CALIFORNIA EARTHQUAKE AUTHORITY
GOVERNING BOARD MEETING
MINUTES

Thursday, August 23, 2012
1:00 p.m.

Location: CalSTRS Headquarters Building
Board Room – Lobby, E-124
100 Waterfront Place
West Sacramento, California

Members of the Governing Board in attendance:

Pedro Reyes, designee of Governor Jerry Brown
Grant Boyken, designee of State Treasurer Bill Lockyer
Chris Shultz, designee of Insurance Commissioner Dave Jones
Dietrich Stroeh, designee of Chair of the Senate Rules Committee Darrell Steinberg
Deborah Doty, designee of Speaker of the Assembly John Pérez

Members of the CEA staff in attendance:

Glenn Pomeroy, Chief Executive Officer
Tim Richison, Chief Financial Officer
Janiele Maffei, Chief Mitigation Officer
Mark Dawson, Assistant Chief Financial Officer
Joe Zuber, Senior Counsel
Susan Pitton, Governing Board and Advisory Panel Liaison
Marc Keller, Legal Office Assistant
Danny Marshall, General Counsel

Also present:

Brian Deephouse, Member, CEA Advisory Panel
Bill Rosenberger, Larson & Rosenberger, LLP

1. **The meeting was called to order at 1:00 p.m. A quorum was established.**

2. **Consideration and approval of the minutes of the June 21, 2012, Governing Board meeting.**

    - Mr. Shultz noted incorrect spelling of his name.

MOTION: Mr. Boyken moved approval of the June 21, 2012, Governing Board meeting minutes as amended; seconded by Mr. Shultz. Motion passed unanimously.

3. **Executive Report by Chief Executive Officer Glenn Pomeroy, assisted by CEA executive staff. Mr. Pomeroy's report will include an update for the Board on federal and state legislative activities of interest to the CEA.**

- Mr. Pomeroy showed a graph entitled Projected 2013 CEA Financial Structure.
    - The graph showed nearly $4.5 billion in CEA capital, which he called a significant growth over the last several years.
    - The participating-insurer level of claim-paying responsibility (at $1.8 billion) showed a decrease.
    - The level of risk-transfer for 2013 was projected at $3.6 billion, a result primarily of an increase in policyholder numbers, as well as increased construction costs, which is a factor beyond the control of the CEA.
- The effort continues in Washington, D.C., to obtain relief from the CEA's high cost of obtaining risk-transfer. Mr. Pomeroy showed a graph depicting the CEA's "financial layers" as they might look after passage of the Earthquake Insurance Affordability Act (EIAA), sponsored by the CEA and now pending in both houses of Congress.
- Mr. Reyes noted that it appeared that having the EIAA layer situated below the risk-transfer layers showed that that location is better for policyholders; Mr. Pomeroy agreed. The policyholder benefit comes from the CEA's ability to lower policyholder premiums after obtaining a price break through EIAA from high risk-transfer costs. And the "CEA-sustainability benefit" comes from CEA's having access through EIAA to diversified forms of claim-paying capacity and enhanced opportunities for robust second-event claim-paying capacity.
- Bipartisan support for EIAA in Washington continues to grow. Mr. Pomeroy displayed the names of senators, members of Congress, chambers of commerce, business organizations, building-industry associations, realtor associations, participating insurers and the businesses working with them, nonprofit organizations, and national earthquake engineering and mitigation organizations that support the concept and the legislation.
- An article in the July issue of *Insurance Insider* showed that the CEA is the fifth largest buyer of natural-catastrophe reinsurance in the world. Even with the passage of the EIAA, however, the CEA would still be a very large and significant buyer of catastrophe reinsurance.
- The CEA has been recognized as "Sponsor of the Year" by the media organization *Trading Risk* for the innovative catastrophe-bond mechanism that supports significant transformer reinsurance now present in the CEA's claim-paying capacity—the mechanism has been supported and approved by the Board, since 2011.

