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California's Homeowner Insurance Market Freefall: Regulatory Folly Run Amok

Richard J. Maher

TOPLINE POINTS

- California's homeowner insurance market is in the grips of an urgent crisis as major insurers cancel existing policies, refuse to write new policies, and, in some cases, abandon the state's insurance market entirely.
- Insurers' unsustainable losses are largely due to poor forest management, which has contributed to wildfires that are more severe and destructive than any recorded in California history.
- Insurers' losses have grown exponentially to unsustainable levels. California's leaders must focus on better forest management and free market solutions to bring insurers back into the state's market and restore reasonable costs.

Introduction

Almost daily, news stories appear of yet another insurer refusing to write new California homeowner policies or canceling current ones. California's leaders are now scrambling to find solutions. Unfortunately, most of their proposals merely repeat the same mistakes that precipitated the crisis—years of a misguided approach to environmentalism and market interventions in the form of price caps and over-regulation. Instead of making the situation worse, California must fix its regulatory approach and remove impediments to a well-functioning insurance market.

Conditions in the state—specifically, the severe California wildfires over the last decade—have subjected providers to extreme losses. Now, California leaders find themselves trying to fix the very problems with state residents' home insurance policies that they created. According to the 2021 California Property & Casualty Market Share Report, losses incurred by insurance companies more than tripled to over $15 billion in 2017 from slightly more than $4 billion in 2016 (California Department of Insurance, 2022). In 2018, losses remained high at $13 billion. Before 2017, California insurers *never* incurred losses greater than $5 billion (Howard, 2023).

The factors that influence the financial viability of the companies involved in the homeowner insurance market are delicate—particularly those that drive premiums and influence profit margins. Premiums[1] are not arbitrary prices. In the absence of government manipulation, premiums are driven almost entirely by anticipated claim expenses faced by insurers, which depend on the frequency of claims, the severity of damage, and the cost of repairs.

More frequent and destructive wildfires, coupled with inflation in construction and rebuilding costs, are the key culprits behind rising premiums. Imposing arbitrary government regulations, putting caps on insurance premium rate increases, or providing subsidies to ratepayers do nothing to address these underlying cost drivers. Subsidies and price controls do nothing to change the circumstances in which these catastrophic wildfires took place All these interventions can do is shift the cost from one set of beneficiaries to another or push insurers to either cancel certain types of plans or exit the market entirely.

To both stem and solve the crisis, California must lift the caps on insurance premium rate increases that currently encourage people to live in high-risk areas and that allow the state to shift the cost of poor forest management onto policyholders instead of addressing the underlying risk of future catastrophic wildfires.

Causes of the Market Crisis

Why have insurer losses in the California homeowner insurance market been so large in recent years when wildfires have been commonplace in California since at least the Gold Rush? Over the last decade or so, the cost of paying policyholder damages has grown exponentially more expensive as wildfire disasters have grown more destructive and intense. Since 2017, 10 million forest acres and 39,000 homes have been reported destroyed in California due to wildfires (Howard, 2023). Indeed, eight of the 10 largest recorded wildfires in California have occurred since 2017, with four of the six largest having occurred in 2020 alone. Table 1 below illustrates these facts:

Table 1

Ten Largest Wildfires in California State History (Acres Burned)

Year	Fire Name	Acres Burned
2020	August Complex	1,032,648
2021	Dixie Fire	963,309
2018	Mendocino Complex	459,123
2020	SCU Lightning Complex	396,625
2020	Creek Fire	379,895
2020	LNU Lighting Complex	363,220
2020	North Complex Fire	318,935
2017	Thomas Fire	281,893
2003	Cedar Fire	273,246
2012	Rush Fire	271,911

The above table lists, from most destructive to least destructive, the 10 largest wildfires recorded in California, based on the number of acres burned. These fires occurred throughout the state, in Southern California, Central California, and Northern California. (CAL FIRE, 2024a).

[1] Premiums are "the amount of money an individual or business pays for an insurance policy" (Kagan, 2022).

The cause of the fires is primarily the state's poor forest management—specifically, its failure to carry out "fuel reduction" practices. Fuel reduction is a means of controlling and mitigating forest growth and includes prescribed burning and thinning. Prescribed burning is "the deliberate use of fire in specific areas within specified fuel and weather conditions." Thinning is "the mechanical cutting and removing of some trees." Fuel reduction may also involve "other mechanical, biological, or chemical treatments" (Hoover, 2020). Forest management in the form of fuel reduction is especially essential in preventing more intense wildfires during extended droughts.

