American Insurance Association

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"POLICY OPTIONS FOR EXTENDING THE TERRORISM RISK INSURANCE ACT"

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WRITTEN STATEMENT OF

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ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION

My name is Brian Dowd, and I am Chief Executive Officer, Insurance-North America, for the ACE Group. I am appearing today on behalf of ACE and our national property-casualty insurance trade association, the American Insurance Association (AIA).

AIA represents approximately 350 major insurance companies that underwrite about one-third of the U.S. commercial insurance market covered by TRIA and TRIEA; the membership includes half of the top ten commercial lines writers in the United States. Terrorism insurance is among the highest priority public policy and marketplace issues for our members.

The ACE group of property-casualty insurance companies conducts business throughout the United States and in more than 50 other countries. We employ more than 4,000 employees here in the U.S., and trace our long, proud history in this country back to 1792, with the establishment of the Insurance Company of North America, the first investor-owned American insurance company. ACE is among the largest property and workers' compensation insurers for businesses and municipalities of all sizes. Our customers include a broad array of organizations that rely on a stable market for terrorism insurance. These customers include many financial institutions, energy companies, hotel chains and professional sports leagues.

The Terrorism Risk Insurance Act (TRIA), as modified and extended through the Terrorism Risk Insurance Extension Act (TRIEA or the TRIA Extension Act), provides a federal backstop for commercial property-casualty insurance in the event of a catastrophic terrorist attack on U.S. soil. Since its enactment in 2002, TRIA has achieved its goals of making terrorism risk insurance widely available to U.S. businesses and stabilizing the private marketplace for a risk that has many features that make it uninsurable. Unfortunately, despite the government's success since 9/11 in interdicting several terrorist plots and preventing another major strike in the U.S., most experts agree that it is not a matter of if, but when, another catastrophic attack will occur on U.S. soil. AIA has testified on numerous occasions before this Subcommittee and other committees in Congress in support of the critical need to maintain the public-private partnership necessary to manage our Nation's economic exposure to terrorist attacks. For the reasons cited in that testimony, the AIA continues to support a TRIA-like structure and has recently worked with the policyholder community and their Coalition to Insure Against Terrorism (CIAT) to produce a set of recommended joint principles, which we have attached to the testimony.

Terrorism Remains an Uninsurable Risk

The characteristics that make terrorism an uninsurable risk remain as strong today as they were immediately following September 11, 2001. These include: 1) the difficulty of predicting the likelihood of a major terrorist attack; 2) the concentration of insured lives and property values in business centers; 3) the magnitude of potential loss from an extreme terrorist attack, particularly those that involve the use of unconventional weapons; 4) the limits of mitigation in reducing terrorism losses; 5) the lack of available public information necessary to analyze the risk; and, 6) the legal, regulatory, and financial hurdles inherent in the current state-regulated insurance system. While TRIA and its extension do not erase any of these criteria that make the risk uninsurable, it puts a box around the volatility associated with terrorism risk and, therefore, facilitates both coverage availability and affordability.

In the past, AIA has testified about each of the aforementioned aspects of terrorism risk. They remain fundamentally unchanged because the nature of terrorism remains largely unchanged.

Is the Existence of TRIA "Crowding Out" the Development of Private Market Solutions?

TRIEA has not reduced the demand for private reinsurance. In fact, demand outstrips supply. For instance, the aggregate amount of all insurers' deductibles is over $35 billion and insurers are responsible for 15% co-pays in addition to their deductibles for every dollar of insured loss up to $100 billion. Private insurers could be liable for as much as $50 billion and yet the Reinsurance Association of America has testified that only $6-8 billion of reinsurance is available. Clearly there is room for the private market to participate if there was any appetite to do so. The characteristics that make terrorism uninsurable for primary insurers also hold for reinsurers. Like insurers, reinsurers lack sufficient confidence in the models and therefore are unwilling to put a substantial amount of their capital at risk. This is the reason that private reinsurance capacity has grown only incrementally since the September 11 attack, and not much additional improvement can be expected, according to reinsurance experts.

The limited private terrorism reinsurance that is available costs more than the amount of terrorism premium that primary insurers are able to obtain from policyholders, due to state regulatory restrictions on rates. As a result, insurers are buying as much reinsurance as they can afford and/or self-insuring their retentions and exposing more of their capital.

I now would like to focus on some of the open questions regarding design of a long-term federal terrorism risk insurance program.

Why hasn't the improved modeling translated to more coverage being available?

Despite the President's Working Group on Financial Markets (PWG) report's optimism, improvements in insurer modeling will not create significant new capacity for the foreseeable future. As the report notes, these improvements are helping insurers to estimate their aggregate loss accumulations at specific locations, based on assumed event scenarios, thus better understanding and more efficiently managing their terrorism risk. However, there is no logic to the implication that an insurer's ability to model losses from a hypothetical event increases capacity. Rather, improvements in modeling improve efficiency in the allocation of existing capacity, which could create availability problems in highly concentrated areas.

