

TESTIMONY OF

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CATASTROPHIC HURRICANE RISKS IN TEXAS & THE PRIVATE INSURANCE MARKET

This testimony is submitted on behalf of my client the Association of Fire & Casualty Companies of Texas (“AFACT”), a trade association composed of mostly domestic property and casualty insurers that provide property insurance in Texas. I have been asked to present testimony on incentives, if any, that would encourage or assist private insurers to write property insurance, particularly coverage against wind exposures from hurricanes, in the coastal counties along the Texas gulf coast. HB 4409 enacted numerous changes in the law regulating the Texas Windstorm Insurance Association (TWIA). Some of the changes in HB 4409 were important in assisting insurers to be able write or continue to write wind coverage not only in the seacoast region in Texas but also to be able to write and continue writing wind coverage in other parts of Texas as well.

This presentation will summarize the changes enacted in HB 4409 that has provided incentives for private insurers and make recommendations for additional incentives that should be considered by the 82nd Legislature. I have included in this presentation a brief background on the basics of demand and supply of catastrophe insurance that may assist you in understanding the forces in the Texas market place that impacts the ability of private insurance companies to supply hurricane catastrophe coverage to *all risks* along the Texas coast. It is important that the committee know that several AFACT member insurers write some wind business along the Texas coast.

BASICS OF DEMAND AND SUPPLY FOR INSURANCE COVERAGE¹

The *demand* for catastrophic insurance coverage is driven by several important factors including the following:

- Financial protection.
- Satisfaction of legal requirements such as those required by mortgage lenders
- Other factors

Hurricanes have been described as low-probability, high-impact events. Obviously, the risk of a large financial loss is most evident after a catastrophic event such as Hurricane Ike or Hurricane Katrina. The reluctance of buyers to purchase enough insurance to provide full coverage can be influenced by several factors including issues of affordability; the availability of aid from the government following a catastrophic event; the ready availability of coverage from agents or companies where an individual has other insurance relationships; and the difficulties some individuals may have in fully understanding whether the probability of a loss is sufficiently large or small requiring the purchase of insurance as protection against loss. Affordability issues are most acute for individuals living in lower value dwellings with relatively low incomes. In such cases, disaster insurance may be a discretionary expense that can be incurred only after the basic necessities are paid.

The *supply* side of the catastrophic risk equation is provided by insurance companies or entities such as TWIA. Insurers are in the business of offer coverage against certain defined uncertain events. Two fundamental concepts drive the ability of insurers to be able to agree to offer coverage for risks:

1. Insurers must have some means or ability to identify and quantify the chances of a particular event occurring and the extent of losses likely to be incurred.

¹ See, Kunreuther, Michel-Kerjan, "AT WAR WITH THE WEATHER: MANAGING LARGE SCALE RISKS IN A NEW ERA OF CATASTROPHES", MIT Press, 2009, which contains a comprehensive discussion of demand/supply concepts as it relates to catastrophic insurance, in Chapters 5-9.

2. Insurers must be able to set premiums at a level for each consumer or class of consumers that will provide sufficient revenue to cover all estimated losses, marketing costs including commissions, other costs including the cost of capital, and a positive net profit over a set period of time.

Risks are generally considerable insurable if both factors are present for a class or type of insurance. If there are risks where there is either insufficient demand or insufficient incoming revenue to cover the cost of claims, expenses, and profit, many insurers will not be able to or want to offer coverage against such risks.

The private insurance market in Texas has not been able to offer wind (hurricane) coverage for *all risks* along the Texas coast for over 40 years for several reasons.

First, premiums insurers were required to charge under the old promulgated rate system in Texas did not provide sufficient revenue to cover all estimated losses much less expenses and profit from a catastrophic event over a set period of time. As Texas progressed to a more competitive rate regulatory system, the prices insurers were willing to charge for risks along the Texas coast were substantially less than the prices TWIA was allowed to charge. Thus, many consumers opted for coverage from TWIA instead of the private market.

