

TEXAS WINDSTORM INSURANCE ASSOCIATION

Legislative considerations to financing structure

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Background

The Texas Windstorm Insurance Association ("TWIA" or "Association"), originally created in 1971 as the Texas Catastrophe Insurance Association, serves as a residual insurer of last resort for windstorm and hail insurance in certain designated seacoast counties located in the gulf coast region of the State of Texas.

On June 1, 2009 the Texas Legislature passed House Bill 4409 which amended the Association's funding mechanism. As a result, the Association is able to pay for losses in excess of premiums and other revenue. Sources of such payments are, in order of priority:

- (i) Available reserves and the Catastrophe Reserve Trust Fund
- (ii) Proceeds from Class 1 public securities
 - a. Not to exceed \$1 billion per year
 - b. Paid from premiums of TWIA policy holders
 - c. Includes Commercial Paper ("CP")
- (iii) Proceeds from Class 2 public securities
 - a. Not to exceed \$1 billion per year
 - b. Paid from member assessments (30%) and a premium surcharge (70%) on all property and casualty lines of insurance in the catastrophe area
- (iv) Proceeds from Class 3 public securities
 - a. Not to exceed \$500 million per year
 - b. Paid from member assessments

Short-term liquidity

To accommodate the short-term cash flow needs arising from a large storm event, the Association currently has two programs which provide an aggregate \$450 million of readily available funds to pay upfront claims.

- (i) \$300 million of Class 1 Commercial Paper – supported by Texas Comptroller liquidity
- (ii) \$150 million line of credit from J.P. Morgan Chase

Commercial Paper is a short-term note program enabling the Issuer to quickly access funds for a variety of purposes. CP provides maximum flexibility with respect to the timing, amount and maturity of individual draws. Commercial paper is limited to maturities of no more than 270 days, but at maturity can be refinanced with another tranche of CP. This refinancing is deemed "rolling" the CP and this strategy can be used until the Issuer decides to pay down the CP or refinance with permanent debt. To provide certainty that sufficient funds will be available to repay the CP draw at maturity, investors require a specific source of liquidity to be tied to the CP program (typically a bank facility from a highly-rated financial institution).

Over the past few years, global credit markets, including the U.S. municipal credit market, have experienced substantial changes due to liquidity challenges associated with the global banking crisis. As a result, the universe of credit providers has diminished leading to a reduction in credit capacity and a corresponding escalation in costs. However, over the past few months market conditions have improved, prices have trended downward and commitment tenures have lengthened.

While we have seen improvements in the credit markets, we expect some continued uncertainty around credit capacity and pricing as U.S. municipals need for credit continues and even increases in the face of potential capacity limitations of a constrained credit provider universe. Adding to the uncertainty, are the implications of the recent Basel III proposal on bank capital requirements. Basel III will require banks to hold a higher level of reserves against lending positions, thus increasing the costs of bank facilities and potentially even causing market participants to pare back positions.

Security Structure Considerations

Although both of the Association's programs above provide short-term funding access, they are unique in their respective repayment/security structures. Class 1 Commercial Paper, including any Comptroller liquidity draws, can be repaid only from Class 1 revenues, whereas, the bank line of credit can be repaid from proceeds and/or revenues associated with any of the 3 security classes.

While Class 1 securities are expected to achieve investment grade ratings, the lack of market precedents and limited policy base from which to make debt repayments hinder the credit quality of the structure on a stand-alone basis. When combined with the current stressed credit market, this could severely limit the viability of obtaining liquidity on Class 1 commercial paper in the public market.

Given the upcoming Comptroller liquidity expiration on December 31, 2010 and the uncertainty of future Comptroller liquidity availability due to the general high demands on Comptroller resources, the Association and the Legislature might consider modifying the security structure for the commercial paper program to make it similar to the existing bank line of credit. The expected benefits would be to increase market capacity for a public market (non-Comptroller) liquidity facility and lower the associated fees.

Similarly, the overall credit strength of the Association's long-term financing structure would be improved by consolidating the security pledges of the three classes of securities into a single pledge. Instead of issuing three classes of bonds, all the bonds would be secured by common assessment on a broad base of insurers and policyholders in the designated area. By doing so, the Association could access the capital markets through the best possible credit structure and achieve the lowest possible borrowing costs, yet still maintain the ability to internally allocate the debt service costs across Classes 1, 2 and 3 achieving the legislative intent with respect to the repayment streams for debt service.

As an example, the Association would impose premium surcharges to actually pay debt service on the first \$1 billion of bonds issued and then allocate the remaining debt service costs appropriately through assessments on policyholders and insurers. This structure in effect provides internally generated credit enhancement on the existing Class 1 securities, which helps to achieve the lowest cost of aggregate financing and also mitigates the execution risk associated with issuing \$1 billion of stand-alone Class 1 securities.

By presenting one well-secured bond structure to the capital markets, the Association can meet investor preferences of high quality, straightforward credits. Furthermore, this structure avoids the negative marketing impacts of complex credits, which is especially important since the recent credit crisis has undermined confidence in rating agency credit ratings and many investors are now relying on limited internal resources for their own credit evaluations. In short, presenting the market with one highly secured credit will significantly improve marketability compared to the three-tiered structure currently in place and ultimately provide for the lowest aggregate borrowing costs.

Pre-event funding vs CP liquidity cost

As an additional consideration, the ability to utilize pre-event funding may provide the Association an alternative to potential heightened liquidity costs under certain market conditions. Although negative carry in the current rate environment (the difference between the Association's borrowing costs and the rate at which it can invest the borrowed proceeds) make pre-event funding less attractive today, the cost of carry in future markets may be less expensive than retaining a bank line of credit or liquidity on a commercial paper program. Additionally, pre-event funding reduces the execution risk related to a large catastrophe event coinciding with a capital market disruption that could possibly limit bonding capacity at a particular point in time.