SENATE COMMITTEE ON INSURANCE

Senator Susan Rubio, Chair

2019 - 2020 Regular

Bill No:	AB 2167	**Hearing Date:**	August 4, 2020
Author:	Daly		
Version:	July 30, 2020 Amended		
Urgency:	Yes	**Fiscal:**	Yes
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SUBJECT: Insurance market action plan

DIGEST: This bill authorizes the Insurance Commissioner ("commissioner") and an insurer to establish an insurance market action plan (IMAP) and defines the process and standards that apply. The IMAP commits the insurer to offer new and renewal policies in targeted areas identified in the plan, establishes individual home and community mitigation and verification requirements for eligible homes, and includes a plan to maintain the insurer's solvency and avoid overconcentration of risk exposure. This bill would allow the commissioner to connect participating insurers with relevant local representatives to foster collaboration on IMAP mitigation requirements. Provides that approval of an IMAP filing is contingent on the commissioner's approval of an accompanying rate filing that may include loss based on a catastrophic risk model and a portion of the insurer's reinsurance costs. This bill includes contingent enactment language that requires enactment of SB 292 (Rubio) in order for it to go into effect.

Due to the COVID-19 Pandemic and the unprecedented nature of the 2020 Legislative Session, all Senate Policy Committees are working under a compressed timeline. This timeline does not allow this bill to be referred and heard by more than one committee as a typical timeline would allow. In order to fully vet the contents of this measure for the benefit of Senators and the public, this analysis includes information from the Committee on Judiciary.

ANALYSIS:

Existing law:

1) Establishes the office of the commissioner, elected by the people in the same manner as the Governor, to oversee the California Department of Insurance (CDI). (Ins. Code §§ 12900 et seq.) Requires the commissioner to perform all duties imposed by the provisions of the Insurance code and other laws regulating the business of insurance in this state, and requires the commissioner to enforce the execution of those provisions and laws. (Ins. Code § 12921.)

2) <u>Cancellations, Renewals, and Nonrenewals</u>. Generally permits an insurer to select the risks that it will insure or renew, subject to certain restrictions:

   a) Limits the ability of insurers to cancel a policy midterm after 60 days except for specified reasons. (Ins. Code § 676.)

b) Requires insurers to provide notice of nonrenewal 75 days prior to the expiration of the policy. (Ins. Code § 678.) Requires insurers provide a reason for nonrenewal, cancelation, or other action based on an "adverse underwriting decision." (Ins. Code § 791.10)

c) When a home has suffered a total loss related to a declared emergency, requires the insurer to renew the policy at least twice following the loss. (Ins. Code § 675.)

d) Prohibits an insurer from cancelling or refusing to renew a homeowners insurance policy covering a property located in a ZIP Code within or adjacent to a fire perimeter, based solely on such location, for one year after the declaration of a state of emergency. (Ins. Code § 675.1)

3) Ratemaking Procedures**.** Requires an insurer to obtain prior approval of any rate it charges for homeowners insurance (and other lines as specified) and requires the insurer to file a complete rate change application, along with necessary data and other information used to justify the rate, and requires public notice of any application. (Proposition 103, Ins. Code §§ 1861.01 et seq.)

a) Provides that public notice include distribution to the news media and to any member of the public who requests placement on a mailing list (Ins. Code § 1861.06) Requires that all information provided to the commissioner during the rate application process be available for public inspection, including information that would have otherwise been excluded under Public Records Act (Govt. Code § 6254(d)), such trade secrets, and information provided pursuant to Insurance Code Section 1857.9. (Ins. Code § 1861.07)

b) Deems the application approved after sixty days unless: (1) a hearing is requested by a consumer or representative within 45 days of the public notice and the commissioner grants the request; (2) the commissioner determines to hold a hearing, or (3) the proposed rate adjustment exceeds 7% of the current rate for personal lines, in which case the commissioner must hold a hearing upon a timely request.

c) Provides the hearings shall be held according to the formal hearing provisions of the Administrative Procedure Act (Govt. Code §§ 11500 et seq.), with some exceptions including one that allows the commissioner to appoint the presiding administrative law judge. (Ins. Code § 1861.08.) Expressly grants the commissioner the authority to adopt regulations governing hearings. (Ins. Code § 1861.55)

d) Authorizes any person to initiate or intervene in any ratemaking proceeding, to challenge any action of the commissioner, and to enforce any provision of the governing law. (Ins. Code $1861.10.) Requires the commissioner or a court to award reasonable advocacy and witness fees and expenses, paid by the insurer to advocates who demonstrate that the person represents the interests of consumers and made a substantial contribution to the resolution of the matter. (Ins. Code §1861.10.) Requires that advocacy and witness fees be paid at the "market rate" for professional services, including legal services, in San Francisco and Los Angeles. (10 CCR §§ 2661.1 and 2662.6)

4) Substantive Ratemaking. Provides that *no rate* shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of the laws governing insurance rates. (Ins. Code § 1861.05.) Establishes standards for the determination of reasonable rates of homeowners insurance. Broadly, these rules and formulas that define whether a rate is "excessive" or "inadequate," set the floor and ceiling for permitted earned premium, and require losses to be projected based on the insurer's past experience. (10 CCR §§ 2644.1 - 2644.28)

   a) *Standard losses*. For establishing the rate necessary to pay projected losses (such as the single event kitchen fire), requires the insurer to develop its standard losses based on the three most recent years (10 CCR §§ 2644.4 and 2644.6). Projected losses are adjusted according to formulas established in CDI regulations, including profit factors and rate of return, leverage and surplus requirements, taxes, projected yield, credibility adjustment, as well as a variance request. (10 CCR §§ 2644.1- 2644.6) Grants the commissioner the discretion to select among a range of actuarially sound choices related to some of those factors in determining their value by granting the commissioner the discretion to select the "most actuarially sound" choice from several otherwise sound choices. (10 CCR §§ 2644.6 - 2644.8.) Defines the "most actuarially sound" as "the most appropriate choice within the range of permissible actuarially sound choices, considering both the relative likelihood of all choices within the range and the context in which the choice will be employed." (10 CCR § 2642.8)

   b) *Catastrophic Loading*. Requires that catastrophic wildfire losses be accounted for through "catastrophic loading" or removing catastrophic losses from the insurer's standard loss experience for purposes of determining base rate, and instead distributing those catastrophic losses "over a period of at least 20 years" for the purpose of projecting future losses. (10 CCR § 2644.5)

   c) *Reinsurance*. Requires that no consideration be given for the cost or benefits of reinsurance, except for catastrophic earthquake coverage (prohibits consideration of reinsurance for standard homeowners insurance coverage). For catastrophic earthquake coverage, insurers may account for the "reinsurance premium, net of ceding and continent commissions" but reinsurance agreements must be entered into "in a good faith arm's length transaction at fair market value." (10 CCR § 2544.25)

   d) *Catastrophic Loss Modeling*. Expressly authorizes the use of "complex catastrophic models," for projecting loss and containment costs for earthquake and fire-following-an-earthquake exposures (not wildfire exposures) if the model conforms to the standards established by the Actuarial Standards Board and the insurer can show that the model is based on the best available scientific information, as specified, and complies with any applicable statutory standard. (10 CCR 2644.4(e))

