

Topic 17: Basics of Insurance Relating to Real Estate

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Insurance is an important matter to discuss in a real estate principles course because owning real estate exposes the owner to possible financial losses (your property is destroyed, someone sues you) and because lenders will not extend financing unless their financial interests are protected by insurance of various types. Some real estate brokers even sell property insurance as a sideline, and lending institutions may sell some types of insurance that relate to real estate transactions or financing. The home owners' insurance industry has lost money in recent years because of high payouts from extreme weather events.¹

I. Definitions of Insurance Concepts

A. *Risk* – The chance that a loss may occur. Real estate owners are exposed to risk in 3 ways:

1. Loss of property or its value (resulting from fire or windstorm damage, or theft, for example).
2. Liability – *money owed to others* who may be harmed financially because of the insured party's *negligence*.
3. Added expenses incurred if property can not be used (after a fire or tornado, for example).

B. Ways to handle risk:

1. *Avoid* the risk – for example, do not own (or make loans secured by) real estate – an impractical approach for most.
2. *Assume* the risk – pay for any losses yourself. People sometimes use the term “self-insurance,” although this is a misnomer unless the owner has enough exposure units (perhaps a large company owning hundreds of buildings) that it can use actuarial techniques to predict the number of loss incidents it will face, and the average dollar loss in each incident.

Note: all insurance is based on *the law of large numbers*. If there is a large pool of insureds, an insurance company's actuaries (statistical analysts in the risk management field) generally can predict within a small percentage range how many claims it will face, and the average dollar cost of each. But even a large insurer can not predict which insured parties will suffer losses, or what the cost of a given claim will be, so an individual certainly has no ability to predict his or her losses.

3. *Transfer* the risk to a third party – we do this by buying insurance policies, paying insurers to accept the risk.

C. *Peril* – the direct cause of a loss. Examples: fire, windstorm, flood, someone else's injury. Some insurance policies cover more perils than others.

D. *Hazard* – a condition that increases the likelihood that a peril will occur. There are three types of hazards:

1. *Physical* (e.g., storing old tires, which might catch fire, on your land).
2. *Moral* (e.g., wanting to set your house on fire to collect insurance money) and 3) *Morale* (also called “attitudinal;” being careless because insurance will pay for any losses suffered – sometimes morale hazard is presented as a perhaps less sinister subset/special case of moral hazard; note that moral/morale hazards exist only because there is insurance coverage).

E. *Insurable interest* – you must have a financial interest in a property to insure it. For example, you can not buy an insurance policy on someone else's house. [Moral hazard would exist; Person A would collect a lot of money if Person B's house burned to the ground, but would suffer no accompanying loss, and gains no benefit if the structure remains standing. After a sales contract is signed but before the closing, the buyer and seller of real estate usually both have insurable interests. A related idea is *adverse selection*, the tendency for parties most likely to file claims to be the most enthusiastic insurance buyers. If only careless drivers bought car policies the company would have to pay far more in claims than it had predicted.]

F. *Indemnity* – the idea that the insured should be repaid only the amount of loss suffered, and not actually gain money (so there is a link to the insurable interest and moral hazard ideas). That is why:

1. Even if you insure for more than an item's value, an indemnity insurer will pay only the value of what was lost, and
2. There may be a *pro-rata clause* – if an insured party has bought indemnity policies from more than one insurance carrier, each company pays only a fraction of the total loss; you generally can not collect double the value of possessions lost in a fire or tornado by having purchased two policies.

[Not all insurance is of the indemnity type. Auto and real property insurance policies are indemnity policies. Life and some types of hospitalization insurance (plus policies on hard-to-value art work or antique cars, for example) are not. They are *valued policies*; if you buy several to cover one peril, they generally all pay in full if the insured event occurs. A justification would be the great difficulty of assigning dollar values to things like someone's life, or a rare work of art. At the same time, an insurer may decline to offer coverage if policies already in place would pay high dollar amounts in the event of a loss – if a person of modest wealth and income has life insurance policies that would pay \$50,000,000 that person could be worth more dead than alive to some potential beneficiaries, and a terrible moral hazard would arise. It also is the case that you can buy a life insurance policy only on someone in whose life you have a financial/insurable interest – e.g., oneself or a spouse.]

G. *Coinsurance* – if the insured with a home owner’s insurance policy does not buy coverage for *at least 80%* (a longtime insurance industry standard) of the value of the improvements, the insurer typically will pay only a percentage of any loss suffered. For example:

Cost to replace improvements	\$200,000
Multiply by 80% (minimally should purchase)	\$160,000
Coverage actually purchased	\$112,000

The insured has only $112/160 = 70\%$ as much coverage as she minimally should have. So on a \$25,000 loss, she can collect only 70% of \$25,000 or \$17,500 from her insurance company (minus the *deductible*, which is what the property owner must pay before the insurance company pays anything, so if the deductible is \$500 the company pays the remaining \$17,000). [A better plan might be to have a policy with a “guaranteed replacement cost endorsement” that assures the property owner of getting enough money to rebuild (for a higher premium that assures full coverage is in place, of course).]

Why does the coinsurance provision exist? If a fire or other peril occurs, it is not likely to cause complete destruction of the improvements. So a lot of people might choose to insure their houses only for a portion of the value, knowing that there would be only a small chance that any peril would cause an amount of damage higher than what they insured for. But then the insurance company would not collect enough in premiums to cover its actuarially-predicted costs. The alternative would be a graduated rate scale (likely much more confusing and difficult to administer), with higher per-unit costs for lower dollar coverage. Or simply note that small losses would be covered in full while large losses would not, creating an unintended relative advantage for small losses (whereas all losses should be equally uncertain and equally treated). While 80% most typically is the coinsurance requirement for home owner’s insurance, policies covering commercial real estate might specify 80%, 90%, or 100% required coverage.

[From an economic perspective the deductible is not, for the most part, a means of reducing the insurance company’s cost when a peril occurs; after all, the \$1,000 a home owner might pay on a large loss is fairly trivial – although it certainly makes sense not to have the insurance company process claims when small mishaps occur, because the cost of sending out adjusters and doing all the administrative work may not be much less on an \$800 loss than on a \$150,000 loss. But the deductible largely exists to change the policy holder’s behavior so the peril does not occur in the first place. The insurance company wants the deductible to be high enough that the policy holder will take steps to prevent a fire or theft from occurring, because having to absorb that \$1,000 or \$2,000 would be so unpleasant. The term “coinsurance” also is used in connection with medical insurance to denote the percentage (typically 10 or 20%) of a doctor or hospital bill that the patient must pay; the insurer pays the remainder (90 or 80%). This idea is very different from the coinsurance concept in property insurance.]

