

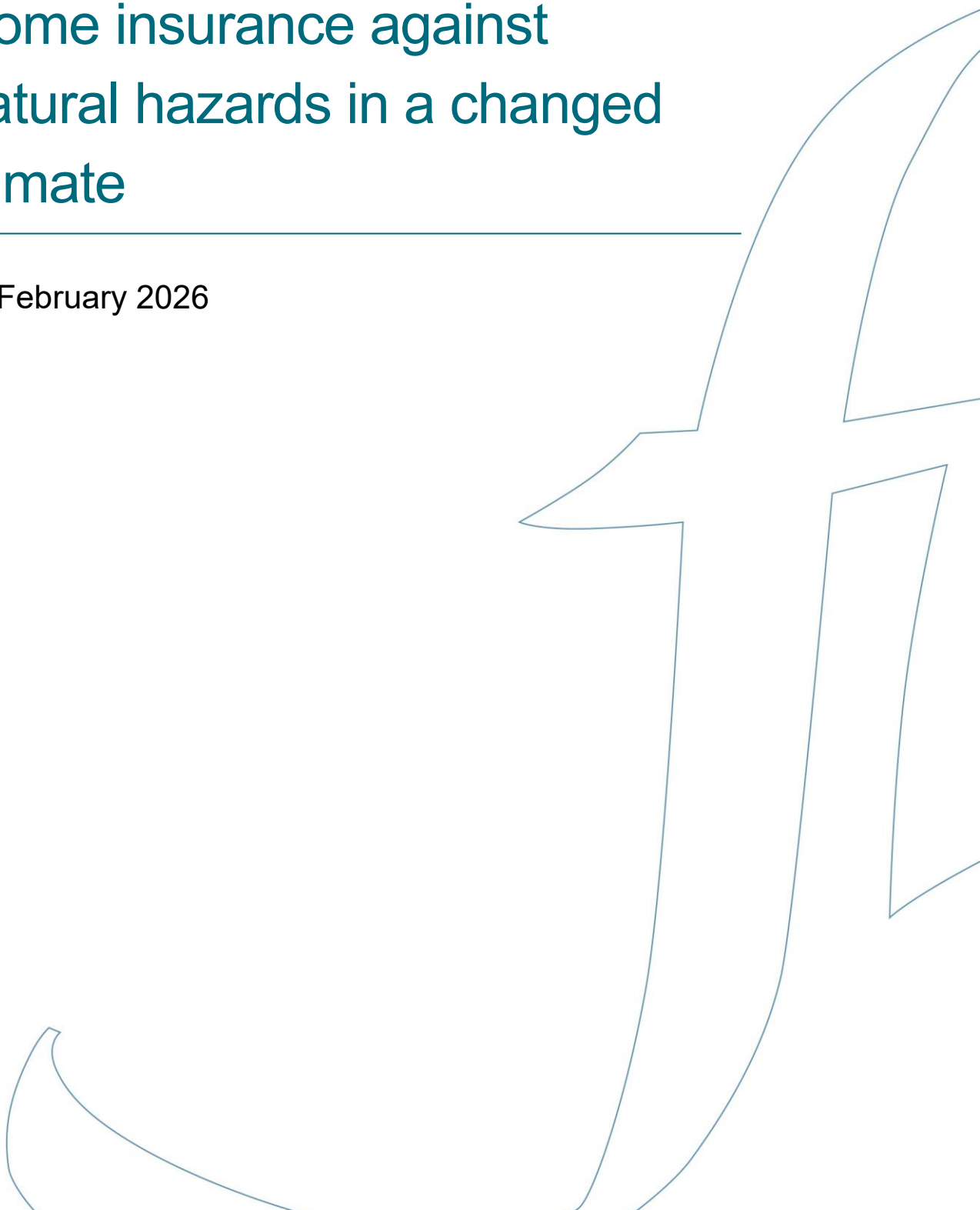


REPORT

# Home insurance against natural hazards in a changed climate

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## Summary

In this report, Finansinspektionen (FI) analyses how climate change could impact consumers' access to home insurance coverage against damages resulting from, for example, flooding, storms or landslides (so-called natural hazards).

Insurance undertakings today include strong insurance coverage against natural hazards in home insurance policies. Climate change is expected to lead to an increase in the risk of natural hazards. An increase in claims risks in turn will lead to insurance undertakings raising their premiums, and firms most likely will consider to a greater extent the risk profile of individual homes when setting the risk premium. In the long run, insurance undertakings' willingness to even agree to provide coverage to exposed homes could decrease. Such a development would lead to weaker protection for consumers, which could have far-reaching consequences for individuals.

