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Natural Disasters and the Homeowners Insurance Market

Insurance consumers in parts of the United States have been experiencing higher prices and gaps in coverage. Households have often struggled to find and afford homeowners insurance that sufficiently protects against hazards such as wind and wildfire. Some are unable to find insurance outside of state-created insurers of last resort. Known in many states as Fair Access to Insurance Requirements, or FAIR plans, these insurers often offer coverage that may be more expensive or less complete than private coverage. In contrast to perils like wind and wildfire, floods are not typically covered by homeowners insurance, and households must purchase a separate flood insurance policy. The National Flood Insurance Program (NFIP) is the primary source of flood insurance for residential properties in the United States.

Recent media reports include accounts of insurers increasing premiums or withdrawing from homeowners insurance markets in many states. Changes in the availability of wildfire insurance in California and wind insurance in Florida have received the most attention, but recent reports also include accounts of insurance companies increasing premiums significantly or withdrawing from the markets in other states. Examples include Colorado, Texas, Hawaii, Washington, Louisiana, Iowa, and Illinois. In 2023, insurers paid more in claims on homeowners coverage than they received in premium in 18 states.

These developments have multiple implications for various groups. Higher insurance rates can serve as an important signal regarding future risk, but may shift the risk of losses to individuals, the government, or other financial institutions. Lenders generally require insurance for buyers to obtain a mortgage, leaving people unable to purchase a home if insurance is unavailable. Current homeowners may be left facing greater financial risk without insurance and may find difficulties in selling their home.

High prices and reductions in the availability of insurance tend to draw policymakers' attention to insurance markets and possible solutions to these problems. Although most such solutions, such as insurance regulation, are enacted at the state level, the scale of recent withdrawals from the market has increased in federal intervention with House and Senate committee hearings and introduced legislation (such as H.R. 3525, H.R. 3997, and H.R. 6944) in the 118th Congress. These bills differ in the exact mechanism, but each would have authorized the federal government to act as a catastrophic risk insurer or reinsurer, as it does for the NFIP, and thus bear more of the cost of disasters.

Property Insurance

Broadly defined, insurance is a financial contract that transfers risk from one party to another in exchange for advance payments, known as premiums. Generally, insurance firms seek to spread risk by entering into contracts with large numbers of policyholders—using the premiums and investment income to cover losses and expenses, as well as to make a profit. Property insurance is defined as "coverage protecting the insured against loss or damage to real or personal property from a variety of perils, including but not limited to fire, lightening, business interruption, loss of rents, glass breakage, tornado, windstorm, hail, water damage, explosion, riot, civil commotion, rain, or damage from aircraft or vehicles." Homeowners insurance is a primarily a form of property insurance, although policies also offer coverage for homeowners liability as well.

Property insurance in the United States is primarily regulated by the individual states. Each state government has a department charged with licensing and regulating insurance companies and those individuals and companies selling insurance products. State Insurance Commissioners typically head these departments. The National Association of Insurance Commissioners (NAIC) fosters some uniformity in insurance regulation, particularly in insurer solvency regulation.

The Challenge of Insuring Against Natural Disasters

Recent rising prices and reduced availability of homeowners insurance largely involves the interplay between two large-scale factors: (1) increasing losses from natural disasters; and (2) a macroeconomic environment marked by rising inflation and interest rates.

Insurance against natural disasters, often referred to as catastrophe insurance, can protect businesses and people against financial losses, but is a volatile type of insurance. Insurance works best for high-frequency, low-magnitude events which are statistically independent and have probability distributions that are reasonably stationary over time. In contrast, natural disasters are low-probability, high-cost events which are difficult to predict reliably; as such, insurers may be hesitant to offer coverage in high risk areas. Natural disasters violate to some degree nearly all of the standard conditions for insurability. Catastrophe insurance is also different from many other types of insurance in that it is difficult to estimate the total potential cost of an insured loss, and a catastrophic event results in a large number of claims being filed at the same time.

Increasing Insured Losses from Natural Disasters

Insured losses from natural disasters have increased over past decades, with nearly every major peril recording an individual insured loss event over $10 billion. Although large events such as major hurricanes cause outsized losses, secondary perils—lower cost but higher frequency events, such as thunderstorms—caused higher combined losses in 2022 and 2023 and have become a substantial source of concern for many. 2024 was the fifth consecutive year where global insured disasters losses topped $100 billion. 2023 was unusual in reaching this threshold without a few dominant events driving annual loss costs—no single event caused more than $10 billion in insured losses.