H. Replacement vs. Reproduction Cost

1. On *the structure* – if coverage is for *replacement cost*, damages are repaired with modern methods and materials. For example, the insurance company would not pay to replace the ornate woodwork found in an older home unless the owner had purchased a more expensive policy calling for *reproduction cost* to be paid (essentially the same way we used the terms replacement and reproduction cost in our appraisal discussion). In recent years insurers have been phasing the reproduction cost option out of the policies they sell, offering instead only an “extended replacement cost” choice that pays up to 20% more than standard replacement cost for unusual situations. A *law and ordinance* endorsement provides coverage for extra costs incurred if a repair must be made with costlier labor or materials to conform with more stringent building codes that may be imposed after the policy goes into effect (of course a benefit of that type carries an additional premium payment).

2. On *contents* (your furniture, etc.) – standard coverage is for *actual cash value* (the cost to buy a new item, minus a percentage for “depreciation”). You can buy a more expensive policy that pays “full replacement cost,” meaning that the insurer will pay for a new TV even if the set you lost in a fire was several years old – and thus might be viewed as only half of a TV lost under actual cash value coverage. (Often there is a limit: for example, the insurance company might not pay more than four times the actual cash value of the destroyed item. This provision reduces the likelihood that someone would burn or otherwise destroy a lot of old items just to collect a large amount of insurance money.)

II. Types of Real Property Insurance Coverage

A. *Standard Fire Policy* – an older policy type that covers only perils related to fire and its damage; most home owners now insure with broader coverage under one of the HO policies described below. But some buy fire insurance in addition to HO policies to handle gaps in coverage (e.g., household possessions in amounts that exceed what HO policies cover). Laws in some states, including Illinois, require all insurance policies that include payment for fire damage to provide coverage at least as good as the Standard Fire Policy offers (this 165-line document was approved in 1943 by the legislature in New York, a state whose strong insurance laws often set standards that other states follow).

B. The HO (Home Owner) Policies

Section I: Protects against financial losses resulting from things that happen to the residence and things inside the home (“contents”). Covered are damage to the structure (premiums are higher if the residence is far from a fire house, or if the building materials are more subject to damage by fire, *etc.*), damage to trees/landscaping if caused by a covered peril, loss of contents (destroyed by fire or tornado, stolen, even accidentally lost), extra living expenses after a covered peril occurs (coverage often limited to 20% of amount payable to replace the structure), and some unusual things like identity theft or unauthorized use of your credit cards. On contents (furniture, computers, clothing, and other personal belongings; payment limit often is 50% of amount payable to replace the structure), there are specified dollar limits for certain types of items that are especially valuable and/or could be overly attractive to thieves: cash, jewelry, firearms. Personal belongings generally are covered for loss or theft even if they are lost or stolen at a location away from the residence covered under the policy.

People with fine jewelry or other expensive items need separate “floater” policies as additions to their standard policies to cover the higher values in the event that such valuable items would be lost, stolen, or destroyed. Safety features like sprinkler systems, or burglar or smoke alarms, can keep HO policy premiums lower. Financial losses usually are covered, net of the deductible amount the policy holder must first absorb, if the damage is caused by perils that include fire, wind, and falling objects – but not flood! (See the flood insurance discussion below.) In fact after a severe weather event like a hurricane, with both high winds and flooding, there can be lawsuits over whether damage done by standing water in someone’s house resulted from flooding (not covered by standard HO homeowner policies’ Section I coverage) or from heavy rains that entered the structure after high winds or a downed tree left a hole in the roof (covered) – or some damage from both.

Section II: Covers personal liability exposure, which applies when “bodily injury” or “property damage” is suffered by someone outside the policy holder’s household, because of a “negligent” (essentially careless) act on the part of the policy holder or that individual’s household members, guests, or even pets. There is no deductible on Section II liability coverage. This part of the HO policy pays for costs (medical bills, repairing or replacing damaged items) resulting from the negligent act, including legal defense if the policy holder is sued, even if the negligent act did not take place at the residence covered in Section I. Intentional acts of destruction are not covered by the Section II personal liability coverage in an HO policy. A “medical payments to others” provision within Section I of the HO policy generally provides coverage for fairly minor bodily injury, often a \$5,000 per person/per incident limit, suffered at the covered residence by a non-household member; it pays on a “no-fault” basis (*i.e.*, even if the cause was not negligence on the part of someone in the policy holder’s household).

Personal liability situations (meaning non-automotive; car insurance liability coverage pays if a household member causes bodily injury or property damage while driving) could include a neighbor’s child getting hurt while playing on the policy holder’s swing set, the policy holder’s son hitting a baseball at the park that breaks a parked vehicle’s window or conks a picnicker on the head, or the policy holder’s dog biting someone at any location. But if the policy holder intentionally pushes a visitor down the stairs the HO policy will not pay anything toward legal bills or the injured party’s medical care; the policy holder will have to cover all ensuing costs out of pocket (and likely face criminal prosecution). And if your Great Dane puppy tears up a neighbor’s couch during a visit the damage is covered, but if he tears up your couch you will pay for a new one yourself (damage done at the insured residence by the policy holder’s own animals is almost always excluded under Section I coverage, and Section II liability protection covers only harm to parties outside the policy holder’s household). Standard HO Section II liability coverage tends to be in the \$100,000 – \$500,000 range.