Yet, California has resisted undertaking adequate fuel reduction activities in its more than 33 million acres of forestry. According to a 2018 study by the Little Hoover Commission, "massive landscapes [in California] once sustained by beneficial, low-intensity wildfire are overrun with fire intolerant trees and thick carpets of forest fuels that can turn even the smallest campfire or sparkling powerline into a raging firestorm" (Little Hoover Commission, 2018). The Commission's study blamed policies that prioritize complete fire suppression and that have abandoned prescribed burnings, which were historically a land management tool employed even before Europeans settled the state and for centuries thereafter. The need for fuel reduction is especially acute in light of the prolonged drought throughout most of the last decade and the infestation of various plagues. These infestations include the bark beetle, which had killed some 102 million trees in the Sierra Nevada as of 2017, and the Gold-spotted Oak Borer, which killed more than 70,000 oaks in Southern California (Little Hoover Commission, 2018).

The existence of so many factors that combine to create massive wildfire tinder, all of which are widely known by state agencies responsible for forest management, such as CAL FIRE, makes it all the more concerning that California leaders stubbornly resist wildfire management and fuel reduction practices. In fact, the Little Hoover Commission report points to a marked decline in fuel reduction activities in the years before 2017, attributing this to a mix of factors, such as lack of funding and the retirements of state employees with this expertise. More importantly, the report also points to policy choices surrounding environmental concerns, such as "increased air quality and other environmental resource restrictions that limit days available for burning…and wildlife species considerations under the state and federal Endangered Species Act" (Little Hoover Commission, 2018).

Given the severe and prolonged statewide drought, multiple plagues, and the resulting hundreds of millions of dead trees throughout California's forests, the state's approach to forest management and resistance to fuel reduction has proved catastrophic. The firestorms of the last decade were not only among the most destructive, as measured by acreage burned, but also the costliest in terms of property destruction. Beginning in 2017, homeowner insurers' exposure grew exponentially over the next four years as their yearly losses tripled. They paid exponentially more for damages with the 2017 and 2018 losses, which combined approached nearly $30 billion. Table 2 illustrates the mounting losses over the last 10 years for which data are available:

Table 2

California Property and Casualty Historical Premium and Loss 2013–2022: Homeowners Multiple Peril[2]

Year	Earned Premium[3]	Incurred Loss[4]	Loss Ratio (%)[5]
2013	7,038,071,457	3,189,727,981	45.32%
2014	7,031,937,018	3,351,846,286	47.67%
2015	7,248,990,918	4,230,850,026	58.36%
2016	7,475,784,553	4,047,329,931	54.14%
2017	7,664,490,935	15,418,577,650	201.17%
2018	7,983,075,132	13,577,455,112	170.08%
2019	8,631,287,540	2,818,562,833	32.66%
2020	9,362,270,255	3,539,955,749	37.81%
2021	10,298,463,872	4,753,166,698	46.15%
2022	11,480,004,192	6,333,910,318	55.17%

Each row represents a given year's cumulative earned premiums for California homeowner insurance providers, the incurred loss, and the loss ratio. Yearly loss ratios were exponentially higher during the years in which wildfires were most severe and numerous (in particular, 2017 and 2018) (California Department of Insurance, 2022).

Under California law, the elected insurance commissioner must approve rate hikes greater than 7 percent annually. Given the exponential growth in property and casualty payments, rate increase proposals well exceeded this threshold. However, the commissioner's slow, bureaucratic approval process means that "by the time a rate increase is approved, it's already out of date" (Venton, 2024).

Nor are insurers merely raising premiums to maximize profits. The table above demonstrates the mounting catastrophic losses—particularly in 2017 and 2018, years in which California experienced especially cataclysmic wildfires. Also, net profit margins[6] in the homeowner insurance market are already known to be thin. A New York University study of profit margins across various industries in the United States found that, as of January 2024, the national net profit margin for property and casualty insurance was only 5 percent (Damodaran, 2024). With expected losses exceeding approved premiums, insurers predictably started withdrawing from the state's market entirely by 2023. Desperate insurers searched for legal pretexts to cancel policies, with reports of drones and consulting aerial internet maps to discover how properties may not be strictly in compliance with their policies (Balevic, 2024).