5) Emergency Powers to Establish a Joint Underwriting Authority. Authorizes the commissioner to establish a joint underwriting authority, as specified, if the commissioner finds that (a) insurers have substantially withdrawn from a property insurance market and (b) a market assistance plan would not be sufficient to make

insurance available. (The Insurance Code does not define “joint underwriting authority” or “market assistance plan” but generally speaking a “market assistance plan” is a program designed to match a consumer with an insurer that is voluntarily willing to offer coverage and a “joint underwriting authority” is a risk-pooling association established by the state to address an availability crisis for certain kinds of insurance coverage, similar in concept to the California Fair Access to Insurance Requirements (FAIR) Plan which is a joint reinsurance association.) (Ins. Code § 1861.11)

This bill:

1) Authorizes the commissioner and an insurer to establish an insurance market action plan (IMAP) that requires the insurer to renew and to issue new policies, up to 85% of its statewide market penetration rate based on policy count, in targeted areas located in eligible counties (“IMAP Commitment”). Counties qualify based on criteria defined in SB 292 (Rubio) according to the number of new FAIR Plan enrollments in relation to the county’s population.

2) Specifies an IMAP submitted to the commissioner include the following

   a) A request for adequate rates subject to the approval of the commissioner.

      i) Prohibits rates that are excessive, inadequate, or unfairly discriminatory and requires rates to be “actuarially sound” so that premiums are adequate to cover expected losses, expenses, and taxes, and reflects investment income.

      ii) Authorizes homeowners insurers to base their rates on complex catastrophic models that are based on the best scientific information and projected losses derived from model results meet applicable statutory standards.

      iii) Provides that if the rate filing includes the “net cost of reinsurance,” the reinsurance agreement shall be entered into in good faith in an arm’s length transaction and at a fair market value for the coverage provided.

   b) A plan for maintaining an insurer’s solvency as the insurer’s policy count grows that takes into account, among other things, potential overconcentration of risk;

   c) Parcel and community-level mitigation and verification requirements. The commissioner is authorized to connect interested stakeholders, including insurers and local government representatives, to promote collaboration and consistency between insurers standard and local policies.

   d) A list of areas within IMAP-eligible counties where the insurer proposes to issue new policies and where the insurer will not issue new policies.

3) Provides that a rate requested as part of an IMAP filing shall be subject to the prior approval of the commissioner.

4) Provides that a rate filing accompanying an IMAP proposal shall receive an expedited review if the filing is based on either:

   a) An actuarial assumption for trend and loss development that is at a midpoint or less of rate impacts and does not otherwise change any other aspect of its filing from its previous department approved rate; or

   b) Solely increased reinsurance costs and does not otherwise change any other aspect of the previously approved rate filing.

5) Provides that objections to the rate filing not based on the rate calculation may be heard separately. Suspends the IMAP commitment if the commissioner later orders a nonconsensual change until CDI and the insurer reach agreement on the filing.

6) Provides that for IMAP filings that qualify for expedited review and subsequent IMAP filings when the insurer has an approved IMAP in place, the IMAP filing will be withdrawn as an operation of law if CDI fails to approve it within 120 days. For subsequent IMAP filings, if CDI fails to approve the filing within 120 days, the insurer's IMAP is suspended until an agreement is reached.

7) Requires the Legislative Analyst's Office, by June 30, 202 in consultation with an appropriate research organization, to issue a report evaluating the effectiveness of the IMAP program including:

   a) Whether the IMAP program achieved admitted market rates lower than the California FAIR Plan plus difference in condition policies.

   b) The overall progress of the IMAP program towards achieving market penetration goals in IMAP counties and the impact on FAIR Plan enrollments.

   c) Participating insurers' use of reinsurance in the IMAP program that considers the impact of reinsurance on insurance availability in high fire risk areas and the impact of reinsurance on residential property insurance premiums.

8) States that the provisions of the bill are NOT severable.

9) Contains detailed Legislative findings and declarations with respect to global warming, development in the wildfire urban interface (WUI), and the need for market solutions to the current insurance availability problems facing parts of the state.

10) Provides that the bill shall take effect only is SB 292 (Rubio) is also signed into law.

11) Contains an urgency clause for immediate enactment.

12) Renders the provisions of the bill inoperative as of July 1, 2026, and repeal its provisions as of January 2, 2027.

Background

According to the author:

> AB 2167 (and its companion measure, SB 292 (Rubio) is designed to address the Governor's statement in his signing message last year for AB 1816 (Daly). AB 1816 adopted several consumer protection and market assistance provisions designed to address the homeowners' insurance issues in California's high fire-risk regions. In signing the bill, the Governor stated "We must do more." AB 2167 is designed to be a market-based proposal that contains a mechanism for insurers to make filings with the Insurance Commissioner, that are entirely within the control of the Insurance Commissioner to approve or deny, that specify the terms and conditions upon which the insurer will accept a legal mandate to issue more policies in high risk areas.

Since 2016, the Senate Committee on Insurance has held five informational hearings and numerous legislative hearings on homeowners insurance and unprecedented wildfire losses. The committee considered issues relating to renewals and nonrenewals, claims problems, underinsurance and loss amplification, California's ratemaking process, insurance market access and the FAIR Plan, among others. In addition to numerous legislative hearings over the last several years, many other efforts have been made to understand and develop strategies that reduce wildfire occurrence and destruction. At the same time, numerous discussions were ongoing. At the same time, indicators suggested that wildfire risk and insurance issues are likely to worsen.

