THE FUTURE OF TERRORISM INSURANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

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THE FUTURE OF TERRORISM INSURANCE

Wednesday, July 27, 2005

U.S. House of Representatives,
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:00 a.m., in room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Oxley, Shays, Sessions, Gillmor, Bachus, Kelly, Biggert, Fitzpatrick, Davis of Kentucky, Kanjorski, Frank, Maloney, Ackerman, Sherman, Capuano, Crowley, Israel, Miller of North Carolina, Scott, Bean, and Wasserman Schultz.

Chairman Baker. I would like to call this meeting of the Subcommittee on Capital Markets to order.

I am advised that Mr. Kanjorski, the Ranking Member, is on his way. I will go ahead and proceed with my opening statement, and I wish to welcome those participants here this morning.

The meeting today occurs on the subject of terrorism reinsurance and the need for and appropriateness of an extension of the current program now in effect.

It also occurs pursuant to receipt of a report by the Department of the Treasury which performed a critical oversight and assessment of the current program. Although many view the report to have been negative in context, the conclusions reached are valuable because of the scope of the study and the findings and recommendations that are included. Specifically, that the committee should consider modifications to the current program before extending any conditional backstop.

Further, Secretary Snow in appearing before the full committee in response to questions which I proffered to him indicated that, one, he felt that there was a need for an extension to be created before the year end, but that such extension should be modified pursuant to identified concerns contained in the report, more specifically retention levels perhaps should be adjusted, trigger levels should be adjusted, and repayment assurances made more clear to taxpayers. Those are perspectives with which I find agreement.

Today, we have the good fortune to have experts in the field to express from their varying perspectives the appropriate manner in which the extension should be considered or in fact whether the extension should be granted at all. My concerns with the findings of the Treasury report go more specifically to a Louisiana view as to the $500 million trigger level that enables a claimant to seek assistance from the Department of the Treasury. I am anxious to try to find an alternative triggering methodology that might be more appropriate to rural communities.

Second, I also share the Treasury's view with regard to what is now a conditional repayment of taxpayer advances of credit which today are discretionary in the eyes of the Secretary and may or may not be recollected. It is my view that a mandatory repayment provision would be extremely helpful.

All of us have shareholders. Those in private business have clearly identified shareholders. Those of us in Congress have constituents, and it is our job to stand between our constituents' checkbooks and those who make application to the Government for assistance, to ensure that any extension of taxpayer resources is not only warranted, but at the appearance of profitability and an ability to repay without detriment to the overall economy, that repayment be made on terms that are responsive to the identified needs.

I do believe, however, that the Treasury has indicated a willingness to work with this committee and the Congress in general to seek a remedy perhaps over the August recess that could be considered in the month of September to meet the needs of the marketplace before the expiration of the current program.

I have come to the conclusion that without a properly constructed reinsurance program, there will be market consequences that are not in everyone's best interest. Accordingly, I look forward to working with other members and those experts who appear here today to seek out those remedies.

At this time, I would recognize Mr. Ackerman for an opening statement.

Mr. ACKERMAN. Thank you very much, Chairman Baker.

I would like to thank our committee Ranking Member, Mr. Frank, and the subcommittee Ranking Member, Mr. Kanjorski, for arranging the hearing today to discuss the important and urgently needed extension of the Terrorism Risk Insurance Act.

I urge that we work together on legislation to extend TRIA and that we move this legislation both through the committee and the Floor of the House this year. We must act to continue to provide TRIA's Federal backstop.

TRIA, as we know, was enacted in response to the events of 9/11, an event that caused over $30 billion in insured losses, and was enacted to help secure our economy against the devastation that might come from another terrorist attack. This was the primary purpose behind TRIA and it is the very reason this law needs to be extended.

This high-level Federal backstop not only protects private commercial insurance interests, but also the long-term interests of the Federal Government, which would be ultimately responsible for funding both short- and long-term costs associated with recovering from a terrorist attack.

Unfortunately, TRIA will sunset on December 31st of this year, and with Congress very soon to adjourn for the August recess, that deadline is fast approaching. The full 2-year extension proposed by Mr. Capuano's bill, H.R. 1153, will prevent destabilization of the insurance industry and, in turn, the national economy. This Congress has no greater domestic obligation.

The Treasury Secretary's recent report on TRIA makes it clear that private markets will develop additional terrorism insurance capacity over time, but that still leaves us with a problem that must be addressed now. Whereas Secretary Snow indicates that the Bush Administration opposes the extension of TRIA in its current form, we do understand that this program may not be the long-term answer to protect all of the stakeholders here.

I agree that in the end we must work to find private sector alternatives to address the liabilities created by the possibility of terrorist attacks. But with no such long-term solution currently in place and the sunset deadline of this protection soon approaching, a short-term extension must be enacted.

Failure to extend TRIA with the uncertainties that still exist in the insurance marketplace would horribly exacerbate the already difficult task that insurers face in trying to accurately and effectively manage the risk of loss resulting from a terrorist attack. Failure to extend TRIA now would lead us back to the same highly uncertain business environment we saw before TRIA, an environment in which firms struggled to get needed coverage. TRIA has provided a short-term solution to successfully protect policyholders from bankruptcy, keep insurers from insolvency, and prevent the taxpayers from paying the full cost of a terrorist attack.

Failure to enact the short-term extension makes no sense whatsoever. We are fortunate that there have been no terrorist attacks on U.S. soil since 9/11. Unfortunately, we have seen with this month's attacks in London that we still face a very real threat of terrorism and this threat will not go away when TRIA sunsets at the end of this year.

We must act as quickly as possible, both in committee and with the entire Congress to avoid the premature expiration of TRIA's Federal backstop. Our security and future prosperity demand it.

I thank the chairman.

Chairman BAKER. I thank the gentleman.

Mr. Ryun?

Mr. RYUN. Mr. Chairman, thank you, and thank you for convening this hearing. It is an issue that has been in front of the committee for some time now.

We have had numerous hours of testimony, and I believe that we have done a commendable job of helping to ensure that terrorism insurance continues to be available during perilous times.

At the same time, we must not lose sight of the goal to return terrorism insurance to a market-based product. If we fail to establish a framework that begins to wean the industry off the Federal assistance, we will create a dependency that is almost impossible to reverse. However, it would be equally irresponsible to allow TRIA to expire if the market cannot bear the product on its own.

I do believe that the industry is not to this point and therefore I believe that the committee should act to extend TRIA in some form. I am hopeful that we will be able to include meaningful reforms that accomplish the goals of holding taxpayers harmless over time, and ensure the availability of this product as it returns to the market-based system.

I want to thank the witnesses for being here today and I look forward to the testimony. I hope we can move quickly toward a responsible reform and extension of TRIA.

Thank you, Mr. Chairman. I yield back my time.

Chairman BAKER. I thank the gentleman.

Mr. Kanjorski?

Mr. KANJORSKI. Mr. Chairman, as you already know, I strongly believe that we now need to extend the Terrorism Risk Insurance Act. This law is critical to protecting our economic security. I am therefore pleased that we are meeting today on this important matter.

After the terrorist attacks 4 years ago, reinsurers curtailed the supply of terrorism reinsurance and insurers began to exclude such coverage from policies. In response, we enacted TRIA to address these pressing problems.

Several studies have already determined that TRIA has worked to increase the availability of terrorism risk insurance and has advanced economic development projects. The Treasury Department's recent report on this law also found that the program has helped to stabilize our insurance market.

TRIA, however, will expire at the end of this year. Like many of my colleagues, I believe that we need to move aggressively now to extend this economic stabilization law. Our failure to reach quick agreement on this important issue will likely result in less terrorism insurance, higher prices, lower policy take-up, and greater economic uncertainty.

Moreover, the recent terrorist attacks in England and Egypt highlight the need for us to extend TRIA despite the preferences of some against doing so. The occurrence of terrorism, after all, is currently unpredictable.

The vast majority of experts testifying before us today, including regulators, insurers, brokers, and real estate investors, will also call upon us to act expeditiously in these matters in the coming months in order to prevent short-term market disruptions. We need to listen to their counsel.

In debating any plan to extend TRIA, I have long held that we ought to work to incorporate group life insurance. Therefore, I am pleased that one of our witnesses will directly address this issue today. Group life products, after all, have characteristics similar to commercial property and casualty insurance in that there is often an aggressive concentration of risk within a small geographic area. As many of my colleagues have regularly noted, we need to insure the people inside the buildings, and not just the buildings themselves.

Additionally, the Administration has proposed a number of reforms that it would like Congress to adopt should we decide to extend the program. I approach these proposals with some doubt and a little skepticism. After all, the original bill was a carefully crafted compromise that resulted from extensive negotiations. In particular, I am especially concerned about Secretary Snow's request for reasonable legal reforms. This proposal for legal reforms could once again stall legislative efforts, as it delayed consideration of the original law.

Nevertheless, as legislators, we have the responsibility to give this proposal and the other reforms suggested by the Administration their due consideration. We also need to evaluate the recommendations of experts testifying before us today during our forthcoming deliberations.

As I noted at our last hearing, Mr. Chairman, time is of the essence. We now have just 4 weeks remaining on the legislative calendar. As a result, we need to have our staffs work diligently over the August break in order for us to move expeditiously in September.

In closing, this is not a Democratic or Republican issue. It is, as I have regularly noted, an American issue. It is a business issue. It is an economic security issue. I therefore stand ready to work with you, Mr. Chairman, and all other interested parties on these matters in the weeks ahead.

Thank you.

Chairman BAKER. I thank the gentleman.

Mr. Frank?

Mr. FRANK. Thank you, Mr. Chairman. I appreciate the promptness with which you and the Chairman of the Full Committee have given us a chance to begin working on this.

We were encouraged when the Chairman of the Full Committee indicated that we will in fact be marking this up. I look forward to this committee doing what we have been able to do in a number of areas in the past, working together in a bipartisan way on the technical matters.

I want to address a philosophical point here today. It is why I strongly support this and why I differ with some of my allies who have said, well, let's not be helping business in this regard. In the first place, the prime beneficiaries of this, in my judgment, are not the insurance companies. They are the insured. The insurance companies could walk away from this.

The problem would then fall on those who seek to build and construct, particularly in our big cities. This is a very important issue for New York and for Chicago. This is, as I said, a matter of the insured. There are people who want to build, who want to help develop. They are the ones who have come to me most passionately about this.

Second, there is the philosophical question of how does this society deal with the costs imposed on us by murderers who dislike our form of government and our way of life. Yes, I suppose it would be possible for the market to take care of this. The market would take care of it by raising the price, if the market works as it should, to those who would be the likeliest targets of terrorism. That is the way the insurance system works. You would in a logical way say, okay, let's try as best we can to figure out who are likeliest to be the victims of terrorism and we will charge them more for their insurance. That is the way insurance works.

Now, that is often a very good idea because what it does is give people an incentive to make themselves less likely to be a cost problem. You can have people diminish the likelihood of fire, diminish the likelihood of automobile accidents, etc. But there is nothing that Americans can do in Chicago or New York or Boston or anywhere else, or in the rural areas about terrorism, because I think the chairman is quite right. When we do the triggering, we should be sensitive to rural areas. We do not know where the terrorists will strike, but we will be guessing.

I do not think we ought to say to the American people, we are going to assess you an extra fee because terrorists may have targeted you. It seems to me, and this is my philosophical justification for TRIA, we should take the cost of terrorism, which may be inflicted on us, and obviously there will be a terrible human cost, but to the extent that it is a financial cost, it ought to be broadly shared. This is a case for totally socializing the risk and not allowing particular sectors of our society, particular geographic regions to be more at risk and to have to pay more for terrorism. That is what we are talking about.

If you go to a purely market-based system of terrorism insurance, you are saying to the extent that you are likely to be targeted by the terrorists, to that extent we will charge you more. Our job ought to be to say to those who would murder and destroy because they disagree with policies of this country, we are going to do everything we can to make sure that you have no effect on us. We are going to neutralize your efforts. The best way to do that is to take the cost of those efforts and spread them as broadly as possible.

I do not want any one segment of the American economy feeling, oh well, wait a minute, I better be careful about this policy, I will be particularly singled out. To the extent that we broadly distribute this risk across the board and say to people that we all share. Let me just be clear on the point. The individuals who might be building big buildings in a particular community, they are not the cause of the murderers and they ought not to bear a disproportionate share of the burden of dealing with it. It is the country as a whole that has been targeted by these people. It is the country as a whole that should respond.

One way to respond is to take the risk of terrorism insurance, and again people cannot diminish that risk. They may be able to mitigate some, but they cannot diminish the risk that they will be victimized by terrorists because that is an exogenous event over which they have no control.

So that is the philosophical justification for saying whether the market can or cannot do this is not to me the primary issue. I do not want to impose on particularly vulnerable people in this society a greater cost because murderers may have targeted them. And that is the justification for doing this in this public way.

Thank you, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Capuano, did you have a statement?

Mr. CAPUANO. Mr. Chairman, first of all, thank you for the hearing.

I have no real opening statement, but I actually would encourage all the panelists, both on the first and second panels. Honestly, I deal in the real world. I think pretty much everybody is going to be on the same line that there is some role for the Federal Government on some sort of backstop at some level. The immediate question, though, is whether we should extend the current TRIA law or some form thereof.

I do not think anybody who is familiar with the legislative process can look me in the eye and tell me that you think we will come up with a permanent solution by the end of this year. Though that is possible, anybody who is familiar with the process I think knows that it is highly unlikely.

That being the case, my biggest interest, my immediate interest is your opinions on the immediate future. Should we extend TRIA? Should we extend it with some amendments? Or should we just let it expire? Beyond that, the permanent fix will take us some time to get to. If you think otherwise, if you think we can do it between now and then, I would like to hear that as well.

Other than that, Mr. Chairman, again I thank you for having this hearing and for opening up the process so that we can hear from people who actually know what they are talking about, instead of just me.

Chairman BAKER. I thank the gentleman.

Are there Members seeking recognition?

Mr. Crowley?

Mr. CROWLEY. Thank you, Mr. Chairman. Let me thank you and Ranking Member Kanjorski for holding this hearing today on the Federal terrorism backstop.

I especially want to highlight the work of Ranking Member Barney Frank on this issue in keeping it at the forefront, as well as my colleagues Mr. Israel, Mr. Capuano, Mr. Kanjorski, in conjunction with my office, in creating the legislation that I think has been at the forefront of moving this issue forward, as well as Ms. Bean from Chicago and her efforts to extend TRIA for an additional 2 years.

I welcome this hearing of the subcommittee on this important issue and look forward to as early a markup as possible. It is my hope that the Capuano-Israel, et al, bill, H.R. 1153, will be the base for this that will include a 2-year extension, as well as inclusion of group life coverage. That bill served as a lonely leader arguing for an extension of TRIA and it deserves its true place as the engine that moves TRIA forward to the next level, as well as the recognition of all those who support TRIA, including a number of the witnesses here today, some of whom I think sometimes forget that this bill exists.

As we all know, the Terrorism Risk Insurance Act passed in 2002 allowed for the reinsurance of terrorism insurance to private enterprise; allowed for the financing of new construction projects; and provided coverage for thousands of businesses that would not have had insurance without it. It was vital and we all agree on this point. As Howard Mills—and we welcome you to the committee today, Mr. Mills, a former State assemblyman, as I was myself, in New York State, who is now serving as the New York State insurance commissioner—stated about TRIA, “The nation’s current economic strength is in large part due to the Federal backstop put in place by TRIA.” Mr. Mills continued by saying, “The removal of that type of protection could return the insurance market to the uncertainty experienced in the aftermath of September 11, 2001.” As a New Yorker, Mr. Mills is very keenly aware of the importance of this legislation, which certainly had the support of our Administration, this Administration, after the aftermath of September 11th.

The Treasury report stated that the creation of TRIA was meant to address any market disruptions and ensure the continued widespread availability and affordability of property and casualty insurance for terrorism risk, and to allow a transitional period for the private markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses, while preserving State insurance regulation and consumer protections.

The report goes on to say that TRIA has been effective in meetings its goals of supporting the industry during a transitional period and stabilizing the private insurance market. Later, this same Treasury report states that the immediate effect of the removal of TRIA subsidy is likely to be less terrorism insurance written by insurers, higher prices, and lower policyholder take-up.

I agree with all of the above. TRIA has been a success. Without TRIA, our country will see serious market disruptions like we saw in the months after 9/11 when there was no coverage and no ability of insurers to assess risk. In fact, what I said last week when Secretary Snow was giving his testimony before the committee, it is a take on the old adage, if it ain't broke, fix it.

But now is not the time to let TRIA die. In fact, now is the time to extend and strengthen it. As we learned both in the Treasury report and over the past few years from conversations with industry and business leaders, many reinsurers have still not yet returned to the marketplace.

I have concerns that as we move forward with any legislation, that we ensure the retention trigger rates as such are kept at a manageable rate to lure more insurers back into the market. I fear that increasing retention rates while weakening TRIA will not lure them back in. As they operate in a free market, reinsurers view terrorism as an uninsurable risk and that simply will not change.

We need to add group life coverage and we need to look at the possibility of covering nuclear, biological, chemical and radiation coverage and other issues. We have a lot of work ahead of us and not much time to accomplish it. Stating that, I do believe that TRIA should not be a permanent program, but rather a temporary program until the private insurance market can develop its own additional terrorism insurance capacity.

Again, I am pleased that the Treasury Department's report on TRIA, as well as the leadership of Mr. Frank in continually charging ahead on the importance of extending TRIA and terrorism risk insurance, will go on. I want to applaud them all once again and commit to industry to all facets who are concerned about this that I, too, am committed to seeing TRIA re-passed before we leave this Congress.

I yield back.

Chairman BAKER. I thank the gentleman for his statement.

Mr. Israel?

Mr. ISRAEL. Thank you, Mr. Chairman.

Let me echo Mr. Crowley's welcome to Superintendent Mills from my home State of New York.

I look forward to hearing your comments and those of the other witnesses.

I am going to be very brief, Mr. Chairman. Some have suggested that with the Treasury report, we are getting very close to building a bipartisan consensus on TRIA. I certainly am hopeful that is the case, but there is a sense of deja vu because we were very close to a bipartisan consensus with TRIA in the last Congress. In fact, we were minutes away from a vote on the suspension calendar with the TRIA bill.

Unfortunately, the clock wound down, we were not able to accomplish it, and here we are again. The clock is winding down again. We do not get two strikes on this issue. If we do not act, we are profoundly disappointing our businesses and our residents back home, and potentially setting back the U.S. economy.

So I think that we have an opportunity to build consensus on what I suspect will be an imperfect bill. I just want to close by suggesting that we have an obligation to make sure that in an imperfect bill we at least cover two bases. One is group life. It makes no sense for us to assure the continuity of insurance for construction, for bricks, for mortar, for steel, and not for the human lives inside that building. It is a very tough argument to make back home that we insured buildings, but not the people inside. So I think group life has to be a critical component.

Finally, we need to ensure that whatever is passed in the remaining weeks that we have here in Washington does focus on a short-term extension and a long-term solution. I look forward to continuing to work with my colleagues. I want to thank Mr. Capuano and Mr. Kanjorski and the ranking member and Mr. Crowley for joining me on H.R. 1153. We continue as we always have at every step for the past 2 years to offer to work in a bipartisan, constructive fashion with our colleagues to make sure that we pass TRIA, put this issue behind us, and sustain our economy in the future.

I thank the chairman and yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

The Chairman of the Full Committee, Mr. Oxley?

The CHAIRMAN. Thank you, Mr. Chairman.

And good morning to our distinguished panel of witnesses and welcome to the committee. We look forward to hearing your testimony today on the future of terrorism insurance.

We recall today how the economy, and specifically the insurance marketplace, was roiled by the terrorist attacks of 9/11. Reinsurance capital fled the marketplace, insurers began to exclude coverage, and large policyholders were unable to obtain enough insurance coverage for their construction and development projects.

In coordination with the leadership of President Bush, Congress acted swiftly to address the problems facing the insurance marketplace. Those problems included a drained industry surplus, insufficient diversification in geographic risk exposure, and an inability to model potential terrorist losses. Within weeks of the terrorist attacks, this committee and the House passed legislation that in 2002 would become the Terrorism Risk Insurance Act or TRIA. TRIA established a public-private partnership with a temporary backstop to protect against future catastrophic terrorist attacks through December 31st of this year.

TRIA was designed to be a temporary fix to address very specific goals, and it has succeeded in that role. The insurance industry's surplus has dramatically increased, the economy has greatly improved, and commercial property insurers have been able to more effectively spread and model their risk exposures.

However, as documented by the recent report from the Department of the Treasury, TRIA may actually be hindering market-based solutions for terrorism insurance. As a result, it would not be prudent to merely extend the current TRIA program. The threat from terrorism will likely remain with us for years to come, and this Nation needs a long-term solution that the current TRIA program simply does not and cannot provide.

We have had the Government Accountability Office perform numerous studies for the committee evaluating domestic and foreign catastrophe programs. From their review, it is clear that the only long-term solution to ensuring market stability for catastrophic risks is by creating dedicated capital. This can be done by allowing long-term catastrophic reserves, creating an industry pool, pre-funding or post-funding losses through assessments and surcharges, tapping the equity markets, or providing a Federal subsidy.

The last option, a Federal subsidy, is often the least efficient as it crowds out and distorts the private marketplace, reducing incentives for mitigation and appropriate risk pricing. For this reason, the Treasury and the White House have indicated their opposition to an extension of TRIA in its current form. I also believe that an extension of the program without reform would be unwise and unwarranted.

Fortunately, the marketplace has not been without new thinking in the last year, and numerous parties have presented the committee with proposed solutions for revamping TRIA to reduce the Federal subsidy, increase private sector involvement, and create dedicated capital sources to ensure long-term stability in the terrorism insurance marketplace.

This is an important due diligence responsibility for our committee. Whether we simply increase the TRIA numbers as the Treasury suggests with full taxpayer payback and more streamlined coverage, or create a more comprehensive solution with greater certainty and free-market discipline, I am confident we can get it done in a timely manner and in our committee's bipartisan tradition.

I look forward to hearing from the witnesses on our panels today, and on working together on a revamped and more effective and efficient terrorism insurance program.

Mr. Chairman, I yield back.

Chairman BAKER. I thank the Chairman for his participation.

Ms. Bean?

Ms. BEAN. Thank you, Chairman Baker and Ranking Member Kanjorski, for holding this important hearing on TRIA.

Thank you to our distinguished panel members for sharing your own valuable real-world perspective in the debate over terrorism risk insurance.

In the wake of the September 11th terrorist attacks, it was important to put a Federal backstop in place to protect against large-scale terror losses. TRIA provided an important step forward in providing relief to insurers and third parties that could suffer devastating losses in the event of a terrorist act.

My own suburban district is located just northwest of Chicago. Many of my constituents work in the city, however, and I have a special appreciation for how TRIA helped restore the confidence needed to revive our local economy after the shock of September 11th.

The London bombings earlier this month illustrate that the threat posed by terrorism is still very real. Sadly, the London attacks underscore the need for Congress to act quickly to renew the Terrorism Risk Insurance Act before it expires at the end of this year. In the absence of a backdrop, I am concerned that the terrorism insurance market will once again become unstable and potentially damage our economy.

The same rationale which compelled Congress to pass TRIA in the first place should again compel us to approve its extension. We can and should avoid further market disruption.

I look forward to the witnesses' testimony and I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady.

Mr. Bachus?

Mr. BACHUS. I thank the chairman. I would like to commend you on your leadership on this issue and your efforts in renewing the Federal Government's commitment to terrorist insurance and the Terrorism Risk Insurance Act.

Over the past few years, terrorist insurance has helped provide needed stability to our Nation's economy. It is often a critical component in the financing of various real estate development projects, including office buildings, residential and condominiums, and retail centers. Its continued availability and affordability plays an important role in the economic health of the commercial real estate market in our economy.

For that reason, I would like unanimous consent to submit a statement by the National Association of Realtors.

Chairman BAKER. Without objection.

Mr. BACHUS. Thank you.

As you know, the program is set to expire at the end of the year. I am concerned that America's economy will not have the adequate financial protection from future terrorist attacks, and we always have to assume that they will come, for purposes of this hearing. Consequently, Mr. Chairman, this program needs to be renewed and extended.

In addition to the renewal of the TRIA program, we should consider the inclusion of group life as part of the Federal terrorist reinsurance program. Unlike property and casualty insurance and their industry, in the absence of TRIA group life insurers are required by State law to offer terrorist protection if they offer the product.

As a result, group life insurers have had to make changes in their underwriting policies with potential risk of an exposure to a terrorist attack. For that reason, I believe that adding group life would help ensure the ability in the life insurance market and allow policyholders additional security in areas of high-risk concentrations. Also, it encourages the offering of group life insurance.

As a proponent of the TRIA program, I have also read the recent Department of Treasury study on renewing terrorist risk insurance, the Act. It is my sincere hope to work with the Administration and the committee and Chairman Baker and Chairman Oxley on suggested changes to the program to ensure that TRIA renewal will not prevent the development of the underwriting ventures and reinsurance products in this area.

Again, I thank you, Chairman Baker, and I look forward to hearing the testimonies of the witnesses here today.

Chairman BAKER. I thank the gentleman.

Mr. Miller, did you have a statement?

Mr. MILLER OF NORTH CAROLINA. Just briefly, Mr. Chairman.

I agree that TRIA should be extended. I voted for that in this committee in the last Congress and I have cosponsored the legislation this year to extend it.

But I wanted to agree in part and disagree in part with the ranking Democrat, Mr. Frank's statement earlier. I am sorry he is not here to see me disagree with him. I just wanted to prove that I could do it.

[Laughter.]

Chairman BAKER. I will tell him about it.

[Laughter.]

Mr. MILLER OF NORTH CAROLINA. Okay. Thank you. I actually felt several people might.

I agree entirely that there is a great deal of terrorism risk that is entirely beyond the power of insurers to prevent. There is nothing the World Trade Center could have done to prevent being struck by commercial airliners, but there is something that airlines could have done to prevent it. I certainly want to get at what the private sector can do to make us safe.

The 9/11 Commission said that despite 9/11, the private sector was woefully unprepared for terrorist attack. It should be a cost of doing business, certainly for some critical infrastructure, for some businesses whose vulnerability puts all of us at risk, many of us at risk.

There are real differences in vulnerability to terrorism, the likelihood that a business will be the target of an attack, that I think should not, I agree with Mr. Frank, should not be reflected in terrorism insurance. Obviously, the greatest single vulnerability is whether you are in a major population center; whether you are in a city or not. I do not represent a large city, but I want America's cities to be vibrant and I do not want businesses to think they have to move away from cities to get insurance or to get affordable insurance.

I do not want a publisher to have to pay more terrorism insurance if they publish Salman Rushdie. They may be at much greater risk of a terrorist attack if they do. It is unacceptable to me that we would make that distinction. I would not want a Jewish community center to have to pay a higher terrorism risk insurance premium than would a Methodist community center or a nonsectarian community center. Those are unacceptable to me.

But if the chemical industry can do something to prevent a Bhopal resulting from a terrorist attack, I want them to do it. If utilities, if power companies can do something, should do something to prevent the grid from going down because of a terrorist attack, I want them to do it, and I want there to be an economic incentive to do it.

So whether it is this legislation and the extension of TRIA or in some other legislation, I do want to have a discussion about what we can do through market forces to encourage the private sector to be prepared for terrorist attack, to try to prevent attacks, to try to reduce our vulnerability, particularly when an attack on you is going to cause loss to others who cannot protect themselves, who can't prepare, and to minimize the damage so that we can recover from attacks.

Chairman BAKER. I thank the gentleman.

Mr. Fitzpatrick?

Mr. FITZPATRICK. Thank you, Chairman Baker.

When Congress enacted TRIA, we made great strides to stabilize the private insurance market and to safeguard the economy in the face of future terrorist attacks. This temporary program effectively limited market disruptions and encouraged economic stabilization.

In the face of TRIA's expiration, we must ask if we are going to try to develop a private reinsurance market for terrorism. Secretary Snow testified that a revamped terrorism insurance program must incorporate greater taxpayer protection and encourage private market development. Chairman Greenspan stated that some of the aspects of the Treasury's proposal to change TRIA by increasing private market participation and lessening taxpayers' potential liability were very sensible. I would like to hear the panel here today address what is sensible and what is not.

Chairman Baker has raised concerns that raising the threshold to $500 million might make TRIA coverage unavailable in some areas, which could possibly include my district in southeastern Pennsylvania. I would also like the panel to address this concern.

No matter how you look at it, the global struggle against violent extremism will be long. We must try to find solutions so that our taxpayers are not so vulnerable in the long run. In the end, terrorism may turn out to be an uninsurable risk, but until this Federal backstop is modified, the private sector will not have an incentive to innovate. Despite our differing views on reform, we can always stand together on one thing: protecting the American economy from the financial consequences of a terrorist attack.

Chairman Baker, I commend your commitment to renew this vital program before it expires at the end of this year. And I yield back the balance of my time.

Chairman BAKER. I thank the gentleman.

Ms. Wasserman Schultz?

Ms. WASSERMAN SCHULTZ. Thank you, Mr. Chairman.

Chairman Baker and Ranking Member Kanjorski, I appreciate your convening today's hearing and for your continued leadership on this important issue.

I particularly want to recognize my esteemed colleague from Massachusetts, Mr. Capuano, for all of his hard work on H.R. 1153.

Specifically, I would like to welcome Ed Harper from Assurant, which is a major employer in my district.

I will not be here for your testimony because I have a Judiciary Committee markup simultaneous to this meeting, but I appreciate your being here. I look forward to your testimony and for all the panelists', and I want to keep my remarks short so we can expedite this process.

I also want to reiterate, as my colleague from Pennsylvania did, that there is a need for a Federal backstop on the reinsurance markets. A failure of the Federal Government to extend TRIA will have very real consequences for our economy and will especially have those consequences for cities like Miami where the costs to private market participants will be simply untenable.

The series of tragic events in London over the last few weeks underscore the need for the reauthorization of TRIA. The war on terror continues. As we heard Chairman Greenspan testify before this committee last Wednesday, private markets presume peaceful and civil societies. You cannot price or model catastrophic events. This is a lesson that other countries facing such threats, countries like the U.K., Israel, Spain and Italy have learned. These countries all provide the equivalent of a Federal backstop for their reinsurance markets.

Like with unanticipated, unavailable insurance for hurricanes in my home State of Florida, the insurance industry cannot be expected to carry the full weight of the aftermath of a terrorist act. I know that many of my colleagues on both sides of the aisle recognize this need and I encourage us to move forward together and do what is best for this country.

Thank you. I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady.

Does any Member seek recognition for an opening statement?

If not, at this time I would like to ask unanimous consent that the gentleman from Texas, Mr. Sessions, be permitted to sit as a member and be recognized in regular order. If there is no objection, without objection—

Mr. SHAYS. Reserving the right to object.

Chairman BAKER. Mr. Shays is recognized.

Mr. SHAYS. As long as Mr. Sessions speaks with the eloquence that he usually speaks with.

[Laughter.]

Chairman BAKER. You will have to be the sole judge of that.

The gentleman from Texas is recognized.

Mr. SESSIONS. Thank you, Mr. Chairman.

You know, it is great to have friends around it, isn't it? Chris, thank you so much.

Mr. Chairman, I appreciate the opportunity to be with you today and to hear this panel as they speak clearly about the needs as we go about reforming TRIA. I would like to be the first one to say that your leadership makes a difference, and the reason why we are here today is because you have been able to bring us along on this pathway to make sure that this debate and discussion takes place.

Also, I want to thank Chairman Oxley, Mrs. Kelly, and Eric Cantor for their long support of this process.

Mr. Chairman, if I could, I would like to just submit my remarks, rather than going through them, but I would like to read one page of them, and like to ask unanimous consent that they be included in the hearing.

Chairman BAKER. Without objection.

Mr. SESSIONS. That is, with the benefit of some distance and greater insight into how the marketplace has responded to TRIA, I believe it is appropriate to revisit this program as we are doing today and determine how it can be improved. Legislation that is fiscally responsible and provides taxpayer protection by narrowing Federal exposure, while still providing certainty and stability to the marketplace is what our achievable goal should be. I believe it is one that can be reached also in a timeframe that is appropriate, considering the impending expiration of TRIA as we currently know it.

Without the certainty provided by the terrorism insurance program, Congress runs the risk of dealing with the financial aftermath of the tragedy again without a plan and without significant involvement from the private sector. This is a bad policy alternative for dealing with the economic effects of such a tragedy, and Congress can and must do better.

Mr. Chairman, I believe what we are doing here today gets us closer to the mark of not only responsibility, but making sure that Congress puts its mark with the private sector to ensure that our economy feels the strength of an ongoing need to make sure that Americans have confidence not only in our government, but also in our process and the free enterprise system.

Thank you so much for allowing me to be here today.

Chairman BAKER. I thank the gentleman.

There being no further statements from members, I have a request for unanimous consent that the statements of the Association of American Railroads and the statement of the Trust for America's Health be included in the hearing record. Without objection, so ordered.

It is now my pleasure to turn to our distinguished panel of witnesses, and advise you that to the extent possible we request that your testimony be constrained to 5 minutes. However, your full statement will be incorporated into the official record of the hearing.

With that, I would first like to call on Mr. Howard Mills, who appears here today in his capacity as superintendent of the New York Insurance Department.

Welcome, sir.

STATEMENT OF HOWARD MILLS, SUPERINTENDENT, NEW YORK INSURANCE DEPARTMENT

Mr. MILLS. Thank you, Chairman Baker, Mr. Kanjorski, all the members of the committee.

It is clear to me from hearing the many opening comments today that all of the members of the committee seem to have a very keen appreciation for my critical point.

My critical point, if I could leave you with one message, Members of Congress, is that we cannot have any gap. On January 1, 2006, something must be in place, a Federal backstop, or we will indeed immediately return to the post-September 11th period in the insurance industry and it will have devastating impacts on our national economy.

I would be pleased to see an extension of TRIA. The NAIC has advocated for an extension of TRIA with the inclusion of group life. I think that is very important. But I have been listening very carefully to the Administration, to the Members of Congress. I do not expect that there is a lot of desire to just go ahead with a straight extension. So I am here to try and offer some thoughts on how we could go about approaching it in a different way.

Before I share some of those thoughts, let me make a couple of points that are critical to what an extension of TRIA or any new program would have. The first thing I would like to say—and I heard it in some of the opening comments here this morning—there is a tendency, and I with all due respect think that it is incorrect and misguided, to still regard this as a large city issue. This is something that we have to really think about. I personally believe that it would be far more devastating if the next, and we all hope of course that there will not be a next, but the experts tell us that there will be a next attack.

I think it would be far more devastating to the insurance industry, to the economy, to the national psyche if that next attack were not at the Sears Tower in Chicago, not at the Empire State Building in New York City, but in a small shopping mall in Iowa or in Louisiana that none of us had ever heard of. That would immediately necessitate that any building project anywhere in this country where people gather would have to have terrorism insurance. Immediately that would occur.

It simply must be there. Our national economy will be devastated if that were to occur. We know that we are dealing with a savage, but a very cunning enemy. They have a history of going after soft targets, not hard. And many of our best minds were focused on trying to predict and prevent the next attack have that very same concern, that it will be an unforeseen attack in an unlikely location designed for maximum economic damage, which of course is one of the major objectives of our enemy.

That brings me to another point that I would like to make. I do think that the industry can do more, should do more, but those who say that the existence of TRIA over the last 2 years has completely depressed industry response, that also is not correct. The industry has done a great deal. You need only look at the security measures taken on by the private sector in large cities primarily, you know, expected targets.

Local governments are bearing a heavy burden and the American taxpayer is already bearing a heavy burden. That is something else that is not often said enough. There is a lot of concern for the cost to the taxpayers. I would point out that TRIA so far has not cost the taxpayers a dime, not a dime has been spent on TRIA.

But the American taxpayers are already paying. They are paying when their local governments have to take up security, enhance security measures, so we are all already paying a cost. It is a question of how that cost will be borne and what will be the most effective use of those monies to protect our national economy.

One of the great problems that the industry has even if TRIA goes away and if there is not a backstop, insurance rates are set based on modeling. To price a product, they have to model. They have to try to predict the likelihood of payment of claims. You simply cannot model a terrorist attack. By its definition, a terrorist attack is meant to be unexpected. It is meant to be a surprise. You cannot model it. Therefore, you cannot price it.

And finally, to those who are questioning whether we should even allow TRIA to just expire and go away with no Federal backstop, and "let the free market respond," I would urge the Congress to consider this. There will be a free market response, but the likely, indeed the probable free market response will be to not write the insurance at all. That will have devastating impacts on our economy.

TRIA has worked very, very well. I think that the major point that I would like to make here is that TRIA, the Congress was wise, the Administration was wise in its make-available clause. It put the onus on the insureds, not the insurers. It is the option of the insureds to look for it. It has to be made available by the insurers, and I would hope that any solution going forward will keep that in mind. I agree with those who said here today, and I am here as the superintendent of insurance, not advocating for the industry. I am here advocating for the consumers of insurance, for your constituents, for the American economy.

Right now, the Congress should be aware that even with this question of whether TRIA will be extended or not, great harm is already being done. Again, I urge you, there must be a Federal backstop in place in some form on January 1, 2006, and I would also urge you to move as quickly as possible because the mere confusion about what is going on is already doing economic damage. You are seeing exclusions being written into policies right now and those exclusions will kick in with any policies going into 2006. If there is not a Federal backstop in place, those exclusions will kick in and we will indeed be right where we were on September 11, 2001, before TRIA was enacted that year, where the economy had such terrible damage.

Congress should be very aware of the fact, you know, it all comes down to an issue of capacity, and there is not unlimited capacity. Capacity has enhanced since TRIA was enacted, that is true, but the capacity is not unlimited. You should be aware that less than half, less than half of all the capacity out there right now in the insurance industry, less than half of that is dedicated to commercial lines.

Also, the hurricanes in Florida have reduced our capacity by $20 billion, and we are in hurricane season again. We have already had the earliest force four tropical storm in the hurricane season on record, so we just cannot count on the capacity being there. It is not yet there and the fact that all of the policies being written are already containing these exclusions in the event that a Federal backstop goes away, shows that the industry is not yet ready to write and that they will indeed, because of capacity issues, in many cases opt not to write if the Federal backstop is not extended. There are just some catastrophes that the private sector is not able to deal with. It is absolutely critical that this backstop continue.

Now, where do we go? I have been listening very carefully. I do believe that there is a sincere effort to come up with a long-term solution. I believe that a long-term solution is preferable. Hopefully, the Congress can enact a long-term solution so it is in place by January 1, 2006. If it is not, if for political reasons or other reasons it just is not able, I urge you to do some sort of a temporary extension as a bridge to get you to the point that a long-term solution can be put into place. Again, the economic impacts of any gap, any gap at all on January 1, 2006, would be devastating. We are already feeling the impacts.

Where would I like to see a long-term solution go? I do believe that we need more private involvement and we need to come up with a mechanism that would over time do two things: build capacity and reduce the Federal Government's involvement. Some type of a mechanism, some other entity created where capacity was built, which was optional, which those insurers that opted to go into the program would then pay an assessment to build capacity. It would be absolutely necessary that if they opted in, they had to cover all types of terrorism.

Chairman BAKER. Could you begin to conclude, sir?

Mr. MILLS. Okay. Chairman, I have many other points I want to make which maybe we can get on, but let me make one final point please, if I may.

The urgency of having this in place is critical. I happen to be a very, very big believer in tort reform. I am very concerned when I hear some of these talks about linking TRIA or another backstop to other issues. I urge you not to do that. I believe that this is, after the men and women in the United States military, TRIA is, or a Federal backstop, an improved Federal backstop is the most critical weapon in our arsenal to fight the war on terror. They want to destroy our economy. TRIA has kept our economy strong and the lack of a Federal backstop will have a devastating impact on our national economy.

I thank you, Mr. Chairman.

[The prepared statement of Mr. Mills can be found on page 145 of the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

Our next witness is Mr. Larry Mirel, who testifies here today in his capacity as commissioner of insurance and securities regulation for the District of Columbia.

STATEMENT OF LAWRENCE H. MIREL, COMMISSIONER, DEPARTMENT OF INSURANCE AND SECURITIES REGULATION, DISTRICT OF COLUMBIA

Mr. MIREL. Good morning, Chairman Baker, Mr. Kanjorski, and Mr. Sessions and members of the subcommittee.

As the insurance commissioner for the District of Columbia, I carry out the laws that were mostly enacted by this Congress, and in many ways I am Congress' State insurance regulator. I am here today on behalf of my department, the District of Columbia Department of Insurance, Securities and Banking, and I am not speaking on behalf of the NAIC, the National Association of Insurance Commissioners.

I want to agree with Superintendent Mills, first, that the issue really is one of 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.

Under TRIA, the deal that was made was that in exchange for insurance companies offering terrorism coverage, the Federal Government steps in under certain circumstances to provide a backstop. TRIA has worked well and it is an important law, but there are two shortcomings, in my view, with the approach taken by TRIA.

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 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. $15 billion in terrorism losses may seem like a high industry retention level, but when compared to the $40 billion caused by the destruction of the World Trade Center, it is clear that the Federal Government would become involved very early under TRIA in a major terrorism event.

To deal with both of those problems, in my view, a long-term solution should make the Federal Government a far more remote guarantor. There needs to be a Federal guarantee. In the end, as Mr. Mills has said, and others, terrorism risk is unpredictable. There needs to be a Federal guarantee, but it should be far more remote than it is currently.

The way to deal with that, in my view, is to use the legislative authority of the Congress to create the establishment of a terrorism risk pool that would be funded and run by the industry; that would act as a cushion between what the industry can cover in the ordinary course of its activities and the point at which the Federal Government needs to step in as guarantor.

In my view, the sensible approach would be for Government to use its authority to create such a pool, which would take some time to be filled up, but as it fills up, the terrorism guarantee provided by the Federal Government could retreat. Basically, what I am talking about is a TRIA-like arrangement, but funded by private money, not by the Federal Government.

I also want to deal with a point that was made earlier about the unfairness of putting the risk of terrorism attack on those people who happen to be in the way of the particular goal of the terrorists. I always use the example of Joe's shoe store down here on 15th Street near the White House. The terrorists are not after Joe. They are after America, and Joe should not have to pay 3 times as much as anyone else for insurance coverage.

The creation of a risk pool would allow the subsidizing of the risk by every American. I think that is only fair. Not only do we not know when the next terrorism attack will take place, but we do not know where it will take place. Everybody is at risk. The terrorists are after America. They are not after Joe's shoe store.

The terrorism risk pool could be funded by a very small increased charge on policies that are covered by the pool. That small charge would very quickly mount up to a great deal of money that would be used as a backstop before the Federal backstop is reached.

Currently, what happens is that insurers, not knowing what the risk will be, not being able to properly model it, charge a high rate. They would rather err on the side of being too high than too low. At the end of the year if there has been no terrorist attack, that money goes to the company's bottom line. The following year, it has the same issue, and so it charges the same high rate.

Instead, if this money were put into a terrorism risk pool, and kept aside for the purpose of backstopping terrorism risk, it could serve a very important role as a cushion between what the private industry can provide in the ordinary course and what the Federal Government ultimately will have to do.

Thank you, Mr. Chairman, for holding this hearing. I do think that it is very important that something happen before the end of the year. I agree with Superintendent Mills that we should not have a gap. Something has to be done. I think also that a long-term solution is in the air and could be done. I hope it could be done by the end of this year, but if not, then something must be done. There cannot be a gap.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Mirel can be found on page 153 of the appendix.]

Chairman BAKER. I thank you for your testimony.

For the appropriate introduction of our next witness, I now turn to Mr. Geoff Davis.

Mr. DAVIS OF KENTUCKY. Thank you, Mr. Chairman.

It is a privilege to be here this morning serving on the Terrorism Subcommittee on Armed Services, the House Task Force on Terrorism and Unconventional Warfare, and also on the Financial Services Committee and Chairman Baker's Subcommittee on Capital Markets.

Before introducing Mr. Stiglitz, I would like to comment on the importance of this hearing today simply from the perspective of this not being a war on terror. This is a war that Islamic extremism has imposed on this country, not simply by poor people from remote areas, but highly educated middle class and upper middle class people who are orchestrating this effort, and understand very clearly that to win the psychological war, to reduce the will of the American people to unutterably defeat them, they need to be able to strike a blow to our economy and our confidence in our governmental structures.

That is one reason I am very grateful to the chairman for holding this hearing and being a champion on reauthorization and reformation of this very critical piece of insurance legislation, because one of the great blows, as a student of the Middle East, one of the great blows throughout the extremist Islamic community was the fact that our markets were open for business again within days after the 9/11 attacks. I think we have to take the steps necessary to show the world our confidence. Indeed, the world is watching this hearing today.

