Homeowners & Auto Insurance 101

Understanding how insurance works is key to developing a healthy insurance marketplace.

Insurance is something most people don't even want to think about until they need it the most. The basic goal behind buying insurance is to make a person financially whole following a loss. You agree to pay a (relatively) small fee to an insurance company today, causing a small but certain loss to you now, in exchange for a guarantee from the insurance company that it will bear the burden of a large but uncertain loss in the future. There are three keys to understanding how insurance works:

Transfer of Risk: We all face risks everyday – some small, some large. If a storm destroyed our home or an accident crushed our car, it would be very hard for most of us to pay for the damage out of our own pocket. By transferring risks to insurance companies, we exchange the possibility of large losses with potentially devastating financial effects for smaller, known costs – insurance deductibles and premiums.

Sharing of the Losses: As policyholders of an insurance company, we share the costs of one another's losses. We each pay premiums, which the company holds to pay claims submitted by those who suffer covered losses. So, even though an individual may not have had any claims, if claim costs for the group are predicted to be higher than previously expected, premiums may need to be increased so that sufficient funds are available to pay everyone's future claims. Conversely, if the group has lower than expected insurance costs, premiums may be lowered.

Not a Savings Account: When we pay premiums for many years and have no claims, it is tempting to wonder what the insurance company does with "our money." Actually, once premiums are paid to the company, the money is no longer assigned to a particular individual in a separate account. Rather, the premiums from all policyholders are pooled together to pay for the group's future claims.

Unlike manufacturers of a product, when an insurance company sells a policy it has no way of knowing whether it will have to pay for a large claim, a small claim or none at all during the policy period. Instead, the company has to make an estimate. This estimate is based on past experience and trends, including loss ratios and combined loss ratios. "Loss ratio" refers to the amount an insurer pays out in claims compared to the premium received. "Combined loss ratio" (CLR) refers to the total expenditures of an insurer compared to the premium received, and includes expenses like overhead, investigations, taxes and others.

The Texas Department of Insurance (TDI) aggregates loss data for the Texas homeowners insurance market. And while data in recent years shows that companies writing homeowners insurance in Texas have had lighter loss years, last year was a different story. In 2015 Texas suffered 16 catastrophic weather events that topped the nation with 466,250 claims for $3.2 billion in estimated insured homeowners property losses. Weather and its risk are the biggest cost drivers of insurance. Because of the diversity of weather risk in Texas - including, tornados, hailstorms and fires - Texas in 2015 had three times as many claims and almost three times the dollar amount in losses as the next highest states (see http://goo.gl/gNJvGM). Whether the staggering losses are due to hail, tornados, ice storms, thunderstorms, fire or hurricane, it is plain to see that Texas is a very high-risk environment for property and casualty insurance.

Texas insurers must simultaneously compete to offer good prices while pricing risk properly to guard solvency in the long term. Since the 2003 insurance reforms in Texas, a number of new companies have entered the market and insurer combined loss ratios and premiums have begun to stabilize, in large part because - unlike states like Florida - Texas policymakers generally recognize that the most important attributes of a healthy market are for insurers to be financially able to pay claims to customers and for the marketplace to be competitive on price and product.