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CRS Report for Congress

California Wildfires: The Role of Disaster Insurance

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Summary

The tragic consequences of the wildfires that struck southern California in late October 2007, have given renewed attention to the partnership between private providers of disaster insurance and the federal government. In broad terms, the disruption to economic systems caused by natural disasters, such as wildfires, windstorms, earthquakes, and floods, have been handled by the insurance and reinsurance industries and by the federal government (taxpayers). Consequently, large government outlays for disaster assistance and higher premiums for disaster insurance and reinsurance have followed the devastation caused by natural and man-made disasters. While it is too early to determine the full impact of the 2007 California wildfires on state and national property insurance markets, early estimates of $1 billion in insured property losses suggest this event will not exceed the most destructive fire in the state's history — the 1991 Oakland fires that cost $2.5 billion in 2006 dollars. The scope of the losses is well within the demonstrated capacity of the private insurance and reinsurance markets.

Generally speaking, losses from wildfires have been a manageable risk in the private insurance market. Insurance coverage has been widely available both in the standard insurance market and in residual or "involuntary" markets established through state legislation in the early 1970s to assure markets for risks not always available or affordable in the standard market. In California, applicants for fire coverage under the Fair Access to Insurance Requirement (FAIR) plan must live in areas of the state specifically designated by the insurance commissioner.

Assistance for uninsured losses is being met through standing authorities; the need for additional federal legislation is not yet known. Federal costs to cover uninsured losses associated with the wildfires in California may require supplemental appropriations. Some may also argue that pending legislation (H.R. 3355/S. 2310, the Homeowners' Defense Act of 2007) would provide a federal backstop for state-sponsored insurance programs to help homeowners prepare for and recover from the damages caused by natural catastrophes such as the wildfires. This report will be updated as developments warrant.

Wildfire Data Overview

On October 24, 2007, President Bush issued a federal emergency disaster declaration in response to property damage from wind-driven southern California wildfires that destroyed approximately 2,200 homes on 450,000 acres of land in seven counties stretching from Los Angeles to San Diego.[1] As of October 24, 2007, estimates of property damage provided by the Insurance Information Network of California suggests that insurance claims "will likely top $1 billion."[2]

While California has a history of significant outbreaks of wildfire, such disasters are not commonplace, nor do they consistently exceed the billion dollar threshold in insured losses that the current wildfires are expected to reach. **Table 1** shows that the current blazes remain short of the $2.5 billion in insured losses (2006 dollars) from the state's worst series of wildfires in over thirty years, the 1991 Oakland/Alameda fire that destroyed 2,000 homes.

Table 1. Top Ten Catastrophic Wildland Fires in California, 1970-2007

(ranked by cost in millions of 2006 dollars)

Rank	Date	Location	Nominal Dollars	Real 2006 Dollars
1	Oct. 20-21, 1991	Oakland, Alameda Counties, CA	$1,700	$2,516.3
2	Oct. 25- Nov. 4, 2003	San Diego County, CA	1,060	1,161.4
3	Oct. 25-Nov. 3, 2003	San Bernardino County, CA	975	1,068.3
4	Nov. 2-3, 1993	Los Angeles County, CA	375	523.2
5	Oct. 27-28, 1993	Orange County, CA	30	488.3
6	June 27-July 2, 1990	Santa Barbara County, CA	265	408.8
7	July 2007	Lake Tahoe	150	150.0
8	Sep. 22-30, 1970	Oakland-Berkeley Hills, CA	24.8	128.9
9	Nov. 24-30, 1980	Los Angeles, San Bernardino, Orange, Riverside, San Diego Counties, CA	43	105.2
10	July 26-27, 1977	Santa Barbara, Montecito, CA	20	66.5

Source: Insurance Services Office's Property Claims Services, Insurance Information Institute.

1 "Major Disaster Declarations, California Wildfires," at [http://www.fema.gov/news/event.fema?id=9045], visited October 25, 2007.

