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*Subcommittee on Capital Markets, Insurance, and Government
Sponsored Enterprises Hearing on
“The Future of Terrorism Insurance”*

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Testimony of

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Good morning Chairman Baker, Chairman Oxley, and Members of the subcommittee. I am Lawrence Mirel, Commissioner of Insurance, Banking and Securities for the District of Columbia. The office I hold was created by Congress in 1901 as the federal office of Superintendent of Insurance for the District of Columbia, and the laws I administer were enacted by Congress or, since 1974, by the Council of the District of Columbia with the approval of Congress. Although the District of Columbia is not a state, I have the authority of a state insurance commissioner and I am a full member of the National Association of Insurance Commissioners.

I am here today on behalf of the District of Columbia Department of Insurance, Securities and Banking, and not on behalf of the NAIC. Because Washington, along with New York and a few other cities, are considered at high risk for terrorism, I have a particular interest in the subject of this hearing. Decisions made by this Committee and the Congress have a direct impact on the people who live and work in the District of Columbia.

The enactment by Congress of the Terrorism Risk Insurance Act in 2002 was very important in stabilizing and calming the international insurance and reinsurance markets which were hit on 9/11 with enormous losses of insured property and lives. The terrorist attacks were unforeseen and unprecedented in this country, and the insurance industry paid out more than \$40 billion in claims under policies for which no specific premiums for terrorism risk had been collected. Although claims were paid and companies managed to survive, the industry was stretched to its breaking point. Had TRIA not been enacted it is very likely that terrorism risk coverage would have been excluded in the future, or available only at very high prices. While the threatened impact of a lack of terrorism risk insurance on the construction and real estate industries was exaggerated, in my view, it was nevertheless cause for concern.

Although the enactment of TRIA was necessary at the time, it is not and was never intended to be a long-term solution to the problem of insuring against the risk of terrorism. It has many shortcomings, not least of which is that it unnecessarily substitutes Government guarantees for private market solutions. At some level the Federal Government must provide a backstop for terrorism risk losses, but the way TRIA is structured the Government is on the hook too soon and with too few protections for the taxpayers. With TRIA scheduled to expire in December, now is the time to fashion something better, something that is permanent, something that maximizes both the strengths of the private insurance industry and the unique responsibility of the Federal Government to protect the public.

The issue boils down to capacity. Will there be enough money available to cover losses due to future terrorist attacks, no matter how large they may be? Will people who pay premiums to protect themselves from financial disaster due to a terrorist attack be able to collect on the promises of reimbursement for which they paid? We do not want to see a situation where a large scale terrorist attack exhausts the reserves set up to pay for those losses, leaving people without financial relief at the very time they need it the most.

Because terrorism is man-made, it is inherently unpredictable. Natural disasters, even those as hard to predict as earthquakes or tsunamis, can be actuarially assessed and reserved for. That is

not true of terrorism risk. Faced with the huge losses caused by the destruction of the World Trade Center, and the inability to predict when or if a similar or even larger catastrophe could occur, insurers immediately after 9/11 were reluctant to write coverage for terrorism loss at all. The bargain made by TRIA is that, in exchange for being required to write insurance against the risk of loss due to an attack by foreign terrorists, the Federal Government stands ready, under certain circumstances, to step in and pay the major portion of losses over a certain amount.

There are two shortcomings to this approach. First, the legislation does nothing to promote growth in the capacity of the private insurance market. On the contrary, the very fact that the Government is willing to step in when losses exceed a stipulated amount discourages the growth of private market capacity above that amount.

Second, the risk that the Federal Government will have to make good on its pledge to act as the insurer of last resort is too high. Fifteen billion in terrorism losses may seem like a high industry retention level before the Federal guaranty would come into play, but considering the actual insured losses of more than \$40 billion caused by the destruction of the World Trade Center, it becomes clear that the Federal Government could become involved very early in a major terrorism event.

