A BLUEPRINT FOR SOLVING THE HOMEOWNERS INSURANCE CRISIS

PROVIDERS ABANDONING FLORIDA AND CALIFORNIA ISN'T AS BAD AS IT GETS

BY **CLIFF ROSSI,** SPECIAL TO *MORTGAGE BANKER MAGAZINE*

Whether termed "climate change" or "extreme weather," an increasingly unstable environment is damaging homes and other property at an accelerating pace faster than observed in decades.

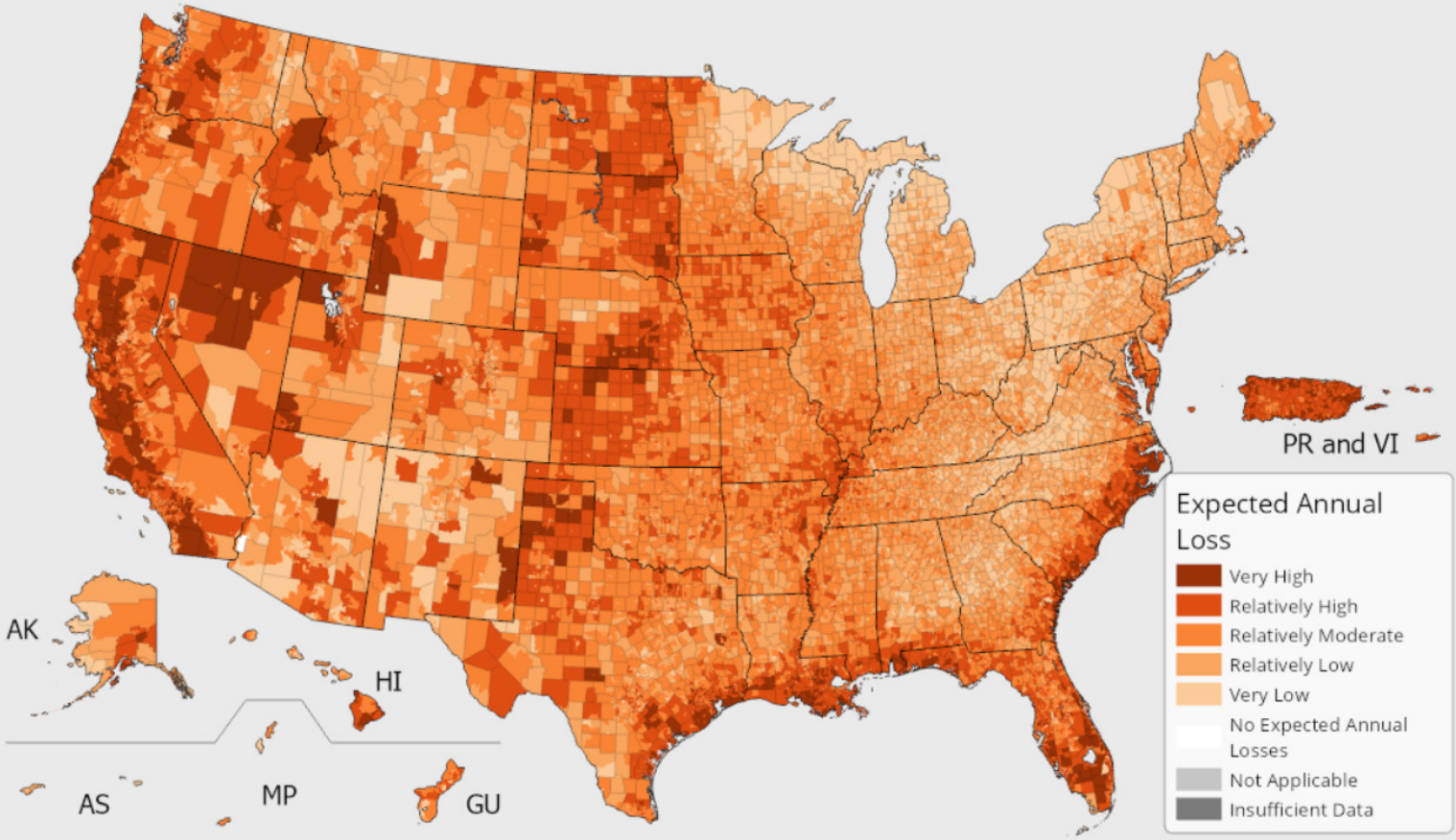
The magnitude of these risks, as seen in **Figure 1** on the following page, grows for homeowners, insurers, lenders, and investors across the country at the same time that solutions to the impending insurance crisis are lacking. Piecemeal approaches are unlikely to provide a long-lasting solution.

