CALIFORNIA EARTHQUAKE AUTHORITY

It Has Taken Steps to Control High Reinsurance Costs, but as Yet Its Mitigation Program Has Had Limited Success

REPORT NUMBER 2000-133, FEBRUARY 2001

Audit Highlights . . .

Our review of the California Earthquake Authority's (authority) reinsurance costs and State Assistance for Earthquake Retrofitting (SAFER) program disclosed:

- ☑ ***The authority's reinsurance costs are high, but not unreasonable compared to what other companies are paying.***
- ☑ ***The authority has reduced its reinsurance costs by negotiating favorable contract terms and exercising contract options.***
- ☑ ***As of December 2000 only 31 of 3,576 homeowners whose homes needed structural retrofits had made them.***
- ☑ ***The remaining backlog of seismic inspections and assessments should be completed and mailed to homeowners by mid-May 2001.***
- ☑ ***The authority has spent $3.5 million on SAFER, which is within its statutory requirement.***

The California Earthquake Authority's (authority) reinsurance costs in 1998 represented 90 percent of its policyholder premiums, prompting the Joint Legislative Audit Committee (audit committee) to request that we determine whether the total annual expenditures for reinsurance and capital market contracts constitute a reasonable and appropriate percentage of the authority's annual collected premiums. The audit committee also asked us to examine the authority's implementation of its State Assistance for Earthquake Retrofitting (SAFER) program, an earthquake mitigation pilot program, which is currently in its second phase. We found that:

Finding #1: The authority's high rate in 1998 was due to one-time factors.

In 1998 the authority's rate (the percentage of policyholder premiums it spent for reinsurance) was 90 percent, according to its audited financial statements. This was due primarily to reinsurance costs that were not allocated evenly over the life of its original two-year contract for the first $1.4 billion of reinsurance coverage. The authority's member companies had existing earthquake policies that would be converted to authority policies over the course of its first year of operation. During that year, the authority's exposure level gradually increased until it reached its full amount when the conversion was complete. Therefore, the payment schedule was set up to reflect the fact that the authority would have considerably more risk to cover in 1998 than it had in 1997. Additionally, the contract for the remaining $1.1 billion of reinsurance coverage required the authority to pay for two years of coverage in calendar year 1998. Therefore, although the authority's 1998 rate seems alarmingly high, this rate is due primarily to a high reinsurance premium split unevenly over a two-year contract and a required up-front premium in the second contract.

Finding #2: The authority's capacity to pay claims relies heavily on costly reinsurance.

The authority maintains roughly $2.5 billion in reinsurance coverage, which makes up about one-third of its capacity to pay policyholders in the event of an earthquake. Because catastrophe reinsurance is more expensive than other types of reinsurance, and because the authority must offer earthquake insurance to all qualified homeowners throughout the State, the reinsurance it purchases is costly. The authority's reinsurance costs are higher than other insurance companies because of its unique restrictions. By law, it must offer earthquake coverage statewide, so it cannot reduce its exposure to loss by limiting coverage in geographic areas that are highly prone to earthquake damage.

Finding #3: The authority has taken steps to reduce its reinsurance costs while maintaining the required amount of reinsurance coverage.

According to its lead reinsurance intermediary, hired by the authority to negotiate its reinsurance contracts, the rate-on-line (the amount of compensation the authority currently pays to reinsurance companies to assume part of its risk) is not unreasonable compared to what other companies are paying.

Nevertheless, the authority has negotiated with its reinsurers to reimburse a portion of the premiums on the first layer of reinsurance if they sustained no losses under the contract for calendar years 1997 through 1999. This, coupled with a reinsurance premium adjustment due to the authority's exposure falling below 90 percent of $203.6 billion, resulted in a reinsurance refund of nearly $82 million for its first three calendar years. The authority is also attempting to lessen its reliance on reinsurance by following the advice of its consultant to reduce the amount of coverage it buys and by testing its ability to transfer some of its earthquake risk into the capital market.

Finding #4: The authority faces critical challenges in the future.

The primary challenge that the authority faces is in maintaining its claims-paying capacity. Its reinsurance contracts will expire in the next two years and its authority to assess its member companies up to $2.2 billion when losses exceed its capital will expire in December 2008.

To ensure that it maintains its claims-paying capacity, we recommended the authority continue to monitor the reinsurance market and research alternative financing to reduce its dependence on reinsurance.

Authority Action: Corrective action taken.

The authority had a project consulting team, consisting of five management consulting firms with expertise in insurance, financial, legal, and tax specialties, spend four months reviewing the financial structure of the authority. The purpose of the review was to determine more efficient ways of securing capital, reducing risk-transfer costs, and diversifying the claims-paying capacity of the authority. The consulting team reported its findings to the authority's governing board (board), who has asked authority staff to identify appropriate financial benchmarks for the strength and survivability of the authority based on the assessments of the consulting team. In addition, the board authorized the authority to enter into agreements to provide reinsurance coverage at a lower rate on line in its second reinsurance layer. Finally, the authority's reinsurance intermediaries continually monitor developments in the reinsurance market, and regularly report to the authority.