This morning, it is my privilege to introduce Mr. William Stiglitz, the third president-elect for the Independent Insurance Agents and Brokers of America, from Louisville and the great Commonwealth of Kentucky. Mr. Stiglitz was elected to the executive committee of the IIABA in October of 2000; was inaugurated as president-elect in 2004 at the IIABA's convention in Orlando, and will become the association's president this year.

Mr. Stiglitz is an account executive with Hyland, Block and Hyland, Incorporated in Louisville, Kentucky. A past president and State national director for the Independent Insurance Agents of Kentucky, Mr. Stiglitz is on the State's board of directors and government affairs committee. Nationally, he served as planning liaison to the executive committee and as a member of the dues taskforce. He also is past president of the Louisville Board of Independent Insurance Agents.

Mr. Stiglitz graduated from Centre College in Danville, Kentucky, and served in the United States Army in Vietnam.

For that, we thank you for your service.

Mr. Stiglitz, we are pleased to have you here this morning at the Subcommittee on Capital Markets, and we look forward to your testimony.

Chairman BAKER. Please proceed, Mr. Stiglitz. Welcome.

STATEMENT OF WILLIAM G. STIGLITZ, III, HYLAND, BLOCK AND HYLAND, AND PRESIDENT-ELECT, INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

Mr. STIGLITZ. Thank you, Congressman Davis, for that generous introduction.

Good morning, Subcommittee Chairman Baker and Ranking Member Kanjorski and members of the subcommittee. My name is Bill Stiglitz, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America, IIABA, to present our association's perspective on the future of terrorism insurance.

I am an account executive with Hyland, Block and Hyland, an independent agency based in Louisville, Kentucky. I also serve as president-elect of IIABA.

Today, independent agents and brokers sell nearly 80 percent of all commercial lines policies in the country. Members of the Big I, as we are known, write the coverage for America's businesses and serve as the intermediary between consumers and insurance companies, thereby seeing the insurance market from both perspectives.

From this unique vantage point, we urge Congress to continue some form of a Federal terrorism insurance backstop beyond the year-end expiration of TRIA. I would like to compliment Chairman Oxley, Subcommittee Chairman Baker, and Ranking Members Frank and Kanjorski for holding this hearing and moving expeditiously to consider the recent report issued by the Department of the Treasury.

The Big I and our 300,000 members are especially encouraged that members of this committee and Secretary Snow reaffirmed support for a continued Federal role in terrorism insurance. The challenge now before Congress is how to follow up the success of the Terrorism Risk Insurance Act, or TRIA, to ensure that consumer have continued access to terrorism insurance.

After 9/11, it was quickly apparent that insurers could not handle the risk of further large-scale terrorist events without a Federal backstop. As insurers reacted to uncertainty in the market with exclusion clauses and outright cancellations of coverage, agents and brokers were left in the difficult position of not being able to meet clients' needs for coverage.

In the market, we began to see economic activity, especially significant new construction projects, impacted by the inability of owners to satisfy demands of current or prospective lenders to demonstrate adequate insurance coverage. Fortunately, through the leadership of the Administration and many in Congress, TRIA was enacted before the worst effects of this availability and affordability crisis further injured our national economy.

As an agent from Louisville, Kentucky, serving many smaller communities, one of the points that I would like to stress to the committee today is that the need for a terrorism insurance backstop is not confined solely to large urban areas. In Louisville, my clients in the downtown area and icon buildings, and those clients with heavy involvement with the public have purchased this coverage. This is not unlike other stories that I have heard from other agents who have seen coverage purchased across the country, from small towns in Mississippi to small and large businesses in New York City.

The bottom line, this is not a big city or a big State problem. It is a business consumer problem throughout the country. This is truly a national issue. Our ultimate goal is to ensure that our customers have access to affordable insurance, which enables them in turn to serve their customers, whether they are hotels and convenience stores like the witnesses here today, or other businesses that drive our economy.

At the end of last month, the Treasury Department released its report on the TRIA program. We agree with the report's conclusion that TRIA has worked well and generally as intended. In our experience, prices have come down, capacity has grown, and demand is up in many geographic areas. Overall, the Treasury Department's findings support the need for an appropriate Federal role to encourage a workable insurance mechanism in the event of cataclysmic terrorism losses.

The report is also consistent with the Big I position that the Federal Government's role in the insurance market be limited, while State insurance regulation is preserved. In fact, most folks in the private sector will tell you that they prefer the private market to handle this risk. In an ideal world, it would, but that is not practical at this time.

However, to the extent that the private sector is able to handle this risk and Federal Government involvement is phased out, we believe that all stakeholders and the market will ultimately benefit. Going forward, the litmus test for Big I is that any solution must work for the consumers with whom our members serve. Put simply, the ultimate test for IIABA support of any proposal will be whether the program works for the marketplace.

Right now, both Congress and stakeholders are at somewhat of a crossroads with two basic choices: either reauthorize the TRIA program temporarily with some modifications suggested by the Treasury Department; or enact a long-term private industry pooling mechanism which phases out the Federal role over time. Both options have some attraction.

Short-term extension legislation may have fewer political complications, although it may be difficult to find the right balance of increased deductibles and triggers for the marketplace. On the other hand, developing a private sector-funded layer of coverage would help reduce Federal involvement in the marketplace and create a long-term market-based solution for a problem which we have every reason to believe will be with us for years to come.

The Big I is committed to working with this committee on parallel tracks to develop both options so the Congress is in the best possible position to move forward with the solution that is most viable.

I thank you very much for the opportunity to testify today.

[The prepared statement of Mr. Stiglitz can be found on page 218 of the appendix.]

Chairman BAKER. Thank you for your statement, sir.

Our next witness is Mr. John Sinnott, testifying in his capacity as vice chairman of Marsh and McLennan Companies.

Welcome, sir.

STATEMENT OF JOHN T. SINNOTT, VICE CHAIRMAN, MARSH AND MCLENNAN COMPANIES, INC., ON BEHALF OF THE COUNCIL OF INSURANCE AGENTS AND BROKERS

Mr. SINNOTT. Thank you, Mr. Chairman, and thank you, members of the subcommittee, for allowing us here today.

I am here also in my capacity representing the Council of Insurance Agents and Brokers, in addition to my own firm. We prepared a statement. I will not read it, but I will try to give you some highlights.

Compared to the chaotic situation that existed 3 1/2 years ago when I last appeared before this committee, I will describe the situation today as far more reasonable, certainly up to this point.

We have attached a good number of statistics to our statement. It is in a document such as this, and I would encourage you and your staff to take a look at it, because it slices and dices take-up rates. It does it by industry. It does it by region. It shows the trend as to what has happened from before TRIA, but more importantly what has happened since TRIA.

I think it demonstrates that substantially due to the actions of this committee during that time, the situation is much better, and that without TRIA we would be in the same chaotic situation that we were back in 2002.

Just a brief resume, prior to 9/11, terrorism was ho-hum. It was just included. There were no issues there. From 9/11 until November of 2002, there was chaos. That does not mean that there wasn't some terrorism availability, but I can tell you most of our commercial clients had Swiss cheese when it came to their property placements, because they are multi-carrier and there were exclusions in some cases. The exclusions differed.

In other cases on workers comp, with high aggregations, in one case we actually were prepared to have a very large financial institution's workers comp insured by the New York State Insurance Fund, which Superintendent Mills would agree that is not the intent of that market of last resort.

The shake-out after TRIA was put through, yes, there was some difficulty while the markets figured out how to respond. But from about November 2003 until let's say June of 2005, we saw a steady increase in the take-up rate and in the level of confidence that the market had in dealing with this. Today, of course, pending your decisions and the decisions of Congress, there is a bit of uncertainty that is building in.

So what are we looking at? Do nothing on December 31st and many consumers will be significantly disadvantaged. I am talking about the consumers. I am not talking about the insurance companies. But the insurance companies will reduce availability to our clients. That is a given. That absolutely will happen. High-risk property, workers comp aggregations and the whole issue of nuclear, biological, chemical and radioactive coverage deficiencies.

Please remember, in our report we show the take-up rates. We believe now that even on property the take-up rate is up to 60 percent. It was 25 percent in 2003. It is 80 percent on general liability, and of course it is 100 percent on workers comp because workers comp is statutory and there is no option for a market to exclude anything in that regard. So doing nothing, I think as everyone has stated, would be disastrous.

An extension, modified extension, we believe that an extension with some modification will continue to serve our clients. Now, the two areas that I have noted, that we have noted have been discussed is particularly the industry trigger point, moving it up to $500 million. Frankly, I will not speak for the large insurance companies, but I suspect that at the very big insurance companies that is not an issue because in many cases their own individual retention is as large if not greater than $500 million.

What you have to look at carefully is the availability among the smaller insurance companies to whom an event, if it occurs, might disproportionately involve smaller or middle-size insurance companies and the amount that they retain, it might be within the $500 million point, so they do not have any protection, and that could risk their balance sheets, or make them withdraw coverage from the clients that they are providing today.

The second thing that we noted was that, okay, can you reduce some of the areas, some of the risk areas. The one that seems to be sort of tossed about is auto. The only thing I would suggest that the committee look a very seriously there is the impact on the trucking industry. Our country, our economy is dependent upon that. I think some investigation should be done as to the impact with those carriers who ensure general liability, auto liability on truckers to make sure that they would continue to maintain coverage for terrorism for those particular categories of users.

Finally, the pooling approach, that might not be the proper term, we have made some suggestions in our written statement. I will not belabor it, but one of the considerations one might look at is whether or not the pool should be voluntary with carriers, as against be mandatory.

Perhaps some of the large carriers might opt out. I do not know that. We do not know that, but I think something that is voluntary should at least be looked at. Having said that, if you opt out, you are out because there cannot be any adverse selection that underwriters go through.

So in summary, our clients' interests would be served if crafted properly by either a modified extension, a pooling arrangement which would still have a backstop behind it, but their interests would be severely damaged if nothing was done by the end of the year.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Sinnott can be found on page 168 of the appendix.]

Chairman BAKER. I thank you for your statement.

It is my pleasure to welcome our next witness, Mr. James Maurin, appearing today in his capacity as chairman of Stirling Properties and as a member of the International Council of Shopping Centers' board of trustees, and more particularly an old college friend.

Welcome, Jimmy.

STATEMENT OF JAMES E. MAURIN, CHAIRMAN, STIRLING PROPERTIES, ON BEHALF OF THE COALITION TO INSURE AGAINST TERRORISM

Mr. MAURIN. Thank you, Congressman, and thank you, Ranking Member Kanjorski, for conducting today's hearing on the future of terrorism insurance.

I also want to thank Chairman Oxley for his commitment to bring legislation regarding this issue to the Floor of the House of Representatives in an expedited manner.

My name is James E. Maurin, and I am the immediate past chairman of the 56,000 members who make up the International Council of Shopping Centers. I am the founder and principal of one of the Gulf South's largest commercial real estate companies, Louisiana-based Stirling Properties.

I am appearing on behalf of the Coalition to Insure Against Terrorism, or CIAT, which includes the United States Chamber of Commerce and 75 other major trade and business organizations that rely on the current Federal program for access to terrorism insurance for the future of our businesses.

The members of CIAT have strongly and consistently supported and encouraged every effort to continue a terrorism insurance program that would provide effective coverage for one overriding reason: the private insurance markets are not yet able to take over the job on their own.

We know this because as policyholders, the consumers of insurance, when the current program expires, so does our coverage. As policyholders, our members have already been subject to a variety of pop-up exclusions and sunset clauses and other restrictions which the insurance industry has begun to impose on renewals of policies that run beyond December 31, 2005.

Furthermore, I need to emphasize the extreme importance of having a new terrorism insurance backstop in place as far ahead of the current scheduled expiration as possible. The uncertainty surrounding the future of Federal terrorism insurance is impacting business today and growth for years to come.

My message to you today is simple. American businesses need to be able to effectively manage risk to function on a long-term basis. Regrettably, terrorism is an unknown risk, akin to wartime risks that cannot be borne alone by the business community in the face of the continued threat of terrorism. Terrorism insurance is a requirement in most commercial real estate loan documents. Investors will not absorb the risk if insurance companies are not able to provide terrorism insurance. This is true for properties in small towns and large cities alike.

Should terrorism insurance not be available, thousands of outstanding existing loans will likely be in technical default and under the covenants of the loan documents, the loan servicer will be forced to seek remedies such as force placing coverage no matter what the price is, or some other legal action against property owners.

While commercial banks remain the industry's principal source of construction financing, commercial mortgage-backed securities, the CMBS market, are the source for much of real estate's longer term debt. CMBS are bonds backed by individual commercial mortgages that are typically owned by commercial banks, insurance companies and savings institutions.

More than $444 billion of loans are pooled in CMBS, representing almost one-fifth of all commercial real estate mortgages. These securities are rated by rating agencies such as Moody's and Fitch, who have already voiced concerns regarding the potential effects of the expiration of TRIA. When CMBSs are downgraded, as they were prior to the enactment of TRIA in 2002, they generally decline in value and restrict access to capital.

Pension funds also play an important role in capital formation for commercial real estate. As of January 2005, $166 billion in assets have been invested by defined pension plans in commercial real estate.

Pension funds with substantial commercial real estate investment include California Public Employees and Teachers, Florida State Board, New York State Employees and Teachers, Ohio State Teachers, and my own home State of Louisiana's Teachers Fund. Should terrorism insurance expire, billions of pension dollars belonging to workers across this country would be exposed to undue liability.

The esteemed members of this panel can appreciate the significant role that retail real estate plays in our economy, and the considerable concern of having our businesses put at risk. Relating back to the shopping center industry, during the first two quarters of this year, the shopping center industry expanded by 102,000 new jobs, accounting for 9.4 percent of job growth. This may help to illustrate why terrorism insurance is not merely an insurance issue, but a widespread economic issue with far-reaching implications on financial markets and our Nation's economy.

The risk of further catastrophic terror attacks appears to be as acute as ever. The recent attacks on our closest ally, Great Britain, remind us all of what may happen here. While the highest levels of government tell us that the threat of terrorism and the war on terror in the United States continues, not surprisingly the insurance and reinsurance markets lack the ability to handle this problem alone.

We have recognized that Congress, the Administration, and stakeholders are now effectively faced with pursuing two options: implementing a short extension of the TRIA program; or developing a more permanent solution utilizing a form of a mutual reinsurance facility, or pool, as discussed earlier, with government bonding.

The short extension legislation should be relatively simple to negotiate, and therefore may provide greater assurance of being completed on time, which is our paramount concern. On the other hand, developing an intermediate private sector layer of coverage would move us toward a long-term, market-based solution for a problem that we have every reason to believe will be with us for years to come.

In creating a successor program under either model, the policyholders of CIAT request that the committee keep in mind the following principles: First, the program should include the make-available requirement for insurers to ensure that property owners and businesses will be able to secure sufficient terrorism coverage to adequately protect their assets and their employees.

Second, new programs must be designed with the goal of minimizing exclusions or gaps, which would undercut the intent of the program. As previously mentioned, this should include coverage for nuclear, chemical, biological, and radiological acts, as well as acts of domestic terrorism.

Mr. Chairman, CIAT is committed to working with your subcommittee and other stakeholders during the next month on parallel tracks to develop both options, if need be, so that we are in the best possible position after Labor Day to enact the solution which proves the most viable.

To close, I am not in the insurance business. I am in the commercial and residential real estate business. I cannot write my own insurance and I cannot decide what levels of risk or capacity my insurers can undertake and still be responsible to the fiduciary interests to which they are subject. I am the end-user and a policyholder. I am being squeezed by both sides in this debate regarding the future of Federal terrorism insurance.

On the one hand, insurers do not want to take on this seemingly open-ended risk, and on the other hand my investors cannot absorb that liability of being exposed. You will have a situation where the cost of capital goes up and the value of assets diminishes. At the end of the day, my colleagues and I in business need to be able to buy terrorism insurance so we can continue to help grow the economies of every community in this country.

Chairman Baker, Ranking Member Kanjorski, CIAT thanks you for holding this hearing and for giving us the opportunity to testify. We look forward to working with you and the rest of the subcommittee on this important subject in the coming weeks.

Thank you.

[The prepared statement of Mr. Maurin can be found on page 132 of the appendix.]

Chairman BAKER. I thank the gentleman for his statement.

I would like to start with just a general observation about our procedural circumstance.

It is very clear, to me at least and I think to Chairman Oxley, that a mere extension of the current programmatic guarantees will not be acceptable to the Administration without modification. The mere process to pass an extension will require the Congress to act over some number of days.

In the intervening August recess, we have the opportunity, I think, to significantly evaluate alternative approaches, perhaps something short of a pooling mechanism which may be more complicated and require more time to implement, but something that would achieve the following goals. One is to ensure market stability by the Federal backstop continuation, but at the same time to reduce the potential exposure of taxpayers to payments which may not necessarily be warranted.

I would refer, I have not had the occasion to review Mr. Sinnott's dicing of the numbers, but I believe there are others on the panel who indicated that with the market enactment of TRIA, meaning the actual operative effect, that stability returned to the marketplace, companies generally showed levels of profitability they had not previously enjoyed because we had the good fortune of pricing the risk and we have had no event on which to make claims.

The result is an industry which has, because of these perverse circumstances, found itself in the better financial condition that everyone hopes for, but at the same time my view, from my shareholders' perspective, we cannot continue to underwrite this indeterminate risk at these levels while the industry enjoys significant levels of profitability. As Chairman Greenspan would say, there is need for equities to be rebalanced.

In that case, I think to upwardly adjust retention levels, for example, immediately may not be warranted, but there certainly is a need to upwardly adjust retention levels for not only the balancing of equities, but I think to incent the industry to move toward the voluntary pooling or other alternatives that bright people may develop.

Secondly, there needs to be not a permissible, but a mandatory repayment of liquidity advanced by the Federal Government when the industry returns to profitability. The current structure in the TRIA Act is a conditional repayment which the secretary may assess. That needs to move over into the "shall" category with certain circumstances on limiting premium run-ups and adverse economic conditions for the industry should it not be warranted in a particular timeframe.

And then finally, the triggering mechanism. I am putting this out maybe for response and comment. As opposed to a hard $500 million trigger, I have noted that in much of Louisiana, you could pretty much take everything out there and you would not get close to $500 million, but it would be a pretty significant event to us.

If we were to take some measure of commercial property concentration and look at it in some geographic area, whether a census tract or something larger, starting with the 9/11 event, valuing the buildings prior to the attack and having them establish as a percentage of value of commercial property in a designated area.

Let's just assume it is 1 percent. Then the triggering device for any other area of the country might be that the attack results in losses exceeding 1 percent of commercial value in that designated area. This is not that complicated a deal, but it takes a little time to get all the data together.

So it is a relative trigger. In other words, our loss in Baton Rouge would not have to hit $500 million, but it would have to hit the same percentage loss that New York had or exceed it. That percentage could go up each year, so we would have a moving window: increasing retentions, increasing triggerings, and a guaranteed repayment to taxpayers.

That, to me, says: Industry, get it together and find a cheaper way to do this because I do not think, at least speaking for this Member of Congress, that we can out-think the entire insurance industry and keep you guys from being profitable almost notwithstanding what happens.

I also know that you cannot calculate the risk of an unknown, unpredicted terrorist event and the consequences of that would be unacceptable if we do not have some balanced backstop in place.

Mr. Sinnott, would you like to start?

Mr. SINNOTT. Yes, thank you.

The idea that I had not heard before of trying to geographically set a trigger, if that is what I understand you are saying, my quick reaction is that the only problem with that is that that would then require the underwriters, the insurers also to only write in certain geographic areas. My example is New York City, Washington, the major cities. It is not just the big carriers that underwrite insurance there. They also want the opportunity to make available insurance for the smaller customers that reside in that area.

If they still underwrote in that area which had the high trigger point, they could be in dire straits if they ended up having an unusually large share in that high-risk area.

Chairman BAKER. But give me alternatives. If today we have a $500 million trigger and the little guy is in that area where it is $455 million, he is in duck soup now.

Mr. SINNOTT. Absolutely.

Chairman BAKER. So if we at least get it down to some census tract level, the idea here is that you cannot have all big guys living only in certain neighborhoods. You are going to have mixed properties, I understand that.

Mr. SINNOTT. Right.

Chairman BAKER. What else can you do?

Mr. SINNOTT. I mean, the only other way to do it is to try to look at a trigger that is somewhere in between the $500 million.

Chairman BAKER. That sounds like an answer I would give.

[Laughter.]

Mr. SINNOTT. I do not know. I would have to give some thought as to whether there is any way that you can balance the two, the geography on the one hand with the, call it the balance sheet sides of the companies that are offering protection or risk transfer in that area. It is something worthwhile working on.

Chairman BAKER. Does anyone else have any comment or adverse comment about increasing retentions, increasing the triggers over time, absolute guarantee of a taxpayer repayment? These are the things that I think would be responsive to the Administration's concerns.

Mr. Mirel?

Mr. MIREL. Mr. Chairman, I think that these kinds of issues can be left to the industry to deal with under rules set by the Congress. I think there ought to be a pool. If Congress were to establish the pool and tell the industry to figure out when and how to pay out of that pool, I think you would find that the industry would do a good job at that.

Chairman BAKER. Do you think there is sufficient time for the Congress?

Let me tell you our timeline. If we were to return and have the good fortune and agreement on some proposal by the middle of September and get it out of the House, the Senate still would have to respond to it, practically speaking, in early October. The industry would be uncertain as to the necessity to do this until Thanksgiving.

Does that really leave time to develop that type of response in light of the time constraint?

Mr. MIREL. Again, I would say—and then I will let Superintendent Mills chime in—I would say that the fewer decisions that have to be made by the Federal Government, the better. If you set the general rules and let the industry figure out how it is going to meet those requirements, I think that it is possible to do things pretty quickly on an industry basis.

Chairman BAKER. Thank you.

Mr. Mills?

Mr. MILLS. Mr. Chairman, I think that the industry could respond very quickly if the Congress were to come up with another idea along the same track. I absolutely agree with the mandatory repayment, but if some new entity, a public-private partnership were to be created which was voluntary, the industry that wanted to offer the coverage could participate it, pay an assessment to build capacity.

Again, getting back to one of the critical points I think you heard all of the witnesses say is we need to build capacity. Capacity would be built. Initially, there would be a heavy Federal involvement, but as capacity is built, the Federal involvement would decrease. There would be an automatic repayment mechanism in there. It is completely voluntary. It could be a self-executing, self-directing entity with a board. I think the industry would respond very, very quickly.

We are convinced and everyone that I have talked to is convinced that the industry can handle this very, very well. They just need to know where their risk is. Right now, they don't. They need to have a ceiling. They need to have a trigger. They need to know what their deductible is. If they know what the deductible is and they know that the Federal Government is there as a backstop and one that will decrease over time as capacity is built, I am confident that the industry would move very, very quickly and would have this up and running.

Chairman BAKER. My time has long expired.

Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman.

Gentlemen, we have to get some more details. I presume today is not the day to do it. Does anyone on the panel right now believe that we should not cover or include group life insurance in an extension or any permanent plan that we might have?

So, therefore, I presume that you think that we should consider including group life insurance. Thank you, because that is one of the issues we have not discussed.

Everything that Mr. Baker has said, pretty much I agree with him. I think the required repayment is a good idea. I think the real issue that we have here is to try to come up with a limit, somewhere between $5 million and $500 million. Five million dollars may or may not be too low; $500 million is too high. At $500 million, there has only been one terrorist attack in the history of mankind that exceeded that limit, and that means we would not be covering, we would not be bumping up against it for the London attack that just happened, or Madrid or Bali.

I am not convinced at all, and again that is all part of the discussions we have to have. That is why I do not think we can do this in the timeframe that we have. Maybe I am wrong. Maybe Congress will somehow do something that they never done in the history of America and actually act quickly, but hope springs eternal, I guess. But I do not see how we can come up with a number.

What is the number that we want? I understand full well that the industry wants a number, and you are right, that is exactly what we need to do. But are we willing to say that America will step up if the next attack is in Oklahoma City, which based on history is no longer out of the realm of possibility. Or Bali—our own Bali could be Disney World. It could happen tomorrow. I do not see how you can set it on geographic precedent, but again I would like to hear if the industry feels that way.

I also would like to ask, is there anyone here who thinks that the insurance coverage wouldn't be impacted by another attack on American soil? If, God forbid, tomorrow in Washington, D.C., the subway gets attacked, what happens then? Whether we have a plan or not, my expectation is that anything we do, we are talking about permanence here. I do not believe we can do this permanently. I do not think this country or this world is ready to do it permanently. I do not think your actuaries are ready to do it permanently, which is why I think an extension is necessary.

I guess I would like to ask whether you think we can do it permanently, or whether you think that, God forbid, the next attack, and many of the experts say it is not a matter of if, it is a matter of when, will it not shake this very aspect of the economy once again? Whoever wants to start is fine by me.

Mr. STIGLITZ. Well, as an independent agent, I think you are going to have to put a number somewhere. We have to start with a number. That is the way insurance works. We cannot model terrorism. So you are going to have to say, we will either pick $100 million or pick $75 million or whatever, and then let the marketplace work from there. I agree with the commissioner. I believe that the industry will respond very quickly if we just know where we are going. We do not know where we are going right now.

The thing that worries me about a geographical deductible, things like that, would be the effect on regional companies. Independent agents for the most part represent regional companies in all their States, and some of them are very, very small. Any type of really high threshold limit or anything like that, any kind of deductible percentage based upon values, I think that would probably affect them. It would probably cause them to withdraw from this market immediately.

I think if you just give us a number and let the industry work on it, I believe we could come up with something quickly.

Mr. MILLS. Congressman, if I may also, with regard to your concern that you do not think it could be a permanent program, I respectfully submit that France, Germany, and the U.K. all have permanent programs based on the pool idea that Commissioner Mirel talks of.

The FDIC is a permanent program. I have often said and some folks have criticized my analogy, but I think it fits. The FDIC is a permanent program to instill confidence in the American banking system, backed up by the Federal Government. We are advocating the same thing for the insurance industry in response to a terrorist attack.

Mr. SINNOTT. To your point, certainly if there is a major event within the next few years, it is going to again create significant disruption in the mechanism. If we have some sort of a backstop there, it will be ameliorated to a great degree. The problem with moving up the thresholds so significantly is that if you just extend and do that, you have created an enormous gap that the whole industry cannot respond to.

So the difficulty here is, yes, if you move things up, you have no choice but to try to create some intermediate mechanism, and that is this pooling. The question is how and how quickly it can be done.

But I do not see how you could move thresholds up without creating an intermediate mechanism, something that involves the insurance company takes its piece; there is an intermediate level that can work out the difference between the major insurance companies and their ability to retain risk; and the smaller insurance companies and their ability to retain risk.

But then ultimately, particularly during the early years, until it is decided that that pooling or funding is adequate, there is going to have to be a backstop there. If you get an event early on in any risk enterprise that can swallow up the funds that you put in initially, yes, that can happen. But the longer you go and the more you build that up, the more you remove the government from involvement.

Chairman BAKER. The gentleman's time has expired.

Mr. MAURIN. Mr. Chairman, I have one quick comment, if I could. And again, I cannot really address the issues here. I am representing the policyholders, CIAT, and the associations of people who actually need this insurance every day.

I would caution that in the tinkering of the formula as far as triggers and copays or whatever, that we do not err on the side of making it not work and the insurance industry cannot provide me what I need.

Prior to 9/11, and my company has been in business for 30 years, I got terrorism insurance for free. I mean, I literally got it as part of the overall package. I have been told by my insurance agents that it was included. Today as we speak, even with TRIA, my insurance costs have risen dramatically on our commercial properties. So don't think that with TRIA I am back to pre-9/11 costs. My costs of doing business have risen dramatically.

If we tinker with this and my costs go up 10 times again, you have maybe fixed the problem from your perspective, and maybe the insurance companies will write it, but they will write it at such a cost that doesn't make it affordable. I would say in negotiating and working with them, come to something that they can look at and say reasonably that they can provide terrorism insurance to policyholders at a cost that we can afford.

Chairman BAKER. I thank the gentleman. His time has expired. Mr. Bachus?

Mr. BACHUS. I thank the chairman.

My first question, Mr. Sinnott, I noticed that you dealt with 9/11 on a very personal basis and that you were the CEO of Marsh and you lost 295 employees.

Mr. SINNOTT. Correct.

Mr. BACHUS. I would like to thank you. I noticed in your bio you were honored by the New York City police and fire widows and children's benefit fund for your contributions. I would like to say thank you for that.

Mr. SINNOTT. Thank you for saying that.

Mr. BACHUS. Being such a personal issue, what some people have said about 9/11 is that we are dealing with a big city skyscraper-type of issue, urban, New York issue. Yet your testimony indicates that TRIA has a much broader impact.

Mr. SINNOTT. Right.

Mr. BACHUS. Would you like to give us your thoughts on that? What your biggest worries are?

Mr. SINNOTT. As this shows with the statistics that we have gleaned from the placements that we have made for our clients, it is not correct to say that it is only in the urban areas where there is a take-up on terrorism. We give the regional percentages and there is a take-up rate, granted, lower perhaps in the middle of the country than elsewhere, but still a take-up rate. Now, that is a function as well of a different pricing structure that the insurance companies are not costing-out the risk the same way as they are in New York, where it is a real issue.

So I do not think that TRIA is something that responded only to what happened in New York and Washington, D.C. It responded universally. As I said earlier, our statistics show a marked difference between how the market would respond, and as with my colleague here, I am speaking on behalf of the consumers, not the insurance companies. But if we do not have availability in the market, my clients are in trouble.

So I think your point is well taken. It is much more universal than just speaking about New York or Washington.

Mr. BACHUS. I appreciate that fact that you pointed out it is not just a New York problem.

Mr. SINNOTT. Yes.

Mr. BACHUS. I thought your testimony was very good.

Mr. SINNOTT. Yes, right. The other thing—well, maybe that is enough.

Mr. BACHUS. I might ask Mr. Stiglitz, the Independent Insurance Agents, you represent small communities in States all over the United States, where you serve consumers as independent insurance agents. How are those towns going to cope without extending TRIA? Are they going to be affected by the lack of terrorist insurance affordability and availability?

Mr. STIGLITZ. I certainly think so. I think it is going to be basically this. When our agents go out to sell the renewal, right now there is an exclusion pretty much across the board that starts 12/31/05.

And when you get into a rural area, and particularly when you are talking about utilities that may serve that area, a rural electric co-op, perhaps a water system, even industrial parks that are somewhat isolated, but can certainly be an easy target. That would include chemical plants, any type of manufacturing facilities.

For the most part, those folks are now, as Mr. Sinnott has said, are now taking up this coverage. They did not initially. There was a lot of laughter when you threw down the quote for the terrorism. But it is not a laughing matter anymore. Certainly, they are buying it and we encourage our clients to buy it. Without it, I think a lot of these people, especially the utilities, are going to be in trouble.

Mr. BACHUS. So you do not see it as a big city issue.

Mr. STIGLITZ. Not by any means. No, sir.

Mr. BACHUS. Okay. That is what I am hearing.

What about the desirability of a backstop as opposed to what we did on 9/11 when we tried to deal with it on an ad-hoc basis? Actually, there was terrorist insurance afforded at that time, and I think the point has been made that it would not be this time. It is now excluded.

But isn't it better to have a long-term solution in place for terrorist insurance, rather than dealing with the aftermath of another attack on an ad-hoc basis? I will ask any of you to comment on that.

Mr. MILLS. I certainly think so, Congressman. I think a long-term solution is definitely preferable. I certainly do not think that the Administration or the Congress are interested in making TRIA permanent. I think the key is a long-term solution with no expiration date, but with a declining Federal involvement and a building of private capital capacity. That I think is the key.

Mr. BACHUS. I think the desirability of a backstop, but then the desirability of minimizing the Federal role over time would be the way we ought to approach this.

Thank you.

Chairman BAKER. I thank the gentleman, who yields back his time.

Mr. Miller?

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Mr. Mills, under TRIA, the insurance industry is still subject to form approval and right approval by State regulators. Has the insurance industry been seeking any differentiation rights based upon risk or upon mitigation efforts, and what has been the response of State regulators?

Mr. MILLS. We have not seen much of a request for differences in rates. There has been some discussion that the industry has come to us for. It certainly will increase dramatically if a backstop goes away, of looking again at exclusions, which the New York department has historically not allowed.

I think that with the continuation of the backstop in whatever form it is, that the rates will stabilize and the industry will be well equipped to go ahead without that type of fluctuation and uncertainty.

Mr. MILLER OF NORTH CAROLINA. But what I am getting at, is there a difference in premiums based upon level of preparedness? For instance, in homeowners insurance, if you have a smoke detector you get a break.

Mr. MILLS. We certainly could see more of that. I think that we could see more of that. I think that we could see more of that.

We do see some differences, but certainly I have seen many instances of the private sector making significant investments. I used the example in my presentation earlier about enhancements to security.

I certainly do think that looking at the investments that the private sector makes and looking at reductions in rates such as a homeowner does when they put in a security system is something that the industry should look to much more closer. There is room for greater allowances for that.

Mr. MILLER OF NORTH CAROLINA. Okay.

Mr. Sinnott, what is the insurance industry doing along those lines? Does the insurance industry try to differentiate rates?

Mr. SINNOTT. First of all, in the commercial side of the industry, there is great flexibility as against homeowners where the rates are more filed and fixed. So I think there is sufficient flexibility I think within the system to allow for this type of risk, the rates to be properly cared for.

As far as the issue of security, you can just go into any, using a large city, I will just use office buildings. You can go into any office building, I do not care whether it is Chicago or New York or San Antonio or wherever. There is security there that we never saw prior to 9/11.

I think the same thing is true, I am not an engineer, so maybe there is a lot more than can be done, but by the same token I think that manufacturing plants and other installations clearly put a higher priority on security, not just loss prevention like more sprinklers and things like that. I mean security.

So I think that it is not perfect. I am sure there is more that can be done, but I do not think that corporate America has not recognized that security is a key aspect, along with the government doing whatever it can to secure our borders, but that people are going to get through and the corporations better make sure that they have done their part. I think in our view, security is a significant item with corporate.

Mr. MILLER OF NORTH CAROLINA. Okay. Anyone else wish to be heard?

Okay. Thank you, Mr. Chairman.

Chairman BAKER. The gentleman yields back his time.

Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman.

The challenge all of us have is we all agree. We are all saying the same thing. It was kind of exciting to have the Secretary of the Treasury come here because his transmittal letter said postpone it, and his written statement, written by OMB, and his public discourse was, you know, I will work with you guys; let's get the job done. So it is a little bit of a conflict.

I think sometimes what we should do is we should ask someone from OMB who approves these statements to testify, so that they have to justify really what is outrageous. I think it is outrageous that we are not dealing with this issue. But I think Mr. Robert Hunter, the director of insurance, Consumer Federation of America, is probably the only one disagreeing. I would just make the point, I would like to have some folks who disagree so I could hear their arguments and hopefully pick it apart.

I do not really have much to ask you all. I think I will just make a statement. I think we should have passed it a while ago. I think it does not pass the smell test for me to think that we are going to ask insurance companies to insure for something they cannot insure for. If there was a catastrophic event, we would be jumping to help out because we are not going to let everybody go under.

So it just seems to me that it makes more sense to deal with it up front. I am sorry I do not have a question, but I just happen to think that we need to get on with this in Congress. Maybe my only suggestion would be—we have Sarbanes-Oxley—and maybe we just need a Baker-something and put your name on it, Mr. Chairman, and pass it and we can hear your name talked about for the next 10 years.

[Laughter.]

I would be happy to yield my time to Ms. Kelly because I understand she has two people up here from her district, so she may need more than 5 minutes. So I will give her the remainder of my time.

Mrs. KELLY. I appreciate that very much.

This is the first time in my entire career in Congress I have faced a panel with two constituents on it. So, Mr. Mills and Mr. Sinnott, I am delighted, as a New Yorker, to have two New Yorkers on this panel. I am delighted also to have read your testimony and to be able to ask you some questions.

I stood looking at the ruins of 9/11 at the Trade Towers, thinking, while the smoke was rising, something needs to be done with regard to the way the insurance is going to handle this. That is why I worked so hard to help to write and pass the original TRIA bill. I am convinced because the Chairman of the Federal Reserve has stated on more than one occasion—Mr. Alan Greenspan—that we must have some kind of a mechanism because the industry simply cannot handle it at some levels.

So I am delighted to have you both here. We New Yorkers know very well firsthand what the net effect is on the markets and on our economy when there is a terrorist act. One of the reasons I believe that the economy of the world has been remarkably stable in light of the London bombings has been because everyone knows that England has dealt with this problem and they have something in place, so there was no real jolt to our economy when those bombings occurred in London.

We need to make sure that if that happens again, and my friend Porter Goss at the CIA says it is not if, it is when—we need to have something in place so that the Federal Government does not have to step in and be the insurer of first resort, but also so that the smaller insurance agencies who cover this do not have to go out of business, and we do not have them in the market again.

That being said, for the remainder of Mr. Shays's time—and, Mr. Shays, I thank you very much for giving me this time.

Commissioner Mills, I wanted to say to you that the Treasury report that came out, you probably read it, they made a remark in that report that the importance of commercial real estate did not need any, that commercial real estate did not need to be covered essentially by any kind of terrorism report.

I would like you to talk to the panel about the importance of the commercial real estate industry to the economies of New York, Washington, D.C, and the United States as a whole.

Mr. Maurin, I would like you to join in.

Mr. MILLS. Well, Congresswoman, I certainly could not disagree with that statement more. The commercial real estate industry is critical to our home State in New York. It drives the economy, but it is not just a New York thing. As I have said, it drives the whole national economy.

The commercial real estate market, whether it is in New York or anywhere—and again I go back to my earlier point. You know, if a terrorist attack, God forbid, were to happen in some small town in Iowa tomorrow or Louisiana, you would need right away to have terrorism coverage for all building projects. Right now—and this point was made by several on this panel—it is not a question of we need to have the backstop on January 1, 2006. We all, I think, know that we do. We need to have it yesterday.

You are already seeing multi-year builders risk policies in New York City not being written, period. You can't get it. Major, major construction projects that employ many, many thousands of people all over this country will stop. Lending from financial institutions will dry up. The commercial real estate market, all sectors of our economy are highly susceptible to it, none more so than commercial real estate.

Mrs. KELLY. Thank you.

Mr. MAURIN. I would agree with Mr. Mills. I would remind everyone, and there are some younger faces here than Richard and I, but the Tax Reform Act of 1986 was passed by Congress for the sole reason of dealing with abusive tax shelters. It devastated the commercial real estate market.

Congress did not, in fact no one anticipated that it would have the effect that it did, but it devastated it, and it was primarily because of the capital markets. The values of real estate dropped. The ratios and various things for banks and lenders got out of whack. We went through a period of years of foreclosure and the RTC and whatever.

This issue, if not handled carefully, has the same potential impact upon the commercial real estate industry. The capital markets, the life insurance companies, the pension funds, the CMBS market, they are not willing to accept this risk. They want the insurance markets to do that. I, as an investor or as a developer, I am not willing to accept this risk. I simply can't.

And if we do not come up with a solution that keeps the capital market stable, I do not care whether that shopping center is in Baton Rouge, Louisiana, or that office building is in New York City, it does not matter, it is going to be in trouble, whether it is an existing property that would be in default of its mortgage because the mortgage requires terrorism insurance, or whether there will ever be another property built in that market or whatever.

So this could have significant impact if not handled carefully, and I might add quickly in the sense that hopefully we can have action here in September or October. As we get closer to December, quite frankly, we will begin to see some disruption, in my opinion, before the end of the year.

Chairman BAKER. The gentlelady has expired the gentleman's time.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Mills, I want to carry on your supposition that we may suffer in the United States the same type of terrorism as we have experienced in Europe in the last year or so. That is, attacks on shopping centers or subways or something like that, which is less catastrophic in terms of damage to real estate or property and more in the nature of loss of life, etc.

It seems our problem here is that we have some support in the Congress not to take any action because they want the ideal, and we are now down to the last 5 months of time. I guess we are going to be called upon to write the ideal statute in order to get it passed, whereas I am a supporter of a 2-year extension.

But rather than trying to spend our time now and hold up the marketplace and put it in jeopardy, I think we are in a perfect position to lay out a plan of attack over the next 2 years to look at things like what happens on the shopping center attack and what happens for the people's compensation programs that we may need to put into place. But that is no reason why, in my estimation, we should hold back from moving ahead with what has stabilized the market.

I think a delay for the purposes of perfection would be a great error. And quite frankly, I am very much worried about it.

As you know in the last terrorism risk insurance bill, there was the effort to make that a vehicle to carry tort reform, which everybody has their own ideology and method of arriving at their ideology, but I do not think we have time for that. I agree with the panel that discussed the idea. We have to move now. We have to stabilize the market as early as possible. Even yesterday was too late.

We have a little window of opportunity here now, at the end of September, to get this done. I do not see any great contribution that could be made to reorganize or re-think a perfect plan. If we try to do that, we are going to only exacerbate the opposition in various quarters, both in this city and around the country, that will cause further delay.

So, I guess I generally want to ask the panel, do you feel that we could, speaking for the Congress, just put a timetable together that within 6 months from January to have everyone—the Treasury, the White House, the Congress, and the insurance industry—submit their ideas as to what we could do to change this, how we could restructure it, and what other facets and potential damages should be covered?

But in the meantime, we cannot put that in place merely as just a study, but a study with tracking. In 6 months, issues will come in; a year from now, a final bill will be put together. We could use the next 6 months to have hearings on that study to reconstruct the program beyond the 2-year period that we are looking at now, as opposed to trying to compress that all together in the next 1 1/2 months and get some comprehensive magic bill that I am quite worried is not really going to cover everything.

For instance, one example that I am worried about is our inability to realize the impact of changing the proportional size standard that the chairman is talking about. I appreciate what he is trying to accomplish, but what impact will it have on various size companies and coverage, and what areas of the economy are going to be weakened because of that.

Because maybe we could end up not covering a large portion of the regional or small insurance companies across the country, by simply not understanding that in Iowa maybe AIG does not cover or write a lot of insurance. Maybe it is the Iowa mutual that does it, and they may be excluded if we start putting triggering mechanisms without an in-depth, fully thought-out analysis of what is necessary.

So, I would like the panel to give me an idea. Do you believe we should just move ahead? We have a bill pending after all. We have, in H.R. 1153, added on group life insurance, and we could add on to that bill a detailed reporting and study process to move beyond the two years. Such a provision would help us be prepared a year from now to really move serious legislation to make the changes we probably should have been thinking about a year-and-a-half ago.

Mr. MILLS. I think, Congressman, again the primary message from everyone on this panel is no gap. And whether that comes in the form of the Congress does work on a long-term permanent solution and has that in place by January 1, 2006, great. If it is a temporary bridge of an extension of TRIA with modifications to get you to that point, great.

As long as the Federal backstop is in place on January 1st, however the Congress can do that, I certainly feel that the industry will work with the Congress. I certainly will in any way I can be helpful to get that long-term solution in place, but just make sure, please, that it is bridged.

Mr. KANJORSKI. Does anybody else want to add to that?

Mr. SINNOTT. I am certainly not competent to figure out how soon Congress can get things done. I think it is clear to say that we are looking at what we feel is the needed result, and we are looking at December 31st. If Congress feels that both can be accomplished within this timeframe, both the backstop, if you will, as well as this interim piece, I think we would all be fine with that. So it is really a question of what Congress feels can be done in this timeframe.

Mr. KANJORSKI. If you recall, it took us 13 months to put the first act into place as a result of the tort reform debate. And an extension is so tempting a bill, particularly as we get closer to the end here, for some people who want to craft something like that to add it on. I am not sure we can control it even on this committee. I imagine there will still be a referral to the Judiciary Committee and they just may have other thoughts on it.

So your argument sort of agrees with me. Let's get it done.

Mr. SINNOTT. I think what I am saying is that question really, I hate to say this, but I have to bounce it back personally to the Congress as to what they feel. If you are saying, and I think we have all said that the worst-case scenario is that nothing happens on December 31st.

Now, the best-case scenario would clearly be if there can be two solutions: a continuing backup with this interim piece. That, I think, would be probably preferable. If that cannot be done, we need something beyond December 31st and we need something that does not drive certain of the providers of risk saying the retention is so big, I can't deal with it. I do not know how to answer otherwise.

Mr. MAURIN. I think from the perspective of the coalition, the CIAT coalition, it would be that you go to work now in the short term and see what tweaks can be done to the current system, but do two important things.

