

COMMENTS ON COMMITTEE CHARGE

Overview

HB 4409 was one of numerous reforms that have been implemented relating to the Texas Windstorm Insurance Association. Originally created in 1971, TWIA has been the subject of numerous legislative changes since 1971. HB 4409 was also part of continuing efforts by the State of Texas for a plan for the management of large scale risks, particularly losses associated with hurricanes along the Texas Gulf Coast.

HB 4409 enacted important changes particularly to the funding mechanism of TWIA. Prior to the enactment of HB 4409, the imposition of unlimited assessments on insurers even though with premium tax credits was causing significant problems for licensed insurers required to be a member of TWIA.

There is a continuing need to develop long-term strategies that reduce losses from natural disasters such as hurricanes and provide a workable financial framework and support for victims of these events. The availability of insurance through TWIA is only one aspect of any successful strategy. The problems facing the Texas legislature are not unlike the problems that other states (La., Ala., Miss., Florida, Georgia, SC, NC, Va., NY, NJ, Mass., and RI) with hurricane exposure face.

You should know that Hurricane Ike caused considerable losses from both wind and flooding. Flood coverage is provided by the federal, not state, government to homeowners. The state had considerable financial losses to clean up damage caused by the storm surge as well as losses from the loss of revenue and business associated with the storm. TWIA is only one piece of this struggle. Insurance is only a bridge between risk mitigation and one form of risk financing. We know that hurricanes will strike the gulf coast. We know that hurricanes can cause considerable damage to waterfront areas from the storm surge and wind damage. Even though hurricanes have been described as "low probability/high consequence" events, the costs are considerable when they do occur especially in populated areas. The costs are not restricted to insured losses but include direct and indirect costs on the state, local cities, counties and political subdivisions. Finding ways to reduce losses for future events is important not only for TWIA but the entire state of Texas.

A new book has described this effort as a "War with the Weather".¹ Even though TWIA is designed to be a market of last resort, it continues to be the market of first resort. Some private insurers, including AFACT members, continue to write business along the gulf coast but are finding more difficult to compete especially on price. It is important to recognize that long-term strategies that will work for TWIA and the gulf coast involve a combination of public and private sector strategies. This is vital for the State of Texas.

SPECIFIC COMMENTS AND RECOMMENDATIONS

1. Funding in TWIA Should be Expanded to Include Additional Funding in the Event of a Maximum Loss for TWIA. The funding for a catastrophe loss is based primarily on TWIA's funds and on "post-event" bonds. The level of funding is sufficient essentially for a

¹Kunreuther and Michel-Kerjan, "AT WAR WITH THE WEATHER, Managing Large-Scale Risks in a New Era of Catastrophes", MIT Press, 2009.

Category 1 or 2 storm striking Galveston or Corpus Christi. The level of funding would not be sufficient for a Category 3 or larger storm. Unless TWIA is able to grow, the maximum claims amount it can pay is approximately \$2.5 - \$3B in claims. There is no provision in the law on what happens if claims exceed that amount. Insurers are particularly concerned that there will be some type of after the fact assessment knowing that TWIA's liability in force exceeds nearly \$80 B and estimates of probable maximum losses are estimated to be as high as \$10-\$12B. There was general disagreement on how to provide funding at higher levels and the funding approach adopted in 2009 has been described by some legislators as a "band-aid." AFACT recommends that the important issue of authorizing a comprehensive funding approach is important not only for TWIA, its policyholders, but insurers in the private sector as well.