Why is there a need to incorporate coverage for domestic terrorism events into the Terrorism Risk Insurance Act?

Since TRIA was enacted, experience has shown that the distinction between foreign and domestic terrorism is artificial. Events such as the London Underground bombing have reinforced the practical difficulty of making this distinction and underscored that it is meaningless from an economic perspective, and impractical from an exposure management perspective. According to RAND, the threat of domestic terrorism is increasing and focusing on private sector targets. RAND also has identified the increasing "franchising" of terrorist attacks by al Qaeda to local affiliates and the added difficulty of attributing attacks to a particular group.

<u>How should the Congress alter insurance company deductibles, event triggers, insurer co-payments, the cap on annual liability, or other elements of the existing program to encourage more capacity?</u>

As a general matter, expanding TRIA by reducing per company retentions, event triggers, and insurer co-payments would reduce the uncertainty that insurers face in managing terrorism risk and their attendant financial exposure; as such, these changes would allow insurers to expand their ability to underwrite coverage, thus improving the affordability of coverage. That said, we believe the program is working relatively well for conventional terrorism risk (e.g., take-up rates have increased every year since the program was enacted).

Congress should also consider a program trigger that provides meaningful protection for small companies. Additionally, the state regulatory system poses significant challenges in managing this risk. We believe that state regulation of terrorism risk insurance rates and forms that can undermine the program's basic objectives should be preempted. We also believe that the changes we are advocating in the program as applied to chemical, nuclear, biological and radiological (CNBR) terrorism risk, which are discussed later in this testimony, not only will test whether a private market can develop, but could improve the market more generally for terrorism risk, for example, in the workers' compensation arena, where insurers have to take CNBR exposures into account when allocating capacity, because state laws do not allow for exclusions.

<u>What are the particular challenges of insuring CNBR exposures?</u>

As mandated by Congress, the PWG report looks specifically at the market for CNBR terrorism risk coverage and concludes that no private market for CNBR terrorism risk insurance existed prior to September 11, none exists today, and none is likely to exist in the foreseeable future. More specifically, the report finds that, unless mandated by state law, coverage for CNBR risk has not been generally available, and reinsurance capacity for CNBR terrorism has been virtually non-existent. Looking to the future, the report observes that "there may be little potential for future market development" in this area. These conclusions are entirely consistent with those of a contemporaneous report by the Government Accountability Office on CNBR terrorism risk.

This absence of CNBR coverage has led to calls from the policyholder community for insurers to be mandated to offer CNBR coverage. AIA has been working with the policyholders to consider whether there is a way that insurers could provide CNBR coverage without risking financial ruin. Before Congress considers mandating the offer of this coverage, the very unique nature of CNBR exposures must be carefully understood.

First, while the loss estimates are staggering—according to the American Academy of Actuaries, exceeding $700 billion in the case of a nuclear attack in New York City—questions remain about whether CNBR terrorist attacks can even be modeled, given the huge number of variables involved. Among the special difficulties in modeling CNBR terrorism risk are the timing of losses (the latency involved in bodily injury claims caused by CNBR exposures mean damages could take years, if not decades, to quantify) and their geographic range (the potential for widespread dispersal of contaminants makes it difficult to limit losses by managing aggregate exposures).

Second, insurers have almost no ability to spread CNBR terrorism risk to reinsurers or the capital markets. While reinsurance for conventional terrorism losses remains scarce, the situation is far worse for CNBR terrorism risk. Most of the available reinsurance coverage, as confirmed by the Reinsurance Association of America, specifically excludes coverage for CNBR losses. Similarly, the capital markets are not willing to take any position in CNBR terrorism risk. As a result, the insurance and financial market tools that help insurers manage their own exposures to other types of risk are simply not available for CNBR terrorism.

Third, CNBR terrorism losses threaten the solvency of insurers in the absence of a federal program. The lack of private reinsurance means that insurers must retain the virtually limitless costs of CNBR terrorism risk in the absence of a federal backstop. As the PWG report recognizes, a large-scale CNBR event could result in losses that would overwhelm an insurer's capital and surplus, and therefore its claims-paying ability. Moreover, a widespread CNBR event could paralyze the economy and shut down sources of outside capital that insurers might otherwise access to pay claims.

How can TRIA be changed to provide the CNBR coverage policyholders need without jeopardizing solvency of insurers?

The program would function most effectively if it provided an economic framework through which insurers are able to offer coverage enhancements without putting their solvency at risk, at rates that encourage policyholders to purchase coverage. This cannot be accomplished simply by imposing a CNBR "make available" mandate.

Rather, changes to TRIA must focus on the characteristics of CNBR risk that pose the greatest threat to a viable insurance system, reduce potential exposure and provide certainty with respect to the role of private insurers in managing CNBR terrorism risk. This can be accomplished by:

- Lowering or eliminating the insurer deductible and eliminating the insurer co-pay for CNBR to reflect that markets are not working in this area as cited by the PWG and GAO reports; and

- Clearly and affirmatively stating that the federal government is solely liable for CNBR terrorism losses above insurers' individual CNBR retentions, including the removal of the current $100 billion program cap.

