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REVERSING A RISING TIDE: Goals for Reforming the Texas Windstorm Insurance Association

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Designed to be insurers of last resort, state residual markets are now the largest insurers in many coastal areas.[1] One such organization, the Texas Windstorm Insurance Association (TWIA), is one of seven state-run residual market mechanisms for hurricane wind coverage. The two hurricanes which struck Texas in 2008 cost TWIA almost $3 billion and revealed the association's unsound financial basis and desperate need for reform.[2]

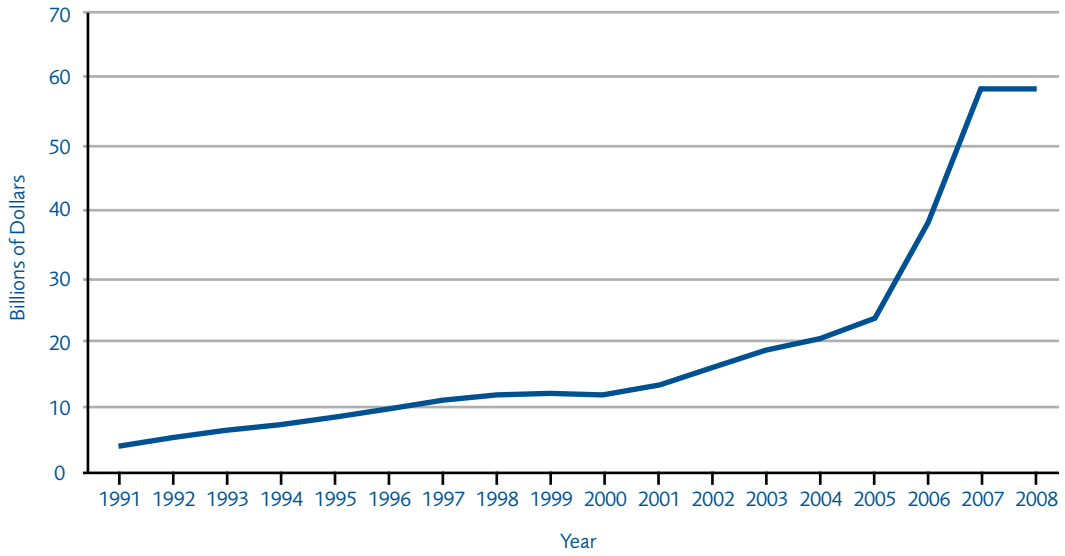
THE CONSEQUENCES OF WINDSTORM INSURANCE SUBSIDIES

TWIA provides a large share—nearly 30 percent—of all wind coverage along the Texas coast. Entering the 2008 hurricane season, TWIA had 221,000 policies in effect with a total liability of $59 billion, up from $19 billion in 2003.[3] Figure 1 illustrates TWIA's recent rapid growth, which is due largely to below-market rates for windstorm insurance.[4]

Over two decades, residential rates have increased by 53 percent and commercial rates by 38 percent. However, these rates have not kept pace with escalating hurricane damages (see figure 2). To compare, between 1993 and 2007, State Farm's homeowners-insurance rates in Florida increased by 523 percent. (This was before the company's requested 47 percent increase in 2008 was denied, prompting State Farm's withdrawal from the Florida homeowner's insurance market.[5])

