Trends and Insights:
Proposition 103 and California's Risk Crisis

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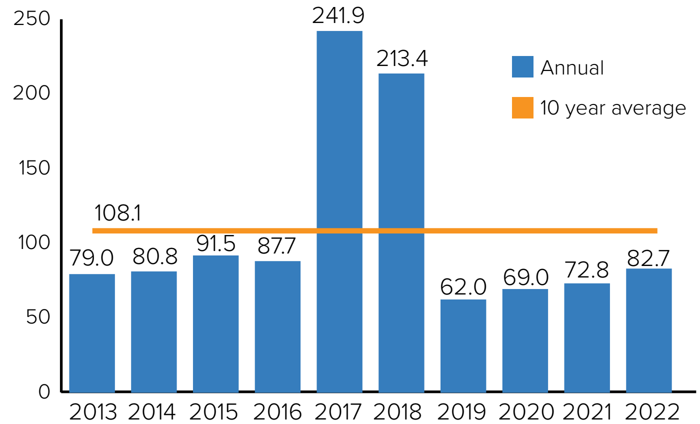
As is happening elsewhere in the United States, homeowners insurance rates in California have been rising. Some of this is due to replacement costs that skyrocketed during the pandemic and Russia's invasion of Ukraine. Some of it is due to wildfires and construction trends in the wildland-urban interface, which put increased amounts of expensive 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 severely constrains insurers' ability to profitably insure property in the state.

California Homeowners Insurance Combined Ratio



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

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 being covered. Insurers hire teams of actuaries and data scientists to make sure pricing is tightly aligned with risk, and state regulators and lawmakers closely scrutinize insurers to make sure pricing is fair to policyholders.

Prop 103 impedes risk-based pricing

To accurately underwrite and price coverage, insurers must be able to set premium rates prospectively. As shown above, one or two years that include major catastrophes can wipe out several years of underwriting profits – thereby contributing to the depletion of policyholder surplus if rates are not raised.

This is where Proposition 103 comes into play. Unlike in most other states, insurers in California are not allowed to price catastrophe risk prospectively. Instead of letting insurers use the most current data and advanced modeling technologies to inform their pricing, this three-decades-old measure – in a dynamically evolving risk environment – requires them to price coverage based on historical data alone.

"We do it in a very old-fashioned way, and it needs to be updated," said Rex Frazier, president of the Personal Insurance Federation of California. "If a company is trying to figure out how much it should charge for earthquake coverage, it would look at proximity to fault lines – but for wildfire insurance the state just says, 'Well, looking backward, what have you paid over the last 20 years for wildfire clients?'"

