

SUBCHAPTER E. TEXAS WINDSTORM INSURANCE ASSOCIATION

DIVISION 3. LOSS FUNDING, INCLUDING CATASTROPHE RESERVE TRUST FUND, FINANCING ARRANGEMENTS, AND PUBLIC SECURITIES 28 TAC §§5.4101, 5.4102, 5.4111 - 5.4114, 5.4121, 5.4131 - 5.4134, and 5.4141 - 5.4147

1. INTRODUCTION. The Commissioner of Insurance (Commissioner) adopts new §§5.4101, 5.4102, 5.4111 - 5.4114, 5.4121, 5.4131 - 5.4134, and 5.4141 - 5.4147 to implement legislative changes to the Insurance Code Chapter 2210 under House Bill (HB) 4409, 81st Legislature, 2009 Regular Session, and amend the plan of operation of the Texas Windstorm Insurance Association (Association). These sections concern the funding of losses and operating expenses in excess of the Association's premium and other revenue under Subchapters B-1, J, and M, Chapter 2210, Insurance Code. Matters addressed in the plan of operation amendments include: (i) the Catastrophe Reserve Trust Fund (CRTF); (ii) financing arrangements; (iii) issuance of public securities; (iv) use of public securities proceeds; and (v) payment of public security obligations. Sections 5.4111, 5.4121, 5.4131, 5.4132, 5.4141, 5.4144, 5.4145, and 5.4147 are adopted with changes to the proposed text published in the July 23, 2010 issue of the *Texas Register* (35 TexReg 6476). Sections 5.4101, 5.4102, 5.4112 - 5.4114, 5.4133, 5.4134, 5.4142, 5.4143, and 5.4146 are adopted without changes. This adoption does not address comments made with respect to proposed new 28 TAC §§5.4161 - 5.4167, 5.4171 - 5.4173, and 5.4181 - 5.4192 published in the July 30, 2010 issue of the *Texas Register* (35 TexReg 6611), including those comments that were presented at the August 24, 2010 hearing. In conjunction with this adoption, the

Commissioner has also adopted the repeal of §§5.9901 - 5.9906 of this chapter in a separate order published in this issue of the *Texas Register*.

2. REASONED JUSTIFICATION. The sections are necessary to implement legislative changes to the Insurance Code Chapter 2210 under HB 4409, 81st Legislature, 2009 Regular Session. The adoption also creates a more efficient rule structure by grouping Association loss funding mechanisms in this division.

To implement HB 4409 it is necessary to amend the plan of operation to address the following: (i) deposits to and disbursements from the CRTF, including deposit of premium surcharges collected under the Insurance Code §2210.259; (ii) financing arrangements; (iii) issuance of public securities; (iv) use of public securities proceeds; and (v) payment of public securities.

To effect these necessary amendments, the following sections become part of the Association's plan of operation: (i) §5.4101, which provides that the adopted sections in this division are part of the plan of operation and shall control over conflicting provisions in the Association's current plan of operation; (ii) §5.4102, which defines terms used in this division; (iii) §§5.4111 - 5.4114, which amend and update the procedures and requirements of repealed §§5.9903 - 5.9906 related to the CRTF; (iv) §5.4121, which addresses financing arrangements authorized under the Insurance Code §2210.072, including the Association's ability to pay and secure the payment of these financing arrangements with public security proceeds; (v) §5.4131, which establishes the procedure for the Association to determine the amount of public

securities to be requested, obtain Commissioner approval before requesting the issuance of public securities, and request the public securities from the TPFA; (vi) §5.4132, which provides a summary of activities that the TPFA will be responsible for concerning the issuance of public securities; (vii) §5.4133 and §5.4134, which set forth a procedure for the Association to request the use of the public security proceeds for the payment of incurred claims and operating expenses of the Association, as well as the uses for excess public security proceeds; (viii) §5.4141 and §5.4142 which set forth the funding of the revenue obligation fund for class 1 public security obligations and the disposition of excess class 1 revenue obligation fund amounts; (ix) §§5.4143 - 5.4145 which set forth the funding of the revenue obligation fund for class 2 public security obligations and the disposition of excess class 2 premium surcharge and member assessment amounts; and (x) §5.4146 and §5.4147 which set forth the funding of the revenue obligation fund for class 3 public security obligations and the disposition of excess class 3 revenue obligation fund amounts. Each of the new sections is explained in subsequent discussions.

Additionally, the sections create a more efficient rule structure by grouping Association loss funding mechanisms in this division. This includes moving existing requirements related to the CRTF into this division as new §§5.4101, 5.4102, and 5.4111 - 5.4114. The requirements related to the CRTF were set forth in §§5.9901 - 5.9906 of this chapter. In conjunction with this adoption, §§5.9901 - 5.9906 have been repealed in a separate order published in this edition of the *Texas Register*.

The sections are necessary for the orderly and timely funding of insured losses on Association windstorm and hail insurance policies. Under §2210.001 of the

Insurance Code, the Legislature has determined that the provision of windstorm and hail insurance is necessary for the economic welfare of the state and its inhabitants, and that the lack of such insurance in the state's seacoast territories would severely impede the orderly growth and development of the state. The Association was created by the Legislature and serves as a residual insurer of last resort for windstorm and hail insurance coverage (insurance coverage) in the catastrophe area designated by the Commissioner under the Insurance Code §2210.005. The catastrophe area is underserved for insurance coverage and consists of the 14 Texas coastal counties and parts of Harris County. Persons seeking insurance coverage from the Association are unable to obtain comparable insurance coverage in the voluntary insurance market. The ability to obtain insurance coverage that will provide coverage for losses resulting from windstorm and hail is crucial to the financial welfare of persons living and working in the designated catastrophe area. The absence of such coverage providing for the payment of losses results in the lack of an important element for economic stability in the region.

House Bill 4409 substantially amended how Association losses and operating expenses in excess of premium and other revenue are funded in new Subchapters B-1 and M, Chapter 2210, Insurance Code. Compliance with these requirements is essential to assure the availability of Association insurance coverage for all eligible persons and properties. The sections implement the legislative loss funding scheme. Thus, adoption of these sections affects the economic welfare of the state and its inhabitants, and positively impacts the orderly growth and development of the state.

The Association operates under a plan of operation which is adopted by rule. The Insurance Code §2210.151 provides that the Commissioner shall adopt by rule the Association's plan of operation to provide Texas windstorm and hail insurance in the catastrophe area. The Insurance Code §2210.152(a)(1) sets out the requirements of the plan of operation and specifies that the plan of operation must provide for the efficient, economical, fair and nondiscriminatory administration of the Association. Further, the Insurance Code §2210.152(a)(2)(G) provides that the plan of operation may include other provisions considered necessary by the Department to implement the purposes of Chapter 2210.

Historically the Association's plan of operation has been specified in §5.4001 of this chapter (relating to Plan of Operation). Neither the Insurance Code §2210.151 nor §2210.152 require the Association's plan of operation to be in a single section of the Administrative Code. With the adoption of HB 4409 related requirements in §§5.4902 - 5.4908 and 5.4911 of this chapter (relating to Additional Requirements; Declination of Coverage; Flood Insurance, Minimum Retained Premium, Certificate of Compliance Approval Program, Certificate of Compliance Transition Program, Alter and Alteration; and Insurance Policy Forms, Endorsements, Manual Rules, Application Forms, and Underwriting Guidelines; respectively), the Department began to revise the format of the plan of operation into sections related to specific topics. Sections 5.4902 - 5.4908 and 5.4911 were adopted to control over conflicting provisions in §5.4001. The sections in this adoption have similar language with respect to control over §5.4001.

As stated, HB 4409 substantially amended how Association losses and operating expenses in excess of premium and other revenue are funded. It is

necessary that these new requirements, which amend or augment the Association's existing plan of operation, be integrated into the plan of operation. The adopted sections integrate these requirements into the plan of operation.

§5.4101. Applicability. As previously discussed, the Association operates under a plan of operation. Section 5.4101(a) provides that the sections in this division shall be considered to be a part of the Association's plan of operation and shall control over any conflicting provision in §5.4001 of this title. It is necessary to adopt the sections in this division as controlling and additional provisions separately from the existing plan of operation to maintain flexibility in implementing the necessary legislative changes and to avoid potential internal conflicts with §5.4001. Revisions to §5.4001 will be addressed at a later date. Section 5.4101(b) is based on repealed §5.9906(e) and provides that the Department retains regulatory oversight of the Association as required by the Insurance Code Chapter 2210, notwithstanding any provision in 28 Texas Administrative Code, Chapter 5, Subchapter E. This provision clarifies regulatory authority in situations where the Association is required to work with the Texas Public Finance Authority (TPFA), the Comptroller of the State of Texas (Comptroller), and the Texas Treasury Safekeeping Trust Company (Trust Company).

§5.4102. Definitions. Section 5.4102 defines terms for use in this division. This section is necessary to ensure that the terms are used uniformly and avoid unnecessary repetition in the sections. The definitions are derived in part from repealed §5.9902, which have been updated as necessary; the Insurance Code Chapter 2210; and information provided to the Department from the TPFA. The adoption does not substantively redefine terms used in Chapter 2210; however, the

definitions have been adapted for use in this division. Additionally, the definitions use terminology TPFA has provided the Department so that, to the extent possible, items may be referred to consistently in these sections and documents TPFA prepares to implement the purposes of HB 4409 and these rules.

§5.4111. Operation of the Catastrophe Reserve Trust Fund. Section 5.4111 is substantially a restatement of repealed §5.9903 of this chapter and incorporates these provisions into the Association's plan of operation. Section 5.4111(a) identifies the basic responsibilities of the various parties involved in the deposit of funds into the CRTF and the status of the deposited funds.

Section 5.4111(b) has been amended from the repealed text in §5.9903(b) of this chapter to reflect that: (1) under the Insurance Code §2210.452, as amended by HB 4409, the Association no longer contributes the net equity of its members to the CRTF, but rather the Association's net gain from operations; (2) under the Insurance Code §2210.259, as added by HB 4409, the Association must deposit into the CRTF a premium surcharge on certain insured property; and (3) the Association may at some point be required to deposit excess public security proceeds, premium surcharge revenue, and member assessment revenue into the CRTF.

In response to a comment that §5.4111(b)(1) did not include a statement that the Association could use the net gain from operations to purchase reinsurance, the text of proposed §5.4111(b)(1) has been changed to indicate that the statute may allow alternative uses of the Association's net gain from operations. Proposed §5.4111(b)(1) restates repealed §5.9903(b)(1) of this chapter, which was adopted effective August 21,

2000, in 25 TexReg 8031. At the time §5.9903 was adopted, the language in the then existing Insurance Code Article 21.49 §8(i)(3) provided that the Association would pay the net equity of its members to fund a commissioner approved reinsurance program or to the CRTF. This is substantively the same requirement that is now set forth in the Insurance Code §2210.452(c), which provides that the Association shall pay the net gain from operations to purchase reinsurance, or to the CRTF, or to both. Members' net equity and the Association's net gain from operations are both "all premium and other revenue of the Association in excess of incurred losses and operating expenses." Thus, although the statutory change from "members' net equity" to "Association's net gain from operations" is significant for reasons such as federal income taxation, the change did not affect the deposit of funds to the CRTF, purchasing reinsurance, or the method of determining the amount of funds involved.

The Association has made deposits into the CRTF and purchased reinsurance in a routine manner without incident since the adoption of repealed §5.9903(b)(1). Thus, changing the text in §5.4111(b)(1), which restates that prior language, raises concerns as to unforeseen consequences. Reinsurance has been considered an operating expense of the Association and has been paid in quarterly installments. Listing reinsurance in §5.4111(b)(1) could be interpreted as changing these prior practices and limiting reinsurance purchases only to the funds that might be available from the Association net gain from operations at year-end. If reinsurance were to be considered payable solely from the Association's potential net gain from operations, the purchase of reinsurance could become uncertain even when prudent. This could potentially place the Association at a significant financial risk. Further, a reference to reinsurance

purchases in §5.4111(b)(1) could be confusing, because this section addresses only deposits into the CRTF and does not address the procedure or requirements for the purchase of reinsurance. Therefore, as discussed, the text has been changed to simply reference that the statute may provide other alternatives, rather than introducing new material and raising the question that the section establishes a procedure or requirement concerning the purchase of reinsurance.

Section 5.4111(b)(2) sets forth the requirement that the Association is to pay the Insurance Code §2210.259 premium surcharge directly to the CRTF. Although the Insurance Code §2210.259 requires that the collected premium surcharge amounts be deposited into the CRTF, the statute does not directly include these amounts within the scope of the CRTF deposit requirement in the Insurance Code §2210.452, nor does the statute state the frequency of these deposits. Although it is within the Commissioner's authority to establish a requirement, the adopted sections also do not impose a requirement as to the frequency or timing of when the §2210.259 premium surcharge deposits must occur. Rather, §5.4111(b)(2) allows for flexibility providing that the Association deposit the funds on a schedule that is agreeable to the Comptroller and the trust company. Finally, because these premium surcharges are not gross premium or other revenue of the Association, but instead are just held by the Association pending deposit in the CRTF, §5.4111(b)(2) requires the Association to account for these funds separately and to pay all investment income earned on the funds into the CRTF.

Section 5.4111(b)(3) addresses the situation that the Association may at some point be in possession of excess public security proceeds, excess premium surcharge

revenue, and excess member assessment revenue. The Insurance Code §2210.608 and §2210.611 and §§5.4144, 5.4145, and 5.4147 of this division authorize that the excess funds be deposited into the CRTF.

Because HB 4409 amendments to the Insurance Code §2210.454 repealed references to funding the annual mitigation and preparedness plan, §5.4111 does not include references to that plan which were in §5.9903. Section 5.4111 also makes nonsubstantive updates to statutory references and uses terminology more consistent with this adoption generally.

§5.4112 and §5.4113. Termination of Catastrophe Reserve Trust Fund and Investments of Catastrophe Reserve Trust Fund. Section 5.4112 is substantially a restatement of repealed §5.9904 of this chapter and is consistent with the requirements of the Insurance Code §2210.452(d) concerning termination of the CRTF. Section 5.4113 is substantially a restatement of repealed §5.9905 of this chapter concerning the investment of funds in the CRTF. The sections make nonsubstantive updates to statutory references and use terminology more consistent with this adoption generally.

§5.4114. Duties and Responsibilities. Section 5.4114 is based on repealed §5.9906 of this chapter and sets forth the duties and responsibilities of the Commissioner, the Association, the Comptroller, and the Trust Company in authorizing the release of CRTF funds. The section does not change the procedural requirement set forth in the repealed rules that the Association must request the CRTF funds through the use of a definitive statement. The section, however, has been amended to reflect the current order of loss funding sources set forth in the Insurance Code

§2210.071, as added by HB 4409; and not the order that was required under the Insurance Code §2210.058, which was repealed by HB 4409. Because of the new statutory requirements, the Association need only determine that losses exceed the Association's premium and other revenue and available reinsurance proceeds before requesting the CRTF funds. The reference to "available reinsurance proceeds" in this section and other sections in this adoption should not be construed as directing the Association to purchase reinsurance. Rather, it is a statement that reinsurance proceeds may be available to pay claims prior to relying on the CRTF under the Insurance Code §2210.071(b) or other funding sources under the Insurance Code §§2210.072 - 2210.074. This is consistent with the Insurance Code §2210.453 which provides that the Association may purchase reinsurance that operates in addition to or in concert with the CRTF, public securities, and financial instruments authorized by the Insurance Code Chapter 2210. It is conceivable that in the future the Association may determine that purchasing reinsurance is financially prudent and cost effective to protect against a single occurrence or series of occurrences that would deplete the entire CRTF.

