Why an Insurer Will Halt the Writing of New Business

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Recently, it was reported that insurer AIG will no longer write new insurance in 200 Zip Codes around the US (there are about 42,000 Zip Codes in total). Two weeks ago, State Farm announced it was ceasing the underwriting of new commercial and personal lines insurance (but continue to write new automobile insurance) in California due to catastrophic wildfire risks, increased costs of construction and rising reinsurance costs.

Why did AIG, State Farm, and earlier, Allstate take these actions?

Insurance underwriting (the selection and premium charges for risks) is one of the three legs of successful insurance operations (the other two legs are claims and investments). Companies halt the underwriting of new business to address the problem of having too many risks exposed to the same time of loss in a particular area (a/k/a concentration of risks or catastrophic risk). The carrier cannot just charge more money if the catastrophic risk could lead to losses greater than the company's reinsurance protection and/or too large a loss in a financial period. For example, if the average house has $400,000 in limits and if a carrier loses 1,000 houses due to wildfire or hurricane that's $400,000,000 in losses, all at once.

Insurers buy protection against multiple losses and/or catastrophic risks by buying reinsurance (insurance by one company (a reinsurer) that protects another insurance company). State Farm cited a "challenging reinsurance market" as one reason for its decision. I assume that meant they could not purchase the amount of reinsurance they deemed necessary (likely hundreds of millions of dollars of coverage) for a price that made economic sense for them. That challenge is driven in part by the fact that rates for homeowners and residential fire are controlled by the insurance department but the rates for reinsurance are an entirely uncontrolled free market. An article at the beginning this year said the catastrophic property reinsurance renewals were running 40% to 60% higher in price. It's like a manufacturer facing a rise in the cost of a major component but the price of their final product is subject to a pre-existing price limit. The other challenge is to find enough reinsurers to fill out the insurer's needed limits. Because of the huge limits required, scores of specialist reinsurers must be willing to participate.

A halt to new business is probably the least disruptive way of adjusting the insurers' catastrophic risk and has the least regulatory problems. For one, the insurer cannot limit new risks by geographic area in a state without running afoul of anti-redlining rules.

Nor can the insurer start non-renewing or canceling as many policies as they think they need to get their book of business in shape since another set of rules restricts mass cancellation of insurance. The threshold is generally 1% or 2% of policies in force (especially for automobile or small residential insurance) beyond which the insurer must seek the insurance department's consent to proceed.

California, like all states, has a FAIR (Fair Access to Insurance Requirements) plan to provide insurance of last resort to its consumers who cannot find fire or property insurance in the free market. While the particulars can differ by state, FAIR plans generally allow companies to write consumers who have been declined one or more times for coverage and share the premiums and losses with the entire insurance market. If the FAIR plan runs at a loss, then all solvent carriers are assessed a proportionate share of the losses. However, Citizens, Florida's non-profit insurer of last resort, is a stand-alone insurance company, that holds onto its own premiums, builds its reserves during "good" years and buys reinsurance, If all of that is still not enough in a particularly bad, catastrophic year, Citizens can collect assessments from its insureds as well as insureds throughout Florida. It appears that Citizens has helped access to insurance but not prices since premiums for Florida homeowners are two to three times the national average.

I've only focused on the reinsurance aspects of this story. Climate change, construction costs and other factors are also driving this crisis. Will we see more carriers pull back from vulnerable areas? Probably. Will California need a government non-profit like Florida's to help insure its wildfire risk? Possibly. Thirty years ago, California created its own insurer for earthquake coverage. Will this negatively impact California's need for additional housing? Probably. This story is likely to get worse before it gets better.

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