Why doesn't the $100 billion annual cap work for CNBR?

Given the potential magnitude of CNBR losses, the $100 billion annual program cap poses real problems. While the current law provides that insurers and the federal government will not be liable for amounts in excess of $100 billion, there are very real practical problems with the implementation of this provision. For instance, individual insurers who are receiving claims will have no way of knowing what other insurers have paid or amounts the government has reimbursed. Since there is a lag between when the insurer pays and when it is reimbursed by the government, there is a real possibility that insurers will unknowingly pay claims that in the aggregate with other insurers' payments will exceed $100 billion. Alternatively, insurers may know that the $100 billion cap has been reached, and are then faced with a decision whether to enforce their right to deny the claims of a policyholder who has purchased terrorism coverage and has suffered a loss. TRIEA is silent about what happens if this occurs.

Solutions

Since the days immediately following September 11, 2001, AIA and ACE have been working diligently with this Subcommittee and others in Congress, the Treasury Department and the White House, the policyholder community, and our colleagues in the insurance industry to develop the most operationally effective and fiscally efficient federal program for the public-private management of terrorism risk. Meaningful solutions must augment existing capacity and spread loss beyond current private sector parameters, while at the same time encouraging the growth of private sector capacity and protecting the taxpayer.

Recognizing that CNBR terrorism risk is uninsurable in the private market, we believe that Congress should consider recalibrating the current TRIEA backstop to provide increased federal financial participation in the event of a CNBR attack. With regard to conventional terrorism risk, we believe that the current backstop has worked and should remain in place. At the current levels (20 percent of subject premium in 2007), the TRIEA backstop would be accessed only in the event of a truly catastrophic conventional attack – most likely a “swarm” or other multiple venue attack – that exceeds the dimensions of the 9/11 strike.

Additionally, as I have mentioned previously, we believe that the distinction between foreign and domestic terrorism should be eliminated, and that the program trigger should be set at a level that provides meaningful protection for small companies. Additionally, state regulation of terrorism risk insurance rates and forms that can undermine the program’s basic objectives should be preempted.

Finally, we strongly support the view that the program should be made permanent, or at least remain in place until the U.S. has won the war on terrorism—our ultimate goal.

Attached to this statement is a list of the principles for a new and revitalized program that AIA developed in close cooperation with the policyholder community, working through the Coalition to Insure Against Terrorism (CIAT). They represent changes that would continue TRIA’s success in stabilizing the market for conventional terrorism insurance and build upon the program’s foundations to create an economically viable way of providing protection against CNBR terrorism risk.

ACE and AIA look forward to working with you to address these important concepts. Thank you again for your unwavering commitment to a strong national economy through a strong TRIA program.

JOINT RECOMMENDED PRINCIPLES FOR 2007 MODERNIZATION OF TERRORISM RISK INSURANCE

This document represents a set of common principles that CIAT and AIA believe must be addressed as Congress renews and improves the existing TRIA program. It is not intended to be an exclusive list of concerns or items that may be supported by individual companies or segments of the industries represented on this joint statement.

Goals:

- Promote long-term availability of terrorism risk insurance for policyholders and provide stability for financial markets and recovery after terrorist attacks
- Spur greater capacity for those areas that are underserved even with the existing TRIA program, *e.g.*, perceived high-risk areas and attacks utilizing nuclear, biological, chemical and radiological means (NBCR)

Duration:

- The program should have no expiration date, and thereby end only when Congress determines terrorism is no longer a threat

Foreign vs. Domestic Acts:

- Remove the distinction found in statute's definition of "act of terrorism" that forces Treasury Secretary to make determination which may not serve national security needs

Program Design: Two-part structure for financing both conventional terrorism risks and NBCR

- Conventional Terrorism Risks:
  - TRIEA-like structure for conventional terrorism perils with continuation of (i) "make available" and (ii) retrospective policyholder surcharges
  - Continuation of current individual insurer retention at 20% of prior year direct earned premium and current individual insurer co-pay of 15% of every dollar of insured losses exceeding the retention up to the $100 billion annual cap.
- NBCR:
  - Reduce potential exposure and provide certainty with respect to the role of private insurers in managing NBCR terrorism risk by:

    (1) Lowering or eliminating insurer deductible and eliminating the insurer co-pay for NBCR to reflect consistent view of GAO, Treasury, and PWG that markets are not working in this area

(2) Clearly and affirmatively stating that the federal government is solely liable for NBCR terrorism losses above insurers' individual NBCR retentions, thus encouraging insurers to provide more capacity

- ➢ So long as the private insurer role with respect to NBCR terrorism is consistent with the above-referenced principles,, enhance "make available" provision to include availability to policyholders of an endorsement that provides coverage for NBCR terrorism that would otherwise be excluded by the nuclear hazard or pollution exclusion contained in certain commercial lines policies

- Covered lines no narrower than those included in TRIEA program

- Program trigger no higher than current $100 million, with possible special provision for small insurers