2. Discretion to Issue Bonds at A Particular Level Should be Limited. In particular, the 1st layer of \$1B to be repaid by TWIA policyholders is unpredictable especially after a storm event. It has been reported that the full \$1B in bonds may not be able to be sold causing uncertainty on the part of payers required to pay bonds at higher levels. The phrase "reasonably practicable" has been used in various draft rules that have been circulated. It is recommended that the Legislature carefully evaluate how this layer can be adequately funded. The use of pre-event bonds or capitalization of TWIA was discussed in 2007 and 2009. This portion of the law should be clarified to make sure that the issuance of bonds at this level is not discretionary with either TWIA or the TDI and all reasonable efforts should be made to obtain funding at every level unless it is determined that funding at any particular level is not "reasonably available" after consulting with the Texas Public Finance Authority.
3. Surcharges in the 2nd level Should be Clarified. The second layer of bonds permits issuance of bonds up to \$1B to be repaid 30% by licensed insurers and 70% through surcharges on all property casualty policies, other than workers compensation, health and medical malpractice, that are issued or have operations in the catastrophe area. For example, general liability policies may be issued in Dallas to insureds that have operations in the coastal area but the splitting or determining how much of the premium in such a policy should be allocated for the surcharge is not readily available by insurers. Commercial property policies may be easier to allocate because of the fact that insurance is on property located by area. Automobile insurance for private passenger automobile can be determined by where a vehicle is garaged but commercial automobile policies become more difficult to allocate. It is recommended that the language in HB 4409 be amended in order to make it easier to comply with this repayment requirement. It is recommended that the funding of the 70% be restricted to policies issued to policy holders in the catastrophe area.
4. Reinsurance: TWIA must increase its claims paying capacity without waiting for the uncertainties of the bond market. Even though HB 4409 permitted reinsurance, there seemed to be an implicit agreement that TWIA should not purchase reinsurance. Reinsurance has proven to be vital in paying for Hurricane Ike claims and will be important in the future if TWIA has another major loss. Other entities such as the California Earthquake Authority buy reinsurance at various levels in order to have claims paying ability up to \$10B. Reinsurance may be less expensive than issuance and repayment of bonds. TWIA should operate more as an insurance company and a market of last resort. Despite assertions that markets are not available, there are insurers willing to write business and take risks in all parts of Texas. Reinsurers would be willing to provide coverage at various levels.

Coverage with a much larger deductible or attachment point is much less expensive than coverage with a lower attachment point. Private insurers buy reinsurance to maintain their solvency. TWIA should be encouraged, not discouraged, to buy reinsurance.

5. Rates. Since 1991, this is an area where the law regulating TWIA's rates has never caught up. The changes enacted in 1991 got away from this principle at least as it regards ratemaking. Rates for beach front dwelling risks were essentially reduced by 75%. Rates for beach front dwelling risks continue to be inadequate as a measure of the risks being assumed. TWIA continues to be a market of 1st resort because the rates it offers are often less than the voluntary market. Especially true for waterfront structures on the barrier islands exposed to storm surge and brunt of windstorm. Current law permits file and use at 5%. Historically, there was a 10% cap placed into the law when the rates for TWIA moved from 30% above the benchmark to a non-contested case type of system. The 10% cap had a repealer with a sunset provisions and was intended to be a transitional provision to avoid "rate" shock while TWIA was in a transition away from the benchmark cap. The sunset provision on the 10% cap was eliminated leaving a 10% cap on rate changes. HB 4409 imposed a 5% cap. Rate adequacy is important as a means of risk mitigation. In "At War with the Weather" two essential principals were enunciated:

PRINCIPLE 1: Premiums should reflect anticipated losses and expenses in order to provide signals to individuals as to the hazards they face and to encourage them to engage in cost-effective mitigation measures to reduce their vulnerability to catastrophes.

Rate setting for TWIA has been very political especially since at least 1991. Many licensed insurers willing to write coverage in some areas of the First Tier at not competitive with TWIA rates. TWIA has not implemented territorial rating or other classifications that would encourage individuals to either engage in cost-effective mitigation or to discourage building on barrier islands. The cap on changes discourages TWIA from approaching an adequate rate and is inconsistent with sound actuarial principles relating to rate making.

PRINCIPLE 2. Equity and affordability issues. Should special treatment for homeowners in low income, or inadequately insured areas be permitted to have public funding assistance or insurance premium subsidies? This is a sensitive issue especially for low-value dwellings along the coast. However, should this be applied to \$1M homes, vacation condos and commercial risks? The legislature should consider a mechanism that permits a subsidy of rates only for low income or low value dwellings. Other structures should pay the reasonable expected cost of insurance. Caps, if any on rate changes, should only apply to low income or other structures.