Meanwhile, the rise in the frequency and severity of natural disasters has underscored a form of market failure that suggests a fully private solution will be unable to provide long-term premium stability and availability of homeowners insurance. A nationwide solution is needed to tackle what is essentially a nationwide problem. >>

FIGURE 1:

EXPECTED ANNUAL NATURAL HAZARD LOSS BY U.S. COUNTY

SOURCE: FEMA NATIONAL RISK INDEX



That solution is the Federal Natural Hazard Insurance Corporation – a private-public approach to providing homeowners insurance across all natural hazards and states that would address myriad failures in today's insurance market.

As a new, federally chartered government-sponsored enterprise (GSE), the Federal Natural Hazard Insurance Corporation (FNHIC) would carve out natural hazards from existing homeowners' policies, offering a separate policy based on a property's exposure to the specific natural hazards in that location. The Federal Emergency Management Agency's (FEMA) National Flood Insurance Program (NFIP) would be absorbed into this new GSE and form the basis for a broader set of insurable hazards to be incorporated into these policies.

Private carriers would continue to offer and underwrite a standard homeowners insurance policy for risks unrelated to natural hazards while the FNHIC's policies would be distributed by a network of insurers as the NFIP's program is today. To reduce the FNHIC's loss exposure and allow insurers and reinsurers to participate in this market, Climate Risk Transfer Securities (CLRTs) would be sold to private investors at tiers commensurate with their risk appetites.

Necessarily, such a major overhaul of how homeowners insurance is priced and provided in the U.S. would have significant implications for all market participants and the process of passing a chartering bill that implements such a program would be financially, politically, and operationally challenging, to say the least. However, examining the merits of this structure – and the challenges such a program would confront—requires an understanding of the issues driving the breakdown in the delivery of homeowners insurance today.

WHY THE HOMEOWNERS INSURANCE MARKET IS FAILING

The combination of state insurance commissions' general reluctance to allow rate increases, increasingly frequent and increasingly severe weather events, rising rebuilding costs and rising reinsurance rates have made it extremely difficult for private insurance companies to charge what it costs to absorb these losses while still earning a fair rate of return.

Most residential property insurance is provided by private insurers, with flood insurance primarily offered through the NFIP. Private insurers get their rates approved annually in each state where they do business. All states cap the amount that insurance rates can increase annually, but to different degrees.

Large, national carriers must navigate the rate approval process of many state insurance commissions. However, individuals on these commissions are typically appointed by the Governor or another governmental entity. Thus, the range of these commissions' perspectives on rate-making and consumer protection varies widely by state.

As the variation and uncertainty in premium determination impacts insurers' ability to charge a price commensurate with the risks taken in that state, pressure on premiums has been mounting in the past decade due to an escalating frequency of natural disasters and claims.

At $65 billion, the property and casualty insurance sector experienced the highest catastrophe losses in a decade in 2023, according to data from AM Best, a credit rating agency that specializes in insurance. That same year, the National Oceanic and Atmospheric Administration (NOAA) recorded 28 separate natural disasters exceeding $1 billion in damages.