- Mr. Pomeroy closed his report with these points.

    1. The financial world has taken note of the leadership the CEA has shown by reaching deeper into the capital markets for innovation in risk transfer, to benefit the organization and its policyholders.

    2. Mr. Richison deserves enormous credit for his determination to devise a way for the catastrophe-bond mechanism to work, resulting in the recognition for the CEA from *Trading Risk*.

    3. It would not have happened without full Board support, which has put the CEA in a stronger position today—fully 20% of CEA's risk transfer is now sourced from the capital markets.

4. Chief Financial Officer Tim Richison will present a CEA financial report.

- Mr. Richison noted his hopes that the catastrophe-bond mechanism for transformer reinsurance would open doors for the CEA in bringing innovation to its risk-transfer program.

- Cash and investments at the end of June stood at $4.6 billion. Capital available to pay claims stood at $4.1 billion.

- Total risk-transfer in place at the end of June was a little over $3.157 billion.

- The New Industry Assessment Layer of $500 million will roll off to a relatively insignificant capacity level, probably within two years.

- The most recent transformer, three-year contract spans August 2, 2012, through August 8, 2015, and provides risk-transfer well into 2015. This type of multi-year contract is designed and implemented to help assure the CEA's continued claim-paying capacity after a major earthquake. The transformer-reinsurance contract pricing most recently obtained was at a favorable level (5.64% rate-on-line).

- Transformer transactions have typically been expensive because of the required overhead. The CEA benefitted by multi-year transactions, which in turn decreased the transaction overhead, from the first transaction to the third and most recent.

- The average insured value of insured dwellings is increasing while the average dwelling premium is decreasing—this appears to be in direct relation to the rate decrease authorized by the Board and approved by the Insurance Commissioner that became effective in January.

- (A slide was displayed depicting the declining number of owner-occupied houses in California since 1998 compared to the remainder of the nation.) Despite that picture, since 2004 the CEA has maintained and even increased its policy-count. Mr. Richison commented that the CEA's Chris Nance has done excellent work with the marketing program.

5. Mr. Richison will propose and seek approval of the CEA 2013 financial structure.

Mr. Richison said the proposed 2013 CEA financial structure is based on modeled losses, using three models: AIR, RMS, and EQECAT. There is an exposure-related financial adjustment that anticipated CEA exposure growth in 2012 (increase in the number of CEA policies).

A demand-surge adjustment is applied starting at the 250-year level of losses and then applied for the losses greater than those occurring at that point.

The loss-adjustment expenses reflect participating-insurer expense as well as CEA's own staff costs associated with claim adjustment.

- The result of these calculations is a 2013 claim-paying capacity that for the first time reaches a level greater than $10 billion.
- In order to accomplish this unprecedented level of claim-paying capacity, the CEA needs substantial risk-transfer in place. The CEA needs to have $1.45 billion of additional risk-transfer, effective January 1, 2013.

This structure gives the CEA much more flexibility so that if external forces affect pricing, the CEA has significant opportunities to make up for any reinsurance it might not place in January.

Mr. Reyes suggested to the Board that it consider giving staff the authority to renew and renegotiate expiring risk-transfer contracts, subject perhaps to a dollar limit, for renewal of the risk-transfer program. Providing that sort of latitude for the staff to negotiate contracts before they expire may give some added ability to negotiate.

Mr. Boyken agreed; the Board wanted to give staff all the flexibility it needs.

- Mr. Richison showed a slide depicting proposed CEA financial structures as of January 1, 2013, and April 1, 2013.
- He presented the staff recommendation to the Board.

MOTION: Mr. Shultz moved to proceed with obtaining the staff-recommended 2013 risk-transfer program of $3.404 million, effective January 1, 2013, and $3.557 million effective April 1, 2013; and to bring back to the Board at the October 2012 meeting a recommendation for the 2013 risk-transfer program for January 1, 2013; and at the February 2013 meeting, a recommendation for the risk-transfer program to become effective April 1, 2013; seconded by Mr. Boyken. Motion passed unanimously.

