FEDERATION OF REGULATORY COUNSEL, INC.

REFORMING THE TEXAS WINDSTORM INSURANCE ASSOCIATION

The Politics and Policy of Catastrophe Risk Sharing

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Hurricanes periodically savage the Texas Gulf Coast. Two storms in the late 19th Century damaged the bustling port city of Indianola so severely that it was never rebuilt. A beneficiary of Indianola's demise, Galveston, was itself flattened in 1900 in the most vicious hurricane ever recorded in the state; 8,000 people died. Another massive storm, Carla, killed 43 people and caused approximately $2 billion in property damage[1] when it roared ashore near Galveston in August of 1961. Hail storms, tornadoes, and floods subject other parts of the state to catastrophe. Indeed, Texas insurers often complain that "cat losses" from these sources are worse because they are more frequent. However, only hurricanes have caused levels of devastation that demanded action by the Legislature.[2]

The State of Texas is searching for ways to deal with the aftermath of a catastrophic storm in the future. It does have a mechanism in place. The Texas Catastrophe Property Insurance Association (or "Cat Pool," as it came to be known) was created by the Texas Legislature in 1971 in response to Hurricane Celia, which caused substantial damage to coastal areas near Corpus Christi in 1970. The Cat Pool was renamed the Texas Windstorm Insurance Association (or "TWIA") in 1997. While TWIA has generally functioned well for the past thirty-seven years, it has become increasingly clear that the entity must be substantially changed if it is to protect Texans from the financial consequences of a major storm in the future. This article focuses on the options available to effect such change.

How TWIA Works Now

TWIA operates under authority of Chapter 2210 of the Texas Insurance Code. It is basically a pool that most observers agree was intended to serve as an "insurer of last resort" for individuals needing property insurance in fourteen counties (and small portions of a fifteenth) along the 367-mile Texas Gulf Coast. Basically, all insurers that write property insurance in Texas are automatically members of TWIA; each faces the prospect of being assessed for TWIA's excess losses on a pro rata basis according to its market share in the state.[3] By far the largest share of TWIA premium in force is found in Galveston County, at 30%, with Nueces County (home of Corpus Christi) second at 20% and Brazoria County third with 17%. Properties insured by TWIA must meet fairly stringent building code requirements, which have been strengthened over the years and continue to be modified. The Texas Department of Insurance ("TDI") licenses building inspectors and engineers to certify new structures as compliant with its promulgated windstorm building codes.

The Problem

The big problem facing TWIA -- and by extension, the State of Texas generally -- is the Association's lack of reserves in proportion to the amount of its liability exposure. While it was intended to function as an insurer of last resort, some say TWIA has become a first-choice (or "only-choice") insurer for many residents of the Gulf Coast. This has occurred at least in part because of the State's reluctance to let TWIA raise its rates to levels that most observers would consider to be actuarially sound. As a result of these artificially depressed premium rates, and the withdrawal of a number of property and casualty insurers from the coastal market, TWIA has become the cheapest source of insurance for many coastal business and property owners. Currently, TWIA has roughly 218,000 policies in force with a total liability of approximately $65 billion. It has "reserves" of only $1.4 billion.[4]

So what would happen if a killer storm were to wipe out the Houston Ship Channel and the communities around it? Or, worse, if such a hurricane were followed by another serious storm just a few weeks later?[5] Experts estimate that such a catastrophe or catastrophes could cause as much as $10 billion in property damage. In response TWIA would fund claim payments as follows: (1) through premiums collected on policies in force; (2) through a $100 million "first-level" assessment against industry members; (3) through TWIA's Catastrophe Trust Reserve Fund, which currently holds $389 million, and reinsurance (currently $1 billion, with a retention of $500 million)[6]; (4) through a $200 million "second-level" assessment to industry; and, finally, (5) through "third-level" *unlimited* assessments to industry.[7] It is possible that some insurers would be unable to pay such unlimited assessments. Their insolvency would in turn put increased pressure on the remaining carriers, some of which might also go broke. Those who could fund both their own claim payments and their share of TWIA's "unlimited" assessments in the short term would be entitled to take offsets against their premium tax liability for all such assessments paid to TWIA. Some industry observers peg the potential loss to the state's general revenue at hundreds of millions of dollars per year.[8]

Possible Solutions

The prospect of such a substantial hit to tax revenue is a sobering one for Texas legislators. The State's 81st Legislature, scheduled to convene in January of 2009, will therefore be casting about for possible solutions to the "TWIA Problem." One of the alternatives that has been discussed in the past is creation of a Texas windstorm reinsurance facility. Another alternative, which has already won the support of many legislators, is authorization for TWIA to issue public securities. Indeed Representative John Smithee introduced a bill, HB 2960, in the 80th Legislature that would have allowed TWIA to issue both pre- and post-catastrophe bonds to fund TWIA claim payments in the aftermath of a major storm. The fees for servicing such bonds would have been charged to insurers, who would in turn have been authorized to recoup them from surcharges on insureds statewide. The bill also proposed to "shrink" TWIA by eliminating caps on its premium rate increases; allow TWIA to charge different rates in different areas of the "windstorm" zone; change the composition of TWIA's board of directors; charge TDI with creating incentives for carriers to write business on the Gulf Coast; and require TWIA to keep its premium rates at a level that could be actuarially justified, including the cost of servicing any catastrophe bonds issued. The measure failed in the waning moments of the 2007 Legislative session, reputedly due at least in part to the efforts of coastal legislators who did not want to allow TWIA rates to increase rapidly. But Representative Smithee's bill, or some variant of it, will almost certainly be revived in the future.[9]

