Biennial Report to the 84th Legislature

December 30, 2014

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Purpose

The Texas Insurance Code, Section 2210.0025 requires the Texas Windstorm Insurance Association Board of Directors to submit to the Commissioner of Insurance, the Senate Committee on Business and Commerce, the House Committee on Insurance, and the Sunset Advisory Commission a written report relating to the operations of the association during the preceding biennium. The report must include:

I. Any proposed changes in the law relating to regulation of the association and a statement of the reasons for the changes; and
II. Any information regarding association operations or procedures that is requested by the department to be addressed in the report.

At the August 12, 2014 quarterly meeting, the Board directed the Legislative and External Affairs Committee to develop potential legislative recommendations for the Board's consideration. The Committee presented recommendations to the Board for consideration at its December 9, 2014 quarterly meeting. This biennial report to the Legislature includes the recommendations approved by the TWIA Board of Directors, the required statement of reasons for the changes, and a summary of the Association's accomplishments and operations.

Executive Summary

Today, the Texas Windstorm Insurance Association (TWIA) is a completely different organization than it was prior to 2011. TWIA has replaced its management team and streamlined or otherwise transformed the organizational structure and all areas of operations. Under the direction of the TWIA Board of Directors, the new management team has successfully addressed legislative changes, improved operational efficiency, transformed the organizational culture, and increased management controls and accountability. In addition to the recommendations for legislative change, this report includes a detailed account of the Association's achievements since 2011. Several key accomplishments are listed below:

- Addressed 100% of HB 3-required changes in TWIA operations
- Projected to contribute over $200 million to the Catastrophe Reserve Trust Fund (CRTF) as a result of 2014 operations bringing the CRTF total to approximately $450 million for the 2015 storm season
- Secured the highest level of funding since 2008 with up to $3.85 billion in total funds available to pay claims
- Issued $500 million in Class 1 public securities to provide immediate claims-paying capacity after a storm and additional protection to Coastal policyholders and residents with no associated impact on rates
- Issued the Association's first catastrophe bond as part of the overall reinsurance program thereby diversifying and further expanding the Association's claims-paying capacity
- Developed extensive controls and detailed financial and operational metrics to measure and evaluate performance at every level in the Association
- Enhanced the Catastrophe Plan and contracted with vendors committed to supplying up to 6,626 field adjusters and 745 desk examiners sufficient to handle claim volume associated with a 100-year event
- Implemented policyholder satisfaction survey which reflects increasingly positive feedback on claims
- Hired an internal auditor to report to the Board and facilitate informed governance through independent validation of the Association's compliance and risk management practices

Audits performed by the Texas Department of Insurance and independent external auditors in 2014 have confirmed the effectiveness of operational improvements and found no material weaknesses or issues in operational or financial controls.

The TWIA Board of Directors and the current leadership team are committed to providing quality service to our policyholders, ensuring the financial sustainability of the enterprise, and operating efficiently to achieve the best use of policyholder funds.

TWIA Operations Overview

Since 2011, TWIA has taken numerous steps to improve corporate governance and the overall operations of the Association. These steps include introducing a new management team, improving overall funding, and providing better service to its policyholders by enhancing the underwriting and claims services. All of these improvements ensure that TWIA meets the needs and exceeds the expectations of its primary stakeholders. Recent audits completed by the Texas Department of Insurance (TDI) and an independent consulting firm reported no significant findings, confirming the vast improvement in operations. TWIA continues to identify areas for improvement in processes and procedures to ensure that the Association complies with applicable statutes, regulatory guidelines, and industry best practices.

History and Regulatory Changes

In 2008, Hurricanes Dolly and Ike together resulted in more than 100,000 claims and almost $3 billion in losses. Partly because of this increased activity, TDI conducted examinations of TWIA operations between 2008 and 2011 and noted several areas of concern related to TWIA's past corporate governance and operations, including accounting procedures and financial statements, internal controls, record-keeping, communications with the Board of Directors, and claims procedures. An independent audit commissioned in 2010 evaluated procedures related to claims, premiums, expenditures, financial reporting, information systems, business continuity and internal controls. The independent auditors reported weaknesses in the claims assignment and quality assurance processes, as well as in the Association's conditions for selecting, contracting with, and evaluating the performance of claims adjusting firms. As a result of these observations and public concerns regarding claim handling, TDI placed the Association under Administrative Oversight in February 2011 and the Texas Legislature passed House Bill 3 (HB 3) shortly thereafter; these events necessitated numerous changes to TWIA operations. The Board of Directors hired John W. Polak to replace the former General Manager in April 2011 and to implement the changes necessary for the Association to comply with applicable regulations and best practices.

HB 3 significantly changed TWIA's residential and commercial policy forms, claims handling procedures, and judicial remedies for policyholders. It called for increased transparency, requiring TWIA to broadcast all Board meetings live and to report on compliance with the Insurance Code and Plan of Operations bimonthly to the Board of Directors, and it specifically mandated that TWIA be subject to the Public Information Act, Government Code Chapter 552. HB 3 also required TDI to create an ombudsman program, funded by TWIA, to inform and educate policyholders about the claims process, as well as an expert panel to provide a methodology for determining the extent of damage resulting from wind versus flood or surge.

