



# PolicyPerspective

## Texas Windstorm Insurance

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### Recommendations

- Implement a file-and-use system for TWIA rates by amending Subsections 2210.351(c) & (d), Insurance Code.
- Make TWIA a true provider of last resort by adding clear language to Subchapter E, Chapter 2210, Insurance Code.
- Eliminate many of the rate-setting requirements found in Subchapter H, Chapter 2210, Insurance Code.

The Texas Windstorm Insurance Association (TWIA) provides windstorm and hail coverage in the 14 coastal counties and a few other specially-designated areas. All property insurers in Texas must participate in TWIA and must help pay losses. Although TWIA was intended to provide windstorm insurance coverage only to those who could not purchase insurance in the voluntary market, it is no longer an insurer of last resort.

While TWIA may have been intended as a residual provider, it has become anything but that. Its unrealistically low rates have made TWIA an unbeatable competitor and are crowding out the private market.

The current funding system was designed in 1993, when TWIA had about \$6.5 billion in exposure. As of the end of January 2009, TWIA's total exposure was \$68.0 billion. However, its Catastrophe Reserve Trust Fund was essentially wiped out by the 2008 hurricane season, leaving TWIA with little cash and only current premiums to draw on in the case of a storm along the Texas coast. This makes reinsurance too expensive, so practically any storm would leave TWIA without adequate funds. Any additional losses would be paid from unlimited assessments against insurers, in return for premium tax credits. This would place a serious strain on the state's general revenue fund. In 2005 alone, property and casualty insurers paid \$472 million in premium taxes.

The Texas Windstorm Insurance Association is overexposed, underfunded, and a massive potential liability for Texas taxpayers and insurers.

**Recommendation 1:** *Implement a file-and-use system for TWIA rates by amending Subsections 2210.351(c) & (d), Insurance Code.*

Implementing a file-and-use regime for TWIA rates would allow TWIA members to get rates to the windstorm insurance market more quickly, due to their not having to haggle over rates with the commissioner, prior to using the rates. The commissioner would, thus, be able to reject only rates already in use.

The result would be increased price competition and insurance availability. By reducing regulatory impediments to true competition in the insurance industry, consumers and capital markets would determine the appropriateness of rates.

Additionally, a file-and-use regime provides a greater opportunity for the use of actuarially-sound rates for windstorm coverage. Inadequate rates have fueled a dramatic rise in the number of TWIA policyholders and, as a result, TWIA's exposure. Any measure that has the potential to bring windstorm market rates more closely priced according to the risk covered, is a measure worth implementing for the sake of insurers, Texas' general revenue funds, and Texas taxpayers.

**Recommendation 2:** *Make TWIA a true provider of last resort by adding clear language to Subchapter E, Chapter 2210, Insurance Code, specifying that TWIA coverage is available only if an applicant cannot obtain coverage in the private marketplace.*

Although TWIA was intended to provide windstorm insurance coverage only to those who could not purchase insurance in the

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voluntary market, it is no longer an insurer of last resort. Fueled by the fact that TWIA does not operate as an insurer of last resort and by below-market rates, TWIA's residual market has seen a tremendous surge in its number of policies.

The number of TWIA policyholders increased from 68,756 in 2001 to 217,237 at the end of November 2008, and, as of the end of January 2009, TWIA's total exposure to potential claims was \$68.0 billion (\$62.1 billion direct exposure, \$5.9 billion indirect exposure). In a recent five-month span, TWIA experienced an increase of nearly 30,000 business and residential policyholders.

Because TWIA is not designed to replace the private insurance market, this has created a scenario whereby rates do not adequately fund risk exposure. TWIA's purpose is "to provide Texas citizens adequate wind and hail coverage when it is not available in the insurance marketplace." While TWIA may have been intended to serve this residual market, i.e., be an insurer of last resort, it has become anything but that. Further, its unrealistically low rates have made TWIA an unbeatable competitor and have harmed the private market. Therefore, the first step toward offering realistic rates for wind insurance is to define TWIA as an "insurer of last resort."

According to TDI Rule 28 TAC Section 5.4606, "The purpose of TWIA is to provide windstorm and hail insurance coverage to residents and businesses in the designated catastrophe areas along the Texas coast that are unable to obtain such coverage in the voluntary market." However, the Code defines TWIA's purpose differently:

An adequate market for windstorm, hail, and fire insurance is necessary to the economic welfare of this state, and without that insurance, the orderly growth and development of this state would be severely impeded. This chapter provides a method by which adequate windstorm, hail, and fire insurance may be obtained in certain designated portions of this state.

