January 21, 2021

The Honorable Ricardo Lara
Insurance Commissioner
State of California
300 Capital Mall, Suite 1700
Sacramento, CA 95814

Re: Investigation of Homeowners' Insurance Availability and Affordability (REG-2020-00016)

Dear Commissioner Lara:

I write on behalf of Consumer Watchdog[1] to follow up on our remarks at the October 19, 2020 Investigatory Hearing on Homeowners' Insurance Availability and Affordability and the issues discussed at the virtual hearing on Home Hardening Standards and Wildfire Catastrophe Modeling in Ratemaking that you convened on December 10, 2020, at which Consumer Watchdog's actuary and expert, Allan I. Schwartz, testified. Accompanying this letter is written testimony by Mr. Schwartz in connection with the latter hearing.

As Californians reckon with the threat of wildfire and its impact on our safety and the Golden State's economy, it's important to correctly contextualize the issues under discussion in these hearings. We in California (and for that matter across the nation) are paying the price *now* for decades of inexcusable inaction on climate change by federal and state governments and the private sector, particularly the insurance industry.

However, the crisis that this proceeding is seeking to address is an *economic crisis caused by insurance companies*. They are exploiting, for their own financial advantage, the wildfires that have swept neighborhoods and towns across the state. Even as Californians' homes burned down and unpaid claims pile up, insurance companies have been denying many homeowners insurance coverage while at the same time demanding that the rest of the state pay excessive and unjustified premiums.

The insurance industry's wildfire strategy is simple: maximize its profits and minimize its responsibility and accountability to the people of California.

This is what the insurance industry has always done after any disaster. And it's why, after the insurance industry destabilized California's economy in the 1980s, jacking up rates and redlining communities, California voters took matters into their own hands and passed Proposition 103 on

[1] Consumer Watchdog is a nonprofit, non-partisan organization founded in 1985; its advocates and attorneys have defended and enforced Proposition 103 for more than three decades.

November 8, 1988. Prop 103 gives you the powerful tools you need as Commissioner to address, in a scientific and objective manner, the most critical problems in the insurance marketplace today.

I. Proposals to Address the Crisis in California's Insurance Marketplace

You've asked participants in the two virtual hearings to suggest possible solutions to the "insurance crisis." Consumer Watchdog offers the following recommendations.

1. <u>Require all insurance companies to provide premium discounts to policyholders who "harden" their homes against wildfire</u>. Consumer Watchdog strongly supports requiring insurance companies to lower the insurance premiums of policyholders who undertake safety measures to protect their homes against wildfire, such as modernizing roofing and building materials, installing sprinklers, and clearing brush. Loss mitigation works. For example: 58 percent of the new homes in Paradise, built to meet new fire-resistant building codes, survived the Camp Fire, while just nine percent of older homes did. ("Grim Lessons Learned and Warnings from California Fire Stories," Government Technology, September 18, 2019.)

As Mr. Schwartz emphasizes in his testimony, there are "loss mitigation" discounts for safe driving, workers' compensation, coverage for theft of property, and losses from storm damage. Similar discounts would incentivize homeowners to make their homes and property safer. Voluntary "Firewise" programs in California and throughout the United States have developed community-based programs that have substantially reduced wildfire risk.

Yet today in California, insurance companies are not *required* to reward homeowners who undertake wildfire safety improvements—sometimes costing thousands of dollars—with a discount on their premiums. As a result, very few companies do so and homeowners are not incentivized to spend money on costly mitigation efforts. These insurance companies are treating such conscientious homeowners as if they pose the same risk as property owners who have done nothing to limit the risk. An insurance company's failure to discount premiums for less risky properties penalizes those homeowners and forces them to subsidize homeowners who have not taken similar measure to mitigate potential wildfire losses.

The failure to differentiate between policyholders who have hardened their homes against wildfire and those who have not done so results in "unfairly discriminatory" rates under Proposition 103. (Ins. Code § 1861.05(a).)

