1050 17th Street, N.W.
Suite 1150
Washington, DC 20036
202.525.5717

Free Markets. Real Solutions.
www.rstreet.org

Assemblyman Tom Daly **April 8, 2015**
Chair, Assembly Insurance Committee
California State Assembly

Re. A.J.R. 6 (Cooley) - California Earthquake Authority: Post-earthquake financing

Chairman Daly, ladies and gentlemen of the committee, my name is Ian Adams and I am the Western region director of the R Street Institute. R Street is a non-profit, free-market think tank based in Washington that maintains the largest insurance-focused project of any non-industry think tank. In California, our focus has been in the area of property insurance reform, with an eye toward the California Earthquake Authority, in particular.

Nowhere is the risk of a major earthquake greater, in terms of a population's exposure to high-intensity and severity events, than in California. In March 2015, the U.S. Geological Survey released its Third Uniform Earthquake Rupture Forecast. The study revised upward the odds of an 8.0 magnitude event occurring in California within the next 30 years from 4.7 percent to 7 percent. Less profound, though severely damaging, earthquakes are a virtual certainty.

AJR 6 neatly encapsulates both the history of California's seismic responses, as well as a call for reform to make the state's earthquake insurance system work better for residents. Indeed, the earthquake insurance take-up rate in California is too low, around 10 percent, and the CEA's structure is something of an impediment to broader coverage penetration. Still, while AJR 6 correctly identifies the problems associated with a low take-up rate, it recommends a number of problematic solutions.

The resolution calls for a federal back-stop, in the form of debt guarantees, to furnish the state with post-event funds in the event of a major earthquake. In turn, the thought is that the CEA would be able to reduce its premiums because it would not need to purchase as much reinsurance. Lower premiums would then lead more residents to purchase earthquake insurance.

Such an approach is problematic for three reasons:

First, consider that insurance is a system to offset prospective large costs in the future by substituting smaller, known costs in the present. By displacing the burden of paying for catastrophe coverage to a post-event period, there is a temptation, which has been realized elsewhere, to underprice risk. Subsidizing earthquake risk by incurring debt after an event potentially places uninvolved and likely more prudent residents on the hook for those most vulnerable and least responsive to the risk.

Second, in the case of bonds, a post-event subsidy burdens future generations for the incurred expenses of present-day losses. In Florida's case, after a series of major hurricanes in 2004 and 2005, residents faced more than a decade of taxes and assessments which, in turn, created a drag on the state's economic recovery.

Third, the supposition that private capital would flock to federal bonds in a sufficiently timely fashion to furnish effective recovery is speculative, at best. Bonds must be drafted, marketed and sold, which will slow CEA's ability to pay claims. Further, bonds must be repaid with interest. There is a qualitative difference between recoveries financed by private funds, as compared with those financed by public funds. Reinsurance pays quickly, jump starts reconstruction, provides an economic stimulus and does not need to be repaid.

Given that the state is characterized as "overdue" for an earthquake, is now the time to shift to post-event debt and repayment obligations? How many more years must the state avoid a devastating earthquake to save enough to justify shifting the risks to taxpayers? Ultimately, that is exactly what AJR 6 embraces – a cost-shifting mechanism to transfer risk from private parties to taxpayers. Lower upfront premiums will lead invariably to taxes and assessments on all Californians.

Thus, while AJR 6 is correct that something must be done to make earthquake insurance affordable to Californians, its recommendations would fundamentally recast the state's response for the worse. California would be better served in the near term by correcting the CEA's backward assessment structure; proving stronger incentivizes for seismic-mitigation efforts; and expanding the number and type of earthquake policies available through the CEA. In the long-term, the state should seek to make earthquake insurance a condition of securing a mortgage, as is currently the case with flood insurance in high-risk flood areas. All of these recommendations would lower earthquake insurance premiums.

For a full discussion of these and other solutions to the state's earthquake vulnerability, please consult our white paper "Insuring a way out: Modernizing the California Earthquake Authority."

Thank you for your consideration. I am happy to field any questions that the committee has.

Ian Adams
Western Region Director
R Street Institute

Cc: Assemblywoman Beth Gaines, Vice Chair
Assemblyman Ken Cooley, Author
Paul Riches, Consultant, Assembly Insurance Committee
Bill Lewis, Consultant, Assembly Republican Office of Policy