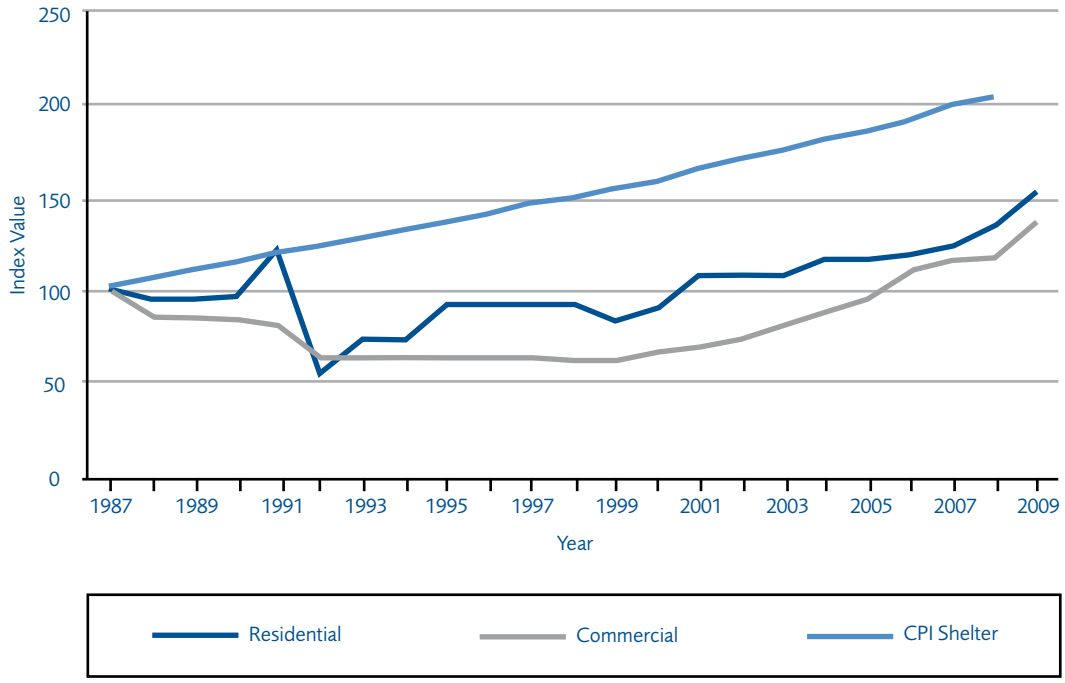
Assessments the association imposed on Texas insurance companies in 2008 also reveal the inadequacy of TWIA's rates. TWIA had accumulated only $470 million in reserves prior to the 2008 hurricane season, and Dolly and Ike burdened the association with around $3 billion in losses. Assessments in excess of $700 million were imposed on insurance companies in the state.[6]

FIGURE 1: TWIA'S LIABILITY IN FORCE 1991–2008



Source: Texas Department of Insurance, "Report on the Texas Windstorm Insurance Association," January 2008; Texas Windstorm Insurance Association Statistical Report, 12/31/08.

FIGURE 2: TWIA COMMERCIAL AND RESIDENTIAL RATES VS. CONSUMER PRICE INDEX FOR SHELTER



The index is normalized so that 1987 rates equal 100. Source: Texas Department of Insurance, "Report on the Texas Windstorm Insurance Association," January 2008; Consumer Price Index—All Urban Consumers —Shelter, http://data.bls.gov/PDQ/outside.jsp?survey=cu.

Because wind pools are partially financed by state subsidies and by assessments on other policyholders, the cost of hurricane damage is shifted from coastal property owners to all Texas taxpayers and insurance policyholders.[7] Texans who do not share the benefits of coastal property ownership unfairly share the costs. Cost shifting creates inefficiency by distorting prices and thus distorting choices to build along the coast rather than inland.

OPTIONS FOR MAKING TWIA SELF-FUNDING

To eliminate future cost shifting, TWIA must become self-funding. This can be accomplished three ways: by building up reserves, purchasing reinsurance, or making self-assessments.

While TWIA accumulates some capital in the Catastrophe Reserve Trust Fund, low rates have rendered this reserve inadequate. By increasing premiums, TWIA could build a more substantial reserve. However, this would take a number of years since the trust was depleted in 2008. Also, when the state does not suffer a hurricane for several years, politicians cannot resist the temptation to lower rates and thus fail to accumulate a meaningful reserve. The sharp decline in TWIA rates in the early 1990s (see figure 2) illustrates this cycle.

