Insolvency
Merced Property & Casualty Company (2018)

United States

Background and context

Headquartered in Altwater, Merced Property & Casualty Company (Merced) has been a prominent provider of property and casualty (P&C) insurance services across California, including Central Valley, since 1906. Operating as Merced Mutual Insurance Company in the past, it provided various insurance for homeowners and property including dwellings, automobiles, marine and farm cover. Merced's comprehensive coverage includes protection against a wide range of direct and accidental losses such as fire, water damage, vandalism, and others.

Amid challenging economic conditions in California's Central Valley, since 2006, Merced experienced a consistent decline in its direct written premiums (DWP) for eight consecutive years. In 2013, Merced opted for demutualisation as a strategy to preserve its viability. The United Heritage Financial Group, Inc (UHFG),[96] based in Meridian, Idaho, acquired all of Merced's shares via its subsidiary, United Heritage Insurance.

The acquisition helped to improve Merced's financial position (Table 12). In 2017, the 23.8% growth in DWP marked its fastest growth in 14 years, mainly due to its homeowners' business segment. Approximately 60.5% of Merced's year-end policies in force and 81.4% of its full-year DWP came from the homeowners' line, all from within California.

> ***Our expectations for positive sustainable growth are now a reality… We are in business for the long haul***
>
> Merced Property & Casualty Company

As at end-2017, Merced had assets of $23.8 million, with liabilities of $7 million and a policyholder surplus of $16.8 million. While classified as a small insurance provider, Merced was highly solvent at that time and the financial ratios[97] used by state insurance regulators (from the National Association of Insurance Commissioners' Insurance Regulatory Information System) did not seem to flag out any major concerns.

[96] UHFG had ownership of three additional insurance firms – United Heritage Life Insurance Company, United Heritage Property & Casualty Company, and Sublimity Insurance Company

[97] Include 13 measures of profitability, growth, liquidity and reserve adequacy

Table 12: Key financial ratios – Merced Property and Casualty Company 2012-2017 (%)

Key ratio	2017	2016	2015	2014	2013	2012
Expense ratio (*SAP)	53.25	58.68	59.19	58.62	58.10	52.09
Loss & Loss Adjustment Expense Ratio	61.19	46.46	66.42	55.65	45.60	53.09
Combined Ratio (*SAP)	114.44	105.14	125.62	114.27	103.70	105.19
Operating Ratio	100.83	87.02	106.16	91.55	86.66	99.18
Retention Ratio (NPW/GPW)	85.89	85.17	85.86	86.86	85.12	85.13
Return on Equity (ROE)	-1.07	3.24	1.18	4.97	18.42	0.90

Notes: SAP indicates that a ratio is calculated using the Statutory Accounting Principles (SAP); Expense Ratio (SAP) = Other Underwriting Losses / Net Premium Written; Loss & Loss Adjustment Expense Ratio = (Loss Incurred + Loss Adjustment Expenses Incurred) / Net Premium Earned; Combined Ratio (SAP) = Loss & Loss Adjustment Expense Ratio + Expense Ratio (SAP)

Source(s): SNL Insurance, PACICC

Impact of the Camp Fire on Merced

In the early hours of 8 November 2018, a powerline owned by Pacific Gas & Electric Co. caused a massive wildfire known as the “Camp Fire” in Butte County, California. Fuelled by strong winds, dry conditions, and flammable vegetation, the fire within the first six hours engulfed the towns of Concow, Magalia, and Paradise, resulting in extensive damage. Authorities took 17 days to extinguish the Camp Fire. This natural disaster became one of the worst wildfires in history, scorching over 150,000 acres, claiming 86 lives, and destroying 18,793 structures including the entire town of Paradise. Estimated insured losses amounted to $17 billion.

The devastating impact of Camp Fire resulted in significant financial problems for P&C insurers. Merced was hit hard given the geographical concentration of its insurance portfolio in areas designated by the California Department of Forestry and Fire Protection as “high severity zones”. It is worth noting that the lack of diversity in business and geography was common among smaller regional insurers in California.

In 2016, details of Merced’s homeowners’ insurance composition showed that about 51.9% of its premiums came from properties with low to moderate wildfire risk. However, a substantial portion of 44.3% and 3.8% of their premiums came from properties categorised as having high and extreme risk.

In the aftermath of the Camp Fire, Merced faced substantial losses. Damages in the town of Paradise alone amounted to $64 million, as Merced was saddled with estimated overall liabilities of $87 million.

While reinsurance programs softened the blow (potential recovery of $17 million), available funds were insufficient to cover Merced’s claim obligations. A state examination revealed Merced’s reinsurance coverage required them to cover the initial $150,000 of any claim, before coverage took effect. This meant that Merced’s assets of $23 million could have been depleted by only 153 claims. Therefore, the California Department of Insurance determined that Merced lacked the necessary funds to cover its liabilities and attempts to rehabilitate the company were not viable.

> ***Small companies tend to have more of their business concentrated in specific areas. That makes it more likely that such a company could be bankrupted by a single catastrophe***
>
> Rex Frazier, President of the Personal Insurance Federation of California

Resolution actions

Resolution of Merced – Timeline of Key Events

- **2006** Merced experienced decline in business due to economic conditions.
- **2013** Merced acquired by UHFG via United Heritage Insurance.
- **8 Nov 2018** Natural catastrophe involving The Camp Fire destroyed Paradise and the neighbouring area.
- **26 Nov 2018** The Camp Fire was fully contained.
- **30 Nov 2018** Liquidation proceedings against Merced were initiated.
- **3 Dec 2018** The Superior Court of the State of California found Merced insolvent and appointed the Insurance Commissioner as the Liquidator for Merced.
- **2 Jan 2019** Cancellation of all Merced insurance policies following the liquidation order took effect.
- **Jun 2019** Almost 90% claims by policy owners have been reimbursed by the California Insurance Guarantee Association (CIGA).