Another alternative that was floated recently by TDI involves the authorized imposition of insurer "surcharges." In March of this year, the agency posted two conceptual plans for dealing with the uncertainty of future TWIA assessments. The first of these is the "Assessment Recoupment Plan." While not committing itself to the position, TDI asked for comments on the feasibility of a rule that would allow insurers to seek quicker recoupment of their TWIA assessment payments through direct surcharges on their insureds, either in lieu of or in combination with premium tax offsets.

TDI's other plan would allow insurers to fund assessment amounts in advance by means of what it calls a "supplemental windstorm stabilization fee or surcharge" (i.e., additional premium) imposed on policyholders. Eligible insurers would be allowed to fund trust reserve accounts with surcharges collected from insureds in coastal areas, with the funds being released to the insurer, and presumably then returned to the *insured*, after five years. In some ways this is a mirror image of the Assessment Recoupment plan, except that the charges would be made *prior* to the assessment rather than after it and would be given back to the insured if no claim event occurred requiring its use.

Insurers and trade groups have raised numerous objections to the two surcharge plans proposed by TDI. For example, TDI has left open the question of how insurers would be allowed to apply the surcharge, even calling for comments on the *geographical* application of such charges, at least with regard to the "assessment recoupment plan." Should an inland policyholder be required to pay a surcharge on his homeowner's policy in order to pay for catastrophe claims incurred by insureds on the Texas coast? Florida policyholders are already experiencing these surcharges, with the potential of more to come, but at least in Florida virtually all property-owners have some exposure to hurricanes. In Texas, portions of the state are 600 miles from the coast.

Traditionally, TDI has discouraged discrimination in premiums among insureds of the same "class" or risk profile. The basic rule is that a difference in premium between two insureds of the same class is "discrimination."[10] What is being proposed, however, could lead to two insureds being made subject to the same surcharge regardless of the fact that they have vastly *different* risk profiles (one lives in Galveston, for example, while the other one lives in the arid, mountainous region around Marfa). This is obviously not "discrimination"; it is arguably an objectionable *lack* of discrimination. Insurance is all about classification. Addressing the future of TWIA presents a classic problem in figuring out how and to what extent the financial contributions of the many should be applied to cover the risks of the relatively few. The problem is exacerbated in Texas because homeowners' insurance premium rates are frequently a political issue, especially in election years, and because Texas is historically a low-tax state.

In one sense, what TDI is proposing is a transfer of public responsibilities to private insurers. In effect, insurers would be imposing a state-approved "tax" on policyholders designed to make up for the inability of TWIA to reserve against the risk of future catastrophe in a particular region of the state.[11] Would an insured have any right to judicial relief for this type of "reverse discrimination," i.e., being subject to a surcharge meant to address a risk inapplicable to his or her property? There is no such cause of action in Texas or anywhere else of which we are aware.[12] The point is simply that the State, instead of acting directly to offer windstorm insurance in certain areas (as the federal government offers flood insurance, for example), or, at the other extreme, declining to regulate the property insurance market on the Gulf Coast at all, would in this circumstance be using private entities to effect a public policy goal -- namely, keeping insurance rates affordable on the Gulf Coast while at the same time protecting the State's coffers from hits to general revenue. While the State and coastal homeowners would benefit from this de facto subsidization, which is also a feature of legislative catastrophe bond proposals, it is unclear whether property-owners elsewhere in Texas will see any advantage to them in such a plan.

Increased development on the Gulf Coast means more jobs for Texans and increased tax revenue for the State of Texas. But it also means that the costs associated with the next big hurricane will be higher than ever. Obviously, someone is going to have to pay for the damage. Some insurers claim that a more rational approach than surcharge and bond issuance proposals would simply be to deregulate premiums in coastal areas and let private carriers collect premiums sufficient to fund adequate reserves -- without the unwieldy apparatus of, say, TDI's proposed "temporary" surcharges. TWIA could continue to function, but now as a true insurer of last resort, along the lines of the Texas Health Insurance Risk Pool, with eligibility predicated on rejection from at least one private market insurer.[13] The Legislature could also impose a sales tax on tourism-related businesses (hotels and restaurants, for example) along the Gulf Coast to create a fund capable of funding disaster-related repairs for those who are priced out of the insurance market--as some individuals and businesses surely would be, at least in the short term.