Reinsurance is essentially insurance for insurance companies. TWIA would pay premiums annually to reinsurance companies, who in turn pay for TWIA's losses in the event of a hurricane. TWIA did in fact have about $1.5 billion in reinsurance coverage that helped to pay for losses after Ike.[8] If TWIA buys sufficient reinsurance to cover its potential losses and charges adequate rates, it can halt the shifting of hurricane costs. Capital to pay for losses can also be raised through catastrophe bonds, which serve as a substitute for reinsurance.

Under a self-assessment system, assessments would be limited to TWIA policyholders only, rather than policyholders throughout the state.[9] TWIA would assess policyholders for excess losses as with the current system, and self-assessments would comprise a payment after the event.

These approaches have advantages and disadvantages. Reinsurance allows access to capital when needed while a reserve could be built up quickly through pre-event borrowing via catastrophe bonds. If reinsurance is relatively expensive, accumulating a reserve becomes more attractive. However, reinsurance payments are an explicit, verifiable cost and can be used to ensure that policyholders are charged adequate rates. Both require that TWIA take into account future growth in coverage and rising construction costs.[10]

Self-assessments would allow policyholders to see how bad a hurricane might be before paying for losses—an attractive alternative if policyholders are skeptical about the potential for very large losses. Reinsurance must be purchased every year, and large amounts of coverage can become quite costly. For example, suppose experts estimate that the loss TWIA might face in a major hurricane would range from $8 to $12 billion. If TWIA buys reinsurance against a $12 billion loss, it will pay annual premiums for $4 billion in coverage it may not actually need. TWIA policyholders might prefer to prepare for an $8 billion loss and deal with the last $4 billion in losses—should they materialize—through self-assessments.

A disadvantage of self-assessment is the potential for very large assessments. TWIA's potential loss from a major hurricane hitting the Galveston area has been estimated at $10 billion.[11] If, say, half of this loss were to be covered through self-assessments on the 215,000 policies in force at the end of 2008, assessments would be over $23,000 per policy. With large self-assessments, customers are more likely to evade or default on payments, and costs might end up being shifted to state taxpayers.

A self-financing TWIA could readily rely on all three of these alternatives. As long as TWIA is self-funding, policyholders can decide for themselves how much they want to pay up front or post event. However, becoming self-funding also requires that TWIA increase premiums to subsidy-free levels. Rates for current policyholders could be raised over several years to facilitate adjustment. A priority should be placed on eliminating subsidies now for future construction to prevent further inefficient development.

SUPPORTING POLICY MEASURES

Two additional reforms could help Texas reduce hurricane risk and contribute to TWIA's viability. The first is mitigation incentives and strengthened construction in coastal areas. Incentives to invest in mitigation, however, depend on whether policyholders will receive lower premiums in exchange for making building upgrades and the likelihood of significantly reduced losses in the event of a hurricane.[12]

A well-designed building code can reduce hurricane damage by 40 to 50 percent. Though Texas adopted the 2006 International Residential Code and the 2006 International Building Code, the state needs to improve building code enforcement. In Florida, 98 percent of communities in coastal counties were rated by the Insurance Services Office, meaning that they have an at least somewhat-effective enforcement program, and 42 percent of these communites have a top rating. By contrast, only 57 percent of coastal county communities in Texas were even rated, and none received a top rating. Unenforced building codes are not effective: Poor building code enforcement in Florida accounted for 25 percent of damage from Hurricane Andrew.[13] A potential guide for Texas is the Institute for Business and Home Safety's *Fortified . . . for Safer Living* program to encourage construction beyond that required by building codes. Currently, state wind pools in South Carolina, Alabama, and Mississippi offer premium discounts for homes built to the program's requirements.[14]

A second policy measure is deregulation of the voluntary market for wind coverage. Market forces, rather than regulation, should set insurance rates and conditions. Given TWIA's subsidized premiums, we would not expect large numbers of customers to immediately switch to the private market. Nonetheless, private insurance could become more attractive for two reasons, especially if TWIA subsidies are phased out. First, some homeowners are willing to pay extra for better or faster claims service. Second, private insurance could be attractive to low-risk homes within coastal counties since they would no longer be paying TWIA's cross-subsidized rates, which force low-risk homeowners to overpay in order keep rates low for the highest-risk properties.

