California Legislature

STATE CAPITOL
SACRAMENTO, CALIFORNIA

August 27, 2010

The Honorable Steve Poizner, Commissioner
California Department of Insurance
300 N Street, Suite 1700
Sacramento, CA 95814

Re: Homeowners' Insurance

Dear Mr. Poziner:

Thank you for taking time in our recent discussions to outline your views about the need for additional regulations affecting homeowners' insurance. As the Chairs of the Legislative Committees with jurisdiction over insurance law, we believe this dialogue furthers the Legislature's ongoing responsibility for oversight of Department of Insurance (CDI) activities.

We heard clearly your belief that homeowners' insurance policyholders and applicants would benefit from additional information to aid their selection of policy limits. We certainly agree that an informed, intelligent decision about policy limits is important, and that an intelligent conversation between a consumer and a well-trained insurer employee or agent can be a key component in that decision. As you consider regulations on this topic, (for example, proposed CDI regulation 2010-00001) we look forward to establishing a common view of the Legislature's prior agreements and enactments in this area of law. In your regulation's current iteration, we are concerned the structure of the proposed regulation might actually *discourage the very conversations that we agree ought to occur.* Specifically, the regulation's "trigger" for imposition of its primary requirements would be the use, in an insuring transaction, of the words "replace" or "replacement". We're concerned that under such a regime, insurers or agents might simply try to avoid using these terms in an effort to avoid the requirements of the regulation; indeed CDI staff has, as we understand it, suggested to the industry that avoiding the use of these terms is all an insurer need do to avoid the regulation if it deems the requirements too onerous. That seems an anti-consumer outcome. We believe that any intelligent conversation about coverage limits for a homeowner's policy *should* include the words "replace" and "replacement."

As lawmakers, we do recognize that the devastating October 1991 fires in the Oakland hills dramatically changed the type of homeowners' insurance coverage available for consumers in California. Prior to the fires, it was common for carriers to offer coverage guaranteeing a complete reconstruction following a total fire loss, regardless of coverage limits purchased. This type of coverage was not without controversy, particularly when homeowners alleged that agents urged the purchase to "too much" insurance and purposely "over-insured" them.

Since the Oakland fires, guaranteed replacement cost policies have become increasingly rare. More common in today's marketplace are homeowners' insurance policies with a specified maximum dollar policy limit which the applicant selects after considering his or her needs. Under such a "limited" replacement cost policy, if the costs to reconstruct a home to pre-loss condition exceed the policy limit, the insurance contract requires the carrier to pay the policy limit, but no more. Many insurers also offered "extended replacement" policies, which still provided coverage above the stated policy limits, but which also contained a firm maximum, usually stated as a percentage of the basic coverage limits.

In the aftermath of the Oakland Hills Fire, the Legislature carefully considered the confusion that a policyholder may experience when shopping for a "limited" or "extended" or "guaranteed" replacement cost policy. After extensive deliberation, the Legislature adopted standardized language that describes the various options that carriers must use when offering homeowners' insurance. (See Insurance Code Section 10102.) Policies promising a complete reconstruction without regard to policy limits are now known as "guaranteed replacement cost" policies; policies promising reconstruction up to, but not exceeding, policy limits are now known as "limited replacement cost" policies.

In our discussions, you indicated a belief, based upon observations at town hall meetings and complaints received by CDI staff, that confusion remains among policyholders about the difference between guaranteed and limited replacement cost policies. You also expressed a desire that insurers and agents be a source of credible information on these matters and not add to marketplace confusion. To address these concerns, with our strong backing, the Legislature has just passed without a "no" vote your sponsored legislation, AB 2022 (Gaines), to improve the standardized form.

With respect to your pending rulemaking, you have advised us that you believe current law authorizes the CDI to promulgate regulations requiring 1) insurance producers to obtain training regarding replacement cost issues, 2) carriers to keep additional records that would aid CDI examinations and 3) carriers/producers to provide consistent and comprehensive information when choosing to provide non-binding estimates of replacement cost. As part of

the Legislature's oversight role, we look forward to reviewing the results of this rulemaking to ensure it is both good policy and consistent with your statutory authority – which we regard as quite specific.

