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jdrenner@rstreet.org

Members of the Oversight Windstorm Insurance Committee,

R Street is a free-market think tank dedicated to limited, effective government, free markets and responsible environmental stewardship. Its founding staff all were previously employed by the Heartland Institute. We applaud your efforts to investigate the best methods for providing insurance against the devastating effects of windstorms in our state's coastal areas. Herein lies a discussion of the state's wind insurance problems and an overview of four things Texas should do in order to assure the state has a functioning, solvent, and risk-based insurance system.

Summary of solutions

- Limit the Texas Windstorm Insurance Association's potential harm to taxpayers by imposing tough new conflict of interest standards and requiring the association to transfer risk away from taxpayers.
- Shrink TWIA by restricting coverage for high-value properties and second homes.
- Phase in actuarially sound rates for all properties in TWIA.
- Resist all calls to create a state-level catastrophe fund.

About Wind Insurance in Texas

Texas' windstorm insurance system is in trouble. TWIA was intended as an insurer of "last resort," but now writes 62 percent of all wind coverage in its service area.[1] Despite numerous reform efforts, TWIA has grown in recent years.[2] As it has a majority market share in its service areas, TWIA is not an insurer of last resort but, rather, an insurer of *first* resort. This has a number of negative consequences for the state.

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[1] Texas Department of Insurance. "Texas Windstorm Insurance Association 2009-2011 Residential Wind Market Share by County, 2009-2011," in *Texas Wind Insurance Overview,* August 10, 2012, http://www.senate.state.tx.us/75r/Senate/commit/c955/handouts12/0912-Kitzman-1.pdf

[2] Ibid.

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First, it imposes potentially large liabilities on taxpayers. Although TWIA is, as a legal matter, not backed by the full faith and credit of the state, longstanding precedent indicates that the state would, like Florida and Mississippi, likely face tremendous pressure to bail it out were it to run out of funds.[3] Between 1983 and 2008, TWIA assessed insurers for $757 million—more than $1 billion in current dollars—all of which served to reduce tax revenues via premium tax credits or raise rates for people with insurance. TWIA's own actuaries now estimate there is a 1-in-27 chance that TWIA simply will not have enough money to cover its claims following a major storm. This is unacceptably high. If nothing changes, TWIA *will very likely* be bankrupt sometime in the next three decades.

A transformation of TWIA will require a series of reforms:

Limit the TWIA's potential harm to taxpayers by imposing tough new conflict of interest standards and requiring the association to transfer risk away from taxpayers.

Past allegations of mismanagement and questionable practices resulted in Commissioner Mike Geeslin initiating the administrative oversight process for TWIA that continues to this day.[4] Certainly, under Commissioner Geeslin, and now Commissioner Kitzman, much good work has been accomplished and several corrections have been made. However, TWIA must be structured to be beyond reproach, and its risk to taxpayers greatly reduced.

To confirm TWIA functions properly, the legislature should assure it follows standards similar to those in the federal Sarbanes-Oxley Act. Sarbox, as it is commonly called, requires auditor independence for publically traded firms.[5] Companies responsible for auditing a public firm's books, in general, cannot subsequently do business with the firm in other fields; for example, by participating in stock and bond issues. Currently, nothing in TWIA's plan of operation or Texas' statute forbids firms from advising on TWIA's bonding capacity and subsequently participating in, and earning fees from, bond issues that follow such a study. This situation presents an obvious conflict of interest and deprives TWIA of truly unbiased advice. Therefore to safeguard

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[3] See e.g. Eli Lehrer. "Reaping the Whirlwind: Mississippi's Wind Insurance Problem is Everyboyd's," in *The Weekly Standard*, March 26, 2007.
[4]. Texas Department of Insurance. "TDI Places TWIA Under Administrative Oversight," March 3, 2011, "http://www.tdi.texas.gov/news/2011/news20116.html
[5] Securities and Exchange Commission, Office of the Chief Accountant. "Audit Committees and Auditor Independence," http://www.sec.gov/info/accountants/audit042707.htm

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TWIA's independence, the Legislature should consider imposing Sarbox-like standards on TWIA and all other similarly situated state entities.

Simply assuring that TWIA receives sound and unbiased advice is not enough. It is impossible regulate competence into existence, and no matter what rules are written, it is possible that TWIA will, by omission or commission, make a mistake. Thus, to protect taxpayers, TWIA should return to the system of operations that served it well between its creation in its current form and Hurricane Ike in 2008. It should transfer risk to private parties. Rather than relying on bonds or assessments (special taxes) imposed on the public, TWIA must strive to transfer as much of its risk as possible to other parties. This practice served it well prior to 2008's Hurricane Ike, when a private reinsurance program shielded taxpayers from $1.5 billion of potential liabilities that accrued as a result of the storm.[6] Within the next few years, TWIA should set a goal of having sufficient capital and private risk transfer—catastrophe bonds or reinsurance—to meet, at minimum, claims stemming from a 1-in-100 year event.

Shrink TWIA by restricting coverage for high-value properties and second homes.