To deal with both of these problems, any long-term solution should make the Federal Government a far more remote guarantor. That can be done by encouraging or mandating the development of a privately funded terrorism risk pool that would act as a cushion between the resources available through the commercial insurance and reinsurance market of today and the ultimate involvement of the Federal Government.

Because TRIA requires insurers to offer terrorism risk coverage for foreign terrorist attacks, and because the risk is essentially unknowable, insurers will estimate high when setting premiums for this coverage. TRIA wisely does not attempt to tell insurers how much to charge for terrorism risk coverage. While market competition does place some limits on pricing, at the end of each year in which there has not been a terrorist attack, the high charges for coverage of terrorism risk become profit for the insurers. No money has been set aside for future years, and each year the unknowable risk must again be put into the premium charge.

A much more sensible approach would be for the government to use its authority to create a large, privately funded terrorism risk pool that would be available to back-stop terrorism losses that strain the capacity of the regular commercial insurance and reinsurance market. The Government would remain the ultimate guarantor, but the likelihood that it would ever be called upon to perform would be much more remote. Premiums charged for terrorism risk would not go yearly to each insurer's bottom line, but instead would be put into the pool, to be used to pay for terrorist attacks, whenever or wherever they occur. As the fund grows, the Federal guaranty can retreat, on a year-by-year basis. In year three, for example, if the terrorism risk pool contains \$20 billion, the Government guaranty would be called upon when the industry retention level exceeded that amount. If by year ten the fund had grown to \$200 billion, that would become the point at which the Federal guaranty could be invoked. On the other hand, if a terrorism event

were to occur, and the risk pool drawn down, the Government guaranty can be advanced down to what remains in the fund, to retreat again as the fund is rebuilt.

Although the analogy is not exact, think of the terrorism insurance risk pool as the equivalent of the strategic oil reserve. Instead of pumping oil into old dry wells to protect against a sudden and unexpected loss of oil supplies, the terrorism risk pool would be the equivalent of pumping money into a virtual well, to be used if commercial funds available for paying insurance claims run out. Just as the strategic oil reserve has a calming effect on oil prices, simply because it exists, even if it is never used, so too will the existence of the terrorism risk pool calm insurance prices just by its very existence.

The privately funded terrorism risk pool can also be used to better spread the cost of terrorism risk. Under TRIA, businesses in Washington, New York and certain other cities considered at high risk for terrorist attack pay very high premiums for terrorism risk coverage. Yet the terrorists are not after those businesses. They want to attack America. It would be far more equitable for all Americans to share in the cost of terrorism risk insurance protection, instead of placing the burden on those who happen to live or work in the shadow of iconic symbols of America hateful to the terrorists. A few cents added to every property and casualty policy written in America could quickly fill up the terrorism insurance risk pool, with negligible impact on the economy. Besides, the very unpredictability of terrorism attacks means that no place in America is truly safe.

The idea of a terrorism risk pool is not new. Great Britain, Germany, France and Spain have put in place such mechanisms. The British terrorism risk pool allows for underwriting of individual risks, so that purchasers pay premiums determined by the perceived risk of their being subject to terrorism attacks. The French, German and Spanish pools, as I understand it, charge the same premiums to all, which seems more equitable to me given the motivation and unpredictability of terrorist attacks.

The rules and procedures governing a terrorism risk pool should be established by the U.S. Treasury Department, with the advice of insurance industry experts. But the pool itself should be run by the insurance industry. By establishing a pot of money that can serve as a kind of strategic reserve to the commercial insurance market, financed by small increments in premiums paid by all policyholders, the capacity of the insurance industry to deal with the potential of even major losses due to terrorist attacks will be greatly strengthened, and, accordingly, the need for the Federal Government to step in as the ultimate guarantor will be substantially lessened.

Thank you for inviting me to testify. I will be happy to answer questions or expand on any of the ideas I have presented here in outline form, and of course I am ready to provide whatever assistance I can to the subcommittee as it works to find the most effective way to deal with the terrorism risk insurance problem.