Section 5.4114(c) is substantially a restatement of §5.9906(d), except that the section provides that the Commissioner, rather than the Department, shall make the determination to release the CRTF funds. This is consistent with §5.4114(b). Further, §5.4114(c) does not restate the language in §5.9906(d) that could be read as limiting the Commissioner's ability to consider information in making the determination to release CRTF funds to reliance only on statements or notices of definitive or estimated losses "provided by the Association's general manager" and "made for that purpose."

The prior language was inconsistent with the premise of “any statement” and further there is no applicable statute proscribing the Commissioner’s reliance on any statement from any source that the Commissioner determines to be persuasive. The section does not reflect §5.9906(e) because that provision has been adopted as §5.4101(b). The section also does not reflect §5.9906(f), because member assessments are not addressed in this section. Finally, the section also makes nonsubstantive updates to statutory references and uses terminology consistent with the current statute and this adoption generally.

§5.4121. Financing Arrangements. The Insurance Code §2210.072 and §2210.612, as added by HB 4409, provide that the Association may enter into financing arrangements directly with a market source for the purpose of enabling the Association to pay losses or obtain public securities under the Insurance Code §2210.072. The Insurance Code §2210.072 and Subchapter M of Chapter 2210 of the Insurance Code also authorize the TPFA to enter into financing arrangements by issuing public securities on behalf of the Association. In particular, the Insurance Code §2210.072 and §2210.612 reference commercial paper, which is issued by the TPFA and defined in the Insurance Code §2210.603 as a class 1 public security. Section 5.4121 relates only to the Association entering into financing directly with a market source. The section does not affect, nor should it be construed as affecting, the TPFA’s ability to enter into financing arrangements by issuing public securities on behalf of the Association as authorized in Chapter 2210.

The Association has had financing arrangements in the past. These prearranged financing arrangements provided the Association with immediate cash to

be paid on initial loss claims and additional living expense claims following prior catastrophic events. The financing arrangements were in turn paid from the Association's collected premium, reinsurance proceeds, or member assessments. These arrangements were known to the Legislature in enacting HB 4409. Section 5.4121 is consistent with the Insurance Code §2210.072 in providing that the Association may continue to enter into financing arrangements separately from public securities issued by the TPFA.

Section 5.4121(a) has been changed from the proposed text based on comments. The revised subsection provides that the Association may enter into financing arrangements that the Association's board of directors has approved in advance and further limits the section to financing arrangements entered into based on the Insurance Code §2210.072. The additional limitation of prior approval by the board of directors is intended to provide additional transparency concerning the Association's loss funding resources. The revision that this section applies to financing arrangements entered into based on the Insurance Code §2210.072 corresponds to the overall purpose of this division, which is to address excess loss funding. Section 5.4121 has not been revised to limit the allowable types of financing arrangements at this time. The Legislature provided the Association with wide latitude as to the type of financing arrangements. Attempting to pre-determine the arrangement as to either type or amount may result in forcing the Association into less fiscally prudent or beneficial arrangements than may otherwise be available to the detriment of the Association's policyholders.

Section §5.4121(b) sets forth the funds that may be used to repay the financing arrangement. As indicated in the listing in §5.4121(b) any premium, asset, financial arrangement, reinsurance, or class of public security proceed collected by the Association may be used to repay the financing arrangement. First amongst these is the Association's collected premium and other revenue as authorized in the Insurance Code §2210.056. The Association may also refinance or enter into a new financing arrangement and use those proceeds to pay off an existing financing arrangement; however, payment of the obligation would ultimately be made from another source of funds. Also, because a financing arrangement under the Insurance Code §2210.072 would be triggered by excess loss payments, the Association may also have reinsurance recoveries that could be used to pay the debt. However, because the financing arrangements discussed in this section arise under the Insurance Code §2210.072, it is likely that the Association will have insufficient premium and other revenue to fund the financing arrangement when due in addition to loss payments, operating expenses, and the repayment of public securities. If the financing arrangements could not timely be repaid in such circumstances, lenders would not make the funds available.

The Association's loss funding scheme has two required layers, the Association's available premium and the CRTF, followed by public security debt. The funding scheme does not require the Association to enter into financing arrangements nor are the amounts of public securities authorized to be issued or issuable based on market conditions affected by financing arrangements. The use of financing arrangements simply expands the Association's options and allows the Association to

pay losses that the Legislature has allocated to public security funding on a timelier basis. It is not reasonable to interpret the Insurance Code §2210.072 as authorizing the continuance of a known means of immediate funding using financing arrangements, but then not also authorizing the means to repay those financing arrangements from the most viable source of funds in the very situation described by §2210.072.

The Insurance Code §2210.072(c) provides that “[I]f the losses are paid with public securities described by the section, the public securities shall be repaid in the manner prescribed in by Subchapter M from association premium revenue.” The repayment of public securities issued under the Insurance Code §2210.072 is addressed in the Insurance Code Chapter 2210, Subchapter M, §2210.612. That section refers only to the repayment of public securities and the issuance of commercial paper, which is defined as a public security in the Insurance Code §2210.602(2). These provisions do not address the repayment of financing arrangements and thus do not limit the source of funds to the Association’s premium revenue. Rather, the Insurance Code §2210.056 and §2210.608 provide alternative sources of funds for the repayment of financial instruments used to pay the Association’s losses.

The Insurance Code §2210.608 authorizes public security proceeds to be used for the payment of the Association’s incurred claims and operating expenses. Additionally the Insurance Code §§2210.072 - 2210.074 authorizes the use of public securities to pay losses. In this context, “losses” includes both loss payments and “incurred claims and operating expenses.”

The Association's financing arrangements provide funding to pay losses. The character of this usage does not change upon payment of the loss. The Insurance Code Chapter 2210 does not prohibit or restrict the Association or TPFA from paying or refinancing Association issued financing arrangements with public security proceeds. This would include situations in which the only available funds to refinance the financing arrangement would result from a class 2 or 3 public security, such as in the case of a subsequent storm occurring after the entire issuable amount of class 1 public securities had been issued to provide for prior losses. Otherwise, if the Association is required to limit payment of its financing arrangements only to the proceeds of class 1 public securities, the Association would need to deliberately limit the amount of its class 1 public security borrowings so as to maintain a future reserve for the repayment of financial instruments necessary to provide for the immediate payment of claims following a potential subsequent catastrophic event in that year. Such a determination is not consistent with the statute nor is it necessary under the funding scheme created by the Legislature. The placement of financing arrangements in §2210.072 also does not limit the repayment of financial arrangements, as discussed. Rather, the placement is directive to the Association that if it is to use financial arrangements they are to be used to provide initial excess loss funding. Therefore, §5.4121 clarifies that in addition to premium, other revenue, other assets, and available reinsurance proceeds, the Association may pay for a financing arrangement with the proceeds of any class of public security.

Section 5.4121(c) provides that the Association may secure financing arrangements with a collateral assignment and security interest in and to all or any

portion of the Association's right, title, and interest in and to all proceeds of any or all class 1 public securities, class 2 public securities, and/or class 3 public securities. Based on comments received, §5.4121(c) has been changed from the proposed text to add "assets, including without limitation, all or any portion of the Association's" after the word "Association's." This additional text clarifies that the Association may secure the financing arrangement with the Association's assets, (primarily premium and other revenue) in addition to class 1 public securities, class 2 public securities, and/or class 3 public security proceeds.

Such a collateral assignment and security interest is likely to be required in order to obtain a financing arrangement because the Association's premium and other revenue may be secured to fund the class 1 public security obligation revenue fund, as provided in §5.4141. It is probable that the Association's only source of funds for the payment of the financing arrangement that was used to promptly fund the initial catastrophic claims will be the proceeds of a public security. It is reasonable for the Association to secure proceeds to pay catastrophe claims pending the completion of the arrangement, issuing, and funding of the public securities. Therefore, the market source might reasonably request that its repayment be secured in the assets of the Association and the proceeds of the public securities that are issued to fund the catastrophic losses.

§5.4131. Issuance of Public Securities.

Section 5.4131 establishes in the Association's plan of operation the procedure to determine the need for public securities and the appropriate amount of public

securities to be requested. The TPFA may provide guidance as to market conditions and requirements in this process. The section first requires the Association to reasonably estimate whether catastrophic losses arising from a catastrophic event exceed funds in the CRTF and proceeds from available reinsurance. If the determination is made, the Association may request the issuance of public securities. The Commissioner's approval is required for the issuance of public securities. To clarify that the procedure is consistent with the Insurance Code §2210.604, the text of proposed §5.4131(a) has been changed to provide that each request for the issuance of public securities must be approved by the Commissioner prior to the issuance of the public securities. The Association's public security funding request to the Commissioner must present the information specified in §5.4131(b). As provided in §5.4131(e) the Association may make multiple requests for public security funding.

The information required in the request for public securities is necessary to determine the losses that must be paid and the amount of public securities that may be issued to pay those losses. The Insurance Code §§2210.072, 2210.073, and 2210.074 each authorize the maximum amount, per year, of public securities that may be issued under each class of public securities, which are \$1 billion dollars in class 1 public securities, \$1 billion dollars in class 2 public securities, and \$500 million in class 3 public securities. However, market conditions and requirements may not allow for the TPFA to issue all authorized public securities in a particular class.

As addressed in §5.4131(g) and §5.4132, the Insurance Code Chapter 2210, Subchapter M, authorizes the TPFA through its Board to issue public securities to fund Association losses that are in excess of the Association's premium, other revenue,

available reinsurance proceeds, and the CRTF. The Insurance Code Chapter 2210 provides that the TPFA is responsible for setting the terms and conditions of the public securities and distributing public security proceeds as well as establishing accounts necessary to repay the public securities in a timely manner. The public security proceeds and repayment amounts are held by the TPFA in funds and accounts it shall establish with the Trust Company, which is maintained by the Comptroller. Public securities issued pursuant to Chapter 2210 by the TPFA must be approved by the Texas Attorney General.

Comments were received indicating that the Insurance Code Chapter 2210 required the Association to issue, or request issuance of, the entire authorized amount of each class of public securities before the Association is authorized to issue public securities in a subsequent class. Commenters indicated that this was required due to the use of the terms “shall” and “may” in the Insurance Code §2210.072(b), 2210.073(b), and 2210.074(b). The Department disagrees with the assertions in these comments and no changes have been made to the proposed text, for the reasons stated in this adoption.

The TPFA has informed the Department and the Association that the markets will set the limit for the amount of class 1 public securities that may be issued by considering the Association’s current net revenue as the source of the funds to pay the class 1 public security obligation and meet the contractual coverage amount, both for the initial year and subsequent years. As defined in §5.4102, the “contractual coverage amount” is the minimum amount that the Association is required to deposit into the applicable public security obligation revenue fund as security for the payment of debt

service on the public securities, administrative expenses on public securities, or other payments required to be paid by the Association in connection with public securities. The contractual coverage amount secures against a drop off in amounts collected to pay the public security. As that amount is required to secure payment, the contractual coverage amount will exceed the required payment. In the case of class 1 public securities, the contractual coverage amount may be greater than the amount owed annually to pay debt service, administrative expenses, or other required payments in connection with class 1 public security obligations.

The Association's net revenue is defined in §5.4102(25) as the Association's gross premium, plus other revenue, less unearned premium, less scheduled policy claims, less budgeted operating expenses, and less amounts necessary to fund or replenish the operating reserve fund. Scheduled policy claims are defined in §5.4102(31) as that portion of the Association's earned premium and other revenue expected to be paid in connection with the disposition of losses that do not result from a catastrophic event. These claims result from localized windstorm and hail events that may involve one to several hundred policyholders per event and could include losses due to straight-line winds, thunderstorms, tornados, hail, or other non-catastrophe wind and hail events. These events occur regularly throughout the catastrophe area, just as they occur regularly throughout the state, and losses related to such events are actuarially calculated into the premium collected by the Association. Budgeted operating expenses as defined in §5.4102(5) are all operating expenses as budgeted for and approved by the Association's board of directors, excluding expenses related to catastrophic losses. These are the ordinary expenses of the Association to issue

policies, pay agent commissions, and adjust and settle scheduled claims. The operating reserve fund, which is defined in §5.4102(26), is established in §5.4141 to allow the Association to continue to function to pay scheduled claims following a loss that requires the issuance of class 1 public securities.

As discussed, the Department has been informed that the market's initial consideration of class 1 public securities would be based on the Association's current net revenue. The Department has also been informed that the market would not necessarily consider additional potential revenue with respect to the issuance of public securities, because even if the Association increased its rates, the net increase in overall gross premium, if any, from this action would not be fully achieved for approximately one year. Premium collections would not necessarily uniformly increase with a rate increase. Some policyholders would pay the increase, some would reduce coverage, and others would cancel or non-renew coverage. Thus, while a rate increase may increase gross revenues and provide an opportunity for a second issuance of class 1 public securities if the funding is needed, it would not be a guarantee that the Association could issue any remaining public securities in that class. Rather, the only definite result of delaying issuance of the next class of public securities to provide needed funding would be to delay payment of incurred claims in frustration of the Association's statutory purpose. Further, the TPFA has informed the Department that the TPFA has a public policy interest in issuing the Association public securities as investment grade. Thus, the Association could not issue securities on what would essentially be a speculative or junk bond basis.

To demonstrate this contractual coverage situation, the Association and the Department were provided estimates that \$1 billion in class 1 public securities could result in first year debt service of approximately \$125 million, with debt service in subsequent years of approximately \$173 million per year. At a 1.5 times contractual coverage amount the Association would be required to have at least \$188 million in net revenue for the first year and \$259 million for subsequent years. At a three times contractual coverage amount, the net revenue amounts for these periods increase to \$376 million and \$519 million, respectively. For comparison, the Association's current estimated net revenue is approximately \$270 million.

However, this information is based on assumptions of what the market may require. The market may require a greater contractual coverage amount. Thus, it would also be speculative for the Association simply to increase its rates in anticipation of meeting any market contingency or desire. As discussed, increasing the rates, especially significant immediate increases, does not necessarily result in an equivalent increase in premium due to persons reducing or canceling insurance coverage. The result of qualifying persons in need of Association insurance coverage being forced to reduce or cancel coverage based on market whims is not necessarily consistent with the Association's purpose as set forth in the Insurance Code §2210.001.

As for the use of the terms "shall" and "may," the Department recognizes that the Government Code §311.061(1) and (2) defines the terms as having different meanings; however, in the context of the Insurance Code §§2210.072 - 2210.074, the provisions function the same. The term "shall" as used in the Insurance Code §2210.072(b) usually creates a duty, but the section has no stated consequence. Rather, the

Insurance Code §2210.073 simply provides that losses not paid under §2210.072 shall be paid as provided in §2210.073. Similarly, the term “may” as used in the Insurance Code §2210.073(b) usually means the act is discretionary; however, in context, neither §2210.073(a), providing that losses not paid under §2210.072 shall be paid as provided in §2210.073, nor the Insurance Code §2210.074(a), providing that losses not paid under §2210.073 shall be paid as provided in §2210.074, indicate that the Association may simply choose to ignore funding such losses. Further, a duty to issue the entire amount, regardless of other concerns, would conflict with the TPFA’s discretionary authority to determine the method of sale, type and form of public security, that best achieve the goals of the association and effect the borrowing at the lowest practicable cost as set forth in the Insurance Code §2210.605.

