Testimony of
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Before the
House Committee on Financial Services
Subcommittee on Housing and Community Opportunity
Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises

Hearing on
"Approaches to Mitigating and Managing Natural Catastrophe Risk:
H.R.2555, The Homeowners' Defense Act"

March 10, 2010

I would like to express my appreciation to Chairman Frank and the Committee, as well as Subcommittee Chairs Congressman Kanjorski and Congresswoman Waters, for the opportunity to be here today and speak on behalf of the California Earthquake Authority.

My name is Glenn Pomeroy, and I am Chief Executive Officer of the CEA. The CEA is California's not-for-profit, public/private partnership that offers residential earthquake insurance in a voluntary market, throughout California.

H.R.2555, specifically in its Title II, would enable the CEA to lower insurance rates and policy deductibles, allowing many more California consumers to have broader access to earthquake insurance that is both more affordable and more valuable.

As a result, we believe many more Californians would insure their homes against the potential catastrophe—and certain occurrence—of large, damaging earthquakes in our state.

I have divided my testimony today into four parts:

1. **California residential earthquake insurance, Northridge, and the CEA**
2. **The CEA today**
3. **The problem: The high-cost of earthquake insurance puts the coverage out of reach for most California homeowners**
    - **CEA's financial capacity is reinsurance-based**
    - **The high cost of CEA's reinsurance is passed on to policyholders in higher rates**
4. **The solution: COGA – the Catastrophe Obligation Guarantee Act**
    - **Big cost-savings and more choices for consumers**
    - **Lower rates, lower deductibles, and much greater value**

1. California residential earthquake insurance, Northridge, and the CEA

Residential earthquake insurance has been available in California for many years, but since the 1980s California law has required homeowners insurers to make a "mandatory offer" of earthquake insurance.[1] Simply put, as a condition to selling a policy of residential-property insurance to a consumer, the insurer must also offer an opportunity to buy earthquake insurance.

Under this system, consumers don't have to buy earthquake insurance, but they must be offered the opportunity to do so. Thus, earthquake insurance in California is historically a

[1] The CEA offers "residential" earthquake insurance — as defined in California's mandatory-offer law, that includes insurance for renters, condominium-unit owners, manufactured homes (mobilehomes), residential buildings of up to four units, and single-family dwellings. References to CEA "earthquake insurance" in this testimony do not refer to insurance for commercial structures or enterprises.

totally voluntary market — indeed residential quake coverage has never been mandatory in California — and the only mandate is the insurers' offer, made at inception of the homeowners policy and every two years thereafter.

Many observers believe insurers generally did not correctly price the residential earthquake coverage they sold, even under this mandatory-offer system, which led to "competitive" rating and too-low premiums collected for the earthquake coverage sold. This practice, and the entire earthquake-insurance market, changed dramatically in the wake of the 1994 Northridge earthquake.

On January 17, 1994, at 4:31 a.m., a magnitude 6.7 earthquake struck California's San Fernando Valley, 20 miles northwest of downtown Los Angeles. While the strong shaking lasted only 20 seconds, the earthquake produced enormous ground acceleration, with devastating results: 30 lives were lost, and residential insured losses exceeded $12 billion, making it one of the costliest natural disasters in our nation's history.

As insurers assessed their huge Northridge losses, their representatives lobbied hard to repeal the mandatory-offer law — put another way, insurers strongly wanted to stay in the homeowners-insurance market, which was profitable and well understood, but most insurers thought that earthquake-insurance risk was too high, threatening profits and (in extreme cases) company survival.

California policymakers were highly concerned that mandatory-offer repeal could spell the end of earthquake insurance, so the mandatory-offer law was retained to preserve availability of quake coverage. Frustrated in their efforts to control their earthquake exposure, insurers responded by severely restricting, or simply refusing to offer, sales of homeowners insurance in the state, and with those efforts eventually reaching some 94% of the market, their actions threatened to deprive Californians of homeowners insurance altogether.

