The California Homeowner's Insurance Crisis, Part 1: Origins

There does not seem to be a week that goes by without news of large wildfires burning up tens of thousands of acres in California. The largest of these, the Park Fire, now approaches containment after having consumed 429,600 acres and destroyed 709 residential and commercial structures. Meanwhile, we continue to read of insurers leaving California or dropping coverage of thousands of customers, notably homeowners in fire prone wildland areas like Bonny Doon. The biggest such announcement was made in March when State Farm, the state's largest insurer, announced that they would drop coverage on 29,000 homes in high fire danger regions. What had started as a trickle around 2017 has become a flood.

How is it that California got to this point? Before attempting to answer this question, it helps to have a basic understanding about insurance.

What Insurance is and How it Works

Insurance is a contract (a policy) between an insured person or entity (a policy holder) to guarantee compensation in the event of a covered loss. The policy holder pays a small sum (a premium) to the insurer relative to the value of the asset being insured. In return, over the period of the policy, the insurer takes on some or all the risk to the asset. For instance, if the asset is a house, in the case of damage to the property through wildfire, earthquake or other disaster (the risk), the insurer may cover up to the full replacement cost of the home minus an amount (a deductible) the policy holder pays. Insurance policies will typically cover numerous risks (perils) that are outlined in the policy document.

Insurers turn a profit by two different methods: (1) through underwriting (issuing policies) and (2) by investing the premiums in a variety of financial instruments. Issuing policies is profitable provided insured losses do not exceed the premiums that are taken in. Meanwhile insurers can profit from investment returns on their pool of invested premiums. The investment assets also form the monetary reserves that insurers use to cover insurance losses.

On the loss side of the equation, the insurers will incur business expenses, general overhead, advertising, etc., which are all lumped into "underwriting expenses". Then there are the incurred losses which come from paying out policy holder claims. These losses can be substantially greater than an insurer's premiums, investment income and reserves combined. In this event, the insurer risks insolvency while the insurer's customers are left without insurance coverage and the pool of insurers shrinks. A shrinking pool of insurers means that risk becomes more concentrated (higher exposure) in the remaining insurers. In turn, this leads to higher premium rates and an increasing risk of insolvency for the remaining insurers. The profitability of insurers is an essential feature of a stable insurance market.

To protect themselves from insolvency, insurers obtain their own insurance policies to cover large catastrophic events. This is known as "reinsurance" and allows the insurers to transfer a portion of their risk onto another company. The cost of this reinsurance may or may not be passed on by insurers to their policy holders. When large scale catastrophes occur, such as the California wildfires of 2017 and 2018, reinsurers act as backstops to the insurance companies with large exposure to claims. The insurers then can recover all or part of claims payouts, ensuring their

survival. Reinsurance in this manner helps to stabilize the insurance market and enables the insurers to take on more customers and more risk.

There is a final backstop to insurers, the California Insurance Guarantee Association (CIGA) which is largely funded by assessments on "admitted" insurers (those licensed and regulated by the California Department of Insurance (CDI) to do business in the state). CIGA ensures that policy holders are compensated in cases where an insurer becomes insolvent, and the claims are left open.

Finally, in California as in several other states, the state has an insurer of "last resort", the California Fair Access to Insurance Requirements (FAIR) plan, for customers who are unable to find coverage from traditional insurers. The FAIR plan is a private insurance plan that is managed and funded by the combined resources of private insurers doing business in the state. Insurers are mandated by the state to participate in the FAIR plan; their contribution to the plan is proportional to their share of the California market. The plan offers only fire, smoke and lightning damage coverage for residential and commercial customers.

Pooled Risk

All insurance, whether it be health, homeowners or auto insurance, is based on the concept of pooled risk. Insurers build portfolios of insured customers who represent a distribution of risk. Optimally, the portion of the pool that is low risk outnumbers the number that are high risk. If the portfolio of risk is properly balanced, the premiums collected from low-risk policy holders plus reserves should be sufficient to cover the cost of claims by high-risk policy holders when they occur.