While the HB 4409 amendments, including the adoption of the Insurance Code §2210.072 concerning class 1 public securities, indicate a shift to making the Association more self-reliant, nothing in HB 4409 indicates any legislative intent that the Association is to stop paying claims if the entire class of public securities cannot reasonably be sold in the market’s determination. Rather, the Insurance Code §§2210.072 - 2210.074 provide funding for the Association’s losses, with the duty that losses not paid under the preceding sections be paid under the subsequent section.

Thus, §5.4131 requires only that the Association request issuance of the reasonably practical maximum principal amount of a class of public security before moving on to the next numerically greater class of public security. Section 5.4131(c) sets out the criteria that the Association must consider in determining the reasonably practical maximum principal amount of public securities. In making its determination

the Association may rely on the advice and analysis of the TPFA. Upon receipt of the Commissioner's written approval, the Association shall request the TPFA to issue the approved requested public securities. The Association may then proceed to work with the TPFA to obtain the funds.

As previously stated, §5.4131(e) provides that the Association may make multiple requests for public security funding. As further stated in that subsection, in making these requests the Association must evaluate and request the reasonably practical maximum principal amount of class 1 or class 2 public securities before moving on to the next public security class. Class 2 public securities are included, because even though these public securities have a greater funding basis, market conditions and requirements, including contractual coverage requirements, might still prevent the sale of all of the securities in this class, and thus require the Association to move on to class 3 public securities before exhausting the amount of class 2 public securities authorized under the Insurance Code §2210.073. Class 3 public securities are not referenced because the statute does not identify additional funding sources beyond that class.

Because of the complexity of the public security funding arrangements, it is likely that the TPFA will have already made certain arrangements prior to the occurrence of a catastrophic event that will give rise to the need for the public securities. Nothing in this adoption should be construed as limiting the TPFA's ability to perform such actions.

The proposal also generated comments concerning the issuance and payment of class 3 public securities. These comments requested a means of paying a lump sum assessment in lieu of participating in the class 3 public security obligation and setting

the insurer's participation percentage at the level it was in the year of the loss, rather than allowing the participation level to adjust annually.

The purpose of §2210.074, and Subchapter B-1, generally, is to provide funding for the payment of Association losses in excess of the Association's premium, other revenue, and the CRTF. The Insurance Code §2210.074(a) provides that the Association's losses payable under §2210.074 be paid either from the proceeds of class 3 public securities or the through reinsurance as described by the Insurance Code §2210.075.

The Insurance Code §2210.075(a) provides that a member insurer may elect to purchase reinsurance to cover an assessment for which the insurer would otherwise be liable under the Insurance Code §2210.074(b). The Insurance Code 2210.074(b) provides that if losses are paid with class 3 public securities, the class 3 public securities will be repaid in the manner described by the Insurance Code Chapter 2210, Subchapter M through assessments as provided by §2210.074. Section 2210.074(b), further provides that the Association shall notify each member of its assessment under §2210.074 and that the proportion of losses allocable to each insurer under §2210.074 shall be determined in the manner used to determine the insurer's participation in the Association under §2210.052. The Insurance Code §2210.6135, which is in Subchapter M, has the same provisions related to notice and allocation, and provides that the class 3 public securities would be paid through member assessments. The Insurance Code §2210.6135, however, further authorizes the Association to assess members up to \$500 million per year.

As a whole, these sections could be read to require that either the entire amount of the applicable losses must be paid with class 3 public securities or the entire amount of the applicable losses must be paid with reinsurance, but not necessarily a mixture of both because the Insurance Code §2210.074 does not suggest a means for allocating between the two categories nor does the Insurance Code provide for the direct payment of losses.

Rather, the Insurance Code §2210.075 provides for the use of reinsurance to pay an insurer's assessment under the Insurance Code §2210.074(b), which is the obligation to the class 3 public securities. The Insurance Code § 2210.074(b) provides that "if the losses are paid with public securities ..., the public securities shall be repaid in the manner prescribed by Subchapter M through assessments as provided by the section." Each insurer's participation in the class 3 public securities is determined by assessment as set forth in the Insurance Code §2210.074(b) and §2210.6135. The insurer may purchase reinsurance to cover this obligation; however, the Insurance Code §2210.075(a) does not require the purchase of reinsurance nor does §2210.075(a) state that reinsurance applies in lieu of participation in the repayment of the class 3 public securities.

Further, the Insurance Code §2210.074 and §2210.6135 indicate that the entire membership of the Association, and thus the Texas property insurance market, will be obligated for the repayment of the public securities. In establishing two groups with one being obligated to repay the public securities and one not being so obligated, that public security funding resource is limited to the financial strength of the obligated participating insurers and the potential that those insurers will continue to write in Texas

until the public securities are repaid. This could limit the ability of the TPFA to issue class 3 public securities and frustrate the intent of the loss funding scheme set forth in the Insurance Code Chapter 2210, Subchapter B-1.

The comment concerning the member participation formula more directly relates to the separate proposal concerning assessments published in the July 30, 2010 issue of the *Texas Register* (35 TexReg 6611). However to the extent the Association may need to consider the outstanding amount of public securities, it is necessary to consider that the public securities will be paid over a period of approximately 10 years. Significant market changes may occur during that period.

This includes the entry and exit of market participants and changes in company writing practices. Under no situation would the formula be truly fixed for the entire term of the public security obligation, because the formula must consider that over the course of time some members will leave the Texas market or fail financially. Also, new members are only exempt from participating in assessments for the first two years. Additionally, members could also seek to decrease their assessment by increasing their writings in the catastrophe area, an incentive which is consistent with the Insurance Code §2210.009(b) and §2210.053(b). Further, the Association and the members would be required to prepare and use a single calculation for all assessments made during the year for class 2 public securities and class 3 public securities regardless of the year the public securities were issued. Finally, because members would have the same assessment obligation to each class 2 public security and class 3 public security regardless of the year in which the security was issued, the TPFA might also be able to

more readily refinance outstanding public securities of the same class and take advantage of changing market conditions.

Therefore, these rules implement the Insurance Code §§2210.074, 2210.075, 2210.0613, and 2210.06135 by establishing and using a system that implements provisions set forth the Insurance Code §2210.074, including the funding of loss payments through the issuance of class 3 public securities which shall be repaid by assessing the Association members. Further, this system reflects an annual set single participation percentage rate for assessing class 2 and class 3 public securities over the course of the public securities, addressing issues resulting from member insurers beginning and ceasing to do business in Texas, and encouraging members to better their assessment position by increasing their writings in the catastrophe area, which is consistent with the Insurance Code §2210.009(b) and §2210.053(b). The members may use reinsurance if they desire and members are not impeded by this rule from working to create reinsurance products that better fit this type of assessment situation.

Additionally, a commenter noted, the authorized amount of public securities is limited. The authorized amount of public securities that may be issued per year is limited, however, under the statute and this adoption, over time funding is only limited by the amount of public securities of any class that may be issued. As previously discussed in this adoption, the limit of public securities that may be issued to fund excess losses under the Insurance Code Chapter 2210, Subchapter B-1 is \$2.5 billion per year. This adoption also notes that public security funding may be further limited and reduced based on market conditions. However, while §§2210.072 - 2210.074 limit the authorized amount of public securities that may be issued "per year," these limits

are not directly tied to losses resulting from an occurrence or series of occurrences in that year.

The Insurance Code Chapter 2210, Subchapter B-1, does not define the term “year.” Because the Association is at greatest risk of a catastrophic event during hurricane season, which occurs June through November, it is reasonable to consider this period to be a calendar year and not twelve months between public security issuances. This is because limiting public security issuances to twelve months intervals could work to significantly delay loss payments to Association policyholders who incurred an early season storm in a year following a significant late season storm. Thus, January 1, of each year an additional amount of funding is authorized.

The Insurance Code §2210.071 provides that a “[I]f an occurrence or series of occurrences in a catastrophe area results in insured losses and operating expenses of the association in excess of premium and other revenue of the association (a catastrophic event), the excess losses and operating expenses shall be paid as provided by [the Insurance Code Chapter 2210, Subchapter B-1]. The Insurance Code Chapter 2210, Subchapter B-1 does not specifically limit funding to the year in which the catastrophic event occurred. Rather, the only limitation is the “per year” amount of public securities that may be issued to fund the losses. Thus, funding, in class order as available, may be accessed to cover losses incurred in a prior year so long as the basic condition of a “catastrophic event” persisted.

However, using funds authorized for a subsequent year has certain limitations. As discussed in this adoption, not all sources of funding under §2210.072 - 2210.074

may be available to the Association annually based on market conditions. Further, use of current year authorized public securities to essentially fund continuing losses from a prior year would significantly reduce or eliminate those remaining funding resources in the current year. Thus, the Legislature may determine that an alternative funding structure is necessary if losses exceed \$2.5 billion or those lesser amounts that can be reasonably borrowed based on market conditions.

In analyzing the statute and rule in response to this comment the Department has determined that §5.4131(e) needs to be clarified as to the funds being requested. The revision adds paragraph (3) providing that the public security request shall be applicable to authorized public securities available in the year the request is made, unless stated otherwise in the request. This clarification is necessary to avoid depleting authorized public securities in subsequent year because a late season catastrophe resulted in a timely public security request, but with public securities being issued after January 1 of the next year due to market delays. This requires the Association to act promptly to request the issuance of public securities. However, once the issuance of public securities is requested, the Association has limited continuing involvement and issuance becomes dependent on the actions of the TPFA and the markets. Because of the adverse affect on funding for subsequent years, it is reasonable to consider that the per year limitation in §§2210.072 - 2210.074 refers to the timely request for issuance during the year of the request rather than the potential elimination of funding for subsequent years based on the market that are beyond the control of the Association, the Department, and the TPFA.

Finally, the Insurance Code Chapter 2210 clearly and consistently distinguishes between issuing and refinancing public securities. Therefore, the annual limitations in the Insurance Code §§210.072 - 2210.074 concerning issuance of public securities do not apply to refinancing already issued public securities of the same class.

§5.4132. Texas Public Finance Authority Responsibilities Concerning Issuance of Public Securities. Section 5.4132 generally informs the reader of certain functions that may be performed by the TPFA pursuant to statute. The adopted sections are not intended to establish additional requirements for the TPFA, the Comptroller, or the Trust Company. While the provision imposes no obligation on the TPFA, a commenter did request that §5.4132(3) be clarified to show each provision as being an independent potential action. Based on the comment the paragraph was revised to clarify that the TPFA may perform the listed acts as authorized by the Insurance Code Chapter 2210 and designates the three provisions setting forth the acts as subparagraphs (A) - (C).

§5.4133. Public Security Proceeds. The Insurance Code §2210.607 provides that the public security proceeds shall be held in trust with the Trust Company for the benefit of the Association. The Insurance Code §2210.606 provides that the TPFA may make additional covenants with respect the public securities, including providing for the establishment and maintenance of funds and accounts. The Insurance Code §2210.608 sets forth how public security proceeds may be used, and these uses are incorporated into the definition of the Association Program in §5.4102(2). Section 5.4133 is necessary to establish in the Association's plan of operation the minimum

requirements on the Association related to facilitating access to and use of public security proceeds to fund Association program obligations.

§5.4134. Excess Public Security Proceeds. The Insurance Code §2210.608(b) provides for the use of excess public security proceeds. The Insurance Code §2210.608(b), however, does not specifically provide who would make any decision as to those funds. The Insurance Code §2210.608(a), however, vests the use of the public security proceeds in the Association. This section clarifies that the Association shall also determine the use of excess public security proceeds pursuant to the Insurance Code §2210.608. The section also clarifies that while the Association may select from available options under the Insurance Code §2210.608, if any, §2210.608 does not confer this discretion notwithstanding the requirements specified in the Insurance Code §§2210.072(a), 2210.073(a), and 2210.074(a). Thus, public securities may be repaid before their term if the Association's board of directors elects to do so and the Commissioner approves. Section 5.4134 is necessary to establish these requirements in the Association's plan of operation. Neither this section nor this statement concerning the application of the Insurance Code §2210.608, is intended to imply or suggest that the Association may change, alter, or disavow any covenant or obligation in a public security or other agreement.

§5.4141. Obligation Revenue Fund for the Payment of Class 1 Public Security Obligations and Operating Reserve Fund. The Insurance Code §2210.609(a) provides that the Association and the TPFA shall provide for the payment of all public security obligations from the Association's available funds. Further, if the Association is unable to pay the public security obligations and public security

administrative expenses, if any, with available funds then the Association shall pay those obligations and expenses in accordance with the Insurance Code §§2210.612, 2210.613, and 2210.6135. The Insurance Code §2210.609(c) provides that all revenue collected under the Insurance Code §§2210.612, 2210.613, and 2210.6135 shall be deposited in the public security obligation fund. Such a requirement is obvious for additional amounts specifically collected for the payment of class 2 and class 3 public security obligations and public security administrative expenses. These amounts will be collected from specifically established premium surcharges and member company assessments. Class 1 public security obligations and public security administrative expenses are paid from the Association's premium and other revenue, however. The Association uses its premium and other revenue to pay for the operating expenses of the Association and non-catastrophic claims.

If the Association's entire premium was held solely for the payment of class 1 public securities, the Association would have no funds available in subsequent years to pay for the operating expenses of the Association and non-catastrophic claims. This would result even if the Association had sufficient income to pay both its class 1 public security obligation and the operating expenses of the Association and non-catastrophic claims. Without access to necessary funds, the Association would be forced to utilize other funding sources to pay non-catastrophe losses and administrative expense. Such an interpretation of the Insurance Code Chapter 2210 would be unreasonable. Therefore, §5.4141 establishes the means for the Association to continue its ordinary operations while funding the obligation revenue fund for the payment of class 1 public security obligations and public security administrative expenses. Under §5.4141, the

Association's net revenue as defined in §5.4102(25) and previously discussed in relation to §5.4131 will be deposited by the Association into obligation revenue fund created for class 1 public securities. This amount will include any required contractual coverage amount, which has also been previously discussed in this adoption.

Section 5.4141(b) provides that the Association shall hold the operating reserve fund, which is defined in §5.4102(26) as the amount budgeted each year by the Association for the payment of scheduled policy claims and budgeted operating expenses divided by four. Thus, this fund holds an amount that is approximately three months of scheduled claims and operating expense. The fund would be replenished throughout the year by Association premium collections, with part of the premium being deposited in the operating reserve fund and part of the premium being deposited into the obligation revenue fund. Section 5.4141 also provides that should premium collections fail to meet the needs of the obligation revenue funds, funds would be transferred from the operating reserve fund to the obligation revenue fund.

This section is adopted with a nonsubstantive grammatical change. The second sentence in subsection (a) was amended to insert the word "the" before "obligation revenue fund."

§5.4142. Excess Class 1 Public Security Obligation Revenue Fund Amounts. It is possible that, from time to time, funds in the obligation revenue fund, including the contractual coverage amount, may need to be disbursed. Revenue related to class 1 public securities is the Association's premium and other revenue, which is otherwise an Association asset. Section 5.4142 is necessary to incorporate

into the Association's plan of operation so that the Association may thus use such a disbursement as an Association asset. The section also reflects that the Commissioner's approval is required if the Association elects to redeem or purchase public securities under the Insurance Code §2210.072.