After the passage of HB 3 in 2011, TWIA developed an implementation plan to address all required changes. 100% of required changes have been addressed, with simplified renewals incorporated into the implementation of TWIA's new policy administration system. The Association has divided the HB 3 simplified renewal mandate into two phases.

The initial phase focuses on simplifying the renewal application process for agents by enabling online submission of renewal applications and corresponding payments. When the new policy administration system is implemented in the second quarter of 2015, agents will be able to make changes to renewals electronically, automatically calculate applicable premium differences, and pay for applications using electronic funds transfer (EFT) and Automated Clearing House (ACH) transactions. Renewal applications submitted by agents will be eligible to auto-issue immediately after submission if all primary eligibility criteria are met.

The second phase focuses on simplifying the renewal process for policyholders. The process entails invoicing the consumer and allowing them to submit payment directly to TWIA if no coverage changes are needed. The Association plans to build technical requirements to develop the application and processes necessary to implement the changes in the new policy administration system following the initial release.

Post-HB 3 Improvements

Leadership

Today, following the replacement of almost all of TWIA's previous executive team, leadership has significantly more experience, including extensive experience with large carriers other than TWIA. The new executive leadership team brings to TWIA a broader range of skills and experience with nearly 150 years of cumulative carrier experience, 90% with national carriers. The TWIA Board of Directors and management now have a greater focus on accountability than ever before, and have established new processes and standards consistent with industry best practices.

Accountability

Current leadership recognizes that the Association must be a continuously improving organization, and the management team persistently seeks ways to enhance the organization's effectiveness. The Association now employs extensive controls and detailed financial and operational metrics to measure and evaluate the performance at every level of the Association, from the organization as a whole to individual departments to individual employees. All operational areas have documented their procedures, and TWIA has greatly increased the level of transparency and communication among all levels of the Association and with outside stakeholders.

In addition to addressing the Association's prior deficiencies through the tactical initiatives broadly described above, the TWIA Board of Directors and management team have committed to refocusing the organizational culture from task-based behavior to results-oriented accountability. To that end, the Association completed the first formal strategic planning process in 2013. Strategic planning is essential for the organization to continue evolving to meet the evolving needs of its policyholders and other stakeholders. As a result of the 2013 and 2014 planning sessions, leadership has articulated not only a clear mission and vision to guide the organization as a whole, but also a set of shared values to guide employee behavior and strategic goals to guide operations and services.

TWIA's vision is to be respected and trusted by stakeholders to provide high quality responsive insurance products and services that facilitate commerce in the Coastal counties by enabling real estate sales and residential and commercial property mortgages. In accomplishing our mission to efficiently provide essential property insurance products and services for eligible Texas policyholders when no one else will, we support the following values:

- Provide quality service to our policyholders
- Value the interests of a broad spectrum of stakeholders
- Ensure the financial sustainability of the enterprise
- Operate efficiently in order to achieve the best use of policyholder funds
- Be a steward of the public trust and hold ourselves to a high standard of ethics
- Objectively measure performance and be accountable for results
- Not intentionally compete with the voluntary market

Through the planning process, leadership has established the strategic goals listed below. Each year, the executive leadership team sets annual objectives, deadlines and metrics to further progress toward these goals in the following year.

1. Secure sufficient funding to pay claims and other financial obligations
2. Drive operational efficiency throughout the enterprise
3. Build a culture of continuous improvement, service and accountability
4. Operate transparently through open communication with stakeholders
5. Attract, develop and retain talented people

Organizational Structure

Current leadership has completely restructured the organization. In 2008, the TWIA Claims Department employed only five permanent managers and claims examiners. That staffing model was not sufficiently scalable, either for acquiring adequate numbers of contractors or for properly training them, during a catastrophe. Available resources were severely tested as the claim volume went from a modest 10 to 15 claims per day to nearly 93,000 in a twelve-month period. With approximately 80,000 of those claims filed within the first 30 days, internal and external staffing resources were strained. Since then, TWIA has designed a new infrastructure able to support claims operations during both catastrophe and non-catastrophe years. The structure now includes a permanent workforce of approximately 50 managers, examiners, and clerical employees supplemented by a flexible, contingent workforce that varies based on claim volume. If claim volume warrants additional staff, the core workforce is able to quickly and effectively train new contract workers. Management has also combined and cross-trained the TWIA and TFPA claims departments to increase operational efficiency and leverage resources. If TWIA claim volume is low, resources are shifted to TFPA claims and vice versa. Employees are also cross-trained to assist in other departments if claim volume is low for both Associations.

TWIA is a completely different organization today, with nearly all of the 2008 organizational structure replaced, streamlined, or otherwise transformed. TWIA has reorganized the IT, accounting, legal, and compliance departments to increase managerial controls, operational efficiency, and accountability; and has established new departments to address the needs that resulted from the recent improvements. Most recently, in 2014, the Association established the Internal Audit department to bring systematic and disciplined independent evaluation of management's control environment. Internal Audit evaluates the adequacy and effectiveness of the Association's governance, risk management, and internal processes, as well as the quality of performance in carrying out assigned responsibilities to achieve stated goals and objectives. Further, Internal Audit assists management and the Board in the effective discharge of their duties by furnishing them with analyses, appraisals, and recommendations concerning the activities reviewed. The Director of Internal Audit reports directly to the Board and demonstrates the Association's commitment to transparency, accountability and continuous improvement.