6. Mr. Richison will present and seek Board approval of a three-year risk-transfer contract.

- Mr. Richison stated that the CEA needs an additional risk-transfer program to be in place for the remainder of 2012 to maintain its risk-transfer program at 1-in-500 years. Through June 2012, the CEA had almost obtained the level of exposure that staff originally thought it would achieve for the whole year.

- Staff has identified a traditional reinsurer that is willing to offer the CEA a three-year contract, on the same terms and conditions as the reinsurance contract executed under the most recent transformer transaction. The key components of the arrangement are the contractual pricing elements of the second and third years of the three-year risk period. The contract would mirror the transformer reinsurance in that if CEA were to experience claims from a significant earthquake, the attachment point of the reinsurance contract would drop on the anniversary of the contract to a pre-agreed level—it's a mechanism similar to one used in the transformer-reinsurance contracts.

- Staff has negotiated a favorable price for both the initial contract year and for any subsequent drop-down years as well. CEA senior counsel Joe Zuber drafted a reinsurance contract, blending provisions of a traditional reinsurance contract and provisions of the transformer reinsurance contracts.

- Because the contract was with a traditional reinsurer, it relied not on posted, contractual collateral but on the reinsurer's own financial standing. CEA staff believes this deal will open the door for reinsurers to consider entering into multi-year contracts, which have not been generally available for a number or years but which are in the best interest of the CEA, moving forward.

- Based on this explanation, staff is presenting to the Board a recommendation to (1) authorize an augmentation to the 2012 reinsurance program, effective September 1, 2012, in the form of a three-year reinsurance contract with a total limit of $100 million on the terms and conditions stated; (2) authorize staff to act immediately to bind that reinsurance, and (3) authorize CEO Glenn Pomeroy, acting under the guidance of the written resolution and CEA General Counsel Danny Marshall, to execute the contracts.

Mr. Marshall explained specifics of the resolution.

MOTION: Mr. Boyken moved approval of the resolution; seconded by Mr. Shultz. Motion passed unanimously.

7. CEA Advisory Panel member Brian Deephouse will provide a summary of the proceedings at the July 19, 2012, Advisory Panel meeting.

- Mr. Deephouse stated that the Advisory Panel discussed opportunities the CEA might have this fall (2012), depending on the outcome of certain elections, to gain additional support for CEA-sponsored federal legislation.

- The Advisory Panel was pleased with the progress staff had made by its innovations with the transformer-reinsurance contracts and with the diversification of risk-transfer renewal dates.

- The Panel spent significant time hearing presentations on the California Residential Mitigation Program. They wished to make sure that the CEA was engaging with existing mitigation programs throughout the state. San Francisco's "Community Action Plan for Seismic Safety" (CAPSS) was specifically called out. The Panel explored the development timeline and the selection of the different targeted areas of the state, in particular types of buildings and types of communities.

8. Mr. Pomeroy will seek Board authorization to begin the recruitment process to hire a CEA Chief Information Officer.

Mr. Pomeroy noted that it is universally appreciated that the IT capability of the CEA must grow, in light of the organization's progress and aspirations.

In that light, both auditors and independent consultants have pointed out the clear need for a CEA Chief Information Officer. This would help the CEA to reach a point, for example, where it could move away from having 17 different insurance companies handle CEA business through maintaining their own, separate data systems, and substitute instead a central CEA system that does this work more efficiently.

The consulting firm CPS has developed both a job specification and a pay range. Mr. Pomeroy presented his recommendation that the Board authorize staff to begin the recruitment and hiring process for a Chief Information Officer as a contract executive employee, and to authorize Mr. Pomeroy to negotiate with and arrive at a contract proposal, which staff would bring back to the Board for approval before entering into a final contract.

Mr. Shultz noted that the CEA'S success, moving forward, would rely to a large extent on its ability to exchange data with participating insurers and to plan for future information-technology infrastructure—as a result, the California Department of Insurance wholly supports these efforts.