The escalating frequency and severity of disasters leads to an increased number of claims and for higher amounts. The escalating costs of rebuilding – which is estimated to have risen by as much as 55% from 2019 to 2023 on account of a shortage of supplies and skilled labor – make claim amounts larger still, driving up policy rates even more.

Further squeezing insurers' financial performance is the rising cost of reinsurance, a standard mechanism insurers use to offload portions of their insurance-in-force to, among other reasons, realign their risk profiles or reduce capital. Property catastrophe rates have increased 50% in 2024 according to Gallagher Re, one of the largest global reinsurance brokers.

When insurers cannot charge fair prices commensurate to the costs they're absorbing, they exit the market altogether, as has occurred in Florida and California.

SPILL-OVER EFFECTS OF A FAILING INSURANCE MARKET

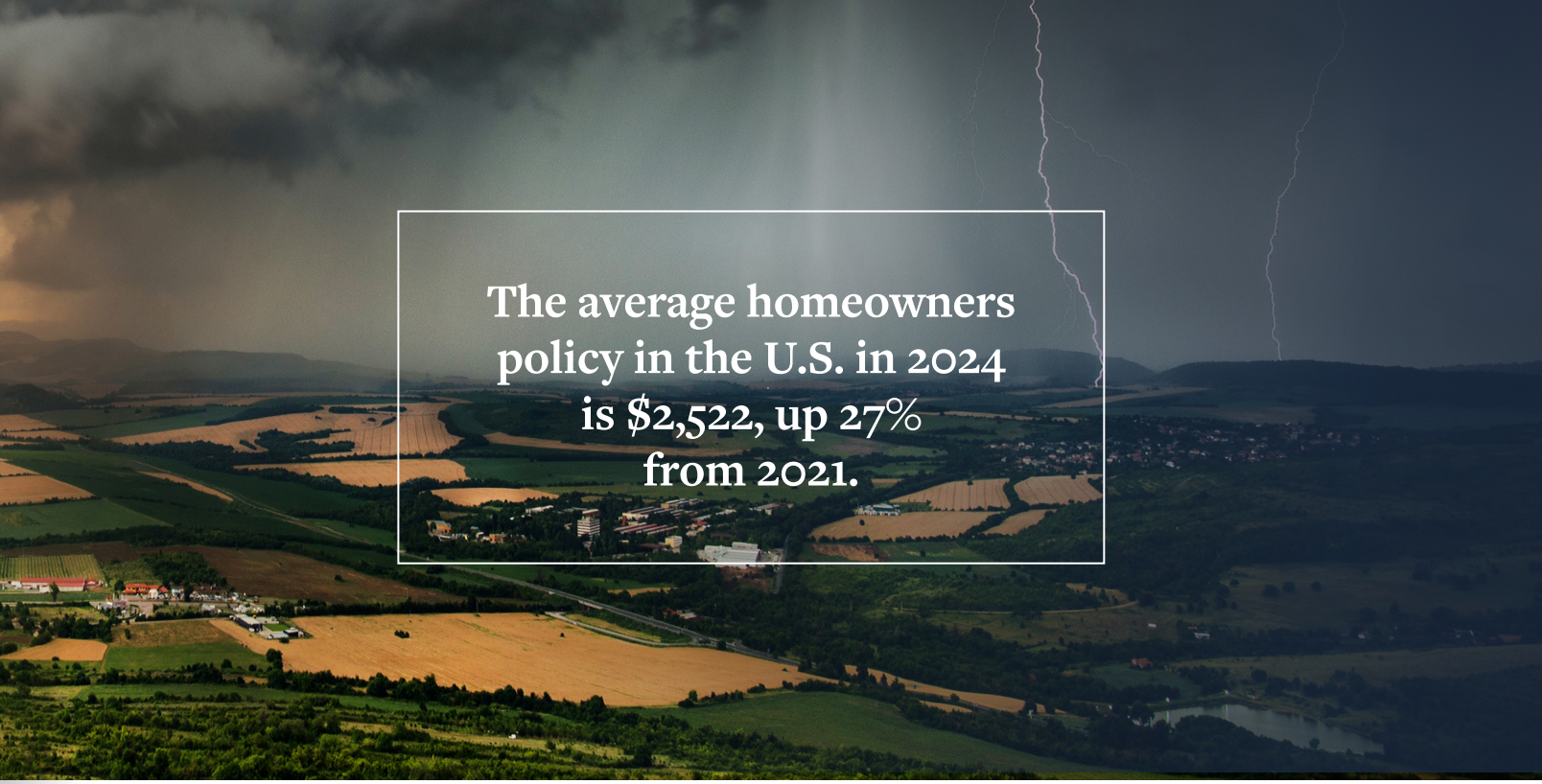
Insurers can choose to absorb some of these costs, but investor pressures limit this as a viable long-term strategy. The breakdown in the provision of homeowners insurance has adverse spillover effects on all market participants, but first of all, consumers, as at the ground level losses hit homeowners in the form of higher annual premiums or policy non-renewals.