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[2] Multiple peril means "a type of insurance coverage that bundles multiple forms of coverage that are often needed together...It creates an all-in-one package that is less expensive than purchasing policies for each one separately" (HUB International Limited, 2024).

[3] Earned premiums refers to "the industry-accepted denominator in the calculation of a carrier's Loss and Loss Adjustment Expense Ratio, also referred to as incurred losses and loss adjustment expenses by earned premium" (Waterstreet Company, 2022).

[4] Incurred loss means "benefits paid to policyholders during the current year, plus changes to loss reserves from the previous year" (Kagan, 2021).

[5] Loss ratio means insurance claims paid plus adjustment expenses divided by total earned premiums (Hayes, 2020).

[6] Net profit margin means "how much net income is generated as a percentage of revenues received" (Murphy, 2024).

More and more insurers began to reduce their presence in California's homeowner insurance market as they incurred mounting and unsustainable losses. In May 2023, State Farm, California's largest homeowner insurance provider, announced in a press release that they would not accept new property and casualty applications for either personal or business policies. As if to warn state insurance regulators of the impossible environment that these officials enabled, the provider soberly set forth the reasons for its actions: "State Farm General Insurance Company made this decision due to historic increases in construction costs outpacing inflation, rapidly growing catastrophe exposure, and a challenging reinsurance market" (State Farm, 2023).

Other major insurance providers quickly followed, with Allstate announcing in June 2023 that they would not write new homeowner policies. Then, the next month, Farmers, the state's second-largest homeowner insurer, announced they would restrict new policies. The latter's reasons mirrored those of State Farm and Allstate. Farmers said, "With record-breaking inflation, severe weather events, and reconstruction costs continuing to climb, we are focused on serving our customers while effectively managing our business" (Maruf, 2023). The following month, Safeco canceled 950 policies in the San Francisco Bay Area, citing a "high concentration of insurance exposure" (Kupfer, 2023). By September 2023, seven of the 12 largest homeowner property insurers had taken steps of this nature and, to varying degrees, limited their exposure in California or left the state market entirely (Christopher, 2023). Unsurprisingly, insurers accelerated their withdrawal from California by increasing the number of policies they refused to renew, including homes deemed at negligible wildfire risk. In early 2024, many suddenly started dropping policies altogether, including policies not up for renewal.

The insurer statements cited above also reveal two more key reasons for an unsafe and, thus, unprofitable insurance environment beyond the increased wildfire risks. The first reason is the acute inflationary pressures in California. The state has higher prices for supplies and materials, as well as added construction costs related to a slow and bureaucratic permitting process. California also imposes onerous licensing laws that create a shortage of qualified contractors and building professionals. Consequently, the payouts insurers issued for claimholder losses soared. The second key reason for increased unprofitability is insurers' increased exposure as development expands markedly closer to forests, particularly those areas termed "the Wildland-Urban Interface" (WUI). Indeed, an estimated 4.5 million homes were in these "wilderness areas" at the beginning of the last decade (Little Hoover Commission, 2018).

To deflect their responsibility for this crisis, state leaders have blamed poorly maintained electrical equipment, negligent utilities, unseasonably intense and dry winds, and "climate change" for causing prolonged droughts. Many of these factors were relevant, to be sure, but these conditions have long existed in California and will continue to do so. Instead, as argued above, the primary reason these wildfires have been so intense, spread so quickly, and have been harder to extinguish than past wildfires is that California leaders poorly managed the state's forests, which set the stage for the riskier circumstances in which these wildfires spiraled out of control.

Wrongheaded and Counterproductive Efforts to Control Costs

Insurance premiums are set at rates that compensate insurers for the likelihood and severity of claims. Therefore, insurance premium increases are an inevitable byproduct of worse fire risk and higher rebuilding costs. They are not driven by escalating profit margins. Government interventions that seek to clamp down on premium increases without addressing the underlying cost drivers to insurers are doomed to fail, as California has been witnessing. Thus far, state leaders seem intent on greater market intervention.