In addition, TWIA created a communications department to ensure open and transparent communications with all stakeholder groups. TWIA has diverse stakeholders, and leadership values the interests of all. To that end, the Association has developed a multi-faceted communications strategy to engage each stakeholder group on multiple levels, an outreach program to educate and inform stakeholders about TWIA's mission, operations and values; and an Agent Advisory Group to solicit input from the agent community and facilitate discussion about TWIA initiatives.

Goals for 2015 include redesigning the TWIA website to be more user-friendly; hiring government relations liaison dedicated to legislative communications; and establishing the frequent, consistent internal communications necessary for continued cultural transformation.

Operational Improvements

Claims

The TWIA Claims Department has instituted sweeping changes over the last few years and continues to boost its operational capabilities. Hurricanes Dolly and Ike revealed shortcomings in prior procedures, including vendor management, catastrophe planning, quality assurance, and training, as well as with the level of managerial oversight present at that time. The new claims management team has addressed all of these areas and developed a detailed catastrophe plan, created a robust vendor management program, improved communications with policyholders, adjusters and agents, and increased speed and accuracy of claims handling via updated technology and quality control measures. The following list summarizes the Claims Department's accomplishments in these areas.

- Enhanced the Association's Catastrophe Plan from a simple outline to an extensive, enterprise-wide plan. Enterprise-wide testing is conducted annually; no significant findings have been made in 2014. Management is meeting with emergency management officials from each coastal county prior to the 2015 storm season to review plan, coordinate response efforts, and solicit feedback.

- Standardized the selection process for independent adjusting firms, issuing RFPs in 2011 and 2013. Current contracts require a firm to pay TWIA if it is unable to deliver the number of contractually promised adjusters in the event of a storm. The 2014 adjuster commitments total 6,626 TWIA-certified adjusters.

- Segmented the claim assignment process to ensure that claims are processed by staff with the appropriate experience levels and skills; claims are assigned to examiners based on line of business and claim complexity.

- Established objective performance standards and a quality assurance process to ensure that independent adjusters, inside examiners, and managers are investigating claims promptly and accurately; results are reported to senior leadership and the Board of Directors monthly.

- Developed Property Damage Evaluation Guidelines to provide uniform guidance to independent adjusters regarding TWIA standards of claim handling, customer service, communication, and professionalism.

- Required all adjusting firms to use the same estimating software (Xactimate) and implemented the associated workflow management technology (Xactware), thus allowing management to monitor cycle times, price changes within estimates, and other adjuster performance metrics.

- Created instructor-led adjuster training programs and online training options for both adjusters and examiners; certification of training is required annually. Established mandatory 10-hour-per-quarter training requirements for inside examiners.

- Implemented a team approach for claims with numerous buildings to ensure prompt and accurate investigations; teams are led by highly experienced executive general adjusters that coordinate a team of general adjusters and liaison with TWIA, the policyholder and their agent.

These changes have resulted in a verified, quantifiable improvement in customer service. TWIA Claims has implemented key performance metrics to objectively measure all claims handling processes, including a customer survey program with excellent results. These metrics include:

- average number of days from receipt of claim by TWIA to inspection of the property;
- average number of days from inspection to receipt by TWIA of the independent adjuster's report;
- average number of days from receipt of the adjuster's report to payment;
- TDI complaints as a percentage of claims received;
- disputed HB 3 claims as a percentage of claims received;
- field adjuster overall performance rating;
- field adjuster reinspection score;
- call center abandonment rate;
- quality assurance scores for inside claims examiners; and
- customer survey scores.

Underwriting

Beginning in late 2013, the new underwriting management team implemented significant operational changes to increase the efficiency and effectiveness of the underwriting process. Key accomplishments are outlined below.

- Simplified workflows in 2014 to eliminate seasonal backlogs and prevent them from occurring in the future.
- Reorganized workflows to assign work to underwriters based on line of business (residential or commercial); residential work is further divided by transaction complexity, ensuring that policy transactions are processed by underwriters with the appropriate experience levels and skills.
- Shifted from a compliance-oriented underwriting model to a risk-based model to ensure consistent decisions across the department and greater operational efficiency.
- Established performance standards and a quality assurance process to ensure that underwriters are adhering to underwriting rules and performance standards; results are reported to senior leadership and the Board of Directors monthly.
- Created a Support Services function to facilitate procedural improvements, automation support, training, quality assurance, agent audits, and fraud investigations.
- Created a dedicated vendor manager and agent services function to improve the department's vendor and agent relationships through communication, training, and quality assurance programs.
- Implemented risk visualization — a more efficient underwriting inspection process that improves assessments of insurability and premium adequacy, increasing the number of annual property inspections, lowering the average cost on a per policy basis, and providing underwriters with a greater volume of accurate data earlier in the underwriting process.
- Established required training hours for each underwriter (10 hours per quarter) to ensure continuous learning and a professional workforce; offered online training for agents.
- Created an agent audit function to verify agents' compliance with statutory eligibility requirements such as licensing, voluntary market declinations, and flood insurance requirements for certain areas.
- Restructured policy administration system project and incorporated an implementation plan to comply with the HB 3 requirement to simplify the renewal process for agents and policyholders.