To respond to this residential-insurance market crisis, the Legislature in 1995 began considering the CEA framework but imposed three tough conditions on the CEA's becoming operational:

- Insurers representing 70% of the homeowners insurance must commit to CEA participation — that participation level would bring the CEA at least $700 Million in start-up capital;
- The IRS must declare the CEA exempt from federal income tax; and
- The CEA was obligated to obtain in reinsurance protection twice the level of initial insurer contributions — this $1.4 Billion (or more) in initial reinsurance was to require an unprecedented reinsurance buy for a single entity writing a single risk.

All of the benchmarks were met, and the CEA opened its doors and accepted its first risks on December 1, 1996. From that day forward the CEA has served a statewide, voluntary residential-earthquake market that private insurers had largely abandoned.

2. The CEA Today

Today, the CEA is the largest monoline writer of earthquake insurance in the United States. With 800,000 policies in force, $600 Million in annual premium revenue, and almost $10 Billion in claim-paying capacity, the CEA now writes 70% of all residential earthquake policies sold in California.

The CEA is organized as a **unique, public-private entity**:

- It has public management.
    - Its Governing Board is composed of the Governor, Insurance Commissioner and State Treasurer (as voting members) and the two leaders of the State Legislature (as non-voting members).
- It is privately financed.
    - Because it is not an agency or department of government, it uses no tax money.
    - It is wholly outside California's state budget.
    - When it incurs debt, it does so without California's "full faith and credit."
    - Its primary revenue is its investment income and its premium receipts.
    - Private-insurer contributions formed the CEA's seed capital, and all participating insurers retain a further responsibility to pay assessments in the event of large earthquakes.

The CEA Governing Board and staff manage the CEA's business activities, but the insurance companies that are the CEA's participating insurers play a central role in the conduct of the CEA's insurance business.

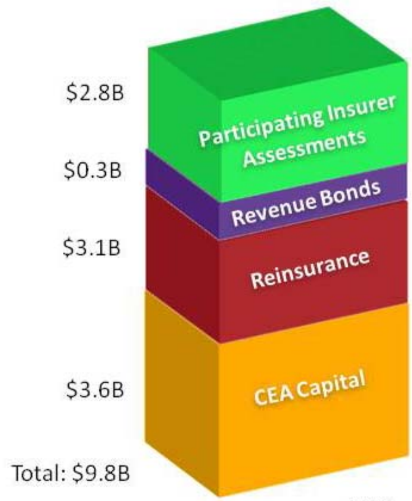
- The first step of the CEA's business process is the (still mandated by law) offer of earthquake insurance that CEA participating insurers retain – California's homeowners insurers still must make the offer, but those that under the CEA Act[2] have committed funds to and participate in the CEA are authorized to offer a CEA policy.
- If an earthquake-insurance offer is accepted, the CEA participating insurer (using its own agents and sales channel) bills and accepts the premium and remits it to the CEA, less a service charge.
- While the policy is in effect, the participating insurer has a continuing responsibility to service the policy, handling policy changes, re-rating, and the like. There is no separate charge to the CEA for handling these matters.
- After an earthquake that CEA determines is likely to produce claims, the CEA advertises widely in affected areas to direct CEA policyholders to report their earthquake-insurance claims directly to their participating homeowners insurer.
    - Recognizing the CEA's expertise in all matters pertaining to earthquake insurance, California law requires all adjusters of earthquake-insurance claims to be trained and accredited under CEA claim-adjusting standards. This requirement applies to both CEA participating insurers and non-CEA insurers.

[2] The CEA Act can be found at sections 10089.5 through 10089.54 of the California Insurance Code.

- CEA participating insurers have primary responsibility to handle CEA claims through their own adjusters, whether employed or under contract.
- The insurers generally pay the claims that are determined eligible, with the CEA providing reimbursement and a claim-handling fee.

The CEA today has $9.8 Billion in claim-paying capacity. The components of this capacity, and the order in which these funds would be accessed to pay claims following an event, are as follows:

1. CEA capital: $3.6 Billion
2. Reinsurance: $3.1 billion
3. Revenue bonds: $0.3 Billion
4. Participating insurer assessments: $2.8 Billion



Claim-Paying Capacity:
1-in-545 Years

3. The problem: The high cost of earthquake insurance puts the coverage out of reach for most California homeowners

California is home to about two-thirds of our nation's earthquake risk. About 2000 known faults criss-cross the state, and although California's strong land-use rules strictly determine conditions for building or living very near a fault[3] or where soil liquefies or is subject to landslides[4], the sheer number of faults means that a majority of Californians live within 20 miles of at least one of them.