In the United States, as in many countries, these increasing losses can be attributed to a combination of factors: increasing property replacement costs, inadequate building codes, and climatological and environmental changes. Exacerbating such factors are population increases in hazardous locations, with about 60 million housing units located in areas under at least a moderate threat of annual losses from natural disasters. The impacts of natural hazards associated with climate change are expected to increase during the useful lifetime of much existing and new U.S. property and infrastructure, placing an increasing burden on federal, state, and local governments, as well as individuals and businesses.

The United States homeowners insurance industry has experienced net underwriting losses in all but one year since 2017 and over the last decade insurers have paid out more in claims than they received in premiums. If risks increase or become more volatile, regardless of the cause, insurers often respond by reducing their net exposure to these risks, typically by increasing premiums or reducing the insurance offered. Premium increases allow insurers to increase the capital available to pay future losses and encourage consumers to purchase less insurance, reducing future claims. Insurers may reduce insurance offered on an individual basis by cancelling or not renewing insurance policies seen as the highest risk, or on a broader geographic basis by ceasing to offer insurance (either entirely or specific product lines) in certain areas. These responses are primarily intended to protect the interests of the individual insurer and may end up creating difficulties for consumers or the broader economy.

The effect of withdrawal on policyholders and the overall economy may be negative in aggregate, as many economic activities effectively depend on the availability of insurance in order to occur. This industry reaction is not new—the NFIP was created in 1968 following widespread insurer withdrawals from offering coverage for flooding.

State and Federal Roles

States are typically the first actors in addressing insurance market issues. They have used their regulatory role to address immediate market disruptions though polices like moratoria on cancellations and to encourage risk mitigation through rate discounts for homeowners who build houses that are more fire resistant or reduce flammable materials around their houses, or elevate flood-prone structures. In some cases, states have created the aforementioned insurers of last resort to address gaps in the market. The state-based insurance regulatory system falls under the auspices of the 1945 federal McCarran-Ferguson Act.

Because insurance plays an important role in the overall economy, larger-scale market instability can lead to federal government intervention. For example, after the September 11, 2001 terrorist attacks, insurers quickly moved to exclude terrorism losses, with terrorism insurance coverage becoming extremely expensive, or unavailable. Congress responded with the Terrorism Risk Insurance Act (TRIA), which required insurers to offer terrorism coverage, while also creating a federal reinsurance program to share in terrorism losses. Other programs, such as Federal Crop Insurance and the NFIP, supply insurance more directly. A primary difference between these types of programs and disaster assistance is that in an insurance program, the government typically collects premiums from the public (or some part of the public) as a condition of participation in the program. Thus, some part of the post-disaster recovery funding is pre-funded by those purchasing insurance.

Federal Actions and Risk Reduction

Encouraging hazard mitigation actions to reduce the likelihood of damage in the event of a disaster may have a stabilizing effect on the insurance market. If mitigation actions lead to lower damages and lower expected claims, they could make policies less expensive for households that implement them. If adopted on a wide basis, mitigation actions could potentially stabilize entire insurance markets.

Federal grants and loans already fund mitigation actions to allow homeowners and businesses to undertake property-level mitigation, possibly targeted at properties with repeated losses, or for communities to adopt and enforce hazard-resistant building codes. Other options to encourage community-level risk reduction measures could include increasing federal funding for mitigation activities, increasing the federal cost share of mitigation grants, requiring minimum standards for receiving federal funding, or providing incentives for communities to implement stricter controls on development in hazardous locations.

Additional federal funding could be made available for floodplain buyouts, which eliminate future losses by removing properties from risky areas. Federal funding could also be used to create an incentive program to encourage community mitigation actions for perils such as wind or wildfire, possibly modeled on the NFIP Community Rating System, which is a voluntary incentive program that gives discounts on NFIP premiums to encourage good practices in floodplain management and flood risk reduction.

An additional aspect of insurance that can naturally lead to individual mitigation actions is through risk-based pricing, particularly if the insurer includes premium reductions for policyholders who act in some way to mitigate risks. Some individual states require this through their insurance regulatory systems, but Congress could step into the regulatory process to encourage or require discounts in some way at a national level. Another approach might be for the federal government to provide incentives for insurance companies to offer discounts for approved mitigation actions.

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