The state's insurance market framework enables this approach. As noted in the previous section, California's elected insurance commissioner must approve any rate hikes greater than 7 percent. Also, Prop 103 (1988) requires insurers to balance rate hikes with the average wildfire losses over the 20 years preceding the proposed rate increase. This requirement prevents insurers from incorporating the reality of worsening wildfires in more recent years, as average losses over the last 20 years are much lower than average losses over the last 5 or 10 years (California Department of Insurance, n.d.).

When insurers began to withdraw from California in 2023, Governor Gavin Newsom responded by creating a "working group" meant to study the issue and brainstorm potential solutions. Ultimately, these deliberations resulted in a largely symbolic and vague executive order exhorting Insurance Commissioner Ricardo Lara to, among other things, "[i]mprove the efficiency, speed, and transparency of the Department's rate approval process" and "[t]ailor the rate approval process to include…potential revisions to the way catastrophe risks and insurer costs are accounted for" (Exec. Order No. N-13-23, 2023).

The governor's executive order did not mention the need for improved wildfire management and fuel reduction, nor were these activities addressed in ensuing executive orders. While the governor acknowledged "global inflation" as contributing to soaring property claims, he failed to recommend reforming factors specific to California that make construction costs particularly elevated. This would include the shortage of homebuilders, who are kept from the market by the state's burdensome licensing laws and the bureaucratic permitting process that imposes multiple reviews and exacerbates rebuilding delays. Instead, Newsom mentioned "climate change" five times as a contributing factor (Exec. Order No. N-13-23, 2023), which indicates a fundamental misunderstanding of the situation. As noted throughout this paper, California has always had wildfires and droughts. The difference in the last decade has been the intensity, severity, and corresponding destructiveness of these wildfires, all of which could have been significantly reduced, if not curtailed, with meaningful forest maintenance.

On March 14, 2024, Commissioner Lara released the broad outlines of his solutions, which largely tracked Newsom's executive order. The new regulations propose adjusting the models that insurers may use when forecasting exposure, thus allowing companies to request rate increases based on "catastrophe models" for events like wildfires, floods, and even earthquakes instead of requiring models based on the previous 20 years of data. These catastrophe models include adjustments "based on the average annual loss generated from one or more catastrophe models" and even "multi-year, long-term average of catastrophe losses net of actual and anticipated salvage and subrogation recoveries" (California Department of Insurance, 2024a). Lara's plan also promised an expedited process for rate approvals, which would be reviewed by a "panel of experts overseen by the Department of Insurance" (California Department of Insurance, 2024b).

The plan proved insufficient, as a week later, State Farm announced the cancellation of 72,000 more policies—both residential and commercial—the largest such insurer withdrawal from California to date (Granda, 2024). Clearly, the state's largest homeowner insurer viewed the changes as inadequate, with good reason. Commissioner Lara's changes retain the same command economy structure in which the state determines insurers' profits rather than letting competition determine premiums and profits. As noted above, net profit margins for property and casualty insurance are known to be thin, with some estimates placing it at only 5 percent (Damodaran, 2024). Consequently, faced with unsustainable losses, the number of insurers in the state understandably declined. Even with an easing of the rate hike proceedings and all the delays and costs associated with them, insurers are still subject to a long, bureaucratic process for any meaningful rate increases. After a year-long delay, the commissioner's brainstorming with experts merely delayed an inevitable conclusion:

Homeowner insurance premiums will rise, most likely by double digits, and consumers will suffer rate hikes larger than any experienced since at least the enactment of Prop 103. Yet, these premium increases still proved insufficient to stop providers from leaving the state.

Emerging from the background of these market interventions is the state-managed insurer of last resort for Californians who are otherwise unable to secure coverage from private providers. Ironically, named the "FAIR Plan," it provides minimal coverage for wildfire-related losses, with an average yearly premium of $3,200. Depending on a property's location and wildfire risk, the cost is often radically higher, with some premiums reportedly as high as $10,000 per year. For an additional charge, homeowners may add coverage for items such as liability. The FAIR Plan, however, is *not* a state-funded program. Instead, licensed insurers who sell plans in the state are required to fund the program. When claims exceed the FAIR Plan's funding, these same insurers are subject to additional assessments (Howard, 2024).

