The Hidden Inflation in Homeowners Insurance

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*The views in this presentation are those of the discussant and not necessarily those of the Federal Reserve System or the Federal Reserve Bank of Chicago.

Summary

- Derive a quality-adjusted index for homeowners insurance premiums
  - Holding fixed policy characteristics and insurer, premiums increase was 19% more than expenditure increase
- Use adjusted premiums to estimate household responses to price increase
  - Small increase in deductibles and nominal coverage; decrease in coverage to structure value
  - Argue that inattention and information frictions can explain the increased spending coupled with decreased coverage
- Find that price increase associated with decreased credit borrowing and increased credit distress

Deriving the National Index

Hedonic Price Index:

$$\ln p_{it} = \alpha + \beta_1 \text{Ded}_{it} + \beta_2 \text{CovShare}_{it} + \lambda_t^{qa} + \delta_z(i) + \gamma_{k(i,t)} + \varepsilon_{it}$$

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  - Hazard growth within a ZIP loads onto the time effects
  - Looks like price inflation

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What Is "Price" When Risk Rises?

- Is higher risk part of the price or part of the product?
  - Price: same promise, now costs more (risk-assuming view; gross premium)
  - Product: more expected payout per policy (risk-pooling view; net of expected losses)

- Example: hazard doubles, premium goes from \$1,000 to \$2,000
  - Price view: the price doubled
  - Product view: expected payout \$750 $\rightarrow$ \$1,500; price per expected dollar unchanged

- A hazard-driven premium increase likely elicits different responses than a markup.

Ways a Policy Gets Less Generous

What changes	Peril covered?	Cov Limit lower?	Example
Peril excluded	No	n/a	Wind/hail exclusion; cosmetic damage
Payment basis	Yes	No	Roof loss at actual cash value
Restructure deductible	Yes	No	Percentage wind/hail; split roof deductible
New or lower sublimit	Yes	No	Cap on one peril, e.g., water backup or mold

- Most documented change is in the middle two rows (qualitative evidence from GAO, FHFA)
- Narrowing of policies could show up in optional endorsements
- Could payouts also be getting less generous?
- Implies quality-adjustment could understate true price change

Responses to Prices

- Should some measure of ex-ante expected losses also be captured in regression?
  - Goes back to the idea of whether risk should be in the price or the product
- Decline in coverage limit relative to structure value
  - Seems to rely heavily on getting the structure value correct
  - Can more work be done to validate structure value?

Inattention and Information

- Inattention is plausible, but are there other explanations?
- When households refinance or purchase a new home:
  - How do lender requirements factor in?
  - Are households reoptimizing or buying what's required of them?
- Are there any policy defaults that homeowners are opted into that would strengthen the inattention story?
  - e.g. Bunching of coverage-to-value at 80%
- Using future refinancing makes sense if the timing of refinancing is exogenous, but I don't think that assumption holds

Credit Responses

- Do the magnitudes make sense given the price changes?
  - Is it surprising that mortgage delinquencies increased?
  - It would be nice to see more exploration
- Conclusion that superprime borrowers self-insure seems strong
  - Decreased credit card balance would not necessarily capture all spending

Final Thoughts

- Really important question
- Careful empirical work and interesting findings
- As prices continue to rise, informative for future policy debates

Thank you!