Initial drafts of the proposed rule have raised questions about the CDI's purpose and authority. We appreciate the assurances you have given us that the CDI does not intend to alter the balance achieved under current law to allow both guaranteed and limited replacement cost policies in the marketplace. Further, we appreciate and agree with your view that CDI rules should respect the current law which 1) allows agents and insurers to offer non-binding estimates of replacement cost without triggering guaranteed replacement cost liability and 2) respects the role of applicants and policyholders in selecting their own policy limits and costs, consistent with the ruling in Everett v. State Farm, 162 Cal.App.4th 649 (2008).

As you consider how to finalize the proposed rule, it is important to ensure that knowledgeable decisions are made up front and clear understandings are reached between consumers and insurers or agents so that a limited replacement cost policy does not become unwittingly transformed into a guaranteed replacement cost policy, and consumers are not unwittingly sold insurance that they do not need. Specifically, as we discussed above, proposed section 2695.183(j) would appear to trigger increased regulation and possible sanction upon the mere use of the words "replace" or "replacement" during a transaction. This approach could inappropriately jeopardize the viability of a limited replacement cost market, which empowers individual homeowners to control their insurance costs and thereby acts as a safeguard against both predatory sales of inflated coverage on the one hand, and sales of inadequate coverage on the other. Further, this approach could wrongly incentivize agents and insurers to pressure the purchase of ever higher policy limits based on a fear that post-fire policy proceeds insufficient to permit a complete reconstruction would result in mandated extra-contractual liability. Neither under-, nor over-insurance is a good result.

We understand and respect your statement that this is not your intent for the regulations. We are relying on your assurances that the final rule will address our concerns in this area.
We also appreciate your clear statement that it is your intent that proposed section 2695.183 work to ensure that applicants receive consistent and comprehensive information when selecting their policy limits. We are inclined to support your view that applicants would be in a better position to select their initial policy limits if the law posed no obstacle, legal or practical, to the readiness of agents and carriers to offer high quality, non-binding reconstruction cost estimates. This does appear to be a service that state law should encourage. We look forward to your attempt to develop a rule that would specify the minimum structural components, including foundation type, which must be factored into a licensee's non-binding estimate of

reconstruction costs that it may choose to provide to an applicant. Ensuring that up front estimates are fair, reasonable, understood and well-documented by both parties is the better way to avoid post-claim disputes. Because questions have been raised about the extent of the CDI's authority to directly regulate the cost-estimation process, we may consider consulting the Legislative Counsel's office to seek additional guidance on this matter.

We also think it very important that, when developing a rule regarding non-binding estimates of replacement cost, that the CDI wisely use its powers under the Unfair Practices Act (Insurance Code section 790) without triggering unnecessary disputes over the extent of CDI power. While the CDI's powers under 790.03 are strong, they are not, of course, unlimited. As the CDI drafts a rule to assist applicants and policyholders, we urge careful consideration of how to improve the current system without jeopardizing the viability of a limited replacement cost system which allows applicants and policyholders to manage their coverage limits and costs.

As the CDI moves to finalize its rule, we will continue to seek input from all stakeholders to evaluate how the rule would fit within the existing statutory and case law framework. Interim hearings may be appropriate should critical issues remain unaddressed by the rulemaking, as both a resource available to the CDI and as a basis for the formulation of legislation in 2011, should it be necessary.

Thank you for your leadership and collaboration on this important matter. We invite you to reply to this letter with a confirmation of our mutual understanding with respect to the development of the law in this area and your intentions to develop further clarity that will avoid post-claim disputes in the future.

Sincerely,

JOSE SOLORIO
State Assemblymember

Sincerely,

RON CALDERON
State Senator