<u>We urge the Department to initiate a rulemaking proceeding under Proposition 103 to (1) establish uniform science-based protocols and practices that homeowners can undertake to reduce the risk and limit the impact of wildfire damage to their properties, and (2) require all insurance companies to provide such discounts to homeowners who implement the protocols and practices.</u>

These actions are well within the power the voters accorded the Insurance Commissioner to regulate rates and premiums to prevent such "unfair discrimination."

2. Investigate and punish the insurance companies that arbitrarily refuse to sell or renew insurance coverage to certain people. Californians need homeowners coverage to protect their most important asset: their homes. People who can't buy insurance are exposed to the danger of a devastating wildfire loss. And those who have a mortgage face the loss of their homes if they cannot show they are insured.

Insurance companies are selectively and arbitrarily non-renewing homeowner policies—while continuing to insure their favored customers (those who, for example, buy auto, life, or other insurance). Reviewing State Farm's underwriting guidelines, Consumer Watchdog found that the company gives preferential treatment to existing homeowners who are already insured with State Farm while refusing to sell to new customers who have similar loss histories. We have learned that some insurance companies refuse to renew existing policies in neighborhoods hit by wildfire, only to begin selling policies to new customers a few months later.

Another example of an arbitrary approach to underwriting is Pacific Specialty's underwriting rule that treats as an "unacceptable risk" "[p]roperties located in a neighborhood not showing pride of ownership." What could be more subjective, unrelated to risk of loss, and evidence of unfair discrimination against communities with limited resources than a decision to deny coverage based on "neighborhood pride"?

We are all familiar with the redlining and territorial rating that disproportionately penalized those on limited incomes and people of color prior to the passage of Proposition 103. The insurance industry's economic boycott of certain neighborhoods is a form of discrimination and redlining. It is doing significant damage to the insurance marketplace and California's economy.

The Department is currently monitoring access to homeowners insurance throughout California and has been vigorous in enforcing laws that prohibit arbitrary cancellations and non-renewals. Consumer Watchdog urges the Department to (1) require insurance companies to file public reports on their underwriting and renewal practices by zip code on a monthly basis; (2) open an investigation into whether insurance companies are discriminating against certain neighborhoods through selective and arbitrary non-renewals and withdrawals from the sale of policies, in violation of Proposition 103; (3) initiate non-compliance prosecutions against insurance companies that appear to be engaged in discriminatory practices; and (4) if the Department obtains evidence that suggests that one or more insurance companies, or insurance industry lobbying organizations, are collaborating with each other in a boycott of certain neighborhoods in California, seek a criminal investigation by the California Attorney General under the state's antitrust laws.

3. Monitor and address claims handling abuses by insurance companies. Unfortunately, what happens after a wildfire or other natural disaster—when policyholders file an insurance claim—can be as traumatic as the event itself. An insurance company's failure to pay a homeowner's insurance claim promptly and fully is unlawful and a gross betrayal of the core purpose for which people buy insurance. Complaints about insurance company mishandling of claims are legion, often leading to time-consuming litigation. Many policyholders who experienced losses in last year's wildfires have yet to receive all the coverage they paid for.

Consumer Watchdog urges the Department to institute emergency reporting requirements that will permit it and the public to assess the insurance companies' compliance with California's claims handling laws. The Department should mandate *monthly public disclosure* by each insurance company of (1) the number and dollar amount of claims received, post-disaster claims handling, including the number and amount of claims received versus paid, and claims processing, duration of claim, and resolution/payment statistics; (2) the number of claim adjusters deployed by each company, and the number of those who have been brought to California from other states; and (3) the number of outstanding claims handling complaints against each insurance company, by category of complaint. The required data should be broken down geographically. In addition, the Department should (4) publish a list of all ongoing enforcement actions against insurance companies related to property losses; and (5) prompt publication of Market Conduct Examinations.

