No. 07-0595

Official Order
of the
Commissioner of Insurance
of the
State of Texas
Austin, Texas

Date: JUL 11 2007

Subject Considered:

PETITION BY THE TEXAS WINDSTORM INSURANCE ASSOCIATION
REQUESTING APPROVAL OF A REINSURANCE PROGRAM
Docket No. 2667

General remarks and official action taken:

On July 2, 2007 came on for consideration by the Commissioner of Insurance (the Commissioner) a petition filed by the Texas Windstorm Insurance Association (TWIA) requesting approval of a reinsurance program to be effective June 1, 2007 to operate in addition to or in concert with the catastrophe reserve trust fund established pursuant to Insurance Code Section 2210.453. TWIA's reinsurance program approved in Commissioner's Order No. 06-0935 (September 1, 2006) expired on May 31, 2007.

Created in 1971 by the Texas Legislature, TWIA is composed of all insurers authorized to transact property insurance in this state and operates pursuant to Chapter 2210 of the Texas Insurance Code to provide windstorm and hail insurance to certain designated areas of the state. The purpose of TWIA is to provide adequate windstorm and hail insurance coverage to residents and businesses in areas of this state that the Commissioner has designated as catastrophe areas.

Section 2210.453(b) provides that with the approval of the Texas Department of Insurance (TDI), TWIA may establish a reinsurance program that operates in addition to or in concert with the catastrophe reserve trust fund established under Section

2210.452. Section 2210.056(b)(4)(B) allows TWIA to use its assets to purchase reinsurance.

On June 22, 2007, TWIA filed a petition (P-0607-05) requesting approval of a new reinsurance program to be effective from June 1, 2007 through May 31, 2008. TWIA's petition included the following documents: (i) a letter request from the general manager of TWIA that outlines the structure of a proposed three-layer reinsurance program; (ii) a graphic depiction of the proposed reinsurance program structure and terms; (iii) a summary of catastrophe modeling; (iv) the recommended final line assignment for reinsurers for layers one and two of the reinsurance program; (v) the proposed reinsurance contract; and (vi) the financial summary of each recommended reinsurer for layers one and two of the proposed reinsurance program.

On June 29, 2007, TWIA filed supplemental information including the following additional documents: (i) a letter from the general manager of TWIA describing the contents of the supplemental packet of information which includes information about the placement of layer three; (ii) a revised graphic depiction of the proposed reinsurance program structure and terms; (iii) the recommended final line assignments for reinsurers of layers one, two and three; (iv) the financial summary of recommended traditional reinsurers for layer three; (v) the financial summary of Allianz Risk Transfer, proposed to act as a front for Nephila Capital, a proposed reinsurer; (vi) a sample Bank of New York trust agreement to place assets in trust in order for Gamut Re to act as a reinsurer; and (vii) a sample irrevocable letter of credit drawn on LandesBank Hessen-Thuringen Girozentrale to provide collateralization for Arrow Capital Re to act as a reinsurer.

The reinsurance program submitted by TWIA on June 22, 2007, provides $1.5 billion in reinsurance coverage involving three layers. The first layer provides $500 million in coverage of losses in excess of $500 million dollars, the second layer provides $500 million in coverage of losses in excess of $1 billion, and the third layer provides $500 million in coverage of losses in excess of $1.5 billion. Under the proposed reinsurance program, TWIA would retain the first $500 million in coverage that would be payable through TWIA's existing premium and other revenue, the first $100 million assessment against TWIA member insurers under Insurance Code Section 2210.058(a)(1), and the next $400 million from the catastrophe reserve trust fund.

The supplemental information submitted by TWIA on June 29, 2007, provides additional information pertaining to the placement and authorization of the third layer of reinsurance. The supplemental information included authorization for the placement of $208,125,000 in reinsurance. The supplemental information indicated that this layer would pay in conjunction with a $200 million assessment against TWIA member insurers under Insurance Code Section 2210.058(a)(3) and a $91,875,000 assessment against TWIA member insurers under Insurance Code Section 2210.058(a)(4).