CONCLUSION

TWIA'S LIABILITY HAS quadrupled since 2003, with over 220,000 policies in effect as of mid 2008. TWIA now insures about $60 billion in property, and the Insurance Information Institute estimates that Texas has about $900 billion in hurricane-vulnerable coastal property.

TWIA must improve its financial situation while eliminating the cost shifting of hurricane losses to noncoastal insurance policyholders and taxpayers. This can be accomplished by amassing an adequate reserve, purchasing sufficient reinsurance, and/or making assessments only on current TWIA policyholders. The first priority in reform should be to eliminate subsidized wind coverage for new construction; subsidies for existing policyholders can be phased out over several years. Improved incentives for mitigation, along with deregulation of the private market for wind coverage in areas eligible for TWIA coverage, would complement a self-funding wind pool.

ENDNOTES

1. State residual markets offer required auto or homeowners or business insurance to persons unable to purchase coverage in the "voluntary"- but regulated—insurance market. Note that regulation often limits premiums insurers charge and the inability to obtain insurance might be due to these price controls. Nine other Atlantic Coast states have Fair Access to Insurance Requirements residual market mechanisms that provide insurance in coastal areas in addition to other coverage.
2. Drew Thornley, "New Ike estimate: Good news…but not good enough," Texas Public Policy Foundation, http://www.texaspolicy.com/legislative-updates_single.php?report_id=2223.
3. All current TWI policies can be found at www.twia.org/news.html#web_news.
4. On the role of subsidized coastal insurance and coastal growth, see Jeffrey J. Pompe and James R. Rinehart, "Property Insurance for Coastal Residents: Government's Ill Wind," *Independent Review* 13, no. 2 (Fall 2008): 189–207.
5. Florida Office of Insurance Regulation, "Documents and Background Materials on State Farm's July 16, 2008 Rate Increase Request," www.floir.com/StateFarm/Docs.aspx
6. See Texas Department of Insurance, "Hurricane Ike Fact Sheet: TWIA," n.d., http://www.tdi.state.tx.us/CONSUMER/storms/documents/windfactsheet.pdf.
7. See Daniel Sutter, *Ensuring Disaster: State Insurance Regulation, Coastal Development, and Hurricanes,* Mercatus Policy Series (Arlington, VA: Mercatus Center at George Mason University, 2007).
8. Bradley Kading, "Hurricane Ike victims benefit from reinsurance," *San Antonio Express-News*, November 4, 2008, http://www.mysanantonio.com/opinion/Hurricane_Ike_victims_benefit_from_reinsurance.html.
9. For more on self-assessments as well as other options for reform see Eli Lehrer, "Restoring Florida's Insurance Market," James Madison Institute *Backgrounder* no. 55 (February 2008).
10. TWIA did in fact have a reserve and had purchased reinsurance prior to 2008, but the amounts did not cover the losses. As Peacock, Thornley, and Stull point out, the current system for financing losses was adequate when adopted in the 1990s when TWIA had a total liability of $6 billion. See Bill Peacock, Drew Thornley, and Machir Stull, *Texas' Windstorm Challenge: Unprepared for the Worst*, Texas Public Policy Foundation Policy Perspective (Austin, TX: Texas Public Policy Foundation, December 2007).
11. Ibid.
12. For more on the role of incentives for mitigation, see Daniel Sutter, *Building a Safe Port in the Storm: Private vs. Public Choices in Hurricane Mitigation*, Mercatus Policy Series (Arlington, VA: Mercatus Center at George Mason University, July 2008).
13. See Dennis Mileti, *Disasters by Design: A Reassessment of Natural Hazards in the United States* (Washington DC: Joseph Henry Press, 1999).
14. For more on this program, see Institute for Business and Home Safety, *Fortified . . . for Safer Living Builder's Guide*, Version 2.2, http://www.disastersafety.org/resource/resmgr/PDFs/builders_guide.pdf

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