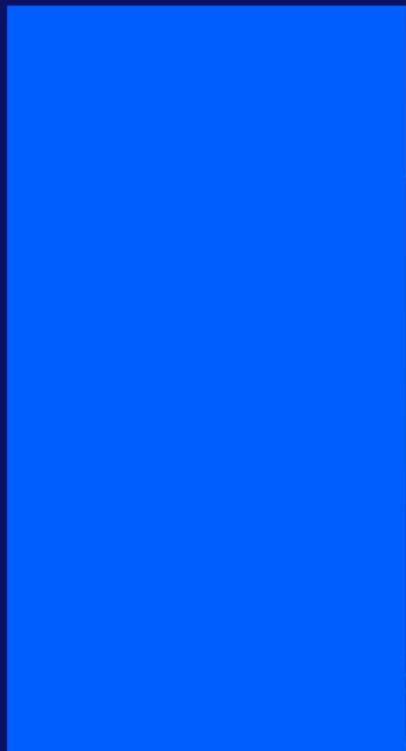


Implications of Southern California wildfires for banks' real estate portfolios



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Table of contents

Introduction: destructive wildfires with multifaceted impacts for lenders	3
Implications for lenders' portfolios in the near term will largely depend on insurance coverages of exposed properties	4
<hr/>	
Credit risk analytics	4
Near-term insurance risks	5
<hr/>	
Implications for lenders' portfolios in the longer term will depend on economic implications driven by insurance market viability	6
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Substantial economic implications	6
Three channels	6
Lessons learned from Florida and Louisiana	7
An insurance industry in flux	7
Action items for banks	8
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INTRODUCTION: DESTRUCTIVE WILDFIRES WITH MULTIFACETED IMPACTS FOR LENDERS

During the week of January 6, 2025, there were up to six wildfires burning in the greater Los Angeles area. The fires have had a devastating toll in terms of loss of life and property as well as disruption to businesses and communities. The largest two fires are the Palisades fire in Pacific Palisades, covering 23,448 acres at the time of writing, and the Eaton fire, covering 14,021 acres as of January 27, including in Altadena and Pasadena.

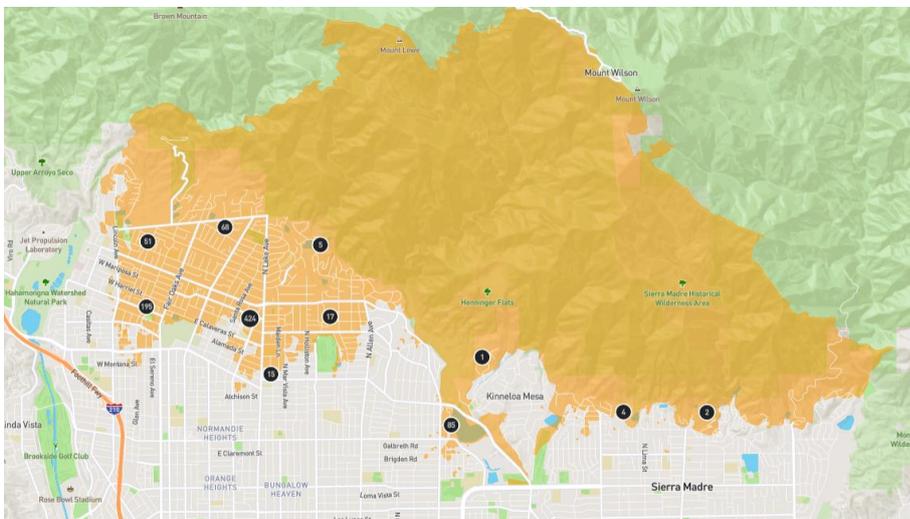
Financial risk to lenders will depend on many factors, including the recovery of economic activity and the viability of redevelopment in the area. There is also the potential for direct impacts on loan portfolios, particularly given the substantial damage to residential properties. Below we unpack each of these risk channels, looking at credit risk for damaged properties, risk pathways to mortgage portfolios, and broader factors such as economic vitality and the insurance industry, which will contribute to longer-term impacts on loan portfolios.

FIGURE 1 Residential property exposure to the Palisades wildfire as of January 27, 2025



Source: Moody's RMS™ ExposureIQ™

FIGURE 2 Commercial property exposure to the Eaton wildfire as of January 27, 2025



Source: Moody's RMS ExposureIQ

To identify exposure in the real estate markets, we looked at sample portfolios of 1,029,052 commercial properties and 3,269,228 residential properties in the Southern California region. Based on Moody's RMS™ ExposureIQ™, we found that the overall percentage of these properties in the current footprint of the wildfires is small, at 0.14% for commercial real estate (CRE) and 0.42% for residential properties. However, the economic exposure is substantial, with these buildings worth an estimated \$3.29 billion for CRE and \$15.86 billion for residential [1].