MOTION: Mr. Shultz moved approval of the recruitment of a Chief Information Officer, on the bases and under the conditions recommended by Mr. Pomeroy; seconded by Mr. Boyken. Motion passed unanimously.

9. Chief Operations Officer Bob Stewart will propose lease modifications and a related CEA budget expense to permit CEA to bring its computer-server room to appropriate insurance-industry standards and to lease limited additional space on a CEA-occupied floor, to better accommodate CEA staff; Mr. Stewart will request the Board to authorize CEO Glenn Pomeroy to negotiate and execute a related amendment to the CEA's office lease.

Mr. Pomeroy explained that the CEA computer-server room presently is a space with a standard (water) sprinkler/fire-suppression system over it—this puts the CEA's servers in obvious jeopardy. The CEA must build a modern, compliant server room, and staff recommends moving on the necessary changes now, to take advantage of Sacramento office-lease market conditions.

He presented recommendation to authorize staff to negotiate and execute an amendment to the CEA's existing lease to pick up additional space. Staff would then bring any needed budget augmentations back to the Board.

MOTION: Mr. Boyken moved approval of the recommendation; seconded by Mr. Shultz. Motion passed unanimously.

10. Assistant Chief Financial Officer Mark Dawson will brief the Board on the completed CEA calendar-year-2011 audit by the CEA'S independent auditors, Larson & Rosenberger LLP; representatives of that firm will address the Board to elaborate on the written audit report.

- Mr. Dawson stated that based on the Generally Accepted Accounting Principles (GAAP), the CEA increased cash and investments by $236 million for the year 2011.

- Net assets, which are what is left over for the CEA to contribute towards capital, increased $340 million during the year.

- Regarding the income statement: the underwriting profit was $275 million, which was $25 million higher than the previous year. This was mostly attributable to revenues from CEA insurance-policy sales, as well as a decrease in reinsurance expense.

- The positive independent-audit report the Board will hear reflects the hundreds of hours that CEA staff in every department has put forward to make this a successful audit, as well as participating insurers who must provide very complex reconciliations and confirmations to the auditors.

- The auditors' statement—"We did not identify any deficiencies in internal controls that we consider to be material weaknesses"—shows that the CEA has addressed issues noted in the past.

Bill Rosenberger, the Larson & Rosenberger, LLC, partner in charge of conducting the CEA audit, then reviewed certain matters directly with the Board, as required.

- Mr. Rosenberger stated that the audit was very clean, and the auditor was pleased with how responsive the CEA has been to its recommendations in the past.

- The auditor had performed two audits: one on the CEA's financial statements, in accordance with generally accepted accounting principles, and the other in accordance with statutory accounting principles, as required by the California Department of Insurance.

- Regarding the CEA financial statements, the auditor used a risk-based approach that centered on gathering and understanding the internal-control processes, procedures, and financial-reporting issues as they are conducted within the organization itself. He explained that the auditor starts with identifying what he thinks the users of the financial statements would be interested in and translate that into some level of materiality—that is a quantitative threshold. At the end of the audit, the auditor looks at that materiality level and thinks of it in terms of some of the qualitative aspects of disclosure that he or she thinks might affect the users of the financial statements.

- The audit is really concerned with analyzing and confirming the claim-paying capacity of the organization: the risk that it takes in, the capital that it sets aside in cash and investments, and the risk-transfer capacity that it obtains through reinsurance.

- The auditor also looks at the expenses and the governance of the organization.

- The auditor had looked at the transformer reinsurance agreement and transaction, to determine whether the catastrophe bonds themselves would represent obligations of the California Earthquake Authority rather than being a reinsurance transaction. Ultimately, the auditor determined that it was a reinsurance transaction.

- The audit is an evaluation in the CEA's environment, because the CEA is a government-related organization, yet it involves elements of both industry GAAP and governmental GAAP; at the same time, the CEA has a layer of statutory reporting.