The Association monitors the following key underwriting performance metrics and reports on them to leadership and the Board of Directors in a monthly scorecard:

- percentage of transactions completed within 14 days of receipt;
- agent and policyholder survey scores;
- budget conformity and cost per transaction; and
- quality assurance scores.

Other Areas

Claims and underwriting are the primary operation centers of an insurance company, but have not been the only areas of focus for operational improvements. Numerous initiatives in other areas have contributed to meeting strategic goals as well as addressing weaknesses noted in past audits. Key accomplishments are summarized below.

- Implemented policies and procedures to ensure proper controls of Association activities, including purchasing and contract management, public information, and complaint handling.

- Developed policies for ethics, conflicts of interest, and fraud reporting to foster a culture of ethical awareness, responsibility, and accountability.

- Established a policy management program to ensure each policy is reviewed annually, approved by management, and communicated properly to all employees, as well as to ensure version control necessary for auditing and incident management.

- Reduced legal costs and reliance on outside counsel by hiring in-house attorneys; insourcing E-Discovery and matter management functions; and implementing legal invoice review procedures.

- Increased timekeeping and leave balance accuracy and minimized potential FLSA liability exposure by implementing an integrated HR Information System with electronic time and attendance tracking and automated leave approval.

- Implemented a comprehensive performance management program that incorporates developing goals and competencies; conducting quarterly and annual reviews to ensure consistency in performance and outcome-focused accountability; and providing credible, objective criteria to align merit pay with performance.

- Developed training programs for managers and employees to foster a learning and continuously improving organization; this training includes the Association's first extensive new hire orientation program, online business skills training, and instructor-led training.

- Increased quality of new hires by implementing enterprise-wide recruitment and selection programs to effectively acquire and manage talent.

- Reduced costs and cycle times, and increased efficiency, by reengineering workflows and implementing new staffing models for print services and mail operations.

At an enterprise level, financial metrics are key measures of performance. The $183 million deficit recorded in 2012 was eliminated by December 2013, three months earlier than projected. Through October 31, 2014, TWIA has exceeded projected contributions to the Catastrophe Reserve Trust Fund (CRTF) by $69 million. The CRTF, along with premiums, is the first source from which funds are drawn to pay claims in the event of a catastrophe. These accomplishments are based in part on staff's successful budget conformity: TWIA-controllable expenses have been at or below budget each year from 2011 to 2013 and through October 31, 2014. Expenses compare favorably with both the insurance industry as a whole and other state residual market plans. Of the 37 property insurance plans in the U.S., TWIA maintains the third lowest cost per policy.

Through diligent efforts, staff has achieved several notable milestones concerning the Association's funding for the 2014 storm season and beyond, including:

- Projecting to contribute over $200 million to the CRTF as a result of 2014 operations, bringing the CRTF total to approximately $450 million for the 2015 storm season
- Issuing $500 million in Class 1 public securities to provide immediate claims-paying capacity after a storm, and
- Issuing the Association's first catastrophe bond as part of the overall reinsurance program, diversifying and expanding total claims-paying capacity.

Audit Results

In addition to the key performance indicators used to measure success internally, TWIA's operational improvements have been independently and consistently verified by external auditors in 2014.

Since 2008, TWIA has undergone more than a dozen independent audits and examinations with varying areas of concentration. Audits have focused on claims handling, underwriting, internal controls, IT systems and security, financial examinations, and actuarial rate reviews. TWIA has developed and diligently implemented corrective measures and created action plans to track and report the Association's progress in addressing all audit or exam recommendations. TWIA has addressed 100% of the recommendations outlined in the completed audits performed by TDI (2009-2011), Robert E. Nolan, Deloitte & Touche, the State Auditor's Office, KPMG, as well as the action items in the Operations Improvement Plan (a document assembled to track progress of recommendations and improvements arising from the Administrative Oversight process).

Earlier this year, TDI and Milliman completed audits of the Association's financial condition and internal controls, and the claims and underwriting functions, respectively. TWIA has received both final reports, which indicate excellent results and no negative findings. The TWIA Underwriting and Claims Departments have prepared action plans, provided them to TDI, and are actively working to implement improvement recommendations.

Through the initiatives implemented since 2011, TWIA management has replaced the previous culture with one dedicated to continuous improvement and accountability, better positioning TWIA to fulfill its mission. Excerpts from recent audit reports are included below:

- Milliman's September 2014 Underwriting report indicates that "under recent new management the Department appears to be committed to more efficient, customer/agent friendly process design and execution." It further states that auditors "believe that current Underwriting management has made extensive progress in improving underwriting effectiveness and service during the interim period in which significant changes in automation are being planned."

- Milliman describes TWIA's claims organization as "well-staffed and well-managed with good controls, procedures, and practices in place to ensure compliance with state law, TWIA's requirements, and sound industry claims handling practices." The report also indicates that the Quality Assurance & Training program, Vendor Management function, and Catastrophe Plan are comprehensive and effectively implemented.

- In March 2014, TDI amended the terms of Administrative Oversight, citing "TWIA's operational improvements" as a factor in its decision to reduce the scope of oversight.