IMPLICATIONS FOR LENDERS' PORTFOLIOS IN THE NEAR TERM WILL LARGELY DEPEND ON INSURANCE COVERAGES OF EXPOSED PROPERTIES

Unlike catastrophes such as hurricanes where property damage is quite variable and widely spread, damage for properties within a wildfire burn area is typically more binary, with the majority of structures being fully destroyed and full content loss. Damage rates for many affected properties will be 100%. This is in addition to those properties in the surrounding area that may incur minor smoke or ember damage, which could lead to more minor insurance claims.

As such, near-term implications for lenders will be driven by insurance coverage of properties underlying loans. In cases where there is no insurance coverage and the property is destroyed, a default would be expected. However, since mortgages require insurance coverage, the more common case will involve understanding the characteristics of a property's insurance coverage, alongside the loan characteristics, to understand how a total building loss will translate into financial loss for the lender.

Credit risk analytics

The below example leveraging Moody's Commercial Mortgage Metrics shows the importance of insurance coverage in mitigating a bank's loss. The property below reflects an average multifamily property in Pasadena as of 2023 — based on Moody's RMS database — with a value of \$490,000, a deductible of \$2,800, and a limit of \$450,000 [2]. In the analysis, we adjusted the insurance coverage based on the estimated probability of insurance in that ZIP code, which is 75%. Accounting for the deductible, limit, and probability of insurance, about 70% of loss would be covered for this property.

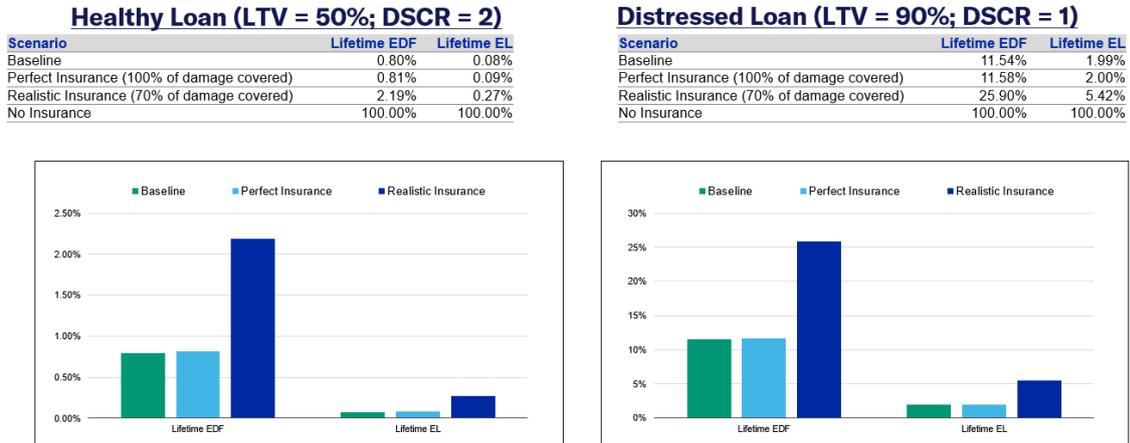
For an already distressed loan with a high loan-to-value ratio, default risk is elevated — about 14% above baseline even with current estimated insurance coverage. It is noteworthy that such an event can have a detrimental effect even on a healthy loan. Our analysis shows a potential threefold increase in default probability and a fourfold increase in expected losses. Such performance deterioration can trigger rating downgrades with associated profit and loss (P&L) and capital implications for the lender.

This analysis also demonstrates the challenges of underinsurance. While perfect insurance coverage would mitigate the wildfire damage's impact on default risk, as seen in the bar chart below, the estimated current insurance coverage of 70% leaves room for a large increase in credit risk due to the wildfire damage. These are important considerations given the ongoing challenges in obtaining wildfire insurance, which we'll discuss in more detail below.

¹ Wildfire footprint as of January 27, 2025 at 18:00 UTC

² This data likely underestimates property values and overestimates insurance coverage, since it is a couple years old.