- Mr. Rosenberger then stated that the auditor had concluded that both the statutory financial statements and the GAAP financial statements were "squeaky clean."

- The CEA has limited estimates in its financial statement because there are no loss reserves. The only significant estimate would be the unearned premium, which is easily calculated because CEA policies are earned over the period of the policies themselves so it is a pro-rata calculation.

- The only significant unusual transaction was the transformer reinsurance transaction. The auditor spent a great deal of time evaluating that program and making sure that the disclosures were appropriate given the circumstances.

- CEA management and staff were a pleasure to work with; it is a very transparent organization.

11. Mr. Dawson will present to the Board for its consideration and approval the annual transfer of the CEA Mitigation Fund of a statutorily directed portion of the CEA investment income.

- Mr. Dawson explained that every year, staff brings to the Board the set-aside amount from the CEA's investment income that goes toward the CEA Mitigation Fund.

- CEA Chief Actuary Shawna Ackerman reviewed the proposed transfer from the CEA to the Mitigation Fund. She concluded that making the transfer would not represent or create a negative financial impact on the CEA.

- Staff recommended that the Board authorize a set-aside amount of $1,584,672.10 for the CEA Mitigation Fund.

MOTION: Mr. Boyken moved the staff recommendation to authorize $1,584,672.10 be set aside in the CEA Mitigation Fund; seconded by Mr. Shultz. Motion passed unanimously.

12. Chief Mitigation Officer Janiele Maffei will update the Board on the CEA's mitigation programming, including its participation in the California Residential Mitigation Program.

- Ms. Maffei reported that in June 2012, staff outlined the strategic goals of the mitigation plan. Implementation of the plan included three activities that were scheduled for 2012:

  1. Establishing statewide standards.

  2. Holding a research symposium.

  3. Launching the mitigation program's pilot program.

- In terms of establishing statewide standards, the purpose is to inform the seismic retrofit incentive program and also to inform the development of mitigation discounts for insured homeowners.

  To that effect, staff has scheduled a guidelines development workshop for September 17, 2012. The process will be a collaboration with FEMA. Staff will use the information gained at the workshop to develop a program plan. It will be a scope of work and a schedule for which staff can then develop a timeframe and a budget.

- In order to develop appropriate mitigation discounts beyond the narrow range of cripple-wall houses, to support the guideline-development process, and inform other strategic mitigation endeavors, staff is planning a research symposium for early December 2012.

- For the California Residential Mitigation Program, staff has proposed a pilot program, a replica of what CRMP would roll out statewide—it will provide financial incentives to homeowners seeking to seismically retrofit their single-story houses.

  The pilot process is tentatively scheduled for early 2013 for a limited roll-out in Northern California and Southern California. Approximately five homeowners from each community will be picked to participate.

  Requests for Qualifications (RFQs) will be issued shortly.

13. Senior Counsel Joe Zuber will brief the Board on the renewal of the CEA's Directors and Officers and Employment Practices Liability Insurance coverages and request the Board's approval to renew the policy and pay the annual policy premium.

Mr. Zuber reported that the CEA has purchased and renewed its Directors and Officers and Employment Practices Liability insurance each year since it has been in operation.

Over the last seven or eight years, staff has found a specialty carrier that sells a policy tailored to a CEA-type business. It covers CEA Board members, staff members and executives, the Advisory Panel, and the entity itself.

The premium has not increased significantly, and staff seeks Board authorization to renew the policy on the same terms as last year, with some very minor modifications.

MOTION: Mr. Shultz moved approval of the request to renew the coverage; seconded by Mr. Boyken. Motion passed unanimously.

14. The Board will meet in closed session to discuss personnel matters and litigation matters, as permitted by California Government Code section 11126, subdivisions (a) and (e), respectively.

There was no closed session.

15. Public comment on items that do not appear on this agenda and public requests that those matters be placed on a future agenda.

There was no public comment.

16. Adjournment.

The meeting was adjourned at 2:15 p.m.