The tidal wave of FAIR Plan applications—270,000 in 2022 alone—has caused severe delays to the point that, while homeowners wait for their applications to be processed, their private plans lapse. In the interim, mortgage companies often impose a forced plan with premiums as high as $2,700 a month (California Department of Insurance, 2023). To illustrate the growth of the FAIR Plan, its exposure grew from $112.75 million in September 2019 to $311.64 million by December 2023, a 176 percent increase. Similarly, the number of plans grew from 154,494 to 339,044 during the same period (California Fair Plan Association, n.d.). By March 13, 2024, the FAIR Plan's president posited during legislative testimony that the state is "one event away from a large assessment" and that the program does not "have the money on hand" to pay every claim. In the event of multiple catastrophic wildfires, the assessment to private insurers could be as high as $3.3 billion, and consumers may face a surcharge as high as $3,700 (Frank, 2024).

Of course, none of these situations were unforeseeable, especially given the state's experience in its struggle with earthquake insurers. Commissioner Lara himself acknowledged these missteps in "overregulation" in his response to State Farm's March 2024 mass cancellation of California policies and admitted that the state risked repeating the mistakes it made after the Northridge Earthquake in 1994 (Granda, 2024). Like wildfires, earthquakes are a fact of life in the state. In fact, 29 percent of Californians had earthquake insurance before that earthquake, paying an average of about $400 a year in premiums. However, companies paid $20 billion in losses resulting from the Northridge Earthquake, more than they had collected in premiums in the previous 80 years. In the wake of that tragedy, companies began withdrawing from the state *en masse*, mostly because of another state market intervention: Beginning in 1984, insurers were prohibited from renewing or issuing residential property policies if they did not also offer earthquake insurance. Thus, insurers facing record losses and the risk of even greater losses with even one other major earthquake were forced to withdraw from the state entirely, rather than withdrawing from just the earthquake insurance market. In response, state leaders created the privately funded California Earthquake Authority, which assumes the majority of losses in the event of major earthquakes. At the same time, California allowed premiums to be based on high-risk models—once insurers were able to offer earthquake insurance at higher premiums in line with their loss exposure, the market stabilized, and many companies returned to the state (Avner Gat, Inc., n.d.).

Instead of working overtime to resolve the very circumstances created by their delayed forest management and the inflation made worse by bureaucracy and over-regulation, California's leaders continue to focus first on government intervention that has perpetuated an impossible market for insurance providers. First, they tried to prevent rate hikes, and now they are incrementally moving toward delaying these increases. Such interventions have failed spectacularly as

Californians face the risk of no insurance at all and overall costs (premiums, deductibles, multiple plans) as high as, if not higher than, would be the case if rate hikes had been tied more closely to insurance company losses. Now, these same state leaders are vainly trying to stem a crisis that they let spiral out of control.

Next Steps: Reducing Fire Risk and the Cost of Rebuilding

Thus far, California has only taken half-hearted measures to address these issues, which have done nothing to substantively restructure an outdated and over-regulated insurance market. The state has proposed changes only on the margins nearly a year after insurers first signaled that the state's homeowner insurance market was no longer viable. Nor has California taken any steps to reform the construction industry and control costs associated with the onerous requirements the state imposes on it.

To enact meaningful reform, the state needs two paradigm shifts. The first involves a shift in its forest management from one that is reactively focused on preventing and extinguishing all fires to one that restores the historically proven and rightful place of fuel reduction, especially through prescribed burnings. The second involves a shift in the state's approach to its homeowner insurance market and the sectors associated with it—namely construction—from one that is still highly regulated (despite Commissioner Lara's proposed changes) to one that is driven by market forces and the reality of property and casualty risk. The following proposals seek to advance these paradigm shifts:

1. Reduce the Risk to Homeowners and Insurers Through Meaningful Forest Management and Other Mitigation Measures

The environment in which this entire insurance crisis takes place is one of immense risk. Improved forest management would greatly reduce losses and destruction. Dry tinder covering the forest ground, plague-infested trees, and dry vegetation have been neglected for decades. For the sake of reducing the intensity and destruction associated with the exponentially more severe wildfires that have been experienced in the last decade, these efforts must be expanded. As noted, California has failed to meet even its own modest goals for prescribed burns in recent years on the lands it controls. The state must act with a sense of urgency to avoid further delays and expand the scope of its forest management activities. The state has a goal of reaching only 60,000 acres of prescribed burning per year by 2030 (up from a goal of 20,000 acres in 2016-17), before which many more severe wildfires will undoubtedly occur (Little Hoover Commission, 2018). To show how paltry even these increased goals are, in 2015, the federal government alone had a goal of "restoring" 500,000 acres in California per year. Instead of reacting to increasingly destructive wildfires, California must instead hasten the timeline by which it will reach and even exceed its 60,000-acre goal and ensure that these yearly metrics are met. If necessary, it must allocate greater resources, including those appropriated to extinguishing fires. Most importantly, California leaders must suspend the self-destructive air quality restrictions that cause substantial delays and only worsen total ash emissions.