FIGURE 3 Credit risk analytics for an average multifamily property in Pasadena, California



Source: Moody's Commercial Mortgage Metrics

Overall, considering that today, damaged properties with mortgages are expected to have insurance coverage, the implications for banks' loan portfolios are likely to be muted. However, this underscores the importance of reviewing insurance requirements for properties exposed to wildfire risk and ensuring the limits are high enough to account for potential damage. Prioritizing loans that are already lower quality would be important to mitigate risk.

Likewise, while damaged properties may have less impact on national portfolios, local or regional banks face concentration risk from events such as wildfires. Identifying distressed loans and maintaining comprehensive insurance coverage would be particularly important for these lenders.

Near-term insurance risks

Lenders could also face near-term challenges related to insurer insolvency. Moody's Ratings' comment "[insurers face large losses from devastating Los Angeles wildfires](#)" shows that the top 10 homeowners and commercial property insurers in California are large companies, with policies across multiple states. With the exception of three homeowners insurers, they all have single-digit percent exposure in California relative to their total US market share. Thus, these companies are likely well capitalized and prepared to pay their claims.

However, smaller, local insurers could face insolvency if their portfolios are concentrated in Southern California. This happened for [Merced Property & Casualty Co. after California's 2018 Camp Fire](#).

This would present challenges for lenders that might face delays receiving their payments if a damaged property was covered by an insurer that went insolvent. Likewise, whether or not the property was damaged, borrowers with that insurer would have to find a new carrier, which could change the cost and terms of their coverage.

IMPLICATIONS FOR LENDERS' PORTFOLIOS IN THE LONGER TERM WILL DEPEND ON ECONOMIC IMPLICATIONS DRIVEN BY INSURANCE MARKET VIABILITY

Substantial economic implications

In the short term, GDP will decline because establishments were lost, power was disrupted, infrastructure was damaged, and homes were destroyed. These factors mitigate LA's ability to produce economic output. There will also be a subsequent burst of economic activity once the rebuilding process begins.

Far more troubling, however, is the potential for long-term economic implications. The extent of the economic fallout depends on whether or not state lawmakers take action to stabilize California's insurance market. The economic consequences will still be dire, even in the best-case scenario where lawmakers stabilize the insurance market, for three reasons.

Three channels

First, as evidenced by major natural disasters that have hit California, Florida, and Louisiana in recent years, homeowners insurance premiums will increase significantly. Events such as Hurricane Andrew, which hit Florida in 1992, and the Northridge earthquake, which struck Los Angeles in 1994, [reshaped the insurance landscapes](#) in their respective states. Insurers limited their exposure, underwriting fewer policies and increasing rates and deductible levels.

Less available and more expensive insurance lowers housing valuations in several ways. Primarily, it can complicate the underwriting process, lowering the percentage of mortgage applications that qualify. That is because calculating a potential homebuyer's debt-to-income ratio requires factoring in all housing expenses, including homeowners insurance premiums. This higher cost will cause loan officers to decline offering a loan to a consumer who would otherwise bid up housing values.

Moreover, higher homeowners insurance costs deplete housing affordability. Insurance costs constitute roughly 5% of the cost of owning and operating a home, and any increase in insurance rates increases the cost of homeownership, driving house prices down by a corresponding amount. This can be represented by a hit to household wealth.

Second, household wealth will also directly decline by the value of uninsured or underinsured damages. After the Northridge earthquake, residents [abandoned entire neighborhoods](#) because building owners had no money to rebuild. Even if a policy covered 70% of the losses incurred by the property owner, the owner could either lack the wherewithal to produce the other 30% or opt to take the money and run. Uninsured property owners are out entirely. In both cases, the value of the housing stock takes a hit.

Third, escalating insurance costs and unavailable insurance render California less desirable to live in compared with other states. High incomes and notorious building restrictions have already made California's housing costs some of the nation's highest, prompting households and businesses to leave the state in recent years. More expensive and less available insurance will only exacerbate this trend. In the long term, labor force growth moves hand in hand with GDP. An economy with 0.5% less labor force growth will also grow 0.5% slower per annum.

All three of these factors become exacerbated in a no-action scenario. Insurance premiums rise more, fewer insurers operate in California, coverage becomes harder to get, housing values fall by

more, and fewer residents stick around in the state over the long term. A robust state response can minimize the long-term impacts to homeowners at the cost of expanding the state government's role. This is the approach Florida took in response to Hurricane Andrew.

Lessons learned from Florida and Louisiana

After Hurricane Andrew, Florida created a hurricane loss mitigation program, a disaster planning and response review committee, and a building codes study committee. Building codes were changed to ensure that new constructions would be resilient to hurricanes. The state also established the Florida Hurricane Catastrophe Fund (FHCF) and later on the Citizens Property Insurance Corporation to backstop the underwriting of catastrophe-exposed coverage. These actions stabilized the insurance market. While premiums rose in response to the storms, the [state limited nonrenewals for three years](#), which meant there was no immediate exodus of major insurers.