2 Insurance Information Network of California, "October 24: Insurance Claims Filings and Estimated Insured Losses," at [http://www.iinc.org/articles/221/1/October-24 — Insurance-Claims-Filings-and-Estimated-Insured-Losses/Page1.html], visited October 25, 2007.

Based on available information, it appears that the current wildfires may not result in the over $2 billion (2006 dollars) in losses that resulted from the wildfires that swept through southern California in 2003, causing $1.2 billion in insured losses in San Diego County and $1.1 billion in San Bernardino County. According to the data compiled by the insurance industry, since 2003 California had been relatively calm in terms of catastrophic property losses until the current outbreak.

Insurance and Disaster Recovery

In brief, when a disaster such as the 2007 California wildfire occurs, productive components in the stricken region or state are destroyed. Resources from other parts of the country are redirected to compensate the victims and to rebuild what was lost or repair what was damaged. The impact of the disaster on the affected region, and its economic recovery, depend in large part on the portion of the losses covered by insurance, or reimbursed through public post-disaster assistance.[3] Through insurance, the risk of financial loss is transferred to an insurance company or other insuring organization.

The problem of under-insurance has been an issue before Congress. A home is considered under-insured when the homeowner purchases less insurance protection than is needed to rebuild after a disaster. Several reasons could explain why a homeowner is under-insured: he or she may not update the policy coverage limits; receive incorrect advice from an insurance agent or insurer about how much insurance is needed; or possess limited financial resources to buy the appropriate amount of coverage. After Hurricanes Isabel in 2003 and Katrina in 2005, for example, homeowners from affected states expressed concerns about claims payments that were substantially lower than the actual replacement value of their homes. Their reasons for under-insurance were all of the above. Likewise, homeowners affected by the California wildfires reportedly have also found the cost of rebuilding exceeds the available insurance claims payments. When property owners have insurance coverage, the uninsured portion of the losses must be absorbed by the property owner, unless federal assistance provides supplementary help.

During the disaster recovery period, the affected local community engages in redevelopment and cleanup efforts (assuming a willingness on the part of investors to redevelop the area after a disaster) that tend to increase local employment and other economic activities. As a general rule, insurance payments and disaster assistance provide a flow of funds into the area.[4] Realizing the potential for profits, investors will likely be attracted to the building boom in the devastated area.

Insurers are able to assume their policyholders' risk because they insure many individuals and can rely upon the law of large numbers to ensure profitability. Insurers

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[3] Information on federal disaster assistance is available in CRS Report RL33053, *Federal Stafford Act Disaster Assistance: Presidential Declarations, Eligible Activities, and Funding*, by Keith Bea. Information on federal funding through supplemental appropriations is presented in CRS Report RL33226, *Emergency Supplemental Appropriations Legislation for Disaster Assistance: Summary Data, FY1989 to FY2007*, by Justin Murray and Keith Bea.

[4] Certain catastrophic disasters have led some insurers to reconsider past practices to address unanticipated losses. For background see CRS Report RL32825, *Hurricanes and Disaster Risk Financing Through Insurance: Challenges and Policy Options*, by Rawle O. King.

know that when a large number of individual risks are combined, the total amount of loss can be predicted with reasonable accuracy. The insurance industry's expertise, therefore, is to forecast the total amount of loss payments for an entire group of risks and charge an amount to cover losses plus the cost of operating the insurance business and a margin for profit. The cost of operating the business is then divided among all the policyholders.

Damages caused by fire and smoke are generally covered under the standard homeowners, renters, and business insurance policies and under the comprehensive portion of an auto insurance policy. While Congress established the National Flood Insurance Program in 1968 due to the absence and high cost of private insurance, no similar program has been established for fire losses, as the private sector generally provides sufficient coverage. Congress and state legislatures have acted in the past, however, to ensure that homeowners in areas deemed higher risk are able to purchase insurance. For example, in addition to standard insurance, homeowners in wildfire-prone areas of California may also obtain insurance protection from California's Fair Access to Insurance Requirement (FAIR) plan.

