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CALIFORNIA UPDATE

LEGISLATIVE ANALYST'S OFFICE

California's New Earthquake Program

Earthquake insurance is now available to California homeowners and renters under a new system that was established through legislation enacted in 1995 and 1996. This legislation created the California Earthquake Authority (CEA) and provided a means for the CEA to pool various sources of finances to underwrite earthquake insurance sold by insurance companies that agree to participate in the new system. The underwriting fund consists of:

- ❖ An initial cash amount of up to $1 billion, supplemented by premium revenues (working capital).
- ❖ Access to additional contingent funds of up to $9.5 billion—consisting of additional assessments on participating insurers, assessments on policyholder premiums, and reinsurance provisions.

This *California Update* describes this new system and how it will operate.

What Is the CEA?

The CEA is a state entity, consisting of a Governing Board and an Advisory Panel. Current law authorizes the CEA to hire up to 30 employees to manage its day-to-day operations: 25 civil service employees and five positions exempt from civil service. Additionally, the CEA may contract for services related to its operations.

Current law limits the operating expenses of the CEA to no more than 3 percent of the insurance premiums received by the CEA. At this time, the CEA expects premiums to total about $1.2 billion annually. On this basis, the CEA's operating budget could be up to $36 million annually. The CEA operating budget is not subject to state approval. The CEA, however, must submit an annual report to the Legislature and is subject to an annual audit by independent auditors approved by the state Department of Finance.

The CEA will be responsible for collecting the required initial cash contribution and insurance premium revenues from participating insurers, establishing rates, obtaining contingency funding, and the ongoing operations of the authority. The CEA is responsible for all claims payments under this program in the event of an earthquake. Its liability, however, is limited to the amount of funding available. In the event of a funding shortage, claims payments would be prorated. In no event does the state General Fund bear any liability for payments.

What Coverage Is Available Under the CEA?

Insurers participating in the CEA are required to offer the same minimum earthquake insurance coverage that all insurers in California must offer. This minimum coverage is commonly referred to as a "mini-policy." It typically requires 100 percent coverage for the residential dwelling at the same value as the basic homeowners' policy, with a 15 percent deductible. Thus, a homeowner would be responsible for the first $15,000 of earthquake damage on a home valued at $100,000. "Outbuilding" structures—such as patios, swimming pools, or detached garages—are specifically excluded from the required coverage.

How Can You Buy CEA Financed Insurance Under the CEA Program?

Any homeowner, condominium owner, or renter can purchase earthquake insurance under the CEA program from an insurer who participates in the program. However, as was the case prior to the CEA program, earthquake insurance must be purchased from the same insurer that provides the owner (or renter) their other residential property insurance (commonly referred to as homeowners' insurance).

Individuals who already have earthquake insurance and whose insurance companies participate in the CEA program will have their earthquake coverage continued under the CEA program when it comes up for renewal. These insurance companies are required to send notices informing a policyholder that their earthquake insurance policy will be transferred to the CEA. Thus, the way an individual buys and receives earthquake insurance will not change under the CEA program. The only time an individual will deal with the CEA directly is if there is a dispute over claims.

How Are the Insurance Rates Set?

The CEA is responsible for establishing rates for earthquake insurance issued under the new system. Interim rates have been set by the CEA. The CEA may modify these rates, however, depending on the CEA's review of a recent geological study that identifies probable earthquake magnitudes through the state.

Figure 1 compares the interim rate for a 15 percent deductible policy on a typical home located within various counties to the rates for the same coverage offered by three insurers before they joined the CEA. (Prior rates for the other 15 insurers participating in the CEA were not available from the Department of Insurance at the time this report was written. When the prior rates are available for these other insurers, it may be more clear what effect the CEA will have on earthquake insurance rates in California.) Based on this limited comparison, the CEA rates for this category of structure are generally lower than prior rates.

Figure 1

Comparison of Earthquake Insurance Rates[a]

	County				
	Western Fresno	Southwest Los Angeles	Western San Diego	San Francisco	Sacramento
Insurer's Rates (Prior to CEA)					
Farmer's	$1.74	$2.26	$4.88	$4.88	$1.74
AAA So. California	1.60	1.96	5.70	—	—
FAIR Plan	1.19	3.45	3.47	6.28	1.19
Rates through CEA	$1.00	$2.70	$2.70	$4.50	$1.00

[a] Rate comparison, per thousand dollars of coverage, single family dwelling, wood frame, 15 percent deductible.

All insurers who participate in the CEA program will sell policies according to CEA rates. The rates include specific amounts (based on a percentage of each premium) that will be retained by the insurer to cover operating costs, compensation for agents selling CEA policies, and expenses associated with claims after an earthquake. All premium payments less the amount retained by the insurer will be transferred to the CEA.

What Is Required of Insurers in Order to Begin the CEA Program?