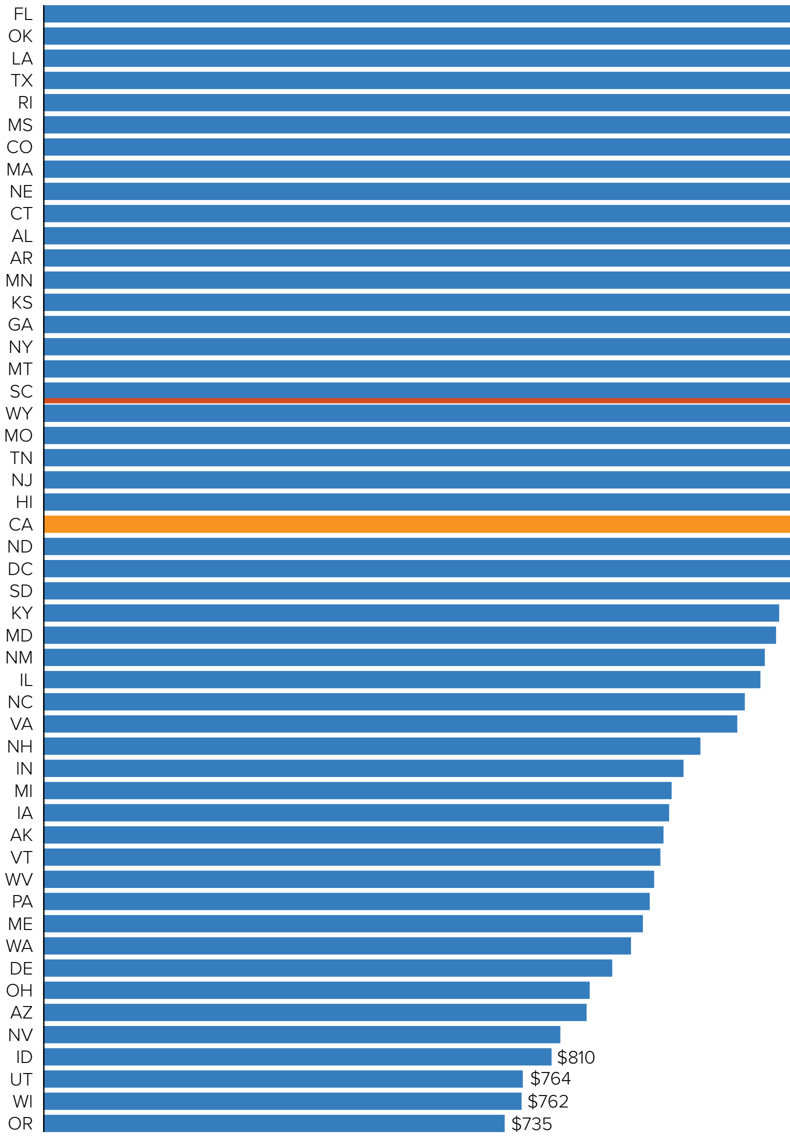
Another way in which Proposition 103 restricts accurate underwriting and pricing is by not allowing insurers to incorporate the cost of reinsurance into their pricing. Reinsurance is another tool insurers use to maximize their capacity to write coverage, and rates have been rising for many of the same reasons as primary insurance rates. If insurers can't use reinsurance costs in their pricing – particularly in catastrophe-prone areas – they must pay for these costs from policyholder surplus, reduce their market share, or do both.

Premiums below the national average

As shown in the charts on the next page, home insurance premiums in California are less expensive than the national median – and much lower than in other disaster-prone states like Florida and Louisiana – despite the fact that California has some of the most expensively built housing in the country.

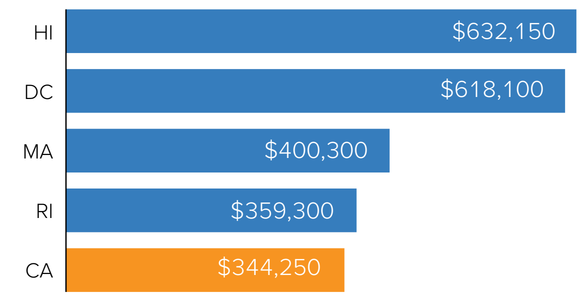
This is a large and potentially profitable market in which insurers want to do business. To make that possible in light of ongoing wildfire trends – as well as events like early 2023's anomalous

Average Homeowners Insurance Premium by State*



*National Association of Insurance Commissioners, 2020

Median Home Value (Top 5 States)**



**U.S. Census Bureau, American Communities Survey, 2020

rains and, more recently, Hurricane Hilary – the state needs to continue making investments that reduce risk. It also needs to update its regulatory regime to allow accurate, prospective pricing.

It's not only homeowners who are experiencing higher insurance rates. Automobile insurance rates 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.

Factors driving rates up nationally include:

- Rising insurer losses due to increasing accident severity;
- More fatalities and injuries on the road, contributing to increased attorney involvement in claims; and
- Rising replacement-parts and labor costs.

On top of these issues, Proposition 103 requires insurers to obtain approval from the state insurance department before changing rates. This makes it hard for insurers to respond quickly to changing market conditions, resulting in rates that don't accurately reflect current risk.

Further, the proposition allows consumer advocacy groups to intervene in rate-setting proceedings, which drives up legal and administrative costs for insurers.

With fewer private insurance options available, more Californians are resorting to the state's FAIR plan, which offers less coverage for a higher premium. In late September 2023, California Insurance Commissioner Ricardo Lara announced a package of executive actions aimed at addressing some of the challenges included in Proposition 103. Lara said he has given the department a deadline of December 2024 to have the new rules completed.