The RAND Climate Change Study estimates that the average number of acres that will burn annually in areas of the Sierra Foothills will double by midcentury and, absent aggressive improvements in carbon emissions, will double again by the end of the 21st century. An insurer with a moderate risk exposure may find over time that the exposure has increased significantly. If these projections bear out, many homes in California will become more expensive to insure as a matter of course, unless the loss trend can be reversed. As the market shifts, it will become more important to develop precise measurements and flexible solutions to address insurance needs. The FAIR Plan provides a general fail-safe for the market, but recent indicators raise some very troubling concerns.

California FAIR Plan.

The California FAIR Plan has served as California's "insurer of last resort" since 1968. However, FAIR Plan policies can be pricey and offer only basic coverage (they do not cover liability, theft, or some types of water damage). Residential policies are currently capped at $3 million (recently raised from $1.5 million). Most importantly, they're expensive. Last year, the FAIR Plan received a 20% rate increase and has a 35% increase pending. Despite the higher costs, FAIR Plan enrollments started surging in 2019, suggesting many residents in impacted areas have no other option.

In August of 2019, the committee began an intensive analysis of FAIR Plan enrollment data and Department nonrenewal data, which suggested the surge appears to be fueled to some degree by a retreating admitted market in the wake of back-to-back years of record losses. This represents a fundamental shift from the FAIR Plan's recent role in the market.

For several years before 2019, the FAIR Plan "policies in force" count remained relatively steady, hovering around 125,000 (FAIR Plan policies in force actually declined slightly from 127,000 in February 2014 to 123,000 in February 2018). FAIR would also typically see a significant number of policyholders cancel their policies in any given month in favor of a voluntary market option. During the last half of 2018, cancellations were typically upwards of 20-25% of new business written. Meaning in a typical month FAIR might write around 2000 new policies, but only net 1500 new policyholders.

FAIR has grown substantially since 2018. From January 2019 through June 2020, FAIR issued 112,273 new policies and saw 14,644 cancellations, retaining 97,629 (87%) new policyholders. As the FAIR Plan is a high-risk pool, its concentration of high-risk policies in any given area contributes to "concentration risk." Wildfire is a correlated risk; the likelihood of the FAIR Plan incurring multiple losses at once grows as its market share become more concentrated. Simply put, FAIR Plan policies become more expensive when there are more of them. FAIR received a 20% rate increase last year (resulting in some policyholders seeing premiums increase by as much as 69%) and the FAIR Plan has another pending rate increase for 35.6%. Additional FAIR Plan growth raises concerns about how these concentrations will affect the long-term affordability of the plan for middle and lower income consumers.

Another surge in enrollments could occur in 2021 if we have another extraordinarily bad wildfire season, or as "nonrenewal moratoriums" currently protecting about 1 million consumers in high fire-risk areas expire later this year. Senate Bill 824 (Lara), Chapter 616, Statutes of 2018, prohibits an insurer from refusing to renew a homeowners policy on property located in any ZIP Code within or adjacent to the fire perimeter, for one year after a declared disaster. The Governor declared several wildfire disasters last year triggering one-year moratoriums. These policyholders may need voluntary market alternatives or may be forced to rely on the increasingly expensive FAIR Plan or the nonadmitted market (where rates are unregulated altogether).

California residents need alternatives to the California FAIR Plan. However, insurers argue that California's ratemaking rules are disconnected from market realities and inhibits consumer's access to voluntary market coverage. This bill is an attempt to reconcile California ratemaking standards and California's "new normal."

Insurance Basics.

The magic of Insurance comes from its use of "risk pooling," where a large number of contributors help to pay for the large losses of an unfortunate few. So long as the each insured property is statistically unrelated, meaning the probability of one home being lost is unrelated to the probability of another home, risk-pooling works to even out year-to-year losses and makes losses more predictable as the size of the pool grows.

A problem arises when insured risks are correlated and vulnerable to wild swings. At that point, risk pooling starts to break down and losses become wildly unpredictable.

This is one of the primary differences between standard house fires, where maybe one or two homes are lost or damaged, and catastrophic wildfires where thousands of homes are at risk at the same time. Traditionally, insurers treated wildfires as a "secondary" risk that followed single-loss residential fires. In California, that started changing in 2013 after the Rim Fire when insurers began recognizing wildfires as it own form of catastrophe on par with earthquakes and hurricanes.

This bill represents a division between two schools of thought as it relates to the way California's regulatory system manages catastrophic wildfire. This bill arises out of concerns that California's existing ratemaking system does not adapt well to catastrophic wildfire risk and that the ratemaking method fails to reflect new dynamics that drive an insurer's risk exposure. These concerns are based on increasing complaints that insurance is unavailable in high-risk areas of the state, that the current system has led to sudden and drastic rate increases, and that the current ratemaking method turns a blind eye to climate change.

In 2018, the RAND Corporation published a study as part of California's Fourth Climate Change Assessment. That study raised numerous questions about California's approach to catastrophic ratemaking relative to wildfires. That study has informed subsequent hearings and committee efforts and will be frequently cited here.

By the end of 2018, the upward trend was becoming visible. For 13 months, from October 2018 through October 2019, FAIR issued more policies than the month before, peaking at 9,033 policies issued in October 2019. FAIR also began retaining more of its policyholders, and the proportion of cancellations has trended downward. Most recent data available from the FAIR Plan shows that in June 2020 FAIR wrote 6,378 new policies but only saw 316 cancellations (4.95%).

Ratemaking.

The price of an insurance policy is determined before anyone knows the actual cost to provide it. Ratemaking is the process for figuring out that price. The insurer must anticipate how much damage will be caused by covered perils, including fire, water, wind, etc., and how much it will cost to repair the damage or replace lost homes. California's current ratemaking system was established in 1988 when California voters approved Proposition 103 (or "Prop 103"). Prop 103 instituted strict regulation of auto, homeowners, and other types of property and casualty insurance rates. It also made several other monumental changes to California insurance regulation and converted the Insurance Commissioner from an appointee to a statewide elected officer to lead CDI.

Prop 103 gave the commissioner broad and unilateral authority to review, approve, and disapprove insurance rates before an insurer uses them. Rates may not be approved if they are excessive, inadequate, or unfairly discriminatory. It also established many aspects of the ratemaking process that heightened transparency and public participation, as well as provided for third-party intervenors. The process usually starts with an insurer filing an application to change its rate, although the commissioner may initiate a review of a rate at any time.