Second, initially, it was difficult for insurers to quantify and assess the potential losses for hurricanes. Part of this was the lack of identifiable building codes and enforcement, as well as the unavailability of computer catastrophe models that allow sophisticated analysis of estimating losses in a particular area. Through the use of hurricane modeling, most insurers are much better able to identify and quantify risks. Part of the process of identifying and quantifying risks is an assessment of the buildings being insured and their proximity to the water. Building codes and enforcement of building codes is an important part of this process.

Third, the cost and availability of reinsurance is an important factor in determining whether an insurer can provide coverage for catastrophic risks. The cost and availability of

reinsurance has been an important factor for individual companies in determining how many risks can be written in a particular area. The cost and availability of reinsurance can fluctuate greatly particularly after a large catastrophic event.

Fourth, the potential for catastrophic losses from a hurricane has been so large that it is often difficult, if not impossible, to estimate losses over even a long period of time. The magnitude of losses from a single hurricane could be in excess of the profits earned for decades not only for a single insurer but the profits the entire private industry, including TWIA, may have earned over the same extended period of time.

Data from TWIA demonstrates that a single catastrophic event such as Hurricane Ike can wipe out over 25 years of profits and surplus built up by a single entity. TWIA was able to pay its losses from Hurricane Ike only after exhausting its Catastrophe Reserve Trust Fund (CRTF, which was the build up of profits in TWIA from 1985-2008); collecting \$1.5 billion in reinsurance; and assessing private insurers over \$400 million. Private insurers typically buy reinsurance and have capital and surplus but private insurers do not have the ability to assess other insurers to pay for their losses.

Finally, the importance of the cost of capital cannot be ignored and is often one of the most important limitations on the ability of private insurers to provide coverage in high risk catastrophe areas. Every type of insurance company, whether it be an investor owned company (such as a stock or Lloyds company) or policyholder owned company (such as a mutual or reciprocal exchange), is required to have a certain amount of risk capital before it can underwrite risks. Investor owned entities can raise capital through issuance of stock. Policyholder owned companies typically raise capital through profits or contributions from their policyholders. In either case, a fair return on capital is fundamentally necessary in order to

convince investors or policyholders to place their funds with an insurer rather than elsewhere. It is fundamental, that large amounts of capital are needed in order to write catastrophic risks. The cost of capital is important and vital for an insurer to maintain sufficient capital to pay claims and expenses associated with a catastrophic event but also important so an insurer can continue in business after a loss and continue to provide coverage for its customers for other perils and other types of coverages (such as auto, liability, etc.).

Because of the way TWIA is structured, licensed insurers continue to have financial obligations for risks in TWIA even if they do not write any risks in the catastrophe area. Thus, prudent insurers must account for not only their own risks insured but must also attempt to quantify and identify the risks that they must pay to TWIA after a catastrophic event. Insurers writing their own business can insure only a limited number of risks that has a likelihood of producing total revenue sufficient to pay claims, expenses and return on capital payments for such risks and that will permit the insurer to remain in business after an insured event and continue to provide coverage for its customers.

In summary, TWIA was created in 1971 because of the lack of availability (supply) of wind insurance from the private market. This shortage of supply was the result of several factors. Basically, however, this shortage of supply is similar to those faced by other states and is the result of either factors influencing the ability of the private market to either properly assess and quantify the risks; or set a premium that provides sufficient revenue to pay for losses, costs and profit associated with those risks over a reasonable period of time.

When TWIA was created in 1971, sophisticated catastrophe modeling was not generally available to most insurers. Today, more sophisticated catastrophe modeling is available but may insurers, including TWIA, have experienced regulatory difficulty in using models to set prices in

regulated rate filings. Interestingly, the regulator often uses models in evaluating whether to allow foreign insurers to do business in Texas and often use models in evaluating reserves and reinsurance required to be maintained for solvency purposes.