Some people buy *umbrella liability* policies, which supplement the basic homeowner and auto liability coverage, providing an additional \$1 million or more in protection for a premium that might average a few hundred dollars per year for an extra \$1 million covered. Companies that underwrite umbrella liability insurance (it might be your own HO policy carrier, or a company that specializes in umbrella coverage) generally require policy buyers to first carry \$500,000 or more in liability coverage on both auto and HO Part II standard liability coverages. One specialty umbrella insurer’s annual premium rate schedule shows a declining scale of \$649 for an additional \$1 million in coverage beyond the basic home and auto insurance liability limits; \$884 for an added \$2 million; \$1,110 for \$3 million; \$1,333 for \$4 million; and \$1,548 for \$5 million.²

(Under the 1979 Illinois Snow and Ice Removal Act you generally are not required to shovel snow or remove ice on the sidewalk in front of your house – though Chicago home owners can be fined \$50 for not removing snow and ice from their sidewalks, under a separate city ordinance. Parties injured by snow or ice on sidewalks would tend to be able to sue for liability only if a home owner’s intentional or extremely negligent acts actually created dangerous conditions.)

The owner or occupant of residential real estate can choose from various types of HO policies that provide different levels of the coverages discussed above, especially with respect to Section I for structure and contents. The listing below shows what generally is and is not covered under the traditional HO policy classifications. But there can be slight variations on the general themes, and sometimes extra coverage can be obtained that blurs the distinctions across the different categories.

1. HO-1: *Basic* policy that covers a group of specifically named perils, including fire, lightning, windstorm, hail, vandalism, theft, and damage caused by aircraft or vehicles – but perils that are not specifically listed are not covered. HO-1 rarely is used today; one reason is that a mortgage lender might not approve this type of policy for a borrower, because of the limited protection provided. Over the years there have been countless cases of serious injury to people falling while trying to shovel their roofs after severe snowfalls – they may well have had HO-1 coverage, under which the weight of ice and snow was not a covered peril.

2. HO-2: *Broad* coverage, with more perils covered, including falling objects, weight of ice and snow, and cracked or bulging water pipes.

3. HO-3: *Special* form, the most common type of home owners' policy purchased today. Covers the structure for all perils *except* those *specifically excluded* (it is “comprehensive” or “open perils”), with non-covered perils including earthquake, floods, termites and other vermin, damage by the policy holder's own animals as noted earlier, mold/settling/corrosion/other wear and tear issues, actions of government, and vandalism to a house that has been sitting vacant for at least two months. (HO policies and other forms of property/casualty insurance generally do not cover for losses caused by catastrophic events affecting most properties over wide geographic areas, or for problems that build up slowly over time.) So HO-3 offers stronger coverage for the structure than HO-2 provides. But contents are covered only for perils specifically listed, and lost contents generally are paid for on an actual cash value, not the more favorable replacement cost, basis. An HO-B policy is similar to the HO-3, but is used in coastal areas and may cover damage to boats and other equipment as well.

4. HO-5: A “premium” version of the comprehensive or open perils policy, which covers all perils the HO-3 covers, but with HO-5 the contents also are covered for the comprehensive list of perils that applies to the structure, and the contents are covered on a replacement cost rather than less favorable actual cash value basis. Premiums are higher than for the HO-3, and not all insurance companies offer HO-5 coverage (or they may limit it to newer structures).

5. HO-4: *Renter's* policy (covers the tenant's personal possessions and liability, including liability to the landlord for negligently damaging the premises, and also possible extra living expenses if the rented house or apartment building must be repaired after, *e.g.*, a fire – but does not cover the structure, which the lessee does not own). Generally, a landlord has a legal right to require a prospective tenant to have renter's insurance, with specified minimum amounts of coverage, as a condition of granting the lease. If the tenant did not have this type of coverage the landlord might fear becoming the “deep pocket” that is sued if the tenant's belongings are stolen, or someone is injured on the landlord's property through the tenant's negligence. Like other HO policies, the HO-4 renter's coverage also has Part II that provides the renter with personal liability protection. A Harvard University study found that only 40% of lessees buy renters' insurance,³ while 88% of home owners are insured.⁴ On-line renter's insurance seller Lemonade advertises that it donates profits each year to charities of policy holders' choice.

6. HO-6: *Condominium* unit owner's policy – like a renter's policy in its coverage of personal property, but also covers damage to the interior walls, floor, and ceiling; the structure is insured by the condo owners' association with premiums paid through unit owners' monthly fees, because if one unit catches fire others will be damaged as well. A project's bylaws might actually state that the owner's association pays only for repairs to the complex's common areas, which could apply even if actions undertaken by the association cause damage to the interior of an individual's owner's unit.⁵ Like other HO policies, the HO-6 for condo owners also has Part II coverage that provides the unit owner with personal liability protection.

7. HO-7: Special mobile home policy (covers damage to the structure and contents, and the owner's personal liability).

8. HO-8: Coverage similar to HO-1, for an older home that would cost far more to rebuild than its market value. Repairs are covered on a “common construction” (modern methods) basis; contents and personal liability also are covered.

A rule of thumb is that homeowner's insurance premiums should be about \$3 per year for every \$1,000 in the value of improvements (such a rule obviously is a generalization; actual costs would be affected by location, age of improvements, type of construction, and other features – including the type of policy/what perils are covered). Financial web site *Bankrate* shows the nationwide average cost of coverage for a \$300,000 dwelling unit in April of 2024 as \$2,151. The Illinois figure at \$2,079 was just slightly under the national average, while pricy Florida was \$5,770⁶ – and in that state wind damage usually is not included under standard home owner coverage (a wind damage rider or separate policy is needed). Recent years' HO insurance premiums have tended to increase by more than the inflation rate – with more extreme weather incidents, higher construction labor costs, and shortages of construction materials among the reasons.

Ways often cited for saving money on homeowner insurance premiums are bundling policies (buying car, home owner, and maybe even life insurance coverage from the same insurance company), living near a fire station, putting in a security system, and (particularly in geographic regions where hurricanes occur) having special structural improvements, like roof straps and impact-resistant windows. Structures built with stronger roof and other features that meet the high “Fortified”

standards of the industry-funded Insurance Institute for Business and Home Safety can get reduced insurance rates, in at least one state because insurance regulators require it. **Deed restrictions in some new subdivisions in hurricane-prone areas require Fortified construction.** (80% of U.S. homes built to Fortified standards are in Alabama, where home owners' insurance in coastal areas remains affordable.⁷ An aerodynamic home style designed for energy efficiency, and with living areas elevated above a floor-level garage, turned out to stand up well to Florida hurricanes, bringing owners reduced insurance premiums.)⁸ As also is true with car insurance policies, premiums will be lower if the policy holder's deductible is higher. As noted earlier, the deductible is the amount the insured party must pay to repair damages before the insurance company starts paying. A typical HO policy deductible amount might be \$500 or \$1,000; your ancient instructor recently netted a \$166 annual premium reduction by increasing the homeowner's policy deductible from \$1,000 to \$2,000.

