Profiting off greater risk: the reinsurance game0011

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This is THE INDICATOR FROM PLANET MONEY. I'm Adrian Ma.

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And I'm Paddy Hirsch. On our listener questions segment this week we got a great question about why the cost of insurance is outpacing the rate of inflation. And one thing that our inimitable hosts, Darian Woods and Jeff Guo, touched on very briefly was the issue of reinsurance.

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Right - so insurance for insurance companies.

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And this market is already super-tight. There's not enough capital to go around. And so the costs - they're going up again. Last year they spiked as high as 50%.

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That was kind of strange. It was like Jeff and Darian were here in the room for a second.

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They're stealing from our own show, like, eating our own cooking. That's what we're doing here.

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I don't think they'll mind. And that 50% spike that Jeff mentioned in reinsurance rates makes sense, right? Because insurance companies - talking home insurers, car insurers - they're jacking up their premiums. They're taking on a lot more risk these days. So naturally, the rates to insure their own business are going up, too.

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Yeah. But here's the thing. While insurance companies clearly are having a tough time - right? - I mean, they're pulling coverage from certain states. In some cases, they're going out of business altogether, reinsurance companies are not. In fact, somehow, reinsurance companies seem to be making out like bandits. 2023 was a record year for reinsurance. Four of the largest reinsurers more than doubled their combined profits.

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So is the insurance business in a crisis or not? On today's show, we'll look at the three main reasons why home insurance is becoming so expensive right now and then we'll talk about reinsurance.

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Yeah. We'll look at why those reinsurance companies look pretty profitable right now, and how they manage their exposure in what's becoming an increasingly risky business. That's coming up after the break.

[중간광고]

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Insurance - it's supposed to make you feel secure, cushioned, protected in the event of something bad happening. But for a lot of Americans right now, insurance is the bad thing happening.

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I have nightmares, nightmares about the insurance here.

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That is Inda Stagg, a homeowner in Saint Petersburg, Fla. She spoke to ABC Action News in Tampa Bay about her insurance premiums, which have been surging.

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I moved here in 2018. The insurance has doubled by 2020.

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From $3,000 a year to $6,000, she said, and doubled again to almost $13,000.

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But Florida is not the only state seeing blistering increases in home insurance.

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It's happening all over the U.S. - Texas, Oklahoma, California. Latisha Nixon-Jones is a professor at College of Law at Jacksonville University in Florida. She also happens to run her own disaster consultancy company.

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We actually help nonprofits to create disaster plans in order to help facilitate their recovery and also as a part of their insurance requirements.

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Latisha says there are three main reasons home insurance rates are climbing right now. We talked about two earlier this week. There is inflation, and there's also the fact that we're seeing way more and bigger disasters. And then there's the third factor we don't hear so much about - lawsuits.

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So we're seeing states that have opened themselves up to large amounts of litigated insurance claims. Whenever you see more litigious state, you're going to see higher insurance premiums because insurances are paying out more money.

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The result of all of this has been chaos in the insurance industry. Huge price hikes, denial of coverage, insurance companies pulling out of entire states as State Farm did recently when it announced its plan to stop doing all-new home insurance business in California.

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Some insurance companies have even gone out of business altogether, but not that many. In the past couple decades, it's about one a year on average. Latisha says there's a simple reason for that.

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Insurance companies, they ensure our risk, but they have to remain solvent. So in order for them to be solvent, they insured their risk.

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And they insure that risk with a reinsurer. OK, I think it's kind of time for an explanation about insurance, don't you, Adrian?

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Yes. OK, so...(Just to catch up. Just to catch up) Yeah. So we all know what insurance companies do, right? They collect monthly payments from homes they insure, and they promise to compensate those homes if, say, the roof blows off in a hurricane.

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Yeah. So if, say, 10 people need a new roof in the aftermath of Hurricane Jiminy, say, then there should be enough money in the pot to pay for that. But what if Jiminy is really big, and 10,000 people make claims for a new roof or 100,000? There's probably not going to be enough money in the pot.

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And in this case, the insurance company makes its own insurance claim to the reinsurer. So the reinsurer then dips into its own pot and makes the insurance company whole, and that means the reinsurer pays for all our roofs and makes sure the insurance company can continue to operate.

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But over the last few years, a lot of houses have been losing their roofs or being flooded or burned. And that means a lot of claims from homeowners. And that, of course, means a lot of claims from overwhelmed insurance companies to their insurers, the reinsurers.

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Now, it may sound like this whole industry is under pressure, but reinsurance companies seem to be doing really well. They just reported a year of record profits. And how does that happen? Well, Latisha says reinsurance companies look at the risk pool in a different way that insurers look at us.

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Yeah. Reinsurers, she says, don't think locally or regionally the way that a regular insurance company does.

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Reinsurance will look at the United States, and they will say, based upon the history and what we're seeing, we believe that the United States should pay - or the companies within the United States that insure us should pay this premium.

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Reinsurers look at the whole picture, at all of the hurricanes and wildfires and ocean storms that are battering the U.S. every year. And beyond the U.S., too. The three biggest reinsurers in the world are all based in Europe. They're considering the fact that there's a war going on right next door to them, which is why reinsurance rates, in some cases, almost doubled in Europe last year.

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Does the reinsurer have a reinsurer?

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So they don't. They're the stopgaps, right? So banks are the reinsurer. That's why risk is so sensitive towards the reinsurer. If they become insolvent or their loss, they then have to take out loans in order to still be solvent enough to pay the claims of the insurers.

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Reinsurers can manage their risks by offsetting or hedging them. They can use something called retrocession, which is when they partner with other reinsurance companies to share the risk. And they can also buy catastrophe bonds, which pay out in the event of a disaster.

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The main way reinsurers offset risk, though, is to raise premiums. And unlike regular insurance firms, which look mostly into the future when they calculate premiums, reinsurers spend a lot of time looking at the past.

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Not only are they charging the premiums for future risk, but they also have to recover the risk from the past incidents in which they may have lost.

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And last year, when reinsurers were looking back on past incidents, they weren't looking at a pretty picture.

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2022 and 2021 were so horrific as far as property damage, where we had cat 4 hurricanes that hit the Gulf Coast, we had wildfires that ensued on the West Coast, we had a winter storm in Texas that took out their electrical grid. So there is barely a state in the United States that did not have a declaration of emergency.

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And that's why reinsurance premiums went so high in 2023. The reinsurers racked up big losses in the previous years - '21 and '22 - and they needed to make that money back. But they were also basing future risks on those bad years, expecting more catastrophe.

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And they were right. 2023 was the worst year in a decade for U.S. property and casualty insurance. Insured natural catastrophe claims surpassed $100 billion, which is 9% above the 10-year average.

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But reinsurers were ready for this. Premiums went up as much as 50% worldwide, and in the end, it all added up to a profitable year for reinsurance. But Latisha says that doesn't mean that insurers, including the reinsurers, are laughing all the way to the bank.

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Insurance companies have to balance between profitability and being affordable, but their profit margin in the reality in the scheme of how they charge is actually small. It generally ranges between 4 to 10 cents per the dollar in order to maintain their profitability.

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Insurance companies have a tough job. They kind of have to peer into the future without the benefit of a crystal ball. So it's not surprising that now and again, they jack up their rates too high, expecting disaster after disaster in a coming year.

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And, of course, if that doesn't happen for whatever reason in that year, then they make out like bandits.

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They do. We do not get a refund.

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We do not get a refund. Of that we can be mutually assured.