According to Insurify, the cost of the average homeowners policy in the U.S. in 2024 is $2,522, up 27% from 2021 to 2024. For a borrower applying for a $350,000 loan with a household income of $107,000 and a 7% 30-year-fixed mortgage rate, that represents roughly one month's payment of principal and interest payment, or adds 2.4% to their debt-to-income (DTI) ratio.

In states with above-average insurance costs like Florida, where rates are 4.6 times the national average, the same mortgage and income would push the DTI ratio up 11%. For low- and moderate-income borrowers this becomes more problematic because those borrowers face difficult choices between other necessities and paying their insurance premiums.

Consider that Freddie Mac's Home Possible program for low-income borrowers allows DTI ratios up to 45%. Sharp increases in the cost of homeowners insurance has a disproportionate impact on these borrowers' budgets. It also simply makes homeownership less affordable in a market environment where affordability is an acute problem for the majority of homebuyers.

In the event of a lapse in coverage, such as when carriers exit a market or stop writing new policies in certain high-risk areas, servicers force place insurance, which is usually more costly for the homeowner and may carry less coverage with higher deductibles, depending on the policy. Such policies may be provided by public insurance pools such as California's FAIR



Plan for wildfire and Florida's Citizens Property Insurance Corporation (CPIC). However, pushing homeowners into those state plans threatens to overburden those 'insurers of last resort.'

Both the FAIR Plan and CPIC have been under severe financial pressure in recent years, needing to assess higher rates themselves on homeowners and taxpayers as private insurers exit high-risk areas. With roughly 1.2 million policies, Florida's CPIC is trying to reduce its exposure. The FAIR Plan is one major wildfire short of insolvency, the insurer's president announced in March. Insolvency would trigger a state-wide assessment on millions of current policies of $2 billion or more.

Downstream from insurers and homeowners are investors. Credit and mortgage-backed security (MBS) investors are necessarily impacted by borrowers' and properties' insurability as a lack of coverage impacts the distribution of collateral risks. The largest credit investors in the mortgage market are the government-sponsored enterprises (GSEs), Freddie Mac and Fannie Mae, who require insurance coverage for every mortgage they back.

For properties located in FEMA-designated Special Flood Hazard Areas (SFHA), the GSEs require flood insurance policies to be carried as well.

Over time, the financial burden of rising insurance premiums on homeowners raises delinquency and severity risk for the GSEs. Furthermore, there is a real potential for home price corrections in high-risk areas, reducing the major buffer that reduces mortgage default—namely the borrower's equity stake. Those risks may be manageable now, but they may not be if a sizable portion of the GSE's borrowers are unable to secure insurance at any cost.

The questions these not unlikely, near-future concerns raise are myriad: would the GSEs be forced to reduce their footprint in those markets, exacerbating rising costs of homeownership in major markets like California and Florida, thereby destabilizing house prices in these areas and beyond?