[In recent years, insurers generally have stopped providing coverage under standard policies for earthquake damage, and many also have cut back on covering wind damage in areas most susceptible to hurricanes. One Florida home owner was quoted a \$9,000 annual premium on a wind damage policy that carried a \$40,000 deductible (the deductible on a special policy covering hurricane damage might be a percentage, e.g. 5%, of the insured limit, and the deductible for special earthquake coverage might be an even higher 10% or 15% of the amount insured). Many private insurance companies have stopped writing policies in Florida, and smaller private insurers have gone bankrupt paying for hurricane damage; hurricane Ian in early fall of 2022 was expected to drive more home owners to policies from the state-owned Citizens Property Insurance Corporation – and upward premium pressure also likely will follow losses the large reinsurance companies, which backstop the primary carriers, have faced from Ian and other costly events. Wind damage remains a standard covered peril in central Illinois, but even here an HO policy could well have a higher deductible for wind damage than for damage from other covered perils. It is interesting that for mobile homes – a generally inexpensive form of housing – the insurance coverage tends to be fairly expensive in relative terms, because of these structures' less stable construction and high susceptibility to wind damage. Vacation homes also are more expensive to insure; since they are vacant much of the time damage can be greater, and theft is a bigger risk. And homes that are rented out are considerably more expensive to insure; one source indicated that a "landlord" policy costs 20 to 30% more than standard homeowner coverage, because of concerns over liability claims from tenants or their visitors and the concern that renters might tend to be less careful than owners.]

Finally, coverage for sewer backup, and especially for repairing and replacing sewer lateral lines that run from the main line at the street up to the house, are not covered under standard HO policies, and the cost of a repair tends to run in the \$5,000 – \$10,000 range. "Riders" may be offered by your own insurer – my HO policy carrier charges about \$90 per year – or by a specialty insurance company. (The city of Bloomington has worked with a private insurance company to provide coverage to residents as an optional addition to monthly water bills; the town of Normal has not offered a similar option.)

C. *Earthquake Insurance* – this coverage is sold in the private market, but it must be purchased as an *endorsement* to the HO (home owner) policies that most people tend to buy. One concern that insurers have with both earthquake and flood coverage is the potential for *catastrophic loss* – the chance that large numbers of insured parties will lose property value in a specific region at the same time (which has happened, to some extent, with Atlantic and Gulf coast hurricane losses in recent years). The predictive models through which insurance companies decide whether to offer coverage, and what premiums to charge, are based on the expectation that only a small number of policy holders would be harmed by a particular peril's occurrence.

D. *Flood Insurance* – the United States Code defines flood as "inundation from rising waters or from the overflow of streams, rivers, or other bodies of water, or from tidal surges, abnormally high tidal water, tidal waves, tsunamis, hurricanes, or other severe storms or deluge." Coverage for flood is sold through private insurance agents, but ultimately very little flood insurance is provided (underwritten) by the unassisted private market (Neptune Flood Insurance is a company that sells private market policies). The coverage these agents typically sell is made available through the National Flood Insurance Program (NFIP), created in 1968 and administered by the Federal Insurance and Mitigation Administration, part of the Federal Emergency Management Administration (FEMA), which is a division of the federal Department of Homeland Security. Any party with a loan made by a federally insured lender or guaranteed by a U.S. government agency (banks, credit unions, FHA, Fannie Mae, Freddie Mac) is required to obtain the protection for any property in a high-hazard location (as we noted, the lender must inform the borrower that the property is in a flood area). Such a location is defined by FEMA as being in a "100-year flood plain," meaning it is judged to have a 1% chance of flooding in any year, or in "Zone A," meaning it has a greater than 25% probability of suffering flood damage over the loan's life. That measured likelihood can be based on proximity (and insufficient elevation) relative to an ocean, lake, river, or creek.

NFIP flood insurance is available to buyers of homes or business properties both in and outside of federally designated flood plain areas (rain from coastal hurricane activity can overflow waterways and cause flooding far inland), with lower premiums paid for coverage in areas that carry less risk of flooding. Lenders often require borrowers to "escrow" flood insurance premium payments (add $\frac{1}{12}$ of the annual premium to each monthly loan payment, so the lender can pay the premium for the borrower and thus be assured that it has been paid). The private market has begun offering more options as risk modeling

tools have advanced, and as government flood insurance policy premiums have risen in recent years to levels with which private carriers can better compete.

Lending Tree showed an average annual home owner's flood insurance premium nationwide of \$985 in early 2023, with prices across states ranging from \$613 to \$1,648 (Illinois \$1,135), but specific premiums are affected by the improvements' value and how flood-prone the location is (property right on a beach is more expensive to insure). The home owner needs to have regular HO coverage as well, and flood insurance typically has a deductible of \$1,000 to \$10,000. NFIP covers only up to \$250,000 for rebuilding a house or business building and \$100,000 for lost contents from a flooded home (\$500,000 for business property contents); higher amounts of coverage can be obtained from private insurers. Lenders require an affected borrower to be covered for the lesser of principal still owed on the loan or the replacement cost of rebuilding the structure (but no more than the maximum available limit, of course). Costs of steps taken to prevent or reduce flood damage also are covered. (One step insurance experts encourage for reducing potential flood damage is to locate electrical and HVAC systems above ground – or even to elevate the entire house.) Interestingly, policies also cover damage from water that seeps into the house from below as a result of soil saturated by melting snow. Typically, coverage does not go into effect until 30 days after the policy is purchased. Someone with an expensive home or business property who has the basic NFIP policy can try to buy supplemental flood insurance from a private insurer to cover what NFIP does not (losses exceeding specified dollar limits, lost value of damaged contents stored in basements, cost of living off premises while repairs are made – and NFIP also does not cover lost income through “business interruption” protection for insured business property owners).