Under the proposed reinsurance program, the contract for the first two layers provides for a term of 12 months and includes a provision for coverage including automatic reinstatement of any amount exhausted by loss for an additional premium calculated at pro rata of the annual premium for the excess layer as respects the fraction of indemnity exhausted. The same contract terms apply for the reinstatement of $163,125,000 in reinsurance coverage within the proposed third layer. The remainder of the reinsurance funds in the proposed third layer, $45 million, relies on sources of non-traditional capital, and as to these funds for reinsurance, the contract provides for a term of 12 months but will not include a reinstatement of any amount exhausted by loss.

In the first two layers, only reinsurers that are rated "A-" or better by A.M. Best or Standard & Poor's and maintain adequate surplus are proposed to participate in the program. All reinsurers in the first two layers meet a $150 million minimum net worth requirement with net worth ranging from $358.5 million to $5.6 billion. Almost half of the reinsurers in the first two layers have a net worth of at least $1 billion. All of the proposed Lloyd's syndicates are secured by a trust established in the United States that has a surplus in excess of $100 million. Some of the reinsurers in the first two layers are proposed to participate in the third layer, which is proposed to fund $208,125,000 in additional reinsurance. Two traditional reinsurers, both rated "A-" or better by A.M. Best, both with a net worth greater than $1 billion, are proposed to participate in the third layer of reinsurance. Another proposed participant in the third layer is a Lloyd's syndicate which operates under the same parameters as the Lloyd's syndicates participating in the first two layers. Collectively, these reinsurers are offering coverage of $163,125,000 in funding for the third layer. The remaining $45 million of the proposed third layer relies on sources of non-traditional capital as follows: $20 million of funding proposed to be provided by Allianz Risk Transfer acting as a front for Nephila Capital, $5 million of funding proposed to be provided by Gamut Re through a Bank of New York trust agreement; and $20 million of funding proposed to be provided by Arrow Capital Re backed by an irrevocable letter of credit drawn on LandesBank Hessen-Thuringen Girozentrale. Financial information was provided for Allianz Risk Transfer, but not for Nephila Capital, Gamut Re, or Arrow Capital Re.

The premium for all three layers of reinsurance is payable in four equal installments on June 1, September 1 and December 1 of 2007, and March 1, 2008. The estimated cost of the proposed reinsurance program for the first two layers is $150.8 million. The estimated cost of the proposed reinsurance program for the third layer is $19,147,500. The total cost of all three layers of the proposed reinsurance program is $169,947,500.

TWIA's liability is now in excess of $46 billion. The dramatic growth of the TWIA's probable maximum loss is an immutable cause for concern for the various stakeholders in the property and casualty industry. At the time of the consideration of the 2006 – 2007 reinsurance program, TWIA's liability was estimated to be in excess of $28 billion. The liability in Galveston and Brazoria Counties has increased by approximately $9 billion. It should also be noted that these two counties account for approximately 50% of TWIA's current liability, which highlights a concentration of risk vulnerable to a single storm.

As TWIA's direct liability grows, the potential for an unlimited assessment against TWIA members increases if the amount of reinsurance and other resources of TWIA do not grow at a similar pace. An unlimited assessment would have an undesirable effect on the voluntary market for property and casualty insurance and on the state as a whole.

If a catastrophic event causing $1.5 billion in losses were to occur, and TWIA had not purchased $1 billion in reinsurance coverage, TWIA would be able to pay approximately $150 million toward losses that otherwise would have been used to pay for reinsurance coverage. However, the member insurers would have to cover $850 million in additional unreinsured losses via assessments. Such losses could impel carriers to pass costs along to its policyholders or in some cases, face solvency pressures. TWIA's failure to purchase adequate reinsurance does not simply raise an issue of potential risk to carriers, but potentially may increase insurance costs to consumers purchasing property and casualty insurance in this state. An exposure of the property and casualty industry at a low threshold to unlimited TWIA assessments may have the undesired consequences of raising rates for all property and casualty policyholders throughout the state and obligate insurers to reevaluate their business plans for providing coverages within the state.