How would investors in credit risk transfer securities (CRTs) and MBS respond to such a major disruption in the housing market?

Today, no policy or regulatory mechanisms to address these possibilities exist because no entity at the national level has such authority. Inherent market failures, the centrality of the housing market to the economy, and the lack of a coordinated, national solution to a nationwide problem demand a new approach to the way homeowners insurance is structured and delivered.

A NEW APPROACH TO HOMEOWNERS INSURANCE

Here, the FNHIC and Federal Insurance Office (FIO) offer a nationwide solution.

FNHIC's mission would be to provide fairly priced insurance coverage from natural hazards to all homeowners with or without mortgages. As a federally chartered GSE, the FNHIC would require regulatory oversight at the national level. Naturally, the FIO could assume this safety and soundness role, but would require a substantial injection of resources and authority.

Separately, the NFIP would be reorganized out of FEMA and into the FNHIC, a move that would start the process of realigning technical and financial resources sufficient for accurately measuring, pricing, and managing the risk of a major insurance portfolio.

In the FNHIC's initial phase (three to five years), flood insurance policies would continue to be provided in a similar manner as today with private insurers acting as brokers and the FNHIC providing coverage. Risk-based pricing under the NFIP's Risk Rating 2.0 would continue, and potentially expand during this phase. At the same time, with the FIO's oversight, the FNHIC would begin building the infrastructure and analysis for expanding coverage to other hazards.

By year five, the FNHIC would begin offering a more comprehensive product that captures a property's risk from natural hazards in that area based on probabilistic catastrophe risk models. This work would require the addition of actuaries and scientists to FNHIC equipped with the expertise to develop models used in assessing and pricing such risks.

All homeowners would carry two insurance policies: the first would be a standard homeowner's policy, similar to what they have now but excluding natural hazard coverage for perils such as wind, hail, wildfire, or hurricane; the second would be a hazard insurance policy the FNHIC. The standard policy would continue to be underwritten and sold by insurers with no role for the FNHIC in that market. Standard homeowners policies should become cheaper since the hazard coverage would be removed from these policies and become embedded in the FNHIC policies.

Meanwhile, those private insurers would act as brokers for the FNHIC for the hazard policies, similar to their current role for the NFIP. Hazard policies would price risk on the individual property level, but pricing tiers would broadly distribute that risk geographically. The FNHIC would provide for some cross-subsidization of low- and moderate-income homeowners that would be transparent and separate from insurance pricing.

Investor properties and second homes would carry higher premiums, and owners of properties located in known high-hazard-risk areas would be incentivized to invest in resilience and risk mitigation improvements through the pricing of their FNHIC hazard coverage. Properties subject to multiple claims for the same hazard such as hurricanes

or flooding without corrective actions would be subject to significant premium increases and/or coverage limitations.

CLIMATE RISK TRANSFERS (CLRTs) AND THE FNHIC

Concurrent with the development of business and risk infrastructure needed to implement its mission, the FNHIC would develop systems and capabilities to systematically distribute its risk to the capital markets. Structurally, this would borrow from the credit risk transfer (CRT) program implemented by Freddie Mac and Fannie Mae for transferring credit risk to private investors.

Climate risk transfers—CLRTs—would resemble CRTs in terms of their sequential loss pay structure, with multiple tranches featured. A conceptual representation of how the CLRTs would work is shown in **Figure 2**. Policy cash flows would be pooled each month providing the market with a continuous flow of securities for investors (reference pool in light blue). That cash flow, given the FNHIC's scale, would provide ample liquidity, making CLRTs attractive to the investors who would bid on tranches of CLRTs, as in today's CRT market.

A CLRT would be created by allocating claims from policies in a sequential manner, as shown on the right side of **Figure 2**. To ensure the FNHIC's risk aligns with that of investors, the FNHIC would take a small first loss and side-by-side catastrophic risk positions (designated by the gray boxes). Private investors would invest in the tranches (shown in the dark blue boxes) that best align with their risk appetite. Insurance companies would be natural investors in junior and mezzanine tranches while reinsurance companies could step into senior tranches.