There are many controversies surrounding the NFIP arrangement. Some economists argue that the program is especially subject to moral(e) hazard, with the subsidized insurance inducing more people to build in flood-prone areas they otherwise would avoid, and that the subsidies crowd out private flood insurance. (The crowding-out argument might be countered, to some extent, by the fact that NFIP started in 1968, while private insurance companies largely got out of the flood insurance business because of catastrophic loss concerns following a serious 1927 Mississippi River flood. The private market has to be leery of flood coverage; a tornado can flatten one house and leave the property next door unscathed, but a flood is likely to do serious damage to every parcel over a wide expanse – a catastrophic loss for any insurer that has underwritten numerous policies in that geographic area. But criticism of subsidies is buttressed by the observation that politically influential people, perhaps even lawmakers themselves, often own expensive waterfront real estate they want to protect with fellow citizens' assistance.) In fact, the low premiums resulting from federal subsidies give insured parties incentives to rebuild in the same flood-prone locations after they suffer water damage and receive benefits. A Texas home owner collected \$1,800,000 in total insurance payouts on a \$600,000 house that flooded 22 times over 38 years. Indeed, a small proportion of insured properties tend to account for a high proportion of claims paid over time; one estimate showed “repetitive loss” properties (less than 2% of insured parcels) accounting for almost half of all NFIP claims.⁹ (Ten or more claims were filed on more than 3,000 insured properties between 1978 and 2022.)¹⁰ It is encouraging that premiums have increased (generally limited to 18% per year)¹¹, with subsidies for sites generating multiple claims cut back (rebuilding cost is now factored in), through federal flood insurance reforms that included Risk Rating 2.0 (a new plan, based on high-technology maps, for measuring flood risk for individual properties), which went into effect in October of 2021. In fact, by summer of 2022 the Senate Banking Committee was discussing a new plan that would end coverage for multiple-claim properties and prohibit insurance on land in areas especially subject to flooding.

Even before severe Midwestern floods in early 2019 led to discussions of a major NFIP overhaul, the government had been moving toward setting premiums based on actual risks, as they would be set in an unsubsidized private market. And both FEMA and the federal Department of Housing and Urban Development have tried to buy flood-prone homes from their owners, toward demolishing them and leaving the land vacant to mitigate future flood damage and costs. After the Mississippi broke through levees during the massive 1993 flood and destroyed almost all of Valmeyer in southwestern Illinois, most of the 900 residents sold their properties to FEMA and rebuilt the town on nearby bluffs high above potential future river crests. (Residents near major rivers or streams typically must also pay levee district taxes.) FEMA then donated the vacant land back to the community, which generates local government revenue by leasing the ground to farmers for crop production.¹² [This type of buyout process is pursued aggressively in Canada.] Most houses in a Louisiana community that has suffered repeated hurricane damage, but whose Native American residents do not want to sell to the government and move away from tribal land, have been raised to twelve feet above ground level. The federal Bureau of Indian Affairs started a program to relocate homes and other buildings in indigenous communities that have become more subject to flooding as temperatures reportedly rise; the first grants went to five tribes in Alaska and Washington state in late 2022.

Still, artificially low premiums, coupled with (according to one source) generous commissions insurance agents get for selling NFIP policies, mean that net amounts collected have historically been far too low to meet expected costs of settling claims. The Gulf region's Hurricane Katrina in 2005 and eastern seaboard “Superstorm” Sandy in 2012 put so much strain on NFIP's resources that a federal bailout was needed. The program was almost \$25 billion in debt to the U.S. Treasury before major hurricanes Harvey and Irma hit in late 2017; the reported figure was still \$20 billion in 2022, after \$16 billion in loans from Congress had been forgiven. One analyst predicted that needed changes would cause the price of coverage to

double over a few subsequent years, and with Risk Rating 2.0 some premiums will be more than doubling in the next few years. But as a result of premium increases enacted after 2012, many owners who were not required to insure dropped their coverage; 883 Illinois owners reportedly dropped coverage recently.¹³ (Parcels located just outside of designated flood-prone areas may be at considerable risk of flood damage, but their owners are not required to get the NFIP insurance. Problems also arise when people get policies to obtain loans, and later let the coverage lapse – though the lender may be able to pay premiums to keep the coverage in place, and then charge the borrower added fees. And some who have moved into flood-prone areas in recent years have paid cash for their houses, thus not facing lender mandates to insure. Also, as of October 2023 ten state governments were suing FEMA to block further premium increases scheduled for coming years.¹⁴

If floods occur, uninsured owners are likely to seek emergency relief from Congress – an interesting outcome in that part of the government’s motivation for creating NFIP was fiscal discipline: use money received as premiums, even if at subsidized rates, rather than giving tax-funded emergency aid to flood victims. (Uninsured owners of rental property tend not to receive the benefits home owners get.) And FEMA’s ability to identify flood risk also came into question after the Houston area suffered, three years in a row (2015 – 2017), flooding of a magnitude expected to occur only once every 500 years. Even the Government Accountability Office has criticized the program for poor internal controls and outdated maps. (But no matter how good current maps are, no one can predict which properties may flood in the future as climate conditions change, and as water runoff dynamics are altered when undeveloped land is built on and paved. And laws in some states do not require property sellers to disclose previous flooding incidents to buyers.) A nonprofit group called First Street Foundation creates flood plain maps that incorporate climate change model data and are more comprehensive than FEMA’s, showing more U.S. land areas to be susceptible to flood problems. Professionals like engineers and land use planners can earn the Certified Floodplain Manager designation (which requires flood insurance expertise) through the private, Wisconsin-based Association of State Floodplain Managers, or through a related Illinois Association of Floodplain and Stormwater Management.

Similar issues have arisen through California wildfires of recent years; home owners’ insurance coverage from the private market is likely to become very expensive when it is available at all – one affected home owner’s annual premium recently rose from \$2,350 to \$18,000. (Areas where home owners can not buy policies from private insurers are called “insurance deserts.”) The state’s FAIR plan covers structures for up to \$1.5 million, but does not cover personal property or liability risk. The same situation is seen in Hawaii with insurance to cover property damage from volcano eruptions. State government created the Hawaii Property Insurance Association in 1991 to subsidize the purchase of property insurance in the riskiest areas (“Lava Flow Zones 1 and 2” near volcanoes Mauna Loa and Kilauea on the “big island” called Hawaii) that an unaided private insurance market no longer serves. (This subsidized coverage is still expensive.) HPIA has come under criticism not only for the high costs to the public, but also for having put lives at risk through home construction in dangerous locations that would have been avoided absent the subsidies, with 2018’s major eruption of Kilauea. Private insurance companies cancelled almost 100,000 home owner policies in hurricane-prone southern Louisiana in the summer of 2022; individuals who lost coverage generally turned to the state government insurance plan, Louisiana Citizens, and even that state option was extremely expensive (\$15,000 and \$41,000 annual premium examples were cited in a news piece).

