Community Finance Brief

Changing Insurance Industry Impact State, Local Economies & Credit

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Quick Takes

In 2021, the property and casualty insurance industry contributed a combined $1.2 trillion to the U.S. economy, or about **6% of the GDP** (Insurance Information Institute, March 2022)

The first half of 2023 global economic losses from natural disasters reached $194 billion - **well above the first half average** of $128 billion in this century (Aon, 2Q2023 Report)

In the U.S., about 12 million properties likely to see premium hikes because of the risk of **flooding**, 24 million because of **wind** damage and 4.4 million per **wildfire** risk (First Street Foundation, 2023)

Property insurance quietly underpins virtually every modern economy around the world and is the backbone for community wellbeing. In the United States, the toll of climate volatility has begun to express itself though the insurance industry in ways that the country has never faced before.

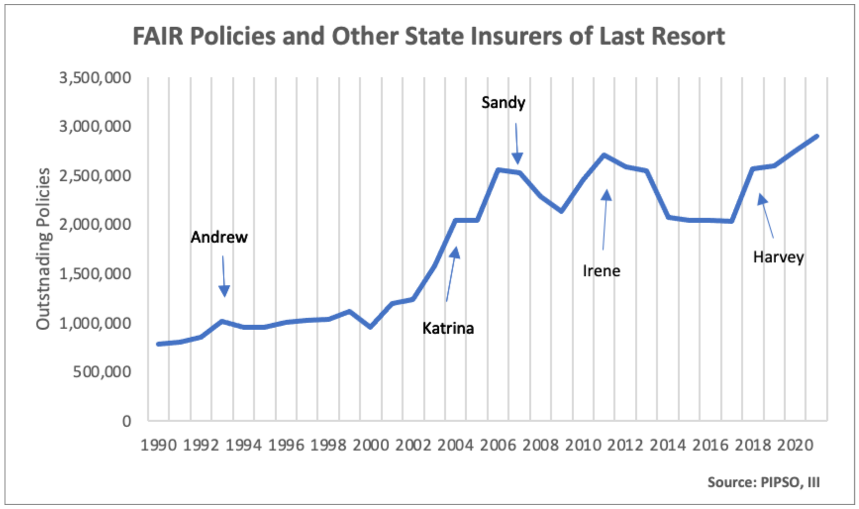
So far this year, in the U.S. at least 20 property insurance companies have announced changes to their coverage as a result of increased natural disaster risk and/or climate change. The impact has been most pronounced in Florida and California where at least 20% of the existing market has ceased to write new homeownership policies in each state (led by Allstate and State Farm). In this day and age, nearly all commercial transactions require insurance of some sort. The building and maintaining of any community hinges upon an affordable insurance market place. That major insurance companies are saying they cannot price risk appropriately because of climate volatility changes the viability of this industry with a wide range of implications.

One such implication that seems to have gone under the radar is the effect on state and local economies and, as a result, the public finance sector and the ability of states and localities to raise capital for public projects and to recover from disasters. Community finance and municipal bonds are tied to a functioning property insurance marketplace in a variety of ways and if this industry continues down its current path, **CSG** expects negative credit implications for several state and local governments that are either prone to natural disasters and/or heavily reliant on the insurance industry in their local economies.

"Just as the U.S. economy was overexposed to mortgage risk in 2008, the economy today is over exposed to climate risk," **said Eric Andersen, president of Aon, PLC in U.S. House of Representatives testimony.** *"This isn't just a story about Florida and California - all over the country there are insurers that are less willing to take risks. The industry, which has historically taken a more reactive approach to disasters, is shifting its strategy as such events become harder to ignore."*