The state need not and must not be the only party that shoulders the responsibility for this undertaking. The federal government owns about 60 percent of forest land in California, and current partnership arrangements allow the state to both make use of federal resources and direct federal agencies to conduct forest management on this land, including prescribed burns (Little Hoover Commission 2018). The state must not use air quality issues as an excuse to delay the federal government–prescribed burn activities.

For privately owned forestry, allowing organizations and even individuals to initiate prescribed burns would enhance collaboration between different parties and share the responsibility among Californians to safeguard forests. Homeowners also have a role in protecting their property from wildfire damage and share responsibility for managing forestry and other fire risks on their land. Creating so-called “defensible space” is among the most important measures homeowners can take, especially in the WUI. Defensible space refers to “the buffer between your structure and the surrounding area… [which] acts as a barrier to slow or halt the progress of fire that would otherwise engulf your property” (CAL FIRE, 2024b). State law mandates a defensible space of 100 feet around a home’s perimeter in the State Responsibility Area,[7] although certain counties already impose stricter requirements for defensible space. Practically speaking, creating a defensible space means “clearing flammable materials to slow down wildfires and provide a safe perimeter for firefighting efforts” (CAL FIRE, 2024c). These flammable materials include such things as dry brush, trees, and wood piles, as well as clearing vegetation down to bare mineral soil. While not mandated by state law, CAL FIRE recommends a 10-foot defensible space around homes in the WUI (CAL FIRE, 2024b).

Beyond defensible space, homeowners can take other measures to avoid catastrophic losses on their property. According to CAL FIRE, most homes lost in wildfires are due to flying embers, so re-landscaping with non-flammable materials like cement instead of bark would reduce the likelihood of an ember igniting a fire close to the dwelling. Adequate spacing of trees and shrubs can prevent fire from spreading quickly, and keeping branches at least six feet off the ground ensures that fires will not easily spread from the ground to the trees (CAL FIRE, 2024b). To encourage homeowners, insurers should consider offering rebates or charging lower premiums to those policyholders who take these mitigation measures. Of course, insurers must then be allowed to cancel policies for those who fail to maintain their property adequately according to these standards.

Environmental concerns about both air quality and endangered species have long delayed, if not entirely stopped, prescribed burns. Yet, assuming air quality and habitat preservation are true concerns for the environmental lobby, scientific studies demonstrate that severe wildfires pollute the environment dramatically worse than prescribed burns, spreading ash for prolonged periods and requiring people to wear N-95 masks to breathe safely outdoors. Indeed, plumes of smoke are regularly visible from satellites orbiting Earth, and blood orange skies appear in broad regions throughout the state during these wildfires. As a study published in *Forest Ecology and Management* noted, “mega-fires carry enormous and often lasting un-wanted human, economic, and environmental consequence… High-impact mega-fires are frustrating efforts to…sequester carbon and reduce black carbon emissions” (Williams, 2013).

Studies also show that forest management, especially fuel reduction, improves animal habitat and overall forest health. A study published in *Ecology* shows the advantageous nature of employing fires in forest management, which redound to the benefit of a forest’s overall ecology:

> When fire is not suppressed, you get all these benefits: increased stream flow, increased downstream water availability, increased soil moisture, which improves habitat for the plants within the watershed. And it increases the drought resistance of the remaining trees and also increases the fire resilience because you have created these natural firebreaks (Boisramé, 2016).

Clearly, environmentalists’ objections to prescribed burns are both incorrect and counterproductive to the very ends they claim to desire. The state ought to reconsider the attention it gives to these objections.

[7] “State Responsibility Area” refers to the “areas where Cal Fire is the primary emergency response agency responsible for fire suppression and prevention” (CA Board of Fire, 2024).