An application will be automatically deemed approved within 180 days after the public is notified of the filing unless a request for a public hearing is filed and granted by the commissioner, the Commissioner orders a hearing, or the proposed rate adjustment exceeds 7%, which is subject to a mandatory hearing if requested. All information provided to the CDI during the process is made public. CDI uses its own administrative law judges to hold ratemaking hearings.

Third-parties representing consumer interest, called “intervenors,” may challenge the rate filing. Intervenors who **substantially contribute** to the proceeding and meet other criteria can recover advocacy and witness fees and expenses at the prevailing rate for professional services, according to the prevailing rate in San Francisco and Los Angeles.

By its own terms, Prop 103 restricts changes to it made by the Legislature and requires a two-thirds vote by each house on any bill amending its terms. It also limits legislation to those measures that further its own purposes. Prop 103 left many of the substantive issues for homeowners insurance for the Insurance Commissioner to determine by regulation.

Prop 103 expressly provides the commissioner with the authority to issue regulations on automobile discounts and the Prop 103 hearing procedures. However, the commissioner has also adopted a host of regulations that govern the substantive aspects of ratemaking for other property insurance lines, such as homeowners insurance. In California, CDI regulations requires insurers to rely on their own historical data, with some exceptions, to justify the loss projections that will drive the approved rate. Since an insurer’s business and underwriting practices will have a substantial impact on loses, different insurers may have radically different rates and rates can vary wildly even for the same piece of property.

Under standard insurance practices and CDI regulations, ratemaking involves two steps. The first requires the insurer to (1) establish an average rate within a range of acceptable choices driven by an estimated need for premium income, and (2) provide a method for applying and modifying that average rate to individual properties based on various risk factors (for example, whether the home has a wood shake roof or whether it is located in a high risk area).

AB 2167 and Insurance Rates.

This bill establishes the minimal standards for insurance rates as a condition of imposing an enforceable IMAP commitment. It has no effect on rates outside of the IMAP process and, since the commissioner may approve or deny an IMAP filing at will, can only impact a rate via the IMAP process with the commissioner’s affirmative approval (because IMAP filings are withdrawn by operation of law after 120 days, the commissioner has a “pocket veto” and cannot approve an IMAP through mere inaction).

However, the bill does establish a test outside of the regulations adopted by CDI:

- Insurers would be permitted to use catastrophic loss models to project loss and containment costs where CDI regulations only authorize the use of models for earthquake and fire following an earthquake.

- Insurers would be able to include a portion of their reinsurance rate if the reinsurance agreement meets specified conditions.

The use of catastrophic model and inclusion of reinsurance is fairly standard industry practice when managing catastrophic risk. However, CDI and advocacy groups strongly object.

The "Catastrophic Load" versus Catastrophic Modeling

While everyday losses, such as the occasional kitchen fire, can be fairly predictable, massive and widespread losses triggered by catastrophic events require a different approach. Maintaining an adequate supply of capital to pay catastrophic claims requires that catastrophes also be accounted for in the ratemaking process. California uses a more traditional approach, "catastrophic loading," to rate infrequent and severe events. Catastrophic losses are separated from the regular experience data and a catastrophic premium component is calculated based on average losses over a period of at least 20 years, although insurers can use a longer window (an insurer can maximize the rate impact by using a shorter timeframe). However, the catastrophe adjustment will be adjusted to reflect any changes between the insurer's historical and prospective exposure due to a change in the mix of business (for example, the insurer restricts its underwriting in high risk areas). The share of premium for catastrophic losses builds up over time in order to save for a "rainy day" but it is not separate from other assets. The additional premium is added to the insurer's assets.

The catastrophic load approach has raised concerns due to its heavy reliance on recent historical information in an era of climate change and that it does not accurately account for account for population movements, tree mortality, changes in replacement costs, and numerous other factors that will likely impact the probability of insured losses (although ratemaking regulations do allow for some "massaging" of the projections). Moreover, concerns have been raised that the catastrophic load method provides widely varying results year-to-year according to which years are used in the calculations (an insurer can justify a higher rate increase by using only the 20-year minimum period). Fundamentally, the ultimate concern is that the catastrophic load approach provides a highly subjective assessment of risk exposure that may bear little relationship to the insurer's actual risk exposure. Particularly given the assumption that climate change is augmenting weather patterns, the current ratemaking approach of relying on historic losses may tend to result in rates that do not keep up with understood changes to wildfire risk.

Rate Differential and the Fire Hazard Score.

But even moderate or mild rate increases will likely hit consumers in the high fire risk areas disproportionately. That is because the bulk of a rate increase driven by wildfire risk will be borne by those policyholders who are vulnerable to wildfire risk. This occurs by adjusting the average rate to match the risk accompanying each individual property using rate differentials.

When calculating the premium on a specific property, the insurer tailors the average rate to the property's individual risk. The insurer starts with the average rate and applies a "differential" to increase or decrease the amount. Rating differentials are calculated by grouping the insured population into levels according to risk and assigning each category a class relative to the average rate. Risks in the same classification are grouped together and expected to incur the similar losses; each category of risk is assigned a rate differential according to the average. This is why an insurer who may have received a 5% increase in its average rate may apply a 20% increase to a particular home while giving another home a 10% rate reduction.

Fire hazard scoring products, such as FireLine State Risk Report or CoreLogic Wildfire Risk Score, measure individual properties for wildfire risk by weighing factors such as topography, vegetation, wind patterns, and accessibility. With this product, insurers know the profile of each house rather than relying on general regional attributes or zip codes. FireLine provides a wildfire hazard score ranging from 0-30 for each property analyzed. That score will be used to determine whether the insurer will insure the property and how much to charge by applying a rate differential. Fire hazard models like Fireline are often confused with catastrophic loss modeling; catastrophic loss models are useful for estimating aggregate losses after simulated event whiles fire hazard models are used to evaluate the fire risk of individual properties.

Catastrophic Models.

Catastrophic models or "CAT models" are computer-driven tools used to give insurers an idea of how much catastrophes of various sizes and intensities will cost given the damage to covered buildings and structures. CAT models work by generating thousands of simulated catastrophic scenarios based on historical data, sometimes going back thousands of years. For large insurers, this may include the use of models analyzing the insurers' own proprietary data and the use of a third party vendor model that will have additional information. Smaller insurers will likely rely on a vendor model. CAT models alone do not produce climate projection years into the future, but rely on projections that anticipate the behavior of wildfire under current conditions.