COST OF STATE SPONSORED PLANS

The increased frequency and severity of natural disasters along with less private insurance options shifts the burden of these weather events on to government balance sheets in a number of ways. The cost of emergency support, infrastructure repair and increased premiums is well spoken for but one area that does not receive a spotlight is the increase usage of state-sponsored insurers (see **chart, right**). Fair Access to Insurance Requirements (FAIR) policies cost state governments directly and indirectly through subsidies, tax breaks for insurers participating in the plans and via direct financial assistance. The recently published National Climate Resilience Framework (**see quote**, below) identifies a functioning private marketplace as an indicator of a healthy, resilience community when it comes to natural disaster risk. Increased usage of FAIR policies and other state insurers of last resort are not only a red flag to follow, but a burden on state budgets. In Florida's case, the insurer of last resort, Citizens Property Insurance Corp. is now the state's largest and the legislature has had taken measures to financially stabilize the entity. Last year, Louisiana's state legislature approved an increase in residential insurance rates last to support the state's insurer of last resort.

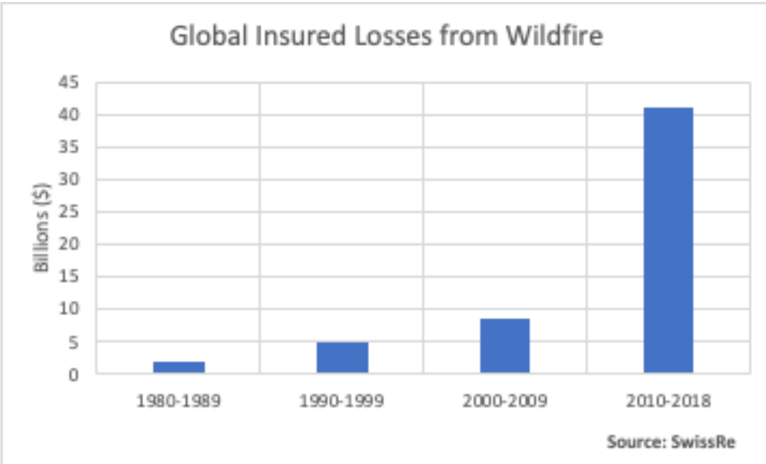


PROPERTY TAXES

With insurers citing actuarial modeling leaving them unable to price risk appropriately in areas prone to natural disasters, it leaves the question as to how property should be valued moving forward in these areas. The last year has seen a jump in reports regarding a "housing bubble" that is the result of the market not properly assessing the risk of various hazards that are linked to climate change. A 2023 study in the journal Nature Climate Change received significant attention pointing to an overvaluation of property in the range of $121 billion to $237 billion as a result of flood risk.

> *"When structured as an appropriate risk-transfer mechanism, P&C insurance can encourage pre-disaster mitigation efforts through lower premiums for more resilient properties, as well as signal areas at greater risk through appropriate premium increases,"* **states the National Climate Resilience Framework, Sept. 2023.** "*However, as climate change increases the frequency of catastrophic, very high-loss events, P&C insurance and reinsurance are becoming increasingly unattainable and unaffordable."*

A decline in property value and related taxes can have a major impact on the financial health of states and local governments - it is estimated that roughly one-third of local government revenue is derived through property taxes (see The Tax Foundation; Lincoln Institute of Land Policy, among others). When property insurance companies pull out of a state, it generally has a negative affect on the price of land and the taxes a government can collect on that land. If an insurance company's departure significantly affects the local property tax base, the remaining property owners may face a higher burden to make up for lost revenues (Insurance Information