With so much earthquake risk within the state, and with a majority of California's large population living near faults, the subject of how to prepare for and recover from the next big earthquake is critical to California policymakers. There is broad consensus in the scientific community that a 6.7 earthquake somewhere in California within the next 30 years is a virtual certainty – this, of course, means that questions of how best to prepare and protect lives and homes against earthquakes is front and center, framed with urgency.

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[3] For an excellent official account of the landmark Alquist-Priolo Earthquake Fault Zoning Act, please see: http://www.consrv.ca.gov/CGS/RGHM/AP/Pages/Index.aspx.

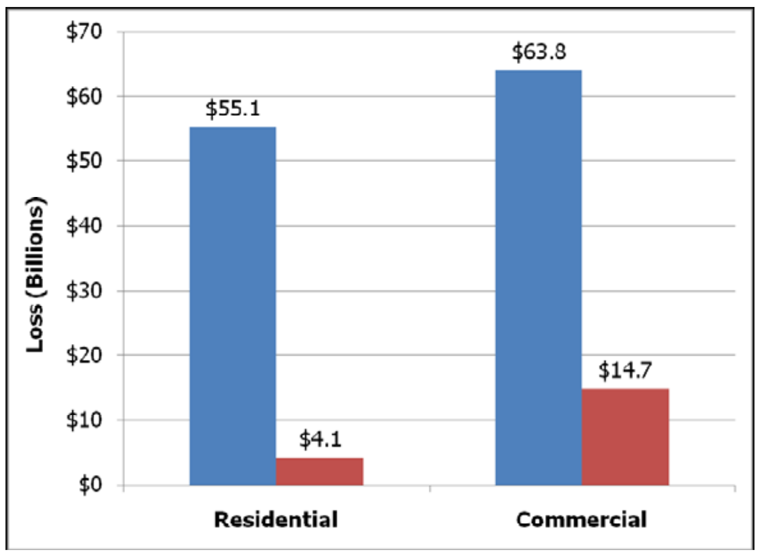
[4] A further, important refinement to the Alquist-Priolo Act was the Seismic Hazards Mapping Act, which addresses seismic hazards not related to surface faults, such as liquefaction and landslides. Please see: http://www.consrv.ca.gov/cgs/shzp/Pages/shmpact.aspx.

As occurs everywhere in the United States, most California homes have mortgages and therefore are covered by fire insurance—that is a mortgage-related requirement. But no homeowners policies cover damage from earthquakes, even though most people believe that a cornerstone of earthquake preparedness *should* be earthquake insurance for homes.

In fact, only 12% of California homes (just one-in-eight) with a fire policy are covered for earthquake shake damage (this 12% number is called a penetration rate or a take-up rate). To flip that coin and focus that statistic on the real public-policy problem, 88% of homes covered for fire (fully seven out of eight) are *un*insured with respect to earthquake risk.

The consequences of such a large uninsured population could be devastating following a large, damaging quake.

For example, if a 7.2 magnitude earthquake occurred on the Peninsula segment of the San Andreas fault (which runs along the peninsula, up and through San Francisco), it is estimated that residential losses would be approximately $55.1 billion. ***At current take-up rates, only $4.1 Billion of these losses would be covered by insurance, while $51 Billion would be uninsured.***



Total economic damage (blue) and insured loss (red) to the residential and commercial lines of business as a result of a M7.2 earthquake on the Peninsula segment of the San Andreas Fault in 2009. Source: Risk Management Solutions, Inc., *Catastrophe Modeling and California Earthquake Risk: A 20-Year Perspective* – copyright 2009 – used with permission.

Barriers to Purchase of Earthquake Insurance. There are two primary barriers that prevent more California householders from buying earthquake coverage:

1. The policy is considered too expensive.
2. The policy requires a deductible that is considered too high and too restrictive.

There is no doubt earthquake insurance can be expensive – especially in high-risk areas – often exceeding the price of the homeowners/fire insurance. And a 15% deductible does mean that a dwelling must sustain considerable damage before a claim can be paid.