AFACT would recommend that the Legislature move TWIA towards having more actuarial sound rates for TWIA. Either raise the 5% cap that exists or eliminate the cap. Require that the "cost" of reinsurance and factor for the CRTF to be included in the rates for TWIA.

TWIA should be encouraged to implement territorial rating factors and other classifications that better reflect the hazards presented particularly by a hurricane. TWIA should implement rating classifications that considers risk mitigation and the proximity of the risk to the brunt of the storm. The existence of a seawall should be reviewed to determine if it

should be part of a new rating structure and classification because of possible savings from damage due to a storm surge.

6. Increases in Coverage and Limits Should not be Permitted except as necessary to reflect the cost of inflation. One of reasons for rapidly escalating exposure in TWIA is the increasing limits available. HB 4409 did not change current law. Under current law, limits are set by statute with an automatic annual index to reflect the cost of construction. In addition, the TWIA board is permitted to recommend that the Commissioner increase limits above any indexed limits. See, TEX. INS. CODE §2210.502(c). Under this authority, limits for residential was increased from \$450,000 to \$1M in one year. Even though there are a limited number of residential dwellings insured for \$1M, the question must be asked whether this is good public policy to permit increases like this when TWIA is designed to be a market of "last resort". How many homes valued at \$1 M or more that are built on the beach should be entitled to essentially a government subsidized insurance program? Compare the limits available from the Federal Government for flood insurance. The maximum limit is \$250,000 on a dwelling or condo. Why should the state of Texas require higher limits for TWIA? Most of TWIA insureds are residential risks with a much smaller percentage comprising commercial property and structures owned by local governmental entities. Current law should be amended to eliminate the discretionary authority to increase limits in TEX. INS. CODE §2210.502(c).
7. RISK MITIGATION SHOULD BE ENCOURAGED. One of the most important principles and strategies is risk mitigation. This comes in two essential prongs: building codes and building code enforcement. HB 4409 required new structures to be built to new and improved building codes. HB 4409 did not address the issue of whether existing structures should be upgraded before a loss to mitigate losses. It is recommended that the Legislature add language that encourages owners of existing structures to invest in cost-effective loss reduction measures in hurricane and flood prone areas. This could be in the form of rate incentives or other incentives through either TWIA or state and local governments. This would be particularly helpful for structures located on the beach that are subject to both wind and storm surge.

The TWIA statute should be amended to may it clear that structures not built to code or not inspected as required by law cannot obtain coverage even with a surcharge.

Even though the TDI has implemented building codes and standards for property built on barrier islands, the question remains how much new building should be permitted especially on the islands and in areas not protected by seawalls and other structures? Should the State impose some type of stricter building requirements for the barrier islands? Certainly one way to mitigate risk is to review the losses from Hurricanes Ike, Dolly and other parts of the United States to determine the sufficiency of building codes and enforcement of such codes in coastal areas and further to determine if new structures should be built on barrier islands.

8. MISCELLANEOUS ISSUES IN HB 4409. It is recommended that the 180 minimum period be clarified on whether this applies to premium finance agreements. Currently, the law appears to have no exception for this even though TDI has authorized an exception for premium financed policies.

9. CLAIMS ISSUES. TWIA and numerous private insurers have been deluged with a flood of recent lawsuits involving Hurricane Ike claims. Many of these lawsuits have been filed after payments were made. Some of the lawsuits and new claims are questionable at best. The cost of defending even questionable claims is considerable and will be reflected in the loss and expense experience in future rate filings. There is always some litigation after a large event such as Hurricane Ike, however, most insurers, including TWIA, go to considerable lengths and efforts to pay claims for damaged property as soon as possible. The recent litigation along the Texas coast has been one of the largest disincentives for insurers to voluntarily write new business and several insurers have been forced to file withdrawal plans because of the escalating costs of reinsurance and costs of defending a large number of catastrophe claims.