The insurance industry's use of claims handling software is the source of many claims handling complaints. Virtually every insurance company doing business in California uses third-party claims software to determine how much to pay a policyholder who has filed a claim for a wildfire loss. However, such software often fails to account for the actual rebuilding and construction costs in local markets throughout California. For example, customers have accused insurance companies of employing software that uses a nationwide average for the cost of rebuilding, which undervalues more expensive California repair and reconstruction costs. As a result, insurance companies are not honoring their coverage and Californians are left without the funds they are entitled to and cannot rebuild their homes. The Department should (1) open up an investigation into insurance companies' reliance on software to calculate claims payments; determine whether insurance companies that utilize this software are violating state law; and the Department should promulgate regulations governing the use of software that processes claims.

4. Limit the use of complex catastrophe models and require full compliance with Proposition 103. The insurance industry claims it cannot rely on traditional actuarial methods to project the future risk of wildfire losses in California, and so it wants to use software "models" to estimate such losses. Currently, the Proposition 103 ratemaking formula only allows models that meet certain regulatory standards to be used for earthquake losses for the earthquake line and fire following earthquake losses for the homeowners line. (10 CCR § 2644.4(e).)

Unlike the traditional method of projecting risk and loss—the use of objective historical data—loss projection models are based on algorithms—formulas, programmed by software engineers, that attempt to predict behavior or events by processing quantities of data. The rates projected by models reflect the data inputted and the assumptions programmed into the formula.

In written testimony submitted today in connection with the December 10, 2020 workshop, nationally recognized actuary Allan I. Schwartz noted that multiple models used by insurance companies in several recent rate applications arrived at greatly conflicting predictions of losses. (Testimony of Allan I. Schwartz, January 21. 2021, p. 13.)

Permitting insurance companies to purchase the models of outside vendors poses an insoluble conflict of interest since the insurance company has a financial incentive to inflate projected losses. Like claims handling software that is easily programmed to underestimate property values and lowball claims payments, the objectivity and legitimacy of rate models require independent verification.

Indeed, insurance companies doing business in California want to use models in order to evade the public disclosure requirements of Proposition 103. The companies want to outsource their loss projections to private modelling firms, which claim that their products are proprietary and must be considered “trade secrets.” As was clear from the presentations at the December 10 virtual hearing, the modelling firms have no intention of complying with Proposition 103’s requirement that all elements of a proposed rate be publicly disclosed and fully justified. There is, however, no exception to Proposition 103’s transparency requirements, as numerous courts have confirmed. The insurers’ attempts to evade rate accountability under Proposition 103 by hiding behind “models” must be rejected.

California law presently does not allow models to substitute for empirical, actuarially based statistical methods of projecting losses for determining overall rates, except for earthquake losses and for “fire following earthquake” losses (10 CCR § 2644.4, 2644.5). However, the Department’s regulations do not prohibit insurance companies from utilizing models for the purpose of determining a person’s eligibility to buy insurance and the amount premium policyholders pay, based on risk assessments of their property (so-called “fireline scores”). Of course, these models are subject to Proposition 103’s disclosure requirement.

As Mr. Schwartz notes in his testimony, the Actuarial Standards of Practice contemplate the use of models when historical data is shown to be insufficient and then only after the model has been vetted by a regulator—here, the Insurance Commissioner—and subject to the requirements set forth in state law—here, Proposition 103.

Consumer Watchdog believes that there is sufficient historical data to support projection of wildfire losses. For the reasons described above, we are deeply concerned by the insurance companies’ use of models to decide who is allowed to buy homeowners coverage, and at what price. Were the Department to find, after a full public investigation, that historical data is inadequate to predict wildfire losses, the Department could consider, through a rulemaking process, whether models would be appropriate generally, and whether a public model, created under the aegis of the Department, would be the most effective way to protect California consumers. Whether public or private, any model or other technology that is used to set insurance rates, premiums or eligibility must be fully transparent and disclosed to the public under the prior approval process established by Proposition 103.