Insurers representing 70 percent of the California homeowners' earthquake insurance market must agree to participate in the CEA program in order for it to begin operations. Furthermore, to participate an insurer must pay to the CEA an initial cash contribution. Insurers with more than 1.25 percent of the California homeowners' earthquake insurance market or with more than $1 billion in surplus, may join the CEA by paying a capital contribution of its percentage share of the market multiplied by $1 billion. If an insurer has less than 1.25 percent of the market or has less than $1 billion in surplus, the payment may be made over five years in 60 equal installments.

To date, insurers representing approximately 72 percent of the market have agreed to participate. Figure 2 (see next page) provides a list of these insurers and their contributions.

How Will the CEA Cover Liabilities?

The CEA will cover liabilities from earthquake insurance claims through the initial cash contributions and annual premiums (working capital), and from various sources for contingency funding. This contingency funding is needed especially in the near term when reserves are inadequate to cover against the losses from a serious earthquake or a series of earthquakes

Figure 2

California Earthquake Authority
Status Report of Insurer Participation (As of January 1997)

(Dollars in Millions)

Carrier	Earthquake Insurance Marketshare[a]	Cash Contribution
State Farm Fire & Casualty	24.030%	$240.0
Allstate Insurance Company	16.650	166.5
Farmer's Group	14.280	143.0
CSAA	4.560	45.6
State Farm General	2.780	27.8
USAA	2.710	27.0
Automobile Club of Southern California	1.400	14.0
Prudential	1.200	12.0
California FAIR Plan	1.080	10.8
USAA Casualty	0.810	18.1
Liberty Mutual	0.700	7.0
C.N.A.	0.500	5.0
Continental	0.400	4.0
Mercury Insurance	0.210	2.1
Allstate Indemnity	0.190	1.9
Armed Forces Insurance Exchange	0.160	1.6
Preferred Risk	0.020	0.2
MidWest Mutual	0.001	0.0
Totals	**71.681%**	**$716.8**

[a]Percentage of market.

The CEA can initially access a total of about $10.2 billion. The different sources of financing must be accessed in a sequential order for paying out earthquake claims. For example, working capital must be used first to pay earthquake claims, followed by the first layer of contingency financing, and so on. The amount used from each layer is dependent on the level of insurance claims and the requirement that the CEA maintain a minimum working capital of $350 million.

Working Capital. The first source of funds to pay claims is working capital—the $717 million cash contribution from the participating insurers plus accumulated premiums. Working capital must be maintained at no less than $350 million. That is, claims that would otherwise reduce working capital below this level have to instead be paid from the layers of contingency funding. (The federal tax status of the CEA is an important aspect of this layer of the CEA's capitalization. The Internal Revenue Service ruled that the CEA will be exempt from federal taxes. This is important because it allows the CEA to accumulate reserves more quickly than a private insurance company.)

There are five layers of contingency funding, including assessments on insurers and policyholders and forms of reinsurance. The assessments are one-time funding mechanisms—once the maximum funding for each layer is depleted, it cannot be accessed again. Figure 3 shows the sequence of the layers and the amount of funds that can be accessed under each layer if insurance claims reduce the CEA working capital to less than $350 million.

Layer 1: Assessment on Participating Insurers, $3 Billion. This layer of financing is an assessment of up to $3 billion on participating insurers. Insurers would be assessed based on their market share of earthquake insurance under the CEA program (similar to their initial contributions). After the CEA has been in operation for 12 years, this layer of financing is eliminated.

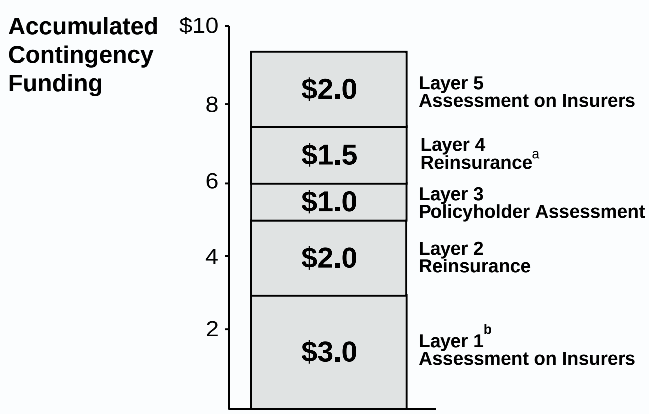
Layer 2: Reinsurance, $2 Billion. The CEA must obtain reinsurance contracts in an amount of at least 200 percent of the total initial cash contributions from participating insurers. To meet this requirement, the CEA has obtained a two-year contract for $2 billion in reinsurance. The cost of this contract is $148 million annually.

Layer 3: Assessment on Policyholders, $1 Billion. To obtain this financing, the State Treasurer is authorized to secure a "credit facility" and/or issue up to $1 billion in revenue

Figure 3

California Earthquake Authority
Layers of Contingency Financing to Meet Liabilities

(In Billions)



[a] Provided through Berkshire Hathaway.

[b] These contingency layers of financing are accessed in order (beginning with layer 1) whenever working capital falls to a level of $350 million.

bonds. The State Treasurer has opted to secure a line of credit which should be in place in January 1997. The CEA is authorized to levy an assessment on all policyholders to pay off the cost of obtaining this layer of financing. This assessment cannot exceed 20 percent of the annual earthquake insurance premium.