- The State Auditor's Office August 2012 report states that TWIA "has improved its processing of claims. The Association also has controls to help produce accurate financial information, ensure accountability for Association funds, and adequately support and authorize non-claims-related expenditures. In addition, the Association's accounting practices for reporting selected financial transactions comply with the National Association of Insurance Commissioners' standards."

Legislative Recommendations

At the August 12, 2014 quarterly meeting, the Board directed the Legislative and External Affairs (LEA) Committee to develop potential legislative recommendations for the Board's consideration. The Committee convened on September 15, October 23, and December 2 and reviewed the Board's 2012 recommendations to the Texas Legislature, and researched and considered new recommendations. The recommendations approved by the TWIA Board of Directors are included in the table below; supporting detail for each recommendation may be found beginning on page 15.

Legislative Recommendations	
1	Remove the current restriction on the use of commercial paper through the Comptroller, which currently confines its use only in the event that TWIA is unable to sell the full amount of Class 1 Public Securities.
2	Clarify the language of Sec. 2210.6136, Alternative Sources of Payment, to avoid overlap of repayment streams in the event all or some of the Class 1 public securities cannot be sold.
3	Consider a policy surcharge in lieu of premium as revenue source for Class 1 public securities in order to save TWIA policyholders money.
4	Change the Level 2 and Level 3 funding layers to permit TWIA to use the portion of these funding layers that is made up of member insurer assessments to meet the immediate needs to pay catastrophe claims rather than using the member insurer funds to issue and repay debt.
5	Consider adopting additional, non-premium, non-reinsurance hurricane loss funding mechanisms – i.e., in addition to current funding methods – to improve TWIA finances to the point where the Association can pay claims in at least a 1/100 year event.
6	Provide to the TWIA Board the option to choose to go directly to the bond market for the issuance of public securities.
7A	Authorize TWIA to develop and adopt a depopulation program, subject to approval by the Commissioner, which permits the removal of policies from TWIA by private insurers through any combination of assumption reinsurance and/or offers of insurance made to TWIA policyholders at policy expiration. Adopt statutory language that makes it clear that all legal and contractual obligations under policies taken out of TWIA, whether by assumption reinsurance or at policy expiration, are obligations of the insurer assuming or taking the policy out of TWIA as of the effective date of the assumption, take-out or removal of the policy, even if TWIA continues to provide some services to the policy until it is renewed on the take-out insurer's policy.
7B	In order to increase the effectiveness of TWIA's depopulation programs, specify that insureds who receive a voluntary market offer for windstorm coverage are ineligible for coverage from TWIA provided that the offer includes comparable coverage and a premium within statutorily set parameters (e.g., no more than a certain percentage higher than the comparable TWIA premium). In addition, specify that if the offer is provided by a surplus lines carrier, the surplus lines carrier must have at least a

	minimum A7 rating from A.M. Best.
8	Consider requiring mandatory use of windstorm resistance building standards in the designated catastrophe area and authorizing sufficient means for the counties to enforce these building codes.
9	Extend the current WPI8 waiver program for residential property with an insured value of less than $200,000 through December 31, 2017 in order to give homeowners additional time to make any required improvements.
10	Consider requiring WPI-8 in all circumstances of new construction, structural reconstruction, or structural repair consistent with existing WPI-8 inspection requirements for properties located within the 14 coastal counties and other TWIA eligible coverage areas.

Supporting Detail

This section includes the detailed supporting documentation and analyses for each recommendation.

Recommendation 1

Remove the current restriction on the use of commercial paper through the Comptroller, which currently confines its use only in the event that TWIA is unable sell the full amount of Class 1 public securities.

The commercial paper program was developed in 2009 to provide quick access to funds to pay claims in the event of a catastrophic event. HB 4409, enacted in 2009, authorized the Comptroller to provide pre-event liquidity for obligations pursuant to the public securities program established for TWIA. TWIA worked with the Comptroller of Public Accounts and the Texas Public Finance Authority to establish a $300 million commercial paper program available for use by TWIA. In 2011, the statute was changed and the Comptroller's authority to provide liquidity was limited to public securities issued pursuant to the "drop down" provisions of statute (Section 2210.6136). Those provisions become effective only when TWIA is unable to issue the full amount of Class 1 public securities. This reduces the potential benefits of the commercial paper program by limiting usage to after a catastrophic event.

Amending the statute to eliminate this restriction would allow TWIA an additional option to improve liquidity, thus enhancing the Association's ability to pay claims timely. The additional liquidity provided by a commercial paper program makes it less likely that TWIA and its policyholders would experience a shortage of funds to pay claims pending the receipt of funds from the issuance of public securities.

Recommendation 2

Clarify the language of Sec. 2210.6136, Alternative Sources of Payment, to avoid overlap of repayment streams in the event all or some of the Class 1 public securities cannot be sold.

In 2011, HB 3 added Section 2210.6136 of the Insurance Code, Alternative Sources of Payment, also known as the "drop down provision." This section addresses the process the Commissioner of Insurance may use to approve the issuance of Class 2 public securities in the event the full amount of Class 1 public securities ($1 Billion) cannot be issued. The Texas Department of Insurance adopted rules to implement this section.

