



Independent Insurance Agents & Brokers of California

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Submitted to:

CDIRegulations@insurance.ca.gov

Ms. Monica Macaluso, Esq.
Assistance Chief Counsel
California Department of Insurance
1901 Harrison Street, 4th Floor
Oakland, CA 94612

Re: Net Cost of Reinsurance and Ratemaking: [REG-2024-00016]

Dear Ms. Macaluso:

On behalf of the Independent Insurance Agents and Brokers of California (IIABCal), I am pleased to submit the following comments in support of California Insurance Commissioner Ricardo Lara's intention to recognize insurers' net cost of reinsurance in ratemaking.

IIABCal is a non-profit organization representing over 350 independent agencies and brokerages, ranging from small, family agencies in rural communities to multi-office brokerages that do business internationally. Our members sell all forms of insurance but do most of their business in personal and commercial property and casualty lines. IIABCal members live, work, and endeavor to serve consumers in virtually every city and town in California.

Independent agents and brokers have been severely harmed by the continuing crisis of availability in property insurance. In our experience, insurance companies **want** to sell policies, and they are generally skilled at assessing and pricing risk, but they need two things in order to be not only willing, but also able, to underwrite property risks: 1) adequate rates; and 2) timely rate decisions. Insurance companies have gotten neither in California for many years, long predating the Lara Administration.

For that reason, we applaud Commissioner Lara's recognition that new regulatory and rating methodologies are required to meet the unprecedented challenges that catastrophic wildfire exposure presents throughout California. The business of insuring property has been changed inexorably and permanently by the magnitude of the insured losses that wildfires now create.

We believe that recognition of reinsurance costs on California exposures, and modification of the cost-of-capital allowance for insurers not ceding wildfire risks, is long overdue—given that California is the only state that excludes such expenses from ratemaking calculations, and these costs have arguably been **the** most significant factor driving property insurance rate inadequacy.

In early 2023, IIABCal retained nationally prominent experts to offer solutions to what was, even then, a dire crisis in insurance availability for independent agents and brokers.

Both the law firm of Eversheds Sutherland, and the actuarial firm, Milliman—which the Department of Insurance itself has retained on multiple occasions—have substantial expertise in insurance ratemaking generally, and in the prior approval statutes and regulations in California, specifically.

Commissioner Lara’s “Sustainable Insurance Strategy” ultimately included every major element of the plan our experts recommended, and they agreed that the single most important reform the Commissioner could implement would be to recognize reinsurance costs (for insurers ceding catastrophic risks), and to modify the permitted maximum cost-of-capital factor (for insurers retaining, rather than ceding to reinsurers for such risks).

IIABCal endorses, and urges Commissioner Lara to consider adoption of the following amendments to existing prior approval regulations to accomplish the aims set forth above:

Section 1. Amend 10 CCR § 2644.16 to Permit Insurers to Exceed the Currently Authorized Maximum After-Tax Rate of Return With Respect to the Portion of Their Assets Supporting Retained Wildfire Catastrophe Risk.

§ 2644.16. Rate of Return

(a) The maximum permitted after-tax rate of return means the risk-free rate, as defined in section 2644.20(d), plus 6%.

(b) The minimum permitted after-tax rate of return shall be -6%, which the Commissioner finds is high enough to prevent any undue risk of insolvency and to prevent injury to competition through predatory pricing.

(c) The Commissioner may increase or decrease the maximum permitted after-tax rate of return by not more than 2% if the Commissioner finds financial market conditions to be such that the difference between the risk-free rate and the cost of capital is significantly different from its historical average.

(d) Notwithstanding subdivision (c), the Commissioner shall permit an insurance company to exceed the maximum permitted after-tax rate of return on the percentage of its assets supporting unreinsured reserves for wildfire risk to California property within the fire, residential multiple peril, commercial multiple peril, and farmowners multiple peril lines. An insurance company must justify any upward deviation from the maximum permitted after-tax rate of return by objective evidence that its proposed cost of capital adjustment is supported by the nature of its exposure to wildfire risks in relation to prevailing reinsurance and capital market conditions for comparable wildfire risk.

Note: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; and 20th Century v. Garamendi, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; and

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Calfarm Insurance Company v. Deukmejian (1989) 48 Cal.3d 805.

Section 2. Amend 10 CCR § 2644.25 to Allow Consideration of the Costs and Benefits of Reinsurance for Wildfire Risks on the Same Basis Currently Allowed for Earthquake and Medical Malpractice Risks

§ 2644.25. Reinsurance

(a) For all lines and sublines except for those listed in the next subparagraph, ratemaking shall be on a direct basis, with no consideration for the cost or benefits of reinsurance.

(b) For reinsurance of earthquake or wildfire risks, and for medical malpractice facultative reinsurance with attachment points above one million dollars, the maximum permitted earned premium is calculated as follows:

The sum of

(1) the quotient of

(A) the difference of

(i) the product of

a. the projected losses, as defined in section 2644.4, plus the projected defense and cost containment expense, as defined in section 2644.8, minus the projected reinsurance recoverables, as defined in section 2644.26,

b. multiplied by 1 minus the fixed investment income factor, as defined in section 2644.19(a),

(ii) minus the projected ancillary income, as defined in section 2644.13,

(B) divided by the sum of

(i) 1.0,

(ii) minus the efficiency standard, as defined in section 2644.12,

(iii) minus the maximum profit factor, as defined in section 2644.15,

(iv) plus the variable investment income factor, as defined in section 2644.19(b).