Number one, let's pass an extension for at least 2 years. Let's not do a 6-month extension or a 1-year extension. We get ourselves into the same box that we are in right now.

Second, if you err in the tweaks that you do to the current system, please err on the side of that it is not going to cause a disruption in the program. That would be our request.

Mr. STIGLITZ. Independent agents would certainly like to see really three things happen. We want to see the program strengthened. We want to see it modernized. And we do want to absolutely maximize private market participation. If you can do that by the end of the year, we are all for it.

Mr. KANJORSKI. And what if we can't?

Mr. STIGLITZ. I think we would probably accept an extension, but there has to be some absolute rules as to what is going to go on, who is going to study it, let's get it into place, and move on from there.

Chairman BAKER. The gentleman yields back.

Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

I have just a couple of questions.

What sort of transition time is needed for companies to produce and distribute new forms or system changes that are needed to accommodate any sort of TRIA modification? And how long would you need, based on past experience, to get up and running with those?

Mr. SINNOTT. Do you want me to try that? Obviously, if you excluded certain risks like auto, which as I said you should look at the trucking industry if you do that, if you are thinking about that, yes, the carriers will have to put some exclusions.

But I do not frankly see anything that we have discussed today creating a big problem in timing from the process. I do not know whether anyone, the commissioner sees it.

Mr. MIREL. That really is a question for the industry. It depends entirely on how complex the changes are. If they are not overly complex, they can do it pretty quickly.

Mrs. BIGGERT. Okay. Thank you.

Then, Mr. Sinnott, with the low trigger and the substantial deductibles, does the current TRIA program distort the marketplace and create a competitive advantage for high-risk captives versus large diversified companies?

Mr. SINNOTT. Clearly, yes. Captives, as you point out, are covered and one could say that the threshold point there is one that they can deal with. On the other hand, clearly if you moved it up very high, they would not be able to deal with that. Pricing has been a function of, yes, of degree of risk.

Mrs. BIGGERT. If there was a hit, wouldn't the captive almost always get Federal reimbursement, while an insurer like Zurich on the second panel would rarely be backstopped? Is this a market distortion that we should avoid?

Mr. SINNOTT. Well, the captive is a capitalized insurance company as well. It just has its own risks that it deals with.

Mrs. BIGGERT. It is separate, yes, management, I should say.

Mr. SINNOTT. You are talking about captives?

Mrs. BIGGERT. Yes.

Mr. SINNOTT. Yes. So it follows the same formula as the smaller insurance companies that have certain thresholds that they have to meet.

Mrs. BIGGERT. Would you say that that would distort the market, that it would be a bad thing?

Mr. SINNOTT. No, I frankly do not think that that is a major issue that we are looking at here as far as the whole issue of availability. I think captives have been a mechanism. One of the things we talked about 3 1/2 years ago, if the backstop is going to be there, you have to sort of follow the way the insurance market operates. Captives have been there for a long time, and captives have been recognized as a viable vehicle for corporations, for companies to use.

So I do not think that in anything that we are doing in the backstop should deviate from what has been traditional insurance practice in that regard. Otherwise, you get the government involved in a lot of complexities and trying to figure out something that I think has been fairly well managed by the industry and by the regulators.

Mrs. BIGGERT. Okay. Then just one last question for Mr. Stiglitz.

As the insurers' deductibles in TRIA continue to increase, is there a risk that a series of attacks over multiple years would decrease the industry surplus so that insurers would no longer be able to handle the higher levels? Would it be wise to have some sort of a re-set mechanism in exchange for the higher deductibles to bring the deductibles back down after a series of major events?

Mr. STIGLITZ. Yes. We would certainly support that. That seems to be reasonable. I would think certainly any type of smaller insurance company is almost going to have to have a re-set in place if we get into a situation like that.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman BAKER. I thank the gentlelady for yielding back her time.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

Welcome. This is a very important panel. You guys are on the front lines. You are the industry out there, representing the agents, putting this together, having to cover it.

In going forward, we had Secretary Snow in last time. We are getting mixed signals from this Administration whether they want to go forward with it and under what terms. Last week when he was in, he mentioned that, Mr. Snow did, that perhaps they could go forward, but with certain conditions that, one, they do away with general liability; that they would increase the premiums; they would raise the trigger to $5 million; they would do away with auto; and would not allow group life.

Is that something you all could accept?

Mr. SINNOTT. I think I have already said that, number one, think carefully about moving up the threshold points to such a point that it reduces significantly availability. Availability, when you move up threshold points, involves small companies. I also said general liability, no. I think that that is something that should be re-thought if they are thinking of excluding that. There you get into nuclear, chemical, biological, and radioactive risks that can be truly catastrophic.

I have just thrown out the issue of studies should be made as to auto, which appears benign, but maybe the trucking industry issue should be looked at.

Mr. SCOTT. Let me ask another question, and if each of you could answer this. Do you think that the risk of litigation exposes taxpayers to excessive costs in backstopping terrorism risk? If so, what do you recommend Congress could do to separate excessive lawsuits from legitimate claims?

Mr. MIREL. Congressman, you are asking a very serious and important question that I think is not going to be possible to answer in connection with this particular legislation. I do think it is very important to ask it, but I do not think it can be answered and also have Congress do something between now and the end of the year.

Mr. SCOTT. Let me ask you this, then, particularly in view of what is happening around the world. Under the current law of TRIA, there is a distinction between domestic and foreign terrorism. Should that be eliminated?

Mr. MIREL. Let me try to tackle that, and it deals with an earlier question you asked, Congressman. My view is that the trick here is to deal with places where the capacity is not sufficient to handle the exposure. I think if we focus not on the kind of insurance, but rather on the risk of catastrophe, we do much better. Is there a risk of catastrophe with group life? If there is, then it ought to be part of this program. If there is not, then it shouldn't be.

The same with any kind of other insurance. I think that can be handled on a market basis. That is, who would be in a pool and who would not be in a pool. The ones who are concerned about the capacity to cover losses would want to be in the pool; and the ones who think they can handle it on their own would not. Again, it can be left to the market, but I think that the issue is a capacity issue, not a particular line of insurance issue.

Mr. MILLS. If I could tie one thing to that, Congressman, if I may. I certainly agree with what Commissioner Mirel said in terms of approaching it from the point of view of capacity, but I would caution that that question of domestic or foreign, there is some question whether the attacks that occurred in London 2 weeks ago, if they had occurred in the United States in a similar fashion, if it would be covered under TRIA because the bombers were British citizens. If there were American citizens in a radical cell here today who detonated a bomb in the Metro system in D.C., or anywhere else, it may not come under TRIA as it exists today.

Mr. SCOTT. Let me ask another question, if I may. I have a couple more before my time is up.

I mentioned a worldview here. Is terrorism reinsurance a unique product for the United States? Has there been a time before 9/11, for example, where there has been a reinsurance crisis? Is there any comparison to the experience of other countries, Great Britain for example? In other words, what is the state of things regarding terrorist insurance from other parts of the world?

Mr. MIREL. Congressman, the proposal that I talked about earlier about creating a risk pool, that is not a new idea. Great Britain has one. Spain has one. I believe France and Germany have them at this point. I think it is not very different than what the State of Florida created in the way of a catastrophe risk pool for hurricanes in that State.

This is not a new concept. It is just a concept that has not been embraced yet in this country.

Mr. SCOTT. Okay. Thank you.

Mr. STIGLITZ. Congressman, let me reinforce that. He is absolutely correct about Florida. There was a reinsurance crisis there about 5 or 6 years, I believe it was, after they had a series of hurricanes. They responded by putting their pool together. It has worked. There is a lot of money in it. It has responded very well, certainly during the last four that they had last year. We have already had two this year. That pooling mechanism does work. So there are precedents for what we are talking about.

Mr. SCOTT. Does the existence of TRIA in your opinion, since we have had it, has an indirect impact on indirectly lowering rates? Or does it cause additional costs to be passed on to the consumer?

Chairman BAKER. That will have to be the gentleman's last question, as his time has expired.

Please respond.

Mr. STIGLITZ. Actually, the rates are coming down. Initially, they were higher. There wasn't near the take-up level, as Mr. Sinnott has mentioned. Now, the rates are coming down because there has not been an incident. They understand it. They have modeling. They have all kinds of stuff that enters into it. So we are seeing the rate come down.

At the same time that we had this problem, we also had what they call a hard insurance market. Pricing increased rather dramatically, which I think Mr. Maurin probably refers to as he got hit by the hard market, not just the TRIA-related calls. So now that market is softening again. We go through cycles every 3 or 4 years in the insurance business and now we are starting back down again. It is just typical of our industry.

So I do not think there is a direct correlation between TRIA rates and the general insurance rates at all.

Mr. SINNOTT. Just to add one comment, and that is that when looking at terrorist rates, I do not think it is so much that all rates came down. The difference was that in the early stages, the rates that were being offered were of such a level that they were declined by the clients. As TRIA took hold, I think the underwriters began to reduce the rates in that area, so those insureds that in 2003 might have decided not to take-up property as an example, in 2004 because the rates seemed more reasonable, took it up. And that is why we saw our percentage double in a period of probably 18 months on take-up on property.

Mr. SCOTT. Thank you, gentleman. You have been very helpful.

Chairman BAKER. The gentleman's time has expired.

Ms. Kelly?

Mrs. KELLY. Thank you.

I am very interested, Commissioner Mills, in the question of whether or not if TRIA were allowed to expire, what impact the higher premiums that would most certainly occur would have on terror insurance with regard to the take-up of terror insurance and the pass-on costs to consumers or tenants in New York. Would you like to answer that for me?

Mr. MILLS. One of the things that we have always felt is that if TRIA goes away, that the take-up rates may be impacted because the terror insurance may not be available. I mean, I really think that the very likely scenario would be that most of this coverage simply would not be available, and so obviously the take-up rates become insignificant.

Mrs. KELLY. Anybody else want to jump in on that? I am interested in what could happen in terms of the pass-on costs to tenants in buildings.

Mr. SINNOTT. I think that there would be some increase in cost because there is a limited market for stand-alone terrorism, and that those rates, just as they did right after 9/11 for stand-alone, jumped up. But I agree with the Superintendent, I mean, I am saying yes there would be some cost impact, but the biggest problem for our clients would be lack of availability.

Mr. STIGLITZ. Ms. Kelly, I might also add that the thing that really worries me is that if this goes away, I think probably the largest exposure, which we really have not addressed, is workers compensation. If statutorily our clients are required or companies rather are required to offer this, workers comp, I can't help but think that that will increase without the backstop in place.

Mrs. KELLY. Well, that takes me to my next question, which is the fact that I think London showed that mass casualty attacks may not cause mass insurer loss, but we also have gotten information that it is possible that you could have 10,000 casualties and they are saying that that could fit under a $500 million cap.

So my question is, is it realistic to say that a catastrophic event would not drive capacity out of the market in that area and essentially out of the industry?

Mr. MIREL. Let me just say, Congresswoman, that my understanding is that the largest amount of money paid out as a result of the attack on the World Trade Center was actually workers comp payments. Maybe Superintendent Mills can say.

It is a real problem. We have it here in Washington, D.C., where very large businesses can no longer get coverage in that area, even under TRIA, and have had to go into our own risk pool, the city's risk pool. Organizations like The Washington Post, AARP, Kennedy Center, these kinds of institutions are having trouble finding coverage even under TRIA for workers comp. That would be much, much worse if TRIA were not extended.

Mrs. KELLY. I understand. I needed to testify on a bill that I have before Congress, which is why I was late. I understand before I got here you had some discussion about the Treasury report and the $5 million. I am interested in what you think the trigger amount really ought to be, what the effect of a major catastrophic event, or multiple minor catastrophic events would be, and where you think that trigger really should be set in order to make sure that the reaction of the industry is not catastrophic in and of itself.

Mr. MILLS. There was a great degree of discussion on the size of the trigger. There was no real resolution. Myself in New York, we have said that we have no problem with significantly raising the trigger event. The chairman made a very good point that frankly I had not considered, because I was looking at largely the New York market. Mr. Sinnott also made a very good point that there are a lot of other small carriers even in New York and in all markets.

So I think the trigger is really one of the major questions that the Congress will have to resolve, and it will not be an easy question to resolve, but certainly I think that it is safe to say it can be increased significantly from what it currently is.

Mrs. KELLY. Anybody else want to address that?

Mr. MAURIN. On that issue, I think the trade that could better this coverage would be if in raising the trigger to be able to move it up from $5 million, which is relatively low, that we could include chemical, biological which is now excluded, and also include this domestic-foreign issue, which was talked about earlier.

We are going to determine whether a claim is paid on a terrorist act depending upon where your passport is. As we saw in London and as we have even seen in America, we have had even some Americans that have joined Al Qaida. Okay?

So I do not think the test should be where your passport is from. The test should be whether it was purely a terrorist act on this country, focusing on a specific property or a specific event. That should be the trigger for TRIA taking place.

Mrs. KELLY. Thank you very much.

I yield back.

Chairman BAKER. I thank the gentlelady.

Ms. Maloney?

Mrs. MALONEY. Thank you, Mr. Chairman.

The timely renewal of TRIA is a critical issue for the city I represent, New York, where the painful memory of September 11th has been renewed by the tragic events in London this month.

I would like to thank you very sincerely and deeply, Chairman Baker and Ranking Member Kanjorski, on behalf of my constituents for advancing the renewal of TRIA. I cannot think of anything that is more important to their lives and the ability for New York City to go forward.

I welcome Superintendent Howard Mills and Mr. Sinnott. I was in your crisis offices on September 12th. You had grief counselors there, assistance for victims' families, and you had offices set up to continue business. On behalf of many of my constituents who benefited from these efforts and your efforts for the city, I express their appreciation.

I can tell you from a very personal point of view in the painful days after September 11th, this great Congress came together like I have never seen it to help New York City and to help the Nation. But of all the efforts, by far the most important was passing TRIA. The city was not moving, and we are a resilient, great city, but no one could build. No one could plan. No one could do anything until TRIA was put in place. As their testimony states, if we are not able to renew and move forward, we face a tremendous challenge.

Mr. Mirel, you spoke beautifully that this is not an attack against a particular shoe store, but it is an attack against America and it is a responsibility of all Americans to come in and be part of the solution. Many people are citing the reaction of London and support for the pool system. The AIA PCI came out in support of this approach.

I would like to ask Mr. Sinnott, if Congress were to move toward a pool system, how long do you think the industry would need as a transition period to get up and running?

Mr. SINNOTT. I do not think I could specifically give it to you in 1 year, 3 years, 5 years. My belief is that it would take several years without an incident, frankly, to build up a sufficient amount of funds in the pool that one could say that the backstop that would still be there behind it is no longer necessary. It might be that you just keep pushing it up and up and up and up, and that the amount of backstop that is reasonably deemed to be there is extremely remote that it would ever be called in.

There are other things like war that are not covered by insurance. I think the fact that the market has responded and Congress has responded, and not just saying, well, war is war and it is excluded and we will figure it out after it happens, which is what would happen if we had a war event. The Federal Government would have to step in.

Now, this with TRIA and I think with what we are talking about today, we are talking about a more organized and thinking ahead of the event as to building something so that there isn't what happened after 9/11 or what happened would not happen if we had actually something that is defined as in the old sense a war event.

Mrs. MALONEY. So if you were stating, in other words, you would need a certain amount of time to build a reinsurance pool similar to London's. So in other words, we would possibly need a 2-year extension of TRIA or something like it in more or less its current form before the industry is ready to have a pool that could really be the backstop. Is that what you are saying?

Mr. SINNOTT. I am sure there are others who might have a slightly different view, but I think that a backstop to a diminishing degree will be required because, as they would say in workers comp, there could be theoretically a $90 billion event. Now, it is going to take a long time. You are not going to build up that sort of a fund in 2 years. The whole commercial industry premium-wise I think is roughly $200 billion. So it will take time, but I think if you start out, you are going to gradually remove the government, push any sort of backstop security out.

Mrs. MALONEY. The chairman came forward with a very thoughtful proposal, and I thank him for his attention to this critical issue before our country. His idea of a geographic slide, a percentage point. You countered that the smaller companies would not be able to compete. How could we adjust that? Could we put in a provision that smaller companies could come together and possibly band together to provide insurance jointly so that they could meet the trigger?

I also thought that Mr. Miller came forward with a good idea. I think that industries that help themselves and protect themselves, and some of our companies now even take photographs before you can enter the building, hire private guards, have put in metal detectors, have gone to great lengths to increase security on their premises.

Shouldn't that effort to invest in security from the private sector be taken into account in any type of formula in order to reward the creativity of the private sector and also the financial and creative effort that they are taking in localities and in particular businesses to help themselves?

Just in New York, there is a wide disparity between different office buildings when you walk into them, to the degree that they have taken steps to really protect their own employees and their clients as they come there.

I see that my time is up. I think the testimony today has been really extraordinary. You have given us a good foundation to go forward.

I cannot mention more passionately how important this is to the city of New York. If we do not have TRIA, building will stop. Nothing will happen. And when the economy is bad in New York, the economy is bad throughout the country. I have always noticed that.

So I would argue that all of our cities have a stake in it, and we have to remember the terrorists were en route to San Francisco, Los Angeles, and our Capitol and the Pentagon on that day.

Anyway, in any event I thank you, Mr. Chairman, on behalf of my constituents. You have obviously put a great deal of work on it, and you will be a big part of making this happen. I hope it happens soon because we need it. Thank you.

Chairman BAKER. I thank the gentlelady for her kind comments. Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman.

You gentlemen are in the business of determining whether an insurance company has adequate reserves to deal with the particular risk that they have assumed. You do that for both insurance companies, presumably also for reinsurance companies.

If there was a company called the United States Government, and it assumed the risks of TRIA, and you may want to respond for the record or respond orally now, how big a reserve would your State require them to have?

Mr. MIREL. The Federal Government has one thing, Congressman, that insurance companies—

Mr. SHERMAN. I am not saying the Federal Government. I realize if you add in the U.S. Treasury, the ability to print money and the ability to tax America, you would say it is a fiscally sound company with or without reserves. What I am saying is, if you were going to have reserves for that particular risk, how big would they be?

Mr. MIREL. That is exactly the problem, Congressman. Nobody knows. I have seen the kind of modeling that has been done by the various—

Mr. SHERMAN. Can you give us the range?

Mr. MIREL. Can you tell me what the next terrorist attack will be and how much—

Mr. SHERMAN. No, but I can't tell you when the next hurricane is, and you are doing that for insurance companies all the time.

Mr. MIREL. Because if you go back over 100 years or 200 years, you can predict where the hurricanes will come.

Mr. SHERMAN. Well, let's say this, you cannot predict the next earthquake. Trust me. I represent Northridge.

[Laughter.]

Mr. MIREL. Okay.

Mr. SHERMAN. So you have companies that sell earthquake insurance. There will be an earthquake sometime in California. It could be in the Mojave Desert. It could be in downtown Los Angeles. Predicting the economic effect of an earthquake is rather difficult. Any of you want to venture, since you do something just as difficult all the time, help us with this difficult issue as to trying to value what the reserve would be, what the risk would be.

Mr. SINNOTT. I will make one comment. When you are talking about an earthquake or hurricane or other catastrophes, there are limits of liability that the carriers are able to put on the policy. On earthquakes in California on commercial properties, nowadays you cannot get $1 billion of coverage. So the limits that an individual insurance company has I think allows—

Mr. SHERMAN. So if somebody built something the size of the World Trade Towers in Los Angeles, they could not get insurance for the full value.

Mr. SINNOTT. Right.

Mr. SHERMAN. Or even half the value, yet people are willing, well may or may not be willing to build huge projects in Los Angeles without such insurance.

Mr. SINNOTT. That is the way the commercial insurance market works, except for workers comp, where it is unlimited liability.

Mr. SHERMAN. One of the other questioners talked about the differentiation between international terrorism and domestic terrorism. I would hate to think that the outcome would depend upon which terrorist had a green card, which terrorist did not. Do you see any reason to differentiate between "domestic" terrorism and "international" terrorism?

Mr. MIREL. I do not see any reason, Congressman.

Mr. SHERMAN. I agree. Now, let's go on from there. Why do we differentiate between an earthquake and terrorism, since both can cause the same amount of damage?

Mr. MIREL. Congressman, as we pointed out earlier, Florida has in fact developed a very good catastrophe fund for hurricanes. Except for the fact that it is probably more difficult to predict man-made events than natural events, I see no difference.

Mr. SHERMAN. What you are saying is that, well, in New York you may not be able to get terrorism insurance for your building. In Los Angeles, you cannot get earthquake insurance for your huge project. I would think that the Federal Government would be just as interested in making sure that projects go forward and are not stopped by risk of earthquake as by risk of hurricane as by risk of terrorism.

Mr. MILLS. Congressman, if I may, you are failing to take into account the most insidious weapon of all that we are dealing with, and that is the power of the human mind. I mean, human beings, terrorists will change tactics. They can come up with new plans to deliberately try. You cannot predict an earthquake, but an earthquake cannot proactively try to confound you.

Mr. SHERMAN. Mr. Mills, neither you nor I know whether during this century the greatest catastrophe and the greatest insurance events will be an earthquake or a terrorist action or a hurricane. You cannot predict it. I cannot predict it. Yes, terrorists can do new and terrible and unpredictable things, but earthquakes can do new and unpredictable things, and of course the tsunami in the Indian Ocean. We never had tsunamis in that ocean. We did not have a warning system in that ocean.

So whether God or man creates the greatest catastrophes is something that only time will tell. I would think that we would want the same kind of system to make sure that you can get earthquake coverage in California, hurricane coverage in the Gulf, other catastrophe insurance. We should have a system where huge projects can go forward everywhere in this country regardless of which is the greatest risk.

It is interesting. I represent a city, perhaps the only city where the earthquake and the terrorism risk have both been illustrated just in the last 10 or 15 years.

Moving on, you folks deal with insurance companies, but I hope you also, and I expect you also deal with policyholders. Have you learned anything in your conversations with commercial policyholders about the price and availability of terrorism insurance? I think you have probably answered this question in different guises through the hearing, but I just got here.

Chairman BAKER. That will be the gentleman's last question, as his time has expired.

But please respond.

Mr. SINNOTT. Yes, we have provided information on what the pricing is. We happen to have in this case statistics that show it by industry, by region. So yes, that is there, and there are differences.

Mr. SHERMAN. Mr. Chairman, I look forward to having the Federal Government play the minimum possible role in order to make sure that some kind of adequate insurance is available for all the risks that otherwise hold up major projects.

I yield back.

Chairman BAKER. I thank the gentleman for his statement.

I want to thank each of you for your participation and just make the observation on behalf of the Administration that the Treasury report, although we may find reasons to differ with the conclusions reached, was a very thorough examination, broad in scope, carefully prepared, and provides I think a great deal of information for this committee to consider.

I would request to each of your respective interests in the matter that over the course of the August recess you make available to the committee any perspectives you have that would lead the committee to reach conclusions different from those presented in the report.

Some have suggested that the committee needs merely to renew the TRIA and engage in a study. I would suggest that the Treasury work is a pretty good piece of critical analysis, and I think the appropriate timeline is over the course of the next 4 or 5 weeks for industry representatives to give us the appropriate take, remedies, whether it is a regional trigger, whether it is gradual increase in retentions. We need assistance, and the reason for the hearing today is to bring that clearly to your attention.

I am appreciative of your time and your effort. Thank you very much.

As appropriate, we will get started with our second panel when folks are settled in.

We will just stand in recess for about 5 minutes.

[Recess]

Chairman BAKER. I wish to call the subcommittee back to order and welcome our distinguished panel of witnesses who have already spent a considerable portion of their day here. For that, I am appreciative.

As you heard in the first panel, we would request that you attempt to keep your statement to 5 minutes. Your entire official statement will be made part of our record. We appreciate your participation here today.

Our first witness is Mr. Robert Hunter, no stranger to the committee, who again is testifying in his capacity as director of insurance for the Consumer Federation of America.

Welcome, Mr. Hunter.

STATEMENT OF ROBERT HUNTER, DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

Mr. HUNTER. Thank you, Mr. Chairman, members of the committee.

Three years ago, Congress was debating creation of a temporary program to give insurance companies time to adjust to the new world we were faced with after the September 11th attacks. As Congress debated this, the property casualty insurance market was reeling from a hard market that had seen capital decline and commercial insurance prices skyrocket. The hard market began early in 2001 and the attacks exacerbated the problem.

Congress wisely sought a temporary program. Some members warned that a program of free reinsurance, as was about to be adopted, would be difficult to terminate as insurers and others who would receive a Federal subsidy would naturally like to keep the tap into the Federal Treasury. Whether Congress did it knowingly or not, the choice of a 3-year temporary program turned out to be perfect for those who would seek to end taxpayer subsidies for terrorism insurance today. Now is the ideal time to end TRIA or sharply cut it back.

Why? The reason is the hard market of falling insurer capital and skyrocketing policyholder rates has ended. We are now in a soft market of skyrocketing capital and sharply declining commercial property casualty insurance rates. It is impossible to justify terrorism insurance subsidies when insurance profits are skyrocketing, property casualty insurance rates are sinking, and beleaguered taxpayers face mounting deficits.

In the first quarter of 2005, the industry had a 92 percent combined ratio, one of the lowest such ratios in decades, meaning mammoth profits lie ahead. The first quarter of 2005 had underwriting profit of almost $7 billion and with investment income, retained earnings jumped $10 billion. Retained earnings of the insurers were $323 billion before the terrorist attacks of September 11th, but now are $403 billion, $80 billion higher than they were before the attacks.

The commercial lines segment of the industry had a surplus of $171 billion at year end 2004, a growth in surplus of almost $50 billion before the attacks. The new capital just in the commercial property casualty insurance area would be enough to pay for losses from an attack more than twice the size of the World Trade Center.

This excess of capital has, happily for commercial policyholders, led to a price war, with rates dropping by 5 percent for small commercial accounts and over 10 percent for medium and large accounts for the 12 months ended June 30, 2005. Since Treasury has shown that average percentage of overall premiums paid out by commercial policyholders for terrorism insurance were under 2 percent in 2004, it means if terrorism rates doubled as a result of TRIA termination or cutback, overall insurance premiums paid by businesses of all sizes would still decline.

More remarkably, for larger commercial accounts, terrorism prices could more than quintuple with no overall premium increases being felt. It is a perfect time to end the program or cut it back. Claims by insurers and large real estate interests that an end to TRIA would put the economy at risk, threaten jobs, stall commerce and delay construction are not credible as Treasury and CBO have indicated.

Our review of the terrorism reinsurance gap in 2002, detailed at great length in my testimony, shows that the Nation adjusted to the terrorism insurance shortage and the private market found ways to provide most of the needed coverage in 2002. Now, this was in the midst of a hard market with surplus falling and insurance prices soaring. Imagine how well it could cope in 2006 with the industry enjoying record reserves and profits and rates dropping.

What should Congress do? We think Congress should let TRIA expire, maximizing the private sector response and maximizing mitigation incentives. However, if TRIA is extended, we think that you should adopt the Treasury Department's recommendations in the main to significantly pare back the program. This would include elimination of lines of insurance such as general liability and commercial auto, with relatively low terrorism risk. Group life insurance should definitely not be added to TRIA since life insurers have never provided any meaningful evidence that it is necessary. CFA also agrees with the Treasury Department's recommendation that the trigger should be increased.

I heard your comments, Mr. Chairman, about rural areas. I think there may be ways to adjust it. I have just started thinking about it. I think that you might have a trigger that varies by size of insurance company, rather than territorially. That might be a better way to handle what you are looking for. But I would like to think some more and get back to you on that.

We do think that the deductible should be raised, we believe, to $75 billion before taxes, which is $50 billion after taxes, which would mean that the industry would never be in a worse position than they were before the first attack. Copayments should also rise as the Treasury Department proposed.

Beyond the Treasury Department's recommendations, we recommend charging a premium for whatever coverage is available to insurers. CBO favors this. Even insurers have agreed there is no legitimate argument against charging a premium, so that taxpayers can be kept whole. Developing and administering a premium payment requires a very small staff. I know. I was the sole actuary who did it for the riot reinsurance program in HUD under President Ford. Any extension of TRIA must be declared temporary and extended only for the purpose of giving the private sector a bit more time to prepare.

Now, there is an area, nuclear, chemical, biological. If you do expand it to that, I think the industry cannot handle it without a Federal backup. You do need to think about that.

Finally, the third choice would be a longer term pool backed by the Federal Government. A pool could be set up with no Federal involvement if TRIA expired or didn't, even, for that matter, and we think over time some States like New York and California might want to have an interstate compact-type pool. A simple solution might be for Congress to authorize a pool that way. It is unlikely that a complex risk pooling bill could possibly be done by January 1 of next year, much less have it up and running.

Further, we are concerned it might significantly increase the risk of a permanent Federal presence in terrorism and therefore unnecessarily increasing taxpayer exposure. We worry that complex Federal-State issues that deserve a separate discussion might be swept into such a bill. However, we do list in my written testimony a series of things that we think you need to be concerned about in how you put together a pool, including cherry-picking the kinds of regulation necessary to protect against a cartel-type structure that would be legally mandated, and making sure coverage is limited to high-risk lines.

I would be happy to answer questions at the appropriate time.

[The prepared statement of Mr. Hunter can be found on page 108 of the appendix.]

Chairman BAKER. Thank you very much, sir.

Before proceeding to the next witness, because of scheduling conflicts, Ms. Bean would like to make remarks at this time.

Ms. Bean?

Ms. BEAN. Thank you, Mr. Chairman, and thank you also for allowing us to have such extensive testimony on the important subject of terrorism risk insurance.

Thank you to our second panel for participating.

I did also appreciate the opportunity to personally welcome two Illinois constituents, Jason Schupp and Penny Pritzker, who have traveled from my home State of Illinois and bring some Chicagoland perspective to the debate over reauthorization of terrorism risk insurance.

Ms. Pritzker is the founder and chairman of Classic Residence by Hyatt, which provides luxury senior living communities nationally. She serves as president and CEO of Pritzker Realty Group, headquartered in Chicago, and is treasurer and on the board of directors of the Real Estate Roundtable. Her numerous chairmanships and board positions at private and philanthropic institutions, as well as her distinguished economic credentials really enable her to provide a broad management perspective.

But it is her industry-relevant experience in the real estate business that makes her testimony so valuable today. Pritzker Realty's diverse asset portfolio includes developed industrial parks, apartments, offices, land, and airport parking complexes. Such development projects are critical to America's continued economic growth, and so her testimony to the impact of TRIA on such development is important today.

Jason Schupp is from Inverness and is an 8th District constituent whom I am honored to be working for every day. He is vice president and serves as chief legal counsel to the underwriting committee for Zurich American Insurance, the third-largest commercial insurer in America. He has been directly involved with developing internal policy addressing exposure to terrorism. His testimony is valuable as well.

I am honored to have you both here today from my home State and I look forward to hearing your testimony, although I may be pulled out for a couple of meetings.

Thank you so much.

Chairman BAKER. I thank the gentlelady.

It is my pleasure to next call on Mr. Ernie Csiszar, who also is no stranger to the committee, who appears here today as president and chief executive officer of the Property Casualty Insurance Association of America.

Welcome, sir.

STATEMENT OF ERNST N. CSISZAR, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA

Mr. CSISZAR. And who is also a new resident of the State of Illinois. I just moved there.

[Laughter.]

Thank you, Mr. Chairman, and members of the committee. It is a pleasure to be able to testify before you today.

I represent the Property and Casualty Insurance Association. We have over 1,000 insurance companies as members. We represent some very small companies with no more than a few million dollars' worth of premiums. And we represent some very large companies with several billion dollars' worth of premiums. So we have a wide cross-section of members.

As a result, I think I can fairly say that we have had a committee together that has worked very closely with members of your staff. We are fully committed to finding as much of a role for the private sector in solving this terrorism risk problem as we possibly can. We have worked well with your staff toward that end and we will continue to do so.

We have made some progress. Nonetheless, let me begin by stating some very simple facts. You have heard some of these before. What we are talking about here is essentially uninsurable. We do not know where it is going to occur. We do not know when it is going to occur. We do not know how often it is going to occur. And we do not know how much it is going to cost when it does occur. It is an uninsurable event for all practical and theoretical purposes.

That very fact immediately brings in the question of how do you price this product and secondly, how do you reserve for this product? Since reserving is an issue, as a former regulator, for instance, I can tell you very clearly that immediately the lights go on when it comes to solvency. What kind of solvency problems are you really creating if you even underwrite this type of product, never mind about whether you are able to price it correctly or not?

The last point I would like to make as a fact is very simply this, and we all know this. You have a bill before Congress now, the SMART Act. We are asked to provide market solutions, but we are not operating in a free market. As you know, there are rate restrictions. There are policy form restrictions that prevent any kind of creativity, oftentimes, from finding solutions to these problems. So we are not operating in a free market. If that is what we are looking for, then one of the issues we need to address is what kind of free market solutions are there in fact that can be part of the solution for terrorism.

While there is no perfect solution, I will say that the only answer in these cases will be a public-private partnership that essentially addresses the problem. What we have worked on essentially has several different prongs. If the private markets are to participate in a significant manner, first of all the private markets need greater freedom to respond. That means greater freedom to rate. That means repeal or a scale-back of some antiquated fire policy provisions, for instance. That also means preventing States from unilaterally mandating that terrorism coverage must be provided. So that is prong number one.

Prong number two is also let's pursue the capital markets and see whether we can find capital market solutions to this. The argument has always been that these kinds of financial instruments—a catastrophe bond, which are quite common these days, in fact—are not unusual transactions, that they may not be liquid; that the markets might not be receptive.

We think there are ways to provide liquidity in this instance. For instance, providing puts to the Treasury as a purchaser of last resort could very simply solve that problem, and there may be other ways in which we can address it. So one component of a solution may well be participation by the capital markets.

We also very much agree with what you have heard earlier today that some type of a pool will be necessary in which companies can participate. Let's not forget that while it is true, again I heard some questions before as to how long an accumulation might take before it is meaningful in such a pool, let's not forget that such a pool might also be able to pre-fundable by way of borrowings, for instance, by way of issuing bonds, by way of revenue creation in fact to repay. These things I think there are details that can be worked out.

We also think as a fourth component of the solution that one needs to look at buildup of tax-deferred catastrophe reserves for terrorism.

Last but not least, we have heard it before, domestic acts are no different from foreign acts. I would also suggest that personal property is really no different from commercial property, particularly homeowners. Now, I know we have not talked specifically about homeowners, but I would suggest it deserves further study as to what kind of coverages, what kind of inclusion one might bring to the homeowners policy.

Let me make a few comments in finishing on just some of the proposals that we have heard. I am quite unclear as to precisely what the Treasury expects at this point or what kinds of changes because the signals have been mixed, quite frankly. I welcome the Treasury report. I agree with you, it was quite comprehensive and I can assure you we will respond to that report. But at the same time, I do not want to be critical because I think it is hard to anticipate exactly what is suggested in that report. But let me make a couple of comments.

On the issue of the $500 million, there is no question that as I speak, for instance, for some of our smaller and mid-size insurers, that would put them out of business. I can think of an insurer we have, for instance, who covers churches and synagogues and mosques and so on. One mega-church on a Monday morning with a single bomber would do the job. It would only be that company exposed to it. So a retention that high, I may agree that $5 million is too low, but I think $500 million is way too high, and we have to find some compromise in between.

As regards retentions, I would also agree there is room for discussion on increasing retention levels. What I would suggest is that we do not approach it as dramatically as suggested by the Treasury, from 15 to 20 to 25. Maybe it is more reasonable to think of 15 to 16 to 17 and so on, a much more gradual approach on those retention levels. But these are details that can be worked out.

Quite frankly, I think a good deal of progress has been made on these issues and I would hope that this committee can use this as an opportunity to continue to pursue those and to put them in place really by year-end. I think it can be done. I think the industry understands the need to do this. The worst of all possible things that can happen here is that we leave ourselves open with nothing at the end of the year. But I would suggest, let's use it as an opportunity. Let's implement a longer-term program than the current one that is in place.

Thank you.

[The prepared statement of Mr. Csiszar can be found on page 81 of the appendix.]

Chairman BAKER. Thank you very much, sir. I appreciate your testimony.

Mr. Schupp, as you have been previously introduced by Ms. Bean, please proceed at your leisure, sir. Welcome.

STATEMENT OF JASON M. SCHUPP, VICE PRESIDENT AND SENIOR ASSISTANT GENERAL COUNSEL, ZURICH FINANCIAL SERVICES GROUP, ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION

Mr. SCHUPP. Thank you.

Chairman Baker and members of the subcommittee, thank you for the opportunity to speak on behalf of Zurich and the American Insurance Association about what is actually happening in the terrorism insurance marketplace.

I am vice president and senior assistant general counsel for Zurich, the third-largest commercial insurer in America. I have been intricately involved in all aspects of our U.S. terrorism underwriting strategy since September 11th. Based on those experiences, I assure you that the private sector has made great strides in understanding the terrorism exposure. However, there are inherent limitations to what the private sector can do.

Since 9/11, we have learned some fundamental principles about terrorism and about the private marketplace's ability to deal with this risk. The first is that terrorism presents a far larger financial risk than private capital markets can handle. For example, insurance rating agencies recently suggested that no more than 10 percent of insurer capital should be exposed to terrorism risks. That amounts to a capital commitment of about $19 billion for the commercial property casualty lines covered by TRIA.

Yet under this year's TRIA retention levels, total industry exposure is $37.7 billion, about double the capital exposure that rating agencies look for. This is an obvious concern for insurers, but should alarm anyone relying on the property casualty sector to respond to another terrorist attack on U.S. soil.

Some academics and others suggest that TRIA has crowded out private market reinsurers or other capital market mechanisms that would commit capital to the terrorism exposure. Over time and on the right terms, it is possible to coax a bit more limited, short-term capacity from private reinsurers and other capital markets. However, there is plenty of space today for these private market solutions to expand and they have not.

The second principle we have learned is that terrorism exposures are not all alike, nor should they be treated alike. For example, it has become clear that NBCR attacks have such unique characteristics that our capability to respond is particularly limited. In addition to thinking differently about the type of attack, we have learned that certain classes of business such as workers compensation and commercial property pose more difficult underwriting and risk accumulation challenges due to the nature of the risk and the regulatory regime governing those lines.

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 committee for the extraordinary bipartisan leadership demonstrated in developing and expressing this common understanding.

There are several ways the subcommittee could proceed. One would be to scale back the existing program, as Treasury has proposed. The viability of that approach depends on the numbers and whether there is room to further respond to the risk characteristics of the various lines. Or a structural alternative to TRIA such as a pool or a pay-to-play reinsurance system could be developed. Either approach needs to encourage higher take-up rates.

Whatever path is chosen, our fundamental concern is that any mechanism must be workable for all stakeholders in the marketplace. We will judge these various proposals based on our real-world, on-the-ground experience and expertise.

I would like a minute to quickly address some of the suggested program changes. We appreciate the expectation that the private sector insurer should shoulder more of the financial burden associated with terrorism, but increasing individual insurance company retention levels will not create more reinsurance capacity. It will simply make it more difficult for insurers, particularly large diversified insurers, to manage the massive unfunded and unreinsured portions of their deductibles.

For similar reasons we have serious concerns about increasing insurers' quota share if a loss exceeds the per-company deductible. Moreover, the existing quota share is consistent with those in many private reinsurance contracts and provides ample incentive for companies to efficiently manage claims to minimize Federal involvement.

The recent Treasury report suggests removing commercial auto and general liability from the program. While commercial automobile is likely to pose a less major terrorism accumulation challenge, general liability is a very real significant exposure. A full impact analysis should be undertaken before acting in this area.

A final policy area that must be addressed is insurance market reform. State rate and form laws limit insurers' ability to manage the terrorism exposure. The still all-too-real risk of catastrophic terrorism attacks on U.S. soil means that we need an effective insurance mechanism in place beyond December 31, 2005. Such a mechanism must be built to reflect marketplace reality, not hopes or theories.

On behalf of Zurich and the American Insurance Association, let me say that we stand ready, willing, and able to work with you to ensure timely enactment of a workable national terrorism insurance mechanism.

Thank you.

[The prepared statement of Mr. Schupp can be found on page 162 of the appendix.]

Chairman BAKER. I thank you, sir.

Our next witness is Mr. Warren Heck, testifying as the chairman and chief executive officer of the Greater New York Mutual Insurance Company.

Welcome, sir.

STATEMENT OF WARREN HECK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GREATER NEW YORK MUTUAL INSURANCE COMPANY, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. HECK. Thank you.

Chairman Baker and members of the committee, my name is Warren Heck. I am chairman, as you indicated, and chief executive officer of Greater New York Mutual Insurance Company and its wholly owned stock subsidiaries, the Insurance Company of Greater New York and Strathmore Insurance Company. I am also the chief underwriting officer of the companies and manage their underwriting activities.

I am here today to testify on behalf of the National Association of Mutual Insurance Companies. Let me start by thanking Chairmen Oxley and Baker and this committee for adopting TRIA in 2002. NAMIC and I are convinced that it played a major role in preventing an economic catastrophe in helping get the country back on its feet economically after 9/11.

We also thank you for your efforts today to reform TRIA and to renew the Federal reinsurance backstop for terrorism before it expires at the end of this year. We agree with Federal Reserve Board Chairman Alan Greenspan's observation before this committee that there is "no way that the private insurance market can handle terrorism-related risk by itself because of the very substantial potential scope of damage." We support his endorsement of government-backed reinsurance for terrorism.

Greater New York Mutual Insurance Company is the fourth-largest writer of commercial multi-peril business in New York State. Much of that business is in New York City. As CEO and chief underwriting officer of our companies, I have first-hand knowledge and understanding of the needs of our policyholders and brokers, particularly with respect to the terrorism exposure.

As a result of the terrorist attack on 9/11 and prior to the passage of TRIA in late 2002, most primary insurance carriers operating in New York City began to non-renew their large commercial property and workers compensation business or to reduce or limit coverage to under $20 million on the property side. With the passage of TRIA, the fear that a worst-case terrorist event could render our company insolvent was reduced, which made it possible for our company to keep its market open to a degree that would not have been otherwise possible.

While we believe that TRIA has been instrumental in creating some market stability, we also agree with Treasury that some reform is needed. We think the Treasury Department's recommendations for changes in TRIA are a reasonable starting point for short-term reforms. We agree with Treasury's assessment that "the immediate effect of the removal of the TRIA subsidy is likely to be less terrorism insurance written by insurers, higher prices and lower policyholder take-up."

Treasury outlined several key areas of reform, particularly higher deductibles and higher event triggers. The private sector has shown that it can operate with a 15 percent deductible. Raising that deductible would provide a further test of private sector capacity. Similarly, an increase in the event trigger is within the realm of reality. However, raising the event trigger much higher would be problematic, particularly for medium and small insurance companies.

In establishing new deductible levels and a higher event trigger, one must recognize that if they are set too high, the program will unfairly discriminate against the medium and small companies in favor of large companies that can afford a much larger hit.

As far as a long-term solution goes, I think it is more likely that the creation of a private-public partnership similar to the system that exists in Great Britain with the Pool Reinsurance Company, Ltd., can be a substantial part of that solution.

A new RAND Center for Terrorist Risk Management study recommended two other possibilities: first, requiring that terrorism insurance cover acts by domestic groups as well as foreign terrorists, a wise admonition in light of the London attacks; and second, requiring that insurance cover attacks involving chemical, biological, radiological or nuclear weapons, perhaps through a direct government insurance program.

Now would also be a good time for the Federal Government to examine tax and accounting policies that NAMIC believes are major impediments to increasing the capacity of insurers and reinsurers to provide terrorism coverage. For example, insurers should be permitted to deduct reserves set up for terrorism losses. The present prohibition against this creates a disincentive for the private sector to invest in the insurance industry.

The flow of private sector capital to this industry is also inhibited by outdated State regulatory policies that often require regulatory approval of the price insurers charge.

Thank you once again for the opportunity to testify on this issue of vital importance to NAMIC member companies and the U.S. economy. Your continuing leadership on this issue represents the best in public policymaking and NAMIC stands ready to assist you in any way in developing the best possible terrorism insurance legislation.

Thank you.

[The prepared statement of Mr. Heck can be found on page 100 of the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Mr. Ed Harper, who appears here today as the senior vice president of public affairs and governmental relations for Assurant, Inc.

Welcome, sir.

STATEMENT OF ED HARPER, SENIOR VICE PRESIDENT, ASSURANT, INC., AND CHAIRMAN, GROUP LIFE COALITION

Mr. HARPER. Good afternoon, Mr. Chairman.