The current law and rules stipulate that premiums must be used to pay for Class 1 public securities and a combination of policyholder surcharges and member insurer assessments must be used to pay for Class 2 public securities. Under the drop down provision, TWIA would repay up to $500 million of Class 2 securities that were issued, from premiums after the initial payment from surcharges and assessments.

This process creates an administrative burden for the Association and member insurers to track the insurance consumers' surcharge payments so that repayments can be returned to them. As insureds change insurers and change locations it is foreseeable that many insurance consumers will not receive their repayment under this process.

Section 2210.6136 should be clarified to eliminate the requirement to repay the Class 2 public securities using the same revenue source required to pay Class 1 bonds.

Clarification should provide assurance to policyholders, potential buyers of the public securities, and other stakeholders of exactly what will happen if the full amount of Class 1 public securities cannot be issued.

A comparison with other states' residual markets with the ability to issue bonds shows that their revenue sources for bond repayment are other than premium, primarily policyholder surcharges and carrier assessments, both of which are viewed more favorably by bondholders and potential investors. As a result, they have no need of similar drop down provisions to successfully market their bonds.

Recommendation 3

Consider a policy surcharge in lieu of premium as revenue source for Class 1 public securities in order to save TWIA policyholders money.

Section 2210.612 specifies that TWIA shall pay Class 1 public securities from its net premium and other revenue. TWIA premiums are not a dedicated source of revenue for bond repayment. TWIA also is obligated to pay operating expenses and claims from its premiums and other revenue. A dedicated revenue source would result in reduced costs to TWIA policyholders because less money would need to be collected to fund repayment of Class 1 bonds.

A dedicated policy surcharge would reduce costs for TWIA policyholders. When TWIA writes a policy and collects the premium, it incurs some obligations that are a fixed percentage of premium, in particular, commissions paid to insurance agents and premium taxes paid to the State of Texas. Thus, in order for TWIA to generate a dollar to repay its debt obligations, TWIA must charge more than $1 to account for the commission and tax payments. It is estimated that TWIA would need to charge policyholders $1.21 of premium for every $1 dollar needed to repay bondholders. However, if the statute were amended to repay Class 1 public securities using a non-premium policy surcharge that is exempt from agent commissions and premium taxes, then TWIA would only need to collect $1 of surcharge for every $1 needed to repay bonds – a reduction of policyholders' costs of more than 17%.

A comparison with other states' residual markets reveals that TWIA is the only plan to fund bond repayment with premiums. Plans that have the ability to issue bonds typically support the issuance with either policyholder surcharges or industry assessments (or a combination thereof). These revenue sources are viewed by bondholders and investors as more secure payment streams.

Recommendation 4

Change the Level 2 and Level 3 funding layers to permit TWIA to use the portion of these funding layers that is made up of member insurer assessments to meet the immediate needs to pay catastrophe claims rather than using the member insurer funds to issue and repay debt.

Sections 2210.613 and 2210.6135 specify that Class 2 and Class 3 public securities be paid by member assessments in part and in whole, respectively. Specifically, 30% of the Class 2 public securities, which can be issued for up to $1 billion if needed, are to be repaid by member company assessments. Class 3 public securities can be issued for up to $500 million if needed, and 100% of Class 3 bonds are to be repaid by member company assessments. However, if TWIA simply uses the member company assessment dollars to pay policyholder claims, TWIA's liquidity would improve significantly. Using the member assessment portion of Class 2 and Class 3 funding to pay losses would enable TWIA to issue fewer bonds and avoid the delay, financing costs and uncertainty associated with issuing post-event bonds. This would greatly enhance TWIA liquidity, reduce the size of post-event public security issuances, reduce the amount of debt incurred by the association, and eliminate the interest and other debt-carrying costs associated with $800 million of public securities.

TWIA could receive funds necessary to pay claims within 30 days through member assessments whereas the issuance of bonds could require 90 – 120 days before funds are received

Paying assessments also would allow member insurers to remove the liability associated with these assessments from their books in the first year, rather than carrying it for up to 10 years as the bonds are repaid.

Recommendation 5

Consider adopting additional non-premium, non-reinsurance hurricane loss funding mechanisms – i.e., in addition to current funding methods – to improve TWIA finances to the point where the Association can pay claims in at least a 1/100 year event.

Chapter 2210 provides up to $2.5 billion of public securities funding for a given catastrophe year, in addition to TWIA premiums and other revenues, amounts in the Catastrophe Reserve Trust Fund, and any reinsurance purchased. For 2014, this combination of sources provides funding equivalent to a 70-year event. The statute is silent as to how any losses above this level would be funded. By comparison, most states would not allow a private insurer to sell property insurance in their state if the company had no plan for how to pay claims in a 1 in 100-year storm.

Increasing the total funding TWIA is authorized to raise in order to pay losses would remove some of the current uncertainty surrounding what would happen if losses exceeded available funding. The silence of the existing statute creates uncertainty for TWIA, its policyholders, bond investors and for the insurance market throughout the State of Texas.

The current funding structure places limits on TWIA's capability to raise funds after an event, and this naturally has raised concerns about how the promises will be fulfilled in the event of a major storm.