Private insurers are generally required by rating agencies and reinsurers to focus through the use of catastrophe modeling on the identity and quantity of risks that can be written at a certain price. The ability to identify and quantify risks and set premiums at a price that yields a competitive rate of return on capital is vital as an incentive on the supply side of the equation in order for insurers to be able to write hurricane business along the Texas coast. The same principles should apply to TWIA. Catastrophe models is also an important new tool that greatly assists insurers and reinsurers in assessing risks and setting premiums and should be specifically encouraged by Texas law.

PREVIOUS RECOMMENDATIONS BY AFACT

In 2009, AFACT submitted a letter to Rep Hunter and members of the key committees in the Texas House and Senate recommendations for incentives that were considered important in order for the private insurance market to write more wind business along the Texas coast. HB 4409 addressed some of these recommendations. The following recommendations and HB 4409 changes were made:

1. Eliminate the potential liability for unlimited assessments. AFACT and its members have discussed many times the fact that the contingent liability for unlimited assessments, even with tax credits, creates a tremendous disincentive to write more voluntary business, not only along the Texas Gulf Coast, but in other parts of the state as well.

HB 4409 Changes: HB 4409 eliminated unlimited assessments, however, insurers still have a contingent liability of \$800 Million for TWIA claims. [\$300 Million Class 2 public securities; and \$500 million for Class 3 public securities]. Because of the fact that TWIA could only pay for approximately a \$2.5 billion unless it has reinsurance, there is considerable uncertainty on the part of licensed insurers on how the Legislature will address this shortfall after a hurricane.

2. Maintain the right of companies to voluntarily write business to reduce their percentage of participation in TWIA to either zero or to a manageable level. In 2008, the Commissioner approved an amendment to the Plan of Operation that permitted a company to reduce its participation percentage in TWIA to zero. This depends on the amount of wind business written in the catastrophe area compared to an insurer's other statewide wind writings. This has been an important incentive that has encourage insurers to write some wind coverage in the catastrophe area and has permitted many companies to voluntarily provide some wind coverage in the catastrophe area. This has also been important in assisting licensed insurers to manage their overall exposure and purchase affordable statewide reinsurance.

HB 4409 Changes: HB 4409 did not change this part of the plan of operation. Today, numerous insurers continue to write business in the catastrophe area in order to reduce their participation. The 82nd legislature should continue this incentive.

3. Assure rate adequacy for TWIA. Beach front residential rates in TWIA were reduced significantly in 1991 (up to 75%). Even though there have been increases since 1991, TWIA rates, especially for residential beach risks, are often less than the rates licensed insurers must charge in order to maintain solvency. Currently, some AFACT member companies writing commercial and residential risks are willing to write some business and not exclude wind from their policies. There have been instances, however, where the insured requested the windstorm exclusion in order to buy from TWIA. A company that is willing to write business without a windstorm exclusion should not have to compete with TWIA for this business.

HB 4409 Changes: HB 4409 made some important changes to the rate filings for TWIA. First, rates seeking a 5% overall change or 10% for an individual rating class can be filed and used. Prior approval is required for greater increases. Second, TWIA can establish rating territories within a county subject to certain limitations on rate differences.

4. Maintain strong building codes and enforcement. Companies do seek to underwrite risks that had been built to strong building codes, and oppose any efforts to dilute the building standards and enforcement of building codes. This includes efforts to allow risks into TWIA that cannot prove compliance with building codes which only undermines the integrity of the building code and inspection process.

HB 4409 Changes: HB 4409 imposed surcharges on non-compliant structures. Mandatory compliance with building codes only applies to structures built on or after the effective date of HB 4409. Better building codes and compliance by all structures assists TWIA and licensed insurers in being able to evaluate and price risks.

5. Eliminate the Authority of TWIA and the Commissioner to Increase Limits of Liability Beyond the Index. The Commissioner increased limits on dwellings

from \$450,000 to \$1,500,000 in one year because of the authority granted in TEX. INS. CODE §2210.502(c). This section should be repealed. These types of increases dramatically increase exposure in TWIA and do not allow individual insurers the ability to adjust their own reinsurance and exposures in TWIA.