Layer 4: Reinsurance. The CEA may access any other private market for funding in this layer. Current law does not set a limit for the amount of funds raised from this source. The CEA governing board, however, has approved a reinsurance contract with Berkshire Hathaway Inc. to provide up to $1.5 billion under this layer of claims financing. This contract costs about $161 million annually for four years.

Layer 5: Assessment on Participating Insurers: $2 Billion. This layer is essentially the same as the second layer, except that while the first assessment is eliminated after 12 years, this assessment is gradually reduced once the CEA's available capital exceeds $6 billion. The amount of the reduction is limited to a maximum of 15 percent per year.

Accessing the Capital Layers for CEA Financing. The different capital sources would be accessed depending on the amount of claims resulting from an earthquake. For example, suppose the CEA had been in operation for one year and had $2 billion in working capital from the initial cash contribution and accumulated insurance premiums. If there were an earthquake that resulted in $4 billion in claims, the CEA would pay the claims as follows:

- ❖ $1.65 billion from the working capital (reduced to $350 million).
- ❖ $2.35 billion from the $3 billion industry contingent assessment layer (layer 1).

Conclusion

The CEA was established to deal with the unique insurance risks inherent in earthquakes. By pooling resources from a variety of sources, the CEA is intended to provide insurance at the lowest possible cost to California homeowners and renters. There are still important questions—especially in the short-term—that will only be answered in time. For example, will there be sufficient funds to cover liabilities in the event of a series of earthquakes or a major earthquake in the near term? How will homeowners respond to the policies offered through the CEA, given the premium cost, the 15 percent deductible, and the potential premium surcharges and prorated claim payments? The Legislature will want to monitor these areas as well as the overall administration of the program so that any changes that may be needed to help assure success of the program can be made in a timely manner.

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Economic and Revenue Developments

The *1997-98 Governor's Budget,* released on January 9, contains an updated economic forecast, along with new revenue projections for 1996-97 and 1997-98.

The Economy

The budget's economic forecast reflects the continuing positive economic performance that has been occurring in California, including healthy year-over-year gains in employment and income. In general, the forecast assumes continued, although moderating, broad-based economic growth through 1997 and 1998. For example, California personal income is forecast to increase by 6.6 percent in 1997 and 5.9 percent in 1998.

The budget's overall economic forecast is consistent with other economic projections made near the end of 1996, including the forecast made by our office in November (see *California's Fiscal Outlook—The LAO's Economic and Budget Projections, 1996-97 Through 1998-99*). The budget's estimate of personal income growth, however, is slightly higher than the consensus view.

Revenues

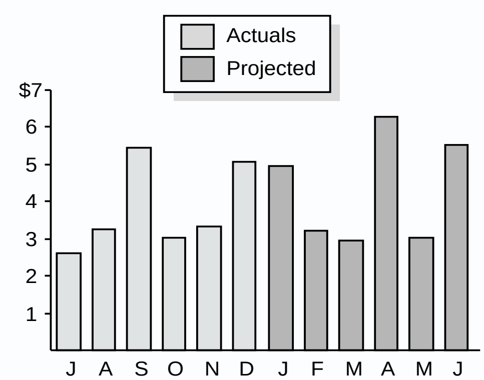
The budget assumes that revenues will increase from \$45.4 billion in 1995-96, to \$48.4 billion in 1996-97 and \$50.7 billion in 1997-98. This new estimate for 1996-97 is \$461 million *above* the *1996-97 Budget Act* estimate adopted last July. The budget's projections for 1996-97 and 1997-98 are lower than our November projections—by \$266 million and \$399 million, respectively. We will update our own economic and revenue projections for *The 1997-98 Budget: Perspectives and Issues,* which will be released by our office on February 19.

Figure 4 shows actual monthly collections of General Fund revenues for July through December of 1996-97, along with the budget's projection for the remainder of the fiscal year. December receipts reflected growth in personal income taxes and sales and use taxes consistent with the economy's continued moderate economic expansion. Bank and corporation tax receipts, however, fell below the December 1995 level, raising some questions regarding the underlying strength in California taxable corporate profits.

Figure 4

Proposed Budget's Projection of 1996-97 General Fund Revenues

Revenues by Month (In Billions)



January is expected to be a fairly large revenue month, with nearly $5 billion in collections projected. Partial-month data are thus far consistent with the projection for the month, but full-month data will not be available until early February.

We will be monitoring monthly revenue performance in future editions of *California Update.*

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An Overview of the 1997-98 Governor's Budget **(January 15, 1997). This Budget Brief describes the major proposals in the Governor's budget and the key budget-related issues and considerations facing the Legislature.**

Analysis of the 1997-98 Budget Bill **and** ***The 1997-98 Budget: Perspectives and Issues*** **(February 19, 1997). These documents will present the results of our detailed examination of the** ***1997-98 Governor's Budget.***

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