It is reasonable to believe that an increase in premium differentiation could lead to consumers becoming more aware of the natural hazard risks to which their homes are exposed. Higher awareness should motivate consumers to become more willing to take measures to reduce their risks. In addition, insurance undertakings could create direct incentives for consumers to reduce these risks. This could occur through insurance solutions, where measures that consumers take to reduce their risks result in, for example, a lower premium.

In the short term, FI does not see a significant risk that consumers will find it difficult to insure their homes against natural hazards. However, it is probable that premiums will go up somewhat, but this is not expected to result in consumers being forced to not insure their home for financial reasons.

There are two situations, though, where the short-term risks appear to be more significant. The first is when consumers have homes that were built despite authorities advising against the build due to natural hazard risks. The possibility of insuring such homes against natural hazards in some cases could be limited already in the short term. The second is when consumers have homes located in high-risk areas and an insurance undertaking reassesses the risk of natural hazards, sharply increasing the premiums. This could lead to more insurance undertakings raising their premiums in the same area to avoid excessive exposure to natural hazard risks. Such a development could force consumers in these areas to not insure their homes for financial reasons. It can not be ruled out that measures may be needed to protect the affected consumers.

In the longer term, climate change will lead in all likelihood to increased claims risks and thus also affect the undertakings' premiums. However, the size and the consequences of the effects are difficult to predict. They depend on, in part, the

climate adaptation measures that are taken at the municipal, regional and state levels. Without effective measures for climate adaptation, there is a significant risk that home insurance coverage against natural hazards for consumers living in exposed areas will be limited in the long run.

Insuring a home is generally a condition for banks to grant consumers a mortgage. From a bank's perspective, less insurance coverage could impact the value of the bank's collateral for lending and thus its credit risk. Therefore, limiting access to home insurance could make it more difficult for consumers to finance the purchase and maintenance of their home. This, in turn, could lead to significant financial consequences for consumers.

## Introduction

The ongoing changes to the climate are expected to lead to an increase in the frequency and scope of many types of extreme weather.<sup>1</sup> This means that the risk of property damage resulting from extreme weather is expected to increase. As a result, insurance undertakings will need to adapt their insurance services and their premiums to the changing conditions. In turn, this could impact consumers' access to home insurance coverage against natural hazards.

### Objective of the analysis

Finansinspektionen's (FI) assignment is to ensure that insurance undertakings can fulfil their commitments to policyholders. This requires that the undertakings not take insurance risks that threaten their financial position. In turn, this means that the undertakings must charge premiums that reflect the risk of claims. In a future climate with higher natural hazard risks, insurance undertakings will need to adapt their insurance services and their premiums to the changing conditions.

FI's assignment also includes advocating a high level of consumer protection and well-functioning markets that meet the needs of households and businesses for financial services. Buying a home is often the largest investment consumers and households make in their lifetime. Home insurance coverage that includes natural hazards thus fulfils an important function. Insurance coverage is also often a condition for receiving a mortgage. Limited access to insurance coverage against natural hazards thus could have far-reaching consequences for consumers.

Currently, most consumers have home insurance.<sup>2</sup> The home insurance policies offered on the Swedish market include coverage against natural hazards as part of the basic cover. This means that consumers today have good insurance coverage against natural hazards for their homes. Given the changes to the climate, however, frictions could arise between the undertakings' need to handle higher claims expenses by raising premiums and consumers' need for good insurance coverage.

The objective of this in-depth analysis is to gain a better understanding of the risk that climate changes could limit consumers' access to home insurance coverage against natural hazards. Such a limit would lead to weaker consumer protection, with far-reaching consequences for individuals.

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<sup>1</sup> See, for example, <https://www.smhi.se/klimat/klimatlaget/viktig-fakta-om-klimatlaget/extremvader-blir-fler-och-kraftigare>.

<sup>2</sup> See Försäkringar i Sverige 2015–2024, Svensk Försäkring.

## Limitations and definitions

This analysis includes home insurance policies on the Swedish market that consumers can take out for coverage against natural hazard risks, i.e., physical risks that their homes could be exposed to as a result of nature-related events.<sup>3</sup>

*Home insurance* refers to home insurance, home (building) insurance, holiday home insurance and tenant-owned unit insurance.