The Group Life Coalition appreciates your leadership and our being given the opportunity to present some ideas to the committee on defending the American economy against terrorist attacks. I am Ed Harper, as you said, senior vice president of Assurant, which is a leading provider of insurance products and services, including health and employee benefits.

I am here today in my capacity as chairman of the Group Life Coalition. The coalition is composed of insurance companies which provide the protection of group life insurance, both as a stand-alone product and as a part of an employee benefits package. I particularly want to thank you, Mr. Oxley and Mr. Frank and Mr. Kanjorski for their commitment to get something done this year and for their interest in and support of group life.

I am here for two reasons. I join with my industry colleagues and Federal Reserve Chairman Alan Greenspan in sharing the belief that the private insurance market cannot fully handle the risk posed by terrorist attacks. Secondly, I hope to persuade the committee to create a successor program to TRIA that protects the people as well as the buildings. That is a program which includes group life insurance going forward.

What is group life? Group life is the financial lifeline for the widowed families of breadwinners for over 160 million Americans. In many cases, group life is the only life insurance most policyholders have to provide protection to their families. It truly is a financial security blanket for the average family. Our prime purpose here today must be to make sure that consumers' claims are paid promptly under the worst of circumstances.

Unfortunately in a post-9/11 environment, this financial protection is threatened by two aspects of group life insurance. One is a concentration of risk from covered employees working in the same building, coupled with an absence of the mechanism that had previously been used to spread such risk, catastrophe reinsurance. Moreover, State insurance laws do not allow for any group life exclusion from acts of terrorism from conventional weapons nor unconventional nuclear, chemical, biological and radiological attacks. But for group life, if someone dies, group life pays regardless of the source of the attack.

The group life market is highly competitive, where employers buy policies from the lowest bidder, usually as a part of a package sold by an employee benefits insurer. Policies are lost to competitors for pennies on the dollar. Faced with the reality of extremely limited or no catastrophe reinsurance protections, group life insurers are faced with few options to address concentration risks in an age of terrorist attacks.

None of the options are attractive. They can raise prices to cover a risk they cannot calculate, thereby cutting themselves out of the market. They can exist the employee benefits market or they can continue to offer coverage without the catastrophe reinsurance mechanism to mitigate such risks. None of these options are truly viable solutions for a group life insurance company, nor do they properly address the problems posed by catastrophic terrorist attacks.

What should the Congress do? The committee has asked for our views on a successor to TRIA. We believe the following four principles should be considered. Number one, the program ought to match the term of the solution to the term of the threat. Historically in times of war, particularly World War II, the Federal Government has made legislation permanent or set to expire at the war's end. Just recently we have seen the House of Representatives make key provisions of the USA Patriot Act permanent in recognition of the long-term danger of terrorism. Unfortunately, the risk of terrorism and our Nation's struggle with the specter of terrorist attacks is not likely to end soon.

Second, we need to have a shared burden with a balance. Any long-term solution should first demand that carriers assume a significant deductible to assure everyone that underwriting procedures are appropriate. Second, it should facilitate the private market-enhancing mechanism supporting pools that have been mentioned here this morning, and finally require that the industry pay to play by repaying over time any funds advanced by the Federal Government in the wake of catastrophic terrorist events.

The program's mechanisms and formulas should: (A) achieve increased capacity where the industry is paying just consumer claims; (B) have an appropriate level of shared burden with the Federal Government; (C) avoid a program where only big companies in big cities could access the program; and finally (D) provide an orderly transition. The creation of something beyond a quick-fix solution may be achievable yet this year, but the implementation will take time to get right.

We support an extension of TRIA with appropriate reforms to the extent necessary, but only as a transition to a more comprehensive approach. As the new program is ready to be engaged in begin functioning, the old TRIA model should be sunset. Protect the people inside the buildings, too. This is where I would end: any program must include group life as a covered line of insurance to make sure that the financial security of the average American families in those buildings is covered as well.

On behalf of the Group Life Coalition, we thank you and your colleagues for holding this hearing on this important subject, and we look forward to working with you.

Thank you.

[The prepared statement of Mr. Harper can be found on page 89 of the appendix.]

Chairman BAKER. Thank you very much, sir.

Ms. Pritzker, pursuant to Ms. Bean's welcome, please proceed at your leisure.

STATEMENT OF PENNY S. PRITZKER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PRITZKER REALTY GROUP, L.P.

Ms. PRITZKER. Thank you very much for the opportunity to be here today. My name is Penny Pritzker. I will not repeat the introduction, the very lovely introduction given by Congressman Bean. However, I do want to say that I am also here as treasurer and a member of the board of directors of the Real Estate Roundtable.

I want to begin by thanking you, Chairman Baker and Ranking Member Kanjorski, for conducting today's hearing on the future of terrorism insurance.

I am pleased that Chairman Oxley and so many members of this committee support the continuation of Federal terrorism insurance programs.

I also want to specifically note my appreciation for the focus and attention given to the issue by Representatives Kelly, Frank, Israel, Crowley, Capuano, and Bean.

I am honored to offer my perspective today as you craft legislation in the area.

Immediately following 9/11, Congress was called upon to develop many new public policies to reflect the changed world. This committee, led by Chairman Oxley, quickly grasped the enormous potential economic problems that could develop if the government did not step into the terrorism insurance marketplace. You led the Congress in developing the legislative solution that became known as TRIA. Thank you for your hard work in this area then, and thank you for recognizing the need to focus intently on the issue once again.

Like many of you, I had hoped that the government's role in terrorism insurance could be ended. I am in a highly competitive market-based business. Like the real estate business that I am in, I was hopeful that the private insurance markets could fully handle the issue of terrorism insurance as it had prior to 9/11. But let me be clear: Unfortunately, that does not seem to be the case.

From my perspective, the reasons that caused this committee to work daily to enact the Terrorism Risk Insurance Act have not significantly changed. Because of this reality, I strongly believe that our economy continues to need a Federal terrorism insurance backstop. We need it to be in place well before TRIA sunsets at the end of the year. So I favor reauthorization for several years while a commission considers a longer-term solution. The issues here are complex and the implications are very broad for our economy.

Obviously, as recent events in London and around the world indicate, the threat of terrorism continues to be strong. Where terrorists might strike and how they might attempt to do so continues to be an evolving picture. Not only does the terrorist threat continue, but the potential economic costs of terrorist attack are almost limitless. You correctly saw the problem in 2002. You enacted TRIA. I believe it has been a tremendous success.

A survey conducted during the post-9/11, pre-TRIA time period showed that more than $15 billion of real estate-related transactions had either been stalled or cancelled because of lack of terrorism insurance. Studies further showed that approximately 300,000 jobs were lost during this period. Almost overnight, TRIA provided the capacity to insurance markets, which in turn yielded the economic confidence for transactions to resume.

I am personally familiar with stalled construction projects that moved forward immediately to the benefit of countless workers in the construction trade, including our newly completed and constructed Hyatt Center, a 1.5 million square foot office building that created over 2,500 jobs that we started just post-9/11 after the implementation of TRIA. Without TRIA, we would not have been able to finance and build our new building. Without the continuation of TRIA, we will not be able to refinance our building.

Having noted the benefits of TRIA, I am also aware that few laws are perfect. You are the ones who must review the technical way in which the Federal backstop functions and make any revisions that you see fit. I personally do not share the optimism expressed in the Treasury report concerning the ability of private insurers to effectively model terrorism risk. However, if reforms to the program along the lines suggested by Treasury Secretary Snow can be crafted to increase the role of the private market in this area that still makes sure that terrorism insurance is widely available to the economy, then they should be done.

I also understand this committee might be interested in crafting a longer-term solution to the terrorism insurance problem. I certainly would not discourage this committee and Congress from exploring a more permanent way to ensure that terrorism insurance is available in our country. There are several models that may be instructive in this area, including the pool approach used in the United Kingdom and the pooling approach for catastrophic risk taken by Florida. I urge you to proceed cautiously when looking at TRIA reforms or at a longer-term solution.

In general, I urge that you make sure that whatever the approach, you do not unintentionally penalize the policyholding community. The economy does not need a situation where terrorism insurance is once again only available in limited supply and then only at extremely exorbitant prices. The resulting illiquidity would not be a functioning marketplace.

During your deliberations, I respectfully offer a few points for you to consider. First, one of the most important aspects of TRIA was the so-called make-available provision. It ensured that terrorism coverage was offered to businesses. I strongly urge that this provision be included in whatever Federal backstop program this committee recommends.

Second, the distinction under current law between domestic and foreign terrorism should be eliminated. In today's world having to determine whether a terror strike is at the direction of a foreign entity is obviously very difficult and seems somewhat meaningless. Even today, little is known about the origins of the anthrax attacks of a couple of years ago.

Third, nuclear, biological, chemical, and radiological exposures are truly limitless. It seems that they should be somehow treated differently than other forms of terrorism risk, if for no other reason than to provide an even greater incentive for insurers to offer this type of coverage. As you know, TRIA currently backstops these events if in fact a primary insurer will write the coverage. I see no evidence that such coverage is being written today. A strong incentive is needed to ensure that this very real risk is covered.

Finally, I would urge you to act in this area quickly. According to the Moody's report, 50 percent to 75 percent of all property and casualty insurance policies written since January 1st have adopted conditional endorsements. Conditional endorsements will automatically void terrorism coverage if a Federal terrorism insurance backstop is not in place by January 1, 2006.

Also, new projects will face increasing difficulties because in many cases terrorism insurance coverage will not extend into next year and therefore the financing will not be available to go forward. The sooner Congress acts on this issue, the less dysfunction will occur in the marketplace.

I would also urge caution in two additional areas. First, there is great discussion about what lines of business are to be included and excluded from backstop coverage. For example, general liability is an important line of business coverage by itself. It also gives support to our officers and directors insurance. I urge you to carefully review the justifications to exclude it from the future backstop coverage. Obviously, if the decision is to move forward on a pooling approach to address this problem, which will bring with it a pay-to-play aspect, then I would strongly urge all existing lines be covered in the successor program.

Second, the issue of tort reform is one that is very important, but one that could overwhelm the prospects for this important legislation if not carefully crafted. First, through regulation, the Treasury Department already has established strong litigation safeguards against runaway verdicts and excessive settlements. These regulations, of course, expire with TRIA. I think reauthorizing these regulations would address the concerns of unwise lawsuits arising in this area.

Just to summarize here, rational litigation management rules are needed in this area, but the debate should not serve as a hurdle to achieving the most important goal here, and this is a workable terrorism insurance program.

In conclusion, the real estate industry is one of the most competitive market-oriented industries in America. We want markets to operate freely, but sometimes they can't. As Alan Greenspan testified last week to this committee, "So long as we have terrorism that has the capability of a very substantial scope of damage, there is no way you can expect the private insurance system to handle it."

Given this situation, I am pleased that a bipartisan group of members of this committee support the continuation of Federal terrorism insurance programs. Without a backstop, the terrorism insurance market is very likely to once again become highly unstable with potentially very harmful effects on the economy. TRIA was successful. Perhaps it can be made more market-oriented without causing market disruption and perhaps a long-term solution is within grasp.

The most important action, however, is to act by putting a program in place long before the year ends.

Thank you for the opportunity to comment today.

[The prepared statement of Ms. Pritzker can be found on page 157 of the appendix.]

Chairman BAKER. Thank you, Ms. Pritzker.

I would like to start with the observation about the nationalization of insurance risk. I disagree with the view that the United States taxpayer should be the first line of response in these circumstances. The industry assesses risk and collects a premium against that risk and tries as best is practicable to be profitable in judging future risk and making profits for shareholders in that business. So as between nationalizing on the one hand, and throwing it all on the industry, there is a balance to be reached here.

What I think the Treasury report underscores in its view of the current TRIA program is that those equities are not properly balanced today, and that we can move more in the private market direction without adverse economic consequences. To that end, we have the month of August plus a week or so before we would come back, even if the decision were made just to extend TRIA as others have suggested, it would not happen this week anyway. So since we have the gift of 5 weeks, let's focus on Treasury, focus on what can we do to move in the direction they would like us to move, and I will acknowledge that the $500 million trigger, for example, is a problem.

In suggesting remedies, I talked about some regional type of measure taking the percent of commercial value lost as opposed to the commercial property in that regional area as a triggering device. Mr. Hunter suggested it might be more appropriate to have some other trigger that relates to the size of the business entity, which is subject to the claims for payment.

The only hesitancy I have about that, and maybe the two can be done in tandem, is that when you move to looking at the individual business enterprise, whether we by inadvertent action are creating additional moral hazard by causing that company to not worry about concentration of risk in a particular community, whether they have properly gauged the risk, whether the business enterprise, for example, has security on the file. As Ms. Maloney rightfully pointed out, we ought to incent professional conduct and people who have security devices in place ought to have lower premium than people who just say, we are open for business. So some blend on the triggering side, coupling that with some graduated increase in retentions.

I agree with you, Mr. Csiszar, that we may not want to go at 5 percent a clip, but maybe nothing the first year, to give us time to graduate to a more sophisticated increase, maybe two points the following year or something thereafter to be negotiated, but certainly an increase in retention. Absolute language of taxpayer repayment under whatever conditions we choose to construct that the secretary of the Treasury would have to administer, and then whatever language the lawyers tell us is necessary to incent the creation of voluntary pools over some time.

My idea is that we still should be in the temporary business. We ought to be providing a transition to where there is sufficient pooling voluntarily, and if you are not in it, you have no claim. I think that really incents people to think these things through, whether it is regionally, by State. It does not matter to me. I think the larger the area, the more you minimize potential risk of catastrophic loss.

Could anybody respond to why this would not make some sense over the next 5 or 6 weeks to try to get something like that agreed to? Mr. Csiszar, I will throw it to you first.

Mr. CSISZAR. I would certainly commit our organization to work with you on that. I think all of those points have merit. For instance, your suggestion that there be some regional. I can see some problems with that, where you are writing a church in New York City now, but you might not be able to write it in New York City, and you are a small company based in Wisconsin.

But I think we need to look at all the options. Nothing should be taken from the table at this point. And there may be some combination formula that we can come up with, or we may find that we can agree on an absolute ceiling, for that matter. Let's not eliminate that possibility as well.

So on all of the points, I think they are worth pursuing. I know 4 weeks, 5 weeks does not sound like much, but under the pressure cooker, we know how much time we have between now and December 31st, and the worst thing that can happen is that we have nothing in place. So I think that puts pressure on us as an industry to work with you and to come up with a solution. So I would be fully committed to that.

Chairman BAKER. Mr. Hunter, how would you jump in?

Mr. HUNTER. CFA would be happy to work with you. I am sitting here thinking about ways to address your rural issue and I am coming up with ideas, but they are half-baked at this point. But if you get the retention to a high enough level, maybe you do not need a trigger. Maybe the retention takes care of it for the small company because that is varied by size. Who knows? But we need to start thinking about those kinds of approaches.

Chairman BAKER. Thank you.

Mr. Schupp, did you want to comment?

Mr. SCHUPP. Certainly. Thank you.

You are absolutely right, Chairman. This is not 2002 anymore. We have learned over the last 3 years quite a bit about the terrorism exposure. We have the Treasury study and assessment to look at and learn from. We have even the documents that are attached to the gentleman from Marsh's testimony that provides some good analysis of the terrorism exposure by line, by geographic region.

Over this time period, I would suggest to you that this is learning that is taking place certainly within my company, within the AIA, and I have confidence within other companies over many months and years that we have now been in the terrorism insurance business. We can bring these learnings together in the short period of time, come up with a program that is more responsive to the unique characteristics of the terrorism risk as that plays out geographically and across the various lines.

Chairman BAKER. Thank you.

Mr. Heck?

Mr. HECK. Yes, I believe that realistically the trigger can be raised. However, as Ernie Csiszar mentioned, insurance companies range in size from a few million dollars in capital to many billions of dollars. So one size does not fit all companies.

I do think the important thing is the deductible and not the trigger, because if the deductible is high, that determines how much the company is going to assume and the government not pay. So I think more focus should be put on the individual company retention, rather than on the trigger. Although as I said, I think it can be higher than it is.

Chairman BAKER. There may be some combination of the two.

Mr. HECK. Possibly, yes.

Chairman BAKER. Mr. Harper and Ms. Pritzker, would you care to comment?

Mr. HARPER. Yes, sir. We are delighted and look forward to the opportunity to work with you and your staff on dealing with these five issues. Of course, the interesting point will be in the details, the incentive, for example, to participate in voluntary pools. In the State guarantee funds, the incentive is a kind of a mandatory incentive, and likewise with the Florida catastrophe funds that we were talking about, it is not entirely a voluntary fund.

So we will look forward to it, and I guess we would lean somewhat toward the view that some of these will have to be mandatory and they will have to be fairly strong incentives to make people play in the game. But we are absolutely delighted to have the opportunity to work with you in this, and we look forward to it.

Chairman BAKER. Well, unfortunately we are not really in a free market anymore when you have must-carry provisions and workers comp is mandated, there went free market. If we want to really go free market, that is a dangerous thing in this environment where you may or may not be able to get it and you do not know what the price will be. So somewhere modifying what we now have, that I am not altogether comfortable with, I think we can improve on it and make modestly better.

Ms. Pritzker?

Ms. PRITZKER. As you said, decreasing the degree of taxpayer potential liability is fine. I think the things to keep in mind are that ultimately the results lead to broad capacity and reasonable pricing for the insured so that you do not have a dramatic impact on the economy.

Chairman BAKER. The only point that I am making is that when you force the market to price the risk, the people who pay the premium are the people who are exposed to the risk. When we have a system that does not achieve that goal, the taxpayers pay it. Mr. Kanjorski and I were talking a moment ago, if there were no program extension and there was an act in January, this Congress would write checks, as we do for earthquakes or any other disastrous consequence, without the type of controls or accountability that either one of us would like to see.

So I do not want to see taxpayers generally called on in Wyoming to continually fork out money for risks that they have no relationship to. But you cannot force all of New York to pay for all of New York losses because there is not an insurance capacity to manage it, so it is a balancing act. And that requires a regimen of barriers to access to the taxpayer that makes all reasonable effort to recoup whatever is on the table. And then we come to the taxpayer and say we will give you a bridge loan, but when you are healthy we are going to get that, too.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

I feel much more comfortable that I know when I return on September 6th you all will have a bill worked out that we can vote on.

There is one other issue that I am interested in, and one of your last statements brought it to mind. We have a tendency to think that because the first terrorism strike was in New York, there is some greater burden on New York City. We are ignoring the fact of what may be the cause of terrorism. At least some enlightened people in our society would argue that it has some bearing on national policy of this country and other countries.

As a result, if there is some part of the mixture that is responsible to the national policy, then the national expense has to be well-shared. It cannot be looked at as a municipal or regional problem jus because the target is nice. I mean, maybe some people like to hit the Washington Monument, but that is not because of something that people in Washington, D.C., did or are responsible for. We have to look at it that we are a target in particular cities, I think, because of policies either we pursue or policies of other nations, but not by having a regional or municipal identification point.

I was interested, Ms. Pritzker, in your testimony when you talked about the $15 billion of delay of investment as a result of the hiatus after September 11th of not having terrorism insurance in place. I have heard that figure used many times.

I am wondering, has anybody done any studies? What would be the effect if we did not pass, at the very minimum, an extension of TRIA? What kind of a jolt to the economy would occur, say, within the first 6 months or a year?

Ms. PRITZKER. I don't know the precise economic studies, because I do not know if those figures have ever been calculated.

What I would say is that obviously the exclusions that I spoke about would come into effect immediately. Your financing markets would be severely affected, which would affect your commercial mortgage-backed securities markets and therefore all the buyers and owners and all the economics and impact on the economy of that, as well as frankly your financial institution because they are not going to lend money to those of us who create buildings if we cannot provide terrorism insurance to them.

They do not want to take, nor are they pricing in to the risk of those mortgages, the risk of a terrorist attack on the asset they are lending against. Unfortunately, I cannot give you a dollar figure.

Mr. KANJORSKI. Do you think it would be as great as the $15 billion figure?

Ms. PRITZKER. I actually think it would be greater because you are dealing with a much more robust economy than we were dealing with around 2001. There is a lot more construction going on right now. I think that construction would be severely impacted, so I think the number would probably be much larger.

Mr. KANJORSKI. Would there be a tendency for the lenders to protect their own assets and treat much of this commercial mortgage market as being in technical default because of the failure of terrorism insurance? Would there be a lot of calls?

Ms. PRITZKER. Absolutely. Today, I will give you an example. For us, we are refinancing a very large building right now. We are just in the term sheet phase, and we spent almost 2 weeks and about a page of a term sheet, not documents, discussing what would happen if there was no terrorist insurance or if TRIA is renewed in such a fashion that costs become astronomically high. The marketplace is already anticipating the various potential outcomes. They are very harsh on the people like us who are borrowing money who are insureds.

Mr. KANJORSKI. Something the chairman mentioned, too, is that we could gear this off-risk. Isn't this a problem? I ask this sort of generally to the panel. We have no experience with risk insurance. I do not really understand how you all write a premium for risk when we do not have a formula to work off of. I am sort of struck with the idea that we are convincing ourselves that there is an intelligent private market to deal with risk that isn't identifiable presently. How do you look at that?

Mr. HARPER. Mr. Kanjorski, you are exactly right. There is no way to calculate the risk properly. We do not have the frequency or severity of experience to be able to calculate and extrapolate. The Treasury report, interestingly, said well, the models are improving. Well, the models are improving, but they also noted that the three major models gave radically different projections of what would happen in a particular situation.

So here are the best models in the world, examined by, we will stipulate the best analysts in the country and coming up with radically different conclusions. So how are we supposed to come up with a single rate that is intelligent, whether it is for group life or for buildings, either one?

Mr. KANJORSKI. And isn't it the normal experience of the insurance industry to be conservative, and therefore anticipate the worst potential?

Mr. HARPER. Absolutely. In the group life business, this is a little business. It is not exciting, but we know that out of every 1,000 employees, approximately three of them will die in a year. So we go to a company and say, here it is. We know what their salaries are. You know what they are. So we will sell it to you at a minimum price that basically is the claim plus a minor administrative charge and we hope to make a few dollars on the deal.

Well, to go from that where the risk is three in 1,000, to 1,000 in 1,000 in a terrorist attack, I mean, how do you figure out what is the right premium for that? There is no way to calculate it.

Mr. HUNTER. Mr. Kanjorski, the models, I am an actuary. I have looked a the models. We had to develop models for riot reinsurance in the wake of that to price it. In the wake of Hurricane Andrew, models had to be developed because up until then the insurance companies thought they could just rely on some recent history. That turned out to be inaccurate.

The models do go through a learning curve, but these curves are relatively fast. They have learned a lot. If you study the models that are in place, not only did they learn a lot. Every insurance company is buying them for small fortunes. They believe in these models.

These models are very valuable and you can predict, not with precision because this is not a precise kind of thing. It is man-made threats, but you can predict with a great degree of comfort at maximum probable losses and annual expected losses, and you will have to improve them over time, but it is doable and it is being done.

Mr. KANJORSKI. How would you account for the fact that we do not have a very strong reinsurance industry out there?

Mr. HUNTER. Because the reinsurance industry cannot compete with a zero TRIA rate. It is not going to come in and compete with that.

Mr. KANJORSKI. So your proposition is that what the Congress did last time and what we may intend on doing in the future is actually counterproductive.

Mr. HUNTER. Absolutely. I agree with Treasury's finding that it has pushed out innovation in the private sector. But they are pricing. You do pay more in New York than you do in rural Louisiana. The pricing is variable by using the models by both geography and type of risk.

Mr. KANJORSKI. If you make the argument, though, that we are pushing the private sector out of the market by having government involvement, then you are really saying let it go. I hear the rest of this panel saying that solution is a catastrophe.

Mr. HUNTER. I am saying you can at least go as far as what Treasury has proposed and significantly increase the private sector involvement. I said earlier I do agree that nuclear, biological, chemical, there is no way that the private sector can handle risks of that magnitude, but the conventional type terrorism risks can be mostly and I think all handled by the private sector.

Mr. CSISZAR. Mr. Chairman, if I can jump in for a moment here. I am a former regulator and I am also a former CEO of a company. I can tell you that the terrorist models that we are using are primitive by comparison to the models we are using on earthquakes and weather-related incidents, for instance.

Secondly, the data available, models are as good as the data: junk in, junk out. So it is only as good as the data and there is very little data available that you can use objectively. A lot of what we are doing here on terrorism really is guesswork. Unless you know, unless you have the comfort, yes, you have the comfort of that model, perhaps, but unless you also know that there are caps to how much you are going to pay; unless you know that there is a formal program in place which limits your exposure, you are not going to write the stuff. I do not care what your model does.

An earthquake is an earthquake, by the way, but two planes hitting a tall building and a nuclear attack are very different from each other. So it is a little bit more complex, I think, than Mr. Hunter is portraying here.

Mr. KANJORSKI. Does anybody else want to comment?

Mr. HECK. I would like to say something about that also. We have done a lot of modeling for terrorism. What you arrive at are many alternative attacks. There are hundreds of attacks. They go from 2,000- to 25,000-pound truck bombs to radiological types of attacks. And when you try to decide what your exposure is, you have to just arbitrarily pick something. Typically what we pick is the smallest exposure because the others are just unmanageable. There is no way to deal with them.

So modeling is so primitive at this point, and so uncertain that it is of really very, very limited value. I think there is a lot of work being done on the models. It is true that the data has to be very accurate. When a lot of these models are done, the data isn't accurate so you have to go into it and try to improve it. But it is very, very difficult to determine exposure from the models, but it is all that we have. We have nothing else. We have no experience.

Mr. SCHUPP. Congressman, that is absolutely right. Models are used today primarily for capital allocation purposes. How much capital is an insurance company willing to lose based on an assumed scenario does not take into account probability, how often will that assumed event occur, and does not do a particularly good job of looking at or helping an insurance company manage scenarios that differ from that assumed scenario, such as two truck bomb events instead of one.

So we can tell you, and we feel we have a fair degree of confidence in telling you that if a five-ton truck bomb were detonated at a certain location in Manhattan what the resulting workers compensation and property losses would be. That can be used to determine how much capital to risk on the exposure.

Converting that into a rate, which is what is the probability, how often should we anticipate suffering that type of a loss, is not something that the models can help us with today. Unlike hurricanes where we can accumulate tens of decades, a hundred years worth of data and make predictions, terrorism is a very dynamic exposure. It is driven by a lot of factors that change rapidly over time.

Thank you.

Chairman BAKER. If no one else, Ms. Bean?

Ms. BEAN. Thank you, Mr. Chairman.

I did want to just follow up on Congressman Kanjorski's question to Ms. Pritzker regarding what if we did not extend TRIA. I know he was looking to quantify that in terms of dollars and it was hard to do that.

But could you give us some insight into as a percentage of projects in your industry that you develop and others like you develop, what could be in jeopardy, both future projects that haven't even started and those that are already in the works that may have financing now that could become in jeopardy.

Ms. PRITZKER. Let me try and just frame the picture. The real estate industry employs about 9 million people in this country, and about 70 cents of every State and local tax dollar comes from real estate. So I will try and give you a whole picture. We think it is at least 10 percent of gross domestic product comes from real estate. Obviously, construction jobs are very high-paying jobs.

So pick a percentage of that that you think is going to be hurt. I would say you would have to think about what kind of attack it is and how large the impact could be. But frankly from my standpoint, if I cannot get terrorism insurance on a project, it means I cannot finance it. If I cannot finance it, I can't afford to build it. And if I am in construction and I lose that coverage because of the exclusions that have been created in policies, I may have to stop construction whether I like it or not, whether I want to or not, I may not be able to continue funding because the banks will say we are no longer going to fund unless you can give us some kind of coverage.

Ms. BEAN. Let me ask it a little differently. Given that there are projects that are happening right now and that are being financed, and there is some uncertainty obviously as to whether this is going to be extended further, what percentage of projects do you think are already going away just because of that uncertainty?

Ms. PRITZKER. I can't answer that question. It is too difficult a question to answer. I think what is happening is that if you thought about it in terms of years, for example, since the beginning of this year there has been the creation of these exclusions, which means the marketplace is anticipating the notion that if there isn't an extension or some new kind of a bill, that they are going to take action or lack of action in terms of offering that insurance.

So you could say okay, projects that began this year will be through the end of the year and then they are going to face the issue. Projects that I am considering today, if I can get insurance, I will begin the process because I have confidence that I think we are going to enact something. The question will then be, I am taking the risk of what is the cost of getting that insurance post-January.

But the closer we get to January or the end of the year, the harder it is going to be for a person to get insurance and therefore the harder it is going to be to begin a new project. So I think that you are starting to see the marketplace, they are assuming right now that something is going to happen to continue the backstop, I believe. If that view changes, I think that is when you will begin to see projects stopping.

Ms. BEAN. Thank you.

Chairman BAKER. The gentlelady yields back her time.

I just want to express my appreciation to you. It has been a long hearing. Your perspectives have been helpful to the committee's work.

And I renew my request I made of the earlier panel. Over the course of the next several weeks, your observations and recommendations are very important in helping us come to formulate some response when the committee returns in September.

We look forward to working with you.

Our meeting stands adjourned. Thank you.

[Whereupon, at 1:50 p.m., the subcommittee was adjourned.]

APPENDIX

July 27, 2005

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
"The Future of Terrorism Insurance"
July 27, 2005

Good morning to our distinguished panel of witnesses and welcome to the Committee. We look forward to hearing your testimony today on the future of terrorism insurance.

We recall today how the economy, and specifically the insurance marketplace, was roiled by the terrorist attacks of 9/11. Reinsurance capital fled the marketplace, insurers began to exclude coverage, and large policyholders were unable to obtain enough insurance coverage for their construction and development projects.

In coordination with the leadership of President Bush, Congress acted swiftly to address the problems facing the insurance marketplace. Those problems included a drained industry surplus, insufficient diversification in geographic risk exposure, and an inability to model potential terrorist losses. Within weeks of the terrorist attacks, this Committee and the House passed legislation that in 2002 would become the Terrorism Risk Insurance Act, or TRIA. TRIA established a public-private partnership with a temporary backstop to protect against future catastrophic terrorist attacks through December 31, 2005.

TRIA was designed to be a temporary fix to address very specific goals, and it has succeeded in that role. The insurance industry's surplus has dramatically increased, the economy has greatly improved, and commercial property insurers have been able to more effectively spread and model their risk exposures. However, as documented by the recent report from the Department of the Treasury, TRIA may actually be hindering market-based solutions for terrorism insurance. As a result, it would not be prudent to merely extend the current TRIA program. The threat from terrorism will likely remain with us for years to come, and this nation needs a long-term solution that the current TRIA program simply does not and cannot provide.

We have had the Government Accountability Office perform numerous studies for the Committee evaluating domestic and foreign catastrophe programs. From their review, it is clear that the only long-term solution to ensuring market stability for catastrophic risks is by creating dedicated capital. This can be done by allowing long-term catastrophe reserves, creating an industry pool, pre-funding or post-funding losses through assessments and surcharges, tapping the equity markets, or providing a Federal subsidy.

Oxley, page two
July 27, 2005

The last option, a Federal subsidy, is often the least efficient as it crowds out and distorts the private marketplace, reducing incentives for mitigation and appropriate risk pricing. For this reason, the Treasury and the White House have indicated their opposition to an extension of TRIA in its current form. I also believe that an extension of the program without reform would be unwise and unwarranted.

Fortunately, the marketplace has not been without new thinking in the last year, and numerous parties have presented the Committee with proposed solutions for revamping TRIA to reduce the Federal subsidy, to increase private sector involvement, and to create dedicated capital sources to ensure long-term stability in the terrorism insurance marketplace.

This is an important due diligence responsibility for our Committee. Whether we simply increase the TRIA numbers as the Treasury suggests with full taxpayer payback and more streamlined coverage, or create a more comprehensive solution with greater certainty and free-market discipline, I am confident we can get it done in a timely manner and in our Committee's bipartisan tradition.

I look forward to hearing from the witnesses on our panels today, and on working together on a revamped and more effective and efficient terrorism insurance program.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE FUTURE OF TERRORISM INSURANCE

WEDNESDAY, JULY 27, 2005

Mr. Chairman, as you already know, I strongly believe that we need to extend the Terrorism Risk Insurance Act. This law is critical to protecting our economic security. I am therefore pleased that we are meeting again today to consider these important matters.

After the terrorist attacks four years ago, reinsurers curtailed the supply of terrorism reinsurance and insurers began to exclude such coverage from policies. In response, we enacted the Terrorism Risk Insurance Act to address these pressing problems.

Several studies have already determined that TRIA has worked to increase the availability of terrorism risk insurance and advance economic development projects. The Treasury Department's recent report on this law also found that the program has helped to stabilize our insurance markets. TRIA, however, will expire at the end of the year.

Like many of my colleagues, I believe that we need to move aggressively now to extend this economic stabilization law. Our failure to reach quick agreement on this important issue will likely result in less terrorism insurance, higher prices, lower policyholder take-up, and greater economic uncertainty.

Moreover, the recent terrorist attacks in England and Egypt highlight the real need for us to extend TRIA, despite the preferences of some against doing so. The occurrence of terrorism, after all, is currently unpredictable.

The vast majority of the experts testifying before us today, including regulators, insurers, brokers, and real estate investors, will also call upon us to act expeditiously in these matters in the coming months in order to prevent short-term market disruptions. We need to listen to their counsel.

In debating any plan to extend TRIA, I have long held that we ought to work to incorporate group life insurance, and I am pleased that one of our witnesses will directly address this issue today. Group life products, after all, have characteristics similar to commercial property-and-casualty insurance in that there is often an excessive concentration of risk within a small geographic area. As many of my colleagues have also regularly noted, we need to insure the people inside of the buildings and not just the buildings themselves.

Additionally, the Administration has proposed a number of reforms that it would like the Congress to adopt, should we decide to extend the program. I approach these proposals with some doubt and a little skepticism. After all, the original bill was a carefully crafted compromise that resulted from extensive negotiations.

In particular, I am especially concerned about Secretary Snow's request for "reasonable" legal reforms. This proposal for legal reform could once again stall legislative efforts, as it delayed consideration of the original law.

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Nevertheless, as legislators, we have a responsibility to give this proposal and the other reforms suggested by the Administration their due consideration. We also need to evaluate the recommendations of the experts testifying before us today during our forthcoming deliberations.

As I noted at our last hearing, Mr. Chairman, time is of the essence. We now have just four weeks remaining on the legislative calendar. As a result, we will need to have our staff work diligently over the August break in order for us to move expeditiously in September.

In closing, this is not a Democratic or Republican issue. It is, as I have regularly noted, an American issue. It is a business issue. It is an economic security issue. I therefore stand ready to work with you, Mr. Chairman, and all other interested parties on these matters in the weeks ahead.

Congressman Jim Ryun
Opening Statement
July 27, 2005

Mr. Chairman, thank you for convening this hearing. This is an issue that has been in front of the Committee for some time now. We have heard numerous hours of testimony and I believe that we have done a commendable job of helping to ensure that terrorism insurance continues to be available during these perilous times.

At the same time, we must not lose sight of the goal to return terrorism insurance to a market-based product. If we fail to establish a framework that begins to wean the industry off of Federal assistance, we will create a dependency that is impossible to reverse.

However, it would be equally irresponsible to allow TRIA to expire if the market cannot bear the product on its own. I do not believe that the industry is to this point yet, and therefore believe that this Committee should act to extend TRIA in some form.

I am hopeful that we will be able to include meaningful reforms that accomplish the goals of holding taxpayers harmless over time and ensuring the availability of this product as it returns to a market-based system.

I want to thank the witnesses for being here today. I look forward to their testimony. I hope we can move quickly towards a responsible reform and extension of TRIA. Thanks you, Mr. Chairman, I yield back.

Opening Statement
Congressman Pete Sessions (R-TX 32)
Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
July 27, 2005

"The Future of Terrorism Insurance"

Mr. Chairman, I would like to thank you for inviting me to join you today at this hearing on the future of Terrorism Insurance in the United States. I am pleased to be rejoining the Chairman and my esteemed former colleagues on the Financial Services Committee to discuss an issue that has long been of great interest to me. I would also particularly like to thank my colleague from Louisiana, Richard Baker, for scheduling this important hearing, for his strong leadership on this issue, and for his diligent oversight of all aspects of the Insurance industry and the Terrorism Risk Insurance Act (TRIA). His tireless efforts here on the Committee are appreciated, and by holding this hearing today, he will have helped Congress to take another important step toward making the United States better prepared for the potential economic effects of a terrorist attack here on American soil.

As the recent horrific attacks in London have reminded us, any modern open society remains at risk of attack by terrorists whose goal is to create fear, distress and economic dislocation in support of their radical ideology. While we have learned a great deal since the tragedy of September 11, 2001 in terms of protecting our homeland and winning the domestic front of the Global War on Terror – we are unfortunately still at risk for another potential attack here at home. And just as we continue to learn more about how to protect the physical security of American citizens and infrastructure, we continue to learn important lessons about how to protect America's economic security in the face of terror.

One important economic lesson that Congress came to realize in the days following September 11th is that the marketplace for terrorism insurance largely disappeared following the attack. The lack of terrorism coverage terminated or delayed billions of dollars in commercial property financing, threatening business operations and development, job creation and our overall economy. As a result, Members of Congress – both Republicans and Democrats – stood with the Administration to address new challenges and to provide stability and security for the American people. I believe that this program worked well for its intended purpose: to act as a temporary stopgap measure that would stabilize the post-9/11 marketplace for terrorism insurance.

Now, with the benefit of some distance and greater insight as to how the marketplace has responded to TRIA, I believe that it is appropriate to revisit this program and determine how it can be improved. Legislation that is fiscally responsible and provides taxpayer protection by narrowing federal exposure while still providing certainty and stability to the marketplace is a commendable and achievable goal, and I believe that it is one that can be reached in a timeframe that is appropriate considering the impending expiration of TRIA as we currently know it. Without the certainty provided by a Terrorism Insurance program, Congress runs the risk of dealing with the financial aftermath of a tragedy without a plan, and without significant involvement from the private sector. This is a bad policy alternative for dealing with the economic effects of such a tragedy, and Congress must do better.

As this Committee considers important policy items that are bound to have a substantial impact on availability and affordability of terrorism coverage – like changes in the deductible and trigger levels under a new federal terrorism backstop – I believe that valuable information can still be discovered by listening to participants from the insurance industry and the policyholder community like our witnesses today. By consulting with and gaining insight from those who deal daily in the marketplace, we can best determine these levels so that the new program provides a meaningful backstop yet allows a private terrorism reinsurance marketplace to develop.

Mr. Chairman, I greatly appreciate the time, effort and leadership that you and Chairman Oxley have shown on this issue, and I appreciate the opportunity to rejoin my colleagues here on the Financial Services Committee, if only for a brief period. I thank the gentleman for his gracious invitation to present my views on this issue of vital importance to America's financial stability, and I yield back the balance of my time.

Testimony of the
Property Casualty Insurers Association of America

Before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives

"The Future of Terrorism Insurance"

July 27, 2005

Ernst Csiszar
President and CEO

Testimony of Ernst Csiszar

President and CEO
Property Casualty Insurers Association of America

My name is Ernie Csiszar and I am President of the Property Casualty Insurers Association of America. PCI is a trade association representing over 1,000 property/casualty insurers that write almost 40 percent of all the insurance policies in the United States. PCI was founded on the philosophy that consumers are best served by free, fair, and well-regulated insurance markets in which a wide variety of financially healthy companies compete for business on the basis of price, product innovation and quality, and customer service.

Terrorism insurance is a national economic security issue and I would like to commend the members of this Committee for understanding the critical role of the federal government in development of a long-term solution to this problem. I am here today to give you our views of this issue. I am also here to commit to you that PCI will work with you to explore all aspects of this problem and all possible solutions in order find a program that will protect our nation's economic security and our policyholders.

The Importance of a Federal Role in Terrorism Insurance

Our members believe in the power of free markets and support competition-driven solutions to public policy problems. We think consumers are best served, wherever possible, by markets that are free, fair, and well regulated. That being said, there are some instances – terrorism insurance clearly being one of them – where we are all better served by some limited federal intervention in the market.

This fundamental point was underscored earlier this year when Federal Reserve Board Chairman Alan Greenspan noted, "There are instances in which markets do not or cannot work, and....I have not been persuaded that a private market for terrorism insurance works terribly well." This view was reinforced last week when Chairman Greenspan told this committee that "...so long as we have terrorism that has the capability of a very substantial scope of damage, there is no way you can expect [the] private insurance system to handle that."

We all know that the ongoing threat of a terrorist attack on our nation and our economy is real. CIA Director Porter Goss has repeatedly told Congress that an attack on our nation is "only a matter of time" and that our enemies continue searching for ways to make future attacks much more devastating than September 11, including the use of nuclear, biological, chemical, or radiological weapons.

We believe our nation must fight terrorism on all fronts, using military action, homeland security measures, and programs that protect our economic security. We believe that a public/private partnership, coupling the power and security of the Federal government with the innovation and agility of private markets, is the best way to protect our economy.

The Impact of TRIA

I want to offer several comments on the Terrorism Risk Insurance Act of 2002. TRIA was adopted in November 2002, more than a year after the September 11 attacks. It was debated significantly in the House and the Senate and emerged from long and thoughtful consideration of the issues involved, observation of the response of private markets to terrorism risk, and evaluation of alternative approaches. It was not done in haste and reflects the well-considered wisdom of the Congress and the Administration. We believe it was a tremendous achievement by the 107th Congress.

TRIA provides essential support and confidence to private insurance markets. The program has created a degree of certainty about the maximum losses that any individual company or the entire insurance industry could suffer and, in doing so, has helped foster what market there is for terrorism insurance. According to the latest statistics, roughly 44 percent of all business insurance consumers buy terrorism coverage. Some have feared that TRIA would "crowd out" the development of a meaningful private market for terrorism reinsurance. On the contrary, we believe it gave the support needed to allow such a market to begin to develop. Without TRIA, we don't believe we would have seen the limited development that has occurred.

Our members write insurance policies for individuals and businesses in every state and virtually every community in our nation. Their commercial insurance policyholders – real estate developers, builders, manufacturers, retail stores, malls, apartment complexes, churches, mosques and synagogues, schools, and universities - have benefited enormously from TRIA. They know the threat of a terrorist attack is real and many have made a deliberate and considered decision to protect themselves from the economic risks of future attacks.

As you know, TRIA will expire at the end of this year. Given the many benefits it has provided, I am here to tell you that all of us – Members of Congress, insurers, and policyholders – must act now to develop a long-term solution to the problem of insuring terrorism risk. I commit to you today the resources of PCI to work with members of Congress and the business community to develop an effective, market-driven system that establishes a long-term, public/private partnership to address the issue of terrorism insurance once and for all.

The Unique Challenge of Underwriting Terrorism Insurance

Our members are in the business of assessing, pricing, and underwriting risk. They work closely with their policyholders to reduce their exposure to all types of loss, including terrorism. Insurers have always risen to the challenge of underwriting and paying for catastrophic losses. Our industry paid nearly $33 billion in claims from the September 11 attacks, not to mention the enormous payments we have continued to make, as always, from "normal" natural disasters such as hurricanes and earthquakes.

When we tell you that terrorism risk is different from other catastrophes, we do so for several reasons. The differences arise mostly from differences in severity and predictability. The size of the potential losses from a terrorist attack dwarfs the financial resources of the insurance industry. The September 11 attack was by far the largest insured loss in U.S. history. The amount of insurance industry capital devoted to insuring the lines of business most likely to be affected by terrorist attacks (commercial property, workers compensation, etc.) amounts today to approximately $148 billion or 40 percent of the total capital of the industry. Since September 11, 2001, insurers and catastrophe modeling experts have modeled many potential terrorist attack scenarios – these experiments convince us that there are many potential attacks, especially those involving the use of nuclear, biological, chemical, or radiological weapons that are well beyond the financial capacity of our industry to withstand. Continuing statements by Department of Homeland Security officials underscore our concerns.

Second, this risk is impossible for insurers to assess and price based on our current knowledge. Weather-related catastrophes are much more predictable. We have years of experience with sophisticated models that tell us not only where these losses are likely to occur, but on average how large they might be and how often they are likely to happen. We know none of this about terrorism. Without a distribution of either the ultimate cost or the probability of loss, we don't have a method to develop the appropriate charge for the coverage nor do we know what losses to expect.

These problems are the reasons that a vibrant, substantial, and healthy private market for terrorism reinsurance has not emerged since September 11. While we can agree with many of the points made in the recent Department of the Treasury report, there appears to be a belief in some quarters that allowing TRIA to expire with nothing in its place will automatically spur the development of such a private market for terrorism risk. We see no reason to expect that will happen without market-based reforms, coupled with a public/private partnership.

