Testimony

Insurance for Wildfire Risk in California

Lloyd Dixon

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Testimony presented before a joint meeting of the California State Assembly and California State Senate Committees on Insurance on October 30, 2018.
Chairman Glazer, Chairman Daley, and members of the Senate and Assembly Committees on Insurance, thank you for the opportunity to speak today. My name is Lloyd Dixon, and I am Director of the Center for Catastrophic Risk Management and Compensation at the RAND Corporation. RAND is a nonprofit, nonpartisan research organization headquartered in Santa Monica.

Today, I will discuss some of the findings from our recently completed study on the impact of wildfire risk on California’s residential insurance market. The study is part of California’s Fourth Climate Change Assessment and was funded by the California Natural Resources Agency.

We looked at two different study areas in the state—one in the Sierra Foothills east of Sacramento (the Sierra Foothills Study Area) and one in the western portion of San Bernardino County (the San Bernardino Study Area). In each, we compared insurance market outcomes in ZIP codes that have high wildfire risk with outcomes in ZIP codes that have low wildfire risk.

Findings on the Cost of Coverage for Homeowners Policies

As expected, the rate per $1,000 of coverage is substantially higher in the high-risk ZIP codes, and premiums have been growing faster over the past ten years in the high-risk areas. In particular,
• Rates per $1,000 of coverage in the Sierra Foothills Study Area are about 50 percent higher in high-risk ZIP codes than in the low-risk ZIP codes. Rates per $1,000 of coverage in the San Bernardino Study Area are about one-third higher in the high-risk ZIP codes than in the low-risk ZIP codes.

• Between 2007 and 2014, rates per $1,000 of coverage in the high-risk ZIP codes of both study areas increased about 15 percent.

• In contrast, rates per $1,000 of coverage fell about 12 percent in low risk-ZIP codes over the same period.4

In spite of the growing difference between rates in high-risk and rates in low-risk areas, several insurers interviewed during the study believe that the differential does not fully reflect the actual difference in wildfire risk between high- and low-risk areas. The California Department of Insurance notes that it has approved substantial rate increases for high-risk areas in recent years but holds that insurers have not provided sufficient evidence to justify all requested rate differentials between high- and low-risk properties.5

Findings on the Adequacy of Coverage

We also found that policyholders in high-risk areas tend to buy less coverage relative to the value of the structure than those in low-risk areas. Specifically,

• The ratio of coverage to insurable value approaches 100 percent in low-risk ZIP codes (and this does not include the extended coverage included in many policies).

• The coverage-to-value ratio is about 10 percentage points lower in the high-risk areas.6

The percentage of wildfire claims that pay at the policy limit provides another perspective on the extent to which homeowners are buying adequate coverage. Across the insurers providing data for the study, approximately 6 percent of wildfire claims paid at the policy limit, including extended coverage.7

We also found that policyholders tend to select higher deductibles in high-risk areas than in low-risk areas; however, the differences are not great.8

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4 Dixon, Tsang, and Fitts, 2018, p. 47. The rates are for policies written in the admitted market on homeowners forms.

5 We have not been able to investigate the extent to which existing rate differentials fully reflect differences in the actual rate.

6 Dixon, Tsang, and Fitts, 2018, p. 49. The amount of coverage is the sum of the policy limits for Coverage A (dwelling) and Coverage B (other structures) for homeowners policies written for single-unit residential structures in the ZIP code. Insurable value estimates the replacement cost of the single-unit structures in the ZIP code. When a policy has extended coverage, the insurer will pay up to a multiple of the coverage limit to repair or replace the structure. The multiples vary by insurer and state. Typical multiples in California are 1.25 and 1.5, and some insurers will pay up to twice the coverage limit. Many insurers provide this extended coverage at no additional charge; others provide it at an additional charge.

7 Dixon, Tsang, and Fitts, 2018, p. 49. The percentage would be higher if the calculation were restricted to cases in which the structure was completely destroyed by wildfire.

8 Dixon, Tsang, and Fitts, 2018, p. 50. The average deductible ranges from $1,000 to $2,000 in the ZIP codes examined.
The potential reasons that policyholders might not have adequate funds to rebuild after a wildfire include the following:

- Insurers might rely on policyholders’ estimates of replacement costs, which might be low either because the policyholder is trying to keep premiums low or because the policyholder has incomplete information on replacement costs.
- Some homeowners might have built additions or remodeled without informing the insurer.
- The costs of materials and labor might rise after a large event because of a surge in demand.
- The limit on coverage on debris removal is typically 5 percent of the policy limit; however, this can be inadequate for wildfire damage because fire debris is considered hazardous waste in California, with often-high disposal costs.
- Even if the insurer relies on its own valuation estimates, it might fail to update them on a timely basis.

One insurer observed that, when there are problems with coverage limits, it is often for the coverage of nonprimary structures (such as barns), and these problems are more common in rural areas.

**Observations**

Rates that reflect actual risk have several advantages, even if that means high rates in high-risk areas. Such risk-based rates

- create incentives to avoid building in high-risk areas
- can encourage mitigation through premium deductions for risk-mitigation measures
- avoid cross subsidies from low- to high-risk areas, which one might argue are unfair to households in low-risk areas.

High rates could create affordability problems for some households. Rather than providing broad cross-subsidies to reduce rates, however, policymakers might consider targeted affordability programs—such as those under consideration in the National Flood Insurance Program. These programs aim to provide assistance to families with low income and net worth.

Higher premiums in high-risk areas create an obvious incentive for policyholders to reduce policy limits and increase deductibles in order to lower premiums. This may not be of much concern for households that have the resources to rebuild after a loss absent full insurance coverage. However, it is important that insurance agents make sure that lower-income homeowners appreciate the risks of selecting lower coverage levels.

Thank you again for the opportunity to testify at this hearing.

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