A review of other states' residual markets reveals that other states statutory funding mechanisms do not cap the amount of deficit funding available to their plans. For example, Florida's property residual market can sell as many bonds as it needs to pay its deficit without any explicit limit (however, the Florida plan does have some practical limits to its deficit financing, such as limits on the amount of the policy surcharges it is allowed to charge as a bond repayment revenue stream, bond market appetite, interest rates, etc.).

One potential method for increasing TWIA's available financing is to authorize the sale of Class 4 public securities to fund any TWIA deficit not alleviated by the use of Class 1, 2 and 3 funding sources. The Legislature would have to determine suitable revenue source to fund such bonds, but a number of other states' residual markets use statewide policy surcharges to fund such a less probable but rather large contingency.

Another source of revenue is the Rainy Day fund. In the event of a major catastrophe, a direct appropriation from the Fund or a loan with favorable repayment terms could ensure that TWIA has the funds needed to pay policyholders' claims.

Recommendation 6

Provide to the TWIA Board the option to choose to go directly to the bond market for the issuance of public securities.

Currently, a TWIA issuance of public securities must be approved by three state-created boards (TWIA Board, Texas Public Finance Authority Board, and the Texas Bond Review Board) as well as the Commissioner and the Attorney General. The practical impact of this multiple layers of review is that the TWIA Board cannot carefully consider the level of need for post-event bonds after a storm, as the Texas Public Finance Authority (TPFA) has advised the TWIA Board that it would take many months after the TWIA Board's bonding decision for the remaining steps to be taken. Because of this situation, each year the TPFA has asked the TWIA Board to pre-approve the issuance of all $2.5 billion of Class 1, Class 2, and Class 3 public securities prior to the beginning of the hurricane season. Such pre-approval does not occur in other states where their property insurance residual markets use bond financing for funding catastrophe losses. Other states' residual markets retain their own investment advisors and go directly to the bond market with their offerings with only the approval of their insurance commissioner. Florida's residual market, for example, uses this approach and has had an investment grade bond rating for many years.

After a catastrophic event TWIA needs to be able to issue bonds as quickly as possible to have funds to pay a large volume of claims. Allowing TWIA the option to choose to go directly to the bond market or use the TPFA allows the TWIA Board to determine the most efficient and effective means for obtaining funds to pay policyholders' claims.

Recommendation 7A

Authorize TWIA to develop and adopt a depopulation program, subject to approval by the Commissioner, which permits the removal of policies from TWIA by private insurers through any combination of assumption reinsurance and/or offers of insurance made to TWIA policyholders at policy expiration. Adopt statutory language that makes it clear that all legal and contractual obligations under policies taken out of TWIA, whether by assumption reinsurance or at policy expiration, are obligations of the insurer assuming or taking the policy out of TWIA as of the effective date of the assumption, take-out or removal of the policy, even if TWIA continues to provide some services to the policy until it is renewed on the take-out insurer's policy.

The TWIA Board of Directors has explored options for establishing a depopulation plan that would allow an insurer to assume a portfolio of TWIA policies as of a specific transaction date. Under a typical reinsurance assumption process in Texas, the assuming insurer 'steps into the shoes' of current insurer. This means the assuming insurer becomes the insurer on the policy but the coverage, conditions and other provisions of the insurance policy remain the same.

The plans considered by TWIA have been similar to the processes used successfully in Florida and Louisiana. In Florida, Florida Citizens Property Insurance Corporation (Citizens), the residual market insurer, enters into reinsurance loss portfolio transfers, essentially reinsurance contracts under which the private insurer takes over full responsibility for all losses under a block of Citizens policies. Under the contract, the private insurer also agrees to offer each of the policyholders a private market policy at their next policy renewal date.

When first entering into the portfolio transfer agreement, Citizens transfers the unearned premium on the block of policies to the private insurer that has assumed the risk. Citizens does not charge the assuming insurer a ceding commission, an amount typically paid by an assuming insurer to cover the costs of producing and issuing the policies (including agents' commissions). Therefore, the financial incentive for an insurer to remove policies from Citizens in this fashion is that the insurer gets to instantly have a large portfolio of policies without having to pay for the initial costs of building the book of business.

Due to certain protections provided solely to TWIA under HB 3, questions have arisen as to whether an insurer can assume a TWIA policy. This issue could be alleviated by amending the law governing TWIA to specifically permit insurers to assume the TWIA policy and all liabilities associated with the transfer of the policy.

The TWIA Board should be authorized by law to develop a depopulation plan subject to approval by the Commissioner of Insurance that addresses other important elements of a successful portfolio transfer plan such as the length of time an assuming insurer must offer coverage to the insured, requiring the policyholder to opt out of the assuming carrier's offer of coverage, provisions regarding rate changes applicable to assumed policies and any other provisions the Board and Commissioner deem necessary for the portfolio assumption transaction.

Another method for incentivizing insurers' depopulation efforts would be the extension of HB 3 claim protections to private insurers willing to take policies out of TWIA. House Bill 3, 82nd Texas Legislature, First Called Session, developed a new claims process for TWIA, including limitations on when claim issues may be brought to suit and the extent of damages that may be awarded in any lawsuit against TWIA (the specific limitations and penalties that may be raised in litigation against TWIA are found in Section 2210.576). These lawsuit limits do not apply to private market insurers.