Development of CAT modeling occurred after Hurricane Andrew in 1992 and the Northridge Earthquake in 1994 cause staggering unexpected losses and demonstrated the weaknesses of relying historical insurance data."

Models also use location-specific physical characteristics, potential physical damage given exposure characteristics, and event intensity. Roger Grenier testimony described the modeling process this way:

> The model begins by first creating an ignition, and then simulates the effects of wind and weather, fire spread, fire suppression, and the physical characteristics of the structures. It considers the impact on the fuel load from multi-year cycles of rainfall and drought, creating a catalog of events that are physically realistic and statistically consistent with the historical

> record. The model considers many thousands of events, including those that have not yet occurred, but could occur. In addition, the model fills a critical gap in the historical record by including events similar to events that have occurred in the past, but on TODAY's exposure.

For insurers, a financial component measures monetary losses based on damage estimates and applied to insurance coverage terms. Based on the expected probability of loss, models estimate a range of *direct losses* such as damage to physical structures and contents, deaths and injuries; *indirect losses* such as loss of use, additional living expenses and business interruption; and *residual losses* including those resulting from demand surge or labor delays.

CAT models also provide flexibility and evolve. Prior to the 2017 North Bay Fire, flying embers were not seen as a substantial risk, but once that factor was realized, it could quickly be built into the model. Other factors, like population growth, can easily be adjusted to reflect current trends on a wide scale. For example, the 2017 Tubbs Fire burned more than 5000 structures but it had a similar pattern as the 1964 Hanley Fire that burned 53,000 acres, destroyed 108 structures. A loss model would apply a similar burn pattern to the location using current structure and building cost data, as well as other factors such as the newly recognized ember flow risk.

Since 2007, CDI regulations allow insurers to measure the probability of loss to develop rates for earthquake coverage and for fire-following-an-earthquake peril with "complex catastrophe models using geological and structural engineering science and insurance claims expertise." This is consistent with standard catastrophic risk management. However, CDI does not permit insurers to use CAT models for the wildfire risks for homeowners insurance and insists insurers use the CAT load method.

One challenge with the use of CAT model under Prop 103 is a requirement that all information provided to the commissioner during the Prop 103 ratemaking process shall be available for public inspection without exception, including those provided under the Public Records Act. (Ins. Code § 18601.06) In order to preserve intellectual property rights, transparency laws commonly have "trade secret" exceptions to encourage cooperation with regulators, protect intellectual property, and encourage investment and development in technology and innovative solution. (Govt. Code Section 6254(k) (trade secret exemption under the California Public Records Act); see also Evidence Code Section 1060 (trade secret protection in civil litigation), and numerous examples under the Insurance Code including information gathered pursuant to an examination. (Ins. Code § 735.5.), the Corporate Governance Disclosure Act (Ins. Code §§ 936.1 et seq.), Own Risk and Solvency Assessment (Ins. Code § 935.8), and others).)

Model vendors have expressed a willingness to submit their models, but, remain reluctant to expose trade secrets via the broad public disclosure requirements of Prop 103, which does not include the standard protection for trade secrets typical with transparency laws, such as the California Public Records Act. Subjecting their models to the rate process may result in the publication of highly sensitive information even when it is not critical to evaluating the validity of the model. (For additional background on CAT models, please see background report for the February 12, 2020 hearing, pages 8 - 10.)

A concern may be raised that, unless California updates its public disclosure laws, it will be stuck in the "regulatory dark ages" relative to catastrophic risk management. On the other hand, consumer advocates argue that transparency is critical when determining a fair insurance rate and that "black box" catastrophic models are one way in which insurers can inflate their rates.

Regardless, because CAT models are used as a matter of course in other transactions, such as reinsurance transactions and internal risk exposure assessment, the industry's perception of their risk exposure may be radically out of alignment with CDI's assessment according to the catastrophic loading method. If insurers and reinsurers perceive a much higher risk than is reflected in their rate, then they may be more reluctant to offer coverage in high risk areas.

Reinsurance.

Reinsurance, a form of "insurance for insurers" is a contract between two insurers where, for a price, one insurer agrees to cover the losses incurred by another insurer. The agreement can be highly customized, but often involves a payment by the reinsurer once losses reach a certain threshold, like a deductible.

Since reinsurance transfers liabilities off the insurer's books, it expands an insurer's capacity. Reinsurance rates are not regulated; the network of reinsurance agreements diversify and normalize global changes in risk. But, reinsurance is also a financial market, with prices dependent on the availability of capital and sensitive to economic uncertainty.

Without reinsurance, insurers would have to raise the funds to hold a larger reserve in order to write the same amount of coverage, which can be particularly challenging for smaller insurers. By transferring risk exposure to reinsurers, small to midsize companies are better able to offer more coverage and compete with larger insurers and employ their own capital to invest in payroll, offices, etc.

When the cost of reinsurance is higher and that cost is not reflected in the approved rate, an insurer may be less interested in expanding their programs. Some industry experts have suggested that CDI's policy of excluding the cost of reinsurance in rates may suppress competition among insurers by posing a barrier to expanding their business. Additionally, a reinsurer can provide helpful information and guidance to the insurer. A helpful reinsurer can also offer detailed information and analysis, including loss data and loss probability data, that will help the insurer grow and manage its book of business.

In California, a portion of the cost of reinsurance is permitted for earthquake risks, but not wildfire. A 2003 CDI report on earthquake exposure recognized that the "reinsurance market plays a vital role in distributing earthquake losses into the worldwide insurance industry" and that earthquake insurance "could not be sold by primary insurers in California without the participation of the reinsurance market." Moreover, the CEA governing statute requires the CEA to purchase reinsurance to expand its capacity and expressly provides for those costs in the CEA premium capped at a "reasonable and appropriate percentage of the annual earthquake insurance premiums." (Ins. Code § 10089.10)

In nearly every state but California, the reinsurance component is a critical part of an insurer's cost of managing catastrophic risk. This is likely because national actuarial standards require consideration of the costs and benefits of reinsurance when setting rates. These costs are not dollar-for-dollar, but a portion of the insurer's premium called the "net cost of reinsurance" which is calculated according to the part of the insurer's reinsurance premium that exceeds the expected loss on the policy, plus the some of the reinsurer's claims adjustment costs, brokers fees, and risk load. When those costs are passed on to policyholders, reinsured losses are excluded from the rate calculations giving policyholders some protection against rate increases following catastrophes.