We have analysed the risk of a limitation on the access to insurance coverage in the short, middle, and long term. *Short term* refers to 5–10 years, *middle term* to 30 years, and *long term* to 80 years.<sup>4</sup>

*Limitation on the access to insurance coverage against natural hazards* refers to the following:

- That insurance undertakings remove all or parts of the natural hazard coverage from the home insurance policy's basic cover and that the consumer instead actively must choose to sign up for a supplement to receive the natural hazard coverage corresponding to their need and pay separately for this coverage.
- That insurance undertakings do not offer any insurance coverage against certain nature-related damages, and subsequently consumers cannot insure their homes against certain natural hazards.
- That the insurance coverage against nature-related damages is offered at such a high premium that consumers may be forced to opt out of the coverage for financial reasons.

## How we conducted the analysis

FI selected eleven non-life insurance undertakings which received a number of questions to answer in writing.<sup>5</sup> The sample of undertakings was based on the size and geographic area of their operations. We also met with the undertakings that have the largest market shares in Sweden to discuss their written responses.

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<sup>3</sup> *Nature-related events* refers to flooding, storms, hail, snow pressure, landslides, rockfalls, avalanches and volcano eruptions.

<sup>4</sup> We have chosen the same time horizons as the European Insurance and Occupational Pensions Authority (EIOPA) in a statement from 2021, see Yttrande avseende tillsynen av användningen av klimatförändringsrelaterade riskscenarier i företagens egna risk- och solvensbedömningar (ORSA).///

<sup>5</sup> Dina Försäkring AB, Dina Försäkringar Göta Ömsesidigt, Eir Försäkring AB, Folksam ömsesidig sakförsäkring, Hedvig Försäkring AB, If Skadeförsäkring AB (publ), Länsförsäkringar AB (publ), Länsförsäkringar Göteborg och Bohuslän, Länsförsäkringar Skåne – ömsesidigt, Länsförsäkringar Stockholm, Trygg-Hansa Försäkring filial.

FI's questions to the insurance undertakings were both qualitative and quantitative in nature. They related to, among other things, the factors that could impact the willingness and capacity of the undertakings to continue to offer natural hazard coverage for homes but also the impact of the reinsurance market, the undertakings' setting of risk premiums for natural hazard risks, specific high-risk areas, and how undertakings are working to encourage their customers to take risk-mitigation measures.

## What is the position of the insurance undertakings?

All of the insurance undertakings stated that it is their ambition even in the future to maintain today's strong home insurance coverage against natural hazards. However, the undertakings vary to some extent in their assessments of what future risks look like and how these risks in turn are impacting the insurance coverage.

### Increased natural hazard risk increases premiums

Multiple insurance undertakings make the general assessment that the risk is low that in the future they will not provide home insurance with natural hazard coverage. They also assess the risk to be low that the natural hazard coverage will be removed from the home insurance policy's basic cover and instead be offered as a supplement.

All insurance undertakings make the assessment that they will first handle higher natural hazard risk through increased premiums. Multiple insurance undertakings highlight that such premium increases would lead to a need for clear price differentiation based on natural hazard risk. When insurance undertakings set their premiums today, they primarily use a risk that is calculated per area. Several insurance undertakings say that they are researching the possibility in the future to differentiate to a higher extent than today the insurance premiums based on the risk of natural hazards using the individual home's risk profile.

Price differentiation is mentioned by several insurance undertakings also as a way in the future both to offer insurance to customers in risk areas and to signal risk and motivate customers to take risk-mitigation measures. However, the insurance undertakings assert that price differentiation could lead to the price for home insurance in risk areas being so high that customers opt out of purchasing this insurance. The insurance undertakings consider the risk of such a development to be low in the short term, but that it cannot be disregarded in the middle and long term.

Some insurance undertakings also describe another scenario in which the premium levels could increase sharply already in the short term. They describe a course of events where one insurance undertaking increases its premium sharply in a high-risk area, which could lead to consumers turning to competitors offering lower premiums. Insurance undertakings say that such a situation probably would lead to more undertakings needing to raise their premiums in the same area to avoid excessive exposure to high natural-hazard risks.

## Climate adaptation an important condition

Several of the insurance undertakings state that the conditions in the middle-long and long term for providing home insurance with natural hazard coverage on the same terms as today is dependent on society taking climate-adaptation measures at both the municipal and the national level that sufficiently strengthen resilience against the effects of future extreme weather. The undertakings also state that there are strong indications that the climate adaptation is progressing too slowly.

As an example of necessary measures, insurance undertakings mention climate adaptations to the municipal water and waste system and measures to adapt existing coastal dwellings.