Finding #5: The authority has not yet captured sufficient data to assess the State Assistance for Earthquake Retrofitting (SAFER) program's effectiveness in achieving retrofits.

The authority has not yet found an effective mix of incentives to encourage homeowners to retrofit their homes, and the number of homes that have been retrofitted is low. Thus, although the authority has spent approximately $3.5 million for the SAFER program, it cannot demonstrate it has achieved its ultimate goal of reducing the State's risk of personal and business economic loss from earthquakes. As of December 8, 2000, only 31, or 0.9 percent, of 3,576 homeowners whose homes needed structural retrofit improvements had completed the needed improvements through the SAFER program. Another 54 homeowners had begun the retrofitting process, but the work was not complete. A telephone survey in January 2001 of 300 homeowners who participated in the SAFER program needs more analysis before the authority can use it to estimate how many other homeowners who received seismic assessments through the SAFER program made some or all of the necessary improvements but did not report them.

Finding #6: The authority has reduced the backlog of seismic assessments for homeowners.

Between October and December 1999, after a great deal of media attention, the SAFER program received nearly 17,000 telephone calls from interested consumers, resulting in 8,304 qualified homeowners interested in receiving a seismic assessment of their homes. To meet this unexpected demand and the resulting backlog of inspections, the authority increased the number of engineering firms that conduct the inspections and prepare assessment reports. As of early December 2000, the authority had spent about $3.5 million for its earthquake mitigation program, had completed roughly 68 percent of the home inspections, and had sent 86 percent of these homeowners their assessment reports. According to the authority, the remaining inspections and assessment reports should be complete and mailed to homeowners by mid-May 2001.

To ensure that the goal of the mitigation program is achieved, we recommended the authority establish a system for determining how many homeowners who participate in the SAFER program complete the recommended retrofit improvements. The authority should also establish a target number of homes to be made seismically secure so it can demonstrate that the goal of the program has been achieved. Until these elements are in place, the authority should delay expanding the program.

➲ ***Authority Action: Pending.***

The authority established a mitigation review committee (committee), which reviewed the current practices of the SAFER program and developed a series of recommendations. Although the authority has not expanded its earthquake mitigation program, only one of the committee's recommendations is related to determining how many homeowners who participated in the SAFER program complete the recommended retrofits. Moreover, none of the recommendations addressed establishing a target number of homes to be made seismically secure by which the authority can demonstrate that the goal of the program has been achieved.

To further encourage homeowners to protect their homes from the peril of earthquakes, we recommended the authority continue to research why more homeowners who received assessment reports have not followed through with retrofitting their homes. Once the authority identifies the reasons, it should make appropriate changes before expanding the program.

Authority Action: Partial corrective action taken.

The authority states that its committee reviewed why more homeowners who received seismic assessment reports did not follow through with retrofit improvements. Although a significant number of respondents indicated a desire to retrofit their homes, a number of homeowners cited financial reasons or other personal circumstances as reasons why they had not followed through with the recommended improvements. Continued education and financial incentives appear to be integral components of follow through with homeowners.

As a result of its review, the committee made a number of recommendations related to the focus of the program, financial incentives, and marketing and education efforts. In addition, the committee provided two long-term recommendations for the authority to partner with employers and local governments to develop additional methods to encourage additional retrofits.

We also recommended that the authority continue to use the information in the SAFER database to develop a strategy to increase the number of retrofits performed as a result of the SAFER program.

Authority Action: Partial corrective action taken.

The authority states that its committee has done some analysis of how the information in the SAFER database can be used to develop a strategy to increase the number of retrofits performed as a result of the program. As the board approved in August 2001, the authority will offer financial incentives to homeowners whose assessment reports identified only water heater strapping problems. The authority will also offer financial incentives to homeowners who bolt their home's foundations or add plywood to its cripple wall (the short wall between the cement foundation and the bottom floor of the house). In addition, the authority will pay part of the standard engineering plans, offer rebates toward construction, and offer free final inspections of completed retrofit improvements.

Finally, we recommended that the authority pursue clarification of its enabling statute to determine whether its limit of 25 staff includes those who work solely on the earthquake mitigation program or whether the program's staff are in addition to the 25 staff the authority is allowed.

Authority Action: Partial corrective action taken.

The authority states that its project consulting team has conducted extensive reviews of the authority and concluded that the limit of 25 staff should be eliminated. As a result, on August 23, 2001, the authority's board directed the authority to pursue legislative changes to the staffing limit.