2. Generate Lower Costs Through Free Market Reforms to State's Insurance Market

Insurance providers can only continue to write policies in California if they remain profitable. Commissioner Lara himself noted that "[i]nsurance companies are not like utility companies…By law, they don't have to be here, and when we try to overregulate…they no longer write…insurance" (Granda, 2024). His comment is ironic given that his recently proposed reforms do little to ease this regulation but rather substitute a new convoluted process for approving rate hikes for the existing onerous one. Ultimately, California must move away from an over-regulating, command economy model to a free-market approach in which premiums track with risk.

Yet instead of stemming the mass exit of insurers, Lara's proposals will merely slow the rate hikes by further confounding the approval process's regulatory requirements. As noted above, Californians will inevitably face higher prices, either in the form of market rate premiums or exponentially higher FAIR Plan premiums. The crisis could instead be stopped and even reversed if insurers could charge consumers market rates in accordance with catastrophe models. The proposed framework has too many opportunities for consumer groups to object and, thus, draw out the rate adjustment process. It also requires studies and models, which may take years to formulate and would put rate hikes, if approved, years behind insurers' exposure. Eliminating this process would make the homeowner insurance market viable again and encourage the return of insurers who fled the state.

Florida and Louisiana face similar crises of insurance companies leaving the state due to regulatory burdens that prevent them from balancing risk exposure and charging premiums that reflect losses due. Instead of wildfires, their catastrophes are hurricanes, floods, and wind-related damage to below-sea-level development. Recognizing that a requirement that prohibits insurance companies from canceling existing policies discourages them from writing new ones, the governor of Louisiana recently signed into law a bill that would rescind this requirement (Lowrey, 2024). Florida, whose catastrophic hurricanes mirror those of Louisiana, recently enacted legislation to provide $200 million in grants for "homeowners to reduce their premiums by reinforcing their homes," thus potentially reducing damage resulting from inevitable hurricanes and floods (Connolly, 2024). Fundamentally, this legislation acknowledges two principles that California would do well to learn: (1) regulatory mandates on the insurance market limit options and raise costs, and (2) state governments must partner with property owners to mitigate the risk from natural disasters.

3. Suspend Onerous Restrictions That Raise Rebuilding Costs

As noted, premium increases in California are not merely due to the higher fire risk but also to exponentially rising housing prices and construction expenses, which raise replacement costs. California's construction sector is highly regulated, with barriers to entry for contractors and other professionals, such as plumbers and electricians, who must seek specialized licenses to practice in California. Of course, ongoing labor shortages persist, which California exacerbates through its expansive welfare and relief policies that arguably discourage labor participation among the very laborers needed for this industry. Shortages in professionals, laborers, and supplies inevitably raise prices (Little Hoover Commission, 2018).

Housing inflation is also largely policy induced. Nationwide, high inflation was largely due to excessive government spending in the wake of the COVID-19 pandemic. This inflation is exacerbated by California-specific legal and regulatory requirements that slow and impede permitting and development, such as environmental impact studies. The California Environmental Quality Act (CEQA) imposes additional layers of review, raising costs for studies that builders must undertake. It may also impose potential mitigation measures in the event the construction project disturbs the habitat of certain insects, rodents, algae, or wild plants, among others. The law also subjects construction projects to lawsuits from parties with essentially irrelevant interests, adding costly legal fees and additional delays.

A complete overhaul of these regulations is needed statewide—one that streamlines professional authorizations and suspends or does away with these layers of environmental impact reviews and corresponding lawsuits. A more modest proposal might focus specifically on the areas that have suffered catastrophic damage. California, through executive order or administrative action, should direct the California Contractors State Licensing Board to approve licenses for potential contractors who work in these designated areas on an expedited basis after a much narrower review. While CEQA should be reformed, if not repealed entirely, a quicker and more workable solution would be a narrow legislative fix that suspended environmental impact reviews and stopped lawsuits for homeowners rebuilding after wildfires. Lowering rebuilding costs for both labor and administrative measures would decrease the losses that insurers pay, mitigating a major contributing factor to this crisis and restoring insurance market viability.

4. Mitigate the Cost of Rising Premiums to Consumers

It is necessary for insurers to collect market rate premiums and return to profitability. Still, the financial strain on ratepayers will be significant. Given that the state has for decades slow-walked rate hikes and kept insurance premiums excessively low, Californians have grown accustomed to below-market rates; the adjustment will not be easy. Politically, exposing consumers to dramatically increased premiums may not be viable. With that said, insurance companies have absorbed massive losses for decades, which is not sustainable considering the exponentially higher losses due to mega-wildfires over the last decade.