In high-risk regions where earthquake insurance is expensive, the higher predicted loss in such areas is an obvious, but only partial, explanation for the pricey coverage. The other, and often predominating, reason is that an insurer's expenses is the other determinant of rates—high expenses drive higher insurance rates. In the case of the CEA, its overhead and operating expense is well *below* industry averages, but its reinsurance costs are simply *massive*.

To explain further:

An insurance company establishes its rates by applying some variation of the following formula and then distributing its rate needs over its exposures, using a rating plan:

projected loss + expenses + profit = insurance company rate

Because the CEA is a nonprofit entity, it collects no profit – for CEA, therefore, the formula is more like this:

projected loss + expenses = CEA rate

It bears emphasizing that CEA rates are required – by law – to be actuarially sound: not excessive, not inadequate, and not unfairly discriminatory.

- The CEA determines its projected losses through sophisticated earthquake-loss modeling and dynamic-financial analyses. In fact, the CEA is recognized in the seismic-science and earthquake-engineering communities as among the most sophisticated, responsible users of modeled-loss outputs.
- In addition, California's property-insurance rates are regulated by a highly professional Department of Insurance, which takes a strong interest in ensuring that rates are set correctly and appropriately distributed over CEA risks.

The bottom line is that CEA earthquake-insurance rates are accurately set and appropriately regulated so that they are appropriate for the risks insured, given the expected losses and the CEA's expense load.

The expense part of the rate formula is the only rate variable over which the CEA has significant control. Fully two-thirds of the CEA's expenses consist of what it spends each year, every year for the reinsurance we place in our claim-paying capacity. Any effort to make the CEA's capital deployment more efficient by reducing its expenses, thus attracting more policyholders, must begin with a careful examination of its reinsurance program.

CEA's heavy dependence on reinsurance. Since the CEA opened its doors in 1996, it has depended heavily on reinsurance coverage for a significant portion of its claim-paying capacity — that heavy reliance is still true today and the purchases are larger, even as CEA capital has grown: nearly one-third of CEA's claim-paying capacity (which today totals $9.8 billion) is provided through reinsurance.

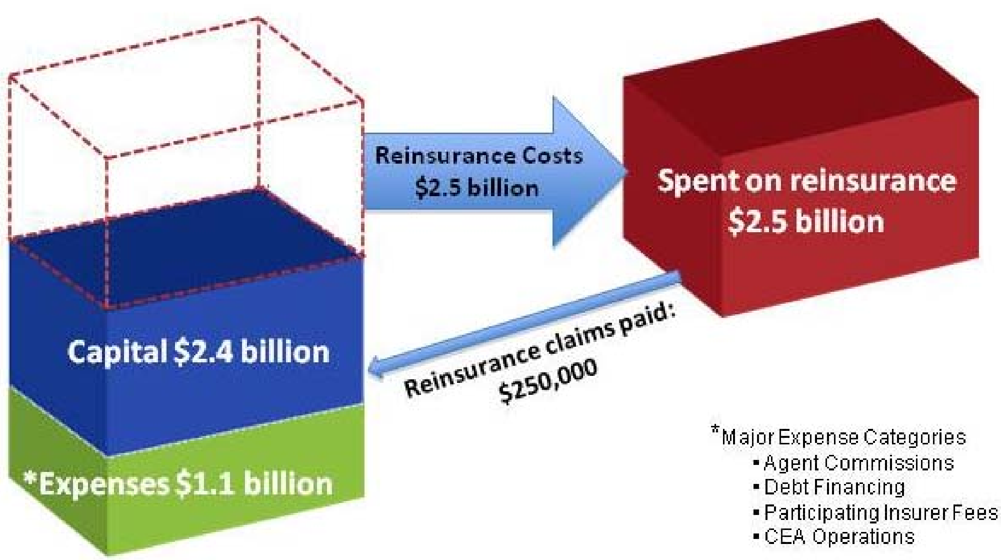
High cost of reinsurance. While reinsurance allows critical risk transfer for the CEA, there have not been suitable alternatives to it, and so the reinsurance protection has come at a huge cost. Over the years, CEA has collected a total of $6 Billion in premium from its policyholders. Of that amount, $2.5 billion – *40% of the CEA's premium revenue over 13-plus years* – has been paid by CEA to the global reinsurance market as reinsurance premium. And of the $2.5 billion paid in reinsurance premium, the reinsurers have paid to the CEA $250,000 in reinsurance claims paid.

