Not IF but WHEN?

A Certified Financial Planner's Guide to

Earthquake Insurance for California Homeowners

&

Risk Management Steps to Minimize Damage

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Recent natural disasters – hurricanes and floods across the southern United States, Puerto Rico and the Caribbean AND the earthquakes in Mexico – remind us that Mother Nature is unpredictable and can cause major devastation to life and property. All of us are well aware that California is subject to very strong and devastating earthquakes. We have had a history of several "big ones" within the past century, including the 1989 Loma Prieta Earthquake and the 1994 Northridge Earthquake. The San Francisco Earthquake was 111 years ago.

The Hayward Fault, near us, is considered by experts to be the most dangerous in our country. Therefore, it is not a matter of *IF* but *WHEN* the next powerful and devastating earthquake will strike.

As CFP's, you work with your clients to create a financial plan for college, retirement, estate planning, aging and long-term care, but have you fully addressed their financial planning and preparedness for natural disasters?

I'd like to arm you with information on earthquake insurance and risk management steps to better educate you and your clients about the most cost-effective ways to manage their financial risks from an earthquake. Your clients will ask if it makes sense to purchase earthquake insurance, invest in retrofitting their homes or take some other course of action to manage the financial consequences of earthquake damage.

Here are 10 valuable questions you and your clients should consider:

1. How many more years do you plan to live in your home?
2. On what type of soil is your house built?
3. How old is your house?
4. Is your house bolted securely to the foundation?
5. How far is your house from a known fault that can cause major damage?
6. Is your home mortgage-free or how many more years do you have until you pay off your mortgage?
7. Despite the age of your home, have you had your home assessed to determine if it needs specific earthquake retrofitting to minimize the severity of damage?
8. How does your financial plan address the possibility that your home can incur severe damage in a major earthquake?
9. What will earthquake insurance cost?
10. What are all the options available today for earthquake insurance in California?

Let's dive deeper into answers for the last two questions. This white paper will give you an overview as to what is currently available in California for earthquake insurance.

A Brief History

Earthquake insurance used to be very broad, especially before 1995 when it was available as an add-on to home insurance policies.

On May 2, 1984, a 6.2-magnitude earthquake occurred near Coalinga, CA. It caused an estimated $10M in damage, injured 94 people and the downtown district of Coalinga was almost completely destroyed. Some homeowners, who did not have the earthquake insurance endorsement on their policies, and sustained major structural damage, nevertheless turned in claims to their carriers, who ended up paying them because of litigation and no exclusions in the policy language for earthquake damage. Insurance carriers were unhappy with these large payouts and requested state lawmakers to exclude earthquake damage from their homeowner policies. In exchange for this exclusion, the CA legislature required by law earthquake insurance to be offered as an option with clear wording that stated: "your policy does not provide coverage against the peril of earthquake." The insurance industry tried to repeal this law, especially after the '94 Northridge earthquake that caused $13-$44B in damages, but to no avail. To pressure the legislature, insurance companies established a moratorium on home insurance sales, creating a crisis in the real estate market. This forced the legislature to amend the law and create what is now called a "mini-earthquake" policy.

The "Mini-Earthquake" Policy

As of 1995, the California Insurance Code requires, at a bare minimum, the following type of "mini-earthquake" insurance to be offered:

- Earthquake insurance must be offered within 60 days of purchase of home insurance or on an every other year basis if earthquake insurance is not accepted
- A minimum dwelling deductible of 15% must be offered
- A minimum of $5,000 must be offered for personal property
- A minimum of $1,500 must be offered for additional costs to live elsewhere
- A minimum of $10,000 for Building Code Upgrades must be offered
- No coverage has to be offered for any detached structures, such as swimming pools, guest cottages or detached garages

Prior to the creation of the "mini-earthquake" policy, when earthquake insurance was added by endorsement to home insurance policies, the deductibles offered were as low as 5% and coverage included the same full limits for other structures, personal property and additional living expenses as provided by the home insurance policy for a loss by fire.

The California Earthquake Authority (CEA)

Insurance carriers were able to get the mandatory law to offer earthquake insurance changed to the "mini-earthquake" policy, but they were still not satisfied. They did not believe that the California Department of Insurance would allow them to charge higher premiums in order to pay for future earthquake claims.