§5.4143 and §5.4146. Obligation Revenue Fund for the Payment of Class 2 and Class 3 Public Securities. The Insurance Code §2210.613 provides for the payment of class 2 public security obligations with premium surcharges on most lines of property and casualty insurance policies in the catastrophe area and Association member company assessments. The Insurance Code §2210.6135 provides for the payment of class 3 public security obligations with Association member company assessments. These amounts would include any applicable contractual coverage amounts that the TPFA informs the Association and the Department are necessary. The procedure for establishing, assessing, collecting, reporting, accounting for, and transmitting the premium surcharge to the Association is the subject of a separate proposal for the adoption of §§5.4161 - 5.4167, 5.4171 - 5.4173, and 5.4181 - 5.4192 published in the July 30, 2010 issue of the *Texas Register* (35 TexReg 611).

Section 5.4143 and §5.4146 establish in the Association's plan of operation necessary requirements for handling collected premium surcharges and member assessments. The requirements are similar. As the premium surcharges and member assessments are collected for the purpose of paying public security obligations and not other obligations of the Association, as set forth in the Insurance Code §2210.613 and §2210.6135, they must be held separately from the Association's assets. In both instances, the Association is required to deposit the collected revenue and investment

income, if any, on that revenue into the appropriate obligation revenue fund. Further, because of the statutory requirements and the limited uses for the funds, the sections provide that the Association is required to: (1) account for these funds separately; (2) hold these funds separately from other Association funds pending transfer to the obligation revenue fund; and (3) not otherwise use or encumber these funds.

§§5.4144, 5.4145, and 5.4147. Excess Class 2 and Class 3 Public Security Obligation Revenue Fund Amounts. Catastrophe area policyholder premium surcharges and Association member assessments will be accumulated in separate class 2 and class 3 public security revenue obligation funds. Due to contractual coverage amounts that will be required by market lenders to ensure payment of the public security obligation, these revenue obligation funds will hold amounts in excess of what is currently needed for repayment of the public securities for that year. The Insurance Code §2210.611 provides that if excess premium surcharge revenue is collected in any year, those funds may be used in the discretion of the Association to (i) pay public security obligations in a subsequent year; (ii) redeem or purchase outstanding public securities; or (iii) be deposited in the CRTF. Section 5.4144 sets out the statutory provision, and also clarifies that while the Association may select from available options under the Insurance Code §2210.611, if any, that §2210.611 does not confer this discretion notwithstanding the requirement specified in the Insurance Code §2210.073(a). Thus, class 2 public securities may be repaid before their term if the Association's board of directors elects to do so and the Commissioner approves.

Section 5.4145 and §5.4147 establish that an excess member assessment may be handled in a similar manner to excess premium surcharge funds under §5.4144.

Thus, if excess member assessment revenue is collected in any year, those funds may be used in the discretion of the Association to (i) pay public security obligations in a subsequent year; or (ii) redeem or purchase outstanding public securities, subject to Commissioner approval. Section 5.4145 and §5.4147 also provide for payment of excess member assessments to the CRTF; however, that option exists only if the other options have been satisfied. While the subject matter of §5.4145 and §5.4147 is not addressed in the Insurance Code Chapter 2210, such a result is considered reasonable and consistent with the overall intent of Chapter 2210. This intent would include the Insurance Code §2210.604 indicating that the public securities be at the lowest practical cost to the Association and the authorizations in the Insurance Code §2210.073 and §2210.074 that the Association's board of directors, subject to the Commissioner's approval as required in the Insurance Code §2210.073 and §2210.074(a), may elect to repay the public securities sooner than their full term. Further it provides for an orderly disposition of the collected funds. Refunding excess member assessment could potentially be considered member participation in the Association which is not authorized under the Insurance Code Chapter 2210.

In reviewing the text, it has been discovered that subsection (a)(1) of §§5.4144, 5.145, and 5.4147 makes the same reference to "the amount of the member assessment that would otherwise be required under to be levied for the year under this subchapter." The statement, which tracks the Insurance Code §2210.611(1), needs to be clarified to provided that the "subchapter" reference is referring to the Insurance Code Chapter 2210, Subchapter M. Therefore, the text of §§5.4144(a)(1), 5.145(a)(1)

and 5.4147(a)(1) have been changed to replace the word “subchapter” with “the Insurance Code Chapter 2210, Subchapter M.”

Finally, §5.4144 is adopted with a nonsubstantive grammatical change. Section 5.4144(a) was amended to remove the word “a” prior to the phrase “premium surcharges under.”

3. HOW THE SECTIONS WILL FUNCTION.

§5.4101. Applicability. Section 5.4101(a) provides that the sections in this division shall be considered to be a part of the Texas Windstorm Insurance Association’s plan of operation and shall control over any conflicting provision in §5.4001 of this title. Section 5.4101(b) provides that the Department retains regulatory oversight of the Association as required by the Insurance Code Chapter 2210, notwithstanding any provision in 28 Texas Administrative Code, Chapter 5, Subchapter E.

§5.4102. Definitions. Section 5.4102 defines terms used in this division.

§5.4111. Operation of the Catastrophe Reserve Trust Fund. Section 5.4111 is substantially a restatement of repealed §5.9903 of this chapter and incorporates these provisions into the Association’s plan of operation. Section 5.4111(a) identifies the basic responsibilities of the various parties involved in the deposit of funds into the CRTF and the status of the deposited funds. Section 5.4111(b) sets forth the situations under which funds may be deposited into the CRTF.

§5.4112 and §5.4113. Termination of Catastrophe Reserve Trust Fund and Investments of Catastrophe Reserve Trust Fund. Section 5.4112 is substantially a restatement of repealed §5.9904 of this chapter and is consistent with the requirements of the Insurance Code §2210.452(d) concerning termination of the CRTF. Section 5.4113 is substantially a restatement of repealed §5.9905 of this chapter concerning the investment of funds in the CRTF.

§5.4114. Duties and Responsibilities. Section 5.4114 is based on repealed §5.9906 of this chapter and sets forth the duties and responsibilities of the Commissioner, the Association, the Comptroller, and the Trust Company in authorizing the release of CRTF funds.

§5.4121. Financing Arrangements. Section 5.4121 relates only to the Association entering into financing directly with a market source. The section does not affect, nor should it be construed as affecting, the TPFA's ability to enter into financing arrangements by issuing public securities on behalf of the Association as authorized in Chapter 2210. Section 5.4121(a) provides that the Association may enter into financing arrangements that are approved by the Association's board of directors prior to entering into the financing arrangement. Section 5.4121(b) sets forth the funds that may be used to repay the financing arrangement, including public security proceeds.

Section 5.4121(c) provides that the Association may, without limitation, secure financing arrangements under this section with a collateral assignment and security interest in and to all or any portion of the Association's assets, including without limitation all or any portion of the Association's right, title and interest in and to all

proceeds of any or all class 1 public securities, class 2 public securities, and/or class 3 public securities and other assets with the priority of each such collateral assignment to be determined by the Association in its discretion.

§5.4131. Issuance of Public Securities. Section 5.4131 establishes in the Association's plan of operation the procedure to determine the need for public securities and the appropriate amount of public securities to be requested. Section 5.4131(a) provides that in the event that the Association reasonably estimates that a catastrophic event has occurred and that the catastrophic losses are estimated to exceed available CRTF funds and available reinsurance proceeds, the Association may request the commissioner's approval for the issuance of class 1, class 2, and/or class 3 public securities. Section 5.4131(a) further provides that each request for the issuance of public securities must be approved by the commissioner prior to the issuance of the public securities. Section 5.4131(b) sets forth the requirements of the request, including that the requested amounts must be at least the reasonably practical maximum principal amount of public securities available for that class. Section 5.4131(c) sets forth the criteria that the Association must consider in determining the reasonably practical maximum principal amount of public securities under subsection (b) of this section. Section 5.4131(d) addresses the Commissioner's consideration in evaluating the Association public security request. Section 5.4131(e) provides that the Association may make one or more requests for public securities, however, the Association must request the issuance of what has been determined to be the reasonably practical maximum principal amount of class 1 public securities before the Association may request issuance of class 2 and class 3 public securities; and likewise

must request issuance of what has been determined to be the reasonably practical maximum principal amount of class 2 public securities before the Association may request issuance of class 3 public securities. Additionally, Department has determined that §5.4131(e) needs to be clarified as to the funds being requested. The revision adds paragraph (3) providing that the public security request shall be applicable to authorized public securities available in the year the request is made, unless stated otherwise in the request. This clarification is necessary to avoid depleting authorized public securities in subsequent year because a late season catastrophe resulted in a timely public security request, but with public securities being issued after January 1 of the next year due to market delays.

Section 5.4131(f) provides that the Commissioner's approval of the Association's public security request shall be in writing. Upon receipt of the commissioner's written approval, the Association shall request the TPFA to issue the approved requested public securities. Section 5.4131(g) provides that the Association may enter into agreements as directed by the TPFA for the issuance, reissuance, refinancing, and payment of public security obligations and public security administrative expenses.

§5.4132. Texas Public Finance Authority Responsibilities Concerning Issuance of Public Securities. Section 5.4132 generally informs the reader of certain functions that may be performed by the TPFA pursuant to statute. The adopted sections are not intended to establish additional requirements for the TPFA, the Comptroller, or the Trust Company.

§5.4133. Public Security Proceeds. Section 5.4133 establishes the minimum requirements on the Association related to facilitating access to and use of public security proceeds to fund Association program obligations. Section 5.4133(a) requires the Association to request the proceeds from the TPFA in writing. Section 5.4133(b) sets forth what the Association's request must specify. Section 5.4133(c) authorizes the Association to request proceeds in advanced of actual claims settlement. Section 5.4133(d) sets forth how the Association may hold the proceeds and requires the Association to hold and account for these funds separately from all other sources of funds.

§5.4134. Excess Public Security Proceeds. Section 5.4134 establishes in the Association's plan of operation requirements concerning the use of excess public security proceeds pursuant to the Insurance Code §2210.608 and early repayment of public security obligations.

§5.4141. Obligation Revenue Fund for the Payment of Class 1 Public Security Obligations and Operating Reserve Fund. Section 5.4141 establishes the means for the Association to continue its ordinary operations while funding the obligation revenue fund for the payment of class 1 public security obligations and public security administrative expenses. Under §5.4141(a) the Association's net revenue as defined in §5.4102(25) and previously discussed in relation to §5.4131 will be deposited by the Association into obligation revenue fund created for class 1 public securities. Section 5.4141(b) provides that the Association shall hold the operating reserve fund, which is defined in §5.4102(26).

§5.4142. Excess Class 1 Public Security Obligation Revenue Fund Amounts. Section 5.4142 incorporates into the Association's plan of operation the procedure for the disposition of excess class 1 public security revenue.

§5.4143 and §5.4146. Obligation Revenue Fund for the Payment of Class 2 and Class 3 Public Securities. Section 5.4143 and §5.4146 establish in the Association's plan of operation necessary requirements for handling collected premium surcharges and member assessments that will be used for the payment of class 2 and class 3 public securities.

§§5.4144, 5.4145, and 5.4147. Excess Class 2 and Class 3 Public Security Obligation Revenue Fund Amounts. Section 5.4144 sets out the available options for the disposition of excess class 2 premium surcharges under the Insurance Code §2210.611. The TPFA has informed the Department that a procedure for excess member assessments consistent with the Insurance Code §2210.611 and §5.4144 is necessary for marketing purposes and tax considerations. Section 5.4145 and §5.4147 establish that excess member assessments collected for class 2 and class 3 public securities shall be handled in a similar manner to the Insurance Code §2210.611 and §5.4144.

In reviewing the text, it has been discovered that subsection (a)(1) of §§5.4144, 5.145, and 5.4147 makes the same reference to "the amount of the member assessment that would otherwise be required under to be levied for the year under this subchapter." The statement, which tracks the Insurance Code §2210.611(1), needs to be clarified to provided that the "subchapter" reference is referring to the Insurance

Code Chapter 2210, Subchapter M. Therefore, the text of §§5.4144(a)(1), 5.145(a)(1) and 5.4147(a)(1) have been changed to replace the word “subchapter” with “the Insurance Code Chapter 2210, Subchapter M.”

4. SUMMARY OF COMMENTS AND AGENCY RESPONSE.

General. A commenter made several statements and provided opinions as to future legislative actions that would provide transparent direct assistance using the state’s broad based taxing authority would be preferable to the limited assessments adopted in HB 4409; and advocating the Association purchase of reinsurance, which is authorized by statute, as a means spreading the Association’s risk of loss globally on a voluntary basis while eliminating the risk of a subsidy of coastal residents by other insurance purchasers in this state.

Agency Response. The Department includes these comments because they were made with respect to the proposal. As the commenter indicates, the sources of revenue for funding public security obligations are set forth in the applicable statutes. This adoption may not change those requirements. Further, as the Commenter noted, the statute authorizes the Association to purchase reinsurance. The adopted sections and this adoption reflect that the Association may purchase reinsurance.

General. A commenter asserts that the Association should adopt risk based rates and establish a system of direct assistance to low income households that have been previously issued Association coverage as a means of fulfilling the Association’s role as

an insurer of last resort rather than just operating as an affordable option to the private market.

Agency Response. The Department includes this comment because it was made with respect to the proposal. The sections do not address risk based rates or affordable rates for the Association and therefore the Department cannot respond to the comment in relation to the proposal.

Section 5.4102(8). A commenter was concerned that unless the proposal specified that the term “catastrophic event” was specifically limited to the allocation of funds from the CRTF or the issuance of public securities, it could be misapplied to the detriment of the Association’s policyholders.

Agency Response. The Department is aware that potential exists for rules and terms in rules to be misapplied. The Department notes that the meanings of the terms in §5.4102 are specifically limited to the adopted division, which concerns Association loss funding. Further, the definition is derived from the Insurance Code §2210.071(a) which describes when the Association may use the excess loss funding mechanisms described in the Insurance Code Chapter 2210, Subchapter B-1. Additionally, the definition is included in this rule because it also is used by the TPFA in its public security documents. Therefore, no change has been made to the definition because its use is already limited to this division concerning loss funding, the definition is limited to the statutory terms triggering the use of the CRTF and public securities; and the change may result in inconsistency with TPFA funding documents.

Section 5.4111(b)(1). A commenter suggested that the language in §5.4111(b)(1) include a reference to reinsurance purchases as provided in the Insurance Code §2210.452(c).

Agency Response. The Department agrees that the language in proposed §5.4111(b)(1) could be read as limiting the options in the Insurance Code §2210.452(c). Therefore, the text of proposed §5.4111(b)(1) has been changed to indicate that the statute may allow alternative uses of the Association's net gain from operations due to a comment that the provision did not include the statement that the Association could use the net gain from operations to purchase reinsurance. Section 5.4111(b)(1) restates repealed §5.9903(b)(1) of this chapter, adopted effective August 21, 2000, in 25 TexReg 8031. At the time §5.9903 was adopted, the language in the then existing Insurance Code Article 21.49 §8(i)(3) provided that the Association would pay the net equity of its members to fund a commissioner approved reinsurance program or to the CRTF. This is substantively the same requirement that is now set forth in the Insurance Code §2210.452(c), which provides that the Association shall pay the net gain from operations to purchase reinsurance, or to the CRTF, or to both. The member's net equity and the Association's net gain from operations are both "all premium and other revenue of the Association in excess of incurred losses and operating expenses." Thus, although the statutory change from "member's net equity" to "Association's net gain from operations" is significant for reasons such as federal income taxation, the change did not affect the deposit the funds to the CRTF, purchasing reinsurance, or the method of determining the amount of funds involved.