The CEA is clear on the benefits of good reinsurance in a financial structure and has obtained important capacity from reinsurance over almost 14 years. The CEA's highly conservative capacity levels have allowed CEA to write very safe and secure insurance policies for its policyholders, but only for those who can afford it and choose to purchase it.

In the absence of a more efficient financing model, however, the CEA has had no alternative but to commit 40% of its policyholder premium to pay in advance, in full and for each and every such year, for the capacity to withstand events of extremely unlikely probability.

For example, in 2010 the CEA's capacity calculations indicate that only once in every 545 years would earthquake events cause CEA to be unable to pay 100% of all its claims. Reinsurance protection in this financing capacity would not even begin to kick in until the CEA had exhausted nearly all of its capital and revenue bond proceeds, a total of almost $4 Billion — for some perspective, $4 Billion is substantially more than the CEA would expect to pay in a repeat of the 1994 Northridge earthquake, and the CEA's total capacity today of $9.8 Billion exceeds what the CEA would expect to pay in a Northridge repeat and a repeat of the 1906 San Francisco earthquake, combined.

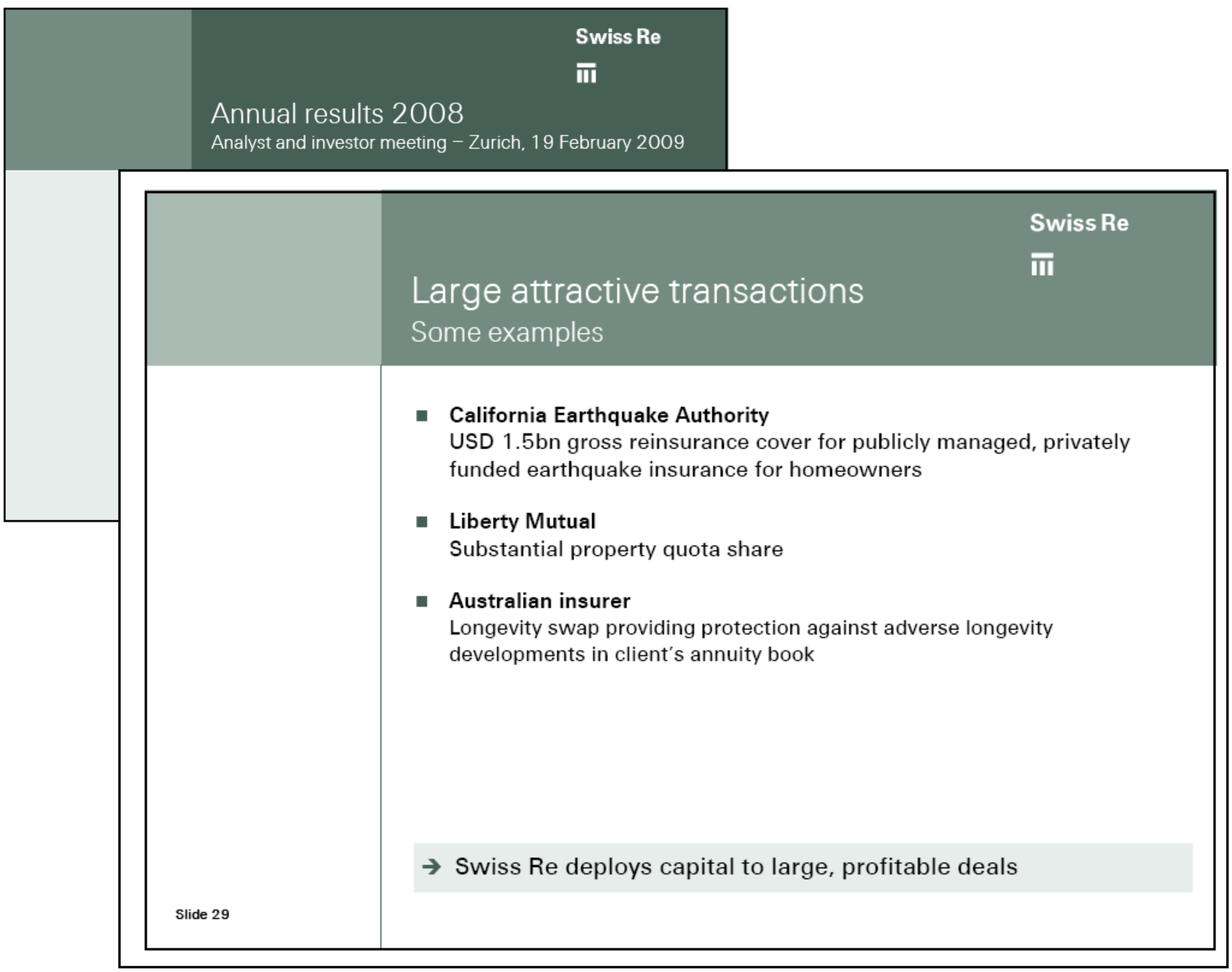
1997-2009: Total policyholder premiums $6 billion