But *rational* does not always mean *feasible*. Texas homeowners' insurance rates are already a hot-button political issue. Given the political problems that would arise as a result of a dramatic hike in windstorm coverage for Gulf Coast residents -- an increasing segment of the state's population -- it's unlikely that any radical free market measures will be taken in the near future. The goal for the Texas Legislature in 2009 will be to make property-owners along the Gulf Coast pay more, but not *too much more*, for their coverage -- and probably to spread the risk of coastal losses to other policyholders in the state in a way that does not spark major political resistance. Only time will tell whether Marfa homeowners will willingly pay surcharges for the protection of Corpus Christi condominiums.**14** As another storm season approaches, such issues will move to the fore again.

Endnotes

1. Measured in 2005 dollars.

2. Some meteorologists believe that hurricanes are becoming stronger and more frequent due to global warming. See, for example, "Warmer Oceans, Stronger Hurricanes," by Kevin E. Trenbarth, *Scientific American*, July 2007, p. 44. Even if they are not, however, the size and density of development on the Gulf Coast is exponentially greater now than it was in 1900 or even 1960. As a result, when another killer storm makes landfall-as another storm will, sooner or later-the magnitude of destruction will necessarily be far greater.

3. Insurers can offset their potential liability by voluntarily writing property insurance in the TWIA-covered counties. Tex. Ins. Code Ann. §2210.052(d) (West 2008).

4. Terence Stutz, "Texas' Coastal Weather Affects Insurance Rates Statewide," Dallas Morning News, March 18, 2008. As recently as 1993, TWIA's total liability exposure was only $6.5 billion, one tenth of what it is now. Senate Research Center Bill Analysis, H.B. 2960, May 14, 2007.

5. Hurricane Rita followed Hurricane Katrina by only a few weeks in the summer of 2005.

6. This is thought to be one of the largest reinsurance contracts in the world. Reinsurance is and will likely remain an important part of TWIA's claims payment strategy. Indeed, Commissioner of Insurance Mike Geeslin recently authorized TWIA to increase its reinsurance purchase for the 2008 storm season to $1.5 billion over a retention of $600 million, significantly strengthening TWIA's claims-paying ability. Disclosure: The authors of this article represent the Reinsurance Association of America (the "RAA"). The opinions expressed are their own, not those of the RAA.

7. Tex. Ins. Code Ann. §2210.052(d) (West 2008).

8. See, for example, Beaman Floyd, "Ensure Protections for Texas," *Austin American-Statesman*, June 29, 2007. Floyd evidently extrapolates from a 2005 figure for total Texas property and casualty insurance premium tax payments of $472 million. A big enough assessment could result in property insurers offsetting against all premium taxes owed to the State for a period of years that is not limited under the current law.

9. South Carolina enacted a wind pool "reform" statute in 2007 that was similar in aim if not in proposed methodology. Its Omnibus Coastal Property Insurance Reform Act of 2007 contained insurance company incentives for providing coverage within the state's "wind pool" territory, codified an earlier expansion of the

pool, and created a requirement that insurers give 90 days' notice before nonrenewing in the wind pool territory during hurricane season. The law also created tax incentives for consumers who set up "catastrophe savings accounts."

10. Tex. Ins. Code Ann. Sec. 544.052 (West 2008); *Cortez v. Progressive County Mutual Insurance Company*, 61 S.W.3d 68 (Tex.App.-Austin 2001, pet. granted, judgm't vacated pursuant to settlement).

11. Purchasers of Texas automobile insurance policies already must pay a mandatory Automobile Theft Prevention Authority fee of $1.00 per vehicle per year, which goes to recoup insurers for the $1.00 per year they must pay to fund Texas's Automobile Theft Prevention Fund. 28 Tex. Admin. Code §5.205. While all insureds pay this amount regardless of whether they operate their own vehicles in a high-theft area, it's likely the small amount of the charge has muted any possible political controversy.

12. The most analogous case we have found in this regard is *State v. Bigham*, 575 A.2d 868 (N. J. 1990). In *Bigham*, the plaintiff sued the State of New Jersey because it applied a surcharge to her after she was ticketed for driving with an expired license. The surcharge was imposed as part of a statutory scheme to use surcharges for various driving offenses to fund the State's Full Insurance Underwriting Association (the "JUA"), a last-resort insurer of high-risk drivers. Bigham argued that the surcharges were meant to apply only to driving offenses that threatened *public safety*, since the intent of the statute that created them was to use surcharges on "bad drivers" to fund the JUA; in other words, she was being lumped into a risk classification to which she felt she did not and ought not to belong. The Court rejected the argument, though one dissenting justice did point out that the actuarial considerations underlying the statute supported Bigham's argument.

13. *See* Tex. Ins. Code Ann. §1506.152 (West 2008).

14. To be fair, advocates for coastal residents argue that their premiums subsidize hail and tornado losses incurred by other Texans during non-hurricane years. Insurance necessarily involves some policyholders subsidizing others; the question is, of course, how much "subsidizing" is either legally or politically viable?