5. Force insurance companies to address climate change. That extreme weather events are driving the increasing number and severity of insurance claims is beyond scientific dispute. No sector of American business had a better reason to anticipate and address climate change than the insurance industry. Unfortunately, focused solely on short-term profits and operating under a "cost plus passthrough" mentality, the insurance industry has only exacerbated the massive risks posed by an overheated planet.

Just as California has led the nation in its reform of insurance laws, you should use the expansive statutory power the voters enacted to (1) require insurance companies to disclose the fossil-fuel related companies they invest in and underwrite, and (2) issue regulations requiring insurance companies to include all direct *and indirect public* costs of risks involving fossil fuels when pricing insurance coverage.

II. The Industry Companies Want to Repeal the Voter-Enacted Protections Against the Crisis They Have Created.

The insurance industry manufactured two insurance crises during the 1970s and 1980s, imposing unexplained, massive increases on the price of home, auto, and business insurance, and withdrawing from the insurance markets. Much later, it was determined by public and private studies that there was no underlying justification for the rate increases and withdrawals. But the insurance industry effectively concealed the truth about those crises from the public and their representatives in government. Proposition 103 was enacted in response to those destabilizing events.

Today, insurance companies are presenting themselves as the victims of the wildfires: they complain that they are suffering staggering losses that they could never have anticipated and are unable to get approval for the rate increases they require. According to the industry, the consumer protections of Proposition 103 are what have caused the crisis!

Fortunately, your agency and the public are no longer at the mercy of an unaccountable industry. One of the transcendent reforms of Proposition 103 is its mandate to place the debate over insurance issues before a neutral, fact-driven forum under the aegis of the Insurance Commissioner, open to the participation of the public and its representatives. The wisdom of this approach is borne out by this proceeding, which has allowed the Department and members of the public to address the wildfire insurance crisis, including the insurance industry's contentions.

The Department and consumer groups have marshalled objective data to dispel the myths that the insurance industry has advanced as its solution to the crisis it has created in California.

First, the insurance companies aren't broke. Loss ratio data published by the Department shows that insurance companies doing business in California paid out on average only $0.62 in claims for every $1 they took in between 2000 and 2019. The insurance companies' public statements also fail to reflect the over $11 *billion* in wildfire-related claims reimbursements they were entitled to. (Some insurance companies did not want to wait for their full payback and sold off their subrogation rights to these reimbursements to Wall Street investment firms. They accepted less money than they were ultimately entitled to get, but the insurers are responsible for that decision, not consumers.)

Second, insurance companies have gotten every justified increase they have requested under Proposition 103, according to data from the Department of Insurance. Proposition 103 requires insurance companies doing business in California to justify their need for rate changes; an insurance company must obtain the Insurance Commissioner's approval before it can raise insurance rates. The law requires the Commissioner to protect the solvency of the insurance companies but also bars price gouging. This process has saved California motorists over $153 billion on their auto insurance alone since 1989, according to the Consumer Federation of America.

Delays in approval of insurance companies' rate increase requests aren't the fault of Prop 103. Consumer Watchdog monitors rate applications and challenges applications for rate changes we think are unjustified. When there's a delay in approving an application, it's because an insurance company refuses to comply with the requirements of the law and disclose the data needed to determine whether they truly need the increase.

Commissioner, at the October workshop, you called upon insurance companies to roll up their sleeves. Consumer Watchdog calls on the industry to drop its relentless assault on California voters and consumers and the state's consumer protection laws, which companies like State Farm and Mercury are continuously attempting to undermine in the courts and the legislature.

It's long past time for the insurance to industry redefine its mission and redeploy its lobbyists. Instead of attempting to maximize its profits at the expense of the people and businesses of the State of California, it should turn its expertise to public safety and reversing climate change.

It's not too late for the insurance industry to become part of the solution rather than the problem itself.

Thank you for considering our views.

Sincerely,

Harvey Rosenfield	Carmen Balber	Pamela Pressley
Counsel	Executive Director	Senior Staff Attorney