In 1996, Chuck Quackenbush, the California Insurance Commissioner at the time, heavily promoted the establishment of the California Earthquake Authority or CEA. The CEA would essentially allow the insurance companies to comply with the mandatory law to offer earthquake insurance but transfers the risk off their books onto this new organization called the CEA. It also required major carriers such as State Farm, Allstate and Farmers to participate and help get it started with their own funds. The CEA has now been in place for over 20 years.

The California Insurance Marketplace Today

There are a number of options to buy earthquake insurance for homeowners today:

- THE CEA – only available from 25-member companies including: AAA, Allstate, Encompass, Farmers, Liberty Mutual, Nationwide, Nationwide Private Client, Safeco, State Farm & USAA. For a complete list of members, please visit the CEA's website at www.earthquakeauthority.com.
- Insurance companies who have opted not to join the CEA but still offer earthquake insurance to policyholders who have

purchased a home insurance policy from them. Some of these well-known companies include AIG Private Client Group, CHUBB, Hartford, PURE & Travelers.

- Stand-Alone earthquake insurance only policies from insurers who don't sell homeowners insurance in California. These companies include GeoVera Insurance Company, ICAT, Palomar Specialty and QBE Insurance Company. These carriers have specific underwriting guidelines - such as the age, the insured value, the number of stories & the location of the home – that must be met to qualify for their policies.

<u>Coverage & Premium Differences</u>

There are major coverage and premium differences among these carriers.

Major coverage differences include:

- Earthquake Deductibles
- Limits offered for
  - Other Structures
  - Personal Property
  - Additional Living Expenses
  - Building Code Changes

Key factors that affect premium differences include:

- The age of the house
- Type of foundation
- The location of the house
- For older houses, has the house been earthquake retrofitted?
- The limits of coverage selected for the dwelling, other structures, personal property, and loss of use
- The deductible chosen

<u>CEA's Earthquake Policy</u>

The CEA offers two earthquake policy forms for homeowners:

1. Homeowner
2. Homeowner Choice

Both forms include:
<u>Dwelling Deductible</u> options of

- 5%, 10%, 15%, 20% or 25%

<u>Building Code Upgrade</u> options of

- $10,000, $20,000 or $30,000

<u>Personal Property Limits</u> options of

- $5,000, $25,000, $50,000, $75,000, $100,000, $150,000 or $200,000

<u>Loss-of-Use</u> options of

- $1,500, $10,000, $15,000, $25,000, $50,000, $75,000 or $100,000

<u>Similarities between Homeowner and Homeowner Choice?</u>

- Both policy forms do not provide coverage for detached structures such as pools, guest cottages or detached garages

<u>Differences between Homeowner and Homeowner Choice?</u>

<u>Homeowner</u>

- Automatically includes $5,000 for personal property (it can't be deleted)
- No deductible for damage to personal property but you can only collect money for damaged personal property if the dwelling damage meets or exceeds the dwelling deductible

Homeowner Choice allows

- Election of your own personal property limit or no personal property coverage
  - A separate personal property earthquake deductible of 5%, 10%, 15%, 20% or 25%
  - Collection of money for damage to personal property even if the dwelling deductible has not been met but the separate earthquake personal property deductible applies to your personal property limit you select

What else should you know about the CEA policy?

- The CEA earthquake insurance premiums are identical regardless of the home insurance carrier
- The CEA can require policyholders to pay a surcharge if the CEA does not have enough funds to pay all its claims after an earthquake
- The CEA can pay less than the amount of coverage you have to avoid having to surcharge policyholders
- The dwelling limit offered has to match the limit on the homeowner's policy (i.e.: it cannot be more or less than this limit)
- The CEA does not require a home to be retrofitted to qualify for an earthquake policy
- Lower premiums may be available for homes with raised foundations built before 1980 if a home is earthquake retrofitted and certain guidelines are met

Earthquake Policies from AIG Private Client, CHUBB, Hartford, PURE & Travelers

A large percentage of the home insurance market share in California is with "direct writers" such as AAA, Allstate, Farmers & State Farm. They have agents who are "captive" and are only able to offer with a few exceptions, earthquake insurance products from the CEA.