E. *Title Insurance* – protects against costs associated with third parties’ claims against a property owner’s *title* (ownership interest). “Clouds” on title can arise from many causes; prominent title insurer First American cites “Ten Common Title Problems” that title insurance may cover (not always under standard policies): errors in public records, unknown liens, illegal deeds, missing heirs, forgeries, undiscovered encumbrances, unknown easements, boundary/survey disputes, undiscovered will, and false impersonation of previous owner.¹⁵

Interesting title example: in the late 1960s a recent Pennsylvania home buyer encountered a neighboring farmer herding pigs across his back yard. When subdivision developer Toll Brothers investigated, the farmer explained that William Penn had granted his ancestors a permanent legal right to cross that land and water their livestock at a spring. The title insurer, whose title search had not found that longstanding easement, paid the farmer \$30,000 to abandon the right,¹⁶ close to \$300,000 in today’s value. (With Penn personally involved the conveyance must have been made somewhere around the year 1700.)

When a home or other property is purchased, *the buyer and lender* both want to be protected by title policies. Typically, the seller (who wants the buyer to buy) pays for the buyer’s policy, while the buyer (who wants the lender to provide financing) pays for the lender’s policy. Title insurance is interesting coverage, in that generally it insures only for perils that already occurred and excludes future events (the title insurer has no obligation if a subsequent event clouds title, to an owner’s or lender’s detriment), whereas most insurance excludes what already happened and covers only future events. Owners of leased vacant land agreed to subordinate their leased fee simple interest to a lender’s mortgage lien if the tenant borrowed money to build improvements and make the land more valuable. When the tenant borrowed \$125,000 the lender obtained title insurance, conditioned on the construction requirement. But the tenant never built anything, so when he did not repay the loan the lender no longer had a security interest in the land. A state supreme court ruled that the lender had no claim against the title insurer, because the tenant’s violation of the construction condition that caused the lender’s unexpected title problem occurred after the policy was issued.¹⁷

(An exception is coverage some title insurers have started offering, for higher premiums, covering “title theft” losses that result when identity thieves later use fraudulent deeds or other documents to transfer ownership or obtain loans. And a 2020 court ruling held a title insurer liable when land was later taken under eminent domain – usually not insurable – because government maps showed the affected parcel to be a possible target for future acquisition by the county.)¹⁸ Especially interesting is that, *e.g.*, State Farm will have to pay more to settle claims if its customers drive carelessly, whereas a title insurer will have to pay more to settle claims if *it* is not sufficiently careful in searching the records of title activity that happened in the past, as with the livestock easement in 1960s Pennsylvania. (Third parties’ interests resulting from adverse possession or easement by prescription that the property seller does not report, or was not even aware of, can not be found in a search of the public records, and thus are not covered under standard title insurance. A title insurer will not visit the site to look for evidence of claims of these types, so a prospective buyer must.)

A single premium is paid to purchase coverage that will last as long as the insured owner’s or lender’s interest remains intact. Title insurance is indemnity coverage; the policy holder generally can collect only the value lost through a title problem, and only up to the policy limit. The insurer must pay if a covered title event occurs (under older practices involving title abstracts and attorney title opinions, a property owner suffering a title-related loss had to sue the abstractor or attorney for negligence).

Title insurers tend to be less profitable when real estate market activity declines, since fewer of those single premiums are collected when fewer transactions occur. Premiums charged generally are greater for higher property values/loan amounts because of the insurer’s increased risk exposure, but the extra premium for each added \$500 or \$1,000 of coverage generally declines (in contrast with equal cost per unit of coverage for an HO policy – recall the co-insurance discussion), because of the largely fixed cost of doing title searches/examinations. The one-time premium for a home buyer’s title policy might run anywhere from several hundred to a few thousand dollars, while the premium for the corresponding lender’s policy generally would be lower because the insurer’s maximum exposure is the loan’s remaining principal balance, which falls steadily over time and eventually is eliminated – although another source suggested that lender policy premiums could be higher because the lender has so much at risk in the early years of a borrower’s ownership, when any title claim would more likely arise.

One source indicates that premium costs generally have fallen in recent years. Rates typically are higher in states (not Illinois) where title work must be done by lawyers, and in states (including Illinois) where litigation is expensive and laws give lenders little protection from having their claims superseded by unrecorded mechanics’ liens. But discounts often are provided if a title policy was issued on the same property in the recent past (the situation often seen with loan refinancings, in which new lender policies but not new owner policies must be issued), because title problems relating to past events are less likely to come to light if recent title work also identified no problems. Title insurers’ premium rate schedules generally must be approved by state insurance regulators (insurance is regulated at the state level, not the federal level; state regulators coordinate and cooperate on regulatory initiatives through the National Association of Insurance Commissioners).

State laws regulating title to real estate can differ considerably, but title insurance policies show reasonable similarity nationwide because most title insurance companies base their coverage on guidelines issued by the title insurance industry organization called the American Land Title Association, which gets input from real estate and lending industry leaders. A title policy covers the insured party’s direct dollar losses, and accompanying legal defense costs, when third party ownership claims impair the “marketability” of title. The goal generally is to indemnify the injured party for its financial losses, rather than securing good title by forcing some other party to vacate its claim. (Real estate owners’ losses through declining local property values, and lenders’ losses through borrowers’ defaults, are not covered by title insurance – those losses have nothing to do with questionable ownership/title.) Title carriers’ “loss ratios” are fairly low – title insurers pay out comparatively little compensating insured owners or lenders for title-based financial losses. Instead, they devote most of the premium dollars they collect to doing a more thorough job of searching relevant records, maintaining their own copies of the public records (“title plant”) with their own indexing systems, and providing legal defense for policy holders when claims arise – while reducing the chance that claims will arise by excluding from coverage perils that would not likely be found in a careful title search, such as an encroachment that a survey of the land would not disclose.