The Code does not state TWIA is, or is meant to be, the state's provider of last resort. As such, the Code should be amended to reflect the language in the TDI Rule stating TWIA's purpose is to be the state's windstorm-insurance provider of last resort.

By clarifying its purpose, TWIA will be better able to offer more realistic and actuarially-sound rates, reduce exposure, and encourage customers to explore the voluntary market. In addition to defining its purpose, TWIA should take an approach to insurance similar to the FAIR Plan. In Texas, FAIR is a homeowners' insurance provider of last resort. Not only does FAIR charge higher rates than the voluntary market, but consumers are also not eligible for FAIR until they have been declined by at least two insurers in the private market. Establishing similar guidelines for TWIA would be a big step toward solidifying it as a true insurer of last resort.

Not only are TWIA's rates unreasonably low, but they also place policyholders at risk in the event of a storm. By offering rates that reflect sound insurance principles, TWIA will slow its growth, decrease its exposure, and create an opportunity for more competition to enter the wind insurance market. The first step is to reiterate the purpose of TWIA as an "insurer of last resort" and not as a competitor in the marketplace.

***Recommendation 3: Eliminate many of the rate-setting requirements found in Subchapter H, Chapter 2210, Insurance Code, including those specifying the precise experience data that must be considered and the requirement that rates must be uniform throughout the first tier coastal counties.***

Chapter 2210 of the Code imposes rate-setting requirements on insurers, including a requirement that a certain number of years of experience be used to develop rates, as well as an instruction that certain combinations of TWIA and non-TWIA data be used to determine the catastrophe and non-catastrophe elements of rates.

Such burdensome regulations keep insurers from setting actuarially-sound rates most efficiently. Heavy-handed statutory requirements add time and expense to the rate-setting process, both of which ultimately harm ratepayers.

For more than a decade, TWIA rates have been dangerously inadequate. In the event of a major storm, TWIA would be unable to cover its losses, and even without a storm, inadequate rates serve as an unnecessary impediment to a competitive marketplace. In order to offer more realistic rates, TWIA rate reform should take the following courses of action:

First, change Texas law to require TWIA to use updated catastrophe modeling methods to calculate rates.

According to a recent report on Texas windstorm insurance, “hurricane loss modeling is widely accepted in worldwide insurance markets to determine the adequacy of rates for hurricane exposures in coastal areas. Unfortunately, these models have not been generally accepted by the TDI in TWIA and individual rate filings.”<sup>1</sup> While hurricane models have proven to be reliable tools for rate setting, Texas insists on using 30 years of historical data to project future storms. This system may please some constituents who receive lower rates, but it is an unsound way to set rates.

Texas is fortunate that it had not been struck by a major hurricane for 30 years. However, as we saw last summer, the past is no guarantee of the future. According to TDI, “Weather forecasters predict an increase in hurricane activity this year and an above-average likelihood of a major hurricane striking along the Texas Gulf Coast.”<sup>2</sup>

By having to rely on past experiences, TWIA had offered inadequate rates that left consumers at risk when hurricane Ike hit in 2008. Therefore, Texas should update the methods by which TWIA calculates its rates to include catastrophe modeling.

Secondly, allow a larger benchmark within which TWIA can change its rates without commissioner approval. Under the current system, TWIA must file for rate changes annually. However, per 2210.359(a) of the Code, TWIA rate changes cannot exceed 10 percent, unless they are approved by the commissioner. This statutory 10 percent cap should be eliminated.

Over the years, there has been a disconnect between what the commissioner approves and the rates needed to support an actuarially-sound system. In order to allow TWIA more flexibility to adapt to changing weather conditions and insurance issues, any reform should increase the current benchmark whereby TWIA can raise rates without seeking approval.

Such reforms would allow TWIA to operate more like a private insurer, free to respond to market and weather conditions. Increased rate flexibility will create a more solvent and financially responsible organization, better benefiting consumers in the event of a major storm.

Thirdly, allow TWIA to differentiate rates based upon actual risk, rather than offering uniform rates in all first-tier coast-

al counties, as required by Section 2210.356(a) of the Code (“Each rate approved by the commissioner in accordance with this subchapter must be uniform throughout the first-tier coastal counties”). This reform will allow TWIA to charge higher rates in higher-risk locations, while charging lower rates in lower-risk locations. Currently, many policyholders are being overcharged, while others are being subsidized.