Since the adoption of §5.9903(b)(1), the Association has made deposits into the CRTF and purchased reinsurance in ordinary routine manner without incident. Thus, changing the language of the text raises concerns as to unforeseen consequences. Reinsurance has been considered an operating expense of the Association. Reinsurance purchases have been paid in quarterly installments. Listing reinsurance here could be interpreted as changing these prior practices and limiting reinsurance purchases only to the amount that might be available from the Association net gain from operations. To the extent that reinsurance were to be considered solely payable annually from the Association's potential net gain from operations could make the purchase of reinsurance uncertain even when prudent, thus potentially placing the Association at a significant financial risk. Further, a reference to reinsurance purchases here could be confusing, because this section addresses only deposits into the CRTF and does not address the procedure or requirements for the purchase of reinsurance. Therefore, as discussed the text has been changed to simply reference that the statute may provide other alternatives, rather than introducing new material and raising the question that the section establishes a new procedure or requirement concerning the purchase of reinsurance.

Section 5.4121(a). A commenter suggested that this §5.4121(a) was overly broad and lacked transparency. The commenter suggested that the rule should limit the financing arrangements to funding losses and public securities as outlined in §2210.072(d); limit the type of financing arrangements that the Association could enter into; and address an appropriate level of oversight with respect to these arrangements.

Agency Response. The Department agrees in part and has made changes to §5.4121(a). The revised subsection provides that the Association may enter into financing arrangements that the Association's board of directors has approved in advance and further limits the section to financing arrangements entered into based on the Insurance Code §2210.072. The additional limitation of prior approval by the board of directors is intended to provide additional transparency concerning the Association's loss funding resources. The revision that this section applies to financing arrangements entered into based on the Insurance Code §2210.072 corresponds to the overall purpose of this division which is to address loss funding. The Department disagrees with limiting the allowable types of financing arrangements at this time. The Legislature provided the Association with wide latitude as to the type of financing arrangements. Attempting to pre-determine the arrangement as to either type or amount may result in forcing the Association into less fiscally prudent or beneficial arrangements than may otherwise be available.

Section 5.4121(a). A commenter states that TWIA is not authorized to enter into financing arrangements except as provided in the Insurance Code §2210.072.

Agency Response. The Department agrees with the statement as it applies to loss funding under The Insurance Code Chapter 2210, Subchapter B-1. For reasons stated in a previous response to comments, §5.4121(a) has been revised to state that it applies to financing arrangements entered into based on the Insurance Code §2210.072, which corresponds to the division's overall purpose of addressing loss funding. The Department declines to further restrict the provision.

The Legislature created the Association to act as the windstorm and hail insurer of last resort for property insurance in the catastrophe area. While in general an entity created by the Legislature only has those powers specifically granted to the entity, other powers necessary to fulfill the specified legislative intent may be implied. The Legislature did grant the Association the power to incur and pay operating expenses in the Insurance Code §2210.056. It is reasonable to consider that the Association is imbued with the implied power under the statute to enter into arrangements and incur expenses that would be consistent with the day to day operations of an enterprise collecting more than \$400 million in annual premium. These arrangements could include banking arrangements.

Section 5.4121(a). A commenter suggests that financing arrangements are limited to the status of class 1 public securities and that the Association may not enter into financing arrangements except within the limitations of class 1 public securities.

Agency Response. The Department agrees that the proceeds of financing arrangements addressed in these rules would be used as provided in the Insurance Code to pay losses not paid under the Insurance Code §2210.071, which is the requirement placed on class 1 public securities. The Department does not agree that the Association's financing arrangements are limited to the status of class 1 public securities or that they must be arranged by the TPFA. No changes have been made to the proposed text based on this comment.

Consistent with the usage in the Insurance Code §2210.072(d), §5.4102(19) defines a financing arrangement as an agreement with any market source under which

the market source makes interest bearing loans or provides other financial instruments to the Association. Thus, a financing arrangement is an agreement concerning a financial instrument. It is not specifically limited to an agreement issued by the TPFA. This contrasts with the Insurance Code §2210.603(7) definition of public security as “a debt instrument or other public security issued by the TPFA.” The Insurance Code §2210.603 goes on to define class 1, class 2 and class 3 “public securities” as the types of public securities that the TPFA may issue. The Insurance Code §2210.072(d) refers to commercial paper as a type of financial instrument, however, the Insurance Code §2210.603(2) defines commercial paper within the meaning of the term “Class 1 public securities.” Consistent with the statute, §5.4102(13) defines commercial paper notes as class 1 public securities.

Further, the Insurance Code §2210.072 differentiates between financial instruments and public securities, as does the Insurance Code §2210.056(a)(4) and §2210.453(b). If all financial instruments were public securities then this differentiation would be unnecessary. Finally, the Association has had financing arrangements in the past. These were short term arrangements with repayment expected in months, unlike the 10 year periods allowed for public securities. These prearranged financing arrangements provided the Association with millions of dollars in immediate cash to be paid on initial loss claims and additional living expenses following prior catastrophic events. The financing arrangements were in turn paid from the Association’s collected premium, reinsurance proceeds, or member assessments that had not been immediately available to pay the losses.

Thus, if the Legislature had intended financing arrangements under §2210.072 to be limited to “public securities” it could have specified that limitation. Instead the statutes clearly create two financing mechanisms. Based on the Association’s prior practice it is reasonable to consider that the Legislature intended this dual result. Therefore, §5.4121 and the Insurance Code §2210.072 provide that the Association may continue to enter into financing arrangements in addition to public security arrangements entered into by the TPFA.

Section 5.4121(b). A commenter states that the Association’s financing arrangements should be paid only from those sources of funds available to pay class 1 public securities.

Agency Response. The Department disagrees that Chapter 2210 places such a limitation on the Association. As indicated in the listing in §5.4121(b) any premium, asset, financial arrangement, reinsurance, or class of public security proceed collected by the Association may be used to repay the financing arrangement. Therefore no change has been made as a result of this comment.

First amongst these is the Association’s collected premium and other revenue as authorized in the Insurance Code §2210.058. The Association may also refinance or enter into a new financing arrangement and use those proceeds to pay off an existing financing arrangement; however, payment of the obligation would ultimately be made from another source of funds. Also, because a financing arrangement under the Insurance Code §2210.072 would be triggered by excess loss payments, the Association may also have reinsurance recoveries that could be used pay the debt.

However, because the financing arrangement discussed in this section arises under the Insurance Code §2210.072, it is likely that the Association will have insufficient premium and other revenue to fund the financing arrangement when due in addition to loss payments, operating expenses, and the repayment of public securities. If the financing arrangements could not timely be repaid in such circumstances, lenders would not make the funds available.

The Association's loss funding scheme has two basic layers, the Association's available premium and the CRTF, followed by public security debt. The funding scheme does not require the Association to enter into financing arrangements nor are the amounts of public securities authorized to be issued, or issuable based on market conditions, affected by financing arrangements. The use of financing arrangements simply allows the Association to pay losses that the Legislature has allocated to public security funding on a timely basis. It is not reasonable to interpret the Insurance Code §2210.072 as authorizing the continuance of a known means of immediate funding using financing arrangements, but then not also authorizing the means to repay those financing arrangements from the most viable source of funds in the very situation described by §2210.072.

The Insurance Code §2210.072(c) provides that "[I]f the losses are paid with public securities described by the section, the public securities shall be repaid in the manner prescribed by Subchapter M from association premium revenue." The repayment of public securities issued under the Insurance Code §2210.072 is addressed in the Insurance Code Chapter 2210, Subchapter M, §2210.612. That section refers only to the repayment of public securities and the issuance of commercial

paper, which is defined as a public security in the Insurance Code §2210.602(2). These provisions do not address the repayment of financing arrangements and thus do not limit the source of funds to the Association's premium revenue. Rather, the Insurance Code §2210.058 and §2210.608 provide alternative sources of funds for the repayment of financial instruments used to pay the Association's losses.

The Insurance Code §2210.608 authorizes public security proceeds to be used for the payment of the Association's incurred claims and operating expenses. Additionally the Insurance Code §§2210.072 - 2210.074 authorizes the use of public securities to pay losses. In this context, "losses" includes both loss payments and "incurred claims and operating expenses."

The Association's financing arrangements provide funding to pay losses. The character of this usage does not change upon payment of the loss. The Insurance Code Chapter 2210 does not prohibit or restrict the Association or TPFA from paying or refinancing Association issued financing arrangements with public security proceeds. This would include situations in which the only available funds to refinance the financing arrangement would result from a class 2 or 3 public security, such as in the case of a subsequent storm occurring after the entire issuable amount of Class 1 public securities had been issued to provide for prior losses. Otherwise, if the Association is required to limit payment of its financing arrangements only to the proceeds of class 1 public securities, the Association would need to deliberately limit the amount of its class 1 public security borrowings so as to maintain a future reserve for the repayment of financial instruments necessary to provide for the immediate payment of claims following a potential subsequent catastrophic event in that year. Such a determination

is not consistent with the statute nor is it necessary under the funding scheme created by the Legislature. The placement of financing arrangements in §2210.072 also does not limit the repayment of financial arrangements, as discussed. Rather, the placement is directive to the Association that if it is to use financial arrangements they are to be used to provide initial excess funding. Therefore, §5.4121 clarifies that in addition to premium, other revenue, other assets, and available reinsurance proceeds, the Association may pay for a financing arrangement with the proceeds of any class of public security.

Section 5.4121(b). A commenter requested clarification as to the use of reinsurance proceeds to pay Association financing arrangements.

Agency Response. Financing arrangements addressed in this section are those used to pay for losses not paid under the Insurance Code §2210.071 as described in the Insurance Code §2210.072. The financing arrangements are intended to provide immediate funding. As losses exceeding funding resources described in §2210.071 may be substantial either due to a single or multiple events, the Association may have reinsurance recoveries that could be used to pay the financing arrangements when the reinsurance is collected at a later date.

Section 5.4121(c). A commenter suggested revising the text of the proposal to provide that a security interest in financing arrangements could extend to all the Association's assets and not just the public security proceeds.

Agency Response. The Department agrees with the comment. The premium and other revenue of the Association are the primary source of repaying the financing

arrangements. Thus, §5.4121(c) has been changed to add “assets, including without limitation, all or portion of the Association’s” after the word “Association’s” in the adoption. This additional text clarifies that the Association is securing the financing arrangement with the Association’s assets, in addition to public security proceeds.

Such a collateral assignment and security interest is likely to be required in order to obtain a financing arrangement because the Association’s premium and other revenue may be secured to fund the class 1 public security obligation revenue fund, as provided in proposed §5.4141. It is probable that the Association’s only source of funds for the payment of the financing arrangement that was used to promptly fund the initial catastrophic claims will be the proceeds of a public security. It is reasonable for the Association to secure proceeds to pay catastrophe claims pending the completion of the arrangement, issuing, and funding of the public securities. Therefore, the market source might reasonably request that its repayment be secured in the assets of the Association and the proceeds of the public securities that are issued to fund the catastrophic losses.

Section 5.4131. A commenter stated that the statute did not authorize the Association to request the issuance of class 2 or class 3 public securities unless the entire authorized amount of the class 1 public securities had been issued or requested to be issued. In support of this position the commenter noted that the Legislature used the phrase “shall be issued” in the Insurance Code §2210.072(b), but used the phrase “may be issued” in the Insurance Code §2210.073(b) and §2210.074(b).

Agency Response. The Department disagrees with the commenter. The purpose of the Insurance Code Chapter 2210, Subchapter B-1 is to provide funding for insured losses on policies that the Legislature has charged the Association with issuing. Placing this funding entirely at the discretion of the bond markets would frustrate that intent. The text has not been changed in response to this comment.

The Insurance Code §§2210.072, 2210.073, and 2210.074 each authorize the maximum amount of public securities, per year, that may be issued under each class of public securities, which are \$1 billion dollars in class 1 public securities, \$1 billion dollars in class 2 public securities and \$500 million in class 3 public securities. However, market conditions and requirements may not allow for the TPFA to issue all authorized public securities in a particular class.

The TPFA has informed the Department and the Association that the markets will set the limit for the amount of class 1 public securities that may be issued by considering the Association's current net revenue as the source of the funds to pay the class 1 public security obligation and meet the contractual coverage amount, both for the initial year and subsequent years. As defined in §5.4102, the "contractual coverage amount" is the minimum amount that the Association is required to deposit into the applicable public security obligation revenue fund as security for the payment of debt service on the public securities, administrative expenses on public securities, or other payments required to be paid by the Association in connection with public securities. The contractual coverage amount secures against a drop off in amounts collected to pay the public security. As that amount is required to secure payment, the contractual coverage amount will exceed the required payment. In the case of class 1 public

securities, the contractual coverage amount may be greater than the amount owed annually to pay debt service, administrative expenses, or other required payments in connection with class 1 public security obligations.

The Association's net revenue is defined in §5.4102(25) as the Association's gross premium, plus other revenue, less unearned premium, less scheduled policy claims, less budgeted operating expenses, and less amounts necessary to fund or replenish the operating reserve fund. Scheduled policy claims are defined in §5.4102(31) as that portion of the Association's earned premium and other revenue expected to be paid in connection with the disposition of losses that do not result from a catastrophic event. These claims result from localized windstorm and hail events that may involve one to several hundred policyholders per event and could include losses due to straight-line winds, thunderstorms, tornados, hail, or other non-catastrophe wind and hail events. These events occur regularly throughout the catastrophe area, just as they occur regularly throughout the state, and losses related to such events are actuarially calculated into the premium collected by the Association. Budgeted operating expenses as defined in §5.4102(5) are all operating expenses as budgeted for and approved by the Association's board of directors, excluding expenses related to catastrophic losses. These are the ordinary expenses of the Association to issue policies, pay agent commissions, and adjust and settle scheduled claims. The operating reserve fund, which is defined in §5.4102(26), is established in §5.4141 to allow the Association to continue to pay scheduled claims following a loss that requires the issuance of class 1 public securities.

As discussed, the Department has been informed that the market's initial consideration of class 1 public securities would be based on the Association's current net revenue. The Department has also been informed that the market would not necessarily consider additional potential revenue with respect to the issuance of public securities, because even if the Association increased its rates, the net increase in overall gross premium, if any, from this action would not be fully achieved for approximately one year. Further, premium collections would not necessarily uniformly increase with a rate increase. Some policyholders would pay the increase, some would reduce coverage, and others would cancel or non-renew coverage. Thus, while a rate increase may increase gross revenues and provide an opportunity for a second issuance of class 1 public securities if the funding is needed, it would not be a guarantee that the Association could issue any remaining public securities in that class. Rather, the only definite result of delaying issuance of the next class of public securities to provide needed funding would be to delay payment of incurred claims in frustration of the Association's statutory purpose. Further, the TPFA has informed the Department that the TPFA has a public policy interest in issuing the Association public securities as investment grade. Thus, the Association could not issue securities on what would essentially be a speculative or junk bond basis.

