



# PolicyPerspective

## Next Steps to Reforming Texas Windstorm Insurance

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### Recommendations

- Fully implement a file-and-use system for TWIA rates.
- Require an applicant for TWIA coverage to have federal flood insurance before being eligible for approval.
- Eliminate the current caps that limit rate increases to 10 (average) and 15 (individual class) percent without a waiver from the commissioner.
- Allow TWIA to differentiate rates based upon actual risk by eliminating the current restrictions on rating territories.
- Allow TWIA to implement new rates with an average increase of up to 10 percent without the approval of the commissioner.

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 which is crowding out the private market yet doesn't have the money to pay off major claims.

In 1993, TWIA had about \$6.5 billion in exposure, i.e., the total amount of coverage it had along the entire Texas coast. Today, however, TWIA's total exposure has grown to \$74 billion dollars—and Texas insurance consumers and/or taxpayers are on the hook for almost all of that.

TWIA only has about \$75 million on hand in its Catastrophe Reserve Trust Fund (CRTF) to pay claims if Texas is hit by a storm. To put that number in perspective, in 2008 Hurricane Dolly cost TWIA about \$1.1 billion, and Hurricane Ike cost \$1.8 billion. TWIA does have authority to issue up to \$2.5 bil-

lion in post-event bonds to pay claims if needed, but there is some question as to whether Texas can sell all of the bonds in the current market.

Even if TWIA can sell all of its bonds, Texas' current debt-funded bond system is only a band-aid. In the long-term, debt can't take the place of an actuarially-sound insurance program. People buy insurance because they can't afford to go into debt every time calamity strikes. Yet relying on debt is exactly what we are doing today using bonds instead of charging actuarially-sound rates and purchasing reinsurance. We are also relying on subsidies from non-coastal residents to coastal residents. Asking non-coastal Texans to prop up the system is not a sound approach to insurance.

The decision to create a debt-based windstorm structure places policyholders and taxpayers at risk in the event of a major storm. Especially since the Texas Legislature instructed TWIA not to purchase reinsurance for the 2009 and 2010 hurricane seasons. Not purchasing reinsurance is a big gamble—with Texan's money. We didn't get a storm this season, so it will pay off this year. But over the long haul—or even the short-haul if we get a couple of major storms in one season—it will cost Texans a lot. We were able to pay off the \$2.9 billion in claims from Dolly and Ike only because we had reinsurance.

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## **As of September 2010, the number of TWIA policyholders had increased to 242,321 from 68,756 in 2001.**

TWIA should refocus its purpose on being an insurer of last resort so it 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. FAIR regularly charges higher rates than the voluntary market. Establishing similar rating practices for TWIA would be a big step toward solidifying it as a true insurer of last resort.

TWIA's unreasonably low rates also place policyholders and taxpayers 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.

One thing that is clear is that in order to reduce the burden to Texas taxpayers, more private companies will need to write on the coast. If TWIA is allowed to raise its rates to become actuarially sound, more private companies will enter the coastal market. The more competition we have along the Texas coast, the more Texans will benefit.

### **How to Fix the System**

Ultimately, we need to get the state out of the windstorm insurance business. As we have seen in state after state along the Gulf Coast, state-run systems end up helping no one. The following are detailed recommendations that will move us toward fixing Texas' broken windstorm insurance system:

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

Implementing a file-and-use system for TWIA rates would allow TWIA members to get rates to the windstorm insurance market more quickly. The commissioner would only be able to review 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 system provides a greater opportunity for the use of actuarially-sound rates for windstorm coverage. At a time when 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 to the 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.

*Require in Sec. 2210.203(a-1) an applicant for TWIA coverage to have federal flood insurance before being eligible for approval.*

Changes made to the Insurance Code last session required "a structure constructed, altered, remodeled, or enlarged on or after September 1, 2009" to be covered by federal flood insurance before being eligible for state windstorm coverage. While this is a step in the right direction, the requirement for flood insurance coverage should be extended to all structures. When adequate flood insurance coverage is not provided, the state often gets into a situation where owners are claiming windstorm damage in instances where the damage may have been caused by floods.

