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Adaptation and Adverse Selection in Markets for Natural Disaster Insurance

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Abstract

This paper studies social welfare in markets for natural disaster insurance. I quantify frictions in uptake, test for adverse selection, and estimate the welfare effects of proposed policy reforms by developing a model of natural disaster insurance markets and compiling new data. The paper has three main findings. First, willingness to pay for natural disaster insurance is remarkably low. In the high-risk flood zones throughout all U.S. Atlantic and Gulf Coast states, fewer than 60% of homeowners purchase flood insurance even though subsidized premia are only two-thirds of their own expected payouts. Second, homeowners select into insurance based on observable differences in houses' defensive investments against natural disasters (i.e., adaptation), but not on private information about risk. Exploiting house-level variation in flood insurance prices and construction codes reveals that requirements to elevate newly constructed homes reduce insurer costs by 31% and insurance demand by 25%. Asymmetric information between homeowners and insurers, however, does not affect average payouts. Third, ignoring how frictions, such as risk misperception, distort demand understates the welfare cost of currently proposed price increases and changes the sign of the predicted welfare effect. In the presence of such frictions, enforcing a natural disaster insurance mandate increases social welfare.

Keywords: Adaptation, Selection, Natural Disasters, Insurance, Welfare, Frictions**JEL Classification:** D60, D82, G22, H50, H84, Q54[Suggested Citation](#) >[Show Contact Information](#) >[Download This Paper \(Delivery.cfm/SSRN_ID3614264_code3739110.pdf?abstractid=3467329&mirid=1\)](https://papers.ssrn.com/delivery.cfm/SSRN_ID3614264_code3739110.pdf?abstractid=3467329&mirid=1)[Open PDF in Browser \(Delivery.cfm/SSRN_ID3614264_code3739110.pdf?abstractid=3467329&mirid=1&type=2\)](https://papers.ssrn.com/delivery.cfm/SSRN_ID3614264_code3739110.pdf?abstractid=3467329&mirid=1&type=2)

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