In 2017, CDI released its own *("CDI 2017 Report")* that gives several reasons for this position. For one, reinsurance rates are not regulated through the prior-approval process and would likely increase costs for all insurance consumers. The price of reinsurance is, in large part, market driven and depends on how much money does, or doesn't, flow into that market. Additionally, reinsurance contracts can be very complex and, from a regulatory standpoint, CDI would have difficulty establishing a baseline for the reasonableness of reinsurance coverage levels. Lastly, CDI also argues that since all losses are reflected in catastrophic load incorporating reinsurance costs is unnecessary.

The authors of the RAND Climate Change Assessment note:

> CDI regulations that do not allow insurers to include reinsurance margins in rate filings will likely have greater impact as fire risk increases. The ability to include the net cost of reinsurance in rates would presumably increase the willingness of admitted insurers to purchase reinsurance and to write in risky areas. Doing so would enable admitted insurers to better compete with surplus lines carriers who face no such restriction, thus improving options available to homeowners. Allowing net reinsurance costs to be considered in the rate filing process would likely lead to higher average overall rates, but depending on rate relativities allowed, insurers may be able to concentrate increases in the risky areas. These higher premiums would create incentives for homeowners to avoid or mitigate wildfire risk, but the higher premiums come with associated affordability challenges.

The CDI argues that some insurers that currently purchase reinsurance are restricting writing in high-risk areas anyway, and some have suggested that these restrictions may be informed by the risk models reinsurers use in their projections, with nonrenewals being done in response to reinsurance rate increases. But the RAND Climate Change Assessment notes that insurers would be restricting writing more without reinsurance. Further empirical work is needed to better understand how practices in this area might affect future market conditions. The authors of the study suggest that including the net reinsurance margin in the rate filing should, in principle, increase an insurer's willingness to write in high-risk areas, but it is uncertain how effective it would be. ***The author of the bill may wish to consider amendments, detailed below, that would***

improve oversight over the IMAP program, particularly regarding the passing of reinsurance costs. (For further discussion on reinsurance, see background report for the February 12, 2020 hearing, pages 10-12)

AB 2167 and Coordinating the Insurance Market

Although the "insurance industry" is spoken as if it was monolithic, that is far from the truth. Although insurers come together through trade associations, they are limited in their ability to act in coordination by anti-trust laws. (Ins. Code § 1861.03(a).) Without a central nervous system, there is no way to direct available insurance capacity to where it is needed most.

This bill allows the commissioner to negotiate with insurer on terms of rate, where the insurer will target IMAP sales, mitigation standards, and other terms required in the IMAP filing. Should the Insurance Commissioner determine that the results do not justify the rate, and the rate is otherwise excessive, the commissioner may reexamine the rate at any time, under Proposition 103, but a change to the IMAP approved rate will nullify the IMAP commitment. At every step, the commissioner retains the authority, but must monitor and balance the various factors to optimize the insurance market.

AB 2167' requires the insurer to designate where it intends to target it IMAP commitment, the commissioner may, through negotiation during this process, influence those decisions and direct insurance supply to impacted areas. SB 292 requires the FAIR Plan send a biannual report on new business written to the insurance commissioner to allow for real time monitoring of market withdrawal, and to determine if the IMAP is working to relieve stress from the FAIR Plan in targeted areas.

But this advantage works in other areas as well. Over the last several years, the committee has heard testimony that individual and communities are seeking guidance as to what sort of home and community hardening efforts will encourage insurers ensure insurance availability. This IMAP process requires insurers to develop home and community mitigation requirements that missing piece in California's overall risk reduction strategy. Since the IMAP requires the commissioner's approval, the IMAP process provides the commissioner an opportunity to influence insurer's decisions regarding those standards in way that cannot be done now.

Under an IMAP, the commissioner would be empowered to connect the participating insurer with the relevant fire planning officials at the local level, so that they may collaborate on developing mitigation strategies, verification practices, or homeowner education of the plan. AB 3164 (Freidman) would provide for CalFIRE establishment of a WUI wildfire risk model to determine community and parcel risk. That such a tool would be made available to local agencies and is expected to help with collaboration on mitigation strategy development.

Questions

Does AB 2167 circumvent Proposition 103?

Opposition to the bill has emphatically argued that AB 2167 circumvents Prop 103 requirements. For insurance lines subject to Prop 103 (including homeowners insurance), Proposition 103 clearly states that "no rate shall be approved or remain in effect which is […] in violation of this chapter." AB 2167 does not include any language that exempts rates submitted pursuant to the IMAP process from the provisions of that chapter (which includes Prop 103. ***However, in order to avoid further confusion, the author may wish to include language that conditions the commissioner's approval on compliance with the ratemaking chapter of the Insurance Code (including Proposition 103).***

Still, some provisions of this bill are not consistent with the commissioner's regulations adopted under *implied* rulemaking authority. An argument could be made that the Legislature may not enact legislation inconsistent with those rules; however, a counter-argument could be made that since the Legislature has authorization to amend Proposition 103 as long as those amendments further the purposes of the initiative, this power is superior to the commissioner's implied rulemaking authority. This argument is strengthened by the express grant of rulemaking authority Prop 103 granted the commissioner; authority to adopt regulations on hearings (Ins. Code § 1861.08) and auto insurance discounts (Ins. Code § 1861.02).

AB 2167 does not impose standards on rates, but sets up the necessary qualifications for restricting an insurer's underwriting freedoms. In this sense, AB 2167 incorporate two tests. (1) The "Prop 103 test" establishes a maximum rate that no rate, IMAP or not, may exceed. (2) The "IMAP test" that establishes the rate for the purposes of determining whether the commissioner can bind an insurer to issue policies in a high risk area. The commissioner is free to adopt an IMAP but only if the accompanying rate meets both tests.

AB 2167 enables the commissioner to waive inconsistent regulations, such as those prohibiting the cost of reinsurance and those that fail to authorize insurers to use catastrophic modeling in ratemaking. (The commissioner has the discretion to amend these regulations anyway.) Opponents of the bill argue that the reinsurance component alone will result in skyrocketing insurance rates. There is no dispute that including some portion of the reinsurance cost will increase rates, but the commissioner would be empowered and obligated to make a cost benefit analysis. The commissioner might also choose to call for an IMAP to address availability in certain areas and make known his intention not to approve IMAPs that do not demonstrate clearly how they will increase insurance access. AB 2167 is intended to provide the commissioner with the discretion to deny the rate if those reinsurance costs are unreasonable and if, on balance, approval of the rate would do more harm than good.