By carefully building a large customer base, assessing risk, and computing premiums that reflect the level of risk and its probability, insurers can turn a profit, invest and grow their reserves to cushion against future shocks. Risks are assessed based upon analysis of past data. For instance, an insurer evaluating the risk of insuring a house for fire in a wildland area, such as Bonny Doon, would look at past data on wildfires in the vicinity, their severity and frequency, and make an estimate of how likely such an event might be over the course of the next year. Other factors, such as the replacement value of the house; the distance from the house to a fire station or to main highways; what home hardening has been done by the owner and adjacent neighbors; the proximity of trees and vegetation, wooden structures and other flammable items near the house; whether the house is situated on a steep forested slope, etc., would all come into play. From this analysis, a premium is computed that is in proportion to the probability a wildfire would damage the home within the policy period (typically 6 to 12 months).

Major Factors Affecting Premiums and Profits

Climate Change + Fire Suppression + Drought = Disaster

Creeping climate change has been gradually affecting California. Average temperatures have risen by 3°F (1.8°C) since 1896, most of that increase occurring since 1970. Winter seasons have become shorter, and the average April snowpack has decreased between 20 and 40% throughout most of the Sierra Nevada. Fall and spring seasons have grown longer, lengthening the dry season,

and bringing the snow melt forward in the year. This has meant less water reserves available to forest ecosystems, particularly in drought years.

A century or more of fire suppression throughout California as well as in other western states has created a vast build-up of fuels. Additionally, sickly and dying trees that wildfire would normally clear out are left instead to add to the fuel load. The decline and disappearance of the logging industry in the west has compounded the build-up of fuels in unmanaged forests. The extended 20+ year drought that we have experienced, coupled with severe climate change fueled heat waves, has led to further desiccation of the land and trees, leaving these vulnerable to bark beetle infestations and other diseases.

Because of all these changes we have seen increasingly severe wildfires of mammoth proportions destroying millions of acres: California's 10 largest fires occurred in the last 7 years and consumed more than 4.6 million acres, an area 15 times the size of Los Angeles. Thousands of homes were incinerated leading to billions of dollars in losses. In 2017 and 2018 alone, insurers lost a combined $13.3 billion to the wildfires, depleting much of their reserves. The financial situation for many insurers has become so dire that many have either stopped writing policies or left the state to minimize their exposure. State Farm General (California subsidiary of State Farm Mutual). the largest insurer in the state, revealed that it had lost nearly $900 million in 2023 with remaining reserves (or surplus) of only $1.3 billion. Another year like 2023 would push it into insolvency.

California Insurance Regulations

A normal response to the increase in fire risk by insurers would be to raise insurance rates. However, in 1988, Californians passed Proposition 103, which greatly increased the powers of the CDI and limited the ability of insurance companies to set rates. The proposition initially rolled back rates by 20% in its first two years and subsequently has required review and approval of all insurance rate hikes by the CDI. These reviews have acted to hold down rates Californians pay but also have greatly increased the length of time it takes to win CDI approval (up to 293 days on average). Insurers say consequently they are unable to react to rapid changes in risk levels due to climate change. They also have not been permitted to make use of advanced, forward-looking wildfire catastrophe models in rate setting. Finally, while reinsurance costs for North American properties have increased, doubling from 2017 to 2022, insurers have been barred from passing any of these costs on to consumers.

The net result of the proposition has been to hold insurance rates to below the national average for over 20 years. Even today, in spite of sharp increases in premium costs, the average homeowner's insurance cost in the state is still below the national average. However, with fewer and fewer insurers in the market there are increasingly fewer options for consumers. And what insurance is available is rising rapidly, to a point where insurance will become unaffordable for most people if there are no significant changes to the regulatory environment.

Cost of Housing

Another contributor to the soaring costs for insurers is the cost of housing in the state. Insurance policies are usually based on the market value of a home, which is the basis for the replacement cost. Housing prices as well as construction costs since 2019 have risen by 46%, and median house prices are, as of May 2024, at a whopping $904,210. Consequently, the cost to service

claims for homes destroyed in fires is increasingly costly, rising by an equivalent percentage, and rapidly eating away at insurers' reserves. Ironically, despite these increases, most homeowners tend to be under-insured—the replacement value in no way reflects the true cost of replacement. Many times, the replacement cost of the house was set based upon the sale price of the home years before, but was not updated each year to reflect the growth in value.

The confluence of all the above factors are creating a perfect storm that if unchecked could soon lead to collapse of insurance in California. In the next part of this article, we will look at what our government is working on to resolve the crisis, and what homeowner's can do to protect themselves.