If such mega-catastrophes do not occur in 2010, CEA's reinsurers will once again have no losses to pay, whether from capital or from CEA premium received, which might lend them the ability and the desire to negotiate a similar (and similarly beneficial) contract with CEA next year. We won't actually know, however, until we are in the reinsurance market later this year.

In short, CEA customers, each and every year, are asked to pay a premium sufficient to ensure CEA has full, reinsurance-based claim-paying capacity for a huge, almost unprecedented earthquake in California. And when each year rolls by and no such mega-catastrophe occurs, the CEA's reinsurers realize generous profits for the risk they assumed for a year, and then the cycle repeats.

The slides below are from a December 2008 Swiss Reinsurance Company (Swiss Re) presentation to analysts and investors and seem to demonstrate how one reinsurer, at least, regards the CEA business as large, attractive, and profitable. The CEA is listed as the number-one example under the heading "Large Attractive Transactions." The summary take-away of this slide is "Swiss Re deploys capital to large, profitable deals."



So again, for the past 14 years the CEA has obtained important catastrophe cover from the reinsurance industry. And while this cover has served its purpose, its placement has been highly profitable for reinsurers but has come at an extremely high cost to CEA policyholders.

A final note about the high reinsurance costs that pose such a challenge to the CEA: Despite the huge disparity between the premium paid by CEA for reinsurance and reinsurance claims that have been paid, last fall, in establishing the reinsurance contracts for 2010, the CEA was forced to pay a 15% overall rate ***increase*** for its reinsurance package, despite a claim-free 2008 and 2009.

4. The Solution: COGA – the Catastrophe Obligation Guarantee Act

Title II of H.R.2555 would create a committed, but strictly limited, federal guarantee for post-event borrowing for certain qualified state programs, as determined by the US Treasury Secretary.

Many states face catastrophic natural-disaster risk so large that private markets won't or simply can't insure it. And, of course, the cost of natural-disaster insurance is so high that many consumers can't afford it.

To bridge these availability and affordability gaps, a number of states have created public insurance or reinsurance programs to help property owners insure their homes against natural disasters. These programs need substantial post-catastrophe capital to pay their claims, but for public entities, the only available form of external capital is debt capital. In severely disrupted credit markets, however, even the most creditworthy public entities face challenges when seeking to raise the debt capital necessary to fully fund their program needs.

Established programs in California, Texas, Florida, and Louisiana came together in 2009 to formulate a common-sense and innovative proposal designed to address their common needs for reliable, adequate private-debt financing.

- This concept was originally embodied in a standalone bill in the U.S. Senate, S.886 (COGA, or the Catastrophe Obligation Guarantee Act), now co-sponsored by Senator Bill Nelson (Florida), Senators Dianne Feinstein and Barbara Boxer (California), and Senator Mary Landrieu (Louisiana).
- A similar concept has been introduced as a standalone bill in the U.S. House of representatives (H.R.4014 – Congresswoman Loretta Sanchez, with a number of co-sponsors).
- And we are grateful to Congressman Klein for his inclusion of the COGA concept as Title II of H.R.2555.