Such structures offer benefits such as providing insurance and reinsurance companies with greater stability of cash flows associated with natural hazards, something that extreme weather events are impacting under the current insurance model. These structures also balance private insurers' loss

FIGURE 2:

CLIMATE RISK TRANSFER SECURITIES STRUCTURE

SOURCE: FEMA NATIONAL RISK INDEX

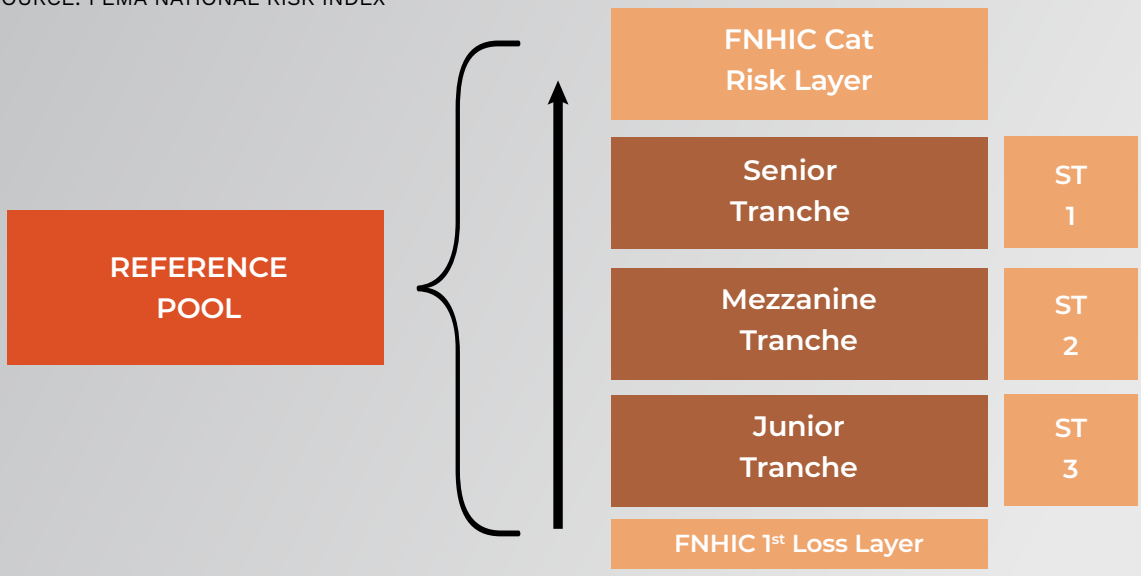


FIGURE 3:

EXAMPLE CLRT LOSS ALLOCATION ASSUMING A 5% ACTUAL POOL LOSS

	NATIONAL VALUE ($M)	LOSS ATTACHMENT (%)	LOSS DETACHMENT (%)	LOSS ALLOCATION (%)	SIDE-BY-SIDE LOSS	5% LOSS SCENARIO LOSSES ($M)
FNHIC 1ST Loss	2.50	0	0.50%	0.50%		2.50
Junior Tranche	5.00	0.50%	1.50%	1.00%	5.00%	4.75
Mezzanine Tranche	15.00	1.50%	4.50%	3.00%	5.00%	14.25
Senior Tranche	10.00	4.50%	6.50%	2.00%	5.00%	2.38
FNHIC Cat Risk	467.50	6.50%	Unlimited			0

of market share of insuring natural hazards by allowing them to purchase the risk on the back side of the market. CLRTs would provide catastrophic risk protection by the FNHIC, the optimal entity for absorbing that risk given its GSE status.