To demonstrate this contractual coverage situation, the Association and the Department were provided estimates that \$1 billion in class 1 public securities could result in first year debt service of approximately \$125 million, with debt service in subsequent years of approximately \$173 million per year. At a 1.5 times contractual coverage amount, the Association would be required to have at least \$188 million in net

revenue for the first year and \$259 million for subsequent years. At a three times contractual coverage amount, the net revenue amounts for these periods increase to \$376 million and \$519 million, respectively. For comparison, the Association's current estimated net revenue is approximately \$270 million.

However, this information is based on assumptions of what the market may require. The market may require a greater contractual coverage amount. Thus, it would also be speculative for the Association simply to increase its rates in anticipation of meeting any market contingency or desire. As discussed, increasing the rates, especially significant immediate increases, does not necessarily result in a set amount of additional premiums due to persons reducing or canceling insurance coverage. The result of qualifying persons in need of Association insurance coverage being forced to reduce or cancel coverage based on market whims is not necessarily consistent with the Association's purpose as set forth in the Insurance Code §2210.001.

As for the use of the terms "shall" and "may," the Department recognizes that the Government Code §311.061(1) and (2) defines the terms as having different meanings; however, in the context of the Insurance Code §§2210.072 - 2210.074, the provisions function the same. The term "shall" as used in the Insurance Code §2210.072(b) usually creates a duty, but the section has no stated consequence. Rather, the Insurance Code §2210.073 simply provides that losses not paid under §2210.072 shall be paid as provided in §2210.073. Similarly, the term "may" as used in the Insurance Code §2210.073(b) usually means the act is discretionary; however, in context, neither §2210.073(a), providing that losses not paid under §2210.072 shall be paid as provided in §2210.073, nor the Insurance Code §2210.074(a), providing that losses not paid

under §2210.073 shall be paid as provided in §2210.074, indicate that the Association may simply choose to ignore funding such losses. Further, a duty to issue the entire amount, regardless of other concerns, would conflict with the TPFA's discretionary authority to determine the method of sale, type and form of public security that best achieve the goals of the Association and effect the borrowing at the lowest practicable cost as set forth in the Insurance Code §2210.605.

Thus, while the HB 4409 amendments, including the adoption of the Insurance Code §2210.072 concerning class 1 public securities, indicate a shift to making the Association more self-reliant, nothing in HB 4409 indicates any legislative intent that the Association is to stop paying claims if the entire class of public securities cannot reasonably be sold in the market's determination. Rather, the Insurance Code §§2210.072 - 2210.074 provide funding for the Association's losses, with the duty that losses not paid under the preceding sections be paid under the subsequent section.

Thus, §5.4131 requires only that the Association request issuance of the reasonably practical maximum principal amount of a class of public security before moving on to the next numerically greater class of public security. Section 5.4131(c) sets out the criteria that the Association must consider in determining the reasonably practical maximum principal amount of public securities. In making its determination, the Association may rely on the advice and analysis of the TPFA. Upon receipt of the Commissioner's written approval, the Association shall request the TPFA to issue the approved requested public securities. The Association may then proceed to work with the TPFA to obtain the funds.

Section 5.4131. A commenter noted that the statute and rule did not address funding losses in excess of \$2.5 billion.

Agency Response. The authorized amount of public securities that may be issued per year is limited, however, under the statute and this adoption, over time funding is only limited by the amount of public securities of any class that may be issued. As previously discussed in this adoption, the limit of public securities that may be issued to fund excess losses under the Insurance Code Chapter 2210, Subchapter B-1 is \$2.5 billion per year. This adoption also notes that public security funding may be further limited and reduced based on market conditions. However, while §§2210.072 - 2210.074 limit the authorized amount of public securities that may be issued “per year,” these limits are not directly tied to losses resulting from an occurrence or series of occurrences in that year.

The Insurance Code Chapter 2210, Subchapter B-1, does not define the term “year.” Because the Association is at greatest risk of a catastrophic event during hurricane season, which occurs June through November, it is reasonable to consider this period to be a calendar year and not twelve months between public security issuances. This is because limiting public security issuances to twelve months intervals could work to significantly delay loss payments to Association policyholders who incurred an early season storm in a year following a significant late season storm. Thus, January 1, of each year an additional amount of funding is authorized.

The Insurance Code §2210.071 provides that a “[I]f an occurrence or series of occurrences in a catastrophe area results in insured losses and operating expenses of

the association in excess of premium and other revenue of the association (a catastrophic event), the excess losses and operating expenses shall be paid as provided by [the Insurance Code Chapter 2210, Subchapter B-1]. The Insurance Code Chapter 2210, Subchapter B-1 does not specifically limit funding to the year in which the catastrophic event occurred. Rather, the only limitation is the “per year” amount of public securities that may be issued to fund the losses. Thus, funding, in class order as available, may be accessed to cover losses incurred in a prior year so long as the basic condition of a “catastrophic event” persisted.

However, using funds authorized for a subsequent year has certain limitations. As discussed in this adoption, not all sources of funding under §2210.072 - 2210.074 may be available to the Association annually based on market conditions. Further, use of current year authorized public securities to essentially fund continuing losses from a prior year would significantly reduce or eliminate those remaining funding resources in the current year. Thus, the Legislature may determine that an alternative funding structure is necessary if losses exceed \$2.5 billion or those lesser amounts that can be reasonably borrowed based on market conditions.

In analyzing the statute and rule in response to this comment the Department has determined that §5.4131(e) needs to be clarified as to the funds being requested. The revision adds paragraph (3) providing that the public security request shall be applicable to authorized public securities available in the year the request is made, unless stated otherwise in the request. This clarification is necessary to avoid depleting authorized public securities in subsequent year because a late season catastrophe resulted in a timely public security request, but with public securities being issued after

January 1 of the next year due to market delays. This requires the Association to act promptly to request the issuance of public securities. However, once the issuance of public securities is requested, the Association has limited continuing involvement and issuance becomes dependent on the actions of the TPFA and the markets. Because of the adverse affect on funding for subsequent years, it is reasonable to consider that the per year limitation in §§2210.072 - 2210.074 refers to the timely request for issuance during the year of the request rather than the potential elimination of funding for subsequent years based on the market that are beyond the control of the Association, the Department, and the TPFA.

Finally, the Insurance Code Chapter 2210 clearly and consistently distinguishes between issuing and refinancing public securities. Therefore, the annual limitations in the Insurance Code §§210.072 - 2210.074 concerning issuance of public securities do not apply to refinancing already issued public securities of the same class.

Section 5.4131. Commenters argued that the rule should allow member insurers the option of paying their proportionate share losses under the Insurance Code §2210.074 in a lump sum assessment in lieu of participating in the payment of the class 3 public securities as a means of simplifying the process and reducing costs.

Agency Response. The Department disagrees with the assertion that an insurer may elect to be assessed for the full amount of its obligation to pay Association losses under the Insurance Code §2210.074(a) in lieu of participating in the payment of the class 3 public securities. The Department considers the assertion to be inconsistent with the

Insurance Code Chapter 2210 and the adopted procedures implementing that chapter. Therefore, no changes have been made as a result of this comment.

The purpose of §2210.074, and Subchapter B-1, generally, is to provide funding for the payment of Association losses in excess of the Association's premium, other revenue, and the CRTF. The Insurance Code §2210.074(a) provides that the Association's losses payable under §2210.074 be paid either from the proceeds of class 3 public securities or the through reinsurance as described by the Insurance Code §2210.075.

The Insurance Code §2210.075(a) provides that a member insurer may elect to purchase reinsurance to cover an assessment for which the insurer would otherwise be liable under the Insurance Code §2210.074(b). The Insurance Code 2210.074(b) provides that if losses are paid with class 3 public securities, the class 3 public securities will be repaid in the manner described by the Insurance Code Chapter 2210, Subchapter M through assessments as provided by §2210.074. Section 2210.074(b), further provides that the Association shall notify each member of its assessment under §2210.074 and that the proportion of losses allocable to each insurer under §2210.074 shall be determined in the manner used to determine the insurer's participation in the Association under §2210.052. The Insurance Code §2210.6135, which is in Subchapter M, has the same provisions related to notice and allocation, and provides that the class 3 public securities would be paid through member assessments. The Insurance Code §2210.6135, however, further authorizes the Association to assess members up to \$500 million per year.

As a whole, these sections could be read to require that either the entire amount of the applicable losses must be paid with class 3 public securities or the entire amount of the applicable losses must be paid with reinsurance, but not necessarily a mixture of both because the Insurance Code §2210.074 does not suggest a means for allocating between the two categories nor does the Insurance Code provide for the direct payment of losses.

Rather, the Insurance Code §2210.075 provides for the use of reinsurance to pay an insurer's assessment under the Insurance Code §2210.074(b), which is the obligation to the class 3 public securities. The Insurance Code § 2210.074(b) provides that "if the losses are paid with public securities ..., the public securities shall be repaid in the manner prescribed by Subchapter M through assessments as provided by the section." Each insurer's participation in the class 3 public securities is determined by assessment as set forth in the Insurance Code §2210.074(b) and §2210.6135. The insurer may purchase reinsurance to cover this obligation; however, the Insurance Code §2210.075(a) does not require the purchase of reinsurance nor does §2210.075(a) state that reinsurance applies in lieu of participation in the repayment of the class 3 public securities.

Further, the Insurance Code §2210.074 and §2210.6135 indicate that the entire membership of the Association, and thus the Texas property insurance market, will be obligated for the repayment of the public securities. In establishing two groups with one being obligated to repay the public securities and one not being so obligated, that public security funding resource is limited to the financial strength of the obligated participating insurers and the potential that those insurers will continue to write in Texas

until the public securities are repaid. This could limit the ability of the TPFA to issue class 3 public securities and frustrate the intent of the loss funding scheme set forth in the Insurance Code Chapter 2210, Subchapter B-1.

Section 5.4131. A commenter suggested that the assessments be based on the participation percentages applicable in the year the occurrence or series of occurrences arose and not vary over the term of the public securities.

Agency response. The Department considers that limiting the participation percentages to the year the occurrence or series of occurrences arose to be inconsistent with the Insurance Code Chapter 2210 and the adopted procedures implementing that chapter. Therefore, no changes have been made as a result of this comment.

As to establishing a participation formula, this comment more directly relates to the separate proposal concerning assessments published in the July 30, 2010 issue of the *Texas Register* (35 TexReg 6611). However to the extent the Association may need to consider the outstanding amount of public securities, it is necessary to consider that the public securities will be paid over a period of approximately 10 years. Significant market changes may occur during that period.

This includes the entry and exit of market participants and changes in company writing practices. Under no situation would the formula be truly fixed for the entire term of the public security obligation, because the formula must consider that over the course of time some members will leave the Texas market or fail financially. Also, new members are only exempt from participating in assessments for the first two years.

Additionally, members could also seek to decrease their assessment by increasing their writings in the catastrophe area, an incentive which is consistent with the Insurance Code §2210.009(b) and §2210.053(b). Further, the Association and the members would be required to prepare and use a single calculation for all assessments made during the year for class 2 public securities and class 3 public securities regardless of the year the public securities were issued. Finally, because members would have the same assessment obligation to each class 2 public security and class 3 public security regardless of the year in which the security was issued, the TPFA might also be able to more readily refinance outstanding public securities of the same class and take advantage of changing market conditions.

Section 5.4132(3). A commenter suggested revising §5.4132(3) to clarify that each of the three provision reasons for issuing public securities was independent of the other two.

Agency Response. While the provision proposes no obligation of the TPFA, the Department agrees that the provisions could be confusing and has revised §5.4132(3) based on the comment. As discussed in this adoption, §5.4132 is intended to provide the reader with a summary of activities that the TPFA will be responsible for concerning the issuance of public securities. The section does not create requirements that the TPFA must comply with. Based on the comment the paragraph was revised to clarify that the TPFA may perform the listed acts as authorized by the Insurance Code Chapter 2210 and designates the three provisions setting forth the acts as (A) - (C).

5. NAMES OF THOSE COMMENTING AGAINST THE SECTIONS.

Against, with changes: American Insurance Association, The Heartland Institute, JP Morgan Chase Bank, N.A., Office of Public Insurance Counsel, Property and Casualty Insurers of America, and Texas Windstorm Insurance Association.

6. STATUTORY AUTHORITY. The sections are adopted under the Insurance Code §§2210.008, 2210.056, 2210.071, 2210.072, 2210.073, 2210.074, 2210.075, 2210.151, 2210.152, 2210.259, 2210.452, 2210.453, 2210.604, 2210.608, 2210.609, 2210.611, 2210.612, 2210.613, 2210.6135, and 36.001. Section 2210.008(b) authorizes the Commissioner to adopt reasonable and necessary rules in the manner prescribed in Subchapter A, Chapter 36, Insurance Code. Section 2210.056 establishes the allowable uses for the Association's assets. Section 2210.071(a) provides that if an occurrence or series of occurrences in a catastrophe area results in insured losses and operating expenses of the Association in excess of premium and other revenue of the Association, the excess losses and operating expenses shall be paid as provided by Subchapter B-1, Chapter 2210, Insurance Code. Section 2210.071(b) provides that the Association shall pay such excess losses from available amounts in the CRTF. Section 2210.072(a) provides that losses not paid under the Insurance Code §2210.071 shall be paid as provided by this section from the proceeds from class 1 public securities. Section 2210.072(a) also authorizes the early repayment of class 1 public securities if the Association's board of directors elects to do so and the Commissioner approves. Section 2210.072(b) authorizes class 1 public securities to be issued in a principal

amount not to exceed \$1 billion per year. Section 2210.072(c) requires class 1 public securities to be repaid in the manner prescribed by Subchapter M, Chapter 2210, Insurance Code, from Association premium revenue. Section 2210.072(d) authorizes the Association to enter into financing arrangement with any market source to enable the Association to pay losses under the Insurance Code §2210.072 or to enable the Association to obtain public securities. Section 2210.073 provides that losses not paid under the Insurance Code §2210.072 shall be paid as provided by this section from the proceeds from class 2 public securities issued in accordance with Subchapter M, Chapter 2210, Insurance Code. Section 2210.073(a) also authorizes the early repayment of class 2 public securities if the Association's board of directors elects to do so and the Commissioner approves. Section 2210.073(b) authorizes class 2 public securities to be issued in a principal amount not to exceed \$1 billion per year and requires class 2 public securities to be repaid in the manner prescribed by Subchapter M, Chapter 2210, Insurance Code. Section 2210.074(a) provides that losses not paid under the Insurance Code §§2210.072 and 2210.073 shall be paid as provided by this section from the proceeds from class 3 public securities issued in accordance with Subchapter M, Chapter 2210, Insurance Code or reinsurance purchased under the Insurance Code §§2210.075. Section 2210.074(a) also authorizes the early repayment of class 3 public securities if the Association's board of directors elects to do so and the Commissioner approves. Section 2210.074(b) authorizes class 3 public securities to be issued in a principal amount not to exceed \$500 million per year; provides that if the losses are paid with class 3 public securities, the class 3 public securities will be repaid in the manner described by the Insurance Code Chapter 2210, Subchapter M, through

