

**United States House of Representatives  
Financial Services Subcommittee on Capital Markets, Insurance and  
Government Sponsored Enterprises**

**Hearing on  
“The Future of Terrorism Insurance”**

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On Behalf of the American Insurance Association**

Chairman Baker, Ranking Member Kanjorski, and members of the subcommittee, thank you for the opportunity to speak about the realities of the terrorism insurance marketplace on behalf of Zurich and our trade association, the American Insurance Association (AIA), the national public policy thought leader on property-casualty issues.

My name is Jason Schupp, and I am vice president and senior assistant general counsel for Zurich, the third largest commercial insurer in America. We serve customers ranging from small businesses to “*Fortune* 100” companies, and provide a full range of risk solution products and services across all four major commercial lines of insurance.

I serve as chief legal counsel to Zurich's North American underwriting management facility and have been integrally involved in all aspects of our U.S. terrorism underwriting strategy since the September 11 terror attack. My responsibilities have included developing and shepherding the first policy wording to explicitly address the terrorism exposure in the months following the attack through the state regulatory approval process; this was done again with enactment of the Terrorism Risk Insurance Act of 2002 (TRIA); and once more at the end of 2004 in anticipation of TRIA’s scheduled expiration.

I also have been involved in developing underwriting tools (including accumulation management strategies), educating our underwriters, claims professionals and producers, and assisting in the design of the many systems changes necessary to accommodate this unique and insidious man-made threat. Based on those experiences, I can assure you that the private sector has made great strides in understanding and assessing the terrorism exposure, but there are inherent limitations to what the private sector can do.

Since 9/11, we also have learned some fundamental truths about the risk of catastrophic terror attacks on U.S. soil and about the private marketplace’s ability to deal with this risk.

The first of these truths is that catastrophic terrorism presents a far larger financial and economic risk than private capital markets can handle.

In recent months, the insurance rating agencies have suggested that, based on their analysis of terrorism exposure, no more than 10 percent of any individual insurer's capital should be exposed to the terrorism risk. As an industry with approximately \$190 billion of capital supporting commercial property and casualty insurance lines covered by TRIA, that amounts to about \$19 billion. Yet under this year's TRIA deductible, which is based on direct earned premium rather than capital surplus, the industry is exposed to \$30.8 billion plus 10 percent of losses above the deductible, bringing total industry exposure under TRIA to \$37.7 billion. For a number of major insurers, this also means that individual TRIA deductibles already exceed 10 percent of capital. This is neither sound nor sustainable.

The private reinsurance market has even less capacity. It reports up to \$6 billion of available capacity, with virtually none of that capacity available for nuclear, biological, chemical or radiological (NBCR) attacks. Six billion dollars of private reinsurance capacity in total – that is less than the combined TRIA deductible of the top two insurers. As you can see, there is simply not enough capacity to fully finance this year's TRIA deductible, much less an increased deductible amount or the full terrorism exposure without federal participation.

I have spoken to academics and public policy advocates who suggest that TRIA has somehow "crowded out" private reinsurers or other capital market mechanisms that otherwise would commit capital to the terrorism exposure.

Perhaps if policyholders did not care about their premiums and insurers were willing to accept dramatically constricted reinsurance coverage (such as NBCR exclusions or index-based triggers), it might be possible to coax a little additional capacity from private reinsurers and other capital markets, but neither scenario will ever happen. Indeed, there is plenty of space today for these private market solutions to develop, yet they have not. I have seen no crowding out and have heard no complaints about it occurring. I have only heard some people theorizing that, because the federal government is involved, there must be displacement of the private sector. There is simply no evidence to back up these theories; in short, there is a great deal of difference between academic theory and the reality we face every day in the actual marketplace.

Dr. Glenn Hubbard, former Chairman of President Bush's Council of Economic Advisors also has looked at this issue and has reached a similar conclusion. In his September 2004 study of insurance and reinsurance markets, Dr. Hubbard concluded that TRIA is "crowding in, not crowding out" private sector capacity.

The second fundamental truth we have learned is that terrorism exposures are not all alike; nor should they be treated alike. For example, as insurers have developed new tools to analyze terrorism exposure, it has become clear that NBCR attacks present such unique risk and claims characteristics that our financial and administrative catastrophe response

capabilities are particularly inadequate. In addition to thinking differently about the kind of attack, we've also learned that certain classes of business – due to the nature of the risk or the regulatory regime governing the products – pose the most difficult underwriting and risk accumulation challenges.

The stabilization brought about by the enactment of TRIA has allowed these two fundamental truths not only to emerge, but has created the opportunity to apply these facts to today's discussion of the future of terrorism insurance.