Insolvency and placement into liquidation

Overwhelmed by claims from policy owners, Merced went from being financially stable to the edge of insolvency within just eight weeks. It was later revealed that Merced had underestimated its exposure to wildfire risks and the potential losses from such events owing to their business concentration in a particular area and arrangements of the reinsurance programme. This was despite having in place risk exposure rules, which were not effectively monitored by the management of Merced.

On 30 November 2018, the California State Insurance Commissioner initiated liquidation proceedings against Merced. Subsequently, on 3 December, the Superior Court of the State of California (the Court) found Merced insolvent and appointed the Insurance Commissioner as the Liquidator[98] as per the Insurance Code. This facilitated liquidation of Merced's assets and recovery for its claimants, creditors, and shareholders.

As a result of the liquidation order, all of Merced's insurance policies were required by law to be cancelled within 30 days from the liquidation date or by 2 January 2019 unless terminated prior to that date by the policy owner. A total of 7,436 cancellation notices were mailed to all known in-force policyholders. The insurance policy claims were covered by the California Insurance Guarantee Association (CIGA) and transferred immediately to CIGA upon the entry of the order of liquidation and finding of insolvency. CIGA was also responsible for reimbursing unearned premiums to insured individuals for coverage extending beyond the cancellation date.

According to CIGA's statute, reimbursements would be provided up to a maximum of $500,000 per claim. In Merced's case, CIGA formulated the option of treating four different coverages. This enabled policy owners to file four different claims instead of just a single claim. The four coverage segments included dwelling, structures, contents and additional living expenses. This novel solution led to CIGA covering almost all policy owner's claims, except those which exceeded the $500,000 cap.

Based on the Statement of Operations by CIGA on 31 March 2019, a total of $83 million in claims and expenses was estimated to be paid on behalf of the Merced estate. CIGA paid a total of $3 million in unearned premiums to policy owners and $66 million in losses, loss adjustment expenses, return premiums and incurred administrative expenses for Merced fire-related claims, as well as other policy claims. Within 7 months after the catastrophic event, CIGA successfully reimbursed 88.5% of total losses sustained by policy owners.

[98] Include (1) David E. Wilson to serve as the Special Deputy Insurance Commissioner in charge of the Merced liquidation and (2) Scott Pearce to serve as Liquidation Manager for Special Deputy Insurance Commissioner Wilson. Liquidation was performed by the Conservation and Liquidation Office, serving the California Insurance Commissioner

Key takeaways

The safety net works

The first key lesson offered by Merced's failure is the critical need for safety nets or last resort protection for consumers to preserve the financial security and resilience of affected insurance policy owners. In this case, CIGA stepped in immediately to assume covered policies and proceeded to reimburse almost 90% of total losses suffered by the owners of Merced's insurance policies. Since its establishment in 1969, CIGA has paid out more than $9 billion in covered claims.[99]

> ***Losing your insurance should be the last thing on someone's mind after surviving a devastating fire ... This law gives millions of Californians breathing room and hits the pause button on insurance non-renewals while people recover***
>
> Ricardo Lara, California State Insurance Commissioner

New underestimated risks

The second poignant lesson is the heightened impact of climate change on the solvency risks of insurers, as well as the speed and cost of its failures. It was recognised that Merced was a small player with over-concentration of geographical risks in areas susceptible to natural disasters.[100] Combined with under-reserving, these factors reflect typical root causes of insurer failures.

Nonetheless, the failure of Merced epitomised strategic shifts taking place in the operating environment of insurers. Even with reinsurance coverage, risk modelling and other controls in place, financially stable insurers can be exposed to unexpected extreme scenarios from unmodeled risks, and face a collapse. Other examples include the rehabilitation order for Real Legacy Assurance Co. Inc., which succumbed to losses from Hurricane Irma and Maria in 2017. According to Aon, 2022 saw total economic losses from natural disasters of $313 billion, with about $132 billion or 42% covered by insurance. In Asia, flooding events were prominent, accounting for more than 61% of total economic loss.

From the perspective of Insurance Guarantee Schemes or IGS, climate risks lessen the time for intervention preparedness and actions. IGS' are also confronted with higher exposures and funding requirements.

New undesirable risks

Lastly, during the post-failure phase, effects on market dynamics can continue to reverberate. Following Merced's collapse and the unabating threat of prospective wildfires, property insurance rates went up as coverage in high-risk areas declined and existing policies were not renewed. Subsequently, the public policy response saw California introducing consumer protection legislation to prevent abrupt cancellations of homeowner insurance policies or non-renewals, providing a one-year moratorium. The new law has since been implemented and recently protected the insurance coverage of over 236,000 homeowners, following wildfire emergencies in Northern and Southern California in September 2022. Nevertheless, the introduction of such policies come with balancing trade-offs, given downside risks on the sustainability of insurers that are prevented from repricing risks in evolving market conditions.

[99] CIGA is a not-for-profit organisation funded by assessments of Member Insurers, distributions from the estates of insolvent Member Insurers, and investment income

[100] Besides Merced, it is worth noting other homeowners' insurance companies in California experienced substantial losses from the Camp Fire and relied on reinsurance, e.g. gross losses of Farmers Insurance Group ($2.1 billion), Allstate Insurance Group ($1.2 billion) and Mercury General ($253 million) (YE 2018 financial reports)