In addition to being more fair, allowing rate variation within coastal areas to reflect actual risk for the specific area within a geographic area (i.e., territorial rating) will create a system whereby rates reflect sound insurance principles, rather than uniform pricing. Therefore, if TWIA will offer more adequate rates, it will reduce its exposure and create an incentive for companies to enter the market.

Finally, it is worth noting that Section 2210.355(c) of the Code requires rates to be “adequate.” The potential multi-billion losses that TWIA’s current funding mechanism cannot cover—and for which Texas taxpayers are on the hook—due to the drastic rise in the number of TWIA policyholders and the resulting skyrocketing of TWIA exposure, prove that TDI has neglected its statutory duty to ensure TWIA’s rates are adequate.

Allowing insurers to calculate windstorm rates as they see fit—free from regulatory interference by TDI—is an easy way to improve the health of Texas’ windstorm insurance market: TWIA’s rates will move closer to actuarial soundness and, as a result, the skyrocketing of TWIA’s exposure will be curbed. Ultimately, Texas taxpayers stand to gain the most from this policy shift.

## Sunset Review Commission Recommendations

*Increase the number of public members on the TWIA Board, and require the commissioner to appoint all Board members and designate the presiding officer.*

This recommendation has the potential to further exacerbate the problem of inadequate rates for TWIA windstorm insurance, as public members and those appointed by the commissioner might be more willing to propose TWIA rates that are not based on risk, but instead lower costs for coastal residents below the market rate. Inadequacy is the primary problem with TWIA rates today and the reason for the “crowding out” of private companies from the windstorm insurance market. The Foundation opposes this recommendation.

*Replace the commissioner's authority to modify TWIA rates, forms, and operations through hearings with a more traditional administrative approval process.*

Assuming “a more traditional administrative approval process” means greater regulatory transparency and decreased unitary authority, then such a move may prove beneficial to the marketplace, if implemented with the Foundation’s recommendation to move TWIA rates to a file-and-use system.

*Transfer the responsibility for windstorm inspections and the oversight of engineers from TDI to TWIA.*

Engineer inspections are a layer of TDI’s responsibilities that can afford to be removed, freeing up TDI resources for duties for which they are more appropriately suited.

*Remove unnecessary rate restrictions in law, permitting the Association to consider additional factors in developing rates.*

Insurers should be able to consider all factors that will contribute to more actuarially-sound rate setting.

*Authorize TWIA to require applicants to provide proof of two declinations from insurers writing windstorm insurance in the state.*

As long as consumers are able to obtain windstorm insurance from TWIA as a first resort, TWIA will never be the insurer of last resort it is intended to be. Requiring proof of two windstorm insurance declinations is a positive step toward turning TWIA into an insurer of last resort.

The Code should be amended to reflect the language in the TDI Rule stating TWIA’s purpose is to be the state’s windstorm-insurance provider of last resort.

## **TDI Self-Evaluation Recommendations**

*Moderate insurance coverage costs through greater rating flexibility for the Texas Windstorm Insurance Association.*

In order to be the insurer of last resort it was created to be, and in order to implement rates adequate to ensure solvency,

TWIA insurers must be given the flexibility to consider as many factors as possible, in order to charge actuarially-sound rates.

*Increase the availability and affordability of ... wind and hail insurance coverage.*

TDI makes several recommendations under this heading, including:

- amending the provisions that allow the commissioner to designate additional catastrophe areas to provide flexibility for the commissioner to expand TWIA eligibility by classification or type of risk;
- establishing a windstorm reinsurance facility similar to the Florida Hurricane Catastrophe Fund to provide a stable and ongoing source of reinsurance to insurers, TWIA, and the Texas FAIR Plan Association (TFPA) for a portion of the hurricane losses incurred by those entities;
- providing for the phase-in of potential TWIA assessments over several years for new property insurance writers; and
- creating a rate-filing “safe harbor” that provides that a coastal rate change not exceeding 5 percent in a 12-month period following a storm is presumed reasonable.

While the last two recommendations propose minor tweaks to remedy the major over-exposure of TWIA and Texas taxpayers in the case of a storm along the Texas coast, the first two recommendations would greatly exacerbate the problem. The Foundation opposes these recommendations. ★

## **Endnotes**

<sup>1</sup> Jay A. Thompson, *The 2007 Texas Legislature: Legal Storm Clouds on the Horizon? What’s Next for Property/Casualty Insurers in Texas*, Thompson Coe Cousins & Irons, LLP (2006) 8.

<sup>2</sup> <http://www.tdi.state.tx.us/consumer/storms/index.html>.