TWIA has been reconstituted under HB 4409 so that it would qualify to be exempt from federal income taxation. Entities such as the State of Texas and other political and governmental subdivisions are exempt from federal income taxation. Even though TWIA is exempt from federal income taxation as a quasi-state agency, it is still subject to penalty provisions including treble damages under Chapter 541 and 18% penalty provisions in Chapter 542 of the Insurance Code. AFACT is not aware of any other state agency that is subject to essentially a form of punitive or exemplary damages. Even though I am not aware of any case that has gone to trial where TWIA has been ordered to pay treble damages or other extra-contractual damages, these damages are frequently asserted and used as a means of obtaining higher settlements in litigation. AFACT would recommend that the TWIA statutes be amended similar to the Property Casualty Guaranty Act to provide that it is not subject to bad faith damages including damages under Chapter 541. Specific references to Chapter 541 in TEX. INS. CODE §2210.552 should be eliminated.

AFACT strongly supports the principle that covered claims should be paid promptly and believes that this should apply to TWIA as well and all insurers. However, TWIA and insurers should not be forced to pay claims that are not covered or excluded. TWIA is not a private insurer even though funds from private insurers can be taken in the form of assessments to pay for losses. TWIA functions essentially as a quasi-governmental entity and should be liable only for benefits covered by policies it issues. TWIA should not pay claims that are not covered.

This issue was raised after the total losses incurred after Hurricane Ike. Evidence from both news and other reports shows that numerous structures were swept away by the storm surge which would not be covered by a TWIA policy that only covers losses caused by wind. The problem with wind v. flood is one that is not new or unique to Hurricane Ike. Numerous lawsuits were filed in Mississippi and Louisiana after Hurricane Katrina and the exclusion of coverage for damages caused by flooding or a storm surge were litigated. In virtually all cases that were tried, the courts upheld the flood exclusion and upheld the denial of coverage.

TWIA has reportedly recently agreed to an approximate \$189 million settlement of the "slab" losses on the Bolivar peninsula. I am sure litigants may argue that the structures were damaged by wind before the storm surge but the evidence to the contrary is compelling and this is an issue that could have been or should have been litigated before this large amount was paid. Several questions come to mind on this settlement. First, it was settled as a type of class settlement but it was not a class action with the duties and requirements imposed on

class counsel that you would expect to see in a typical class action lawsuit. How will members of the class be treated? How will compensation for attorneys fees be handled? Who are the members of the class? Would individuals not represented by lawyers be entitled to monies? What should future claimants expect? Second, will funds from reinsurers be expected to pay for this settlement and will reinsurers have the right to contest this settlement on the basis that it provides coverage for excluded losses? Third, were funds provided by insurers including funds subject to premium taxes part of the source of funds? Was the settlement authorized by TWIA's board, the Commissioner, or any Court? Was there any hearing on disputed questions of fact or law.

This is a most unusual settlement especially in light of the fact that TWIA has never covered losses from flooding or a storm surge. If settlements of this type are in the public interest, there should be some better way to handle this through the statute governing TWIA that would permit some oversight or approval on whether large dollar amounts should be paid. AFACT would recommend that the Committee consider several options. One option may be to codify requirements for an administrative class action on claims involving common issues of fact or law involving TWIA. Either TWIA or claimants could request that the Commissioner determine if an administrative class action was appropriate and SOAH could conduct hearings on disputed issues of fact or law. Slab type of losses often involve common issues of fact: was it the storm surge or wind that caused the loss. The common issues of law include whether there is coverage. Because of the large dollar amounts of claims of this type, this would be better suited for administrative determinations through some type of administrative class action procedure designed especially for catastrophe claims of this type. Appeals from determinations and findings made by SOAH could be subject to judicial review in the district courts in Travis County, Texas.

TWIA should be permitted to sell policies that contain a binding arbitration clause for claims after a "named storm" as determined by the National Weather service. This could be further restricted to arbitration of coverage disputes such as the large dollar wind v. flood claims. This would be optional with insureds and priced to reflect the savings from expensive litigation. Such a method to resolve disputes could also be potentially faster and more streamlined procedure to resolving disputed claims than litigation through the courts or SOAH. It could also ease the strain on the both court and SOAH dockets in handling thousands of suits after a catastrophic event.

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