There are four major firms with national operations (the largest, Fidelity National, has giant Chicago Title as a subsidiary), and many smaller regional players (including Champaign-based Advocus, formerly Attorneys’ Title Guaranty Fund). Title insurance is primarily a lawyer-driven industry, with most title firms owned or at least managed by attorneys. Title insurance originated with the Real Estate Title Insurance Company of Philadelphia in 1876,¹⁹ as a means of compensating title-based financial losses without requiring injured parties to sue and prove that their attorneys had done inadequate title searches. In some states title examination and related activities actually are considered the practice of law and can be conducted only by licensed attorneys, but Illinois allows non-lawyers to be “abstractors” who complete title search and examination work. All title insurance policies in Iowa are issued by state-run Iowa Title Guaranty, with premiums reported to be far lower than those in some states.²⁰

F. *Mortgage Life Insurance* – to repay the mortgage loan in the event of the death of a family’s breadwinner(s). The policy typically is of the *decreasing term* variety, to roughly parallel the declining loan balance. A lender might encourage the borrower to have life insurance, but can not require it, and certainly can not force the borrower to buy a policy from the lender. A borrower with concerns about how survivors would be able to repay a loan without his income if he were to die might be better off increasing the amount of coverage under his standard life insurance plan, because of reportedly high premium costs on mortgage life (although mortgage life sometimes can be good for older or otherwise hard-to-insure people).

[*Title insurance* and *mortgage life insurance* both have been criticized as being characterized by *reverse competition* – coverage frequently is arranged for by the lending institution, which might choose to offer an expensive policy that pays the lender a high commission rather than a policy with low premium payments for the seller/buyer/borrower.]

G. *Mortgage Default Insurance* – Federal Housing Administration or Private Mortgage Insurance (VA coverage from the Department of Veterans Affairs is a guarantee of a portion of the amount borrowed, not insurance), as we saw in our lending discussion. The borrower must buy this coverage to protect the lender when the loan-to-value ratio on a home mortgage loan exceeds (usually) 80%, meaning the borrower’s down payment is less than 20%. The lender wants a cushion of 20% from the borrower’s equity or insurance/guarantees to absorb legal, brokerage, and other possible costs if default occurs and the lender has to foreclose on the loan and take possession of the property, and then sell it under difficult conditions that could well be accompanied by a sale price too low to cover the amount owed, plus related legal and selling expenses.

H. *Security Deposit Insurance* – as noted in our leasing discussion, residential tenants sometimes can obtain insurance that compensates landlords for tenants’ damages or unpaid rents, instead of having the tenants pay lump-sum, up-front security deposits. There could be a one-time larger premium (though smaller than a security deposit would be) that covers the entire lease term, or smaller premiums perhaps paid monthly for part or all of the lease term. This is a fairly new type of insurance; company E-Premium sells security deposit coverage, but only to buyers of its HO-4 renter policies.

I. Business insurance related to real estate ownership

1. Business interruption (or business income) insurance – to cover ongoing costs such as rent and payroll if a business is forced to close its operations temporarily after a covered peril occurs. Most U.S. firms could not collect under business interruption policies during the 2020 Covid shutdowns. One reason for denied claims was that viruses were specifically identified as catastrophic loss events excluded from coverage (a provision insurers put into policies after the 2002 – 2004 Severe Acute Respiratory Syndrome, or SARS, virus epidemic). Another was language in some policies stating that coverage applied only if there was actual physical damage to property, and Covid did not cause overt physical property damage – although some lawsuits argued there was physical damage from causes like contamination of surfaces.
2. Rent insurance – to cover a landlord’s lost rent, for example if an apartment building burns down.
3. Leasehold insurance – the tenant buys this kind of coverage if she has a favorable lease (*i.e.*, one on which she pays below-market rent) and would lose money if she lost the use of the property.
4. Coverage of business property and profits.

J. Surety – a special kind of insurance arrangement, *surety bonding*, is used in construction projects (particularly for large commercial buildings) to assure that the work will be completed as agreed to. Whereas a liability insurance policy covers damage an insured policy holder might do to an unknown party (no one knows who might be injured if a driver skids on ice), a construction surety bond provides payment for financial damage an insured contractor might do to one specific party: the construction client, called the “obligee,” which might be a commercial real estate developer. An insurance company acts as the third-party surety, paying the obligee if problems arise and then seeking reimbursement from the contractor, called the “obligor” or “principal.” Government bodies that hire contractors to construct buildings almost always require surety bonds.

There are several types of surety bonds. A *bid bond* compensates the obligee if the building is not completed according to the price and specifications the builder agreed to; the amount collected could be the difference between the low bid accepted and the next highest bid. (The contractor generally would not be required to meet the bid price if major unforeseen problems arose, such as extreme weather events or a labor strike, or if the client had misrepresented something to the contractor.) A *maintenance bond* pays the obligee if repairs are needed after construction is finished because of faulty materials or badly done work. A *performance bond* provides payment if the contractor does not finish the work and a different contractor must be hired (all but the smallest U.S. government building projects must be covered by performance bonds). The related *subdivision bond* pays for repairs if a contractor fails to meet subdivision restrictions when putting in items like streets. A *payment bond* provides assurance that subcontractors will be paid, if the general contractor does not pay them, and thus will not file mechanics’ liens against the property. (Subcontractors may be legally required to complete their work at the prices they quote to the general contractor, which the general contractor has relied on in bidding an overall price to the client.)