An unlimited assessment may cause a decrease in general revenue to the state due to the availability of premium tax credits under Section 2210.058(c) of the Insurance Code. The operation of the reinsurance program in addition to or in concert with the catastrophe reserve trust fund may prevent or delay a loss of revenue to the State of Texas, and will make additional funds available for payment of losses in the event of a catastrophic storm.

However, in considering the appropriate amount of reinsurance to purchase, it is important to note that although reinsurance benefits the State of Texas and TWIA member companies and their policyholders, funding for the purchase of reinsurance comes exclusively from the TWIA policyholders, and represents an expenditure that is relevant for one year only. Some concern is due to the coverage amount and cost of the reinsurance program. The overall estimated premium for the coming year is $169,947,500, as compared to $69,504,809 for last year. The Department of Insurance is asked to approve the purchase of reinsurance costing a hundred million dollars more than last year. Despite the magnitude of the expenditure, the proposed reinsurance program is not sufficient to fund even a 50 year storm without resorting to member insurer assessments at a level that would qualify for premium tax credits. At the same time TWIA's liability has approximately doubled and the anticipated premium to be collected has also doubled. This illustrates the limitations of attempting to offset ever-increasing probable maximum losses through the purchase of greater amounts of reinsurance, and any approved program has to be regarded as a stop-gap measure.

Given the incomplete subscription to the third layer of reinsurance, its reliance in part on non-traditional reinsurance mechanisms, and the fact that a portion of that coverage is not subject to reinstatement, the purchase of the third layer of reinsurance is not appropriate. However, purchasing layers one and two of the reinsurance proposal is warranted based upon the available evidence.

Despite the current stop-gap expenditure to continue TWIA's relatively equal coverage position as compared to the 2006-2007 reinsurance program, the effective and efficient operation of TWIA must prepare for the impending circumstances and conditions which have dramatically increased the liability of TWIA. Efforts must be seriously considered to address the increased liability and the economic stability of TWIA based on its dependence upon traditional funding sources such as member company assessments, reinsurance, and the general revenue of the state.

Long term planning is necessary and should be conducted to provide both cost effective and adequate funding for TWIA. The dramatic growth in the probable maximum loss for TWIA and the increased concentration of risk call for measures to manage expenses and operations in a manner that ensures that TWIA's viability is not threatened by catastrophic loss.

Based on the information filed in petition P-0607-05 and the testimony and exhibits submitted at the hearing of July 2, 2007, the Commissioner has determined in accordance with the authority granted in Section 2210.453 of the Insurance Code that a reinsurance program consisting of the first two layers of the reinsurance proposal as detailed in petition number P-0607-05 should be approved.

IT IS THEREFORE ORDERED by the Commissioner of Insurance that a reinsurance program consisting of the first two layers of the reinsurance proposal as detailed in petition number P-0607-05 is hereby approved. The third reinsurance layer is not approved as part of the reinsurance program.

IT IS FURTHER ORDERED that the Texas Windstorm Insurance Association's reinsurance program be effective June 1, 2007.

ANY OTHER RELIEF NOT HEREIN GRANTED IS DENIED.

AND IT IS SO ORDERED.

TEXAS DEPARTMENT OF INSURANCE

Mike Geeslin

MIKE GEESLIN
COMMISSIONER OF INSURANCE

RECOMMENDED BY:

Marilyn Hamilton

Marilyn Hamilton
Associate Commissioner
Property and Casualty Program

AND

Tony Trevino

Tony Trevino
Interim Chief Examiner

Attest:

Gene C. Jarmon

Gene C. Jarmon
General Counsel and Chief Clerk
Texas Department of Insurance

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