Insurance In California Is Changing. Here’s How It May Affect You

KQED

For most people, insurance is the first line of defense against climate change. When struck by wildfire, flooding or other calamity, an adequate insurance policy can come to the rescue. It’s like a financial first responder, an ambulance full of money to help people back onto their feet. Insurance is the reason something bad happening to you, like losing your home in a wildfire, doesn’t guarantee a slide into poverty.

But the industry is in serious trouble. Climate disasters around the state, especially worsening wildfires, threaten the current business model and millions of middle-class Californians. Climate risks exist everywhere. However, California is notable for companies racing out of Dodge. Seven of the top 12 insurance companies in the state, including Allstate, State Farm, Farmers Insurance and American International Group (AIG), have left California or pulled back from offering new policies in the last year.

As the Golden State grapples with the devastating consequences of increasingly frequent and intense wildfires, California officials are crafting a major overhaul to insurance regulations. It is meant to stop the exodus of companies and promote market stability, but it will almost certainly mean that insurance premiums will rise. Here is what we know, what to expect, and how it may affect you.

California announces action, at last
For the better part of the last year, California did not make any structural changes to its insurance marketplace despite the ballooning crisis and the urgency of the problem.

“Structural changes are not sexy,” said Sashi Sabaratnam, former mayor of Mill Valley and manager of Sonoma County’s UC Cooperative Extension wildfire vegetation mitigation program. “Making those changes [won’t] win anybody big fans or win elections. You need somebody with the kind of political courage to look at the problem and really be able to take the heat for making those structural changes.”

Some members of the state legislature considered putting forth a bill to fix some of the many problems. But the effort dissolved at the last minute before the close of the legislative session. Some officials were reportedly afraid they would not be seen as being tough enough on insurance companies and felt that maintaining the status quo would be politically safer.

State Sen. Bill Dodd (D-Napa) said he was disappointed when the legislative effort fell through.

“To state the obvious, we do not have a stable insurance market. And when you don’t have that, a lot of things can go awfully wrong,” he said in the hours after the legislative collapse. “High costs force people to go naked without insurance. That’s happening all over my district. It’s going to affect home and business mortgages because if you can’t get insurance, your mortgages will get called in.”

When the state legislature stepped back from the problem, it placed increased pressure on California Insurance Commissioner Ricardo Lara, who had mostly avoided talking about making big regulatory changes all year. Instead, he largely focused on talking about reducing the risk of wildfire through mitigation.

As important as mitigation is, Sabaratnam said, “It means nothing if you do not deal with those structural issues.”

Insurance commissioner is an elected position, but Lara was re-elected in 2022, so his seat is secure until his term ends in 2026. That ought to give him a little room to breathe, suggested Sabaratnam.

Still, an executive order from Gov. Gavin Newsom urging the insurance commission to take swift action to strengthen the property market apparently gave Lara enough political cover to announce changes.

In September, he announced that a significant regulatory overhaul would be in place by the end of next year.

“California’s current regulatory framework does not meet our needs,” Lara said. “We need to update regulations.”

All that is to say, policymakers felt strongly that someone needed to do something. Just who would do what took the better part of a year to figure out.

And, as anticipated by policy experts, few people cheered. Some TV news outlets framed the announced changes as a win for the insurance industry. Advocacy groups personally attacked Lara. The powerful Consumer Watchdog even attacked other advocacy groups who expressed some support for Lara's changes.

Why the insurance market is in trouble
Perhaps curiously, home insurance in California actually costs less than in other states with the same sorts of climate risks. From the insurance industry's point of view, this is a sign that risk in California is not priced accurately.

Companies trace this situation back to 1988, when voters approved a law limiting how much insurance companies could raise rates and said the state has to approve. It was a voter-backed initiative that attempted to improve insurance for consumers, protecting them from arbitrary insurance rate hikes.

Groups that did not like a proposed rate hike could intervene and recoup the legal and administrative costs of doing so. Insurance companies had to set rates tied to historical data from the past 20 years of losses, but they could not look forward to estimates of future losses.

The 1988 measure — Proposition 103 — was prompted by skyrocketing auto insurance, but it also worked on home insurance. The law has saved Californians billions of dollars, but insurance companies, who have had to shell out tens of billions of dollars to cover losses from the Camp, Tubbs, Thomas, LNU Lightning Complex, Dixie and other major fires in recent years, hate this rule. Many have effectively said, 'Hey, we are not doing this anymore.'

Parr Schoolman, Allstate's chief risk officer, told California insurance officials at a hearing this year that the company needs to be able to raise prices or else it would drop more individual customers or even totally leave the state's home insurance market.