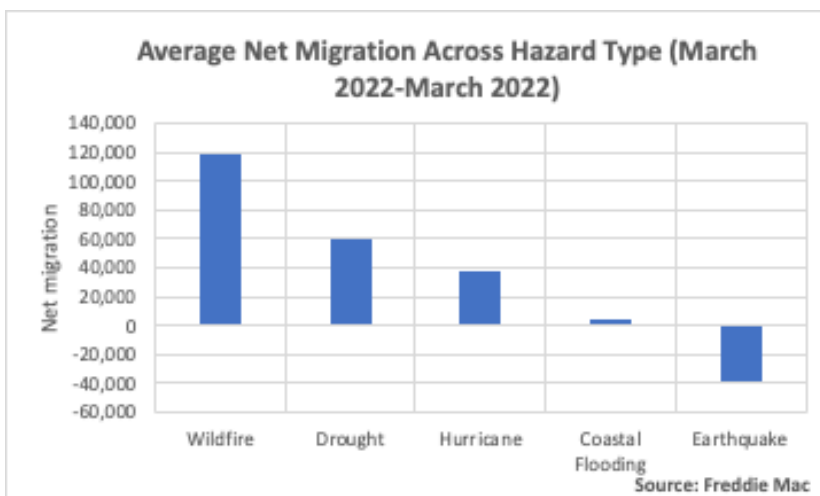
Institute estimates property insurance in Florida is 3.3. times higher than the national average while California's is 2.1 times higher). In some cases, governments will adjust property taxes or reassess property values to distribute the tax burden more evenly.

In the early post-pandemic period, there has yet to be any real correlations linking the departure of insurers in these areas to any changes in property values but **CSG** sees this as the result of pandemic-era migration trends, which are *unlikely* to be tenable for the long term.

MIGRATION TRENDS

There is a preponderance of studies that dive into the U.S. Census Bureau data that indicates people gravitate to states and cities with low tax rates and affordable housing. Cost of living is a motivator for people more than anything else. This would imply a correlation between property taxes and migration trends that would suggest people are leaving areas prone to natural disasters. The data does't reflect that and nor does polling conducted in this time frame (two-thirds of Americans would rather rebuild than move because natural disasters).

This time frame is important because during the pandemic era, people with the economic freedom of mobility, net migrated into areas prone to natural disasters. A Freddie Mac report (read here) demonstrates this aptly, pointing to a doubling of migration to high- and moderate-risk areas since the onset of the pandemic. Generally speaking, Americans who could, left areas prone to certain natural disaster and entered, en-mass, areas prone to different natural disasters. For example, California residents (earthquake) sought refuge in Idaho (wildfires) or New York City residents (flooding) left for Florida (hurricanes). The **chart above** indicates that during the height of the pandemic, people in the U.S. moved into areas prone to natural disasters, save for earthquakes, which is likely skewed by wealthy Californians leaving the state.



What has yet to be fully reconciled though, is whether or not the changes in the property and casualty industry will motivate people to leave these areas because of the cost of living. In the migration story of the pandemic, more space was clearly a key indicator, but the cost of the living was still apparent (see: Idaho or states with no personal income tax like Florida and Texas).

If history holds true, expect the cost of living to continue to be an impetus for migration trends. Population projections have yet to fully incorporate the impact of less affordable insurance options as Americans adjust to post-pandemic life. It is our expectation that migration trends should reflect the cost of living vector more heavily as cost of living is reflected in changes to cost of property insurance. This is problematic from a credit perspective in these areas.

CALIFORNIA AND FLORIDA

These two states have received the most attention on this topic as each are major economic engines and are geographically highly impacted by climate change. Each state has taken a very different political path when it comes to climate change with Gov. DeSantis declining climate change as an issue in the most recent republican presidential debate while Gov. Newsom being on the forefront of climate action plans at the state and local level.

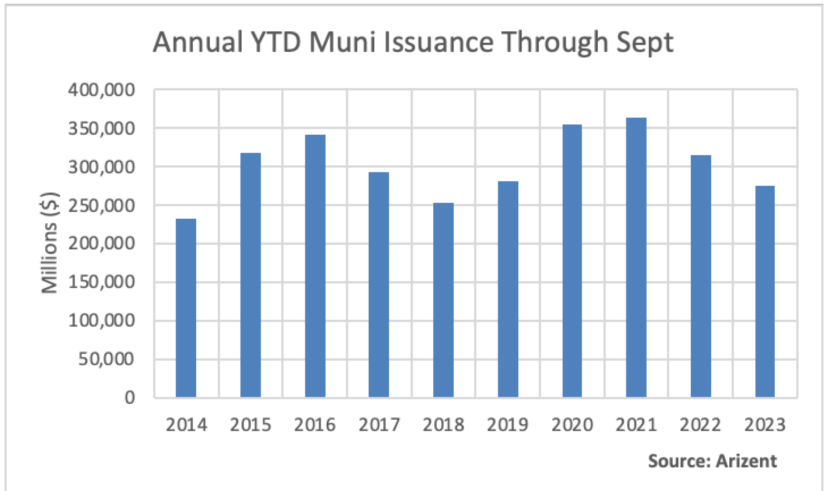
> *"To date, [California] state and federal disaster relief funds have largely mitigated the financial impact of weather-related events on Fitch-rated local governments,"* **according to a Jan. 1, 2023 Fitch report.** *"However, local government credit quality could be affected if there are reductions in state and federal disaster support and local resources are insufficient to address adverse effects."*