The title of this hearing asks “What is the future of terrorism insurance?” The American Insurance Association, including Zurich, believes strongly that a continued federal role is necessary, and we congratulate this subcommittee and the full Financial Services Committee for the extraordinary bipartisan leadership demonstrated in developing and expressing this common understanding.

There are a variety of ways for this subcommittee to proceed with respect to revamping a federal terrorism insurance program. One approach would be to scale back the program, as the Treasury Department has proposed, by doing such things as limiting lines covered and increasing retentions and co-pays. Such a truncated program could be extended for a short duration, or for a longer term, but its viability would be determined by the size of the retentions and the structure of the quota share relative to the lines covered, as compared to the deductible burden shouldered by insurers under the current program. Another approach would be to develop a structural alternative to TRIA, such as a pool, pay-to-play reinsurance system, or other mechanism. A third option would be to utilize key structural features of TRIA, while incorporating new elements of other alternatives.

Whatever the course of action taken, our fundamental concern is that any new mechanism must be workable – for all stakeholders in the marketplace. It must be simple to understand and to implement. This issue is fundamentally important to our nation's economic viability, and we cannot support a program that meets political litmus tests, but fails in terms of actual functionality. The metrics against which we will measure various proposals' effectiveness and workability derive solely from the real-world, on-the-ground lessons we have learned since the horrific 9/11 attack.

TRIA was designed to act as a bridge to the development of a fully functional private marketplace for terrorism insurance. While it has worked to ensure that terrorism insurance is available to all commercial enterprises that want such coverage, as the program expires, we do not have a fully functional private marketplace to address the unique characteristics of this risk.

As I have already noted, TRIA's current deductibles stress insurers' capital surplus. Increasing individual insurance company retention levels will not lead to more, much-needed reinsurance capacity, but will simply make it more difficult for insurers – particularly large, diversified insurers – to manage the massive unfunded and un-reinsured portions of their deductibles.

Even under the current national terrorism insurance program, private reinsurance amounts to, at most, 20 percent of the industry backstop – and provides virtually no capacity to the NBCR exposure. In theory, there is plenty of room for private solutions to develop below the backstop today. Yet, in reality, private reinsurers have shown little appetite for assuming any additional risk.

An example from my own company's experience may put this issue in perspective. Zurich's TRIA deductible this year is \$1.8 billion – an amount equal to more than a quarter of the available private sector terrorism reinsurance capacity – but Zurich has a market share of only 5 percent. In other words, 5 percent of the market is chasing up to 25 percent of available reinsurance capacity – hardly evidence of crowding out. Even assuming an aggressive 60 percent growth in private sector terrorism reinsurance capacity by 2007 to between \$7 billion and \$9 billion (and this is extremely optimistic), an increase in programmatic retention levels from 15 percent to, for example, 20 percent, will cause the reinsurance gap to widen. Of course, if there were another major terrorist attack, private reinsurance capacity is likely to shrink precipitously.

We appreciate and acknowledge the Administration's and congressional leadership's expectation that the private sector shoulder even more of the financial burden associated with catastrophic terrorism, but we also would respectfully suggest that a backstop deductible increase is a largely ineffective tool that does not take advantage of all we have learned about this exposure over the last three years.

Additionally, we have serious concerns about any increase in the quota share paid by insurers if a loss exceeds their per-company deductible. Under the current statute, insurers are responsible for paying 10 percent of their TRIA-eligible losses above their program deductible. Depending on the terrorism loss scenario, the existing 10 percent quota share could total tens, if not hundreds, of millions of dollars in additional losses for companies for whom the losses associated with their deductible already could seriously undermine their financial condition. Any further increase in the quota share would adversely affect companies already hard hit as a result of a major terrorist attack. Moreover, the existing quota share is consistent with those in place in many private reinsurance arrangements, and provides ample incentive for companies to manage their claims efficiently so as to minimize federal involvement.

Treasury's recent study notes that an increase in terrorism insurance pricing – perhaps a dramatic increase – may attract a certain amount of opportunistic offshore capital to the terrorism risk. But the study also observes that policyholders are price-sensitive; the societal impact of higher prices for terrorism insurance would be an erosion of take-up rates. Today, the take-up rate for terrorism coverage is well over 60 percent in some economic sectors, and 100 percent of workers' compensation policies provide terrorism coverage; however, the general take-up rate stands at only 50 percent by Treasury's estimation. Indeed, the recent RAND report expresses concern that the existing take-up rates may be too low, increasing disruption after future attacks and undermining resilience. In light of these concerns, the subcommittee should think carefully about the implications

for national security of changes to TRIA that are likely to erode existing take-up rates and the protection that TRIA provides to the economy.

