What is Reinsurance?

What (the #%!) is Reinsurance? And how does it impact homeowners insurance in California?

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I'll start here with the timeworn definition – reinsurance is insurance for insurers.

Isn't that catchy phrasing?

Just as you purchase insurance to protect you against a major financial loss, insurers buy reinsurance to cap their losses – say for a given peril (as just one example of a reinsurance coverage). To illustrate this example, let's say an insurer we'll call Trusty is buying $10 million in reinsurance coverage for any Fire losses it pays out exceeding $ 50 million in a given year. Trusty retains the loss exposure for the first $50 million of Fire losses before the reinsurer would step in to pay losses from $50,000,001 to $60 million. For losses above $60 million Trusty would again be responsible for those losses.

Buying reinsurance is the established "norm" in the insurance industry as it greatly stabilizes the financial strength and security of our primary insurers – the insurers that insure our homes. That benefits the insurance consumer. In fact, it allows insurers to write more business, also good for the consumer.

Think about how much loss exposure an insurer can have in just a single neighborhood. Say there are 100 homes in a general neighborhood in Exampleville. And each of those homes has a homeowners policy that provides dwelling structure coverage of $500,000 – the estimated cost to rebuild.

Say our example insurer “Trusty” happens to write the coverage for 10 of those homes. Of course, each of those $500,000 homes Trusty insures under its standard homeowners policy also has $250,000 in contents coverage and $100,000 in Additional Living Expense coverage and $50,000 in Other Structures coverage and $50,000 in Building Code Upgrade coverage. And maybe an additional $100,000 in extended replacement cost if construction costs exceed the dwelling coverage limit.

That’s over $1 million in exposure for each property and thus more than $10 million in total that Trusty has at risk – in just one neighborhood that could be destroyed by a single wildfire. Given the many such concentrations of risk Trusty has across a given region or state or group of states, it behooves Trusty to buy coverage that smooths its expected losses in an any given year – that is, it makes its loss experience more predictable and sustainable. That just makes sense.

The purchase of reinsurance is broadly accepted as a legitimate, rational undertaking for insurers and the cost of the reinsurance is typically built into the rates paid by individual policyholders for their homeowners coverage. Except in California.

In California, where insurers’ rates must be approved by the Department of Insurance, the regulations governing the categories of insurer expenses to be included in their rates do not allow for reinsurance costs to be added to the rates charged to policyholders.

Why is that?

First, the regulatory process in place in California since the passage of Proposition 103 in 1988 is intended to regulate insurance rates so that insurer profits/rates are not excessive, inadequate or unfairly discriminatory. But these laws do not apply to reinsurers. Reinsurers are free to charge “whatever the market can bear”, in other words, they are “regulated” only by competition. And every insurer’s need for reinsurance coverage can vary greatly based on the insurers’ financial situation, its distribution of risk, its blend of holdings, corporate partnerships, and surplus, etc. etc. Trying to incorporate this complex and unregulated tangle of reinsurance costs and needs into the California rating scheme would be nearly impossible. It could arguably undermine all the other protections in the California regulations.

So does this result in California completely ignoring an expense for a valuable financial safeguard? Not entirely.

While California does not allow insurers to include reinsurance expenses in the rates, it also does not remove the losses paid/reimbursed by reinsurers from an insurer's request for a rate change.

So if our insurer friend Trusty paid out $60 million in Fire losses in a two of the last three years and subsequently files for a rate increase, the fact that a reinsurer reimbursed Trusty for $20 million of those losses will not be accounted for in the rate approval process. Those $20 million in losses will not be deducted from Trusty's loss experience. So the basis for the rate approval will thus be higher than if it were based on Trusty's actual retained losses – and it is that additional amount of rate that is considered a source of reimbursement for reinsurance costs (for those people people who are actually contemplating this calculation). Obviously, there may be many years where Trusty pays for reinsurance but receives no benefits at all – just like you and I typically experience from our insurance coverages.

It is admittedly an imperfect response to a challenge where there is no perfect answer. The insurance industry argues that reinsurance is a necessity and thus the cost should be included in the rate approval process. There's some truth to that. But also consider: Since the consumers are paying for insurance to protect themselves, should they also have to for their insurers' insurance? There's a logic to that concern too.

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