assessments as provided by §2210.074; and that the Association shall notify each member of its assessment under §2210.074 and that the proportion of losses allocable to each insurer under §2210.074 shall be determined in the manner used to determine the insurer's participation in the Association for that year under §2210.052. The Insurance Code §2210.075(a) provides that a member insurer may elect to purchase reinsurance to cover an assessment for which the insurer would otherwise be liable under the Insurance Code §2210.074(b). The Insurance Code §2210.075(b) provides that an insurer choosing not to purchase reinsurance remains liable for its assessment under the Insurance Code §2210.074(b). Section 2210.151 authorizes the Commissioner to adopt the Association's plan of operation to provide Texas windstorm and hail insurance coverage in the catastrophe area by rule. Section 2210.152 provides that the Association's plan of operation provide for the efficient, economical, fair, and nondiscriminatory administration of the Association and include both underwriting standards and other provisions considered necessary by the Department to implement the purposes of this chapter. Section 2210.259 requires the Association to assess a 15% premium surcharge on a noncompliant residential structure insured by the Association as of September 1, 2009, under Section 2210.251(f) that had been approved for insurability under the approval process regulations in effect on September 1, 2009 and to deposit the premium surcharge in the CRTF. Section 2210.259 further provides that the premium surcharge is a separate nonrefundable charge in addition to the premiums collected and is not subject to premium tax or commissions. Section 2210.452 requires the Commissioner to adopt rules under which the Association makes payments to the CRTF including the net gain from operations of the Association at the

end of each calendar year or policy year; and the procedure relating to the disbursement of money from the trust fund to the Association to fund the obligations of the trust fund under Subchapter B-1, Chapter 2210, Insurance Code. Section 2210.452(b) further provides that the comptroller, as custodian of the trust fund, shall administer the trust fund strictly and solely as provided by Chapter 2210, Insurance Code and Commissioner rules. Section 2210.452(d) provides that the trust fund may be terminated only by law and that on termination of the trust fund, all assets of the trust fund revert to the state to provide funding for the mitigation and preparedness plan established under the Insurance Code §2210.454. Section 2210.453 provides that the Association may purchase reinsurance that operates in addition to or in concert with the CRTF, public securities, financial instruments, and assessments authorized by Chapter 2210, Insurance Code. Section 2210.604 requires that the Commissioner approve an Association request to the Texas Public Finance Authority for the issuance of class 1, class 2, or class 3 public securities. Section 2210.608 provides how the Association may use public security proceeds and excess public security proceeds. Section 2210.609 provides that the Association shall repay all public security obligations from available funds, and if those funds are insufficient, revenue collected in accordance with the Insurance Code §§2210.612, 2210.613, and 2210.6135. Section 2210.609 further provides that the Association shall deposit all revenue collected under §§2210.612, 2210.613, and 2210.6135 in the public security obligation revenue fund and further provide for the payment of the public security obligations and the public security administrative expenses by irrevocably pledging revenues received from premiums, premium surcharges, and amounts on deposit in the public security

obligation revenue fund, together with any public security reserve fund. Section 2210.611 establishes that the Association may use premium surcharge revenue collected under the Insurance Code §2210.613 in any year that exceeds the amount of the public security obligations and public security administrative expenses payable in that year and interest earned on the public security obligation fund to (i) pay public security obligations payable in the subsequent year; (ii) redeem or purchase outstanding public securities; or (iii) make a deposit in the CRTF. Section 2210.612 provides that the Association shall pay class 1 public securities issued under §2210.072 from its premium and other revenue. Section 2210.613 provides that the Association shall pay class 2 public securities issued under §2210.073 with premium surcharges and member assessments as provided by §2210.613. Section 2210.6135 provides that the Association shall pay class 3 public securities issued under Section 2210.074 as provided by §2210.6135 through member assessments. Section 36.001 provides that the Commissioner of Insurance may adopt any rules necessary and appropriate to implement the powers and duties of the Texas Department of Insurance under the Insurance Code and other laws of the state.

7. TEXT.

DIVISION 3. LOSS FUNDING, INCLUDING CATASTROPHE RESERVE TRUST FUND, FINANCING ARRANGEMENTS, AND PUBLIC SECURITIES

§5.4101. Applicability.

(a) Sections 5.4101, 5.4102, 5.4111 - 5.4114, 5.4121, 5.4131 - 5.4134, and 5.4141 - 5.4147 of this division are a part of the Texas Windstorm Insurance Association's plan of operation and shall control over any conflicting provision in §5.4001 of this subchapter (relating to Plan of Operation). If a court of competent jurisdiction holds that any provision of this division is inconsistent with any statutes of this state, is unconstitutional, or is invalid for any reason, the remaining provisions of the sections in this division shall remain in effect.

(b) Notwithstanding any provision in this subchapter, the department retains regulatory oversight of the Association as required by the Insurance Code Chapter 2210, including periodic examinations of the accounts, books and records of the Association and no provision should be interpreted as negating or limiting the department regulatory oversight of the Association.

§5.4102. Definitions. The following words and terms when used in this division shall have the following meanings unless the context clearly indicates otherwise:

- (1) Association--Texas Windstorm Insurance Association.
- (2) Association program--The funding of any or all of the purposes authorized to be funded with the Public Securities under Subchapter M, Chapter 2210, Insurance Code.
- (3) Authorized representative of the department--Any officer or employee of the department, empowered to execute instructions and take other necessary actions on behalf of the department as designated in writing by the commissioner.

(4) Authorized representative of the trust company--Any officer or employee of the comptroller or the trust company who is designated in writing by the comptroller as an authorized representative.

(5) Budgeted operating expenses--All operating expenses as budgeted for and approved by the Association's Board of Directors, excluding expenses related to catastrophic losses.

(6) Catastrophe area--A municipality, a part of a municipality, a county, or a part of a county designated by the commissioner under the Insurance Code §2210.005.

(7) Catastrophe Reserve Trust Fund (CRTF)--A statutorily created trust fund established with the trust company under Subchapter J of Chapter 2210, Insurance Code.

(8) Catastrophic event--An occurrence or a series of occurrences in a catastrophe area resulting in insured losses and operating expenses of the Association in excess of premium and other revenue of the Association.

(9) Catastrophic losses--Losses resulting from a catastrophic event.

(10) Class 1 public securities--A debt instrument or other security authorized to be issued by the TPFA under §2210.072 and Subchapter M of Chapter 2210, Insurance Code.

(11) Class 2 public securities--A debt instrument or other security authorized to be issued by the TPFA under the Insurance Code §2210.073 and Subchapter M of Chapter 2210, Insurance Code.

(12) Class 3 public securities--A debt instrument or other security authorized to be issued by the TPFA under the Insurance Code §2210.074 and Subchapter M of Chapter 2210, Insurance Code.

(13) Commercial paper notes--A type of class 1 public security issued by the TPFA.

(14) Commissioner--Commissioner of Insurance of the State of Texas.

(15) Comptroller--Comptroller of the State of Texas.

(16) Contractual coverage amount--Minimum amount that the Association is required to deposit into the applicable public security obligation revenue fund as security for the payment of debt service on the public securities, administrative expenses on public securities, or other payments required to be paid by the Association in connection with public securities.

(17) Credit agreement--A loan agreement, revolving credit agreement, agreement establishing a line of credit, letter of credit, reimbursement agreement, insurance contract, commitment to purchase obligations, purchase or sale agreement, interest rate management agreement, or other commitment or agreement authorized by the TPFA in anticipation of, related to, or in connection with the authorization, issuance, sale, resale, security, exchange, payment, purchase, remarketing, or redemption of some or all of its public security obligations or interest on public security obligations, or both, or as otherwise authorized by Chapter 1371 of the Government Code.

(18) Department--Texas Department of Insurance.

(19) Financing arrangement--An agreement with any market source under which the market source makes interest bearing loans or provides other financial instruments to the Association to enable the Association to pay losses or obtain public securities under the Insurance Code §2210.072.

(20) Gross premiums--The amount of premium received by the Association. The term does not include premium surcharges collected by the Association pursuant to the Insurance Code §2210.259 and §2210.613.

(21) Investment income--Income received by the Association from the investment of funds held by or for the benefit of the Association.

(22) Letter of instruction--Written authorization and direction to an authorized representative of the trust company, which is signed by the commissioner or an authorized representative of the department.

(23) Losses--Amounts paid on Association insurance policy claims, including adjustment expenses, litigation expenses, and other claims expenses.

(24) Net gain from operations--The gain from operations, for a calendar year or policy year as the case may be, including all earned premium and other revenue of the Association in excess of incurred losses, operating expenses, and amounts to satisfy in whole or in part the obligations of the Association incurred in connection with the Insurance Code Chapter 2210, Subchapters B-1, J, and M, including reinsurance, public securities and financial instruments.

(25) Net Revenues--Gross premiums received by the Association from policyholders, plus other revenue, less unearned premium, less scheduled policy

claims, less budgeted operating expenses, and less amounts necessary to fund or replenish the operating reserve fund.

(26) Operating Reserve Fund--The amount budgeted each year by the Association for the payment of scheduled policy claims and budgeted operating expenses divided by four.

(27) Other Revenue--Revenue of the Association from any source other than premiums. Other revenue includes investment income on Association assets; but other revenue does not include premium surcharges collected pursuant to the Insurance Code §2210.259, premiums surcharges collected from Association policyholders and other insurers under the Insurance Code §2210.613, Association member assessments collected under the Insurance Code §2210.613 and §2210.6135, and investment income on premium surcharges and member assessments collected under the Insurance Code §§2210.259, 2210.613, and 2210.6135.

(28) Plan of operation--The Association's plan of operation as adopted by the commissioner pursuant to §2210.151 and §2210.152 of the Insurance Code.

(29) Public Securities--Collective reference to class 1 public securities, class 2 public securities, and class 3 public securities.

(30) Public security obligations--The principal of a public security and any premium and interest on a public security issued under this subchapter, together with any amount owed under a related credit agreement.

(31) Scheduled Policy Claims--That portion of the Association's earned premium and other revenue expected to be paid in connection with the disposition of losses that do not result from a catastrophic event.

(32) Trust Company--Texas Treasury Safekeeping Trust Company managed by the comptroller pursuant to the Government Code §404.101, et seq.

(33) Trust Company Representative--Any individual employed by the Trust Company who is designated by the trust company as its authorized representative for purposes of any agreement related to the catastrophe reserve trust fund or the public securities.

(34) TPFA--The Texas Public Finance Authority.

(35) Unearned Premium--That portion of gross premiums that has been collected in advance for insurance that has not yet been earned by the Association because of the unexpired portion of the time for which the insurance policy has been in effect.

§5.4111. Operation of the Catastrophe Reserve Trust Fund.

(a) In General.

(1) The comptroller shall administer the catastrophe reserve trust fund in accordance with Insurance Code Chapter 2210, and this subchapter.

(2) The comptroller shall ensure that all money received from the Association pursuant to subsection (b) of this section is deposited with the trust company in the catastrophe reserve trust fund.

(3) The trust company shall receive, disburse, invest, hold, and manage all money deposited in the catastrophe reserve trust fund.

(4) All money, including investment income, deposited in the catastrophe reserve trust fund is state funds to be held by the comptroller outside the state treasury on behalf of, and with legal title in, the department until disbursed as provided by the Insurance Code Chapter 2210 and this subchapter.

(b) Payment of Funds to the Catastrophe Reserve Trust Fund.

(1) Except as provided by statute, on an annual basis, the Association shall pay the net gain from operations of the Association directly to the comptroller for deposit with the trust company in the catastrophe reserve trust fund.

(2) In a time period acceptable to the trust company and the comptroller, but not more frequently than monthly, the Association shall pay all premium surcharges collected under the Insurance Code §2210.259 during the preceding period and accumulated investment income on those premium surcharges directly to the comptroller for deposit with the trust company in the catastrophe reserve trust fund. Premium surcharges collected by the Association pursuant to the Insurance Code §2210.259 and investment income on those funds are not gross premium or other revenue of the Association and must be accounted for separately from the Association's gross premium and other revenue.

(3) As necessary, the Association shall pay directly to the comptroller for deposit with the trust company in the catastrophe reserve trust fund all:

(A) excess public security proceeds resulting from the Insurance Code §2210.608;

(B) excess premium surcharges resulting from the Insurance Code §2210.611 and §5.4144 of this subchapter (relating to Excess Class 2 Premium Surcharge Revenue); and

(C) excess member assessments resulting from §5.4145 and §5.4147 of this subchapter (relating to Excess Class 2 Member Assessment Revenue; and Excess Class 3 Member Assessment Revenue).

(4) All deposits received by the trust company under this subsection shall be deposited in the catastrophe reserve trust fund immediately upon receipt.

(c) Disbursements from the Catastrophe Reserve Trust Fund.

(1) Prior to a disbursement of funds from the catastrophe reserve trust fund other than a disbursement under paragraph (3) of this subsection, the department must determine that:

(A) a catastrophic event has occurred; and

(B) the catastrophic event has resulted in losses in excess of available reinsurance proceeds.

(2) To disburse funds from the catastrophe reserve trust fund in response to a catastrophic event, the commissioner or an authorized representative of the department shall issue a letter of instruction to the trust company, specifying the amount of money to be disbursed in immediately available funds and specifying any third party payee.

(3) To disburse funds from the catastrophe reserve trust fund to pay for costs associated with maintaining or managing the catastrophe reserve trust fund, the commissioner or an authorized representative of the department shall issue a letter of instruction to the trust company specifying the amount of money to be paid and specifying any third party payee.

(d) Maintenance of the Catastrophe Reserve Trust Fund.

(1) In maintaining and managing the catastrophe reserve trust fund, the trust company shall be charged with the duty of care, which applies to the comptroller as trustee of funds in the treasury.

(2) The department shall pay the trust company an amount sufficient to reimburse the trust company for the actual monthly costs of administering and maintaining the catastrophe reserve trust fund. The trust company shall deduct the appropriate amount directly from the earnings of the catastrophe reserve trust fund and advise the department monthly in writing of the amount of these costs.

(3) The trust company shall submit to the department a report of all transactions relating to the catastrophe reserve trust fund promptly after the end of each month. The trust company shall furnish other information relating to the catastrophe reserve trust fund as the department may reasonably request from time to time.

(4) The trust company is required to keep a book of records in which the complete and correct entries are made of all transactions relating to the receipts, disbursements, deposits, withdrawals and transfers in the catastrophe reserve trust

fund in accordance with generally accepted accounting principles. The records shall be available for inspection by an authorized representative of the department at all reasonable hours of the business day and under reasonable conditions.

§5.4112. Termination of Catastrophe Reserve Trust Fund.

(a) The catastrophe reserve trust fund may be terminated only by law.

(b) On termination of the trust fund, all assets of the catastrophe reserve trust fund revert to the state and shall be used by the department to provide funding for the annual loss mitigation and preparedness plan established under the Insurance Code §2210.454.

§5.4113. Investments of Catastrophe Reserve Trust Fund.

(a) The money in the catastrophe reserve trust fund may only be invested in investments as authorized by the Government Code §404.024 and §404.106, and as amended.

(b) The Association does not have authority to direct investments or money in the catastrophe reserve trust fund.

(c) All earnings and losses from the investment of funds in the catastrophe reserve trust fund shall be credited to or charged against the catastrophe reserve trust fund. Investment income on money in the trust fund shall be maintained as part of the funds in the trust fund.

(d) The funds of the catastrophe reserve trust fund may be intermingled with other funds held by the trust company for the purposes of common investment and operational efficiency.

§5.4114. Duties and Responsibilities.