Limits on the Private Sector Role

We have spoken above of our support for the greater use of private sector responses to this risk. At the same time, it is critical that policymakers also recognize the limits of the private sector response and why a federal role is essential. As already noted, insurers face significant problems underwriting this risk because of the enormous potential losses and because we don't know size or frequency distributions for the risk.

In addition, private markets require that buyers and sellers are able to determine for themselves whether a product will be offered and under what terms and conditions. If there is to be a greater private role in solving the terrorism insurance problem, there must also be federal support for giving insurers and insurance markets more freedom to negotiate these terms and conditions. Let me offer some examples of the problems we face:

- In certain states, insurers writing commercial property insurance are still required to cover losses from a "fire following" a terrorist attack, due to restrictions in 1940s-era laws enacted for a very different world. This is true even if insurers and policyholders would prefer to alter coverage.
- State regulators in three key states (New York, Florida and Georgia) continue to refuse to allow insurers to exclude or limit coverage for terrorist attacks after the expiration of TRIA this year. This refusal continues even if the insurer and the policyholder both might want the flexibility of a free market.
- TRIA itself provides state oversight and control of the rates insurers can charge for terrorism coverage, with the result that insurers cannot truly experiment with the

appropriate price for this coverage and, if they try, must fear potential future requirements that they return supposedly "excessive" rates.

- No state allows an insurer writing workers compensation to exclude or limit coverage for losses caused by terrorism. The only way workers compensation insurers can avoid this risk is to stop writing certain insureds – i.e., to walk away from policies they think may pose excessive risk. However, even when they do so, they face exposure in many states to losses from those same policies through mandatory residual market pools and guaranty funds.

We understand the desire for consumer protection behind many of these requirements, but we must emphasize that it is inconsistent to urge a more robust private sector response without giving the private sector the tools it must have to build that response.

Guiding Principles for a Long Term Solution to the Terrorism Insurance Problem

As you consider how to proceed, we believe there are several important principles for you to consider when evaluating long term solutions to the terrorism insurance problem:

- Terrorism is the most significant risk facing our nation's economic security today. It is critical that it be addressed. It requires uniform protection and a nation-wide response (not state by state). The fight against terrorism is a long-term battle and we should now build on the steps initially taken by Congress to provide a long-term solution.

- The insurance industry does not have the financial capacity to bear the total risk of terrorism losses due to the nature of the exposure and the scale of the risk. Addressing this risk to our nation's economic security requires a partnership between the private sector (and its infrastructure) and the Federal government. This partnership must protect the public, the nation's economy and insurers' ability to meet their many obligations to their policyholders.

- A long-term solution should minimize cross-subsidies by line of insurance and by insurer, maximize incentives for sound economic underwriting and pricing, and cover exposures most seriously threatened by terrorism. There should be an equitable distribution of costs based on geographical location and risk of loss, including potential losses to life, property, agriculture, and critical economic infrastructure.

- The program should cover losses from both domestic and foreign terrorism events.

- A long-term solution should encompass group life coverages and address terrorism exposure for homeowners and automobile insurance arising principally from potential "weapons of mass destruction" attacks, given the catastrophic potential losses it poses for our industry and for the American public.

- The program should be consumer friendly and implementation costs should be kept reasonable by following standard industry business practices.

Components of an Alternative Solution

I want to emphasize the need for us to develop a long-term solution to the terrorism insurance problem. PCI recognizes the goal of increasing the reliance on the private insurance market and reducing the role of the federal government over time. We believe that all reasonable ideas should be considered and, to that end, I'd like to offer several thoughts on such a design.

Greater Reliance on Private Insurance Markets

In order for the private insurance market to assume a greater relative share of the risk insurers need greater freedom to respond and innovate, the ability to share losses and seek capitol in the marketplace, and encourage build-up of catastrophe reserves.

Market Reform

In order to assume a larger role, insurance companies need to be able to experiment and innovate, as well as respond quickly to opportunities and developments. Unfortunately, a patchwork of state laws and regulations, enacted or adopted before Sept. 11, impose counterproductive barriers and obstacles. Recognizing the national scope of the risk, PCI urges Congress to modernize and streamline the handling and treatment of insurance relative to terrorism. Specifically, we believe a long-term solution should:

- Provide greater rating freedom to encourage the market to respond by allowing insurers to charge an appropriate price for the degree of risk assumed.
- Repeal or scale-back antiquated Standard Fire Policy (SFP) laws. The SFP was created in 1943, before the detonation of the first atomic bomb. This area cries-out for modernization and a more level playing field across the country.
- Clarify that no state can unilaterally mandate terrorism coverage in the absence of the federal Program.

Loss Sharing and Capital Creation

As federal involvement diminishes, private insurers need the ability to safely and predictably share risks and spread losses on a limited basis among themselves, over and above individual company retention levels. To facilitate loss sharing, insurers need the ability to band-together and fill the gap or layer between individual company exposures and the federal backstop. This mechanism is analogous to many state catastrophe funds or pools already in existence and is essential as the level of the federal backstop diminishes.

The creation of a reinsurance facility would provide participating insurers, particularly smaller insurers, the ability and flexibility to "buy-down" to lower retention levels, with the cost and terms of doing so determined by the governing board of the facility.

We envision mostly "post-event" funding, through the use of revenue bonds and policyholder assessments, although there would be a "pre-event" component as well, to cover start-up and administrative costs. The facility would accumulate reserves on a tax-free basis and have the ability to purchase private reinsurance.

In order to attract capital from the private market (not just insurers), we also believe a facility should be authorized to issue tax-free "pre-event" bonds. The facility could be the reinsurance facility noted above or another entity created for this more limited purpose, but would serve to attract private market capital.

Reserve Accumulation

In order to encourage private insurers to voluntarily experiment with accepting increased risk in the free market environment, we believe the government should provide them with the ability to voluntarily accumulate tax-free reserves on a pre-event basis, and to retain and manage such reserves themselves.

Current tax law permits insurance companies to establish tax-deferred reserves only against losses that have already occurred. The establishment of tax-deferred reserves for future catastrophic losses from terrorism events would incentivize U.S.-based property and casualty insurers to build capacity and properly manage catastrophic loss exposures, and help protect the insurance market from insolvencies if a terrorist event occurs.

Based on a concept similar to individual IRA accounts, funds would be set aside and held in segregated accounts on a tax-deferred basis and would be included in taxable income in the year the funds are withdrawn. There is a long history of bipartisan support for a similar concept for catastrophic losses from natural disasters.

More Limited Federal Role

Recent events in London serve to remind us that the threat of terrorism is real. Treasury Secretary John Snow and Federal Reserve Chairman Greenspan have acknowledged the need for a continuing and significant federal role in terrorism insurance. However, PCI recognizes that this role also needs to evolve in the next phase of our public/private partnership.

As we have noted, given a free market, the private insurance market is willing to assume a larger share of the risk. Nevertheless, a long-term continuing federal role is integral to encouraging this evolution. We support extension of the federal program for an additional ten years and reducing federal financial involvement over time via gradual increases in the industry aggregate and individual company retention levels. These reforms should be coupled with market-based reform.

PCI recognizes your role and obligation as stewards of the taxpayers' money. We pledge to work with you to balance this with the imperative need to protect the economy and avoid even larger potential outlays in the future.

Covered Lines

The threat of terrorism is not limited to commercial property interests. We commend the Treasury Secretary for acknowledging the need for extending a federal role relative to commercial property and workers compensation insurance. Unfortunately, the suggestion has also been made that general liability and commercial automobile insurance be dropped from the TRIA program. We respectfully suggest that such a move would be harmful to commercial insurance consumers, as well as the general public, for a variety of reasons.

Along with property and workers compensation, general liability and commercial automobile coverages are often written as part of a discounted "package" or "program" for a variety of large, mid-sized, and small businesses. Eliminating general liability and commercial auto from the program will make it harder for the most vulnerable employers to obtain affordable coverage tailored to their needs. As an example, many of our hospitals will be on the front line in the aftermath of the next terrorist event. Our medical and pharmaceutical research facilities serve a key role as well, particularly in the case of a biological or chemical event. These facilities need a broader array of affordable commercial coverages to remain open and viable.

Second, as with workers compensation, potential losses under group life insurance can be enormous, given the concentration of risk in some workplaces. Group life insurance products provide valuable protection to more than 150 million citizens and in many instances is their only life insurance. As we protect our nation's assets we must not neglect protection of the economic security of its workers. PCI, therefore, strongly supports the addition of group life coverage to the program.

Third, until now, the debate over the elements of a long-term program have been focused on the needs of businesses and commercial property owners. However, many experts predict that the next mass terrorism attack could very well be a nuclear, biological, chemical or radiological (NBCR) event. By their nature, such events have the potential to destroy or neutralize not only businesses and commercial ventures, but also many homes and automobiles. Whole neighborhoods could be destroyed or rendered uninhabitable, and both local and national economies severely harmed, yet TRIA does not address this scenario. PCI suggests a thorough study of the potential losses faced by individual consumers and how the public/private partnership can best address the matter, with recommendations for any needed legislation.

Conclusions

Our members again commend you and your colleagues for addressing this issue and for offering ideas for a solution. We believe terrorism is the most significant threat today to America's economic security and we applaud your efforts to address this very serious problem.

We believe TRIA represents the considered will of the Congress and has worked well at very low cost to the government. It has been a success and has promoted the ongoing development of private markets for terrorism coverage. We understand and support the desire of many to encourage new private sector responses and an increased role for private solutions, we would be remiss if we did not tell you that we believe the current system works well.

Finally, we want you to know that our members are committed to addressing this issue. We have been working closely and diligently with them, and will continue to do so, to identify and formulate potential solutions to this problem. We look forward to continuing to work with you and your colleagues as we work toward a long-term, market-based solution.

Testimony of
Edwin L. Harper

SVP, Assurant Inc.
Chairman, Group Life Coalition

Before the
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises

Committee on Financial Services
United States House of Representatives

July 27, 2005

Good morning Chairman Baker, Ranking Member Kanjorski and members of the subcommittee. I am Ed Harper, Senior Vice President of The Assurant Group, a leading health and employee benefits company. I am here in my capacity as Chairman of the Group Life Coalition. The Coalition is composed of insurance companies which provide the protection of group life insurance, both as a stand-alone product and as part of an employee benefits package.

In the public sector, I have served on the White House staffs of two presidents and was an original member of the White House Domestic Council. I have also served in the Office of Management and Budget under Democrat and Republican Administrations. I also serve as the Chairman of the American Council of Life Insurers' (ACLI) Committee on group life insurance. ACLI shares the views that I will express here today. In addition, the inclusion of group life in any mechanism going forward is commsurate with the views of the Financial Services Roundtable, which adopted a policy in 2001 supporting the inclusion of group life as a covered line under TRIA.

I want to thank you for having this hearing on the successor to the Terrorism Risk Insurance Act (TRIA) and I commend you, Chairman Oxley, Ranking Members Frank and Kanjorski for the previous bipartisan effort in 2002 that resulted in the federal TRIA program. This committee and the Administration acted to protect the economy from destabilizing terrorist attacks and we look forward to working with you to continue the federal government's role in this area.

Group life insurance represents approximately 42 percent of the U.S. life insurance market and is the proud provider of financial security to 160 million Americans. In many cases, it is the only life insurance most policyholders have to provide protection to their families. As such, the fate of group life insurance and TRIA is no trivial concern.

We strongly urge Congress to expressly include group life in any market-based successor to the TRIA program. Quite simply, Congress needs to insure the people inside the buildings too.

The Coalition joins with other insurance and financial services groups, building industries and labor unions, insurance policyholders and all state insurance commissioners in strongly urging the creation of a market-based successor to the TRIA program. The TRIA legislation produced a public-private partnership that has created stability in certain high-risk insurance markets that could not otherwise cover properties for catastrophic terrorist events.

As the current law is set to expire on December 31, 2005, we want to work with the Financial Services Committee to craft a viable solution to the terrorism insurance problem. Few people in government or private industry disagree that a successor to TRIA is necessary; the question is what the program should look like moving forward. In our view, that solution should reflect that appropriate balance of government and private industry involvement that will help to ensure economic stability in the event of another large scale terrorist attack.

Congress should include group life insurance in any market-based successor to the TRIA program going forward for many reasons. Chief of among these reasons is to protect a critical employee benefit that provides financial security for millions of Americans in the event of a devastating terrorist attack. Group life insurance is similar to workers compensation insurance, a line that is currently covered under TRIA. Like workers compensation insurance, group life is a basic benefit to workers and it is coverage for which there are no exclusions allowed under state insurance law. The high level of risk concentration at the workplace coupled with low premiums means that group life is particularly susceptible to large scale losses from catastrophic events such as terrorist attacks.

Furthermore, the means by which group life insurers had protected themselves in the past - the group life catastrophe reinsurance market - has reduced dramatically since 9/11 and has not returned in a meaningful way. In the event of another massive terrorist attack with a multitude of casualties, group life insurers could face significant losses, solvency crises and claims payment problems. The potential for these types of effects on the group life market is an acute concern particularly for high-risk jobs, such as first responders and health care workers. This is a concern not only to state insurance commissioners, but should also be of note to U.S. public health officials.

As such, the Group Life Coalition firmly supports a continuing federal role in helping to mitigate the economic effects of a catastrophic terrorist attack. Specifically, we urge members of the House Financial Services Committee to create a new successor to TRIA that includes group life insurance as a covered line in the program.

It is our belief that by including group life insurance in a successor program to TRIA, the market for group life catastrophe reinsurance will actually return as reinsurers can feel confident that they will not face immediate insolvency risks from massive terrorist attacks that cause thousands of casualties and billions of dollars worth of property damage. We are supported in this viewpoint by the Treasury Department's recent Report to Congress on the TRIA program: the review concluded that TRIA had served its purpose and the terrorism insurance market for property and casualty insurers was benefiting from the unique private-public partnership created by TRIA.

WHAT IS GROUP LIFE INSURANCE?

One hundred-and-sixty million working Americans hold group life insurance policies. For many, this employer-sponsored benefit represents their only source of life insurance coverage because it is provided at little or no cost to them and is available without underwriting limitations. Everyone from survivors of cancer to the healthiest employees qualify for some coverage because the underwriting for such coverage is based on mortality tables provided by state insurance departments and the theory of large numbers used in insurance underwriting. The typical group life policy provides coverage in the amount of one and up to two times a worker's annual salary and most employees have come to expect as a part of their total compensation packages. At the end of 2003, the average face amount of a group life policy was $44,500 per certificate. In this way, group life insurance functions as a privately funded Social Security death benefit for middle-income Americans.

The pricing of group life insurance is not regulated as the market is so competitive that it is not uncommon for carriers to lose policies to other competitors on pennies on the dollar.

The terms of the coverage are also not particularly regulated with one key exception: An insurer operating in the United States must pay out the coverage for ANY cause of death. There is no reason an insurer can not pay a legitimate claim upon proof of death. There are no "time of war" exclusions or exclusions for deaths caused by nuclear, chemical, biological or radiological incidents. If there is a death of a covered individual, group life insurers pay the claim. In fact, even in instances where there isn't a confirmable death – a sad facet of the 9/11 attacks – insurers created new ways to meet their obligations in a timely and sensitive manner.

REINSURANCE IS WHAT MAKES GROUP LIFE INSURANCE WORK

From the insurers' perspective, reinsurance is what allows carriers to provide coverage to employees at a relatively low cost to the employer. Carriers assume that in any given year, insurers will pay claims on a small number of employees for whatever reason (generally 3 out of 1,000 employees). In most instances where more than a small number of employees die in a particular year, general reinsurance that is capped and limited as well as insurer reserves allow group life insurers to meet their obligations.

In a catastrophic event, such as a terrorist attack or an industrial accident where there may be wide-scale death and destruction, group life insurers - before 9/11- purchased catastrophe reinsurance as a way to further hedge the concentration risks associated with many covered employees generally working in the same location. Since 9/11, numerous studies and the Treasury Department have confirmed that the once-viable group life catastrophe reinsurance marketplace barely exists in any meaningful way that would cover insurers in a massive terrorist attack with many deaths.

STUDIES CONFIRM NO VIABLE GROUP LIFE CATASTROPHE REINSURANCE MARKET

Milliman Inc., a leading actuarial consulting firm with extensive experience in helping insurers and reinsurers address all types of risk, has conducted three separate studies on the state of the group life catastrophe reinsurance market. The first study was conducted one year after the September 11 attacks and a less formal one was performed mid-year 2004. The results of both of those studies indicated a significant decline after September 11, 2001 in the number of group life insurers that have catastrophe reinsurance, along with a dramatic increase in deductibles and cost.

A June, 2005 survey also conducted by Milliman, Inc. (*"Recent Trends In Catastrophe Reinsurance For Group Life Insurance"*) was the most comprehensive portrait of the group life catastrophe reinsurance market in that it solicited information from insurers regarding how their catastrophe reinsurance coverage had evolved from a pre-9/11 marketplace to the current situation with extremely limited catastrophe reinsurance. Information obtained included specific dollar amounts in terms of differing coverage amounts over three different time periods (one of them being pre-9/11) and any new information on what companies had been doing to protect themselves from catastrophe risk in an age of terrorism. Additional data on underwriting, pricing, or benefits changes among the group life insurers was also surveyed.

The key findings from the survey of twenty-five companies who offer group life insurance and which represent over 70% of the group life insurance market were:

- Fewer than half of those surveyed currently had catastrophe reinsurance.
- From 9/11/2001 to 12/31/2002, the average amount of catastrophe reinsurance decreased 50-60% while deductibles increased 10-15 times and prices increased 500 -700%.
- From 12/31/2002 to 6/1/2005, despite modest increases in coverage amounts and decreases in costs, coverage was still only 37% of prior levels and cost was over six times higher.
- The use of exclusions for terrorism due to nuclear, biological, and chemical events has increased significantly since 9/11/2001. Prior to that date, only one company of those surveyed had an agreement with such exclusion. Today, nearly half of all catastrophe reinsurance agreements have some such exclusions.
- In the absence of meaningful catastrophe reinsurance, companies have taken a variety of other actions, including examining new pooling arrangements, making changes to traditional reinsurance programs, increasing premium rates, and restricting availability to certain industries and locations.

In addition to privately-funded studies, the Treasury Department's July 2005 Report to Congress on the TRIA program notes "...there was a general lack of catastrophic reinsurance for insurance companies that offer group life coverage..."

NO CATASTROPHE REINSURANCE LEAVES INSURERS WITH FEW OPTIONS

Faced with the reality of extremely limited or no catastrophe reinsurance protections, group life insurers are faced with few options to address concentration risks in an age of terrorist attacks. The limited menu of immediate options to address concentration risks include:

1. **Drastically raise prices of group life insurance.** An insurer could decide to raise their prices for group life insurance to boost both immediate profits and reserves in an effort to meet future unanticipated and incalculable risks associated with terrorist attacks.

Why this is not a viable option: Raising the prices of the premiums of group life insurance would not have the immediate intended effect of raising profits or reserves to meet future costs because that insurer would no longer be in business. Again, the group life insurance market is one where policies are bought from the lowest bidder, usually as part of an employee benefits package: raising premiums to cover numerous potential claims due to a massive terrorist attack will price an insurer out of the group life market or the employee benefits market.

If smaller insurers raise their prices, only the very largest insurers could remain in business because they are large enough or diversified enough to "self re-insure." As competition decreases due to the exiting of smaller insurers, market dynamics dictate that the availability of group life insurance will become limited or restricted to select employees and prices will increase. Coincidentally, the Treasury Department's Report to Congress confirms this reality when it stated that "the immediate effect of the removal of TRIA ...is likely to be less terrorism insurance written by insurers, higher prices and lower policy holder take-up."

Moreover, there is no accurate or agreed-upon way for an insurer or a group of insurers to raise prices or instill a "terrorism risk" cost into pricing group life policies. As terrorism on U.S. soil is a recent phenomenon, it is virtually impossible to quantify its risk. Studies indicate that terrorism is both multifaceted and dependent upon factors that are beyond our experience. Not only insurers, but the U.S. government is grappling with the absence of data and how to handle this new risk.

Additionally, the profit margins in selling group life insurance are too low to allow shareholders to ever recover from a significant catastrophic loss. Prior to 9/11 catastrophic reinsurance was the mechanism that allowed companies to mitigate this risk and this reinsurance is currently either not available or is very limited, very costly and excludes acts of terrorism in most cases.

2. **Exit the group life insurance marketplace.** An insurer could decide that providing group life insurance as part of the employee benefits packages entails too great a solvency risk and thus no longer sell group life insurance. In effect, this insurer may exit the group life market but not the employee benefits marketplace all together.

   Why this is not a viable option: For an insurer, giving up a specific market can be difficult and final—posing significant regulatory, financial, and public relations issues. In some cases, companies have sold products that cannot be cancelled (unless premiums are not paid or the group's participation falls below an acceptable level). Also, group life insurance coverage constitutes a portion of a typical employee benefit package— which normally includes group medical, group disability, and pension benefits. If a group life writer were to stop offering life insurance coverage, that carrier would be at a competitive disadvantage for other products in the package. Such barriers to exiting the market may be why companies are still offering group life insurance.

3. **Purchase remaining available catastrophe reinsurance coverage**. An insurer could decide to buy currently available catastrophe reinsurance - despite significant increases in cost for limited and capped catastrophe reinsurance and loaded with multiple exclusions.

   Why this is not a viable option: Purchasing currently available catastrophe reinsurance as detailed in the June 2005 Milliman Inc. survey shows that prices cost over six times their 9/11 levels while only offering 37% of the pre-9/11 coverage. Moreover, many more reinsurers are writing exclusions in their agreements with insurers for terrorism and nuclear, biological and chemical events. In essence, the available coverage does not begin to address the potential risk.

4. **"Fly naked" and proceed as if a catastrophic terrorist attack will never occur**. An insurer could continue to provide group life insurance in an age of terrorist attacks with no or highly defined and limited catastrophe reinsurance.

   Why this is not a viable option: As the Treasury Department Report to Congress has noted "Group life insurance companies have stayed with their customers and continued to make group life insurance available on much the same terms as before September 11th." Most fortunately, the United States has not experienced a terrorist attack on scale or larger than the 9/11 attacks. Yet, as recent world events attest to, the problem of calculated terrorist attacks intending to inflict mass casualties remains a persistent threat in today's world.

   Ultimately, an insurer needs to consider all risks, even the unthinkable catastrophic event, and weigh such potentialities against its current business model. However, the limited capacity and reserves of the group life industry as well as the absence of a viable catastrophe reinsurance market, coupled with the inherent responsibility of the federal government to prevent terrorism through federal policy, naturally and appropriately calls for a federal public-private TRIA-like solution for group life insurance. Without reinsurance, the companies remaining in these tenuous markets run the risk of being worthless shells of companies that cannot keep their promises to their policyholders.

CONGRESS HAS ALREADY APPROVED GROUP LIFE INCLUSION

Congress approved the inclusion of group life into the original TRIA program that was created in 2002. As drafted, TRIA provided the Treasury Department with broad authority to study and decide on "an expedited basis" whether "adequate and affordable" catastrophe reinsurance was available to group life insurers and to what extent the threat of terrorism was reducing the availability of group life coverage of consumers in the United States. The Treasury Department found that even though group life catastrophe reinsurance coverage had receded, primary group life insurance still existed. Due to this finding, the Treasury Department excluded group life insurance from TRIA.

Since that time, lawmakers in both the House and Senate have introduced legislation that would extend the TRIA program as well as include group life insurance as a covered line. In the 108th Congress, the House approved legislation sponsored by Chairman Baker and Representatives Eric Cantor (R-VA), Sue Kelly (R-NY) and Pete Sessions (R-TX), that included group life insurance as part of the federal TRIA program.

Notably, the state insurance commissioners - who have a dual responsibility to protect consumers by making sure companies make good on their claims as well as ensuring the solvency of such companies - have repeatedly urged Congress to extend TRIA and include group life. Most recently, the National Association of Insurance Commissioners (NAIC) unanimously approved a resolution during the 2005 NAIC summer meeting urging Congress to renew the TRIA program with group life insurance.

WHY CONGRESS SHOULD INCLUDE GROUP LIFE

As Congress moves to address and improve upon the federal TRIA program with a market-based successor, the Coalition believes that group life insurance should be included for the following reasons:

1. **Group life inclusion addresses a potential solvency crisis in the group life insurance market and provides the private market with a role in helping people recover financially from a massive terrorist attack.** Notwithstanding the recession of the catastrophe reinsurance market, the apparent stability of the primary group life insurance market is an illusion in at-risk sectors. If group life insurance was excluded from a successor to the TRIA program going forward, many group life insurance companies would exit these at-risk markets and make a business decision not to insure at-risk workers.

   Worse, some insurers may choose to stay in these markets without catastrophic reinsurance to cover their exposure and create a ticking time-bomb solvency concern. A collection of group life insurers providing a meaningless veneer of "protection" will be of little comfort to victims seeking death benefits from insolvent companies. One only needs to remember the disaster of the Victims Compensation Fund from the 9/11 attacks to see a need to create an orderly way to manage financial loss for victims of terrorist attacks.

2. **The Federal government naturally has a role in addressing terrorism risk through its policy and actions.** Federal lawmakers have a responsibility to proactively take steps to insure the financial security of the people inside the buildings prior to a catastrophic terrorist attack as well as ensure that insurance companies are solvent; that the insurance market remains competitive; and that insurers meet their obligations in the times when such protection is most needed.

3. **Group life insurance has a similar risk concentration profile to worker's compensation insurance which is currently included in the TRIA program.** Worker compensation was included in the original TRIA program due to its concentration of risk and no meaningful reinsurance coverage. Similarly, group life insurance is also offered at the workplace, has no exclusions for acts of war or nuclear, chemical, biological or radiological attacks. Moreover, death benefits on group life policies are to be paid in total immediately and at significantly higher amounts of payouts than typical workers compensation payments. According to the Treasury report, the inclusion of workers compensation in TRIA has improved the private reinsurance market. Conversely, without TRIA's protection, the private group life insurance reinsurance market has not reappeared because the exposure and risk that reinsurers face is unknown.

4. **The 9/11 attacks showed how vital catastrophe reinsurance is to the group life market.** On 9/11/2001, CNA Financial had a 3% national share of the group life insurance market, but had a 35% share of the market for companies in the World Trade Center. As the group life insurer for the brokerage firm Cantor Fitzgerald, which lost 658 employees in the attack, as well as other large tenants, CNA had an exposure of $175 million. All but about $15 million of the claims were covered by reinsurance. Post 9/11, the market for such reinsurance has been reduced dramatically and the method to mitigate the risk from this type of attack has vanished. CNA Financial was able to meets its obligations after the 9/11 attacks because of reinsurance that is now no longer widely available or affordable.

BOTTOM LINE

Including group life in a market-based successor to TRIA will preserve a fiercely competitive market for consumers; provide a critical death benefit to middle class workers in high-risk professions and/or areas; and establish a high end level of federal liquidity that will not be accessed by a group life insurance company except in the case of ten of thousands of lost lives. Lastly, group life's inclusion will create an orderly mechanism to quickly provide a death benefit to victims and the Treasury will ultimately recoup money for these payments.

A NEXT GENERATION OF TRIA

The committee has asked for our views on the future of a successor to the TRIA program and what policy principles should guide Congress. We believe the following four key principles should be considered:

Create Long Term Solution: Congress should take this opportunity to create a long term solution to a long term threat. Historically, as has been the case in times of war and particularly WWII, the federal government has made most legislation permanent or set to expire after a war's end. Just recently, we have seen the House make the key provisions of the Patriot Act permanent in recognition of the long term danger of terrorism.

Unfortunately, the risk of terrorism and our nations struggle with the specter of terrorist attacks is not likely to end soon. As such, it is only common sense that the Congress should put a system in place to provide long term stability to the economy in the wake of a terrorist attack. All other governmental approaches to the terror threat are constructed along these lines of long term solutions to dangerous problems. Providing economic stability in the face of terrorist attacks should be no different. Terrorist attacks remain the single biggest threat to our economy. Surely this reality deserves a well thought-out, long term solution that creates that protects the economy, the individual and taxpayers as a whole.

The risk facing group life insurance from terrorist events can be viewed as three layers. The first layer is the potential losses that can be absorbed by the direct writers of the coverage. The size of an event that could be handled by this first layer is hard to quantify since it would depend heavily on the size of the company and how concentrated the losses were for any particular company.

The second layer is the losses that could be absorbed by spreading the losses as widely as possible over the entire group life industry. Prior to 9/11 the mechanism for creating this spreading of loss was reinsurance. However, since 9/11 investors have been very reluctant to put their capital at risk and as a result there is very little reinsurance available to cover terrorist related losses. The amount of losses that can be handled by this second layer has decreased dramatically since 9/11. Any governmental effort should strive to materially increase the amount of losses that can be handled within this second layer.

Broadly speaking the way to create a much larger second layer is to have a government mandated pooling of risk. The government does not bear the risk or the costs. Rather, it creates a new structure that materially increases the capacity of the industry to bear the risk. A government mandated pooling structure would greatly increase the amount of risk that could be handled in this second layer. The costs and risks associated with this mandatory pooling would be largely borne by the group life insurers. It is estimated that with the right structure a terrorist event that produced 100,000 deaths could be handled without any government funds.

Finally, the third layer would require government funds to be directly involved. As mentioned above this layer would exist only if there were an event that was so large that there would be roughly 100,000 or more deaths.

Specifically, a new federally-administered pooling fund might be created in order to make available additional risk-bearing capital via free-markets. Should an event exhaust the retention of insurers and the capacity of the capital markets, the federal government would provide the necessary liquidity to handle the event through a financing mechanism. All insurance companies would face significant trigger and retention levels prior to accessing the fund. Once an event triggered payouts from the structure, re-payment (with market-based interest) would be accomplished via assessments against insurance company premiums with the companies receiving the most benefits being assessed first. Participation would be mandatory for all companies writing applicable business.

Balance the Burden to Make Program Workable: Any long-term solution should require that the industry "pay to play" and have the appropriate level of shared burden with the federal government. However, any program must also recognize that the industry only has a limited capacity to self- protect from high end terrorist attacks and remain solvent and stable for the next attack or the next claim.

Provide for Orderly Transition: The creation of a long term solution may be achievable yet this year but the implementation will take time to get right. We support any extension of TRIA with appropriate reforms to the extent necessary as a transition to a more comprehensive approach or as an alternative to a comprehensive, long-term approach if the latter is not politically viable to enact this year. Our view would be to extend the current program for a short period of time while the Treasury enacts regulations to guide the new program. As the new program will almost surely have a higher threshold for government involvement, Congress and the short term extension should use the transition phase to orient the market towards higher trigger and retention levels while taking care to keep the program viable as a backstop.

Specifically, we would support extending TRIA with group life for 2 years with upwardly adjusted triggers, retention levels and co-shares to provide catastrophic protection for the policyholders and the economy and to protect the taxpayer. As the new program is ready to be engaged and begin functioning, the "old" TRIA model should sunset.

Protect the Financial Security of People as well as Buildings: Any program must include group life as a covered line of insurance to make sure that the financial security of the people in the buildings is covered too. Bricks and mortar are of no greater value than the financial security, the protection and the dreams of the people inside those buildings.

On behalf of the Group Life Coalition, I want to thank you and your colleagues for holding this hearing on this important subject. We look forward to working with you on a solution to continually insure America's economic security against terrorist attacks.

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NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

STATEMENT OF WARREN HECK
CHAIRMAN AND CEO

GREATER NEW YORK MUTUAL INSURANCE COMPANY,
INSURANCE COMPANY OF GREATER NEW YORK
AND STRATHMORE INSURANCE COMPANY

ON BEHALF OF
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

HEARING ON "THE FUTURE OF TERRORISM INSURANCE"

BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

JULY 27, 2005

Chairman Baker, Chairman Oxley, Ranking Minority Member Kanjorski, Ranking Minority Member Frank and Members of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, my name is Warren Heck. I am Chairman and Chief Executive Officer of the Greater New York Mutual Insurance Company (GNY) and its wholly owned stock subsidiaries, Insurance Company of Greater New York and Strathmore Insurance Company.

Thanks to the vigorous efforts of Chairmen Oxley and Baker and of this Committee, as well as the rest of the Congress and the Administration, TRIA was adopted. NAMIC and I are convinced that it played a major role in preventing an economic catastrophe and helping get the country back on its feet economically after 9/11. We thank you for your efforts then and we thank you for your efforts today to reform TRIA and renew the federal reinsurance backstop for terrorism before it expires at the end of this year. We appreciate your comments about moving a terrorism insurance bill to the House floor in the fall as we agree with Federal Reserve Board Chairman Alan Greenspan's observation last week before this Committee that there is "no way" that the private insurance market can handle terrorism-related risk by itself because of the "very substantial" potential scope of damage and we support his endorsement of government-backed reinsurance for terrorism.

NAMIC strongly supports extension of the federal terrorism reinsurance backstop in TRIA

I am here today to testify on behalf of the National Association of Mutual Insurance Companies (NAMIC). Founded in 1895, NAMIC is the largest property/casualty insurance trade association in the country, consisting of more than 1,400 member companies that underwrite 43 percent ($196 billion) of the property/casualty insurance premium in the United States.

NAMIC strongly endorses an extension of the federal terrorism reinsurance backstop in the Terrorism Risk Insurance Act (TRIA), with modifications designed to maximize the development of a private market and to provide a viable long-term system to protect the economic strength of the country against terrorist attacks.

Greater New York Mutual Insurance Company's history and post 9/11 experience

Let me tell you a little about our companies and our experience with terrorism risk because we have been on the frontlines of this problem. As with many mutual insurance companies, whether they be rural, farm, or specific to a particular industry GNY began in the early 1900s at a time when there was a flood of immigration into the United States. Many of these immigrants settled in the lower East Side of New York City and they earned their living as plumbers, electricians, steel workers, carpenters and laborers in other trades. Many of them saved and purchased tenement apartment houses, however, they found it difficult to obtain liability insurance for their properties because the tenement houses were extremely crowded and because of burgeoning litigation at that time. These tenement house owners formed a trade association to protect their interests and to which they gave the name of Greater New York Taxpayers Association. This lack of insurance availability motivated the association to form an insurance company that became the Greater New York Mutual Insurance Company, as it is known today. Our legacy is that of early immigrants who came from humble beginnings as trades people with little formal education and started the insurance operation applying solid business principles and practices to their work.

Today, the company is a multi-line regional commercial lines company operating in New York, New Jersey, Connecticut, Massachusetts, Pennsylvania, Maryland, New Hampshire and Virginia. The majority of our business is in New York, New Jersey and Connecticut, where we have done business for many years; we began developing business in the other listed states in recent years. Our companies have had an A+ rating from A.M. Best for many years, and an A rating from S & P. We have also been selected as one of Ward's 50 Benchmark property/casualty companies for the last five consecutive years for outstanding achievement in the areas of safety, consistency and performance.

In New York State in 2004, our companies wrote direct written premium of $189,371,747, of which $158,405,329 was Commercial Multi Peril, making us the fourth largest writer of Commercial Multi Peril business in New York State. In New Jersey in 2004, we wrote direct written premium of $73,068,997 of which $56,246,531 was Commercial Multi Peril making us the fifth largest writer of that business in the State of New Jersey. For many years, we have been the largest writer of co-op apartment houses in the boroughs of New York, particularly Manhattan, and the leading writer of apartment buildings in the state.

Although I have served as President and Chief Operating Officer of the company for 18 years and Chairman and CEO for the past four years, I have continued to also serve as Chief Underwriting Officer and manage the underwriting activities of our companies. This has enabled me to have first-hand knowledge and understanding of the needs of our policyholders and agents, particularly with respect to the terrorism exposure.

As a result of the terrorist attack on 9/11, and prior to the passage of TRIA in late 2002, most primary insurance carriers operating in New York City began to non-renew their large commercial property and workers' compensation business, or reduce limits of coverage to levels below what was needed by the business community. Most primary companies refused to insure property on buildings with values in excess of $20 million, and would not insure any risk that had more than a limited number of employees in a single building. The extreme hard market for property and workers' compensation coverage in New York State, particularly in New York City, was worse than other places because New York State prohibited carriers from excluding coverage for terrorism, and reinsurance companies universally excluded terrorist acts in property and casualty treaties. The only alternative was to offer less coverage or not write the business at all.

The few companies willing to provide coverage increased their pricing because of the significant terrorism exposure. However, many of those companies began to cut back when concentrations of values and employees became too large. The lack of insurance capacity had a negative impact on the New York economy resulting in the postponement of many construction projects, lack of or inadequate property coverage for many commercial office buildings, and significant increases in pricing of commercial multi-peril business.

With the passage of TRIA, the fear that a worst case terrorist event could render our company insolvent was somewhat reduced, making it possible for our company to continue to do business in New York City and other urban areas. TRIA placed a ceiling on individual company terrorism losses, which permitted our company to quantify its terrorism exposure and find a way to deal with it.

We devised a new underwriting strategy and guidelines that permitted underwriters to insure skyscraper office buildings up to $50 million or more depending upon risk accumulations in a given area of the city and proximity to so-called target buildings. We also do not insure commercial tenants in a property where the company insures the building. With respect to workers' compensation coverage, as long as employee counts were not too concentrated, our company considered offering coverage. We also implemented a real-time computer system to track risk accumulations and the number of employees in a given building and zip code. Since the passage of TRIA, we have purchased very expensive stand-alone terrorism reinsurance to cover as much of our TRIA deductible and co-insurance as we could reasonably afford. Without the passage of TRIA our company could not have kept its market open in the same way in New York City, and retained the insurance capacity needed to write new business and grow its direct written premium.

The Treasury Department's recommendations are a reasonable starting point for short-term reform of TRIA

We think the Treasury Department recommendations for changes in TRIA are a reasonable starting point for short-term reforms. We agree with Treasury's assessment that "the immediate effect of the removal of the TRIA subsidy is likely to be less terrorism insurance written by insurers, higher prices and lower policyholder take-up." Given the Madrid bombings of last year and the recent bombing events in London, including one devastatingly successful one, we think the failure of the Congress to extend a terrorism reinsurance backstop could have a very harmful impact on the U.S. economy if terrorists such as al Qaeda and its Hydra-headed offspring succeed in attacking the United States again. If Treasury is correct in its assessment of the short-term effect of ending the program, then the economic cost to our country of another terrorist attack would undoubtedly be far greater if the program is ended instead of extended. The cost of government reinsurance provided under TRIA would pale in comparison to the billions in aid that the government would inevitably disburse in the form of terrorism disaster relief. That would be a cost borne by not just by the people where the attack occurred but by taxpayers from Hawaii to New York, as well as from Alaska to Maine and all the states in between.

"The Economic Effects of Federal Participation in Terrorism Risk," an excellent report written by the former Chairman of the Council of Economic Advisers, Glenn Hubbard, and Bruce Deal of the Analysis Group, estimated the economic impact of not extending TRIA:

- Absent another major terrorist attack, GDP may be $53 billion (0.4 percent) lower, household net worth may be $512 billion (0.9 percent) lower, and roughly 326,000 (0.2 percent) fewer jobs may be created.
- Were another attack to occur of the size of 9/11, tens of thousands more jobs could be lost due to the lack of insurance coverage and thousands of additional bankruptcies could occur compared to the 9/11 event, which was covered by the insurance industry.

These potential results are not acceptable risks in a world where the Secretary of the Department of Homeland Security warns us that another terrorist attack on our homeland will – not could – occur.

As I mentioned previously, I think Treasury outlined several key areas of reform, particularly higher deductibles and a higher event trigger. The private sector has shown that it can operate with a 15 percent deductible. Raising the deductible would provide a further test of private sector capacity. Similarly, an increase in the event trigger is within the realm of reality. However, raising the event trigger much higher would be problematic, particularly for medium and small companies. In establishing new deductible levels and a higher event trigger, one must recognize that, if they are set too high, the program will unfairly discriminate against the medium to small companies in favor of large companies that can afford a much larger hit.

In reforming TRIA, it is important to recognize that terrorism insurance does not operate in a free market in the United States. The state regulators in New York, the state most likely to be a terror target, have prohibited companies from excluding coverage for terrorism. There is no similar regulation requiring the reinsurance market to provide protection to the direct market, leaving insurers in a catch 22: Medium and small companies will face a difficult choice, leave the market place for terror target-area risks or face the prospect of a financial disaster that could result if they write coverage. Should companies choose to leave the market, then it would eliminate competition in the market place.

Such government intervention by some state regulators to prevent terrorism coverage exclusions or by all states that require the inclusion of terrorism risk in workers' compensation insurance, is the very problem preventing the development of a terror cover market. Forcing companies to write this coverage prevents the free market forces from developing a private market that can be priced and reinsured accordingly. Thus, unless the terrorism insurance bill includes the ability to exclude coverage in all states in the same manner as TRIA, Congress must provide a meaningful backstop that does not discriminate among insurers. Otherwise, a market will never be created that is priced according to the true nature of the risk.

NAMIC supports a public/private partnership as the key element of a long-term solution

A long-term solution is likely to involve a public/private partnership as well. Here the Treasury report is less instructive than elsewhere as it says only that, "Over time, we expect that the private market will develop additional terrorism insurance." I'm afraid that such a conclusion is based more on perhaps excessive faith in the private enterprise system than a more pragmatic understanding of the distinction between the insurability of large natural disasters and unpredictable catastrophic acts of terrorism by barbaric people whose goal is to cause the maximum number of casualties and to bring the U.S. and other western economies to their knees. Unfortunately, all it requires to make weapons of mass destruction in 2005 is a computer, Internet access and a college-level education. The effects can be devastating, as reflected in the recent report by the Organization for Economic Co-operation and Development (OECD), which estimated that the maximum losses that could result from a single terrorist attack range from $50 billion to $250 billion. That is from *one* terrorist attack, not multiple attacks as historically favored by al Qaeda.

While the Treasury Department is correct that the U.S. insurance industry has improved its modeling of terrorist attacks, such modeling is not analogous to modeling hurricanes and other natural disasters which have long historical records and whose future predictability is buttressed by sophisticated geological studies. Terrorism modeling can help individual insurers reduce their exposure by diversifying their risk geographically and otherwise. However there is no guarantee that, for example, limiting one's exposure in New York City by underwriting risks in the U.S. heartland will succeed, as low-tech attacks such as those in Madrid and London could cause enormous economic harm if replicated in shopping malls in the south and Midwest. Even greater harm could be caused in these areas if terrorists attacked chemical plants or the food supply.

Smaller insurers, as are many NAMIC member companies, face additional problems because they operate in only a few counties in a state or in only a few states. They simply lack the financial resources to withstand a terrorist attack in their home areas. In addition, many of them today are in financial jeopardy because, when they write commercial insurance with the federal obligation to include terrorism coverage, they cannot get reinsurance to cover the deductibles set by TRIA today, nevertheless the higher deductibles in a modified TRIA extension could very well work for companies other than those very small companies.

Workers' compensation presents particular concentration risks. For workers' compensation, a private mutual insurance company or a state fund handles the bulk of insurance coverage for businesses in 27 states. Many of these companies, often characterized as guaranteed markets, must accept all applicants. While most large multi-line commercial insurers may limit the scope or aggregation of risks that they are willing to cover in a specific area, many private mutuals or state funds find themselves with tremendous risk concentration. This concentration of risk is best exemplified by the California State Fund which is the single largest writer of workers' compensation business in the United States despite the fact that it only operates in its own state.

State laws prohibit workers' compensation policies from excluding terrorism related losses, thus leaving many regional workers' compensation specialists in an extremely vulnerable position. Many of them have high a concentration of risk, a mandate to take all customers and an inability to exclude terror related occurrences which have the ability to render catastrophic levels of human and economic devastation in particular areas or regions.

Even if an insurer were able to diversify its risk exposure through modeling and get sufficient private reinsurance to cover the TRIA deductibles, the notion that the private market can protect itself through good modeling is flawed. Absent a terrorism insurance program, a $250 billion terrorist event, the high estimate by the OECD, would wipe out so much of the property/casualty insurance industry surplus for all lines, estimated at $350 billion in 2003, that it would be unable to meet its obligations to its other insureds for the many different coverages beyond terrorism insurance protected by that surplus.

So what would a long term terrorism insurance solution look like? Raising the deductibles and the event trigger along the lines I discussed earlier would provide a further test of private market capacity. The failure of sophisticated investors to actively seek out profit opportunities since 9/11 indicates that they understand that predicting terrorism risk is itself a highly risky investment. Nonetheless, I believe higher deductibles and event triggers will provide a further real world test of the private sector's willingness to make terrorism insurance available at an affordable price.