Insurance products are also offered through independent insurance agents, such as David Shaffer Insurance Services, but cannot offer insurance from direct writers. These agents work with companies such as AIG Private Client, CHUBB, Encompass, Hartford, PURE, Safeco & Travelers, just to name a few, who only offer their products through independent agents. Each carrier has slightly different offerings, but here are some highlights:

- They all have to offer the "Mini-Earthquake" policy
- They can offer more comprehensive earthquake coverage than the CEA or Stand-Alone carriers, if the home is eligible
- Their earthquake coverage must be purchased with the homeowner policy and cannot be purchased by itself

An Example:

Let's take CHUBB's Earthquake Insurance policy options as an example. CHUBB offers three types of policies:

1. "Mini-Earthquake" – the bare minimum required by law
2. Enhanced "Mini-Earthquake" – allows higher limits than required by law
3. Basic Earthquake – the most comprehensive policy for those who are eligible

Key Features of CHUBB's Policies:

The Enhanced Mini-Earthquake policy provides

- Higher limits for personal property, up to $750,000 (The CEA's maximum offer is $200,000)
- More options for Other Structure limits, including $5,000 or up to 5% or 10% of the dwelling limit (The CEA provides no coverage for detached structures)
- More options for Loss of Use coverage, starting at $5,000 or 5%, 10% or 30% of the dwelling limit (This can be substantially more than the CEA's $100,000 loss of use limit)
- More options for Rebuilding to Code coverage, including an automatic $10,000 or 25% or 50% of the dwelling limit provided to rebuild to code

The Basic Earthquake policy

- Automatically provides coverage for other structures, personal property and loss of use that match the same limits on the homeowner's policy for fire coverage
- Provides 100% of the costs to rebuild to code compared to the CEA's maximum of $30,000 to rebuild to code.

Earthquake Insurance Only Policies

Now let's take a look at some of the Stand-Alone earthquake insurance only policies from insurers who don't sell homeowners insurance in California, GeoVera Insurance Company, ICAT, Palomar Specialty & QBE Insurance Company, and discuss what their earthquake policies have to offer.

GeoVera Insurance Company

GeoVera offers two policies:

1. GeoVera Comprehensive Policy
   - This policy provides up to a maximum single limit of $1.9M for the dwelling, other structures, personal property and additional livings expenses up to a maximum of twelve months
   - The minimum deductible offered is 10% and can be increased up to 25%
   - The earthquake deductible is applied to the single limit shown on the policy, and once met, the full dollar amount of coverage on the policy is available subject to all the terms and conditions of the policy
2. GeoVera Standard
   - This policy is very similar to the "Mini-Earthquake" Policy required by California State Law

GeoVera reserves the right to approve or not approve an earthquake insurance policy, based upon the location of the home and other underwriting guidelines.

ICAT

ICAT offers three types of policies:

1. Mini-Earthquake Insurance
2. Comprehensive
3. Comprehensive Plus

Under Comprehensive and Comprehensive Plus

- ICAT offers dwelling deductibles of 2%, 3%, 5%, 7.5%, 10%, 12.5%, 15%, 20%
- The deductible chosen above will also apply separately to Other Structures and Personal Property
- No Deductible applies to Loss of Use

- With Comprehensive, the maximum limit offered for Loss of Use is $25,000
- With Comprehensive Plus, the maximum limit offered for Loss of Use is up to 20% of the dwelling limit but cannot exceed $250,000
- With Comprehensive and Comprehensive Plus the minimum amount of coverage required for Loss of Use is $14,000 and higher limits can be selected subject the maximums above
- With Comprehensive and Comprehensive Plus, coverage limits can be fine-tuned for Other Structures and Personal Property as follows:
    - The minimum amount of coverage required for Other Structures is $7,000 with options to buy a higher amount and $25,000 is included for a pool w/Comprehensive Plus if you have at least $25,000 or greater for Other Structures
    - The minimum amount of coverage required for Personal Property is $35,000 with options to buy a higher amount
- On all three policies,
    - The maximum dwelling limit offered is $5M
    - The maximum available for building code changes is $10,000 except on their Mini-Earthquake policy
    - Homes built after 1900 are eligible but subject to underwriting guidelines for eligibility
    - Homes built prior to 1972 must meet specific retrofitting guidelines
    - The home's type of construction & foundation, number of stories, as well as other factors, determine the home's eligibility