Louisiana's approach post-Hurricane Katrina was vastly different. State lawmakers concluded that they could not afford to backstop the insurance market. Instead, they followed a path of legislative reforms and deregulation to attract smaller insurers that would replace the large insurers that almost universally stopped operating in southern Louisiana. These small insurers with concentrated portfolios are particularly vulnerable to losses during storms, and many went [insolvent after the 2020 and 2021 hurricane seasons](#). This path minimized the cost to Louisiana taxpayers, but it also led to much higher insurance costs for homeowners that persist to this day. Louisiana is the [fourth-most expensive](#) state for homeowners insurance in the United States. Soaring insurance premiums contributed to the exodus from New Orleans post-Katrina. The city's population has never recovered.

In California, we expect housing values to lower, household wealth to diminish, and outmigration to be amplified regardless. However, if policies can stabilize the insurance industry, California's economy will remain more robust in the longer term than if the markets continue to endure soaring premiums and insurer withdrawals that contribute to continued outmigration.

An insurance industry in flux

The Southern California wildfires shine a spotlight on an insurance industry that has been facing regulatory challenges and an escalation in wildfire hazard severity. [The 2017-2019 wildfires caused around \\$20 billion in losses for California's property and casualty insurers, destroying more than the prior 26 years of profit.](#)

As insurers cope with these losses, [many have pulled out coverage in recent years](#). Accordingly, there has been a large increase in policies with California's residual insurer of last resort, the Fair Access to Insurance Requirements (FAIR) Plan. Moody's analysis, "[Los Angeles: Wildfires deliver a catastrophic start to 2025](#)," notes that the FAIR Plan's residential exposure in Pacific Palisades grew by about 576% between 2020 and 2024, up to \$2.95 billion. Meanwhile, the plan's \$241.5 million in commercial exposures represents a 2,770% increase in the past four years. The FAIR Plan residential coverage limit is US\$3 million while commercial is US\$20 million.

[Throughout this year, Fair Plan executives have mentioned](#) that the insurer may not have enough surplus to cover potential losses during an extreme event. In [1996, the FAIR Plan had to assess all carriers](#) to help pay for claims, and earlier this year it warned that it might have to do the same thing if a catastrophic event occurred. This means insurers would have to help pay for losses on the FAIR

Plan, which could impact an insurance industry that has already faced challenging losses and threats to profits in the state. The FAIR Plan's future viability will influence the viability of real estate transactions.

Meanwhile, [this catastrophe](#) comes as [the California Insurance Commissioner recently finalized legislation](#) aiming to stabilize the state's insurance market. It allows insurers to use catastrophe models to inform wildfire premiums while also requiring that they offer certain amounts of coverage in exposed areas.

[This is an important step](#) in enabling insurers to charge prices that better reflect risk while still providing coverage in areas they otherwise may have pulled out of. Moody's submitted the [Moody's RMS US Wildfire HD Model](#) for the California Department of Insurance's Pre-Application Required Information Determination (PRID) procedure for approval to be one of the catastrophe models used by insurers in the state. How these reforms will influence insurers' response to the wildfires is yet to be seen.

Insurers in California are also required to provide premium discounts for certain wildfire risk reduction measures, which helps incentivize resilience efforts. How risk mitigation and wildfire resilience efforts are integrated into rebuilding efforts will also influence the region's long-term viability.

Action items for banks

Banks have an opportunity to mitigate their risk from such events in the short and long term. In the near term, keeping an eye out for distressed loans exposed to the wildfires will help them preemptively identify potential financial challenges.

In the longer term, banks can leverage climate-adjusted catastrophe models that simulate hundreds of thousands of events to provide a comprehensive picture of the potential for wildfires of certain sizes and severities as well as each property's expected damage from wildfire. Leveraging models adjusted for the changing conditions over the lifetime of a mortgage can inform insurance requirements and help lenders negotiate with borrowers and carriers around insurance coverages and costs. Understanding how properties' building styles and materials affect their potential wildfire risk can also help inform resilience requirements a lender may want to ask of the borrower before making the loan.

Monitoring the insurance industry and broader macroeconomic conditions in Los Angeles and other areas hit by catastrophes can help inform banks' long-term portfolio strategies.

Implications of Southern California wildfires for banks' real estate portfolios

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