I think it is more likely that the creation of a private/public partnership, as exists in Great Britain with the Pool Reinsurance Company Limited, commonly known as Pool Re, can be a substantial part of the solution. Pool Re is a mutual insurance company that is authorized only to write reinsurance relating to terrorism risk on commercial property insurance. It differs from normal insurers and reinsurers in that it reinsures its liabilities with the British government, to which it pays a reinsurance premium and from which it will recover any claims that exceed its resources. I think such a balanced private/public partnership might be a key element to protecting the U.S. economy from the *sui generis* risk presented by a catastrophic terrorist attack.

What other components might the Congress consider? A new RAND Center for Terrorist Risk Management Policy study recommended two possibilities: (1) requiring that terrorism insurance cover acts by domestic groups as well as foreign terrorists, a wise admonition in light of the London attacks, and (2) requiring that insurance cover attacks involving chemical, biological, radiological or nuclear (CBRN) weapons, perhaps through a direct government insurance program. Most private insurance policies now exclude such coverage and yet our government has warned us time and again that terrorists are trying to obtain such weapons to use against us and other opponents of terror.

Now would also be a good time for the federal government to examine tax and accounting policies that NAMIC believes are major impediments to increasing the capacity of insurers and reinsurers to provide terrorism coverage. For example, insurers are not permitted to deduct reserves set up for just these types of situations. That policy creates a huge disincentive for insurers to do just what they should do to maximize protection against terrorism risk. It also creates a disincentive for the private sector to invest in the insurance industry.

The flow of private sector capital to this industry is also inhibited by outdated state regulatory policies that often require regulatory approval of the prices insurers charge. Such controls have been lifted from almost every other area of the economy and should be lifted from the insurance industry as well.

Finally, Mr. Chairman and Members of the Subcommittee, thank you once again for the opportunity to testify on this issue of vital importance to NAMIC member companies and the U.S. economy. Your continuing leadership on this issue represents the best in public policymaking and NAMIC stands ready to assist you in any way in developing the best possible terrorism insurance legislation.

CFA Consumer Federation of America

WEANING THE INSURANCE INDUSTRYAND LARGE COMMERCIAL POLICYHOLDERS FROM TAXPAYER SUBSIDIES UNDER THE TERRORISM RISK INSURANCE ACT

TESTIMONY OF
J. ROBERT HUNTER,
DIRECTOR OF INSURANCE

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
of the
House Committee on Financial Services

July 27, 2005

Mr. Chairman and members of the Subcommittee, thank you for your invitation to appear before you today to discuss the Terrorism Risk Insurance Act. I am J. Robert Hunter, Director of Insurance for the Consumer Federation of America. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education. I am a former Federal Insurance Administrator under Presidents Ford and Carter and have also served as Texas Insurance Commissioner.

I. Introduction

As a result of the dreadful terrorist attacks of September 11, 2001, the property/casualty insurance industry suffered losses of almost $21 billion after taxes ($32 billion before taxes). Although a tax write-off of 35 percent is a significant financial benefit to insurers, Congress enacted the Terrorism Risk Insurance Act in 2002 to ensure that terrorism coverage was affordable and available in the aftermath of this unprecedented event. Congress also wanted to assure that a lack of affordable terrorism insurance did not set off a chain reaction that would prevent large construction projects from going forward, thus harming the overall economy.

TRIA established a program of federal reinsurance with no premium charged to the insurers. The law mandates that insurers write terrorism coverage, which is then backed by the federal reinsurance program. If and when a terrorism event occurs, the Secretary of the Treasury must certify that it qualifies as a reimbursable loss under TRIA, with at least $5 million in aggregate losses. Someone acting on behalf of a foreign interest must commit the attack. If an incident meets these criteria, taxpayers pay for insurance industry losses in accordance with a schedule that varies over time. The Act expires on December 31, 2005, unless renewed by Congress.

In 2003, insurers were responsible for losses below a deductible of 7 percent of their direct earned premium (DEP) for eligible commercial lines in the 2002 calendar year. In 2004, 10 percent of the 2003 DEP was the deductible. In 2005, 15 percent of the 2004 DEP is the deductible[1]. Above the deductible amount, the federal "backstop" is 90 percent of a company's insured terrorism losses, capped at an overall industry level of $100 billion. If an event triggers federal involvement, insurers are required to pay back a very small layer of taxpayer assistance, which could be passed on to insurance consumers in the form of a surcharge, but it is not a significant amount in major terrorism events.[2]

Not surprisingly, insurers and the real estate industry have encouraged lawmakers in both houses of Congress to extend TRIA in much the same form it is in now, and even expand it to cover group life insurance losses. These interests receive significant financial benefits from a program that provides expensive reinsurance coverage at no charge. If consumers received free, taxpayer funded auto insurance, there would likely be a clamor for Congress to extend that program as well.

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[1]Under TRIA, the Secretary of the Treasury is authorized to extend the program through 2005, and in 2004, the Secretary elected to extend the program.

[2] TRIA does not require <u>any</u> payback if losses exceed $10 billion in the first year of the program, $12.5 billion in the second, and $15 billion in year three. Even when payback is required, it is miniscule: insurers only repay the <u>difference</u> between the total amount of retentions paid by individual insurers and the caps stated above.

However, the U. S. Department of the Treasury, which administers TRIA, has just issued a report determining that TRIA should not be extended in its current form.[3] The report found that TRIA had achieved its temporary objectives and that, given the robust economy, TRIA's expiration or extension would have little impact. The Treasury Department found that the program should be cut back to enable private sector terrorism insurance to develop and to reduce taxpayer exposure. The report therefore called for higher triggers for the availability of the backstop, higher deductibles and co-pays for the industry and the complete exclusion of smaller lines of insurance from the program.

In the wake of this important report, insurers are warning that, if TRIA is significantly pared back, there will be little terrorism insurance coverage available. As a result, the nation's economy will be seriously damaged as construction projects that cannot obtain terror coverage grind to a halt.

In this testimony, I will evaluate the current capacity of the property/casualty insurance industry to provide terrorism insurance if the TRIA program expires or is significantly scaled back and requires insurers to pay actuarially sound premiums and the degree to which commercial policyholders could afford increased terrorism insurance premiums. I will then review, briefly, the findings of the CBO and Treasury Department reports on extending TRIA. By reviewing what happened in most of 2002 when no TRIA was in effect, I will also addresses the claims of insurers and others that the elimination of TRIA will cause extreme dislocations in the nation's economy. I will then comment on what Congress should do as the termination of TRIA approaches.

II. Perfect Timing: Insurers and their Policyholders are in a Good Position for TRIA to Expire or be Sharply Scaled Back

A. The Insurance Industry is Flush with Profits and Retained Earnings

Since the attacks of September 11th, the property/casualty insurance industry has experienced a significant period of growth and raked in profits that are virtually unprecedented, and expected to increase further. In fact, the industry is clearly overcapitalized.

A significant shift in the insurance market since September 11th has also meant major benefits for insurance policyholders. The property/casualty insurance market has moved from the "hard" part of the cycle, when prices increased sharply and coverage cutbacks were widespread, to a soft market, where abundant capital has caused prices to drop precipitously.

In the first quarter of 2005 alone, the industry had a 92.3 percent combined ratio (the total of losses and all expenses divided by the premiums), one of the lowest such ratios in decades, signaling huge profits ahead. First quarter 2005 underwriting profit was $6.8 billion, investment return was $14 billion, offset by capital market losses of $4 billion, for a jump in retained earnings of $10 billion.[4] These extraordinary returns have spurred robust competition as insurers compete for greater market share.[5]

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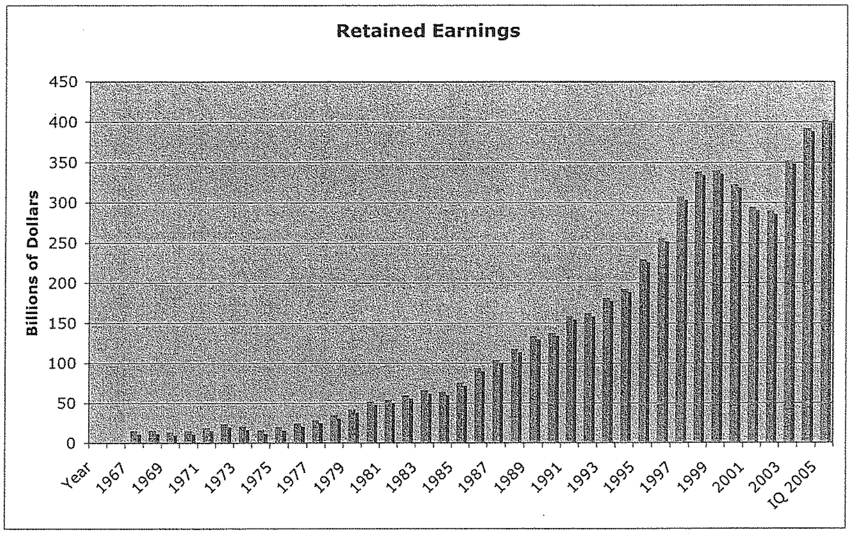
[3] "Assessment: The Terrorism Risk Insurance Act of 2002, U.S. Department of the Treasury, June 30, 2005.

[4] U.S. Property/Casualty Insurers Gain $6.8 billion in First QuarterBestWeek, July 8, 2005.

[5] US P/C Industry Loss Ratio Improves 2 Points in 2004, BestWire Service, July 11, 2005.

The industry has emerged from a classic cycle bottom with huge profits and is in one of the strongest periods in its history. The retained earnings (surplus) are exploding to record highs, as the chart below illustrates:



Source: 1967 to 2003, Aggregates and Averages, 2004 Edition, A. M. Best & Co. 2004 and 2005 calculated by CFA from Best reports of surplus growth.

Data for all segments of the property/casualty industry indicate that retained earnings were $323 billion at year-end 2000, before the terrorist attacks. As of the end of the first quarter of this year, retained earnings are $403 billion, fully $80 billion more than in 2000.

CFA estimates that the current property/casualty insurance premium writings-to-surplus-ratio is a remarkably safe one to one. By historical standards, this is a very wealthy and financially stable industry. The commercial lines segment of the industry was reported by Best's Aggregates and Averages to have a surplus of $155 billion at year-end 2003, which Best's estimates grew by 10.3 percent in 2004 to $171 billion.[6] At year-end 2000, the surplus was $122 billion. This growth in surplus of $49 billion alone would be enough to pay for losses for an attack more than two times the size of the World Trade Center attacks of September 11th.[7]

[6] Best's Aggregates and Averages, 2004 Edition, page 30 for 2003 data; 2004 growth in Best's Review/Preview, January 2005, page 20.
[7] An attack that resulted in losses of $49 billion after taxes would be $75 billion before taxes ($49/.65). This is 2.2 times the estimated $35 billion before taxes that the WTC event cost insurers and taxpayers.

The hugely profitable situation that exists today offers the perfect opportunity for Congress to end or sharply scale back TRIA. Excess insurer capacity is causing fierce competition for market share. This capital in search of risks to underwrite is a very promising sign for growth and development of a private terrorism market.

Moreover, this very wealthy industry has reaped significant financial benefits from the taxpayer subsidy provided by TRIA. So far, taxpayers have granted free reinsurance worth $2.8 billion.[8] Had insurers been required to pay premiums for this coverage, this $2.8 billion would now be available to the Treasury Department to pay for any attacks that might come in the future.

B. Policyholders are Enjoying Deep Premium Cuts in All Insurance Lines

As the following chart shows, price increases were severe as Congress was considering enactment of TRIA in 2001 and 2002. Year-to-year price increases approached 50 percent in some lines. That situation has changed dramatically over the course of the normal economic cycle:

	2001	2Q 2002	2Q 2003	**2Q 2005**
Small Comm. Accounts	21%	20%	7%	-5%
Mid-size Comm. Accounts	32%	27%	8%	-10%
Large Comm. Accounts	36%	34%	8%	-11%
Business Interruption	30%	21%	5%	-6%
Construction	46%	44%	17%	-3%
Commercial Cars	28%	27%	11%	-5%
Property	47%	42%	6%	-12%
General Liability	27%	24%	11%	-8%
Umbrella Liability	56%	52%	18%	-6%
Workers' Compensation	24%	26%	15%	-7%
D&O	NA	NA	21%	-3%
Employment Practices	NA	NA	17%	-4%
Medical Malpractice	NA	NA	48%	2%
Surety Bonds	NA	NA	13%	-6%
Terrorism	NA	NA	6%	-1%

Source: Council of Insurance Agents and Brokers.

As the Department of the Treasury report found, the average percentage of overall premium paid out by commercial policyholders for their terrorism coverage was 1.8 percent in 2004 (1.7 percent according to the policyholder survey).[9] Thus, if terrorism charges doubled as a result of TRIA's termination, the overall insurance premiums paid by all sizes of businesses

[8] See calculations at page 5 of the Testimony of J. Robert Hunter before the Committee on Banking, Housing and Urban Affairs of the U.S. Senate, April 14, 2005.
[9] Department of the Treasury's Report, at page 4.

would still decline. At the current time, for large commercial accounts, terrorism prices could more than quintuple with no resulting premium increase overall.

C. Another Marketplace Improvement: the Risk of Terrorism Is Being Modeled and Insurance Companies Are Using These Models

The insurance industry argues that predicting terrorism risk for insurance purposes is impossible. The truth is, insurers are doing it already. Modeling terrorism risk is an imperfect science, but it is improving fast. A huge amount of research has been done in this area since TRIA was enacted, and several private companies have produced and are selling models to measure the actuarial and underwriting implications of the terrorism risk. The fact that insurers use these models is proof that they are of at least some value. Insurance companies pay significant dollars for the licenses to use these models. Businesses would not do that if they did not think the models were valuable. For instance, many insurers use the Insurance Services Office (ISO) model for setting terrorism rates. ISO's research shows that the terrorism insurance risk is limited to a fairly small number of cities and that for the vast majority of the nation, the risk is low and the cost can be fully borne privately.[10]

III. Reports by the Congressional Budget Office and Department of the Treasury Support Ending TRIA or Sharply Reducing Coverage in any TRIA Extension

A. The Congressional Budget Office Study

The well-balanced Congressional Budget Office report of January 2005 made these important points about how the market would be affected if TRIA expired:

- Terrorism premiums would likely rise for those buying insurance in high-risk situations.
- The number of businesses buying insurance would probably decrease. (Only about half of all businesses are currently purchasing terrorism coverage.) Such a decrease would mean more taxpayer involvement in a post-terrorism attack situation.
- Mitigation efforts would increase. Efforts to lower the risk of terrorism attacks or reduce their effects would be encouraged by the market charging actuarial rather than taxpayer-subsidized rates for terrorism insurance. Steps such as hiring guards and placing metal or explosives detectors at entrances to higher risk buildings would be encouraged by the expiration of TRIA.
- Private sector alternatives to TRIA would be encouraged by the expiration of TRIA, such as reinsurance to replace the free TRIA coverage or the development of securitized responses, such as bonds similar to catastrophe bonds.[11]

[10] For a complete discussion of the implications of ISO's research, see CFA's report, "The Terrorism Risk Insurance Act: Should it be Renewed?" at http://www.consumerfed.org/terrorism_insurance_report.pdf. The report was presented to the Senate Banking Committee at its hearing of May 18, 2004.

[11] Indeed, there is evidence that just the potential of TRIA expiration is causing insurers to develop and risk managers to seek alternative ways to cover the terrorism risk.

- The economy might be affected somewhat, but not as much as the insurers contend. CBO indicates that the analysis presented to the public through press releases sent out by the insurance industry overstates the potential costs to the economy if TRIA expires.

- The cost of insuring against terrorism would not change much for the nation. TRIA does not change the anticipated terrorism costs except, CBO states, to the extent it increases national costs because it undermines the incentives of insurers to insist on mitigation measures and insured parties to implement these measures in order to get lower premium charges. Not extending TRIA would merely shift roughly the same costs from taxpayers to private firms and insurers.

- There could be insurance market disruption if another large terrorism event occurs. CFA believes that Congress knows how to handle this sort of situation, given the success it had in stabilizing the insurance market after September 11, 2001 and during the riots in the nation's cities in the 1960s, for example.

CBO also listed the pros and cons of altering TRIA by requiring that insurers be charged actuarial (or above actuarial) premiums for the coverage that is provided:

- Charging premiums would result in more mitigation by insurance purchasers because increased premiums would encourage the development of discount plans for safety precautions taken by insured businesses.

- Charging premiums would encourage the private sector to grow, since the private sector cannot compete with the free reinsurance provided by the taxpayers under TRIA.

- Charging premiums might result in less terrorism coverage being purchased. This would mean more taxpayer involvement in a post-terrorism attack situation.

CBO summarizes their conclusions as follows:

"In sum, as the Congress considers whether to extend TRIA (and in what form), it is useful to consider what has changed in the two years since the law was enacted. The most significant development seems to be a growing sense that the terrorism threat to the United States will continue for the foreseeable future. That development suggests that the economy, especially the stock of physical capital, needs to be responsive to the prospective losses from terrorist attacks. For example, new construction might be designed, located, and built to withstand such attacks. Existing structures might need to be retrofitted with safety features. *Those needs argue against extending the TRIA program in its current form, which subsidizes insurance and dampens incentives for mitigation activities.* (Emphasis added.)

"*The macroeconomic costs of scaling back the federal subsidy for terrorism insurance are likely to be small.* One reason is that the capacity of insurance companies to provide terrorism coverage has improved recently. Another reason is that TRIA does not lower the costs of terrorist attacks but rather partially shifts those costs from property owners to taxpayers. As noted above, total costs might be lower without TRIA. However, the gains in economic efficiency from allowing TRIA to expire could require a significant trade-off: without the TRIA program, an especially large loss from a terrorist attack would be likely to produce another episode of scarce coverage, rising prices, and uninsured assets." (Emphasis added.)

Thus, CBO concludes that immediately gaining more safety and lowering terrorism costs through mitigation – current real gains stemming from TRIA's expiration– have little possible future downside, except for the possible insurer reaction *after* a terrorist event. The benefits of improved mitigation efforts and increased private sector involvement in insuring against terrorist risk that would be encouraged if TRIA expires far outweigh the potential costs of insurer reaction after some future event, particularly since Congress has shown that it knows how to offset that potential cost through prompt action after such events.

B. The Department of the Treasury Report

On June 30, 2005, the Treasury Department issued their report, as required in TRIA. This is the most extensive review of TRIA by any party and represents an important contribution to the deliberations of Congress on what to do when the current TRIA expires. The report found that TRIA had served its purpose and should not be extended "as-is." If TRIA is extended at all, the Department recommended that it should be sharply cut back. In delivering the report, Secretary Snow stated:

> "While TRIA has been effective in achieving its temporary objectives, the economy is more robust today than when TRIA was enacted. GDP growth is up from 2.3 percent in 2002 to 3.9 percent in 2004 (fourth quarter over fourth quarter). Unemployment, which reached 6.0 percent in December 2002, is down to 5.1 percent in May 2005. Construction jobs, taking residential and nonresidential together, now stand at a record high 7.2 million. Extending TRIA would have little impact on the economy given its current strength.
>
> "It is our view that continuation of the program in its current form is likely to hinder the further development of the insurance market by crowding out innovation and capacity building. Consistent with its original purpose as a temporary program scheduled to end on December 31, 2005, and the need to encourage further development of the private market, the Administration opposes extension of TRIA in its current form.
>
> "Any extension of the program should recognize several key principles, including the temporary nature of the program, the rapid expansion of private market development (particularly for insurers and reinsurers to grow capacity), and the need to significantly reduce taxpayer exposure. The Administration would accept an extension only if it includes a significant increase to $500 million of the event size that triggers coverage, increases the dollar deductibles and percentage co-payments, and eliminates from the program certain lines of insurance, such as Commercial Auto, General Liability, and other smaller lines, that are far less subject to aggregation risks and should be left to the private market."

The Treasury Department study offers Congress a reality check on the hype and misinformation about TRIA that has been offered by the insurance industry. Insurer claims that terrorism insurance will not be available or affordable unless TRIA is extended "as is" and even broadened are debunked by the Department of the Treasury study. The study makes it very clear that the financially well-off insurance industry is receiving an overly generous and unnecessary subsidy from beleaguered taxpayers and consumers and that the law must be scaled back in order to foster the growth of the private market for terrorism insurance. The report also debunks the myth that the potential lack of terrorism coverage in 2001 and 2002 led to a slowdown in non-residential construction or that TRIA has been effective in increasing this construction since it took effect.[12]

The report is silent on whether insurers should be required to pay a premium for the reinsurance they receive in the future. CFA strongly believes that taxpayers should no longer be required to give away billions of dollars in free reinsurance to an industry that is financially flush. Even representatives of the insurance industry have agreed that it is hard to justify not requiring the payment of premiums for this coverage.

CFA does disagree with Treasury Secretary Snow's contention that the legal rights of Americans should be further rolled back in order to prevent TRIA from paying for illegitimate liability claims, a position not mentioned in the report itself. Current laws would certainly prevent payment for unjustified claims. Moreover, the Insurance Services Office estimates that <u>all</u> liability payments under TRIA would be very small, about ten percent of paid insurance losses. If the Treasury Department's proposal to remove federal back up from commercial auto and general liability lines of insurance is adopted by Congress, then this percentage will fall to a trivial level.

<u>IV. Industry Claims of Economic Disaster if TRIA Expires Are Invalid</u>

<u>A. Current Industry Claims</u>

Insurance companies and some large policyholders are making claims that, should Congress not extend TRIA in its current form -- or even expand the coverage to include group life -- there will be serious economic consequences. Some examples of these claims follow:

> "If the year ends without a federal program of any sort, then the economy is at risk."
> Jeffrey DeBoer, President
> Real Estate Roundtable[13]

> "It certainly creates enormous economic disruption. It threatens jobs. It threatens economic growth."
> Marolyn Davenport, Senior Vice President
> Real Estate Board of New York[14]

[12] "From our current perspective it appears that neither the potential lack of terror risk insurance nor a general economic downturn were responsible for weakness in nonresidential building activity. In any case, nonresidential building is only 2.2 percent of GDP, and commercial office construction only 12.2 percent of the nonresidential building total. When the economy is fragile, concerns over weakness in even very small sectors of the economy (nonresidential construction) can loom large...such concerns recede as the economy strengthens. Given the small size of nonresidential and commercial office construction, stimulating this sector (whether through TRIA or otherwise) would be neither effective nor warranted." Treasury Department report at page 135.

[13] "Congress Urged to Extend Help After Attacks," New York Times, July 11, 2005.

"That is potentially the start of a serious storm for our economy."
Rolf Lundberg, Senior Vice President
U. S. Chamber of Commerce[15]

"If TRIA is not extended...this will...have a severe negative effect on the national economy, including job loss, stalled commercial transactions and delayed construction projects."
Brian Duperreault, Chairman
ACE Limited[16]

"CIAT is unanimous in its belief that the Federal government must continue to provide a reinsurance backstop beyond 2005 if we are to avoid major disruptions to the economy."
Robert J. Lowe, Chairman and CEO
Lowe Enterprises
Speaking on behalf of the Coalition to Insure Against Terrorism, the Real Estate Roundtable and the United States Chamber of Commerce.[17]

B. The Terrorism Market in 2001 and 2002

These claims are identical to those made by insurers and the real estate industry in 2001 as Congress was considering what to do about terrorism insurance after the September 11th attacks. In late 2001, insurers and some policyholders warned that a national crisis would ensue in early 2002 if no terrorism back up was put in place by Congress. Insurers claimed that the crisis would hit suddenly in 2002, since most reinsurance contracts would expire January 1, 2002.

The Consumer Federation of America initially supported legislation to provide a federal terror insurance back up, as long as insurers were required to pay back the taxpayer-supported reinsurance that was provided. However, Congress adjourned in late December 2001 without enacting terror insurance legislation. CFA took this position of support in part because the insurers were making a strong argument that if no program was in place by January 1, 2002, there would be significant problems in the insurance market leading to unavailability of insurance, banks calling loans, damage to the nation's economy and other dire consequences. Congress failed to act in 2001.

C. CFA Study of January 2002

Fearing that a crisis would develop immediately after reinsurance contracts expired on December 31, 2001 and new contracts took effect on January 1, 2002 without terrorism reinsurance back up for primary insurers, CFA undertook a major study of market conditions in late January 2002. To our surprise, CFA found that, contrary to the grim scenarios feared by many and predicted by the insurance industry, the failure of Congress to enact a terrorism

14 Ibid.

15 Ibid.

16 Testimony Before Senate Banking Committee, April 14, 2005.

17 Testimony Before Senate Banking Committee, April 14, 2005.

insurance back up program had not caused major gaps in coverage or economic disruption in the nation. As a result, CFA changed its position and called upon Congress to enact narrower, targeted measures to provide terror back up only to the "target risks" and parts of the country (like New York City) that were still having trouble procuring terrorism insurance.[18]

The study CFA released in late January 2002 had five major conclusions:

1. The insurance industry was wealthy and overcapitalized.
2. High rates were a problem for mid-sized and larger firms.
3. The rate problem was caused by the classic turn in the economic cycle of the industry, sped up--but not caused by--terrorist attacks.
4. Banks were freely loaning money to the vast majority of businesses--if not all of them---regardless of the terrorism insurance situation in the nation.
5. There were no widespread economic problems related to the terrorism insurance situation.

D. CFA Study of August 2002

Insurers responded to CFA's report by saying that it would soon be apparent that the lack of terrorism reinsurance was having negative consequences as policy renewals took place through the year. This was a change from their earlier prediction so we waited to study the situation until well after at least half of the policies in the nation had been renewed (i.e., after July 1, 2002). By August, at least 80 percent of the policies in the nation had been renewed without terrorism reinsurance coverage. CFA's August report on the terrorism insurance marketplace had three significant findings. We report these finding here in great detail since insurers are now making identical claims of dire consequences if TRIA is not renewed.[19]

1. No General Terrorism Insurance Crisis Existed in 2002.

CFA found that a broad-based terrorism insurance crisis did not exist as of August 2002. There were reports of problems in some areas of the nation (New York City and Chicago were mentioned as problem spots by some reinsurers) but most of the nation had not had significant difficulty finding coverage. Moreover, the price had dropped for stand-alone terrorism insurance, although it was still expensive.

Below is a sampling of contemporaneous news stories that demonstrate that coverage was often available and prices were coming down:

> Terrorism coverage, which was unobtainable immediately after the September attacks, is becoming more widely available and in larger amounts. Premiums are falling as more insurers enter the market. So what of the dire predictions?
>
> New York Times, February 27, 2002

[18] "How the Lack of Federal Back Up for Terrorism Insurance Has Affected Insurers and Consumers: An Analysis of Market Conditions and Policy Implications," Consumer Federation of America, January 23, 2002.
[19] "How the Lack of Federal Back Up for Terrorism Insurance Has Affected Insurers and Consumers: An Update," Consumer Federation of America, August 22, 2002

A growing number of insurers are beginning to offer terrorism insurance to U.S. businesses, a development that has begun to lower the cost of such coverage while at the same time casting doubts on the need for a government-sponsored terrorism-insurance solution...

Wall Street Journal, April 15, 2002

Terrorism insurance isn't only available, the price of it has fallen in the last six months, according to an executive with American International Group's new Lloyd's syndicate.

BestWire, April 16, 2002

Last fall, insurers were offering dire predictions that unless Congress stepped in quickly, the construction industry would all but come to a halt because builders and owners wouldn't have insurance against terrorist attacks. For thousands of companies, protection against terrorism was going to expire on January 1, and the industry wasn't rushing to renew. Well, it's May. The sky hasn't fallen.

Chicago Tribune, May 1, 2002

In the seven months following Sept. 11, the market has stabilized, more capacity has become available, and prices have dropped, sources agree. "The market has settled down and is obviously more comfortable with the type of risk that it's seeing, the cover that's being offered, and the pricing," said Simon Low, divisional underwriter for the war and political risk department at Wellington Underwriting, a Lloyd's managing agency.

National Underwriter, May 6, 2002

The world's largest commercial lines insurer, AIG, asked the federal government not to offer airlines war and terrorism insurance any more since, as the CEO Mr. Greenburg put it, "We, as taxpayers, don't want to compete with our own government for business that the commercial sector can underwrite."

New York Times, February 26, 2002

Hard markets are extremely rare. But the moment that terrorism brought down the World Trade Center towers, it was obvious that insurance prices would jump. Capitalists react at such moments...At first, after Sept. 11, it looked as if both primary insurers and their reinsurers would, to the extent possible, flee from covering any losses terrorism might cause in the future. But that hasn't happened. Said Donald Kramer, a vice chairman of ACE, in late April: "Is terrorism insurable? Everybody's said no. Yet everybody's coming out with terrorism products." ...It's uncommon for insurers to spell out the details of their terrorism coverage. But in the 2001 Berkshire Hathaway annual report, Warren Buffett gave some facts about four contracts exposing Berkshire to terrorism risks. One new property catastrophe policy that Berkshire has taken on, for example, leaves it providing "significant coverage" on Chicago's Sears Tower once losses there pass a threshold of $500 million. In another instance of terrorism tolerance, Bermuda's RenaissanceRe, a master at using sophisticated simulation models to write natural-disaster catastrophe reinsurance, has put the models to use in filling, at prices that have soared, today's demand for workers' comp catastrophe reinsurance. When they can get terrorism out of their minds, P&C insurers are loving the market they're in right now.

Fortune, June 10, 2002

Discussing the state of reinsurance markets at the annual conference of the Inland Marine Underwriters Assn. earlier this month in Oak Brook, Ill., Vincent D. Liotta, managing director at Guy Carpenter & Co. Inc., said prices are "dramatically dropping" for terrorism reinsurance. Mr. Liotta, who is head of the marine and aviation department at the New York-based reinsurance brokerage, said capacity is readily available for terrorism reinsurance, with coverage available on an excess-of-loss and pro rata basis, as well as on an annual aggregate-of-liability basis. The principal markets for terrorism reinsurance are Bermuda and London, Mr. Liotta said, and available coverage includes reinsurance for biological and chemical attacks.

Business Insurance, June 17, 2002

2. The Capacity to Write Insurance in the Wake of the Terrorist Attacks Had Increased.

One of the concerns expressed when the terrorist attacks occurred was that the drain on capital in the insurance industry might adversely impact insurers.

CFA found that the insurance industry continued to be overcapitalized. Year-end 2001 data indicates that Net Premium Written in 2001 was $324.0 billion and Surplus at year-end was $289.6 billion.[20] This is an ultra-safe premium to surplus ratio of 1.1 to 1.[21] We predicted that: "This continues to be a rich industry which, given the massive cyclical price jump they have enjoyed since late 2000, will be getting even richer."

The below excerpts from various news articles from that time period illustrate this positive trend:

Bermuda is once again the hub of renewed insurance activity as a second wave of new insurers and reinsurers landed on its shores following the Sept. 11 terrorism, according to the cover story, "Bermuda Bound," in the March issue of Best's Review. Within weeks of Sept. 11, March & McLennan formed Axis Specialty, through its private equity subsidiary MMC Capital, and Bermuda-based RenaissanceRe Holdings Ltd. started DaVinci Reinsurance to address the industry's capacity shortage. In all, nine new insurers have moved into Bermuda since the terrorist attacks. The other seven are Allied World Assurance, Endurance Specialty Insurance, Arch Reinsurance, Montpelier Reinsurance, Goshawk Reinsurance, Olympus Reinsurance and Queens Island Reinsurance.

Best Wire, March 1, 2002

"My observation would be that, in seven months post 9/11 the insurance market has done pretty well" with regards to providing capacity, said Stephen Ashwell, war, terrorism and political violence underwriter at Syndicate 33, which is managed by Hiscox plc, a Lloyd's managing agency. For a fairly innocuous risk, a buyer could get between $500 million and $1 billion of standalone terrorism coverage placed in the global insurance marketplace, he said, although he emphasized there are clearly aggregation issues. "The worldwide capacity probably now is approaching $1 billion [for one risk]," said Tom Bartleet, executive director in global property-casualty for Willis Ltd. in London. "It's theoretically possible," to put together a program with $1 billion of coverage, although the ability to do so "relies on the industry, the location, the accumulations around it and the price you're prepared to pay." In the seven months following Sept. 11, the market has stabilized, more capacity has become available, and prices have dropped, sources agree.

[20] Industry Financial Results, Insurance Services Office, June 28, 2002.

[21] The proper target leverage ratio is 2 to 1, according to the National Association of Insurance Commissioners (NAIC.) A 3 to 1 ratio is considered to be a sign of instability for an insurer.

"The market has settled down and is obviously more comfortable with the type of risk that it's seeing, the cover that's being offered, and the pricing," said Simon Low, divisional underwriter for the war and political risk department at Wellington Underwriting, a Lloyd's managing agency.

National Underwriter, May 6, 2002

Chances for passage of a federal terrorism reinsurance program are hard to judge, but failure to pass it would not have an adverse effect on his brokerage firm, the head of Marsh [Marsh and McLennan, the world's largest insurance broker] said today during an insurance conference in New York...he said failure to pass such a plan would not have great implication for his company. Terrorism coverage is available on a limited basis. Mr. Sinnott said the firm can write coverage of up to $300-to-$400 million. But for clients who are considered targets of terrorism, such as high-rise buildings, it can "price itself out of most client's view," Mr. Sinnott observed.

National Underwriter, June 5, 2002

Fortunately for buyers, the immediate post-Sept. 11 situation for terrorism coverage appears to be easing somewhat as new players enter the field.

Business Insurance, July 8, 2002

Terrorism coverage, a huge concern for ceding insurers since its exclusion from most contracts last year, is now reappearing in limited forms, but with continuing exclusion of nuclear, chemical and biological terror risks, reinsurers and brokers say. On the plus side, the post-Sept. 11 chaos that characterized the Jan. 1 renewal market has ended and renewals are being completed smoothly. In most cases, capacity is available to complete programs where reinsurers are satisfied with pricing, observers report.

Business Insurance, July 8, 2002

3. Terrorism Coverage Was Available in Most Cases. Even Hard to Place Policies Were Being Written.

The key problem CFA found at the time was limited to very large properties (in excess of the available $500 million to $1 billion stand alone coverage), particularly in very large cities (New York, Washington and Chicago). This problem seemed to be restricted to the areas with the heaviest concentration of risk and therefore the most reluctance by underwriters to fully cover all risks that applied.

But even very hard-to-place risks were finding coverage, as these contemporaneous articles indicated:

Construction contractors for years have turned to the surplus lines market for liability coverage.... Now, even very large commercial construction project accounts are seeking coverage through wholesalers, noted Swett and Crawford's Mr. Hartoch. "We are doing some huge ones," he said.

Business Insurance, August 19, 2002

The ground zero cleanup and construction project at the World Trade Center site is covered in a "wrap up" policy issued by Liberty Mutual.

BestWire, January 24, 2002

Captive insurance companies are forming to cover terrorism, for instance for construction trades.

National Underwriter, January 31, 2002

U.S. airlines are planning to set up their own insurance company as a way of covering their big-ticket liability exposures in the wake of Sept. 11, sources said Monday.

Reuters, February 11, 2002

Simon Property Group, Inc. announced today that it has purchased two stand-alone policies of terrorism insurance, each with $100,000,000 aggregate limits. The first policy will insure Mall of America in Bloomington, Minnesota against damage incurred from acts of terrorism. The second policy will insure the remainder of Simon's shopping center portfolio against similar perils. The policies were purchased from Lexington Insurance Company, a subsidiary of American International Group..."We are pleased that we were able to successfully negotiate an acceptable premium for terrorism insurance with Lexington Insurance Company," said David Simon, the company's chief executive officer.

First Call Newswire, March 27, 2002

"Even with insurance expenses increasing on average 30%, it still, in most cases, represents only about 1% to 3% of a property's expenses. This addition to overall expenses, by itself, will not in most cases make a dramatic difference in debt-service coverage," said Roy Chun, a managing director in Standard & Poor's surveillance group. "Standard & Poor's has not yet had to downgrade a transaction due to rising property and casualty insurance premiums," he said. "Rated REITs have also reported material increases in property and casualty insurance costs," added Lisa Sarajian, managing director of Standard & Poor's REIT group. "But these costs have risen during a time when other operating costs have fallen, which has helped to cushion the impact," said Ms. Sarajian. Thus, there has not yet been any significant impact to the operating cash flow of REITs due to rising insurance premiums.

National Underwriter, May 16, 2002

Even in New York, the picture has improved sharply from the immediate aftermath of Sept. 11, when insurers simply refused to provide coverage for terrorist attacks. "It is available, for the most part, at a price," said Walter L. Harris, the president of Tanenbaum-Harber, a brokerage firm providing coverage for big New York City buildings."

New York Times, June 11, 2002

Fitch Ratings has affirmed and removed from Rating Watch Negative GS Mortgage Securities Corp II, series 2001-LIB, classes A-1 ($58.4 million) and A-2 ($186.9 million) and X (interest only), rated 'AAA'. Fitch also affirms and removes from Rating Watch Negative the class B certificates ($50.8 million), rated 'A'. The four classes were placed on Rating Watch Negative on June 3, 2002 in connection with 12 other CMBS deals. Fitch has been in contact with ORIX Real Estate Capital Markets, LLC, the master and special servicer of this transaction, and the sponsor of the loan, Brookfield Properties, with regard to the terrorism insurance policies specific to One Liberty Plaza and other properties covered under Brookfield's terrorism insurance policies...After this review, Fitch believes the current insurance policies provide sufficient coverage for these certificates.

Businesswire, June 12, 2002

> Fitch Ratings has affirmed and removed from Rating Watch Negative 1345 Avenue of the Americas Trust, classes A-1 ($40.8 million), A-2 ($233.3 million), and X (interest only), all currently rated 'AAA'...The three classes were placed on Rating Watch Negative alert on June 3, 2002 in connection with 12 other CMBS deals. Fitch has been in contact with Wells Fargo Bank, N.A., the master and special servicer for this transaction, with regard to the terrorism insurance policies specific to 1345 Avenue of the Americas and other properties covered under the borrower's terrorism insurance policies...After this review, Fitch believes the current insurance policies provide sufficient coverage for these certificates.
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> Businesswire, June 13, 2002

E. Claims that Ending TRIA or Cutting it Back Sharply to Protect Taxpayers Will Result in Economic Chaos Are Not Justified

If the terrorism reinsurance "gap" in 2002 taught us anything, it was that the nation quickly adjusted to the terrorism insurance shortage and the private market found ways to provide most of the needed coverage. In 2002, the insurance industry was in the early stages of steep price increases and general insurance shortages, which are typical of the hard market phase of the insurance cycle that had begun in early 2001 and was exacerbated by the September 11th attacks. In 2005, the industry is in a much better financial position. It has record reserves, as well as extremely high levels of profits and retained earnings. If this industry could adjust to a lack of terrorism reinsurance in 2002, it certainly can do so in 2006. If terrorism insurance premium charges increase in the wake of TRIA's expiration or limitation, policyholders are in a good position to handle these increases because overall insurance rates are generally falling as the market enters its "soft' phase.

V. Recommendations to Congress

A. The Best Short-Term Solution: Allow TRIA to Expire

Based on the findings of recent studies by CBO and the Department of the Treasury, improvements in terrorism risk modeling, low terrorism rates in much of the country, as well as strong industry profitability and financial soundness and the growing capacity of insurers to offer terrorism coverage, CFA finds no compelling reason to extend TRIA beyond the end of 2005. In fact, as stated above, insurers and large commercial policyholders are in a very good financial position right now to deal with the expiration of TRIA.

B. The Next Best Short-Term Solution: The Treasury Department's Recommendations

If TRIA is extended, it should be dramatically scaled back along the lines recommended by the Department of the Treasury:

- **Increase the retentions that insurers must pay for losses.** The industry is flush with profits and higher retained earnings. CFA believes that any new TRIA that extends beyond December 31, 2005 should be based upon the Treasury Department's minimum of a $500 million event trigger, but should also include an industry retention of at least $75 billion pre-tax (which translates to $50 billion post-tax). This would guarantee that, even in the worst case of terrorism, the industry would be in at least as strong a position as they were just before the attacks of September 11th.

- **Ensure that taxpayers pay no costs for backing up terrorism losses.** Overall, commercial insurance rates are dropping fast. There could be no better time to allow private alternatives to develop. The Treasury Department should require that insurers pay premiums for the coverage that taxpayers are providing that are actuarially sound, if a not a little higher. Requiring insurers to pay rates that are slightly higher than estimated will, as CBO noted, encourage private insurance mechanisms to quickly compete by offering lower rates and will encourage mitigation efforts.[22] This process would not necessitate the development of a large government bureaucracy. A handful of staff handled premium payments by insurers under the Riot Reinsurance Act.

- **Remove TRIA back up for commercial auto, general liability and other minor lines of insurance.** It makes perfect sense to limit the TRIA backstop to important lines of insurance that the industry might have trouble covering, as the Department of Treasury proposed.

- **Make it clear that this extension is a one-time, temporary extension that will not be renewed absent remarkable events.** The industry and large commercial policyholders must be told clearly that taxpayer assistance completely ends on a date certain.

- **Do not get into a tort reform fight as part of this debate**. The proposal by the Department of the Treasury to eliminate coverage for general liability lines is at odds with Treasury Secretary Snow's accompanying letter to Congress recommending that tort reform be a part of the TRIA extension process. Liability only amounts to 10 percent of the terrorism risk according to the ISO model and will be almost completely eliminated from federal coverage if the lines of insurance recommended by the Treasury Department are not covered by TRIA. Secretary Snow's proposal is not only harmful to consumers, it is unnecessary. The proposal also adds an extremely divisive element to the debate about renewing TRIA that could endanger renewal of the program in any form.

- **Increase the share of losses that insurers must pay above the deductible amount** from 10 percent to 15 percent, increasing by 5 percent a year.

- **Provide taxpayer back-up only for truly exceptional terrorist events**, such as attacks with weapons of mass destruction.

- **Do not add group life coverage to TRIA.** The Treasury Department's report proposes to reduce the number of lines of insurance that are covered by TRIA by excluding coverage for auto insurance losses and commercial general liability coverage. Group life

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[22] When the author of this report, an actuary, was Federal Insurance Administrator under Presidents Ford and Carter, he had the job of calculating actuarially sound rates for the Riot Reinsurance Program. This program was very similar to TRIA, covering violent man-made attacks on property. These riot reinsurance rates were determined by only one employee, in consultation with the insurance industry and actuarial organizations. It is feasible to make actuarial rates for terrorism insurance, starting with extant models (such as the Insurance Services Office model used by most insurers) and building on that effort. This effort would not require a large bureaucracy.

insurers, meanwhile, are actually proposing an expansion. There is no meaningful evidence that justifies expanding TRIA to cover group life insurance. The Treasury Department has already rejected the request to expand the current TRIA to include group life. Than was the right decision. Even the National Association of Insurance Commissioners, a group well known to be very industry-friendly and particularly concerned about solvency and any possibility of undue risk, has refused to allow group life exclusions. It is likely that a major reason that both the Treasury Department and NAIC have rejected the appeals of life insurers for relief is that these insurers have not attempted all meaningful measures to spread their risk privately. CFA has not received a single complaint from a consumer or business indicating that there is a problem in the life insurance market. Since there are no exclusions allowed by the NAIC, we would likely be hearing about rising costs if they were rising, but we are hearing no complaints at all. To test this hypothesis, CFA did research using the NAIC complaint database.[23] The top ten group life insurance writers had 294 complaints under "group life" in 2001 and 361 in 2003. The increase in complaints (67) was virtually all related to Metropolitan Life Insurance Company, which had a growth in complaints of 65. Looking in detail at Metropolitan's complaints, we found zero complaints related to "terrorism" in either 2001 or 2003.[24]

- **Beware of insurer attempts to use TRIA renewal as a pretext to deregulate insurance.** Insurers appear to be opportunistically seeking to cripple key aspects of insurance oversight under the guise of creating a uniform, national market for terrorism insurance. There is simply no connection between TRIA renewal and regulatory issues. There is no evidence that over-regulation has in any way hampered the ability of insurers to innovate and come up with viable private alternatives to TRIA. Indeed, some insurers are creating terrorism insurance alternatives today, such as stand-alone policies and automatic coverage in some instances. Several insurers are prepared to offer stand-alone terrorism coverage should TRIA expire. Given the soft market, market sources say that some insurers stand ready to "give away" terrorism coverage to attract business.[25] Insurers are poorly regulated in most states regarding necessary consumer protections. Congress should not interfere with state insurance regulation unless a balanced, thorough study of such action is undertaken separate and apart from TRIA issues.