K. Interesting recent controversies and issues

1. An insurance company typically will pay a claim only if the peril causing the loss was a specific event. The forty-foot tall concrete block foundation wall on a house built on a North Carolina hillside started showing signs of weakness over time, and when noticeable cracks appeared in the wall an engineer advised the owner to move out because the wall could collapse soon. When it did in fact collapse the entire house had to be demolished, and the homeowner's insurance policy did not pay for any of the costs of losing an entire expensive home – because the cause of the financial losses was not a specific event like a fire or tornado, but rather a slow wearing away of the wall's structural integrity over many years.
2. A Colorado house where the tenant (the owners' son) was away was broken into by a WalMart shoplifter evading police. The suspect was armed and shot out at the police, and ultimately a SWAT team with explosives and heavy equipment did so much damage apprehending the suspect that the house had to be demolished. The owner's insurance policy paid \$345,000 in claims, but the owner reported damage almost double that amount. The owner's attorney said it was surprising that insurance had paid anything, since insurance is designed to cover things like fire and earthquake damage, and not total destruction by the police (recall that government action is an excluded peril even under the most comprehensive HO coverage, and news accounts did not explain whether the insurance did not pay for all losses the owner reported because the event was not a covered peril, or because the owner lacked sufficient coverage). The owner sued the city for compensation for a taking of property under eminent domain, but a trial court ruled for the city, and in late 2019 the 10th Federal Court of Appeals ruled that the government had exercised non-compensable police power for the public's safety, not a compensable taking under eminent domain. But is a regulatory action not compensable if the owner is left with no use of the property? In summer of 2020 the owner's attorneys petitioned the U.S. Supreme Court to hear the case (*Lech v. City of Greenwood Village*), arguing that costs resulting from police action in apprehending a criminal should be borne by the community as a whole, not by a single property owner, but the Court declined to hear the case.
3. If you convert all or part of your residence to a rental property your homeowners' insurance policy will not cover the risks you face as a landlord; you need to get a special landlord's policy to cover hazards affecting the property and the landlord's liability. This situation is becoming common in some areas, as people create accessory dwelling units or ADUs on their lots by adding tiny houses, or converting their basements or garages to apartments²¹ (a finished-room-over-garage is a FROG). The tenant renting such a unit will want to get an HO-4 renter's policy to cover personal possessions and personal liability.
4. After Katrina and other recent hurricanes, disputes often arose between insurance companies and insured parties over whether damage was caused by a peril that was covered by the policy or one that was not. For example, it might be argued that water damage resulted not from flooding (not covered) but because high winds (covered) knocked down power lines and prevented a sump pump from working. When an insurance agent encourages a client to buy more comprehensive coverage, it might be to prevent this kind of dispute and assure that the insured party can be indemnified no matter what peril causes the damages (of course for flood damage the additional coverage generally would have to be through an NFIP policy).
5. During the financial crisis of the mid-late 2000s, some home owners in neighborhoods with many foreclosed and abandoned homes saw their home owners' insurance premium rates rise, because of increased risk of crimes (vandalism, drugs) often experienced in and near empty houses.
6. After a natural disaster, a large number of people in the affected area are likely to seek to have their properties rebuilt or repaired. The accompanying spike in local demand for building materials and skilled labor can cause construction costs to rise considerably, possibly leaving some insured parties with contractor bills greater than their policies' payout limits.
7. Some states (Alabama, South Carolina) where severe weather damage has caused home owners' insurance premiums to soar now allow "catastrophe" savings accounts, on which interest earnings are exempt from state income tax as long as money is taken out of the account only to pay for the type of damage that an HO insurance policy typically would cover.
8. A person's credit history can affect the premiums paid for home owner's insurance. Some "consumer advocates" (and people with low credit scores, of course) are highly critical of this practice, but justification might be that those with debt problems might file claims alleging lost or stolen personal belongings to get money in a pinch. (A few states have laws that prohibit insurers from factoring credit score information into insurance premium rates, but Illinois is not one of them.)
9. A new type of policy called "parametric insurance" pays a covered home or business owner in a high-risk area a fixed dollar amount when a major event occurs, based on certain parameters, like the home's distance from a hurricane in Florida, or from earthquake or wildfire in California, and the intensity of the covered event. A Texas warehouse owner automatically collects \$3 million if internet-connected electronic sensors show eight inches of flood water, and \$5 million if water levels reach sixteen inches. Claim costs are low because human judgment is minimized; a parametric policy pays a stated, pre-set

dollar amount if objective data show that a covered event has occurred, with the policy holder collecting even if the property sustains no direct damage (on the theory that most people suffer at least some costs when such an event occurs nearby).²²

10. People who place ownership of their houses into trusts, which increasing numbers have done to simplify estate planning issues, must be careful to have both the trusts (legal owners) and themselves (beneficial owners) listed as owners on HO policies as insured parties. Otherwise, complications can arise when claims are filed.

11. Workers compensation insurance, which pays workers who become sick or injured on the job for their medical expenses and lost pay, is usually purchased by businesses. But a home owner with a nanny or other employee working in the home should also get this coverage; one source showed a \$750 average annual premium to cover a worker earning \$50,000 yearly.

12. People with expensive wine collections need special insurance coverage. A news account related that there can be a blanket policy on an entire (and constantly changing) collection, with no more than \$50,000 (!) payable on a single bottle, or else a policy that covers individually listed bottles. One expert estimated the premium cost as approximately 35¢ per year for every \$100 of coverage, or about \$350 annually for a \$100,000 collection.²³

13. Love those senior discounts – some insurers offer discounts to home owners age 55 and older. Older people’s greater average time spent at home reduces the likelihood of burglary, and allows for quicker response if a fire or other peril occurs.

14. There have been cases in which an insurance company cancelled the coverage of someone who had never filed a claim, but who bought a house with a history of having claims filed on it.

15. Toward that end, if you buy a house you might want to ask the home seller to obtain, and share with you, a copy of his or her Comprehensive Loss Underwriting Exchange report (with the interesting acronym CLUE). Just like a person can get a free report once per year from each of the large credit reporting companies Equifax, Experian, and Trans Union (go to AnnualCreditReport.com), every individual can get a free CLUE report annually from the Risk Solutions division of business and legal information reporting company Lexis Nexis. (FACTA, the Fair and Accurate Credit Transactions Act passed in 2003, established a legal requirement that consumers must have free access to information reported about them.) Lexis Nexis compiles insurance claim information from the entire insurance industry, and then reports on claims filed over the previous seven years. So if the home owner has filed a claim for property damage in the recent past the CLUE report should disclose it, and you can judge whether the property may have inherent flaws that you will not want to have to deal with or pay for. Information contained in the report includes the date of the claim, the insurance company involved, the cause of the damage, and the amount paid.

You can also ask for a CLUE report when considering a car purchase from an individual, although Car Fax purports to provide the same kind of information, and based on the vehicle rather than the individual or other party that currently owns it – perhaps a better model, since used cars so often are sold through dealers. (However, I once bought a used car from a dealer and it got a clean Car Fax report, but my mechanic noticed a misalignment that indicated a previous wreck, and when asked the dealer conceded that the car had indeed been in an accident.) •

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