Attempts to address the sensitivity of homeowners to increased premiums have yielded wrongheaded proposals to mitigate consumer costs. These proposals largely repeat the same mistakes associated with previous government intervention. The most high-profile of these proposals would make homeowner insurance premiums tax deductible. Yet, this would do little more than enable the same lack of effective forest management that gave rise to this crisis and would do nothing to reduce the risk that both homeowners and insurers face.

The best solution is to mitigate fire damage through proper forest management while allowing insurance companies to fully incorporate the increase in fire damage risk into their premiums. This risk stems, after all, from failed environmental policies and the higher cost of home replacement arising from the failed economic policies that caused inflation. While not ideal, given the political sensitivities, an argument can be made to provide short-term preferential tax treatment to homeowners suffering from these government failures through either premium support for high-risk areas or tax-deductibility of homeowners insurance premiums. Although these proposals would not address the root causes of this crisis, doing so would give immediate relief to consumers who are directly affected by the state's missteps. Additionally, the Franchise Tax Board allowed 2021 disaster victims to claim the disaster loss for that year. This initiative should be expanded, allowing losses to be amortized over future years' income, easing the burden on insurance providers while providing financial relief for victims to rebuild (California Franchise Tax Board, 2021).

5. Address Macroeconomic Reforms Beyond California

This crisis occurs in the context of an inflationary macroeconomy. While inflationary pressures are especially acute in California, labor shortages post-COVID persist throughout the nation, driven by ongoing government spending, during and even long after pandemic-driven adverse economic impacts were mitigated. As noted above, cost increases due to supply chain issues are not limited to California or even just the construction industry. Clearly, national policymakers must address their fiscal and regulatory approach and its effect on building costs and insurance premiums.

Insurance companies are under pressure nationwide as they remain over-regulated and unable to adjust their business model to address mounting losses (Liu, 2024). Restrictions such as California's ill-fated requirement that insurers provide earthquake coverage, only make it more challenging for companies to remain profitable. A good start would be a paradigm shift in how states regulate their insurance markets—a shift that moves toward deregulation and acknowledges the need for catastrophe models in adjusting premiums. Ultimately, states need to abandon the bureaucratic processes they use to manage rate hikes, which destructively intervene in the relationship between consumers and insurers to the detriment of both parties.

Conclusion

Jerry Williams, in the *Forest Ecology and Management* study cited above, argues that "[a]t a fundamental level," mega-fires call into question whether governments can protect citizens "at the most extreme levels of threat" (Williams, 2013). To reverse course, California needs dramatic and expedited reforms to address the crisis of insurance companies abandoning the state's homeowner insurance market. Thus far, state leaders have refused to approve much-needed rate hikes that insurers need to mitigate risk and adjust for recent losses. Commissioner Lara's recent interventions are too little and too late. These proposals only make superficial changes that still subject insurers to onerous processes and delay approval of the premium increases needed to remain profitable. In slow-walking unavoidable rate hikes, the commissioner's proposals merely delay their inevitability and subject Californians to exponentially higher premiums through the FAIR Plan or the risk of going without insurance entirely. The reforms will do little to increase the number of insurers and the resulting competition the state desperately needs to maintain fair homeowner premiums.

The state would do well to learn from the free-market trajectory that Florida and Louisiana, two states facing similar issues, are instituting to reform their insurance markets. Further deregulation and seeking ways to change the circumstances that give rise to the unsustainable losses in the first place are the solutions for California. While no one wants to pay higher premiums, California's overregulation of the insurance industry to the point of unsustainable losses that provoke exit from the state is not a viable outcome, a principle to which even Commissioner Lara has paid lip service.

California's ultimate solution must be to change the very set of conditions that make these catastrophes and the ensuing losses possible. Undergrounding power lines and ensuring defensible space around homes are important. Yet the only long-term and sustainable way to reduce the intensity and devastation of recent California wildfires is immediate, proactive, and thorough forest management—activities that multiple parties must aggressively pursue. The sooner the state moves away from its antipathy toward fuel reduction to reduce insurers' risk, the quicker its insurance market can become viable once again.

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BIOGRAPY

Richard J. Maher *is the senior policy analyst at the America First Policy Institute—California.*