High-Level Roundtable on the Financial Management of Earthquakes

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CALIFORNIA EARTHQUAKE AUTHORITY (CEA)

Glenn Pomeroy
California Earthquake Authority (US)
The CEA today

• Publicly managed, privately financed residential earthquake insurer

• More than 800,000 policies in force
  → Largest earthquake-insurance provider in U.S.
  → Covers 70% of insured risk in California

• $10 billion in claims paying capacity

• One of largest purchaser of reinsurance in world
  → $3 billion cover annually
Publicly managed

CEA Governing Board

- Senate Rules Chair
- Insurance Commissioner
- Governor
- State Treasurer
- Assembly Speaker

- Voting member
- Non-voting member

Privately financed
CEA’s claim-paying capacity

2011 Financial Structure
Total: $9.5 Billion

CEA Claim-Paying Capacity:
a conservative 1-in-526 years

CEA claims are paid from “the bottom up,” first using CEA capital and then accessing higher levels of risk transfer.

Problem:

Only 12% of California households with homeowners insurance also have earthquake coverage – it is strictly a voluntary purchase.
CEA is overly dependant on reinsurance

2011 CEA Financial Structure
Total: $9.5 Billion

Rating Agencies:
• Require 1-in-500 year capacity

Reinsurance:
• Costs CEA about $200 Million each year
• Comprises 2/3 of CEA’s overall expenses but just 1/3 of claim-paying capacity
• Absorbs 40% of policyholder premium

Costs borne by consumers:
• Expensive premium — especially in high-risk areas
• High deductible (15%)

Reinsurance cost = 40% of policyholder premium

• To date, CEA policyholders have paid $6.77 billion in premium.
• Almost $3 billion has been expended on reinsurance.
• CEA has received $250,000 in paid reinsurance claims.

CEA must develop additional risk transfer solutions.
The way forward for the CEA – diversification of capital sources

- Diversification of capital sources will:
  - Reduce policyholders costs
  - Increase CEA’s ability to offer different coverage options
  - Improve long-term stability of the CEA

Result:

- More households protected by earthquake insurance
- Faster and more complete economic recovery post-event

Diversification tool 1: Capital markets risk transfer

- The catastrophe bond market has matured to become an established source of risk transfer capacity for global P&C companies - 9 of 10 largest U.S. insurers have accessed cat bond market
  - Provides multi-year, collateralized cover with alternative, potentially much larger, investor base than traditional reinsurance
- Currently there is $11.5 billion of cat bonds outstanding and over $30 billion in cumulative issuance – but this market still represents less than 15% of global risk transfer annually

Source: Guy Carpenter
Diversification tool 2: S. 637

The Earthquake Insurance Affordability Act

- US Congress will consider legislation authorizing U.S. Treasury Department to create a limited federal guarantee for post-event bonds issued by eligible state programs.

- Proposal limits federal guarantee to $5 billion.

- Other states may consider creating CEA type programs.

Post-event bonds will lower costs and increase financial strength

- A limited amount of post-event bonds will replace some of the (pre-funded, annually renewed) reinsurance program.

- Probability of borrowing will be less than 2%.

- More flexible capital management strategies will strengthen CEA’s ability to repay and prepare for subsequent events.
Post-event bonds and cat bonds provide needed diversification

Current CEA Financial Structure

- "New" IAL
- "2nd IAL
- Revenue Bonds
- Reinsurance
- Capital

Potential Structure with Post-Event Bonds

- "New" IAL
- "2nd IAL
- Revenue Bonds
- Post Event Bonds
- Reinsurance
- Capital

Potential Structure with Post-Event/Cat Bonds

- "New" IAL
- "2nd IAL
- Revenue Bonds
- Post Event Bonds
- Reinsurance & Cat Bonds
- Capital

Risk management through diversified risk-transfer solutions

More arrows in the quiver

Developing access to capital markets and post event bonding capability will allow the CEA to offer more affordable, higher value coverage – and will strengthen the sustainability of the organization.

- Capital
- Reinsurance
- Catastrophe Bonds
- Debt