In this context, insurance undertakings have raised the importance of a dialogue between the insurance industry, municipalities, county administrative boards, and other government actors in the work to adapt society to climate change, in particular with regard to new construction in high-risk areas. Several insurance undertakings also highlight that they will probably limit the possibility for insurance coverage for homes built despite the authorities' objection related to natural hazard risks.

## Insurance solutions with incentives for risk-mitigation measures

The responses from the insurance undertakings in the questionnaire show that most provide information and give advice to consumers to raise their knowledge level about various natural hazard events and about preventive measures they can take to reduce their risk. Several undertakings inform consumers via both a website and through targeted mailings about the preventive measures consumers can take. For example, consumers are informed about suitable measures to protect their property from torrential rain, storms and lightning strikes.

A few insurance undertakings offer consumers a lower deductible in the event of damages if certain risk-mitigation measures have been taken. None of the insurance undertakings report that they offer a lower premium for implemented measures, so-called *impact underwriting*.<sup>6</sup>

All insurance undertakings state that they are positive about being more active in the future in encouraging consumers to take measures that lower the risk of the home being exposed to natural hazards by offering them financial compensation as

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<sup>6</sup> The term *impact underwriting* was introduced by EIOPA in 2021 and describes how insurance undertakings can contribute to the limitation of and adaptation to climate change by encouraging their customers to pursue risk mitigation to reduce vulnerability and increase resilience. See the report from EIOPA from 2021 on non-life underwriting and pricing in light of climate change.

part of their policy if certain measures are taken. Several insurance undertakings also state that such a solution could be one way for the undertakings to continue to offer insurance coverage against natural damages in risk-exposed areas at premium levels that are not so high that consumers are forced to opt out of the coverage for financial reasons.

## Insurance undertakings' assets for reinsurance

Reinsurance is used in part to protect an insurance undertaking from the cost of large claims and is often described as an insurance for insurance undertakings. The market for reinsurance is highly international, and Swedish insurance undertakings are primarily reinsured in other countries.

It is evident in the insurance undertakings' responses that they are mainly optimistic to the possibility of also continuing to being reinsured for natural hazards. According to the insurance undertakings, if natural hazards increase in frequency and scope, a probable development would be that the reinsurance undertakings would raise the price of reinsurance and demand that insurance undertakings take greater risk.

## Conclusions

Climate change will lead to insurance undertakings needing to adapt their insurance services and premiums to the changing conditions. A limitation on consumers' access to home insurance against natural hazards is not judged to be probable in the short term, even if some uncertainty exists. In the longer term, FI makes the assessment that the risks are higher and that this could have a significant impact on consumers.

The fundamental idea behind insurance activities is to spread risk between a sufficiently large number of policyholders that together can cover costs for unexpected events that an individual policyholder would have difficult covering on their own. This means that increased risks must be offset by higher premiums that correspond to the cost of covering them.

Since natural hazard risks are expected to increase in the future due to climate change, insurance undertakings will need to adapt their insurance services and premiums. The undertakings' adaptations based on the changing conditions could in turn affect consumers' access to home insurance coverage against natural hazards. Effective measures for climate adaptation at the municipal, regional and national levels, among others, could decrease the impact of climate change and thus improve the conditions for consumers to gain access to strong insurance coverage against natural hazards even in the future.

### Low risks in short term, but some uncertainties

Insurance undertakings currently offer strong insurance coverage against natural hazards as an integrated part of the home insurance policy. In the short term, FI does not see a significant risk of limited access to home insurance coverage against natural hazards for consumers in general. A slight increase in premiums due to increased natural hazard risks in general appears to be probable, but the overall premium impact on home insurance is expected to be low. Therefore, this should mean that consumers will not be forced to opt out of home insurance due to financial reasons.

There are two situations, though, where the short-term risks appear to be more significant. The first is when consumers have homes that were built despite authorities advising against the build due to natural hazard risks. For these homes, the possibility of insurance coverage against natural hazards could be limited in some cases already in the short term. The second is when consumers have homes located in high-risk areas and an insurance undertaking decides to reassess the risk of natural hazards, resulting in sharp increases to premiums. This would probably lead to more insurance undertakings raising their premiums in the same area to

avoid excessive exposure to natural hazard risks. Such a development could force consumers in these areas to opt out of home insurance for financial reasons. It can not be ruled out that measures may be needed to protect the affected consumers.