Despite the differing political stances on climate volatility, the near-term impacts of insurance industry changes as a result have been nullified by economic and population growth in each state. As the Fitch report (**above**) notes, thus far in California, the state and local governments are generally prepared for weather-related events in the near-term. **CSG** would point out though that this is highly dependent federal and state support and it is unclear what type of modeling has been used in scenarios where more than 20% of the existing property insurance market declines to do new business. In Florida, the same generally holds true and we would also point to what **CSG** would see as an unlikely population projection increase over the next decade by the state itself. The Florida Office of Economic & Demographic Research offers nothing in terms of climate change impact or that of less affordable insurance.

In the case of each state, recent economic and population trends have allowed each state to withstand what **CSG** expects to be longer-term, chronic issues revolving around the insurance marketplace. With a lack of modeling on the cost of living in each state and the impact of insurance policy changes to that cost, the extent of risks is not clear.

RATING AGENCIES & BOND MARKETS

The resulting challenges from less affordable insurance will affect state and local debt obligations as governments grapple with how to address safety, rebuilding, maintenance and strengthening infrastructure and the toll it takes on operating budgets, reserve funds and capital improvement plans, to name a few. The most direct element that will impact these governments will be that of the way rating agencies approach the credits of states and local governments.



Every major rating agency takes into account the availability of property insurance in a community in their rubrics for assessing a government's creditworthiness. Specifically, they look at the affordability of insurance, the cost of insurance, the presence of state-run insurance pools and a government's efforts to mitigate the risk of natural disasters. They will also consider a municipalities history of claims of losses as with a history of higher volume of claims and losses, it may be more difficult for homeowners and businesses to obtain affordable property insurance. Moody's, S&P and Fitch have all publicly stated that the activity of the property insurance industry in a community impacts its bond rating (**see quote, below**). It is hard to see a scenario where outlooks are not dimmed in certain geographies as a result of this.

> *"The availability of property and casualty insurance is a factor Moody's considers in evaluating a municipality's creditworthiness,"* **states a January, 2022 Moody's report**. *"Adequate and affordable property and casualty insurance is essential for property owners and businesses in a community. It helps to protect them from financial losses caused by natural disasters and other events. The availability of insurance can also help to support economic development and investment in a community.*

Already we see proprietary investment managers offering so-called climate-adjusted yields for various municipal credits where these changes are occurring. That being said, as we noted two weeks ago, credit spreads for California and Florida remain near historically tight levels - largely the results of supply/demand balances that tilt in favor of the issuer. Overall, year-to-date primary market supply is at a 5-year low and the third lowest in a decade (**see chart above**) bolstering demand regardless of the fundamental credit issues noted in this report. The long-only municipal bond market generally operates at the whims of technical factors rather than underlying fundamental ones. This hurricane season, federal government uncertainty and a lack of state political support to address the reality of climate-engaged actuarial modeling by insurers and re-insurers, leaves bond markets with many unknowns.

Expect natural disaster immediate response to generally be status quo with FEMA recently getting supplemental funding but it is the longer-term rebuilding that will struggle the most- and it is in the nation's most vulnerable communities that will bear the brunt of these problems going forward. A focus on vulnerable communities will be published in next week's edition.