Insofar as Texas provides a state-backed residual market that charges rates below those found through private carriers, it should prioritize offering coverage to those of limited means. Right now, however, a significant portion of TWIA's resources are devoted to policyholders who can clearly afford private coverage. As the attached charts demonstrate, TWIA currently provides subsidized insurance for houses with coverage limits of up to $1.8 million. The median sale price of a home in Texas, which includes the value of the underlying land, is currently $175,000.[7] Right now, the 3,210 most expensive homes that receive TWIA's subsidized coverage account for nearly twice as much exposure as the 27,081 least expensive ones. If the state hopes to shrink TWIA and return it to its place as a market of last resort, it should limit coverage to no more than $500,000 (most such homes, particularly with water views, will sell for more than $1 million.) Millionaires should not be able to rely on taxpayers to provide them with insurance.

Such a step not only relieves the average homeowner of an expensive liability, but also serves as a useful catalyst for the market. If wealthy coastal property owners must either buy homeowners policies or private excess or umbrella policies to insure that portion of their home values that are in excess of the $500,000 limit, it will create an opportunity for insurers to offer innovative new

[6] Texas Wind Insurance Association. Quarterly Board of Director's Meeting, September 13, 2011, http://www.twia.org/Portals/0/Documents/TWIA_Book_Final.pdf, 5

[7] Zwilliow.com. "Median Home Price, Texas," August, 2012, http://www.zillow.com/local-info/TX-home-value/r_54/

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jdrenner@rstreet.org

products to meet their needs. These products, in time, may filter down to more moderate income consumers, become increasingly price competitive, and come to serve a larger number of coastal Texans.

Just as importantly, the 51,587 second homes covered through TWIA should be eliminated from the program altogether. If people can afford to purchase two homes, they do not have any need or right to have the taxpayers assume any liability for insurance on their second homes. Eliminating coverage for second homes would reduce TWIA's total $42.29 billion in exposure by 17%, or $7.2 billion, not counting the reductions in contents coverage such homes might carry.

Phase in actuarially sound rates for all of TWIA

Over time, TWIA should simply end all of its subsidies and charge rates that meet the same standards as those charged in the private sector. Residual market plans in Virginia and South Carolina already do this and there is no reason that Texas cannot follow their lead. Because TWIA currently charges too little for its coverage, a sudden rate increase to bridge the gap is not an option, due to the "sticker shock" it would cause policyholders. However, in the medium-to-long term, TWIA should strongly consider adopting a "glide path" that increases rates for properties at a predictable rate until they achieve standards of actuarial adequacy.

Avoid creating a statewide catastrophe fund

Although I have yet to see any hard legislative language, many in Texas have proposed creating a "statewide catastrophe fund" in addition to or in place of TWIA. Such a fund, as I have heard it described, would serve as a government-run reinsurer and supposedly protect properties throughout the state from a variety of natural disasters. Whatever the legislature does, it should not follow this route. In particular, other state funds have failed dismally wherever attempted, no such fund could benefit the entire state, and such a fund cannot work as advertised in any case.

The Florida Hurricane Catastrophe Fund, the only current state catastrophe fund, is a dismal failure that does not have the resources necessary to pay its likely claims following a major

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jdrenner@rstreet.org

storm. As such, it would have to impose special assessments of up to $8.5 billion to make good on its obligations.[8] Texas' taxpayers need fewer liabilities, not more.

Such a fund, in any case, would not provide a statewide benefit. Although natural disasters are technically possible in any part of the state, the private market provides adequate insurance and affordable prices in the areas not served by TWIA. There is no lack of coverage for tornados, inland hailstorms, dust storms, thunderstorms or any of the other numerous natural disasters. Texas should focus its efforts on areas where the market is inherently incapable of providing a given service (law enforcement) or can fairly be said to under-produce something that is socially beneficial (education). Nobody can contend that this is the case with property insurance. As such, Texas' government should step aside and let the free market work.

Most importantly, a statewide catastrophe fund simply could not work as advertised, no matter how it is structured or designed. Insurance is based on spreading risk. Through global markets, private insurers and reinsurers can combine the risk of hurricanes hitting Texas with that of earthquakes in California, floods in the United Kingdom, and industrial accidents in Japan. Since these events will almost never happen simultaneously, insurers remain in business even while paying out massive claims. All other things being equal, a company with a broader pool will be able to break even at a lower price level than one with a narrower pool. By concentrating all risk within the borders of a single state, a Texas catastrophe fund would have to charge rates for its coverage much higher than those in the private sector in order to merely break even.

If it were to function at all, a state catastrophe fund would have to systematically underprice its coverage and thereby saddle taxpayers with massive contingent liabilities. The idea, therefore, is fundamentally flawed. Although many options should be considered, a state catastrophe fund should not be among them.

Final Thoughts

Texas faces a significant challenge in providing wind insurance that is available to all of its residents. The current system, which has transformed a market of last resort into the largest carrier on Texas' coast, simply does not work. If it wishes to improve the situation, the

[8] Stephen Alexander. "Potential Assessments from Florida Hurricanes," Office of the Insurance Consumer Advocate, State of Florida, http://www.myfloridacfo.com/ica/docs/AssessmentStudy.pdf

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Legislature should consider imposing new conflict-of-interest standards on TWIA, limiting the number of high-end and second homes that it covers, and raising its rates to actuarially sound levels. The Legislature should not, under any circumstances, consider proposals to create a state-level catastrophe fund of the sort that have only lead to financial crisis in other states.

Respectfully submitted,

Julie Drenner
Texas Director
R Street