

# Trends and Insights: California's Risk Crisis

Even as California takes steps to address regulatory obstacles to fair, actuarially sound insurance underwriting and pricing, the state's risk profile continues to evolve in ways that underscore the importance of [risk-based insurance pricing](#) and investment in mitigation and resilience.

As is happening elsewhere in the United States, [homeowners insurance rates](#) in California have been rising. Some of this is due to [replacement costs](#) that skyrocketed during the pandemic and Russia's invasion of Ukraine. Some is due to wildfires and construction trends in the wildland-urban interface (WUI), which put increased amounts of property at risk. [According to Cal Fire](#), five of the largest wildfires in the state's history have occurred since 2017.

Much of California's problem, however, is related to a 1988 measure – [Proposition 103](#) – that constrains insurers' ability to profitably insure property in the state.

## Underwriting profits can't keep up with losses

Insurers' underwriting profitability is measured using a "combined ratio" that represents the difference between claims and expenses insurers pay and the premiums they collect. A ratio below 100 represents an underwriting profit, and one above 100 represents a loss. As the chart at the right shows, insurers have earned healthy underwriting profits on their homeowners business in all but two of the 10 years between 2013 and 2022.

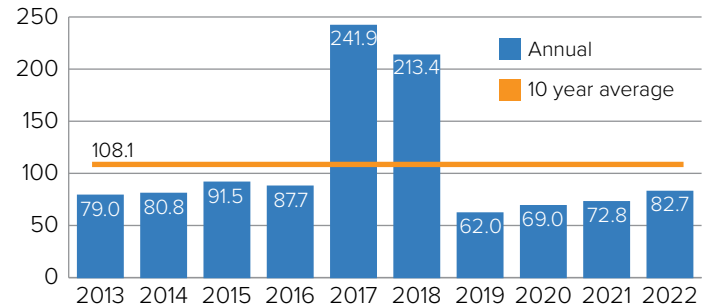
However, the claims and expenses paid in 2017 and 2018 – due largely to wildfire-related losses – were so extreme that the average combined ratio for the period was 108.1.

Underwriting profitability matters because that is where the money comes from to maintain "[policyholder surplus](#)" – the funds insurers set aside to ensure that they can pay future claims. Integral to maintaining policyholder surplus is risk-based pricing, which means aligning underwriting and pricing with the cost of the risk.

Unlike in most other states, insurers in California have not been allowed to price catastrophe risk prospectively. Instead of letting insurers use the most current data and advanced modeling technologies to inform their pricing, Proposition 103 – in a dynamically evolving risk environment – has required them to price coverage based on historical data alone.

Proposition 103 also has restricted accurate underwriting and pricing by not allowing insurers to incorporate the cost of reinsurance into their pricing. Insurers use reinsurance to maximize their capacity to write coverage, and reinsurance rates have been rising for many of the same reasons as primary insurance rates. If insurers can't reflect reinsurance costs in their pricing – particularly

## California Homeowners Insurance Combined Ratio



Source: Best's Market Share Reports, Homeowners Multi-peril

in catastrophe-prone areas – they must pay for these costs from policyholder surplus, reduce their market share in the state, or do both.

Proposition 103 also has impeded premium rate changes by allowing consumer advocacy groups to intervene in the rate-approval process. This makes it hard for insurers to respond quickly to changing market conditions, resulting in delays in approvals and rates that don't accurately reflect current (let alone future) risk. It also drives up legal and administrative costs.

It's not only homeowners who are experiencing higher insurance rates. [Automobile insurance rates](#) also have been rising in many states. But, once again, Proposition 103 is making California drivers' problems worse than they need to be by restricting the use of certain actuarially sound rating factors that insurers consider when determining individual drivers' rates.

## Moves in the right direction

The state's evolving risk profile, combined with the underwriting and pricing constraints imposed by Proposition 103, has led to rising premium rates and, in some cases, insurers deciding to limit or reduce their business in the state. With fewer private insurance options available, more Californians are resorting to the state's [FAIR Plan](#), which offers less coverage for a higher premium. This isn't a tenable situation.