- **Spur non-governmental alternatives to TRIA.** Private markets can handle most, if not all, of the terrorism risk. Stand-alone policies are ready to be used should TRIA expire. Except in the largest cities, terrorism coverage should be available at little or no increase in price should TRIA expire. As we indicate above, even a five-fold increase in terrorism insurance premiums would not result in an overall increase for large and medium sized businesses as their insurance premiums are sharply dropping due to the soft market conditions caused by excessive capital in the property/casualty insurance business. TRIA itself has hampered the development of private alternatives such as normal reinsurance and securitization alternatives, such as catastrophe bonds. Expiry of TRIA will very likely result in the development of such mechanisms to cover terrorism risk.

[23] The database can be accessed from the NAIC web page, www.naic.org at the Consumer Information Source (CIS).
[24] "Terrorism" is itemized as a complaint area in the NAIC complaint database.
[25] Liability and Insurance Week, March 21, 2005, page 2.

Creating private pools of like risks, similar to the pooling done in several other countries, is another method for covering terrorism risk that requires no federal role. There has been no need to create such private pools given the availability of free, taxpayer-subsidized TRIA reinsurance. TRIA also does not cover terrorist attacks involving most weapons of mass destruction (WMD), including attacks using biological, chemical or nuclear methods. This is one area where a federal role might be needed to create such coverage in the future. If a federal backstop for WMD is created, it should require actuarial rates for the reinsurance so that taxpayers are not subsidizing insurers that don't need the help. Finally, the federal government could assist in the development of private alternatives by allowing catastrophe reserves to build up tax-free on funds earmarked for the sole purpose of paying terrorism losses and nothing else, (perhaps by placing such funds into fiduciary accounts not available except for the purpose of funding payments after terrorism losses are incurred).

C. Longer Term Solutions

We understand that this Subcommittee is considering a longer-term solution to the terrorism insurance problem -- perhaps modeled after the risk pool that Florida has established to cover losses due to windstorm damage.

CFA believes that such a longer-term solution would be exceedingly complex. It is unlikely that Congress could reach a consensus on such a solution by January 1, 2005. Further, we are concerned that such a solution would significantly increase the risk of a permanent federal presence in the terrorism insurance market and, thus, unnecessarily increases taxpayer exposure. We are also concerned that such a solution would raise many complex federal/state issues that deserve a separate discussion, perhaps in the context of this committee's discussion about "SMART" legislation.

1. How Florida's Extremely Complex Risk Pool Works

The Florida risk pool, known as Citizens Property Insurance Association, was created by the Florida legislature to provide windstorm coverage in high-risk areas of Florida. It sells personal lines of insurance directly to consumers (outside the designated high-risk areas), commercial lines of insurance directly to consumers (outside the designated high-risk areas) and high-risk coverage directly to consumers (within the designated high-risk areas). The Association and participating insurers may, by law, enter into a quota share reinsurance arrangement for wind coverage only, which means that the Association and insurers share each risk on a percentage basis as determined in the reinsurance contract. The percentage share must be in the range of 50 percent to 90 percent with the Association sharing the majority of each risk. Insurers can opt out of the reinsurance program. If they opt in, however, they pay a premium at the percentage of the quota share applied to the total written premium paid by the policyholder.

Insurers are required to pay an assessment for each account and can lower their assessments by covering higher risks voluntarily or covering risks currently receiving insurance from the pool. If deficits occur in the pool, insurers are assessed. This assessment is limited to 10 percent of the premiums written for these lines of insurance. If the deficit exceeds 10 percent, the Association then collects this amount over time from insurers and can obtain loans to cover the deficits, by issuing bonds pledging the assessments as collateral.

Rates are required to be actuarially sound so as not to interfere with private sector competition with the corporation. The corporation is free from federal taxation, enabling it to accumulate reserves more quickly. Every aspect of the corporation is subject to regulation by the Florida Insurance Department, including policy forms, rates, the reinsurance arrangement, the plan of operation for the corporation and other matters. This highly complex review requires the services of attorneys, underwriters, actuaries and other experts.

2. Federal Pool Concept

We understand that the federal long-term proposal differs from Florida's pool in that it would authorize an industry reinsurance facility designed to provide a middle layer of coverage between what primary insurers supply and any federal reinsurance offered above and beyond that covered by the pool. Insurers that pay into the pool would build capital, tax-free, to be used as a buffer to cover terrorism losses below the level of federal reinsurance. It is unclear if this would be quota share reinsurance that the pool provides to the primary insurers, or excess of loss reinsurance. If it is excess of loss coverage, the rates for the reinsurance will have to be separately determined. We understand that the federal reinsurance over that covered by the pool would be excess of loss reinsurance above the retentions paid by primary insurers. This provision would be structured in a manner similar to TRIA, but at increased retention levels and with an "event trigger" similar to that proposed by the Department of the Treasury of around $500 million. We further understand that the coverage would be limited to commercial businesses but would include all property/casualty lines, as well as group life.

Insurers would be required to pay premiums for the reinsurance coverage. Insurers could opt not to take federal reinsurance. Provisions to prevent adverse selection are being considered, including charging reinsurance rates to each insurer based on the risk of the coverage the insurer is offering, and/or requiring all members of an insurance group of companies to either accept federal reinsurance or not. We understand that the Committee is looking for a reaction to this general idea in the absence of a specific, drafted plan.

3. Principals for Ensuring the Proper Implementation of a Risk Pool

CFA believes that a pool could be established by insurers with no federal involvement if TRIA expires. In fact, we think it is likely that, over time, at least some states with higher risks would do so via interstate compact, such as New York, Illinois, California, D.C. and Texas. The simplest solution would be for Congress to authorize this approach and step away. If Congress considers a long-term solution, such as a federally authorized risk pool with federal reinsurance, we offer several principles for your consideration.

a. Beware of insurer cherry picking against the pool. Several pool plans we have seen over the years would allow insurers to "cherry pick" against the pool, by sending the highest risk policyholders into the pool and keeping the lowest risks for the insurer's own accounts. This can be done if an insurer is allowed to send individual risks to the pool or it can be done if a group of insurance companies is allowed to place the high risks into one company that is part of the group and only reinsure that company (as opposed to all companies that are part of the group). An insurer group must, if it has any choice, be completely in or out of the pool.

Any legislation authorizing a pool must recognize that such an arrangement subjects the government to potential adverse selection as insurers with less catastrophe risk are less likely to voluntarily purchase coverage, while those with greater risk are more likely to purchase coverage. If legislation were to create a government reinsurance program, the program should encourage the inclusion of both low-risk and high-risk policyholders to promote greater risk spreading in a way that does not subject the government to adverse selection.

b. Beware of insurer attempts to deregulate insurance oversight as part of a pool proposal. A pool established by the federal government is a legally authorized cartel that requires regulatory oversight. When terrorism insurance was first being considered in 2001 and 2002, insurers proposed adopting the Illinois regulatory system for the national pool. This provoked a strong negative reaction from consumer organizations, which view Illinois as the worst system in the country because it has very few consumer protections. If Congress is seeking uniformity as part of this process, it should raise standards, not lower them, by picking a state such as California with high regulatory standards.

c. The reinsurance offered by the federal government should not cover lines with minor terrorism exposure. As Department of the Treasury proposed, the lines covered by any federal reinsurance plan should be scaled back from the current TRIA coverage. General liability and commercial auto and other such lines should not be part of the federal backstop plan in effect after December 31, 2005. Group life insurance should not be added, as study after study by the Treasury Department and the regulators has found that to be unnecessary.

d. Beware of attempts to override state and federal anti-trust laws. When Congress last considered such a pool, insurers sought an override of federal and state anti-trust laws. This is not needed and is dangerous if there is little or no regulation of the pool. After all, the association would be a cartel and, unless regulation is effective, there would be potential for price gouging by the pool.

e. Make sure insurers pay the federal government full actuarial rates. Taxpayers should no longer be required to subsidize the extremely flush insurance industry, especially in light of the size of current budget deficits. Insurers must be required to pay the full cost of any coverage they receive. Excess of loss reinsurance prices can be established, but such a process will take time.

f. The pool should be supervised by a board representing policyholders, not just insurers, regulators and the federal government. Different private and public interests must be represented on the board of directors of any pool that is established, so that all parties are adequately represented.

g. All records of the pool must be public. All records must be fully available for federal and state audit and, to the extent possible, available online to the public.

h. Assure that the cost of terrorism coverage charged by reinsured insurance companies to the consumer is actuarially based and correlated in price with the reinsurance offered by the government, especially if a quota share arrangement is adopted. This will ensure that policyholders are not overcharged.

i. The legislation must clearly define "terrorism" and exclude any coverage beyond that definition. The Secretary of the Treasury should determine if a specific event falls into the definition. Consideration should be given to including losses incurred through Weapons of Mass Destruction (nuclear, chemical and biological attacks) as part of the coverage for terrorism, as this is an area where the private sector will require help if coverage for these events is to be provided.

j. Promote or encourage coverage that is available to any property that meets reasonable standards of insurability. Federal security requirements should be met within reasonable time periods by insured risks and policed by inspection by reinsured insurers. A requirement to sell insurance to businesses meeting such standards should be imposed as part of any long-term federal reinsurance backstop plan.

k. State residual market mechanisms and other pooling mechanisms for insurance should be allowed to participate in the entity established by legislation to provide terrorism insurance, in such a way as to not create incentives for business to be placed in the residual market. To the extent that a risk meets the minimum-security requirements, it should be able to get terrorism coverage through some source, and a residual market if necessary.

l. Jurisdiction over claim settlement practices should remain with the states. There are many sorts of abusive claims practices that harm policyholders and consumers. These are defined by state unfair claim settlement practices acts in all states. States regulate to assure that claims are not unnecessarily delayed or denied. These important consumer protections must be maintained.

m. State and federal tax laws should be amended or overridden to avoid penalties on and encourage the accumulation of reserves for terrorism losses.

n. Encourage loss reduction and hazard mitigation efforts through enhanced security.

VI. Conclusion

Unlike the period when TRIA was adopted by Congress and signed by the President, the property/casualty insurance industry is earning record profits and has set aside record retained earnings (surplus) in their accounts. The industry is overcapitalized at near historic low leverage ratios. As a result, competition to offer insurance coverage is intense and is sharply driving down current premiums for policyholders. Large and medium sized commercial risks are seeing premiums drop by double digits in 2005. Smaller commercial risks are witnessing a five percent drop.

Now is the perfect time to wean the affluent insurance industry and its largest policyholders from the current free reinsurance provided to them by taxpayers who face mounting federal deficits. The recent CBO and Treasury Department reports make clear that there is no need to extend TRIA in anything like its current form. CFA agrees.

In the wake of these reports the property/casualty industry and some of the insurance industry's largest and most affluent policyholders have warned of disastrous consequences to the economy should TRIA expire or be sharply cut back. We find these predictions of impending doom to be easily disproven by events during the year following the terrorist attacks of September 11th, when there was no TRIA in place. In fact, insurers warned of exactly the same repercussions if TRIA was not enacted before January 1, 2002. These did not materialize when the insurance industry faced declining surpluses and skyrocketing premium charges to the policyholders. If it did not happen in 2002, it will not happen in 2006, when the industry is in a far stronger financial position.

CFA believes that TRIA should simply expire (this is our first choice). But if TRIA is extended, CFA largely supports the Department of the Treasury's recommendations to significantly pare back the program. This would include the elimination from the program of lines of insurance such as general liability and commercial auto with small terrorism risk. Group life insurance should definitely not be added to TRIA since life insurers have not provided meaningful evidence that it is necessary. CFA also agrees with the Treasury Department's recommendation that the "trigger" for reinsurance coverage should be raised to $500 million in losses and that the retention (deductible) should be raised (we believe the deductible should be raised to $75 billion [$50 billion after tax considerations]). Co-payments should also rise, by five percent per year.

Beyond the Treasury Department recommendations, CFA recommends charging a premium for whatever coverage is available to insurers. CBO appears to favor such a premium charge. Even insurers have agreed that there is no legitimate argument against such a charge. Developing and administering a premium payment system is very easy and would require only a handful of staff.

Any extension of TRIA must be clearly temporary and enacted only for the purpose of giving the private sector a short time to prepare to handle all terrorism coverage itself.

CFA does not support Secretary Snow's call for tort reforms to be enacted in conjunction with TRIA, which would likely harm consumers with legitimate claims. Such changes are also not justified given the small size of projected liability losses from terrorism, which will all but disappear if general liability and auto is removed from TRIA coverage, as the Department has recommended.

By ending TRIA or sharply cutting it back and charging actuarially sound premiums for the coverage provided, Congress will enable the private sector to grow and manage this coverage. The charging of accurate, risk-related prices will also enhance mitigation efforts as policyholders seek ways to achieve discounts from insurers.

The third and least effective choice is the establishment of a longer-term terrorism risk pool backed by the federal government. Such a pool could be set up by insurers with no federal involvement if TRIA expires (and we think it is likely that, over time, at least the key risk states, such as New York, Illinois, California, D.C. and Texas would do so via interstate compact.) So a simple solution would be for Congress to authorize that approach and step away.

It is unlikely that Congress can put together a complex risk-pooling bill by January 1, 2006, much less institute such a program. Further, we are concerned that it significantly increases the risk of a permanent federal presence in the terrorism insurance market and, thus, unnecessarily increases taxpayer exposure. We also worry that it may raise many complex federal/state issues that deserve a separate discussion.

If Congress attempts to create such a pool, there are many requirements that must be included, such as blocking insurer cherry picking, creating federal regulation to replace any preempted regulatory requirements, and assuring full actuarial rates are part of the plan.

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT-SPONSORED ENTERPRISES

JULY 27, 2005

STATEMENT OF JAMES E. MAURIN
ON BEHALF OF
THE COALITION TO INSURE AGAINST TERRORISM

Thank you Chairman Baker and Ranking Member Kanjorski for conducting today's hearing on the future of terrorism insurance. I also want to thank Chairman Oxley for his commitment to bring legislation regarding this issue to the floor of the House of Representatives in an expedited manner.

My name is James E. Maurin. I am the recent past Chairman of the International Council of Shopping Centers, and the founder and principal of one of the Gulf South's largest commercial real estate companies, Louisiana-based Stirling Properties. I am appearing today on behalf of the Coalition to Insure Against Terrorism, or CIAT, which includes the United States Chamber of Commerce and 75 other major trade and business organizations that rely on the current federal program for access to terrorism insurance for the future of their businesses.

To date, Stirling, with 15 offices and 280 people in Louisiana, Mississippi and Oklahoma, has developed more than $300 million worth of property, including retail, office and residential projects. It is also a leading real estate services company in the region; it manages some 6.2 million square feet of commercial property, about 65 percent of which is retail, and also provides brokerage and market research services.

The shopping center industry, like many of the members of CIAT, relies on sophisticated financing models to obtain the capital necessary to keep the retail engine of this country humming. In 2004, there were 12.5 million retail and real estate leasing, or shopping center related jobs in the United States and during the first two quarters of 2005, shopping center industry employment has expanded by 102,000 jobs, accounting for 9.4% of total job growth. In 2004, shopping-center inclined sales accounted for slightly over $2 trillion of retail spending power or 51.7% of total retail sales, 17% of nominal GDP. By the way, these sales raised approximately $109 billion in sales tax revenue for state and local governments.

The members of CIAT were pleased to work with the members of this Subcommittee to help develop and enact the Terrorism Risk Insurance Act of 2002 (TRIA). We thank the members of this Subcommittee and the full Financial Services Committee for their continuing leadership in addressing this national problem.

We wish to emphasize the extreme importance of having a new terrorism insurance backstop in place as far ahead of the current scheduled expiration on December 31, 2005 as possible. As policyholders, our members have already been subject to a variety of "pop-up exclusions" and "sunset clauses" and other restrictions which the insurance industry has begun to impose on renewal of policies running through December 31, 2005.[1] These exclusions are in anticipation of a possible disappearance of the TRIA backstop. Worse, these exclusions take effect even if TRIA is renewed or replaced, but the changes to it reduce the backstop protection to insurers. These gaps, or potential gaps, in coverage will begin to have an effect on construction lending and debt ratings the later in the year that we go without a replacement program being in place.

CIAT has strongly and consistently urged Congress to keep a terrorism insurance program in place for one overriding reason: the private insurance markets cannot and are not yet able to take on the job on their own. We know this because, as policyholders – the consumers of insurance – when the current program expires, so does our coverage. We know our coverage expires because more and more of our insurers tell us so every day, in the form of exclusionary notices and coverages that extend only to the end of this year. If the private insurance market was capable of dealing with this issue, it would be preparing to do so now. Unfortunately, we see no evidence of that occurring. As a result, the crisis that Congress and the Administration dealt with in 2002 looms again and requires immediate legislative action.

CIAT has supported and encouraged every effort in this Congress to continue a terrorism insurance program that would provide effective coverage. We expressed support for the only legislation introduced to date, H.R. 1153 and S. 467, which would extend TRIA in substantially its present form for another two years while setting up a commission to work out the details of a replacement program. We also have supported this Subcommittee's efforts to work with the Senate and the Administration to address problems and gaps in the current program, and are grateful for the commitment of the leaders of this Subcommittee to putting a new terrorism insurance program in place before the end of this year. The policy imperatives laid down in the Administration's June 30th letter to Congress also recognize that a new program may now require some additional features, which makes the task of legislating a new program in the next few months a real challenge.

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[1] In anticipation of TRIA's expiration, Insurance Services Office, Inc. (ISO) has filed three new endorsements with state insurance commissioners for use with commercial policies with inception dates from January 1, 2005, through December 31, 2005. These conditional endorsements will supersede other terrorism endorsements or coverages attached to the policy. They will become effective if any of the following circumstances occur:
• TRIA is not renewed; or
• a make-mandatory obligation is not made part of a TRIA extension, and there is:
– an increase in the statutory deductible, which is set at 15 percent for 2005;
– a decrease in the government's 90 percent reinsurance of the loss in excess of the insurer's deductible; or
– a redefinition of terrorism within TRIA.
For property policies, the three filed endorsements either exclude terrorism, exclude terrorism if all losses exceed $25 million, or provide a sub-limit for terrorism. According to Marsh's *Marketwatch: Terrorism Insurance 2005* (July 2005), the ISO property endorsements have been approved in 46 states and in Guam, Puerto Rico, the Virgin Islands, and Washington, D.C.; have not been approved in Florida, Georgia, and New York; and have been approved for certified acts only in Texas. Because Florida, Georgia, and New York have not approved the ISO conditional endorsements, property insurers are offering lower policy limits for accounts with exposures in these states, particularly for risks in New York City. Again according to Marsh, many insurers have adopted these endorsements—starting with January 1, 2005, renewals— where it is their intention not to continue terrorism coverage if TRIA is not extended.

We do not share the Treasury Report's confidence that the TRIA's expiration would likely lead to only a "short-lived adjustment in coverage and pricing." On the contrary, we can only repeat our concern that the American economy is already being adversely affected by the anticipated year-end expiration of TRIA. If we want to avoid a repeat of the near-paralysis of major construction and interruption of other business activity which we experienced in 2001-2002 before TRIA was in place, then Congress needs to act well in advance of year-end. We are also unconvinced, to say the least, that the private insurance and reinsurance industries are yet able to provide anywhere near adequate coverage or capacity for this peril without some sort of Federal backstop for the large catastrophic events. Moreover, there is little evidence in the Treasury Report to suggest that capital markets will respond any more positively – in the short run – than insurers or reinsurers in terms of filling the void that TRIA would create if not renewed.

A significant portion of the financing for commercial real estate is achieved through Commercial Mortgage Backed Securities, often referred to as CMBS. CMBS pool commercial mortgages and issue bonds that are backed by individual loans. More than $444 billion of loans are pooled in CMBS, representing almost one-fifth of all commercial real estate mortgages.

CMBS are rated by rating agencies such as Moody's and Fitch, which is why we were concerned when each rating agency voiced apprehension regarding the potential effects that the expiration of TRIA could have on the CMBS market.

When ratings become volatile, bonds lose their attractiveness, existing bonds lose value, and reserves must be adjusted to reflect the ratings changes, limiting cash flow for everything from capital for new development to funds for pension benefits.

Pension portfolios are heavily invested in commercial real estate, through investment in CMBS, real estate investment trusts (REITs) as well as through direct investment. As of January 2005, $166 billion in assets have been invested by defined benefit pension plans, with almost $107 billion in real estate equity, which represents an actual piece of ownership.

As many of the members of this esteemed panel will be aware, the public pension funds from your state are substantially invested in commercial real estate. Some of the pension funds with substantial commercial real estate investment include CalPERS, the Florida State Board, New York State Employees and Teachers, Ohio State Teachers and Public Employees, Pennsylvania State and School Employees, Massachusetts PRIM, Alabama Retirement and Louisiana Teachers. Should terrorism insurance expire, billions of pension dollars belonging to workers across this country could be exposed to undue liability.

Having spoken to institutional investors in preparation for this testimony, some are beginning to take a "wait and see" approach to commercial real estate investment, especially on properties or projects where obtaining full terrorism coverage would be in doubt in a degraded market. This wet blanket on capital creation will slow down new development, economic growth and job creation.

The uncertainty surrounding the future of federal terrorism insurance is impacting business today and growth for years to come. I cannot put a project together in 6 months, my lead time is 3-4 years at a minimum, but I need to have terrorism insurance in place before I buy the land and start rezoning, permitting or negotiating with tenants. The markets need certainty and the effects of this debate and the length it extends could impact the economy years out.

In addition, even with TRIA in place, most businesses have significant gaps in coverage for potentially catastrophic losses resulting from nuclear, biological, chemical, and radiological (NBCR) related terrorist attacks. Both the RAND Corporation and the Organization for Economic Cooperation and Development have issued reports over the last several weeks stating concerns with the lack of protection against this growing threat. How can we expect the private marketplace to cover NBCR attacks when they are not even covered with TRIA in place?

As consumers of commercial property and casualty insurance, policyholders are pleased with the success of TRIA and the terrorism insurance program it instituted. With virtually no cost to the taxpayer, the terrorism insurance program has worked largely as intended. It put the economy back on track after 9-11 and restarted the stalled construction industry putting some 300,000 people back to work. Since then it has allowed businesses across America to continue operating and growing, saving countless jobs in the process. Although there are still some gaps in coverage, TRIA has made terrorism insurance broadly available to all businesses that want and need this vital coverage.

The TRIA insurance program was intended to be a temporary measure to "backstop" the market until the private insurance markets could fully assess and price the risk. Unfortunately, the situation the Nation is in today does not make that possible. Our most senior government officials tell us that the threat of terrorism remains undiminished. Our Nation has had a great deal of success at dealing with and deterring terrorist threats over the past three years. Paradoxically, that success makes it impossible for the government, the insurance industry, or insurance policyholders like CIAT members to determine where, when, or with what frequency future terrorist attacks might occur.

The risk of further catastrophic terror attacks appears to be as acute as before. The recent attacks on our closest ally Britain remind us all of what may happen here. Earlier this spring CIA Director Porter Goss told the Senate Intelligence Committee that al-Qaeda is intent on finding ways to circumvent U.S. security enhancements to attack the homeland. He said, "the terrorist threat to the U.S. in the homeland and abroad endures . . . [i]t may be only a matter of time before al-Qaeda or other groups attempt to use chemical, biological, radiological or nuclear weapons." And FBI Director Robert Mueller expressed concern to the same Committee about the risk posed by radicalized Muslim converts inside the United States and said that he worries about a "sleeper operative" who may have been in place for years, awaiting orders to launch an attack: "I remain very concerned about what we are not seeing," he said.

Not surprisingly the insurance and reinsurance markets have not re-established an ability to handle this problem alone. Federal Reserve Chairman Alan Greenspan, in his appearance last week before this Committee, said he has yet to be convinced the private market alone can adequately insure against the continuing threat of terrorism. Saying terrorism and geopolitical risk have become enduring features of the global landscape, Chairman Greenspan again made clear his view that private insurers alone can't handle the risk of losses resulting from terrorist attacks: "The type of terrorism that is arising in the context of increasing technologies which were not available before has created the possibilities of huge losses. And there is no way for a private 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." In and earlier appearance this spring, Chairman Greenspan said, "[t]here are regrettable instances in which markets do not work, cannot work," and "I have yet to be convinced" that the terrorism insurance market can be made to work. Even with the terrorism insurance program in place, the most severe risks cited by the CIA Director Goss —chemical, biological, radiological and nuclear attacks—are almost wholly uninsured today, aside from workers' compensation.

All these factors – the likelihood of future terrorist attacks; our success in thwarting more attacks to date; the impossibility of assessing where, when, and how terrorist attacks may occur; and the severe consequences for the economy without the continued availability of coverage – combine to make it imperative for Congress to act promptly to provide for the availability of terrorism insurance beyond this year.

We recognize that Congress, the Administration, and stakeholders are now effectively faced with pursuing two basic options: (1) a short extension, say for two years, of the TRIA program structure, albeit with some changes which move in the direction of the criteria set forth in Secretary Snow's June 30th letter, or (2) developing now a more permanent solution perhaps in the form of a mutual reinsurance facility (pool) with government bonding or retrocessional support which could be the vehicle for development of significant private capacity over time.

Both approaches have some attraction to us. The short extension legislation should be relatively simple to negotiate and therefore may provide greater assurance of being completed in time for year-end renewals – which is our paramount concern. On the other hand, developing an intermediate private-sector layer of coverage would move us toward a long-term, market-based solution for a problem which we have every reason to believe will be with us for years to come. The new structure might also provide more opportunity to address some of the continuing problems that we have with the TRIA experience, e.g., unavailability of NBCR coverage, than would a simple extension with higher event-triggers and deductibles.

In creating a successor program under either model, the policyholders of CIAT request that the Committee keep in mind the following several principles:

First, the program should include a requirement for insurers to "make available" insurance against the terrorism peril in all lines of commercial insurance to all customers. Such a requirement is necessary to ensure that property owners and businesses will be able to secure sufficient terrorism risk coverage to adequately protect their assets and their employees who work there.

Second, in order to prepare the nation's economic infrastructure for the possibility of a catastrophic terrorist attack, the insurance program needs to be comprehensive in nature. Any new program must be designed with the goal of minimizing any exclusions or gaps which would undercut the whole purpose of the program. In particular, coverage for NCBR acts, as well as acts of domestic terrorism, not certified under the current program, should be part of the private sector solution in exchange for any government backstop.

In addition to these key two points, CIAT believes that there are other aspects of the rewrite that are important. For example, care needs to be taken to fashion a backstop which attaches at the appropriate point (establishing the financial responsibility of both insurers and policyholders, as well as identifying the level of insured losses at which the government's participation would be initiated) to adequately protect insurance policyholders, insurance providers and the federal taxpayer from undue risk tied to a catastrophic terrorism event. Where and how the attachment point is established for each participant in the overall system will have a significant impact on the availability and affordability of terrorism insurance coverage.

Moreover, the new program should create a system which is sufficiently flexible that it allows the private sector to develop over time alternative forms of capacity to cover the terrorism risk, while still retaining the Federal reinsurance backstop during the life of the program. These alternatives might include catastrophe bonds, an industry reinsurance pool, or securitization products in addition to traditional insurance and reinsurance products. This is the surest way to maximize the development of private risk capacity which someday might be able to stand alone without the government backstop.

CIAT is committed to working with your Subcommittee and other stakeholders during the next month on parallel tracks to develop both options, if need be, so that we are in the best possible position after Labor Day to enact the solution which proves most viable.

We sense an emerging consensus within the Financial Services Committee, and hopefully the whole of Congress, that a continuation of some Federal backstop is needed at least in the near-term. For that reason we will not burden the record unduly with further evidence of the need for this program. However, as an Appendix to this statement ("Five Reasons Why America Needs a Terrorism Insurance Backstop"), we submit some additional observations about the unique characteristics of the terrorism risk, the nature of heavily regulated insurance market, the constraints on reinsurance capacity which went largely unexamined in the Treasury Study, and details of a range of Federal insurance and backstop programs both historical and current which may provide useful precedent for a longer term public-private structure.

CONCLUSION

To close, I am not in the insurance business; I am in the commercial and residential development business. I cannot write my own insurance and I cannot decide what levels of risk or capacity my insurers can undertake and still be responsible to the fiduciary interests to which they are subject. I am the end-user and as a policyholder I am being squeezed by both sides in this debate regarding the future of federal terrorism insurance. On one hand, insurers do not want to take on this seemingly open-ended risk and on the other my investors cannot absorb that liability of being exposed. At the end of the day, my colleagues and I need to be able to buy terrorism insurance so we can continue to help grow the economies of every community in this country.

CIAT is unanimous in its belief that the Federal government must continue to provide a reinsurance backstop beyond 2005 if we are to avoid major disruptions to the economy. Indeed, these disruptions are already beginning to occur as major insurers cut off coverage at year-end in absence of a clear signal from Congress. Only a seamless continuation of the Federal backstop in some form in the meantime will avoid the more severe economic impacts, some of which already are emerging with the widespread use of sunset clauses in current renewal policies.

Chairman Baker, Ranking Member Kanjorski, we at CIAT thank you for holding this hearing and for giving us the opportunity to testify. We look forward to working with you and the rest of the Subcommittee on this important subject in the coming weeks.

APPENDIX

FIVE REASONS WHY AMERICA NEEDS A TERRORISM INSURANCE BACKSTOP

The Unique Nature of the Risk

Terrorism is a man-made risk -- intentional, organized and adaptive. It is unlike any of the other, usually natural or fortuitous, risks that the insurance industry typically underwrites. Terrorism is much more akin to war risk, both in its man-made characteristics (intentional, organized, and adaptive) and its potential for massive, unpredictable destruction. Experience has shown that war risk insurance is not (and will not be) readily available on most ordinary commercial property and casualty insurance policies; most such policies carry war-risk exclusions and have done so for decades. Thus, there is little reason to believe that insurers, or their reinsurers, will develop any time soon the ability, much less an appetite, to write terrorism insurance on a wide scale without some government role.

While war-risk exclusions on most policies have been tolerable to insurance buyers (and their lenders) because the advent of, or at least the proximity to, military operations is relatively uncommon and generally avoidable, exclusion of terrorism risk from commercial policies today would be a significant deterrent to economic activity because of uncertainty and unavoidability of the risk. This is what we saw in the months between the September 11th attacks and the establishment of the TRIA program. Lack of coverage in those months significantly impaired economic activity and chilled financial markets and lending sources for large-scale development, until TRIA created the ability for insurers to fill the gap (or most of it).

There is another reason the current terrorism risk is so difficult for private markets to handle without some government role. Insurers have few data points (e.g., the attacks on September 11th) by which to attempt to model the risk. With other potentially large catastrophic risks such as hurricanes and other natural phenomena, there is significant historical data on past events which can be used to model the frequency, severity, and locations (or paths) of future events. This modeling in turn can be overlaid with historical loss data and with policyholder location or density information to calculate each insurer's maximum probable loss for certain statistically probable events. With terrorism, however, there is a deficiency of data about potential attacks.

This deficiency of data is exacerbated by an important additional fact. The Federal government is the most informed source of information about terrorism risks; presumably assessing such risks are a primary focus of our national intelligence organizations. That is, the Federal government may well be in possession of such intelligence or other information regarding likelihood or nature of future terrorists acts, but it is unlikely that the government would share such information with the insurance and reinsurance industry as well as their customers.

Given the unique nature of the risk, the paucity of useful data to model future events and the controls in place on relevant information concerning terrorism, it is entirely understandable that the insurance and reinsurance industries have not yet developed an ability to underwrite intelligently on their own the complete amount of terrorism insurance necessary for the U.S. businesses to operate effectively and the U.S. economy to achieve its full potential.

The State of the Insurance Market

In the debate over a terrorism insurance mechanism three years ago, there was much concern expressed about government intervention in a "free market" of insurance. Free market principles are a laudable starting point for most economic policy discussions. The insurance industry, however, is a sector which the courts and legislatures have long recognized as "affected with the public interest" and therefore subjected to heavy government regulation. Indeed, it is one of the most pervasively regulated of all industries. Both entry into and exit from the industry is strictly controlled by government licensing and regulation. While there seems to be real competition for some of the easy-to-write lines of insurance, both the form of product and often the price in most lines of property and casualty insurance are subject to state-by-state regulation (and sometimes Federal creation). The latitude of insurer actions in many aspects of their business is to a large degree a function of state solvency regulation. It is also an industry where various government actions (both state and federal) require or encourage the pooling of certain risks, and where, in many cases such as workers' compensation insurance, the insurable risk is itself created and defined by government mandate. So, to assume that there is a market otherwise unaffected by government action or that unfettered market forces will somehow be prepared to respond to the threat of terrorism in the absence of a federal backstop seems to ignore the reality of that industry.

The state-by-state nature of insurance regulation and therefore market conditions means that, in the absence of Federal backstop, availability of coverage and industry response to a catastrophic event may be quite variable from jurisdiction to jurisdiction. In the event of a multiple-jurisdiction attack following TRIA's expiration, the regulatory patchwork could result in businesses in one location with effective coverage and those in another location without coverage or with coverage from an insolvent carrier.

This is not to say that there is no role for private capital or entrepreneurial spirit in this line of the insurance business. TRIA proved that the presence of some form of Federal backstop enables the private sector to respond in various ways to their customers' needs (if far from completely in the case of nuclear, biological, chemical and radiological risk). All of the responsible studies and reports produced since TRIA was put in place show that the private insurance and reinsurance sector do not have the capacity to underwrite this risk without the Federal backstop. Reinsurers this year have available terror-related capacity of only $4 to $6 billion dollars. To provide some context, the World Trade Center attack resulted in insurance payments exceeding $32 billion. Moreover TRIA does not appear to have "crowded out" the development of private capacity. To the contrary, all data show that private reinsurance capacity has not even been able to cover the primary industry's collective deductibles and retention layers which the TRIA backstop leaves to the private sector. Any thought that reinsurers will commit additional resources now to terrorism coverage in the absence of a backstop defies logic. More time, and perhaps a re-thinking of the division of risk between the Federal backstop and the private sector, is needed in order to better develop private capacity for terrorism coverage.

One deficiency that we note in the Treasury Study is the apparent failure to consult professional brokers and especially reinsurance intermediaries. One of the world's largest brokerage and insurance consulting groups, Willis North America, points out that, on the most optimistic basis for the perils that reinsurers are most comfortable reinsuring; i.e., property natural catastrophe, the maximum worldwide reinsurance capacity is no more than $25-30 billion. They go on to argue that surely the worldwide capacity for terrorism reinsurance will be a subset of this amount – that is, considerable less than the incurred losses from the World Trade Center attacks, much the potential attacks of the future.

The Proper Role of Government

When terrorists target symbols of a nation's economic, political and military power, they are attacking the nation as a whole, not just the symbol itself. We need to recognize that the terrorism risk is different from other types of insurance for other reasons. By its definition, terrorism is an effort to effect changes in government policy and public attitudes. Terrorists target places and properties on American soil in an effort to change U.S. government policy and our behavior as a society. While we may not be able to truly understand the motivation of such actors, whether it is our way of life or our government policy which they attack, it does seem that the risk has little to do with the particular policyholders who need protection. How is a business owner in Baltimore or an insurer in Birmingham expected to cope with that threat without some role by the government? We look to the Federal government to protect us from this threat militarily; why not, in some limited way, economically?

Other leading nations on the forefront of the war against terrorism have found it necessary to adopt national programs to help manage this economic risk. Most involve a mix of both government and private sector roles. These include government programs in at least the following countries: the United Kingdom, Germany, France, Spain, South Africa, Austria, and Israel. Recently the Government Accountability Office released a report entitled, *"CATASTROPHE RISK: U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risk,"* which gives a detailed description of the governmental guarantees provided for terrorism coverage in the first four European countries mentioned above. In every one of these cases, the program extends beyond the current expiration of TRIA.

A Matter of Fairness

The Federal terrorism insurance backstop does not exist in a vacuum. TRIA was part of a comprehensive set of policies which comprise the war on terrorism which President Bush rightly declared after the September 11th attacks on our country. These in turn fit with already existing policies, some of which found heightened purpose in the post-9/11 world. The PATRIOT Act is one example of the new set of actions launched after 9/11. Like TRIA, much of the PATRIOT Act was originally authorized for three years, and the Administration is now calling for renewal of those provisions because the war on terrorism is far from complete. Just as the PATRIOT Act will be re-examined this year in light of three years' experience, we do not insist that an automatic extension of TRIA is the only appropriate response to the continuing insurance market failure. However, some Federal insurance backstop mechanism is surely a necessary component of this continuing war to protect America's economy from these enemies.

An example of a pre-existing government policy which has found new importance in the post-9/11 world is the Overseas Private Investment Corporation (OPIC). Founded in 1971, and recently reauthorized through 2007 by Congress, OPIC provides insurance against political risks – including terrorism – for U.S. businesses' overseas operations. Currently, OPIC provides insurance and financing to U.S. investors for projects in approximately 150 developing countries and emerging markets. Among the most recent projects insured by OPIC are the construction financing of $250 million for a natural gas pipeline in Israel and a $300 million development of Egypt's natural gas industry. To take another example, OPIC recently issued long-term government-backed political risk coverage (including for terrorism and other "political violence") for a commercial facility in Uzbekistan. It would be a sad and hard-to-explain irony if TRIA were to expire this year and no Federal terrorism insurance role was in place within the U.S. next year, but OPIC continued to provide next year Federally-backed terrorism insurance for U.S. businesses and facilities abroad. Such a development would mean that American businesses and facilities just down the street from the Capitol, as well as anywhere else in the Nation, could be left without sufficient and adequate terrorism insurance, but that, thanks in part to the Federal government, U.S. businesses doing business outside the U.S., ranging from operations in Afghanistan to Zimbabwe, would have all the terrorism insurance coverage that they require.

OPIC is an example of a long-standing program which serves continuing U.S. foreign policy objectives. To be sure, there are some domestic Federal insurance programs which deal with long-standing marketplace failures, most notably Federal flood insurance and some forms of crop insurance. However, there are also examples of Federal insurance programs which were authorized to deal with immediate and acute problems at the time, which were then de-commissioned when the emergency subsided. These include the Federal crime insurance and Federal riot reinsurance programs which were established in response to the insurability problems arising out of the urban disturbances in the late 1960s. Both of these programs were administered by the Federal Insurance Administration, an office within FEMA, but were allowed to expire by the 1980s.

The precedent which perhaps most closely parallels the current case of terrorism risk is the War Damages Corporation ("WDC") which was authorized by Congress within days after the December 1941 attack on Pearl Harbor. This government-owned corporation provided direct war risk coverage to both personal and business property owners throughout the United States and its overseas possessions for the duration of World War II. Approximately 8,700,000 polices were issued for property values totaling $117 billion. WDC collected premiums of approximately $221 million, returning most of this to the U.S Treasury as profit.

WDC conducted its business with remarkable efficiency by authorizing private insurers to attach the war risk rider to existing multi-peril insurance policies, and working with representatives of the industry to develop policy forms and pricing guidelines within a matter of months after its authorization; the first policies were issued effective July 1, 1942. The WDC premium insurance program was terminated in March 1946 and WDC assets were liquidated before June 30, 1949, although its capital stock was not returned to the United States Treasury until the 1950s. Net income of approximately $211 million had been remitted to the Treasury by 1947-48, even after payment of all claims (mostly arising in the Philippines or from the 1944 explosion of the destroyer USS Turner in New York harbor) and after sharing commissions and profit-incentive payments with private insurance industry which had acted as its agents.

Sunset Clauses in Insurance Policies Are Already Hurting Our Homeland's Economic Security

The threat of terrorism will be with us for the foreseeable future; in the words of President Bush, delivered on February 14, 2005, "We must not allow the passage of time or the illusion of safety to weaken our resolve in this new war."

If TRIA is allowed to expire, and is not replaced with another form of Federal backstop, the nation will be more exposed economically than was the case after September 11th. There will be a scarcity of terrorism insurance and what is available will be at an exorbitant price. There is no doubt that without a Federal backstop, fewer businesses will have such terrorism coverage than today with TRIA in place or before 9/11. In fact, the evidence is already in front of us. Most major insurers already appear to be imposing "sunset" clauses in their policies being renewed this year. Appendix 1 to this testimony is a selection of the sunset clauses from many of the largest insurers in the U.S. and globally. All of these documents come from renewal quotation packages actually received by policyholders or their brokers in recent weeks. These sunset clauses make it clear that there will be no terrorism coverage under the policy after 12/31/2005 unless Congress renews TRIA. In some cases, there is no promise to provide the coverage even if Congress acts – presumably the policyholder and insurer will have to take some action in these cases to restore the coverage if TRIA is renewed between now and year-end. With each passing week, more and more of these "sunset" disruptions are being built into the nation's business insurance picture, and more economic effects are being felt. The extent of the problem is illustrated by Appendix 2, a chart showing the actual results of an April renewal program of $1 billion of property insurance for a major real estate company with assets throughout the U.S., which shows substantial holes in its terrorism coverage after December 31 of this year.

Multi-year construction and financial markets which depend on commercial mortgage-backed securities are being affected adversely by the year-end sunset of terrorism coverage. Appendix 3 is a chart showing a limited sampling by the Real Estate Board of New York of construction project in just two areas of the country – metropolitan New York City and South Florida. In all eighteen projects sampled, the builders' risk insurance either was subject to a sunset clause, renewal was overdue/delayed, or the policyholder was required to secure dramatically more expensive stand-alone terrorism cover from a limited market to satisfy lender requirements.

Aon is the world's second largest insurance brokerage firm. Aon has been actively tracking the terrorism insurance market and, in particular, TRIA coverage with the potential expiration of TRIA on December 31. In an update to Aon's 2004 *Terrorism Mitigation & Risk Transfer Overview*, based upon first quarter 2005 data, Aon estimates that 80% to 90% of the available TRIA property insurance capacity will resort to the use of absolute TRIA exclusions or low sub-limits for top-tier metropolitan areas/target risks effective January 1, 2006. In short, insurance market behavior during the first quarter 2005 indicates that there will be a substantial shortfall in terrorism capacity both for existing properties and for new projects. At the same time, Aon confirms that lenders are requiring terrorism coverage for the full loan values or for a stipulated amount within loan covenants – whether or not TRIA is reauthorized. We will be pleased to provide the Committee with copies of the Aon report when published.

The important commercial mortgage-backed securities (CMBS) marketplace ($444 billion outstanding) is also at risk of credit downgrades. As one prominent publication put it, "the possibility [of TRIA non-renewal] re-ignites the threat of downgrade for certain CMBS transactions and has the more macro and ominous potential of reducing property valuations and the attractiveness of commercial real estate as an investment vehicle. Without TRIA and with little confidence that reinsurers and primary property and casualty insurers will offer affordable terrorism coverage without a Federal backstop, it's highly probably that at least two of the major rating agencies will place certain CMBS transactions on watch for possible downgrade." The extension of TRIA would serve to remove a significant credit risk from the CMBS marketplace. Moreover, it would help the market avoid the ratings volatility experienced from late-2001 through 2002 as it related to terrorism insurance.

This sunset problem not only dampens economic activity now and for as long as the non-renewal persists, but, in the event of another attack, there will be substantially less insurance coverage in place – and therefore fewer and less insurance industry payments than were available for the 9/11 losses. This means, most likely, that – in the absence of a program like TRIA – the government's costs, one way or the other, following a new event similar in size to 9/11, would actually be greater than after September 11th. Continuation of some form of Federal backstop which maximizes the involvement of the private insurance and reinsurance industry is in fact the policy which is best able to encourage economic activity in the near term while minimizing the government's own exposure in the event of another catastrophic event.

Planning the day <u>before</u> for the day <u>after</u> an attack should be viewed as equally important to efforts to protect ourselves against such an attack.

STATEMENT OF THE
NEW YORK STATE INSURANCE DEPARTMENT

BEFORE

U.S. HOUSE OF REPRESENTATIVES SUBCOMMITTEE
ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

JULY 27, 2005

BY HOWARD MILLS
SUPERINTENDENT OF INSURANCE

I. Introduction

Thank you Chairman Baker and members of the subcommittee for the opportunity to discuss a very important issue for New York and the nation, the future of terrorism insurance.

The global war on terror is being fought on many fronts, and rightly so. The insidious nature of the terrorist enemy today; an enemy with no defined nation, borders, ideology, or structure; an amorphous enemy whose misguided foot soldiers come from all walks of life and backgrounds and are recruited from, and reside in, nations around the globe, require us to develop new defense paradigms to protect our national interests. These diverse individuals are united only in their hatred toward what we value the most - our freedom, and their zeal to destroy our way of life, in wanton disregard for the lives of our citizens and property. While the courageous men and women of the United States Military protect us from this enemy worldwide, the existence of a federal backstop for terrorism insurance in the form of The Terrorism Risk Insurance Act of 2002 (TRIA) has protected our economy from the destabilizing economic effect of the terrorist threat right here at home.