*Eliminate the current caps that limit rate increases to 10 (average) and 15 (individual class) percent without a waiver from the commissioner by deleting Sec. 2210.359.*

There is no actuarial reason for the current 10 percent cap on average rate changes or the 15 percent cap on individual rating class changes. While the commissioner can waive these under circumstances of catastrophic or continuing loss, the caps inhibit—if not outright preclude—the adoption of actuarial sound rates. The effect of these caps can be seen in the increased exposure of TWIA over the years.

*Allow TWIA to differentiate rates based upon actual risk by eliminating the current restrictions on rating territories in Sec. 2210.355(i).*

The Insurance Code, amended in 2009, allows only minimal differentiation of rates between territories in the same county rather than rates based on risk. Currently, Sec. 2210.355(i) restricts differentiation of rates as follows:

A rating territory that subdivides a county may be used only if the rate for any subdivision in the county is not more than:

- a) 5 percent higher than the rate used by the association in 2009 in any other subdivision in the county;
- b) 6 percent higher than the rate used by the association in 2010 in any other subdivision in the county;
- c) 7 percent higher than the rate used by the association in 2011 in any other subdivision in the county; and
- d) 8 percent higher than the rate used by the association in 2012 in any other subdivision in the county.

It is obvious that these restrictions are not actuarially- or market-based. As noted elsewhere, rates based on other factors distort this market and, in this case, have led to rapid growth in policyholders' and TWIA's exposure to levels that have made the Texas windstorm program actuarially unsound—leaving policyholders unprotected in the case of a major hurricane that makes landfall in a densely populated area. Eliminat-

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## **As of September 30, 2010 TWIA has \$74.1 billion in total exposure (including indirect exposure).**

ing the restrictions on ratings territories will move the program toward sound actuarial footing.

*Modify Sec. 2210.351 to allow TWIA to implement new rates with an average increase of up to 10 percent without the approval of the commissioner.*

There has generally been a disconnect between the rates the commissioner has approved 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 a reform would increase TWIA's ability 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.

It is worth noting that Section 2210.355(c) of the Insurance Code requires rates to be "adequate." The drastic rise in the number of TWIA policyholders and the resulting skyrocketing of TWIA exposure prove that today's rates are far from adequate. The potential multi-billion dollar losses that TWIA's current funding mechanism cannot cover, may well leave Texas taxpayers on the hook.

Allowing insurers to calculate windstorm rates based on market conditions 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 and TWIA policyholders stand to gain the most from this policy shift. ★

## About the Authors

**Bill Peacock** is the vice president of research and director of the Texas Public Policy Foundation's Center for Economic Freedom. He has been with the Foundation since February 2005. Bill has extensive experience in Texas government and policy on a variety of issues including, economic and regulatory policy, natural resources, public finance, and public education. His work has focused on identifying and reducing the harmful effects of regulations on the economy, businesses, and consumers. Prior to joining the Foundation, he served as the Deputy Commissioner for Coastal Resources for Commissioner Jerry Patterson at the Texas General Land Office and as the Deputy Assistant Commissioner for Intergovernmental Affairs for then-Commissioner Rick Perry at the Texas Department of Agriculture.

**Ryan Brannan** joined the Texas Public Policy Foundation in 2009 as a policy analyst in the Center for Economic Freedom. Ryan graduated with honors from Southern Methodist University with a Bachelor's in Political Science and minor in History. He received his Juris Doctorate at the University of Oklahoma where he was a member of the American Indian Law Review, Dean's List, Dean's Counsel, and several trial teams including the National Trial Team. He received special recognition in advocacy and public service by receiving the Dean's Award for Advocacy and the Dean's award for Service, respectively.

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