The current system makes it very difficult for insurance companies to get rate increases of anything more than 7%. It can take years. Typically, the state does not grant requests in total.

So, from an insurance company's perspective, their rates lag years behind the actual price of the risk they are insuring. Meanwhile, reinsurance, which is insurance for insurers, has skyrocketed, along with construction costs and other expenses impacted by inflation. That is all laid against the backdrop of jawslackening wildfire losses, which have wiped out decades of profits, particularly in 2017 and 2018.

Change is afoot
The big elements of Lara’s announced changes include:

- An agreement with insurance companies to write more policies and collectively offer coverage to at least 85% of homeowners in high wildfire-risk areas. This would allow homeowners currently on the state’s insurer of last resort, the FAIR plan, to transition back to the normal market.
- Allowing insurance companies to use forward-looking climate catastrophe models instead of historical data about risk.
- Letting companies pass on California-related reinsurance costs.
- Increase California Department of Insurance staffing to allow rate increases to be approved faster.

Some consumer advocates and ensuing news coverage suggested it was a victory and bailout for the insurance industry. One of the most strident opposing voices comes from Consumer Watchdog, which has spent years attacking not only the insurance industry but the insurance commissioner himself.

The consumer protection organizations painted Lara as an industry insider and said the deal would not guarantee coverage and would increase premiums. In response, the commission pointed out in recently released data that Consumer Watchdog has also benefited from collecting $8.9 million over a decade in compensation for its work-challenging rate increases. Proposition 103 allows members of the public to intervene on behalf of ratepayers and apply for compensation for the expenses of doing so. That money comes from insurers, who pass those costs on to their customers.

Amy Bach, executive director of United Policyholders, an organization that advocates for insurance customers, dismissed Consumer Watchdog’s view as ignoring the very real threats to the market. Some of the announced changes will likely mean higher premiums. But what is most important, Bach said, was that a compromise would be workable for both consumers and insurers.

“I don’t like [all the changes],” Bach said. “Using catastrophe models and passing on some reinsurance costs? As far as I know, every other state in the union does that — it is not the end of the world. But what is the end of the world if [the insurance flight] keeps going on like this?”

While public utilities are legally required to serve customers, insurance companies can do business in the state or not, as they please.

“To stop selling insurance entirely the way that [insurance companies are] doing suggests to me that they are genuinely worried about the adequacy of their rates,” Bach said.

If the insurance market collapses in the state, people can’t buy homes or sell homes. Most homes have mortgages, and banks won’t lend money unless it’s insured. If the real estate industry collapses, it will reverberate through the entire economy.

California is not the only market with insurance troubles. Around the nation, climate-driven disasters are accelerating price hikes, coverage withdrawals and instability.

If insurance market trends continue on the current path, Sen. Sheldon Whitehouse (D-Rhode Island), speaking at a congressional hearing this year, said it puts the global economy at systemic risk.

The term “global systemic risk,” he said, “has a rather bland quality to it. But it describes something that is anything but bland.”

It is bland in the way talking about subprime mortgages seemed in 2007, just before they triggered a global financial meltdown. The current insurance market situation poses the same kind of risk to the economy.

Dive deep: How insurance works
There are three different ways you can get home insurance in California. By way of a high school lunchroom analogy: You can eat with the “the cool kids,” the “not-cool kids,” or the vice principal, who is your last choice, but it might be better than having lunch alone.

The cool kids are the “admitted market.” They are licensed to sell in the state, California has to approve rate increases, and if the company fails, California will pay out the claims. Being a cool kid comes with a lot of rules, but if you are a company that wants to sell in bulk to Californians, this is the route you need to go. These companies, like Allstate, State Farm or Farmers, are generally best to have your insurance with. But they have scaled back their offerings in wildfire-prone parts of the state.

Then there’s the “not-cool-kids.” These are specialty or surplus lines of coverage from companies such as

Lloyds of London, Chubb Custom Insurance Company or Spinnaker Specialty Insurance. They'll write riskier policies for homeowners or businesses, but they are also more high-risk themselves. They're not guaranteed if they fail, which means more exposure for a consumer. And they can basically charge what they want. These rates are typically more expensive.

The vice principal is the FAIR Plan, the state's insurer of last resort. It is expensive, and the coverage is lousy. But you can get some coverage when no one else will take you.

The FAIR plan: California's least-loved insurer
The FAIR plan stands for Fair Access to Insurance Requirements, and it's derisively known as "the un-fair plan" by some of its customers, who feel frustrated they have to use it. It was one of those well-intentioned solutions created to fill a need, but it has ballooned and taken on the dimensions of its own problem.