Fair Access to Insurance Rate (FAIR) Plans

During the urban riots and civil disorders of the 1960s, many of America's cities suffered property losses that caused many private insurers to become reluctant to underwrite property insurance in communities with a high potential for loss. As property insurers withdrew from inner city neighborhoods, citing huge losses, Congress passed, as part of the Housing and Urban Development Act of 1968, three major property insurance programs to alleviate the availability and affordability problem. Fair Access to Insurance Requirement (FAIR) plans provided insurance against fire, riot, and looting to homeowners and businesses who could not obtain such insurance in the voluntary market. FAIR plans are essentially state-mandated and supervised insurance pools of all property insurance companies operating within a state. Although the FAIR plans act as a single insurer, participating insurers actually share the premiums as well as the profits or losses and expenses incurred, based on their share of the voluntary property market in the state. Property owners residing in eligible urban communities (or in designated hazardous brush areas) who are able to meet reasonable underwriting standards, such as minimum fire and health protection standards, may apply to their state's FAIR plan for coverage. FAIR plans offer rates that are set at break-even levels.

As of July 2007, 32 states and the District of Columbia had FAIR plans. In most states, subsidies lower rates below the amount that would be charged in the voluntary market for the same level of risk. While most FAIR plans have lost money in high loss years, they have also been profitable in other years. Losses under the FAIR plan are covered by assessment imposed on member insurers according to their share of the voluntary property market in the state. Insurers are then able to pass the losses onto policyholders in the form of higher rates and in some states to policyholders in the voluntary market as well. Several states allow insurers to recoup losses through rate surcharges. These charges, however, are itemized on a policyholder's premium bill.

In all states except California, residents in any part of the state can apply for insurance through the FAIR Plan as long as they meet Plan criteria. In California, applicants for fire coverage must live in areas specifically designated by the insurance commissioner. These include not only urban communities and some entire counties but also certain areas that are prone to brush fires. According to the Property Insurance Plans Service Office (PIPSO), an organization that compiles data and information on FAIR plans nationwide, in 2006, the California FAIR plan generated $82 million in direct written premiums from 193,615 habitational policies and 12,509 commercial policies with exposure of $51 billion.[5]

Conclusion

Everyone who needs insurance coverage, particularly those in high-risk disaster-prone areas, might not be able to buy insurance because of its cost or the lack of availability. As a result, a number of residual market mechanisms have been established to meet the needs of these buyers. Generally speaking, insured losses from wildfires, however, have been a manageable risk, unlike, say, hurricane risks in most Gulf and Atlantic coast states — particularly following Hurricanes Katrina, Rita, and Wilma in 2005. Insurance coverage for wildfires is widely available both in the standard insurance market and residual or "involuntary" markets established by acts of state legislatures in the early 1970s to assure a market for risks that found difficulty obtaining property coverage the standard market. In California, applicants for fire coverage provided under the FAIR plan must live in areas of the state specifically designated by the insurance commissioners.

Legislative Options. Should the current appropriations for federal disaster assistance prove insufficient to meet the needs of California, Congress may face a request to appropriate additional funds. In addition, Members of the 110th Congress might elect to address the issue of catastrophe insurance through pending legislation such as H.R. 3355/S. 2310, the Homeowners' Defense Act of 2007. These identical bills would establish a nonprofit National Catastrophe Risk Consortium authorized to inventory catastrophe risk obligations held by participating state reinsurance funds, risk pools, or primary insurance corporations; to issue securities and other financial instruments linked to catastrophe risk in the capital markets; or to enter into reinsurance contracts with private parties, among other purposes.

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[5] Information on PIPSO is available at [http://www.pipso.com/], visited October 24, 2007. Users of the website must be authorized to have access.