<u>Palomar Specialty</u>

Palomar Specialty offers

- Dwelling Deductibles at 2.5%, 5%, 7.5%, 10%, 12.5%, 15%, 20% and 25%
- Deductibles apply separately to each coverage section, including Loss of Use
- Up to $15M in Total Insured Value
- Choice of dollar limits for Other Structures, Personal Property and Loss of Use
- Building Code Changes up to $10,000
- No Earthquake Retrofitting required of older homes
- Partial Dwelling Limits to reduce the premium
- Shared Loss Settlement Option to reduce the premium

<u>QBE Insurance Company</u>

QBE offers three policies:

1. Mini-Earthquake Insurance
2. Superior
3. Superior with EQ Plus Endorsement

QBE insurance policies offer

- Dwelling Deductibles of only 10% and 15% and set percentage limits for other structures, personal property and additional living expenses based on the dwelling limit
- Dwelling Limits that can be approved up to $5M
- Deductibles that apply separately to each coverage section, including loss of use
- The Superior policy at $25,000 for Loss of Use while the Superior with EQ Plus Endorsement provides $100,000 for Loss of Use

- Homes built before 1955 must meet specific retrofitting guidelines

Risk Management Steps to Minimize Damage and Injury

1. **Earthquake Retrofitting**

What makes more sense - should your clients purchase earthquake insurance OR earthquake retrofit their home instead?

It depends on the particular circumstances, financial goals and risk tolerance of each client!

Howard Cook, co-owner of Bay Area Retrofit, a seismic retrofit contractor who specializes in earthquake retrofitting, has told me paying for proper retrofitting may be more cost effective than paying for insurance premiums but does not totally offset the need to consider coverage. He believes retrofitting done correctly will reduce the likelihood of the house suffering major earthquake damage when the next big one hits. (For further information, please see their website www.bayarearetrofit.com)

Structural engineers have told me that building code requirements today *merely minimize* the damage to the house structure to prevent homes from completely collapsing so the occupants are not injured and can safely exit the house. If homes were built to stronger building codes that prevented severe structural damage, the construction costs would be substantial and prohibitive.

Proper earthquake retrofitting goes beyond minimum building code standards and per Howard Cook will substantially minimize structural damage and thus reduce repair costs.

Earthquake insurance premiums, spread out over the number of years the homeowner plans to stay in the home, may or may not be more cost effective. Therefore, it will be important to factor the earthquake insurance cost vs. the retrofitting cost in the decision-making process.

2. **Automatic Earthquake Seismic Shut-Off Valve**

The insurance industry predicts that, in addition to structural damage, devastating fires will most likely ensue after a major earthquake. Fires broke out after the 1906 San Francisco Earthquake, after the 1989 Loma Prieta Earthquake in the San Francisco Marina district, and after the 1994 Northridge Earthquake in Los Angeles.

Therefore, I highly recommend installing a specialized "Earthquake Seismic Gas Shut-Off Valve" on your gas meter. This valve automatically shuts off the gas to your house in the event of a large earthquake. For peace of mind and the safety of your family, call a licensed plumber or company specializing in installing these valves properly for you. One such company is MBS Engineering, located in San Ramon, CA. (For further information, please see their website: www.mbsengineering.com)

3. **Protecting Personal Property in the Home from Earthquake Damage**

Personal Property in the home can also be severely damaged and be the source of injuries to the occupants.