Focusing on the COGA provisions in Title II of H.R.2555, the bill would authorize (<u>only</u> for qualifying state catastrophe-insurance programs) a federal guarantee of private-market debt incurred to pay insured losses from natural catastrophes. Each of the programs that today qualify for the Title II guarantee provisions has actuarially sound rates, and each has both experience in, and high ratings for, debt issuance.

Upon application by a qualifying state program, the Treasury Department would provide a three-year rolling commitment to guarantee private-market debt, re-affirmed each year, but in amounts limited by law: $5 Billion in guarantees would be available for public earthquake programs and $20 Billion available for public wind programs.

A three-year COGA guarantee commitment would give each State program the vital certainty it needs when planning its claim-paying capacity.

Unlike reinsurance, which requires advance payment of premium for all coverage that might be needed, the COGA guarantee would be issued only *after* an event, when the state program would go into the private debt markets, and it would be issued only for such borrowing as is needed for event-related claim payment. On that basis, it would be available to ensure that programs relying on authorized debt have the market access they need in difficult times, such as might occur after a large event or during demanding economic times.

A federal guarantee, as helpful as it may be, should only be available through programs such as COGA that are sensitive to a central factor: no guarantor — private or government – wishes to provide a guarantee that is certain to be exercised. Good business sense demands that guarantees be issued only to responsible borrowers, lest the guarantor become a "co-signer."

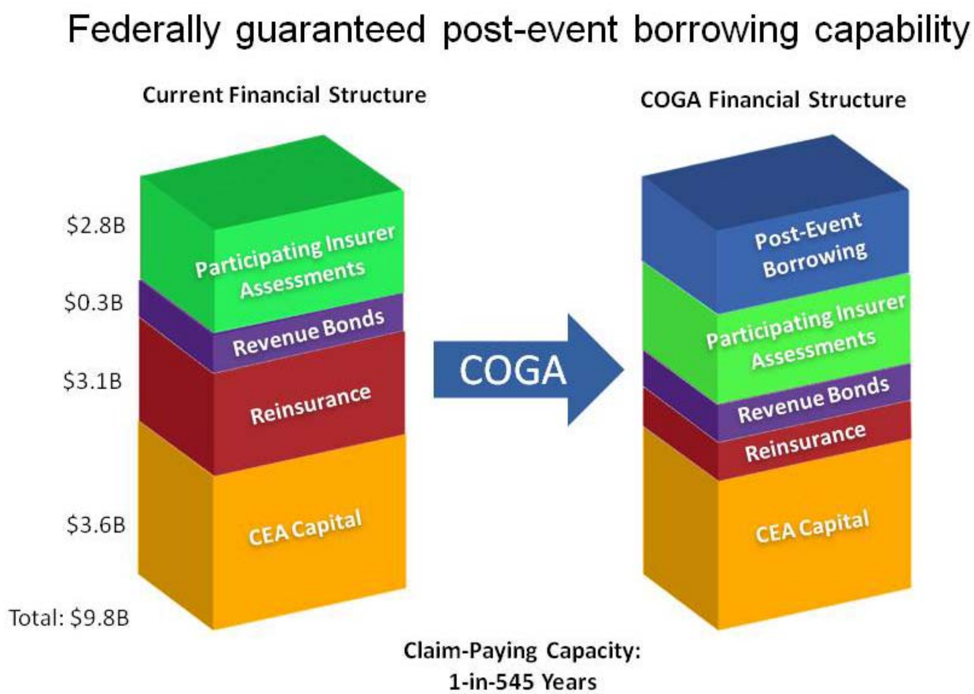
That is why under COGA and Title II of H.R.2555, only state catastrophe programs that meet stringent criteria qualify to receive committed guarantees:

- The program must fulfill a public purpose and be a public organization, governed by a board composed of or appointed by public officials.
- The public program must be exempt from paying federal income tax.
- The program must have a proven ability to repay debt.
- Rates and rating structures for the program must be actuarially sound.
- States with qualifying programs should have strong building codes, support good land-use principles and goals, and have effective loss-mitigation measures in place.