"Put simply, increasing the number of policyholders in the FAIR Plan threatens the solvency of insurance companies in the voluntary market," [California Insurance Commissioner Ricardo Lara explained](#) to the State Assembly Committee on Insurance. "If the FAIR Plan experiences a massive loss and cannot pay its claims, by law, insurance companies are on the hook for the unpaid FAIR Plan losses."

In September 2023, Lara announced a [Sustainable Insurance Strategy](#) for the state that includes allowing insurers to use

forward-looking risk models that prioritize wildfire safety and mitigation and include reinsurance costs into their premium pricing. In exchange, insurers must cover homeowners in wildfire-prone parts of the state at 85 percent of their statewide coverage.

## Wildfire and more

California historically has accounted for about 10.5 percent of U.S. acres burned, according to the National Interagency Fire Center (NIFC). That amount has grown to approach 40 percent in recent fire seasons, but in 2022 California represented 4.5 percent of acres burned – an all-time low.

These numbers don't tell the whole story. The chart below illustrates a divergence of wildfire experience between northern and southern California. Since 2012, about 224 acres on average burned per fire in northern California, which has increased to an average of 353 acres per fire since 2017. Damage from southern California wildfires, by contrast, has remained relatively flat over the 10 years.

This divergence may reflect the fact that northern California has more development in the WUI than the southern part of the state. WUI fires tend to ignite naturally and burn longer and more extensively. The more densely populated southern area likely experiences fewer fires of this type and more that are human caused. These don't tend to burn as long or as far and are becoming fewer in number.

But wildfires aren't the only climate-related peril California faces. The state has experienced devastating floods in recent years due to [atmospheric rivers](#) that bring large amounts of rain in from the tropics. Standard homeowners policies don't cover loss from flood damage. Most flood insurance is made available through FEMA's [National Flood Insurance Program](#) (NFIP) – though the number of private insurers writing flood coverage is [growing](#). But in California – where drought, not flooding, had been the more common problem until recently – homeowners are often ill prepared for this peril. In many California counties, [NFIP insurance purchase rates](#) are below 2 percent.

And then there are [earthquakes](#). Six of the 10 costliest earthquakes in U.S. history have occurred in California. Standard homeowners, renters, and business policies do not cover earthquake damage. Coverage is available either as an endorsement or as a separate policy. In California, homeowners can also get coverage from the California Earthquake Authority (CEA), a privately funded, publicly managed organization.

[According to Shawna Ackerman](#), CEA's chief risk and actuarial officer, the "take-up rate" on earthquake insurance has hovered between 10 percent to 15 percent from 2002-2022, after peaking above 30 percent following the Northridge earthquake in 1994. The CEA's "[Brace and Bolt](#)" grant program offers qualified policyholders up to \$3,000 to complete a code-compliant retrofit of their home. As part of the program, policyholders may also qualify for up to a 25 percent discount on their CEA earthquake insurance premium once their retrofit is complete.

## Risk transfer is not enough

Traditional risk-transfer mechanisms are not sufficient to address the looming risk crisis. Insurers are working with communities and commercial partners to encourage investment in disaster mitigation and resilience – efforts that are demonstrating varying degrees of success at improving insurance availability and affordability.

Unfortunately, too often, the public discourse frames the risk crisis as an "[insurance crisis](#)" – conflating cause with effect. Legislators, spurred by calls from their constituents for lower insurance premiums, often propose measures that would tend to worsen the problem because these proposals generally fail to reflect the importance of accurately valuing risk when pricing coverage. California's Proposition 103 and the federal flood insurance program prior to its [Risk Rating 2.0](#) reforms are just two examples.

Issues around property insurance affordability were a long time in the making, and they won't be resolved overnight. Any sustainable solution will have to rest on actuarially sound underwriting and pricing principles.

California Acres Burned Per Fire