The Treasury report suggests removing the commercial auto and general liability lines of coverage – or about half of the commercial marketplace premium – from the national terrorism reinsurance mechanism. That proposal would be a massive reduction in the scope of the program. As for the wisdom of taking such a dramatic step, the AIA is willing to acknowledge that commercial automobile is less likely to pose a major terrorism accumulation challenge, but would suggest that general liability is a very real and significant exposure. We would hope that removal of these lines would be considered only in conjunction with effective litigation management techniques, some of which may already exist under other federal laws such as the SAFETY Act.

There are other lessons we have learned since TRIA's enactment in November 2002 that can and should inform today's discussion. For example, the threat of an NBCR attack on U.S. soil poses a different set of risks, including virtually infinite losses. As such, these threats clearly warrant specific, and we believe, different treatment from conventional attack threats. We understand that this concept has been under consideration. We would strongly endorse this approach.

Also, there remains a fundamentally important issue with respect to what type of attack triggers the federal program. According to the RAND Center for Terrorism Risk Management Policy, the current program's exclusion of domestic terror attacks is problematic because it "leads to confusion in light of the increased 'franchising' of terrorist attacks by al Qaeda to local affiliates and the added difficulty of attributing attacks to a particular group." This problem has been vividly and tragically underscored by the recent bombings in London. We would advocate that the definition of what triggers the program be as clear and inclusive as possible.

In addition, we certainly appreciate and share the desire to hasten the point at which terrorism no longer threatens the American way of life. However, based on our extensive experience with the capital markets – including the reinsurance market – we see no reason to believe that this goal will be achieved within two years, or that new forms of capital will be found in that timeframe to obviate the need for a federal role.

Despite general capital availability, private markets have not rushed in to provide that capital to these risks during the past three years, and financial experts do not expect them to come running in to fill the void if TRIA is allowed to expire at the end of this year. In this connection, there has been much talk about so-called catastrophe or "cat" bonds as a source of new capital for terrorism risks. Here is a case of theory meeting reality: today, private cat bonds secure less than three percent of worldwide catastrophic insurance risks. They provide almost no terrorism coverage. Only two "multi-event" terrorism-related bonds have been issued, and they are extremely limited in their scope (e.g., one only dealt with event cancellation). While it may be possible to structure a terrorism cat bond, there is no reason to believe a terrorism-linked bond market would be any more significant than the maturing national catastrophe bond market. It is our sincere hope that Congress would

take such facts into consideration, with the result being a realistic timeframe for assimilating terrorism exposures more broadly into the U.S. economy.

The Treasury report also emphasized the Administration's desire to limit taxpayer exposure to the costs of terrorism. While AIA has concerns about the impact of policyholder surcharges on the long-term stability of insurance markets, the concept does beg the question of whether policyholders are better served by charging them for the costs of spreading this risk before the event occurs – with all the inefficiencies and uncertainties that we're currently seeing in the pricing process – or after the event, when we know the precise economic costs incurred. Either way, it is important to acknowledge that commercial property-casualty policyholders are ultimately paying the costs of addressing the terrorism exposure.

A final policy area we understand to be under consideration is insurance regulatory/market reform to facilitate private sector management of this exposure. In general, state rate and form regulations limit the ability of insurers to adjust insurance prices to reflect exposure in the marketplace and/or to flexibly provide options through terrorism coverage endorsements (including exclusions or other coverage limitations). The first year of the TRIA program had a state rate and form regulation pre-emption. While state adherence was uneven, this pre-emption allowed insurers to do in days what the normal state process would have taken months, or even years, to accomplish. In addition, permanently addressing the anachronistic standard fire policy statutes that exist in nearly half the states would clarify when terrorism losses are covered and when they're not.

Economic thought leaders from Federal Reserve Chairman Alan Greenspan to nationally renowned jurist and University of Chicago School of Law Professor Richard Posner publicly acknowledge that private markets cannot manage all aspects of the catastrophic terrorism risk. As Chairman Greenspan said before the Financial Services Committee only last week: "so long as we have terrorism which has the capability of a very substantial scope of damage, there is no way you can expect the private insurance system to handle that. ... I don't see how we can avoid the issue of a significant segment of government-backed reinsurance in this particular area."

The enduring risk of catastrophic terror attacks leads to a continuing need for an effective insurance mechanism beyond TRIA's December 31, 2005, expiration date – a mechanism based on the reality of the marketplace, not the untested hopes of theorists. Thus, there remains a critical need for a continuing public-private partnership for terrorism insurance. This is not an insurance issue; it is a business and national economic security issue.

In closing, let me commit to you – on behalf of Zurich and the entire membership of the American Insurance Association – that we stand ready, willing and able to work with you to quickly pursue all of these issues, and to do so in a manner that ensures timely enactment of a workable national terrorism insurance mechanism.

Thank you.