(a) In the event that the Association reasonably estimates that a catastrophic event has occurred, the general manager of the Association shall promptly notify the commissioner and the comptroller in writing of the total amount of the estimated catastrophic losses and potential reinsurance recoveries related to those losses. The general manager of the Association shall further promptly notify the commissioner and the comptroller in writing of any subsequent changes in such estimates.

(b) Upon receipt of a definitive written statement from the Association's general manager that a catastrophic event has occurred and that the catastrophic losses exceed available reinsurance proceeds, the commissioner or an authorized representative of the department shall provide a letter of instruction to pay the Association an amount from the catastrophe reserve trust fund that is equal to the lesser of the portion of the catastrophic loss that exceeds the premium and other revenue of the Association and available reinsurance proceeds or the balance of the catastrophe reserve trust fund. The Association shall report to the department any subsequent changes in the amount of catastrophic losses and the amount due either party shall be remitted promptly. Any funds received by the Association from the catastrophe reserve trust fund but not expended for the payment of loss and loss

adjustment expenses shall be remitted by the Association to the catastrophe reserve trust fund.

(c) In authorizing the release of catastrophe reserve trust funds, the commissioner may rely on any statements or notifications of definitive or estimated losses, Association revenue, reinsurance proceeds, or any other related or supporting information, from any source, including the general manager of the Association.

§5.4121. Financing Arrangements.

(a) The Association may enter into financing arrangements. The financing arrangement must:

(1) enable the association to:

(A) pay losses under the Insurance Code §2210.072; or

(B) obtain public securities under the Insurance Code §2210.072.

(2) be approved by the Association's board of directors prior to the Association entering into the financing arrangement.

(b) The Association may pay a financing arrangement with:

(1) premiums and other revenue of the Association;

(2) reinsurance proceeds;

(3) the proceeds of any financing arrangement;

(4) the proceeds of any class of public security issued under Insurance Code Chapter 2210; and

(5) any other Association asset.

(c) As collateral security for such financial arrangements, including interest bearing loans or other financial instruments, the Association may grant in favor of the applicable market source a collateral assignment and security interest in and to all or any portion of the Association's assets, including without limitation, all or any portion of the Association's right, title and interest in and to all proceeds of any or all class 1 public securities, including commercial paper notes, class 2 public securities, and/or class 3 public securities, with the priority of each such collateral assignment and security interest, whether first or secondary, to be determined by the Association in its discretion.

§5.4131. Issuance of Public Securities.

(a) In the event that the Association reasonably estimates that a catastrophic event has occurred and that the catastrophic losses are estimated to exceed available catastrophe reserve trust funds and available reinsurance proceeds, the Association may request the issuance of public securities as set forth in this section. Each request for the issuance of public securities must be approved by the commissioner prior to the issuance of the public securities.

(b) The Association's request under subsection (a) of this section must be in writing and specify:

(1) the total estimated amount of catastrophic losses as of the date of the request;

(2) the reasonably practical maximum principal amount of public securities the Association is to request;

(3) the term of the public securities;

(4) the estimated amount of debt service for the public securities, including any contractual coverage requirement;

(5) the Association's current gross premium and other revenue; and

(6) the Association's current net revenues.

(c) In determining the reasonably practical maximum principal amount of public securities under subsection (b) of this section, the Association must consider:

(1) the Association's current gross premium and other revenue;

(2) the Association's current net revenues;

(3) the Association's obligations for outstanding public securities, including contractual coverage requirements;

(4) the Association's obligations for other financing arrangements; and

(5) market conditions and requirements necessary to sell the public securities with an investment-grade rating, including issuing classes in installments.

The Association may rely on the advice and analysis of the TPFA in determining such market conditions and requirements and in determining the reasonably practical maximum principal amount of public securities.

(d) In considering the Association's request, the commissioner may rely on any statements or notifications of definitive or estimated losses, Association revenue,

reinsurance proceeds, or any other related or supporting information, from any source, including the general manager of the Association and the TPFA.

(e) The Association may make one or more requests for funding under this section following a catastrophic event.

(1) The Association must request issuance of what has been determined to be the reasonably practical maximum principal amount of class 1 public securities before the Association may request issuance of class 2 and class 3 public securities.

(2) The Association must request issuance of what has been determined to be the reasonably practical maximum principal amount of class 2 public securities before the Association may request issuance of class 3 public securities.

(3) The amount of public securities being requested shall apply against the balance of the authorized amount of public securities for that class in the calendar year the public securities are requested, unless the written request specifically provides that:

(A) the public securities are to be issued in the subsequent calendar year; and

(B) the amount of public securities being requested shall apply against the balance of the authorized amount of public securities for that class in the year the public securities are actually issued.

(f) Upon receipt of the commissioner's written approval, the Association shall request the TPFA to issue the approved requested public securities.

(g) As provided in the Insurance Code Chapter 2210 the Association may enter

into agreements as directed by the TPFA for the issuance, reissuance, refinancing, and payment of public security obligations and public security administrative expenses.

§5.4132. Texas Public Finance Authority Responsibilities Concerning Issuance of Public Securities. Pursuant to Insurance Code, Chapter 2210, Subchapter M, the TPFA has the certain statutory obligations regarding the issuance of public securities on behalf of the Association, including:

(1) determining the terms of the public securities to best achieve the goals of the Association and result in borrowing at the lowest practical cost. Within the scope of the reasonably practical maximum principal amount, the TPFA may increase the maximum amount of the public securities to include amounts sufficient to:

(A) pay the cost of issuance;

(B) provide a public security reserve fund; and

(C) capitalize the interest on the public securities for the period specified by the Association;

(2) complying with any credit agreement, including a liquidity agreement issued by the Comptroller;

(3) as authorized in the Insurance Code Chapter 2210, issuing the requested public securities on behalf of the Association for the purpose of:

(A) financing and refinancing the Association program;

(B) paying and refinancing outstanding public securities of the same class; or

(C) paying and refinancing other financing arrangements;

(4) arranging for the issuance of commercial paper notes prior to a catastrophic event. The Association and the commissioner shall approve each tranche of commercial paper notes issued under a commercial paper program;

(5) establishing all necessary accounts with the trust company;

(6) together with the trust company and the comptroller, managing the obligation revenue fund, or funds, and the distribution of money to the various accounts in the public security obligation revenue fund, or funds, as necessary to fulfill the obligations of the TPFA and the Association under the Insurance Code Chapter 2210;

(7) informing the Association and the commissioner at least annually of the amount required to fund the outstanding public security obligations and the estimated amount of public security administrative expenses, including any required contractual coverage amount; and

(8) causing the public security proceeds to be delivered to the trust company for deposit into such funds and accounts as are necessary to fulfill the obligations of the TPFA and the Association under the Insurance Code Chapter 2210 and this section, including to:

(A) pay the costs of issuing the public securities and any administrative expenses related to the public securities;

(B) provide a reserve fund; and

(C) pay capitalized interest on the public securities.

§5.4133. Public Security Proceeds.

(a) As necessary, the Association shall make written requests to the TPFA for the distribution of public security proceeds for the Association program, including:

(1) for the payment of incurred claims and operating expenses of the Association; or

(2) to purchase reinsurance for the Association.

(b) The Association's written request must specify:

(1) the amount of the request; and

(2) the purpose of the request.

(c) To facilitate timely payment of losses, the Association may request funds to be disbursed to the Association prior to the settlement of incurred claims.

(d) The Association shall account for the receipt and use of public security proceeds separately from all other sources of funds. The Association may hold public security proceeds in the manner authorized by the Association's plan of operation or as required by agreement with the TPFA.

§5.4134. Excess Public Security Proceeds.

(a) The Association may use any excess public security proceeds remaining after the purposes for which the public securities were issued are satisfied in accordance with the Insurance Code §2210.608.

(b) As specified in the Insurance Code §§2210.072(a), 2210.073(a), and 2210.074(a) public securities may be repaid before their full term if the Association's board of directors elects to do so and the commissioner approves.

§5.4141. Obligation Revenue Fund for the Payment of Class 1 Public Security Obligations and Operating Reserve Fund.

(a) While class 1 public securities are outstanding, all of the Association's net revenue shall be paid into the obligation revenue fund created for such class 1 public securities. The Association shall deposit the required amounts in the obligation revenue fund created for class 1 public securities at such periods as required under agreements with the TPFA.

(b) The operating reserve fund shall be held by the Association. If the class 1 public securities obligation revenue fund does not contain sufficient money to pay debt service on the class 1 public securities, administrative expenses on the class public securities, or other class 1 public security obligations, the Association shall transfer sufficient money from the operating reserve fund to the obligation revenue fund for class 1 public securities to make such payment.

§5.4142. Excess Class 1 Public Security Obligation Revenue Fund Amounts.

(a) Excess revenue collected to fund class 1 public security obligations that is disbursed to the Association shall be an asset of the Association and may be used for

any purpose authorized in the Insurance Code §2210.056 or deposited into the catastrophe reserve trust fund.

(b) As specified in the Insurance Code §2210.072(a), class 1 public securities may be repaid before their full term if the Association's board of directors elects to do so and the commissioner approves.

§5.4143. Obligation Revenue Fund for the Payment of Class 2 Public Securities.

(a) The Association shall deposit collected premium surcharges and Association member assessments pursuant to the Insurance Code §2210.613 in the obligation revenue fund created for class 2 public securities. The Association shall also deposit in that obligation revenue fund any investment income earned on the premium surcharges and Association member assessments while these amounts are held by the Association. The deposits shall be made as required under agreements with the TPFA.

(b) Pending deposit as required under subsection (a) of this section, the Association shall hold such collected premium surcharges and Association member assessments as required under agreements with the TPFA, or in the absence of an agreement, as required in the Association's plan of operation, including this section. Premium surcharges and Association member assessments collected by the Association pursuant to the Insurance Code §2210.613, must be held by the Association separately from all other Association funds. The Association may not directly or indirectly use, borrow, or in any manner pledge or encumber premium

surcharges and Association member assessments collected, or to be collected, by the Association pursuant to the Insurance Code §2210.613.

§5.4144. Excess Class 2 Premium Surcharge Revenue.

(a) Revenue collected in any year from premium surcharges under the Insurance Code §2210.613 that exceeds the amount of class 2 public security obligations and class 2 public security administrative expenses payable in that year from premium surcharges and interest earned on the class 2 public security obligation fund may, in the discretion of the Association, be:

(1) used to pay class 2 public security obligations payable in the subsequent year, offsetting the amount of the premium surcharge that would otherwise be required to be levied for the year under the Insurance Code Chapter 2210, Subchapter M;

(2) used to redeem or purchase outstanding class 2 public securities; or

(3) deposited in the catastrophe reserve trust fund.

(b) As specified in the Insurance Code §2210.073(a), class 2 public securities may be repaid before their full term if the Association's board of directors elects to do so and the commissioner approves.

§5.4145. Excess Class 2 Member Assessment Revenue.

(a) Revenue collected in any year from a member assessment under the Insurance Code §2210.613 that exceeds the amount of class 2 public security

obligations and class 2 public security administrative expenses payable in that year from member assessments may be:

(1) used to pay class 2 public security obligations payable in the subsequent year, offsetting the amount of the member assessment that would otherwise be required to be levied for the year under the Insurance Code Chapter 2210, Subchapter M; or

(2) used to redeem or purchase outstanding class 2 public securities.

(b) As specified in the Insurance Code §2210.073(a), class 2 public securities may be repaid before their full term if the Association's board of directors elects to do so and the commissioner approves.

(c) If options (1) and (2) of subsection (a) of this section have been fully satisfied, the excess member assessments may be deposited in the catastrophe reserve trust fund.

§5.4146. Obligation Revenue Fund for the Payment of Class 3 Public Securities.

(a) The Association shall deposit collected member assessments pursuant to the Insurance Code §2210.6135 in the obligation revenue fund created for class 3 public securities. The Association shall also deposit in that obligation revenue fund any investment income earned on the member assessments while these amounts are held by the Association. The deposits shall be made as required under agreements with the TPFA.

(b) Pending deposit as required under subsection (a) of this section, the Association shall hold such collected Association member assessments as required under agreements with the TPFA, or in the absence of an agreement, as required in the Association's plan of operation, including this section. Member assessments collected by the Association pursuant to the Insurance Code §2210.6135, must be held by the Association separately from all other Association funds. The Association may not directly or indirectly use, borrow, or in any manner pledge or encumber Association member assessments collected, or to be collected, by the Association pursuant to the Insurance Code §2210.6135.

§5.4147. Excess Class 3 Member Assessment Revenue.

(a) Revenue collected in any year from a member assessment under the Insurance Code §2210.6135 that exceeds the amount of class 3 public security obligations and class 3 public security administrative expenses payable in that year from member assessments may be:

(1) used to pay class 3 public security obligations payable in the subsequent year, offsetting the amount of the member assessments that would otherwise be required to be levied for the year under the Insurance Code Chapter 2210, Subchapter M; or

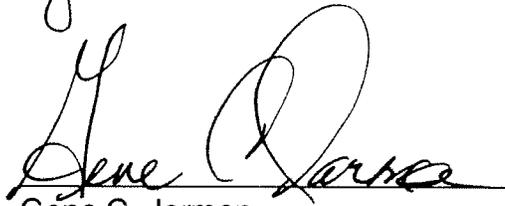
(2) used to redeem or purchase outstanding class 3 public securities.

(b) As specified in the Insurance Code §2210.074(a), class 3 public securities may be repaid before their full term if the Association's board of directors elects to do so and the commissioner approves.

(c) If options (1) and (2) of subsection (a) of this section have been fully satisfied, the excess member assessments may be deposited in the catastrophe reserve trust fund.

CERTIFICATION. This agency hereby certifies that the adoption has been reviewed by legal counsel and found to be a valid exercise of the agency's legal authority.

Issued at Austin, Texas, on January 12, 2011, 2010.


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

IT IS THEREFORE THE ORDER of the Commissioner of Insurance that new §§5.4101, 5.4102, 5.4111 - 5.4114, 5.4121, 5.4131 - 5.4134, and 5.4141 - 5.4147 specified herein, concerning the funding of losses and operating expenses in excess of the Association's premium and other revenue under the Insurance Code Chapter 2210, Subchapters B-1, J, and M, is adopted.

AND IT IS SO ORDERED.

11-0031

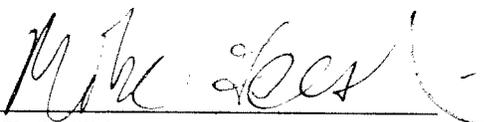
TITLE 28. INSURANCE

Part I. Texas Department of Insurance

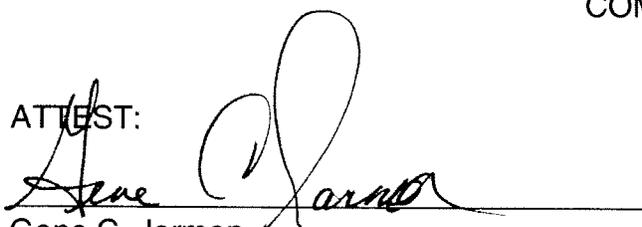
Chapter 5. Property and Casualty Insurance

Adopted Sections

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MIKE GEESLIN
COMMISSIONER OF INSURANCE

ATTEST:


Gene C. Jarmon
General Counsel and Chief Clerk

COMMISSIONER'S ORDER NO. **11-0031**

JAN 13 2011