HB 4409 Changes: HB 4409 did not repeal this provision.

6. Litigation Environment. The current Texas laws for bad faith causes of action against insurance companies under Chapter 541 and Chapter 542, create a liability environment for insurers writing first-party coverages that encourages rather than discourages litigation in the settlement of property claims. The problems in the litigation environment are real not only for TWIA but also for licensed insurers. The litigation environment in some counties along the Gulf Coast, particularly after a major storm, has resulted in loss and loss adjustment expenses considerable higher than predicted and considerably higher than similar experience in other states and other parts of Texas. Exposure to prolonged litigation, attorney's fees and recovery of mental anguish in cases where there are reasonable and legitimate disputes is not an incentive to write business. While the AFACT member companies have not engaged in a wholesale pullout of writing property insurance in coastal areas, Texas bad faith laws and the litigation environment has been a factor in causing some of the larger competitors to withdraw from property writings along the Texas Gulf Coast. Amendments should be made to Chapter 541 to conform it to the provisions in the Deceptive Trade Practice Act in Chapter 17 of the Business and Commerce Code. Amendments should be made to Chapter 542 so that plaintiffs will not have an incentive to delay litigation to increase the liability for attorney fees and the penalty for 18% interest in cases where an insurer responds by making an offer of settlement less than demanded and a reasonable dispute exists on the liability under a policy.

HB 4409 Changes: This issue was not addressed in HB 4409.

7. Wind v. Storm Surge. Even though it is clear under both TWIA policies and policies issued in the voluntary market that storm surge is not covered, properties located near where a storm surge can damage or destroy property is often the subject of expensive litigation on the issue of whether the damage was caused by wind or water from a storm surge. This is particularly true after Hurricane Ike and Bolivar peninsula where several thousand homes were destroyed by the storm surge of Hurricane Ike. Incentives to write risks closer to the water could include finding some way for consumers to acknowledge at the time the policy is issued that storm surge is not covered and to require some type of adjudication of disputes on wind v. surge through some central agency such as SOAH or by arbitration.

HB 4409 Changes: HB 4409 required structures constructed, altered, remodeled, or enlarged after September 1, 2009 located in Zone V to have flood insurance in order to be eligible for coverage in TWIA.

RECOMMENDATIONS FOR THE 82ND LEGISLATURE

The following additional recommendations are made for consideration by the 82nd Legislature that could provide incentives for companies to write business not only in the catastrophe area but in other parts of Texas as well.

1. Legal Environment. Specific changes should be considered to the penalty provisions and liability for attorneys fees in Chapter 541 and Chapter 542 on handling of claims.

- Amend Chapter 541 to impose liability for treble damages only for an intentional violation of chapter 541 similar to that in the DTPA, TEX. BUS. & COMM. CODE, Ch. 17. Require statutory punitive type of damages to have a reasonable relationship to actual damages. Clarify when non-economic damages can be recovered similar to the DTPA.
- Amend TEX. CIV. PRAC. & REM. CODE §42.004(f) to clarify that interest including penalty interest and penalty damages under Chapter 542 and 541 cannot be recovered by a claimant that rejects a qualifying settlement offer under Tex. Civ. Prac. & Rem. Code §42.004. The following language is suggested for your consideration:

“§42.004. Awarding Litigation Costs

(f) If a claimant or defendant is entitled to recover fees and costs under another law, the court must not include fees, penalties, interest (including interest under §542.060 of the Insurance Code), and costs, incurred by that claimant or defendant after the date of rejection of the settlement offer when calculating the amount of the judgment to be rendered under Subsection (a).”