Like Prop 103, AB 2167 confers much discretion to the Insurance Commissioner. If circumstances do not justify the IMAP, the commissioner need not approve the IMAP or the rate. For example, if there are insurers offering coverage in that area at a lower rate, or coverage through the FAIR Plan or nonadmitted market is readily available and less expensive (for equivalent coverage), etc. On the other hand, if coverage in the voluntary or admitted market is unavailable or only available at a higher rate, then the Commissioner may determine another voluntary market option is warranted.

Questions

Does AB 2167 further the purposes of Prop 103?

Consumer Watchdog writes in opposition that AB 2167 does not further the purposes of Prop 103, arguing:

> "Proposition 103 contained the following limitation on the power of the Legislature: "The provisions of this act shall not be amended by the Legislature except to further its purposes by a statute passed in each house by roll call vote entered in the journal, two-thirds of the membership concurring[.]"

They argue California Supreme Court invalidated a bill to exempt certain surety insurance from Proposition 103, and made clear the court would not simply defer to the Legislature's determination:

> [T]he voters have the power to decide whether or not the Legislature can amend or repeal initiative statutes. This power is absolute and includes the power to enable legislative amendment subject to conditions attached by the voters. (Amwest Surety Ins. Co. v. Wilson, 11 Cal.4th 1243, 1251 (1995).

However, in *Amwest*, the court also notedthat "In enacting section 1861.135, the Legislature did not purport to interpret the Constitution, *but only to amend the statutory provisions enacted by Proposition 103*." [emphasis added] This is an important distinction from the current case in AB 2167, which as proposed to be amended by this analysis specifically states that the statutory provisions enacted by Prop 103 are controlling.

The findings and declarations states the Legislature's finding that this bill furthers the purposes of Prop 103 (Section 1, (d)) for the following reason:

> "To the extent that a court may find that this legislation amends the Insurance Rate Reduction and Reform Act of 1988, an initiative measure, enacted by Proposition 103, as approved by the voters at the November 8, 1988, statewide general election, the Legislature has determined that this act furthers the purpose of Proposition 103 because the primary goal of this act is to increase statewide availability of insurance using risk-based pricing subject to the prior approval of the Insurance Commissioner, and seeks to prevent unfair discrimination in pricing or unjustified regional subsidies in high fire-risk areas."

Consumer Watchdog further points to *The Foundation for Taxpayer and Consumer Rights v. Garamendi* (2005) 132 Cal.App.4th 1354, where the Court of Appeal reviewed an amendment to modify the Commissioner's authority to regulate auto insurance premiums. The Court found the Legislature sought to override the Insurance Commissioner's authority to set rates and premiums for automobile insurance.

A specific issue in this case is a regulation adopted in 2002 that provides "[a]n insurer shall not apply a persistency credit for a new policy issued to an individual, unless that individual is currently insured. Nor shall any insurer apply persistency, at any time, when based in whole or in part upon automobile insurance coverage provided by a non-affiliated insurer," and SB 841 (Perata) Chapter 169, Statutes of 2003, enacted to override the Insurance Commissioner's new regulation restricting the use of persistency as an optional rating factor.

However, in *Foundation,* the court notes, “The voters further provided in section 1861.02, former subdivision (a)(4): "**The regulations shall set forth the respective weight to be given each factor in determining automobile rates and premiums. Notwithstanding any other provision of law, the use of any criterion without such approval shall constitute unfair discrimination**." It is not clear that the *Foundation* decision is on point relative to AB 2167 because it involved in an express delegation of regulatory authority for a specific purpose; in this case, there is no express grant of regulatory authority. Instead the code is silent on the Commissioner’s authority to promulgate regulations regarding reinsurance and CAT modeling for residential property and the commissioner must rely on implied authority.

Suggested Amendments

The Committee suggests the following amendments to:

- Clarify the commissioner’s authority to deny an IMAP filing for any lawful reason,
- Specify that decision is not subject to judicial review,
- Expand the scope of the mitigation collaboration effort,
- Clarify that a rate proposed as part of an IMAP filing is subject to the Proposition 103 statute, and
- Align inconsistent usage of “commissioner” and “department,” in favor specifying the commissioner retains powers and duties.

10109.1 (a) An IMAP filing submitted to the department by an insurer shall include all of the following:

(1) A request for adequate rates, as described in Section 10109.3.

(2) A plan for maintaining the insurer’s solvency as policy count grows in IMAP counties, taking into account, among other things, risks related to overconcentration in high-risk communities.

(3) Parcel-level and community-based mitigation and verification requirements, as described in Section 10109.2.

(4) A list of the areas within an IMAP eligible county in which the insurer proposes to issue residential property insurance pursuant to its IMAP filing, and a list of the areas

within that county in which the insurer shall not issue residential property insurance pursuant to its IMAP filing.

(b) (1) An insurer shall commit in the IMAP to offer new and renewal residential property insurance policies in a set of IMAP counties until the insurer achieves a market penetration rate in those IMAP counties that is no lower than 85 percent of its statewide market penetration rate. The IMAP commitment shall be calculated based on the insurer's residential property insurance policy count across the entire designated set of IMAP counties, but need not be met in each county individually.

(2) Notwithstanding paragraph (1), an insurer shall monitor and avoid overconcentration in any one particular area within an IMAP county or across a particular IMAP county in order to prevent a catastrophic loss that could impair its solvency.

(c) The commissioner may deny an IMAP filing for any lawful reason, including that the filing is not in the best interest of homeowners, and that decision shall not be subject to judicial review.

10109.2. (a) An IMAP filing shall set forth community and parcel-level mitigation standards, along with any necessary procedures for verifying mitigation activities, including any required governmental or third-party certifications.

(b) The commissioner may periodically connect IMAP eligible county representatives with representatives from IMAP participating insurers**, local government officials, Firewise USA coordinators,** and third-party fire protection or certification associations to promote collaboration between local governments and industry on local policies for IMAP filings made pursuant to this article.

10109.3. (a) A rate proposed as part of an IMAP filing shall not be excessive, inadequate, or unfairly discriminatory, and shall be actuarially sound so that premiums are adequate to cover expected losses, expenses, and taxes, and shall reflect investment income of the insurer.