These structures raise the question of whether an implicit or explicit guarantee would be provided on the FNHIC's debt. A case could be made for either option. The existence of some form of guarantee would lower the FNHIC's debt costs but raise its risk to taxpayers in the event of a major catastrophe. Policymakers could consider alternative models to a purely federal, GSE structure, though. A cooperative-style, private model would have insurers and reinsurers inject capital into an entity that pools catastrophic risk. That structure would reduce taxpayers' exposure but may not provide adequate coverage at the scale required.

A TEST CASE FOR CLRTs

To illustrate the mechanics of the CLRT security, consider a reference pool with a notional value of $500 million consisting of FNHIC insurance policies with broad geographic distribution and $400,000 per home in coverage against natural hazard risk. Homeowners incur deductibles ranging between $1,000 and $10,000. The CLRT has a one-year term reflecting homeowners policy terms, though the issuance of an annual policy could be revisited by FNHIC – offering multi-year policies could add more stability to the homeowner and the CLRT market.

The FNHIC takes the first 50 basis points of losses on the pool. The junior tranche takes the next 100 basis points, the mezzanine tranche absorbs the next 300 basis points of losses, and the senior tranche takes the last 200 basis points for a total loss subordination of 650 basis points (6.5%), before the FNHIC picks up any catastrophic losses.

The structure assumes the FNHIC would take 500 basis points (5%) of the losses in each of the private tranches. A summary of the notional value of each tranche and loss allocation is shown in **Figure 3**.

If over the course of a year actual losses were 5%, the FNHIC would absorb the first $2.5 million of loss. The junior tranche would take $4.75 million in losses (adjusted for the 5% side-by-side risk by the FNHIC), with the

mezzanine tranche picking up $14.25 million and the senior tranche taking the remaining $2.38 million. In this example, the FNHIC bears a total of $3.62 million ($2.5 million first loss plus $1.12 million in side-by-side losses for each of the private tranches).

Each tranche investor would bid on their CLRT tranche based on their assessment of the distribution of losses that could be realized.

The FNHIC would stabilize the market for homeowners insurance by providing greater certainty to insurers and reinsurers by way of their participation in CLRTs. Over time, this should lower the cost of homeowners' policies and ensure that no homeowner can be dropped from a policy based solely on the location of their property. It should also ensure that, in the near-term, no regions of the country are completely devoid of catastrophic, natural hazard-related coverage.

BENEFITS AND CHALLENGES OF NATIONAL HAZARD INSURANCE

While private insurers would still need to seek approval from state insurance commissions on standard homeowners policies, the issues they face today in obtaining rate approval on policies related to natural hazard exposures would no longer exist given the FNHIC's national hazard insurance preemption. Another benefit of the FNHIC model is that it removes taxpayers from the direct exposure to natural hazard losses on flood insurance by folding the NFIP into the FNHIC.

Over the years, NFIP has significantly underpriced the costs of flooding such that the program is roughly $20.5 billion in debt to the U.S. Treasury. Moving the NFIP off of the government's books will reduce that direct exposure. Establishing the FNHIC as a standalone, publicly traded GSE would ensure

its operational solvency while maximizing returns for shareholders. That structure, in turn, would reduce long-term exposure to taxpayers from indirect losses.

The GSE model also provides a mechanism for offering subsidies to low- and moderate-income homeowners that today are unavailable. A national hazard insurance program would reduce risks to the housing GSEs and other credit investors, as well as provide certainty surrounding the availability of homeowners insurance for the housing finance system. The FNHIC would eliminate the need for state-run property insurance programs, providing significant savings both for consumers and taxpayers while reducing state-by-state exposures.

Establishing the FNHIC carries a number of financial, political, and operational challenges.

The financial requirements to capitalize the FNHIC would be daunting, to say the least. To gain a sense of the magnitude of cost, consider that between 2014 and 2023 insured losses associated with natural disasters ranged from $29.9 billion in 2015 to $163.9 billion in 2017, according to the Insurance Information Institute's figures. Losses averaged $78.3 billion annually over that period.

