to the insurer's ability to write new business. Reinsurance is credited against an insurers' liabilities when calculating capacity. In fact, state insurance regulators are limited in their authority to deny an admitted insurance credit against its liabilities for reinsurance contracts; those transactions are governed, in part, under federal law, Nonadmitted and Reinsurance Reform Act, part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as well as conforming state law based on the Credit for Reinsurance Model Law adopted by the National Association of Insurance Commissioners.

Actuarial principles require consideration of reinsurance costs when setting rates, although they do not establish how they are treated.<sup>11</sup> CDI regulations do not allow homeowners insurance rates to consider the cost or benefits of reinsurance, except for earthquake and medical malpractice insurance, for several reasons.<sup>12</sup> First, reinsurance rates are not regulated through the prior-approval process and would likely increase costs for all insurance consumers. Second, CDI is not confident that insurers would adopt a more liberal underwriting approach even if they were able to pass on reinsurance costs. Third, reinsurance contracts can be very complex and, from a regulatory standpoint, CDI would have difficulty establishing a baseline for the reasonableness of reinsurance coverage levels.<sup>13</sup> It might also be argued that reinsurance is an optional financial management tool for protecting insurer profits rather than an integral component of the insurance engine.

CDI also suggests that it is unnecessary. Rates reflect all losses in the calculation, not just those that are net of reinsurance. While rating formula does not compensate for reinsurance costs, it

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<sup>11</sup> Casualty Actuarial Society, [Statement of Principles Regarding Property and Casualty Insurance Ratemaking](#) (1988).

<sup>12</sup> 10 CCR § 2644.25.

<sup>13</sup> CDI, [The Availability and Affordability of Coverage for Wildfire Loss in Residential Property Insurance in the Wildland-Urban Interface and Other High-Risk Areas of California: CDI Summary and Proposed Solutions](#) (2018).

also does not reduce approved rates to reflect the payments and claim reimbursements the insurers obtain from reinsurance. CDI also points out that current regulations allow for catastrophe loading permitting the insurer to accumulate additional income every year in order to pay for those years where there are higher catastrophic losses.

So when an insurer's reinsurance rate increases, those additional costs are not reflected in the rate charged to the policyholder and absorbed by insurers. And while the cost and availability of reinsurance may not directly impact insurance rates, it will likely impact an insurer's willingness to offer coverage in high fire-risk areas.

### III. CONCLUDING THOUGHTS

A healthy market may be viewed as a balancing act that manages competing pressures on the availability, adequacy, and affordability of insurance products. Any proposal to address insurance supply issues must be carefully tailored to avoid unintended consequences that upset the balance by increasing costs or picking winners and losers among consumers. This is the time for creative, but carefully crafted solutions.

Looking to other states may be helpful, but we must also be mindful that each state has its own unique circumstances. Florida faced a similar problem with insurance availability because of hurricane risk. In addition to creating the Citizens Property Insurance Corporation, which serves as Florida's market of last resort, Florida took several bold steps to expand the availability of coverage in a very hard market.<sup>14</sup> To facilitate hurricane modeling improvement, Florida created the Commission on Hurricane Loss Projection Methodology that is made up of independently appointed subject matter experts and establishes standards for CAT models. To stabilize reinsurance costs and subsidize some consumers, the Florida Hurricane Catastrophe Fund provides a source of state-backed reinsurance in order to provide some insulation against large swings in reinsurance costs. Florida's Department of Insurance established the Public Hurricane Loss Model as a public CAT model to help evaluate rate filings, assess losses by counties and zip code, to make employing models more affordable and accessible, and to help evaluate reinsurance risk for the Catastrophe Fund, among other purposes. However, Florida is still plagued by high insurance costs and remains a relatively uncompetitive market. Citizens Property Insurance Corporation long had the largest market share and is now second in the state. Moreover, all Florida policyholders are subject to additional assessments if either the Catastrophe Fund or Citizens exhausts their claims-paying resources.

Insurance is a cooperative effort that relies on redistributing resources among insureds, but how much each insurer may collect is subject to CDI approval on a case by case basis, and at times includes a public hearing. This creates a tension between the affordability of individual policies and the availability of insurance generally. The adequacy of coverage also comes into play. For example, the Legislature has passed many measures to ensure that fire victims have adequate coverage. Anything that expands policy benefits, however, also increases insurer losses, and losses are what insurers file for their rate. As policies grow richer, so do pricing pressures and, to

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<sup>14</sup> John Rollins, [Testimony for April 3, 2019 Meeting of the Commission on Catastrophic Wildfire Cost and Recovery](#).

the extent they significantly increase an insurer's exposure, increase demand. If the rate paid for the benefits received is perceived by insurers to be inadequate, the potential for shortages increases.

Bright line rules designed to protect consumers against shortages may have unintended consequences as well. Many of these rules serve only one category of consumer while prejudicing another. When supply is limited, guaranteeing access to one group of consumers may undermine access and affordability for another.

Market indicators suggest that some policyholders in high fire-risk areas are being forced to the FAIR Plan at an accelerating rate. As the FAIR Plan grows more expensive and possibly out of reach to some consumers, the urgency to act increases as well and, perhaps, so does the need to take bolder and more aggressive steps. Nevertheless, given the complexity of the problem and the potential for unintended consequences, using the best data and information available, careful study with diverse stakeholder interests, and considering the impact on all of California's insureds is probably the wiser course.