(b) A rate requested as part of an IMAP filing shall be subject to the prior approval of the commissioner **and in accordance with Chapter 9 of Part 2 of Division 1 of the Insurance Code (Section 1861.01 et seq.).**

10109.4. A rate requested as part of an IMAP filing may be based on a complex catastrophe model, as follows:

(a) The complex catastrophe model shall be based on the best available scientific information for assessing the risk of catastrophic wildfire frequency, severity, and loss.

(b) The projected losses derived from the catastrophe model shall meet all applicable statutory standards.

(c) The complex catastrophe model shall consider both parcel-level mitigation and regional mitigation.

10109.5. (a) An insurer that submits an IMAP filing pursuant to this chapter shall receive an expedited review of its rate filing if either of the following conditions are met:

(1) The insurer uses an actuarial assumption for trend and loss development that is at the midpoint or less of rate impacts, and does not otherwise change any other aspect of its rate filing from its previous department approved rate.

(2) The insurer files for a rate increase based solely on increased reinsurance costs, subject to the requirements of Section 10109.6, and does not otherwise change any other aspect of its rate filing from its previous department approved rate.

(b) The time period for the expedited rate review shall not exceed 120 days, and the **~~department~~** **<u>commissioner or employee of the department</u>** shall not request that the insurer waive the 120-day requirement.

(c) If the **~~department~~** **<u>commissioner</u>** does not approve the filing within the 120 days, the IMAP filing is automatically withdrawn and the insurer may continue with its previously approved rate and the insurer retains the ability to select risks without meeting the requirements of subdivision (b) of Section 10109.1.

(d) Notwithstanding subdivision (c), if an insurer submits an IMAP filing to amend a rate level approved in a previous IMAP filing, and the **~~department~~** **<u>commissioner</u>** does not approve the filing within the 120 days, the insurer's IMAP commitments, including the commitment required by subdivision (b) of Section 10109.1, shall be suspended until the **~~department~~** **<u>commissioner</u>** and the insurer reach agreement on the filing.

Information Provided by the Senate Judiciary Committee:

This bill touches upon issues within the jurisdiction of the Senate Judiciary Committee. The Senate Judiciary Committee has been approached by opposition comprised of the Department of Insurance (DOI) and various consumer groups and organizations with serious concerns about the bill, including, among others, that it will harm California consumers by allowing large rate hikes, removes the prohibition on excessive rates remaining in effect as required by Proposition 103, violates Proposition 103 because it does not further its purposes, and takes away existing rights of interveners. Existing rate filings are governed by the provisions of Proposition 103 (Nov. 1988, gen. elec.) and the proposition only allows for amendments of its provisions with a two-thirds vote of the legislature and if the amendments further the purposes of the proposition. The court has held that a "valid amendment to Proposition 103 must not only further its purposes in general, but it cannot do violence to specific provisions of Proposition 103. So even if an amendment can be shown to further its purposes, it may nonetheless be invalid if it violates a specific primary mandate." (Foundation for Taxpayer & Consumer Rights v. Garamendi (2005) 132 Cal.App 4th 1354, at 1370.) The Legislature may wish to consider whether the bill's provisions violate Proposition 103 because they do not further its purposes and are therefore invalid.

Related/Prior Legislation

SB 292 (Rubio, 2020) and AB 2167 have contingent enactment language. The bill would require FAIR, on or before January 31 and July 31 of each year, to submit a report to the commissioner that lists certain counties, according to specified population thresholds, in which the number of new residential property insurance policies issued by the FAIR Plan during the prior 6 months equals a certain percentage of the number of single family residences in that county. The bill would require a county listed on the report to be designated by the department as an insurance market protection (IMAP) eligible county under the IMAP program.

AB 1816 (Daly) Chapter 833, Statutes of 2019, required insurers to provide a 75-day notice to policyholders when they nonrenew a homeowners policy and expands the areas that qualify for "write-out" credits against assessments issued by the California FAIR plan.

ARGUMENTS IN SUPPORT:

The FAIR Plan writes in support, "After reviewing AB 2167 and SB 292, we believe the Insurance Market Action Plan (IMAP) presents a reasonable and balanced approach to address California's wildfire issues. In particular, both bills attempt to address the core issues in the private market including availability of homeowners' insurance in high risk areas, use of catastrophe modeling for purposes of rate filing, inclusion of mitigation efforts, and data related to specified high-risk areas of the state."

In their support letter, the California Fire Safe Council (CFSC) argues in support of AB 2167 that wildfire risk management is a complicated process. CFSC argues that insurance rates need to be evaluated and managed in the context of a changing wildfire risk future; supports oversight details of wildfire risk, mitigations, and urge industry outreach to fire services and those coordinating community wildfire mitigation efforts and processes such as educational materials, home assessments, compliance inspections, community engagement and more.

The Personal Insurance Federation of California additionally writes in support, "The ability to manage risk is fundamental to the existence of insurance. Serving high fire-threat regions, as required by these bills, is not a commitment that insurers take lightly or easily. However, because these measures provide a comprehensive plan that will increase the availability of admitted market insurance in high fire-threat areas in a responsible manner, allow insurers to utilize modern risk analysis models, and facilitate the reduction of risk and loss through home hardening and community-wide wildfire mitigation, the undersigned trade associations support AB 2167 and SB 292."

ARGUMENTS IN OPPOSITION:

In opposition, CDI argues this bill creates a "fast track" around the Prop 103 approval process and circumvents the authority of the commissioner and existing regulations for catastrophic loss models and when determining whether reinsurance should be included as a factor in setting rates. Amendments offered by this committee intend to address these concerns by clarifying that the rate filing must be subject to the Prop 103 Statute, and that the Insurance Commissioner may deny the IMAP for any lawful reason. The commissioner may always choose to promulgate new regulations on reinsurance and loss projection if they decide to entertain IMAP filings.

SUPPORT:
American Property Casualty Insurance Association
CAL FIRE Local 2881
California FAIR Plan
California Fire Safe Council
National Association of Mutual Insurance Companies
Pacific Association of Domestic Insurance Companies
Personal Insurance Federation of California

OPPOSITION:
California Department of Insurance
City of Carpinteria
City of Rancho Palos Verdes
Consumer Attorneys of California
Consumer Federation of America
Consumer Federation of California
Consumers for Auto Reliability and Safety
Consumer Watchdog
Public Advocates
San Bernardino County Supervisor
United Policyholders

-- END --