This combination of factors is calculated to ensure that COGA-program benefits support good public policy, and that COGA borrowers are responsible, managed with transparency, and are safe and suitable candidates for a guarantee of debt by the U.S. Treasury.

The CEA would use the new COGA tool to reduce reliance on expensive reinsurance, replacing part of that cover with the certain ability to borrow money in the private capital markets, incurring that debt only after an event, and repaying the debt as required.

This would be a paradigm shift, a true game-changer for the CEA. The CEA could significantly reduce its rates, charge its policyholders less and lower their deductibles, while at the same time enhancing and enlarging coverage choices. All this would be accomplished in a highly responsible and transparent manner, within a proven, actuarially sound rating structure. It would be a win-win-win situation: the U.S. Treasury, the State, and the CEA's customers would all be beneficiaries of the new system.



The illustration above shows that COGA would create a new layer of CEA claim-paying capacity, allowing CEA to reduce its customary reliance on prepaid, expensive reinsurance, and providing the certainty of being able to borrow after a catastrophic event. The CEA would continue to obtain a layer of reinsurance protection, but it would no longer be forced to spend 40% of its policyholder-premium revenue on this expensive form of risk transfer.

CEA modeling indicates that once the new COGA tool becomes available to the CEA and the financial structure is modified, the CEA's odds of borrowing under COGA would be extremely remote – between 0.5% and 1%. Put in practical, scenario terms, the CEA could pay all policyholder claims from **any** of the following events ***without*** any borrowing using COGA:

- Repeat of San Francisco 1906 earthquake (M 7.8).
    - Projected CEA losses: $5 – 6 billion.
- Repeat of 1989 "World Series Earthquake" (M 6.9).
    - Projected CEA losses: $0.5 billion.
- Repeat of Northridge earthquake (M 6.7).
    - Projected CEA losses: $3.2 billion.
- 2008's Great California Shakeout Scenario (M 7.8).
    - Projected CEA losses: $7 billion.
- Hayward Fault Scenario (M 7.2).
    - Projected CEA losses: $3.9 billion.

Big cost savings for consumers: Since fully two-thirds of all CEA's expenses are in the cost of its reinsurance program, COGA cost-savings will be passed directly on to policyholders as reduced premium. We estimate that we would be able to implement an across-the-board premium-rate decrease of about 35%.

More choices for consumers – lower deductible and greater value
In addition to making earthquake insurance more affordable, COGA would enable the CEA to offer greater choices of coverage – and greater value – as well.

- Most CEA policies are sold with a 15% deductible. This means that the insured dwelling must be damaged in an amount equal to 15% of the CEA structure limit before CEA can pay a claim. And a CEA policyholder with contents coverage receives no contents-damage payout until the dwelling deductible is met.
- COGA would enable the CEA to slash the dwelling deductible in half – cutting the typical 15% deductible to just 7.5%. This would create CEA coverage that is much more likely to result in claims paid. And the CEA could create a new *contents-specific* deductible and for the first time pay contents losses if just the insured contents suffer a 15% loss.

More insured California homes helps homeowners, which can mean less financial pressure on the Federal government following a mega catastrophe:

The CEA strongly believes that by offering a more affordable, more valuable earthquake-insurance policy, many more Californians could and would decide to insure their homes for earthquake loss. After all, we know that in California's voluntary residential-earthquake-insurance market, price and deductible level are the declared barriers to purchase – and COGA goes straight to the heart of lowering those barriers.

Indeed, our goal would be to double the take-up rate of earthquake insurance in California within five years of COGA's enactment.

Scientists and citizens alike know that it is clearly a matter of when, not if, the next damaging earthquake will strike in California. By your taking favorable action on H.R.2555 today, and in the process providing qualifying state programs with COGA benefits, you can help ensure that this nation is better supported – and better protected – when that big earthquake occurs.

Conclusion.

The CEA is grateful for the opportunity to be here today, to be a part of informing the Committee's and Subcommittees' process on these critical preparedness and recovery challenges for the States. We thank you for your great interest in this subject, which to those of us on the front lines is so important.

If there is any matter on which you would like follow-up or more information, please let us know – I'm more than happy to offer you, and the Committee and Subcommittee staff members, the expertise and technical assistance of the CEA staff.