- Amend Chapter 542, Subchapter B to require claims for supplemental payments to be presented allowing an insurer to accept or deny the supplemental claim.
 - Prohibit penalty interest unless there is a knowing delay in paying the amount owed to an insured. (The current statute allows 18% interest even if there is an innocent, good faith underpayment.)
 - Cap any penalty interest at a rate based on a recognized standard that is reflective of current market conditions and is calculated on the total amount at issue, without recovery of additional interest over time. (Plaintiffs often are motivated to delay reasonable settlement discussions

- because accrued penalty and prejudgment interest of 23% often exceed actual damages.)
- Prohibit recovery of attorney fees unless there is a knowing statutory violation by the insurer
 - Establish safe harbors for carriers to avoid extra-contractual liability, attorney fees, and penalty interest; e.g., if an insurer timely pays an appraisal award or pays in line with an independent expert's report.
 - Eliminate awards of exorbitant attorneys' fees based on a jury finding of an immaterial underpayment of a claim. Such windfalls encourage frivolous lawsuits and discourage settlements in mediation.

2. Appraisal

- Clarify the appraisal rules regarding, among other things, waiver, scope, effect of refusal to cooperate, and the effect on an insurer's liability.
- Establish guidelines for judicial appointment of impartial umpires.
- Require the Texas Department of Insurance to maintain an approved list of impartial, knowledgeable umpires from which judges must select.
- Amend the Texas Code of Insurance to provide that timely payment of an appraisal award protects an insurer from extra-contractual liability.
- Amend the Texas Code of Insurance to provide that mere failure to pay a claim, without a showing of bad faith, is not, in and of itself bad faith or a statutory violation .

3. Public Adjusters/Damage Estimators

- Require identification of public adjusters or estimators by name and license number on all estimates.
- Subject public adjusters to the same standards as insurers' adjusters; require estimates to be made in good faith.
- Require public adjusters to execute a verification of damages on all estimates submitted to an insurer for catastrophe claims, including estimates submitted in appraisal, mediation or litigation. (Currently there is no accountability for fraudulent estimates submitted by attorneys, or public adjusters.)
- Enforce disciplinary action against persons representing insureds who write false, misleading or inflated estimates.

4. Regulation of Roofing Contractors

- Prohibit rebates to insureds, including “hidden” rebates such as payment equal to the policy deductible made to an insured who allows a roofer to place a business sign in the insureds’ yard.
- Require contracts for roofing repair to (i) require that an insured be furnished with a written copy of all estimates in advance of repairs; (ii) contain a conspicuous notice that the insured may be liable for any excess cost over the repair estimate; (iii) include the right for the insured to seek competitive bids and (iv) provide the insured the right to cancel the contract if the roofer’s estimate exceeds the insurer’s repair estimate.
- Require registration or licensure for roofing contractors.

5. Building Codes and Enforcement. The losses from Hurricanes Ike and Rita indicate a lack of adequate enforcement of building codes causing greater losses than should have been expected.

6. Rate Inadequacy in TWIA. The 82nd Legislature should continue to explore ways for TWIA to achieve rate adequacy. Many insurers willing to write coverage in the first tier cannot compete with TWIA's rates.

7. Cost of Reinsurance. AFACT recognizes that the reinsurance market is a world-wide market that is not subject to regulation. However, the TDI has recently begun requiring insurers to buy reinsurance for two 1:250 year event even though there is no statutory authority for this requirement and no formal rule has been adopted. Most insurers buy catastrophe reinsurance to protect their solvency. This requirement may create barriers to being able to write business along the Texas coast and has also prevented some foreign insurers seeking to do business in Texas from being licensed in Texas. The cost of reinsurance for a 1:250 year event is considerably higher than the cost of reinsurance for a 1:100 year event. TWIA has no reinsurance. The more business a company writes in the 1st tier the more the cost of reinsurance for all business in all parts of the state. The cost of reinsurance can fluctuate greatly from year to year. The Legislature should explore options that address the cost of insurance including whether the TDI should require insurers to buy greater amounts of reinsurance than is required for TWIA or non-licensed insurers.