(2) plus the quotient of

(A) the reinsurance premium, net of ceding and contingent commissions,

(B) divided by the difference of

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(i) 1.0,

(ii) minus the variable expense factor, as defined in section 2644.14.

Stated as a formula:

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(c) For the calculation of fixed investment income factor, the numerator and denominator of the loss reserves ratio shall be adjusted for projected reinsurance recoverables, and for the variable investment income factor, the numerator and denominator of the unearned premium reserve ratio shall be adjusted to reflect the cash flows of the unearned reinsurance premium.

(d) Reinsurance costs shall be allowed for ratemaking purposes as set forth in this section only if:

(1) the reinsurance agreement was entered into in good faith in an arms-length transaction and at fair market value for the coverage provided, and

(2) the reinsurance meets the statement credit requirements of Sections 2303 through 2303.25.

(e) There will be no allowance for reinsurance between affiliated entities as set forth in Schedule Y of the Annual Statement.

(f) Copies of the reinsurance agreements shall be submitted with the filing.

(g) For the purposes of this section and section 2644.26, reinsurance shall include other risk financing mechanisms, such as catastrophe bonds.

(h) For the earthquake line, if at least 30% of the requested rate results from the cost of reinsurance, and a consumer or the consumer's representative requests a hearing within 45 days of public notice, the Commissioner shall hold a hearing on the issue of the reasonableness of the reinsurance costs, as defined in section (d), and whether some or all of those costs shall be reflected in the proposed rate change. An insurer's rate application shall indicate whether at least 30% of the requested rate results from the cost of reinsurance.

(i) For the fire, homeowners multiple peril, commercial multiple peril, and farmowners multiple peril lines, if at least 30% of the requested rate results from the cost of reinsurance of wildfire catastrophe risks, and a consumer or the consumer's

representative requests a hearing within 45 days of public notice, the Commissioner shall hold a hearing on the issue of the reasonableness of the reinsurance costs, as defined in section (d), and whether some or all of those costs shall be reflected in the proposed rate change. An insurer's rate application shall indicate whether at least 30% of the requested rate results from the cost of reinsurance.

(j) For the medical malpractice line, if at least 30% of the requested rate is attributable

to the cost of facultative reinsurance with attachment points above one million dollars, and a consumer or a consumer's representative requests a hearing within 45 days of public notice, the Commissioner shall hold a hearing on the issue of the reasonableness of the reinsurance costs, as defined in section (d), and whether some or all of those costs shall be reflected in the proposed rate change. An insurer's rate application shall indicate whether at least 30% of the requested rate results from the cost of reinsurance.

Note: Authority cited: Sections 1861.01 and 1861.05, Insurance Code; and 20th Century v. Garamendi, 8 Cal.4th 216 (1994). Reference: Sections 1861.01 and 1861.05, Insurance Code; and Calfarm Insurance Company v. Deukmejian (1989) 48 Cal.3d 805.

Turning to the questions posed in the Department's Nov. 21, 2024 "Invitation to Workshop:"

• Does incorporating the standard Net Cost of Reinsurance promote insurer solvency and address market stability?

Without question, YES. As stated above, the existing regulatory omission of such expenses from ratemaking calculations may be the single most important factor driving current rate inadequacy in California. The first, most basic rule of insurance is that risk is spread and dispersed. Especially where the risk of catastrophic loss presents—and with dramatic climate changes occurring globally, virtually no corner of our Earth is now immune to catastrophic weather—it is essential for insurers to use reinsurance in order to maintain or increase their capacity to underwrite property risks, and to have their net reinsurance costs recognized and reflected in ratemaking.

• What information about reinsurance programs is most important to be provided to the public?

CDI should require insurers seeking credit for net reinsurance costs to clearly document which of its reinsurance costs are attributable to loss exposures in California. Because reinsurance is a financial product that consumers have little to no experience with, CDI should consider publication of consumer materials that explain why reinsurance is essential to maintaining a healthy, and highly competitive, insurance marketplace for California homeowners and commercial property owners.

• How could a regulation on the net cost of reinsurance and corresponding insurer commitments most effectively align with the diversity of insurance companies writing in California?

IIABCal believes the specific regulatory language we've presented above would maximize alignment with the wide variation found in California insurance company finances and operations—not only by allowing credit for reinsurance premiums paid by insurers ceding risks, but also by adjusting to more accurate levels the cost-of-capital factor plugged into rate change applications for insurers retaining, rather than ceding, catastrophic loss exposures.

• What are the most important components for establishing and conducting an efficient variance process?

As stated above, IIABCal believes the cost-of-capital allowance needs to be modified to provide a more realistic calculation of losses an insurer needs to be prepared to pay, if catastrophic loss exposures are not being ceded to reinsurers.

• Is there any aspect of the process that is not addressed in this proposal?

As stated above, IIABCal believes the cost-of-capital allowance needs to be modified to provide a more realistic calculation of losses an insurer needs to be prepared to pay, if catastrophic loss exposures are not being ceded to reinsurers.

On behalf of IIABCal members, thank you for the opportunity to submit these comments. We would be happy to provide any other assistance the Department of Insurance might request as it evaluates these issues and our recommendations.

Respectfully yours,

Stephen L. Young

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