Limiting the exposure to insurers by removing the threat of treble damages being awarded by a court of law could provide an incentive to insurers that may consider writing policies in the catastrophe area.

The requirement that appraisal must be used on accepted claim disputes with limited judicial review should also be beneficial to insurers as it would eliminate an entire category of claim disputes from litigation exposure.

Recommendation 7B

In order to increase the effectiveness of TWIA's depopulation programs, specify that insureds who receive a voluntary market offer for windstorm coverage are ineligible for coverage from TWIA provided that the offer includes comparable coverage and a premium within statutorily set parameters (e.g., no more than a certain percentage higher than the comparable TWIA premium). In addition, specify that if the offer is provided by a surplus lines carrier, the surplus lines carrier must have at least a minimum A7 rating from A.M. Best.

Pursuant to Chapter 2210, TWIA is required to make insurance coverage available only to applicants who are unable to obtain wind and hail insurance in the private market. Chapter 2210 also directs TWIA to function in a manner as not to be a direct competitor in the private market. To obtain insurance from TWIA pursuant to Section 2210.202, each applicant for TWIA coverage in the catastrophe area must make a diligent effort to obtain property insurance through the voluntary market. However, these "diligent efforts" need only be evidenced by one declination from an insurer writing property insurance, including windstorm and hail coverage, in the first tier coastal counties. A single declination of coverage is easy to obtain in the coastal region, so policies are readily put into TWIA for competitive reasons – i.e., for the cheaper premiums offered by TWIA – even if private market insurers were willing to write a particular policy. Obviously, to the extent consumers are choosing TWIA for reasons of price, the practice thwarts efforts to reduce TWIA's exposure.

To remedy this situation, the Legislature should consider making insureds who receive an offer from a voluntary market insurer ineligible for a TWIA policy if the offer includes substantially equivalent coverage. Making an applicant who receives a voluntary market offer for substantially equivalent coverage ineligible for a TWIA policy would help ensure that TWIA operates as the residual market insurer of last resort. Replacing TWIA policies with policies offered by private insurers would help reduce TWIA's policy count, exposure, and associated costs. Furthermore, adopting requirements that make policyholders ineligible for TWIA coverage if they receive comparable voluntary market offers would greatly assist TWIA in attracting private carriers to participate in depopulation programs. Private insurers would be more willing to invest the time and effort needed to develop TWIA depopulation plans if they could reasonably anticipate that a large percentage of policyholders would be likely to accept their offers of voluntary market coverage. Thus, adopting such an eligibility rule would enhance the effectiveness of TWIA's depopulation programs.

If the Legislature is concerned about the size of premium increases that consumers might be offered under a depopulation initiative, lawmakers could consider making mandatory TWIA ineligibility apply only if the offer is within a statutorily set parameter, such as no more than 15% higher than TWIA's quoted premium.

Recommendation 8

Consider requiring mandatory use of windstorm resistance standards in the designated catastrophe area and authorizing sufficient means for the counties to enforce these codes.

Underlying all of these legislative recommendations is the concern that TWIA could experience large losses that outstrip its ability to fund them under the current statute. However, few of the other recommendations attack the underlying problem at its most fundamental level – reducing the seacoast's vulnerability to loss. By reducing the magnitude of property losses in storms, enhanced building codes not only would reduce TWIA's probable maximum losses, but private market insurers also would have greater interest in insuring structures when the code is mandatory and they can rely on more resilient structures. When Miami-Dade and Broward Counties in Florida adopted some of the strongest wind resistance standards in the country in 1994, homes built in compliance with that code became much easier to insure than homes built before 1994.

If IBHS fortified building standards are adopted, lawmakers could consider allowing TWIA to offer premium discounts for structures built in compliance with the new code.

In addition, when new codes are adopted all areas of the state impacted by the new codes, not just cities, should receive ample resources and authority to enforce the codes and to contract with nearby towns, where needed, for code enforcement services.

Recommendation 9

Extend the current WPI-8 waiver program for residential property with an insured value of less than $200,000 through December 31, 2017 in order to give homeowners additional time to make any required improvements.

Extending the waiver program would provide TWIA policyholders more time to plan and save for any improvements needed to obtain a WPI8 or qualify for the Alternative Eligibility Program.

If the waiver program were extended, TWIA would communicate with impacted policyholders to make them aware of the new deadline and encourage them to begin planning now for the necessary work on their home's roof, siding, or exterior opening protection. By extending the deadline and giving homeowners an extended period to plan and save for the needed improvements, it is hoped that such a change would ease the financial burden on owners of homes valued at less than

$200,000.

Recommendation 10

Consider requiring WPI-8 in all circumstances of new construction, structural reconstruction, or structural repair consistent with existing WPI-8 inspection requirements for properties located within the 14 coastal counties and other TWIA eligible coverage areas.

If WPI-8 certifications were required for all new construction, reconstruction, and repairs in the coastal area (not just for TWIA applicants and policyholders), homeowners would be assured that all new structures built after the effective date would qualify for TWIA coverage in the event the building owner needs to apply for TWIA coverage at some future date.

Loss potential would be mitigated due to better structures in the aggregate and consumers would be better protected from future wind losses.

Standard markets also will have greater interest in insuring structures when the WPI-8 requirements are mandatory and they can rely on more resilient structures.