Affordable Housing's Growing Insurance Problem

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Even though many academics are sounding the alarm over the housing affordability crisis in the United States (Hallett, 2021; Rohe, 2017), the affordability problem continues to intensify. Recently, the researchers at Freddie Mac increased their 2018 housing shortage estimation by 52% to 3.8 million housing units (Khater, Kiefer, and Yanamandra, 2021). One common cause for the lack of housing supply stems from the double-digit increases in affordable housing development costs over the last decade (Reid, 2020). In addition to these upfront costs, escalating operational costs are threatening the affordable housing industry. These unseen costs fail to make newsworthy headlines but are just as damaging to the successful operation of the affordable housing industry. This article seeks to broaden awareness for a new affordable housing problem just on the horizon, insurance.

Insurance companies use predictive modeling to evaluate the potential risk and estimate future losses associated with real estate policies. In a survey of over fifty insurance company executives, over 60% said the use of predictive analytics reduced underwriting expenses and increased profitability (Willis Towers Watson, 2019). These models include dozens of variables and are increasing in complexity every year. One recent addition to the predictive model is location-based crime scores. As of 2017, twelve state Departments of Insurance approved insurance rate filings using predictive crime analytics (Insurance CIO Outlook, 2017).

Crime scores started gaining traction within the insurance industry because of a few large 'nuclear verdicts' against multifamily property owners. Nuclear verdicts are large dollar insurance settlements or jury awards. Within the larger context of the multifamily apartment marketplace, the legal landscape shifted away from the nuisance cases of the past, the sidewalk potholes and common slip-and-falls, to a broader array of litigation seemingly outside of the control of multifamily owners and operators. Today, litigation may involve domestic violence or assault and battery cases. A single assault and battery case may cost an insurance company millions of dollars. While the entire multifamily industry is at risk, the affordable housing industry remains especially vulnerable to this litigation.

The mission of affordable housing providers is to benefit low to moderate-income community residents. In some communities, the location of affordable housing properties coincides with areas of higher crime rates. Generally, there are three potential outcomes for affordable housing providers and their insurance company. The first outcome is that insurance companies justify increasing policy premiums with crime scores. Second, insurance companies may exclude either specific properties or certain insured events. In the third and most extreme outcome, the insurance company may not renew the insurance policy. All these outcomes have dire consequences for affordable housing providers.

According to Section 42 of the IRS code, some affordable housing rents are limited to annually published ceilings and by the market, which may be less than the ceiling. As a result of timing and scale of insurance premium increases, the ability of affordable housing providers to increase rents may be limited. For example, many jurisdictions enacted rent increase moratoria during the pandemic.

Unless residents' incomes increase accordingly, affordable housing operators cannot raise rents. Restrictions such as these make it difficult to generate sufficient rental revenue to cover the premium increases that some providers are experiencing. Out of necessity, affordable housing providers are forced to cut expenses elsewhere, which results in reduced services for residents. In the end, the impact of these higher insurance premiums are borne by the low-income residents and the communities in which affordable housing operators serve. Furthermore, higher operational expenses may translate into a lower number of affordable housing units provided to the community as higher operating expenses make long-term financing more challenging.

For an affordable housing provider with a portfolio of covered properties, the insurance company may exclude the individual properties with the highest crime scores. These exclusions force the affordable housing provider to seek insurance coverage elsewhere and pay significantly higher insurance premiums. In other situations, insurance companies are no longer providing general liability coverage for assault and battery claims. As a result, assault and battery cases may be completely excluded from the covered policy. If an insurance company underwrites a policy, it is more common to see a $25,000 limit on assault and battery claims with a $ 50,000-lifetime aggregate limit. These coverage limits increase the development and operational risk of affordable housing and may impede the expansion of affordable housing.

In addition to higher premiums and exclusions, insurance companies are reducing risk by lowering the amount of coverage provided. An affordable housing provider described a recent experience obtaining umbrella coverage for their portfolio. Their debt covenants require the affordable housing organization to maintain at least $10 million in umbrella coverage. In the past, the organization had no difficulty obtaining a $25 million umbrella policy. However, this year, the organization could not obtain the same $25 million policy at any premium price. The insurance company cited their crime score as the underlying factor, even though the affordable housing provider did not have any increase in the insurance claims. The affordable housing provider assembled multiple insurance coverages together from several insurance carriers to obtain the required $10 million policy. Not only did this take more time for staff, but also, the organization paid more for the $10 million policy than the previous $25 million policy.

The lack of insurance coverage at any price highlights a significant problem for affordable housing providers. Most affordable housing developments are financed through state, federal, or private debt issuance combined with a large infusion of equity through the Low Income Housing Tax Credit. These equity providers and debt instruments require insurance coverage at specified levels and categories, such as Assault and Battery coverage. Failure to maintain insurance on a property would result in a technical default of the debt or the breach of contract with the limited partnership agreement with the equity partner. Upon default, the affordable housing provider must pay the remaining debt balance to the creditors. If cash is not available, the affordable housing provider would be forced to sell the property at a significant discount or loss to repay the debt. This negative outcome for the affordable housing owner increases development risk and may further dampen the number of affordable housing units provided to low-income families.

Since crime scores may represent the next challenge for the affordable housing industry, some state legislatures have enacted or are exploring bills to study insurance premiums and the lack of availability of insurance coverage for affordable housing (A.B. A5574). Yet, some legislative solutions may have negative unintended consequences.

If legislation prohibits the use of crime scores for insurance premium increases or rejections, there could be unintended behavioral consequences on behalf of the insurance company. However well-intended, when faced with the uncertainty of crime in an area, insurance companies may exit the marketplace and no longer provide insurance coverage to affordable housing communities. An allegory to this behavior can be found in previous legislation to 'ban the box' and its negative impact on workers it was written to help (Raphael, 2021; Doleac and Hansen, 2020).

Yet, legislation has a role to play in protecting affordable housing developers while simultaneously allowing insurance companies to adequately model risk. Solutions may be found in the previous legislation to remedy Florida's nursing home crisis of the early 2000s. The State of Florida enacted a mixture of regulation and tort reforms to provide additional guidance and standards for the nursing home industry and to reduce the monetary risk for insurance companies (Polivka, Salmon, Hyer, Johnson, and Hedgecock, 2003).

If legislative consensus cannot be made, states may be forced to increase the amount of money provided to affordable housing operators to cover higher insurance premiums. With scarce state resources allocated to the affordable housing community already, these higher allotments may lessen the funding for future affordable housing development projects and continue to exacerbate the housing affordability crisis.

To solve this multifaceted problem, a collaboration must occur between state legislators, affordable housing operators, and insurance companies. Insurance companies should have the ability to model risk, but that modeling cannot disproportionally impact affordable housing developers and operators.

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