Assuming a stress loss that is three times the average in order to approximate an extreme outcome, the total stress losses for natural hazards would be roughly $235 billion annually. By comparison, the cost to recapitalize Freddie Mac and Fannie Mae has been estimated at $150 billion. The largest U.S. initial public offering (IPO) to date was Alibaba Group Holding Limited, in 2014, at $22 billion in 2014. These reference points underscore the heavy up-front financing requirements to get the FNHIC off the ground.

Congressional approval would be required to create the FNHIC's charter and place the NFIP under control of this new GSE. In a stable political environment, compromise would be needed for such a transformational change in the way insurance for natural disasters is conducted. In the current climate of extreme partisanship, passing the FNHIC chartering bill would (likely) be extremely difficult.

State commissions would presumably voice strong opposition to what would be perceived to be federal preemption of their rights to regulate insurance terms in their states. And yet, as outlined, states would benefit from no longer having to prop up insolvent state-run programs.

For existing property and casualty insurers, the FNHIC model presents a mixed bag of outcomes. The fact that insurers would no longer have to submit rate plans to multiple state insurance commissions would relieve companies from a substantial regulatory burden. Though the industry might view the FNHIC as a competitive threat, taking away a major portion of their business, private insurers would hopefully realize that they can continue to invest in this business via CLRTs with greater certainty about potential losses than they currently experience.

Reinsurers would likewise benefit from having a backstop on catastrophic losses via the FNHIC.

A final obstacle relates to the operational infrastructure required to set up the FNHIC, integrate the NFIP, expand the business to incorporate other hazards, and issue CLRTs. The technical and system infrastructure to manage this new enterprise would be

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significant. Likewise, building out the regulatory oversight beyond the current structure of the FIO would be a sizable task.

TAKING THE FIRST STEP

Despite the challenges of implementing the FNHIC, such obstacles must be weighed against the many benefits that a national level hazard insurance program would offer, like:

1. Cost savings for all stakeholders,
2. Consistent availability of hazard insurance,
3. The reform of an inefficient and politically infused state-level rate commission process,
4. Improvement in the ability of insurers and reinsurers to manage their potential loss exposure from natural hazards, with greater certainty by way of CLRTs,
5. The elimination of state-run insurance programs,
6. The reform of a federal, agency-run flood insurance program,
7. And the development of a true nationwide insurance program able to accommodate a changing climate.

For these reasons, a national hazard insurance program is a sensible and worthwhile effort to tackle. An increasing number of homeowners will find themselves in an annual insurance lottery, of sorts—not knowing whether they will be summarily dropped by their insurance carrier or what the magnitude of their premium increase will be. Major announcements of insurance companies withdrawing from markets coast-to-coast are forcing homeowners and their mortgage servicers to scramble to find alternative coverage, which usually raises costs for less coverage.

As the pace of extreme weather events continues to increase across the country, this trend in the homeowners insurance market is unsustainable because the national market for homeowners insurance is fundamentally broken. Incremental changes to the existing homeowners insurance market will be insufficient to tackle the central issue affecting today's market, namely, that uncertainty in the frequency and severity of natural hazards is disrupting the ability of insurers and reinsurers to reliably estimate the range of loss outcomes. Constraints on their ability to charge rates consistent with their costs and losses exacerbate the problem.

The housing market will continue to see more homeowners insurance policy cancellations and increasing premiums as the environment grows ever more unstable. The problem exists at a national level and therefore demands a combined public-private solution.

Creating a federally chartered hazard insurance GSE overseen by a federal insurance regulator provides the best path forward to ensuring the availability of affordable and fairly priced homeowners insurance. While the path to a new era in property insurance will not be easy, the benefits to homeowners, taxpayers, and the housing and insurance markets far exceed the costs and impediments associated with implementing this new structure. MB

Clifford Rossi (PhD) is the Director of the Smith Enterprise Risk Consortium at the University of Maryland (UMD) and a Professor-of-the-Practice and Executive-in-Residence at UMD's Robert H. Smith School of Business.