The FAIR plan now has 330,000 policyholders. That's up from 140,000 in 2018 before insurance companies began their flight from California. More people are using it today than were ever intended to. This places the financial foundation of the plan on really shaky ground. And the more people who join, the worse it gets.

The FAIR plan is regulated by the state but it's funding is guaranteed by private insurers. California created it after the Watts Riots in the 1960s, when years of simmering anger and distrust had built up between mostly Black residents of the Watts neighborhood and police around Los Angeles exploded for days of unrest. Following those days, insurance companies began canceling policies for homeowners and businesses. The FAIR plan was crafted to provide homeowners and businesses some coverage when nothing else was available. Most states have their own version.

"The Fair Plan, which is supposed to be sort of a temporary last resort insurance policy, is becoming a permanent insurance policy for many people in high fire risk areas in California," said Michael Wara, a climate and energy lawyer and researcher at the Stanford Woods Institute for the Environment.

"The economic structure of the FAIR plan is that homeowners pay a lot more money for less insurance," he added. "And hopefully that's enough. The reality is it's not."

Apart from offering fairly poor coverage, the FAIR plan is just about one big disaster away from not having enough money to pay claims to its customers.

“If the FAIR plan were a regular insurer, the insurance department would have to step in and shut it down because it’s so undercapitalized,” Wara said.

If there were a big fire, something on the scale of the Tubbs Fire or Camp Fire, in an area where the FAIR Plan covered many homes, the plan would then charge insurers in the admitted market, aka the “cool kids,” for the rest of the money. In insurance jargon, this is called “levying an assessment.”

Here is the scary thing: insurance companies do not have the money saved for this, and they are not allowed to make up the deficit by charging their customers more, so many of them would probably go bankrupt. Other companies would offload policies, basically firing their customers, to try to become financially stable again. The whole market could collapse.

That would stop the buying and selling of homes and also the building of any new ones. California is doing a lot to build more houses, but if the insurance market collapses, that progress will evaporate.

“One entity that is going to sell a lot of houses is a builder,” Wara said. “And if they can’t sell their houses because the people that want to buy them with a mortgage can’t get insurance. It threatens everything that we’re trying to do to make the state more affordable and more equitable.”

What will the changes mean?
The changes coming to California’s market are a start, but no one seems to think they’re sufficient on their own, least of all officials at the state’s insurance department.

“Modernizing our insurance market is not going to be easy or happen overnight,” Lara said. “We are in really unchartered territory, and we must make difficult choices when the world is changing rapidly.”

While no consumers, elected officials, or consumer advocates want to see prices increase, there is a sense that the era of cheap insurance is over for good.

“Do I like the days when people were paying a thousand bucks a year for their home insurance? Of course, everybody liked it,” said Bach from United Policyholders. “But we don’t have that option anymore, so something has to change.”

Source: https://uphelp.org/insurance-in-california-is-changing-heres-how-it-may-affect-you/ Date: May 9, 2024

United Policyholders
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However, how much rates may increase is an open question. One of the few people who has studied how rates rise using historical data versus catastrophic data is Nancy Watkins, an actuary at Milliman, an independent consulting firm.

A 2022 study she did indicated that using catastrophic models did not necessarily mean higher rates. Her work also found that rates were more stable using modeling and, crucially, that models could incorporate wildfire preparation into risk estimates — something historic data fails at.

That can incentivize home- and community-level fire mitigation work, something she and many fire and insurance experts hope is the way of the future.

What comes next
In the coming months, the state's insurance department will shape the new regulations and implement reforms. Michael Soller, spokesperson for the department, said this work would focus on a couple of fronts, with some tasks being administrative in nature and some taking place through public meetings and hearings. The state will:

- Create maps of where they will require insurance companies to write more policies, offering coverage to 85% of homeowners.
- Evaluate catastrophe models and consider the creation of a new public model, owned by the state, versus adopting existing models made by companies.
- Consider incorporating some California-related reinsurance costs into rates.
- Hire more staff.
- Deny intervenor petitions by advocacy groups that replicate the work already being done by staff.

Bach said following the announcement of coming reforms, she hoped the exodus would be staunched. But she said many companies still seem wary of offering coverage. She thinks they're afraid advocates, like Consumer Watchdog, will sue to block the changes. "I think that's part of the problem of why nothing has really shifted since the announcement," she said.

The nature of hard problems is that there are no easy, short-term wins, policy expert Sabratnam said.

"If these changes are made and people's rates go up and some people still lose their insurance and some people still go on the FAIR Plan, people will then turn around and say, 'Well look, you didn't succeed, you failed,'" Sabaratnam said.

But, she added, structural change is what is needed, even if it is unpopular.

"Everything else is just a Band-Aid," she said.