To prevent damage to valuable personal property and injuries to occupants:

- Securely fasten to the walls any shelving and other furniture that could fall over on top of people in the home

- Securely fashion paintings with high quality fasteners to prevent them from falling off the wall
- Securely fashion sculptures and other breakable art items with special earthquake wax to prevent them from falling off mantles, shelves and tables
- Install hinges on kitchen cabinetry that will prevent the doors from opening and not allow items to fall down and break
- Never hang on a wall next to a bed items that can fall off on top of people sleeping in a bed
- Always keep next to your bed at night slippers with solid bottoms and a flashlight to avoid stepping on sharp objects that have fallen and broken or from broken windows or mirrors

How to obtain a quote for Earthquake Insurance

Here are three easy ways to obtain a quote for your estimated earthquake premium:

1. Get an estimate on the CEA's website on your own. Visit www.earthquakeauthority.com and use their simple Premium Calculator to obtain a quick quote, based on parameters that you enter.
2. If you already have a homeowner policy with a CEA-member company, contact your agent to run the calculations for you. Keep in mind, they will simply do the same as #1 above
3. Contact David Shaffer of David Shaffer Insurance Services who represents some of the CEA-member companies, carriers such as AIG Private Client, CHUBB and Travelers; and the carriers GeoVera, ICAT, Palomar Specialty and QBE Insurance that offer the Stand-Alone earthquake insurance policies and to discuss specialized policies for those with art collections or other collections and want coverage for earthquake damage

Will my insurance company be able to pay all the claims after a major earthquake?

To share the burden of paying huge sums for claims after catastrophic events, all insurance companies, including the CEA, purchase "reinsurance" on their portfolios of business.

Reinsurance plays a vital role to help the claims paying ability of all insurance companies to meet their financial obligations to policyholders.

This article was not intended to include how to analyze the financial strength of the insurance company paying the earthquake claim but is a legitimate concern to take into consideration.

Conclusion

Each client has unique financial goals and different priorities, dwelling considerations, risk tolerance levels and budget restrictions, therefore, addressing the financial issues related to earthquake damage **must be highly personalized**.

Today, only 1 in 10 California homeowners purchase earthquake insurance. This means that most Californians are 100% self-insured and plan to pay out of pocket for earthquake damage to their homes and personal property. FEMA only provides loans up to a maximum of $250,000 and the loans must be repaid. How many can truly afford to rebuild their homes to new building codes, replace damaged personal property and pay the additional costs to live elsewhere while their home is repaired or rebuilt after a major quake? Who will end up tapping into their assets that were originally accumulated for other financial goals?

Insurance and Risk Management is a very important subject area of financial planning. With all the recent news about natural disasters this is a great time to re-evaluate with your clients their financial planning for earthquake damage because California has two-thirds of our nation's earthquake risk.

You are now armed with valuable information on earthquake insurance and risk management steps. Keep in mind the 10 valuable questions at the beginning of this article that you and your clients should consider as you advise them about the financial consequences of earthquake damage and how it relates to their financial plan.

Remember… it's not a matter of IF but WHEN the next "big one" will occur!

David Shaffer, Agency Principal

David has over thirty-four years of insurance industry experience. He has owned and operated his own independent agency, David Shaffer Insurance Services, since 1983.

In 1991, David helped establish United Policyholders (UP), www.uphelp.org, a national insurance consumer non-profit group headquartered in San Francisco dedicated to educating and empowering consumers. He has continued to stay involved with UP since 1991.

David's experience also includes testifying in Sacramento on behalf of his professional trade association, the Independent Agents and Brokers of California, on legislation for home insurance in front of the California State Assembly and California State Senate.

His business objectives are to protect his clients' assets and to identify, reduce and/or eliminate potential financial catastrophes that can be appropriately handled by the right cost-effective insurance products and risk management strategies with an Asset Protection Plan custom designed to meet each client's individual needs and goals.

Many clients of David Shaffer Insurance Services are affluent and successful individuals and families. They include art collectors, bank presidents, CPAs, attorneys, doctors, Certified Financial Planners, wealth managers and business owners who appreciate working with a knowledgeable and detail oriented insurance professional.

David has been quoted in the following magazines and newspapers: Journal of Financial Planning, San Francisco Chronicle, Oakland Tribune, Contra Costa Times, and the Los Angeles Times. He has appeared many times on KTVU Channel 2 news broadcasts to discuss insurance issues with Consumer Editor, Tom Vacar.

In addition to his insurance licenses, David has two professional insurance designations that show his commitment to his professional work: Associate in Risk Management (ARM) and Chartered Private Risk and Insurance Adviser (CPRIA).

David can be contacted by email: david@davidshaffer.com or by calling his office: 925-944-7100 to discuss this important financial planning issue in greater detail.