## Higher risks in the longer term

In the longer term, insurance undertakings will be more affected by the climate changes we are facing. How large this impact will be is difficult to predict today since it is highly uncertain what future limitations on emissions of greenhouse gases will look like and what the effects of climate change will be. One example of an effect that is difficult to predict the scope of is the rate at which the sea levels will rise, even if it is clear that the sea levels will rise for a long time going forward.<sup>7</sup> An increase in the sea level combined with, for example, storms, increases the risk of natural hazards for existing coastal residences. This could limit the access to home insurance coverage against natural hazards in these areas.

The extent of the effects of climate change on buildings and infrastructure is largely dependent on the adaptation measures taken at the municipal, regional and national levels. In turn, this will affect the insurance undertakings' conditions for offering home insurance that includes natural hazard coverage. Without effective measures for climate adaptations, there is a significant risk that consumers will face limited possibilities for obtaining insurance coverage against natural hazards in the long term. This would entail a sharp deterioration in consumer protection. To prevent such a development, FI is positive to an enhanced dialogue between insurance undertakings, municipalities, regions, county administrative boards and other government actors involved in the climate adaptation work. Insurance undertakings' knowledge and experience related to risk management is valuable in this context.

## Premium levels more clearly linked to risk

FI makes the assessment that it is probable that home insurance premiums will increase in general in the future given higher natural hazard risks. Moving towards clearer price differentiation based on the exposure of individual homes to natural hazard risks also appears to be probable. Such price differentiation could give insurance undertakings better conditions for managing higher risks of natural hazards and at the same time still offer home insurance coverage against natural hazards. However, it cannot be ruled out that an increase in price differentiation in the long-term risks leading to a sharp increase in premiums for consumers whose homes are located in high-risk areas.

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<sup>7</sup> <https://www.smhi.se/kunskapsbanken/klimat/vattenstand-och-klimat/global-havsnivahojning>.

## Increased awareness and incentives for consumers

In the long term, increased price differentiation in insurance premiums could probably contribute to consumers becoming more aware of the natural hazard risk to which their homes are exposed. FI considers an increase in the awareness of consumers to be positive since this should lead to them becoming more willing to take measures to reduce their risk exposure. However, it is not always possible for an individual consumer to reduce their exposure to natural hazard risks at a reasonable cost. Therefore, measures at the municipal, regional and state level could be justified in some cases.

Insurance undertakings could also design insurance solutions that create even more direct incentives for consumers to take risk-mitigation measures. Consumers could be encouraged to take measures, for example by installing a check valve in the home, in exchange for lower insurance premiums. FI sees benefits in insurance solutions that have this type of incentive. They can help keep down claims costs for insurance undertakings, which in turn could enable the insurance undertakings to offer insurance coverage against natural hazards in high-risk areas at premium levels that will not force consumers to opt out of the coverage for financial reasons. This thus creates conditions for high consumer protection even in the future. This is beneficial for the individual consumer if the measures mean that damages are avoided. In addition, damage-mitigation measures from many consumers could help enhance society's resilience to the effects of climate change.

## Good access to reinsurance

All participating insurance undertakings said that in general the conditions for them to gain access to reinsurance via international reinsurance undertakings are good. However, FI notes that the reinsurance market is a global market concentrated to a few actors. It is not possible to rule out that a sharp increase in natural hazard costs globally could have a negative impact on the reinsurance undertakings' creditworthiness or capacity. This could lead to Swedish insurance undertakings experiencing more limited access to reinsurance; they could then experience increased costs, which could impact their willingness and ability to offer insurance coverage against natural hazards. FI will therefore continue to follow Swedish insurance undertakings' access to reinsurance with regard to natural hazard risks.

## Insurance coverage is a condition for a mortgage

Normally, banks require home insurance for the approval of a mortgage that uses the residential property as collateral. Limiting access to home insurance would thus make it considerably more difficult for consumers to finance the purchase of and maintain their property.

In this context, it is worth noting that home insurance has a term of one year and is renewed annually, while a mortgage normally extends for a significantly longer period of time. If home insurance cannot be renewed or is limited in scope, this lowers the market value of the property. This also worsens the terms for the mortgage. From a bank's perspective, less insurance coverage could impact the value of the bank's collateral for lending, which increases its credit risk. Such a development would have a noticeable financial impact on consumers.

Most consumers currently have home insurance that includes natural hazard coverage in the basic package. It is not possible to rule out a deterioration in consumers' insurance coverage in the long term, which could affect banks' business. FI will continue to analyse this topic.