As vividly demonstrated by the recent cowardly attacks in London and Egypt, the terrorist threat has in no way subsided and continues to be an immediate and significant risk to our nation's physical and economic wellbeing. Reminders of this threat are omnipresent in our daily lives as evidenced by barricaded office buildings in urban centers, the necessity to search the bags of entrants to our mass transit systems, the increasing presence of security personnel on our streets, and news headlines about another bomb explosion or evacuation somewhere grabbing our attention. Just as the terrorism threat has not subsided, our response to this threat, both physical and economic, cannot be allowed to diminish or abate.

Given the vital role that TRIA has played in ensuring the affordability and availability of terrorism insurance in the market, and by extension the overall US economy, we cannot and should not lower our economic preparedness by allowing TRIA to expire without an appropriate federal backstop being in place on January 1, 2006.

II. The Post September 11th Market and the Effects of TRIA

In the months following September 11th, the insurance marketplace experienced significant disruptions. Coverage for terrorist acts became either unavailable or priced beyond the reach of businesses. Large businesses and institutional concerns were compelled to cobble together coverage from various sources in order to reach barely adequate limits of insurance. Trophy properties and businesses in close proximity to those properties, particularly in major cities, found it especially difficult to secure adequate coverage in all lines. Many businesses in the post-September 11th market were faced with the unenviable choice of paying suddenly higher premiums for less coverage or going without insurance altogether for the terrorist risk. Some insureds were compelled to consider lowering the amount of insurance they carried in order to afford the premium increases or engage in other cost-cutting activities such as reevaluating expansion plans in the works on September 11th or reducing employee benefits. Others adopted the risk management technique of "avoidance" by disengaging themselves from otherwise economically sound activities that could be subject to the peril of terrorism. The inability of insureds to satisfy lenders' "all risk" insurance coverage requirements resulted in billions of dollars in stalled construction projects. We also saw a substantial migration of insurance writings to the excess and surplus lines markets, where rates and forms are not regulated.

In enacting TRIA, Congress and President Bush took the right step to address these market conditions. TRIA, as acknowledged in the recent Treasury report on its effectiveness, has been successful in stabilizing the insurance marketplace. The presence of this federal backstop has provided an appropriate means for the insurance industry to make vital terrorism coverage widely available to American businesses. By requiring insurers through the "make available" mechanism to offer coverage for acts of terrorism they otherwise might not have offered in the wake of September 11th, TRIA brought certainty and stability to the insurance marketplace. American businesses - both large and small - have been offered choices they might not otherwise have had and those businesses that needed the coverage most were able to obtain it. Thus, TRIA worked exactly as intended by Congress.

If a federal backstop is not in place on January 1, 2006, we may revisit some of the same market disruptions and economic uncertainties that we faced in the aftermath of September 11th - especially since the private market currently does not have the means to appropriately address this exposure. In particular, businesses viewed by insurers as having a greater risk of terrorism losses, such as those located in America's financial and commercial centers, may have great difficulty in finding terrorism insurance.

III. A Need for Immediate Action

Given the looming expiration of TRIA, the current lack of a free market solution to the terrorism exposure, and the negative economic consequences that will ensue without the existence of a federal backstop, both my fellow regulators at the National Association of Insurance Commissioners and I believe that immediate action must be taken to ensure that this essential economic protection remains in place without any gap in coverage. Congress may wish to consider modifications to the existing program that strike an appropriate balance between protecting taxpayers' funds and providing sufficient levels of coverage to ensure the continued availability and affordability of terrorism coverage. Alternatively, Congress may wish to take a more comprehensive approach by establishing mechanisms for increasing private market participation coupled with diminishing federal involvement, recoupment of taxpayers' expenditures, and developing dedicated capacity.

Developing a pool of private capital specifically designed to support terrorism writings will be a crucial component to any long-term solution. Federal participation on a mega-catastrophe level, however, will also be a necessary piece to any successful long-term solution. The objective would be to increase the capacity at the private market level while at the same time limiting federal involvement to truly extreme catastrophic events. Federal Reserve Board Chairman Greenspan, in his recent testimony before the House Financial Services Committee, recognized private market limitations with respect to extreme terrorist events stating that, "…so long as we have terrorism that has the capability of a very substantial scope of damage, there is no way you can expect (the) private insurance system to handle that."

While industry capacity, measured by the capital and surplus available to insurers to support their policy writings, has increased over the last few years, there are competing demands on this resource. It is important to note that, in general, less than half of those funds are available to support commercial products in all lines of insurance, including terrorism coverage. Insurers have demonstrated their continued reluctance to expose this capacity to the terrorism peril in the absence of a backstop by filing conditional terrorism endorsements with regulators that, in the event that TRIA expires, reinstate terrorism exclusions and limitations which were in effect after September 11th. If triggered by the expiration of TRIA, these limitations will greatly reduce the terrorism coverage in the states that have approved these endorsements. In those states that have rejected these endorsements - like New York - insurers will have to make the difficult choice of writing the coverage and accepting the potentially catastrophic terrorism exposure or not writing it at all. This will leave the insurance marketplace in much the same position that it was in the post-September 11th and pre-TRIA environment with respect to the availability and affordability of terrorism coverage. These contingent endorsements also suggest that there is a need for maintaining the "make available" requirement or similar offer mechanism in any successor backstop.

The industry's reluctance to provide coverage for this exposure is also a function of their inability to accurately price terrorism coverage – a task that will be made all the more difficult in the absence of some form of backstop. While advances have been made through modeling to estimate potential losses that may arise as a result of a terrorist attack, the frequency of such attacks can not be accurately predicted. Unlike natural disasters, which are random and where historical data forms the basis to predict future events, the intentional acts of terrorists are all but impossible to predict with any degree of accuracy. The challenge of accurately predicting attacks is made more difficult because terrorism is a shifting threat where the culprits modify their tactics and targets in response to security and loss mitigation efforts.

Finally, I'd like to briefly mention workers compensation coverage which is an area of particular concern for insurers in the context of industry capacity. A single, mid-sized employer with 250 employees at one location can represent a potential exposure to an insurer of tens of billions of dollars in the event of a terrorist attack. Moreover, insurers cannot utilize exclusions or limitations to reduce this aggregation of risk as they have done in other commercial lines because state laws do not permit exclusions or limitations to be applied to workers compensation coverage. One method of treating aggregation of risk concerns in the workers' compensation line would be to syndicate coverage through layering and diversification amongst different entities. Syndication involves structuring a layered program, vertically and/or horizontally, to cover insureds, locations, or lines of businesses that present a catastrophic exposure. Each layer of the syndicated program could be covered by a different entity, including insureds, through retentions and coinsurance, primary insurers, and reinsurers.

IV. Conclusion

Regardless of whether a short-term or long-term approach is taken with respect to the terrorism issue, the most important point is that a successor program be in place on January 1, 2006 to avoid any gaps in coverage. We urge Congress and the Administration to take the appropriate steps to ensure continuation of this vital economic protection. Of course, any solution to this issue will require the insurance industry to assume its appropriate role in the development of a long-awaited, free-market response to the threat of terrorism.

I stand ready to work with this Committee, Congress, the Administration, my fellow regulators and the insurance industry in achieving the goal of making terrorism coverage affordable and available.

Thank you.

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Hearing on "The Future of Terrorism Insurance"

July 27, 2005

Testimony of

Lawrence H. Mirel
Commissioner
District of Columbia Department of Insurance, Securities and Banking

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.

Statement of

Penny Pritzker

before the

Committee on Financial Services

Subcommittee on Capital Markets, Insurance

and Government Sponsored Enterprises

regarding

"The Future of Terrorism Insurance"

July 27, 2005

Statement of

Penny Pritzker

before the Committee on Financial Services

Subcommittee on

Capital Markets, Insurance and Government Sponsored Enterprises

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"The Future of Terrorism Insurance"

July 27, 2005

Thank you very much for the opportunity to be here today. My name is Penny Pritzker.

I am the founder and chairman of Classic Residence by Hyatt, a national leader in luxury senior living. Classic Residence by Hyatt owns, manages and operates luxury senior living communities coast to coast. I also serve as president and CEO of Pritzker Realty Group, L.P headquartered in Chicago, Illinois. Pritzker Realty Group manages a diverse portfolio of assets across the United States, including land developments, industrial parks, apartments, offices, and off-airport parking.

I am also Treasurer and a Member of the Board of Directors of The Real Estate Roundtable.

I want to begin by thanking you Chairman Baker and Ranking Member Kanjorski for conducting today's hearing on the future of terrorism insurance. I am pleased that Chairman Oxley, and so many members of this Committee, support the continuation of a federal terrorism insurance program. I also want to specifically note my appreciation for the focus and attention given to this issue by Representatives Kelly, Frank, Israel, Crowley and Capuano.

I am honored to offer my perspective today as you craft legislation in this area.

Immediately following 9-11, Congress was called upon to develop many new public policies to reflect the changed world. This Committee, led by Chairman Oxley, quickly grasped the enormous potential economic problems that could develop if the government did not step into the terrorism insurance marketplace. You led the Congress in developing the legislative solution that became known as TRIA -- the Terrorism Risk Insurance Act. Thank you for your hard work in this area then, and thank you for recognizing the need to focus intently on this issue once again.

Like many of you, I had hoped that the government's role in terrorism insurance could be ended. I am in a highly competitive, market-based business. And, like the real estate business that I am in, I was hopeful that the private insurance markets could fully handle the issue of terrorism insurance, as it had prior to 9-11.

Unfortunately, that does not seem to be the case. From my perspective, the reasons that caused this Committee to work daily to enact the terrorism risk insurance act have not significantly changed. And, because of this reality, I strongly believe that our economy continues to need a federal terrorism insurance backstop . . . and we need it to be in place well before TRIA sunsets at the end of this year.

Obviously, as recent events in London, and around the world indicate, the threat of terrorism continues to be strong. Where terrorists might strike, and how they might attempt to do so, continues to be an evolving picture. Notice I said "where" they might decide to strike . . . not "who" they might decide to strike. As I see it, terrorism is an act against our governmental policies. It is an act against our "way of life". It is not an attack on an individual business or property owner. It is an attack on all of us. It is, as the President has stated, war.

Not only does the terrorist threat continue, but the potential economic costs of a terrorist attack are almost limitless.

You correctly saw this problem in 2002. You enacted TRIA. I believe it has been a tremendous success.

A survey conducted during the post 9-11, pre TRIA time period showed that more than $15 billion of real estate related transactions had been either stalled or cancelled because of a lack of terrorism insurance. Studies further showed that approximately 300,000 jobs were lost during this period.

Almost overnight TRIA provided capacity to insurance markets which in turn yielded the economic confidence for transactions to resume. I am personally familiar with stalled construction projects that moved forward immediately to the benefit of countless workers in the construction trades.

Having noted the benefits of TRIA, I am also aware that few laws are perfect and, as Members of Congress, you are the ones who must review the technical way in which the federal backstop functions. While I personally do not share the optimism expressed in the Treasury Report concerning the ability of private insurers to effectively model terrorism risk, I will say that if reforms to the program, along the lines suggested by Treasury Secretary Snow, can be crafted to increase the role of the private market in providing terrorism insurance to the economy, then they should be done.

Alternatively, in addition to solely focusing on TRIA, and the various recommended reforms to TRIA, I understand that this Committee might be interested in crafting a longer-term solution to the terrorism insurance problem. I certainly would not discourage this Committee and Congress from exploring a more permanent way to ensure that terrorism insurance is available in our country. There are several models that may be instructive in this area including the Pool Re approach taken in the United Kingdom and the pooling approach to catastrophic risk taken by Florida.

But I urge you to proceed cautiously whether looking at TRIA reforms, or at a longer-term solution. In general I would urge that you make sure that whatever the approach, you do not unintentionally penalize the policy holding community. The economy does not need a situation where terrorism insurance is once again only available in limited supply and then only at extremely exorbitant prices. The resulting illiquidity would not be a functioning marketplace.

During your coming deliberations, I respectfully offer a few points for you to consider.

First, one of the most important aspects of TRIA was the so-called "make available" provision. It ensured that terrorism coverage was offered to businesses. I strongly urge that this provision be included in whatever federal backstop program this Committee recommends.

Second, the distinction under current law between domestic and foreign terrorism should be eliminated. In today's world, having to determine whether a terrorist strike is at the direction of a foreign entity is obviously very difficult and seems somewhat meaningless. Even today little is known about the origins of the anthrax attacks of a couple of years ago.

Third, nuclear, biological, chemical and radiological exposures are truly limitless. It seems that they should be somehow treated differently than other forms of terrorism risk, if for no other reason than to provide an even greater incentive for insurers to offer this type of coverage. As you know, TRIA currently backstops these events if in fact a primary insurer will write the coverage. I see no evidence that such coverage is being written today. A strong incentive is needed to ensure that this very real risk is covered.

And, finally, I would urge you to act in this area quickly. According to a Moody's report . . . 50 percent to 75 percent of all property and casualty insurance policies written since January 1st have adopted "conditional endorsements" that will automatically void terrorism coverage if a federal terrorism insurance backstop is not in place on January 1, 2006.

Also, new projects will face increasing difficulties because, in many cases, terrorism insurance coverage will not extend into next year and therefore the financing will not be available to go forward. The sooner Congress acts on this issue the less dysfunction will occur in the marketplace.

I would also urge caution on two additional areas.

First, there is great discussion about what lines of business are to be included and excluded from backstop coverage. For example, general liability is an important line of business coverage by itself. It also gives support to our officers and director insurance. I urge you to carefully review the justifications to exclude it from future backstop coverage. Obviously, if the decision is to move toward a pooling approach to address the problem, which will bring with it a "pay to play" aspect, then I would strongly urge all existing lines be covered in the successor program.

Second, the issue of tort reform is one that is very important but one that could overwhelm the prospects for this important legislation if not carefully crafted. First, through regulation, the Treasury Department already has established strong litigation safeguards against runaway verdicts and excessive settlements. These regulations, of course, expire with TRIA. I think reauthorizing these regulations would address the concerns of unwise lawsuits arising in this area. These regulations make sure that federal funds are not to be used for punitive damages; they ensure that federal funds will not be utilized to subsidize excessive, bad faith, collusive, or otherwise untoward settlements, and the regulations also require claims to be consolidated into federal court. Importantly, the regulations also institute an important brake on excessive attorney's fees. Treasury is instructed to take an active role in evaluating the appropriateness of attorneys' fees and expenses, applying the same factors weighted by federal courts regarding the reasonableness of fees and expenses, including time and labor expended, novelty and difficulty of the questions, the skills required to pursue the claims, the customary fee, whether the fee is fixed or contingent, the amount of fees and results obtained, and the lawyers' ability, awards in other states, and whether the fees have resulted in over stated insured losses under the underlying policies.

Rational litigation management rules are needed in this area, but the debate should not serve as a hurdle to achieving the most important goal here and that is a workable terrorism insurance program.

In conclusion . . . the real estate industry is one of the most competitive, market-oriented industries in America. We want markets to operate freely. But sometimes they can't.

As Alan Greenspan testified last week to this Committee. . . "so long as we have terrorism that has the capability of a very substantial scope of damage, there is no way you can expect (the) private insurance system to handle that".

Given this situation, I am pleased that a bipartisan group of members of this Committee support the continuation of a federal terrorism insurance program. Without a backstop, the terrorism insurance market is very likely to once again become highly unstable, with potentially very harmful effects on the economy.

TRIA was successful. Perhaps it can be made more market oriented without causing market disruption, and, perhaps, a long-term solution is within grasp. The most important action, however, is to "act" by putting a program in place long before the year ends.

Thank you again for the opportunity to comment today.

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

Hearing on
"The Future of Terrorism Insurance"

July 27, 2005

Written Statement by Jason Schupp
Vice President and Senior Assistant General Counsel – Zurich North America
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 the 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 <u>none</u> 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 thought-leaders 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 (which we asked Dr. Hubbard to undertake), 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.

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 strong litigation management techniques.

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 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.

THE
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Statement of
John T. Sinnott, Vice Chairman, Marsh and McLennan, Inc.

On
The Future of Terrorism Insurance

Before the
House Financial Services Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises

July 27, 2005
Washington, D.C.

Mr. Chairman and members of the Subcommittee, I am John T. Sinnott, Vice Chairman, Office of the CEO, of Marsh & McLennan Companies, Inc. (MMC). MMC is a global professional services firm with annual revenues exceeding $12 billion. It is the parent company of Marsh, the world's leading risk and insurance services firm; Guy Carpenter, the world's leading risk and reinsurance specialist; Kroll, the world's leading risk consulting company; Putnam Investments, one of the largest investment management companies in the United States; and Mercer, a major global provider of consulting services. Approximately 60,000 MMC employees provide analysis, advice, and transactional capabilities to clients in over 100 countries.

My testimony today is on behalf of my firm as well as the member firms of the Council of Insurance Agents and Brokers.

Introduction: TRIA and the Successful Stabilization of the Insurance Market

First, I would like to thank you, Mr. Chairman, for giving me this opportunity to testify today on the future of terrorism insurance. Before I talk about the future, however, I would like to take a few minutes to talk about the past. It is sometimes hard to believe it has been nearly four years since the terrorist attacks of September 11, 2001, when thousands of our fellow Americans, our friends, colleagues and family members, were killed. Marsh itself lost 295 colleagues that day. While it has been said many times before, I think it bears repeating that the events of that day changed the United States and the world, and life and business as we once knew it will never be the same.

Of the many steps that our Nation has taken to recover and move on, one of the most critical steps was the enactment of the Terrorism Risk Insurance Act (TRIA) in 2002. After September 11, we were extremely concerned about the insurance industry's capacity to withstand a similar attack and the ability of the industry to cover terrorism risks going forward. Although the focus was on the insurance industry, the real concern was – and is – much broader. Insurance provides individuals and businesses with the ability to take the risks that are essential to the functioning of our economy; crippling the insurance industry would be economically devastating. Thus, passage of TRIA was critical not only for the insurance industry, but for the economy as a whole. Because we have had no terrorist attacks in this country since 9/11, federal funds provided by the TRIA "backstop" have not been tapped. Nonetheless,

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the program has proved to be an unqualified success in stabilizing the insurance markets, allowing insurers to provide much-needed terrorism coverage to commercial consumers and providing the time and market information necessary to begin the development of long-term solutions to the issue.

As we all know, TRIA expires at the end of this year. The question before you now is "what then?" We believe the federal government continues to have an important role to play in terrorism insurance, particularly in fostering the development of a private-sector solution to the problem. In fact, we believe federal involvement, particularly in the short-term, is critical to avoid serious disruptions to the marketplace. That does not mean, however, that federal involvement has to be unlimited or un-ending. As I will discuss more fully below, of the options available going forward, we believe the most promising is the creation of a pooling mechanism, with a limited federal backstop that would phase out over time.

I must note that when I testified about the need for government involvement in the wake of the 9/11 attacks, my expectation was that the private market would be able to come back on its own and that the TRIA program that was enacted could truly be a limited stop-gap type measure to help us bridge that gap. What has become evident in the ensuing three and a half years, however, is that there is a very mixed appetite toward insuring terrorism risks. It is for that reason that broader thinking is needed. I hope you will receive my testimony in that spirit today.

Where do we stand today?

Since 2001, Marsh has been compiling data and issuing reports tracking the terrorism insurance marketplace. The "Marketwatch: Terrorism Insurance 2005" report issued in May, a copy of which is attached – shows that the "take-up" rate for property terrorism coverage has steadily increased since enactment of TRIA, reflecting the increasing demand by America's business community for such coverage at commercially viable prices. The fact that terrorism coverage is now both available and affordable is directly due to the existence of the federal backstop. A quick recap of the terrorism insurance marketplace for the last five years demonstrates this quite starkly –

- Prior to September 11, 2001, terrorism generally was not treated as a separate risk category and coverage was included at no additional cost in most property and casualty policies.
- After 9/11 and prior to the enactment of TRIA, terrorism insurance became almost entirely unavailable. The little capacity that was available was prohibitively expensive. One consequence was that construction projects and real estate financing arrangements were derailed or delayed due to a lack of adequate terrorism insurance protection.
- Immediately after TRIA was passed, and for about the next four months, insurance companies were scrambling to make terrorism coverage available to all of their policyholders. There was confusion about the process and the coverage, and as a result the initial pricing was high and the take-up was low.
- From April 2003 through today, the purchase of terrorism insurance has been steadily increasing. Americans understand that the terrorism risk is not going to disappear and they feel the need to insure their businesses against the possible risks. Nearly half of large- and mid-sized U.S. businesses obtained insurance to cover property terrorism risks during 2004, a dramatic increase from the 27 percent average in 2003, the first full year of the program. To date in 2005, the take-up rate is even higher, trending towards 60 percent.
- Importantly, over these last two years, the cost of property terrorism insurance – thanks in part to TRIA - has somewhat stabilized. Consequently, policyholders have been better able to budget for their existing and expanding business plans.

Marsh's report, based on data compiled from 2,371 businesses and government entities that purchased or renewed property insurance policies in 2004, reveals that the property take-up rates are high and widespread across the country and across industries. Specifically, the take-up rates were highest in the

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Northeast and Midwest (53 percent); in the South (47 percent) and in the West (34 percent). Among the major cities, take-up rates were: 69 percent in Boston, 58 percent in Chicago, 57 percent in Dallas, 54 percent in New York City, and 60 percent in Washington, DC. On the West Coast, 39 percent of Los Angeles businesses and 37 percent of those in San Francisco purchased terrorism insurance. And in Houston, almost 25 percent of all businesses purchased terrorism coverage.

The Marsh study also reveals that a company's purchase of property terrorism insurance in 2004 varied not only on the company's location but also on the size of the company, its industry, and the price of coverage. Understandably, take-up rates are higher for companies with a higher perceived risk, whether that is due to size, location, industry or other factors. The cost of terrorism insurance has also been an important benefit of TRIA: making coverage available to consumers that possess a risk profile calling for terror coverage but that might not possess the means to afford astronomical premiums.

Within specific industrial sectors, financial institutions, real-estate firms, and health-care facilities had the highest overall take-up rates, each exceeding 60 percent. The survey categorizes all insureds into 15 overall categories and even companies in the sectors with the lowest take-up rates on a comparative basis – energy, manufacturing and transportation, for example – each had take-up rates exceeding 33 percent in 2004. In terms of size, the take-up rates for all-sized businesses were dramatically higher in 2004 than in 2003. Firms with total insured values of $500 million to $1 billion had the highest take-up rate (57 percent). Next were firms with total insured values of $1 billion or more (53 percent), followed by those with $100 million - $500 million (50 percent). Even among smaller firms, those with total insured values under $100 million, about 35 percent of companies purchased property terrorism insurance in 2004.

By providing stability to the terrorism insurance marketplace, TRIA has allowed insurers to increase their capacity to cover terrorism events. As a complement to certified TRIA coverage, some property insurers are offering "non-certified" coverage for terrorism risks not covered under the program, including terrorism risks outside the U.S. and terrorism in the U.S. arising from indigenous acts. In 2004, 70 percent of companies that purchased property terrorism insurance bought a combination of TRIA and "non-certified" coverage. In addition, some businesses purchase separate, standalone terrorism insurance policies that are outside of their property insurance programs and provide the equivalent of "certified" and "non-certified" coverage both in the U.S. and internationally.

According to Marsh's report, capacity in the stand-alone property terrorism insurance market is relatively stable but limited. The amount available for a specific risk can vary significantly, depending on the risk's location, an insurer's accumulated exposure, and the concentration of exposures in a given area. We and other Council members are greatly concerned that, in the absence of a federal backstop, the standalone insurance market will not be able to – or simply will not – offer capacity at commercially viable prices sufficient to satisfy the expected demand.

Development of a Permanent Private-Sector Terrorism Insurance Market

Based on available data, it appears that TRIA has stabilized the insurance market and insurers have become more comfortable offering terrorism coverage. That is not to say, however, that the private markets are prepared today to assume full responsibility for losses due to terrorism. Capacity in the terrorism insurance market remains limited. Although there are varying degrees of enthusiasm for continuation of the federal program, we perceive that the great majority of industry players believe a federal backstop is essential as we move toward the development of a private terrorism insurance market, and to assist Americans who may be harmed in a terrorist attack before such a market is fully developed. We are very concerned that the absence of a federal backstop could stop the development of the private market in its tracks.

This issue is critical to Marsh and members of The Council because terrorism coverage is critical to our clients. Commercial insureds need terrorism coverage not just for piece of mind, but for their businesses. In some cases, companies may choose to purchase terrorism insurance (or not) based on their particular risk profile. In many cases, however, purchase of terrorism coverage is not optional – it is required by state laws and regulations, contracts, loans and mortgages. The most important issue for the broker community, therefore, is consumer access to coverage. In order to get this access, we need insurers who are able and willing to provide the coverage.

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We are not seeking a permanent government role in the solution to this problem. We do not believe, for example, that the federal government should be the permanent "insurer of last resort" for terrorism losses. Rather, we support the idea of government assistance to help foster the development of a private-sector solution that is economically viable for the insurer community and therefore beneficial to American business.

There are, essentially, three options for going forward: (1) take no further action; (2) modify and extend the current TRIA program; or (3) take a new approach that helps to facilitate the creation of a permanent private market solution that allows TRIA to sunset.

1. Take no further action: Letting TRIA expire at the end of the year without taking further action is not advisable. As I have discussed, the terrorism insurance market is not strong or developed enough to stand on its own. The absence of TRIA and the federal backstop would cause significant disruption to the insurance marketplace and, ultimately, to the economy in general. For example, in the property market today insurers are already adding conditional endorsements allowing them to exclude terrorism coverage post January 1, 2006 should TRIA not be renewed. In the Workers Compensation market, insurers are becoming more conservative in offering coverage post January 1, 2006 due to concerns over the potential aggregation of exposures to terrorism.

2. Modify and extend the current TRIA program: Extending the life of TRIA and readjusting its terms to address the parameters outlined in the Department of Treasury's report could work in the short-term to keep terrorism coverage available and the market and economy stable, which would continue the positive trends I outlined earlier. It also would allow time to develop a more permanent solution. For example, we believe the dollar threshold and the applicable lines of coverage included within the program merit review although any change must recognize the financial abilities of smaller insurers.

3. Create permanent private market solution: We are aware of a number of proposals circulating which envision a pooling arrangement. Such a mechanism would allow the insurance industry to essentially "backstop" itself, by growing the capacity to handle a catastrophic attack like those of

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4. September 11. Currently, terrorism reinsurance is limited and prohibitively expensive in many cases. The existence of a terrorism insurance pool and backstop may make insurers more comfortable in the market, providing them with a reinsurance vehicle that will allow them to further expand capacity. Growth in capacity will stabilize prices and decrease the need for the federal backstop over time until the government's potential liability is zero.

Although the details of the proposals appear to differ, their general approach is the same. In general, a terrorism insurance pool would be financed by participating insurers which would each deposit some percentage of their written premium covered by the program into the pool. In order to avoid adverse selection, contributions to the pool should be based on each individual company's entire premium for lines of insurance covered by the pool, not select lines or policies. In the unfortunate circumstance that a qualifying loss from a terrorist incident occurs, participating insurers would first pay down a pre-established deductible (all or part of which could be covered by the premium deposits); once deductibles are fully paid, funds from the pool would be tapped; when the pool is drained, the federal backstop would kick in, up to a pre-set limit. The federal backstop is more likely to be tapped in early years, before the pool has a chance to fully develop, and the government's potential short-term liability will decrease as the pool grows. All federal backstop payments would be repaid through policyholder surcharges or other means.

Although it is not our role to comment on the details of the economics of a pooling program, there are two general issues on the pooling ideas that merit attention. First, we must closely review whether the participation in the pool should be voluntary or mandatory. In a voluntary structure, if a company chooses not to participate, the company would not be obligated to offer terrorism insurance, nor would it benefit from the proceeds of the pool or the backstop. If a company chooses to participate, it should be required to offer terrorism coverage. The voluntary nature of the pool may maximize its utility as an option – some companies may choose to withdraw from the market completely; others may choose to reinsure this exposure themselves; and still others could rely on the availability of the pool reinsurance mechanism to continue to offer terrorism coverage.

Second, we must review whether participation in the pool should be on an individual company basis, or a "family of companies," holding-company-wide basis. The holding company approach penalizes the largest insurers because the size of their deductibles renders the program somewhat superfluous for them. Allowing individual insurers in a holding company family to participate in the pool separately may allow more flexibility and entrepreneurship as those companies explore the various ways through which to address terrorism coverage concerns. The insurance industry has been renowned for its ability to come up with new ways to solve problems old and new, and providing this type of flexibility could help maximize the extent of that entrepreneurship that is needed so desperately here.

Conclusion

In closing, I would like to thank you once again, Mr. Chairman and members of the Subcommittee, for your diligent work on this issue, which is critical to the insurance industry, policyholders, and the Nation. The TRIA program, which this Subcommittee was so instrumental in creating, has stabilized the terrorism insurance marketplace and provided the foundation for the development of a long-term private sector solution. The work is not done, however, and there remains an essential role for the federal government to provide stability and certainty to facilitate the growth of the private marketplace. If crafted properly, we believe a pooling concept has the potential for creating a viable alternative to a modified TRIA proposal We know the time is short to get legislation passed this year, but we hope you will consider this proposal and both Marsh and The Council are prepared to assist you in any way that we can.

I would be happy to respond to any questions you may have.

# # #

MARSH

Research Report

Marketwatch: Terrorism Insurance 2005

Marketwatch: Terrorism Insurance 2005

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Marketwatch: Terrorism Insurance 2005

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Introduction 1

The future pricing and availability of terrorism insurance are in question this spring as Congress debates whether to renew the Terrorism Risk Insurance Act (TRIA).

The Act, which became law in November 2002, was a direct response to the business fallout from the terrorist attacks of September 11, 2001, which caused an estimated $40 billion in losses. TRIA's purpose was to provide a temporary window of reinsurance relief to help insurers manage the ongoing risk of terrorism. One of TRIA's original goals was to enable the insurance industry to amass the private capital necessary to insure catastrophic terrorism losses. To date, the industry has not amassed that capital, leading many to call for TRIA's extension beyond its slated expiration at midnight, December 31, 2005.

Terrorism insurance and associated risk management strategies are dynamic and complex issues, with many interdependent factors contributing to risk. Foreign relations, the effectiveness of homeland defense, and the ambiguous nature of the risk make terrorism loss extremely challenging to predict and quantify. For this reason, it is difficult for insurers to effectively price and reserve capacity for their potential exposure to catastrophic terrorism loss. TRIA provides a temporary reinsurance backstop to insurers to protect them against such loss.

If TRIA is not renewed, it is not realistic to expect insurers to maintain their present terrorism capacity, nor is it realistic to expect the reinsurance market to fill the void. Given this reality, many insurers are already reducing or eliminating available terrorism coverage for 2006, and clients may find themselves unable to transfer terrorism risk in a cost-effective manner.

With TRIA's fate still undecided at the outset of the second quarter of 2005, companies need to be planning their strategies for managing terrorism risk, whatever Congress decides. This publication, the second annual *Marketwatch* focused on terrorism, is designed to help clients address terrorism risk issues despite these uncertainties. It is part of Marsh's ongoing effort to inform clients of notable developments in the terrorism insurance marketplace—including the cost of, demand for, and gaps in insurance coverage. The report looks at:

- key issues under TRIA;
- property terrorism insurance purchasing in 2004;
- the standalone property terrorism insurance market;
- terrorism issues in workers compensation and liability insurance;
- TRIA's impact on the insurance and reinsurance markets;
- insurance for terrorism exposures in captives; and
- terrorism risk management.

Through benchmarking and by staying aware of important developments, risk managers and other key executives can help their companies prepare strategies to manage the ever-shifting realities of terrorism risk. Marsh remains committed to assisting our clients in developing a robust, comprehensive strategy.

2 Executive Summary

This report provides a snapshot of the major issues surrounding terrorism insurance at the beginning of the second quarter of 2005. Key issues and findings include:

Property Terrorism Insurance

- Nearly 50 percent of Marsh's risk management and middle-market clients purchased property terrorism insurance in 2004, a dramatic increase from the 2003 average of 27 percent.
- The purchase of property terrorism coverage in 2004 varied significantly, depending on a company's total insured values (TIV). Smaller companies (less than $100 million TIV) were much less apt to purchase this coverage.
- Take-up rates—the percentage of companies buying the coverage—varied considerably among regions. Take-up rates were about 53 percent in the Northeast and Midwest, 47 percent in the South, but only 34 percent in the West.
- The cost of property terrorism insurance in 2004 was unchanged from the price in 2003, indicating that the increase in take-up rates was not driven solely by price.
- Financial institutions, real-estate firms, and health care facilities had the highest take-up rates, each exceeding 60 percent.

The Standalone Market

- If TRIA is not extended, the standalone insurance market is unlikely to have sufficient capacity to satisfy all of the expected demand at commercially viable prices.
- Capacity in the standalone property terrorism insurance marketplace is relatively stable, though limited. The amount available for a specific risk can vary significantly, depending on the risk's location, an insurer's accumulated exposure, and the concentration of exposures in a given area.
- Outside of major metropolitan areas, Marsh estimates terrorism market capacity is approximately $1.4 billion; however, program limits greater than $500 million are relatively rare due to pricing constraints.
- In major metropolitan areas with high levels of concentrated risk, terrorism market capacity is more limited and considerably more expensive.

Workers Compensation and Liability Coverages

- Workers compensation provides lifetime medical care for on-the-job injuries, leading some experts to project the worst-case cost of a terrorism incident could exceed $90 billion dollars.
- If TRIA is not extended, some insurers may feel they have no choice but to nonrenew some workers compensation policies because there is not enough reinsurance capacity to protect them from the essentially unlimited exposure arising from terrorism.
- Eighty-four percent of companies purchased TRIA coverage in their primary auto liability programs in 2004, a decline from 95 percent in 2003.
- Eighty-one percent of companies purchased TRIA coverage in their primary general liability (GL) programs in 2004, a decline from 93 percent in 2003.

- The actual rate charged as a percentage of premium for the overall coverage in both GL and auto held steady at about 1 percent, implying that the reduction in the take-up rate was driven not by the cost of the coverage, but by the perceived risk.

TRIA's Impact on the Insurance and Reinsurance Markets

- If TRIA is not renewed, it is unrealistic to expect reinsurance market capacity to expand from its current estimated level of $6 billion up to the anticipated needed capacity of over $100 billion.
- Insurers' responses to the potential expiration of TRIA vary considerably. Some are unwilling to provide any coverage post-TRIA.
- In 19 of the 29 states that use some version of the Standard Fire Policy (SFP), regulators may not allow a terrorism exclusion for fire losses.
- Ten SFP states allow terrorism to be excluded from property policies for fire losses resulting from an act of terrorism.

TRIA and Captives

- U.S. captives are subject to TRIA and have been used in a number of ways to address both certified and noncertified terrorism risk.
- Captives provide their owners a viable means to directly access reinsurance markets and potentially realize cost, capacity, and breadth-of-coverage benefits.
- Captives used in concert with TRIA are arguably the only means of securing protection in meaningful quantity for nuclear, biological, chemical, and radiological exposures.
- Certain benefits of using a captive to insure terrorism risk will be diminished or eliminated without TRIA.

Terrorism Risk Management

- When it comes to terrorism risk management, one size does *not* fit all. Every insured requires a different plan that will need to be continuously updated relative to changing global security conditions.
- A primary security goal of any potential terrorist target is to deter an attack by aggressively influencing the terrorists' target research and risk/reward assessment.

Since its enactment in November 2002, TRIA has helped stabilize the terrorism insurance market, making coverage for this risk more available and affordable. Debate about whether or not to extend TRIA will take place on Capitol Hill this spring and summer. If TRIA is allowed to expire, the terrorism insurance market is likely to once again become unstable, with potentially harmful effects on the economy. Marsh supports extending TRIA in some form for the next few years to allow government, insureds, brokers, insurers, and reinsurers the time to develop a more permanent solution.

3 An Overview of the Terrorism Risk Insurance Act—TRIA

President Bush signed TRIA on November 26, 2002, as a direct response to the terrorist attacks of September 11, 2001. The intent was to provide temporary reinsurance relief to help insurers manage the risk of terrorism in the wake of the attacks.

Insurers—including captives licensed in the United States and surplus lines insurers approved as nonadmitted insurers in any state—are generally subject to TRIA's provisions. The Act applies to almost all commercial lines of insurance, including surety, auto, property, liability, and workers compensation. Although it is mandatory for these insurers to offer terrorism coverage, it is not mandatory for insureds to purchase the coverage. Some key issues under TRIA follow:

Certification: For an act of terrorism to be covered under TRIA, it must be certified by the Secretary of the Treasury, the Secretary of State, and the Attorney General. The act must involve violence or be dangerous to human life, property, or the nation's infrastructure; and it must result in aggregate losses of $5 million or more. It must also have been committed on behalf of a foreign person or interest as part of an effort to coerce the civilian population of the United States or to influence the policy or conduct of the U.S. government. The loss must occur within U.S. borders, to the premises of a U.S. mission, or to a U.S. air carrier or vessel. TRIA defines the "United States" to include the U.S. territorial seas and the U.S. continental shelf (see "Noncertified Acts of Terrorism" on page 5). No act may be certified if it is committed in the course of a war declared by Congress, with the exception of coverage related to workers compensation.

Domestic terrorism: An act of domestic terrorism—one that takes place in the United States and is perpetrated by a person or group that is *not* being directed by a foreign source—would not qualify for reinsurance under TRIA. Insurers are not obligated to offer coverage for such acts.

Cost of coverage: TRIA does not provide specific guidance on pricing; however, insurers may charge an additional premium for coverage provided under TRIA. From its enactment until December 31, 2003, TRIA pre-empted state regulations for prior approval of rates. However, the Act has always retained a state's right to invalidate a rate as excessive, inadequate, or unfairly discriminatory.

Terms and conditions: Insurers subject to TRIA are required to make available to their policyholders coverage for "certified acts" on terms and conditions that do not materially differ from the policy's other property and/or casualty coverages. Insurers are required to offer the coverage at each renewal even if the insured has declined coverage previously. The Act does not prescribe specific terms and conditions for required coverages.

Adequate disclosure: The Act requires insurers to provide to their policyholders "clear and conspicuous disclosure" of both the premium being charged for TRIA coverage and the share of reinsurance provided by the federal government. If the insured rejects an offer to purchase terrorism coverage, the insurer may then reinstate a terrorism exclusion.

Government participation: The federal government will cover 90 percent of certified losses once an insurer's deductible is reached; the other 10 percent is the insurer's responsibility. An individual insurer's deductible is a percentage of its direct earned premiums for the prior year for the commercial lines of coverage subject to TRIA. This percentage is set at 15 percent for 2005. The Act caps the total liability of the program and of the insurers—including the insurers' 10 percent participation and their deductibles—at $100 billion in any one program year. If insured losses exceed $100 billion for a given program year, then the allocation of loss compensation to insurers within the $100 billion cap will be determined by Congress. Insurers would not be liable for certified losses in excess of this amount unless Congress were to pass legislation increasing the limit.

Government recoupment: If the government makes any payments following a TRIA-certified loss, the Act includes provisions for both mandatory and discretionary recoupment. The Act *mandates* that the government recoup payments if the insurance market's aggregate retention—comprising the insurers' deductibles and 10 percent participation excess of the deductible—is less than the amount established by TRIA, which was $15 billion in 2005. The Act also gives the Secretary of the Treasury the *discretion* to require additional recoupment when the government determines that the economy can sustain such additional payment. To accomplish recoupment, all commercial property and casualty policyholders would be assessed a surcharge as a percentage of their commercial property and casualty premiums that are subject to TRIA—whether or not the policyholders purchased any terrorism coverage. The assessment percentage is limited to 3 percent per year, but may continue until full recovery of all government payments is accomplished.

Noncertified Acts of Terrorism

The Terrorism Risk Insurance Act (TRIA) says the federal government will act as a reinsurer should there be a "certified" act of terrorism (see page 4).

An act of terrorism that does not meet the certification test is called a "noncertified act." This refers to such events as acts of domestic terrorism that, despite taking place on U.S. soil, are not committed by or sponsored by a foreign party. For example, the April 19, 1995, bombing of the Alfred P. Murrah Federal Building in Oklahoma City would have been a noncertified act under TRIA. Other noncertified acts would include those committed against U.S. companies that occur outside the United States.

Acts of domestic terrorism have the potential to inflict massive damage, as evidenced by the Oklahoma City bombing, which took 168 lives. In August 2003, an ecoterrorist group claimed responsibility for the firebombing of a condominium project in California that caused an estimated $43 million in damage.

Equally chilling in their potential for damage are the domestic plots law enforcement officials say they have prevented, including:

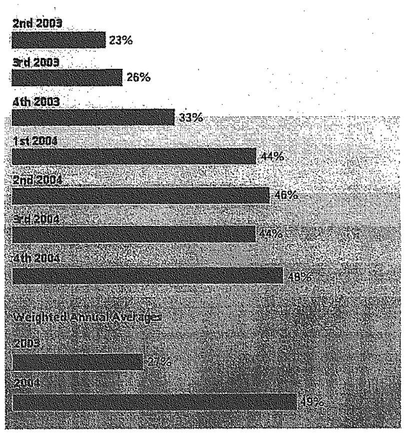
- the sentencing in May 2004 of a Texas white supremacist found guilty of stockpiling weapons and enough sodium cyanide to kill hundreds of people; and
- the arrest in October 2004 of a man in Tennessee authorities say was attempting to purchase explosives and chemical weapons to blow up a federal building.

Competitively priced insurance for noncertified acts of terrorism is available. Marsh's data indicate that 70 percent of companies that purchased property terrorism insurance in 2004 bought a combination of TRIA and noncertified coverage.

4 Findings and Analysis: Property Terrorism Insurance Purchasing in 2004

Over the seven quarters that Marsh has tracked the purchase of property terrorism insurance by our clients, there has been an almost continuous increase in the take-up rate—the percentage of companies buying the coverage. The take-up rate in the fourth quarter of 2004 was more than double the rate in the second quarter of 2003, the quarter Marsh's analysis began. And 2004's annual take-up rate of 49 percent was an 80 percent increase over the 2003 annual rate (see Chart 1).

Chart 1: Terrorism Take-up Rates by Quarter



Methodology

This chapter relies on data drawn from Marsh's offices across the United States. It focuses on which of Marsh's risk management and middle-market clients are buying property terrorism insurance, what coverage they are buying, how they are buying it, and how much they are paying for it. This year's report also looks at why some companies are not buying terrorism coverage.

Purchasing patterns are examined in the aggregate and also on the basis of client characteristics such as size, industry, and region.

The 2004 data come from property insurance placements incepting during calendar year 2004. To account for skews within the regional and TIV data sets, the national annual figures were weighted to allow the findings to be extrapolated to the overall population. The study population does not include placements in the United States for foreign-based multinationals or for small-firm placements made through package policies.

The 2004 study included 2,371 firms with the following characteristics:

	Minimum	Median	Maximum
TIV	$500,000	$200 million	$208 billion
Property Premium	$1,300	$275,000	$75 million
Terrorism Premium	$1	$13,000	$6.75 million

(Continued on page 7)

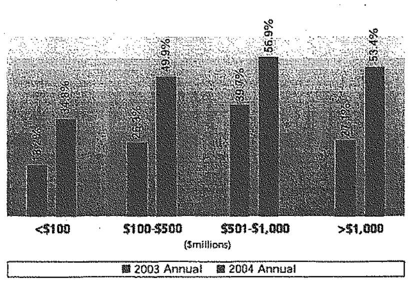
Take-up Rates by Company Size

Marsh's analysis established four categories of TIV as the measure of company size:

- Companies with TIV in excess of $1 billion are major accounts for insurers, paying large premiums due to size alone. They typically work with several insurers. Many of these companies used their existing captives or established new captive insurers to provide TRIA coverage.
- Companies with TIV between $500 million and $1 billion are large organizations that also typically work with multiple insurers and have layered programs.
- Companies with TIV between $100 million and $500 million tend to have no more than three insurers involved in their insurance programs.
- Companies with TIV less than $100 million generally entail a smaller spread of risk, have lower overall premiums, and work with a single insurer.

In 2004, take-up rates within all TIV ranges nearly doubled (see Chart 2). There was a distinct difference in take-up rates at the $100 million TIV breakpoint—52 percent among companies with TIV over $100 million; 35 percent among companies with TIV under $100 million.

Chart 2: Terrorism Take-up Rates by TIV



Methodology (Continued from page 6)

Unless otherwise noted, the calculations include TRIA policies, noncertified policies, standalone policies, and placements made through captives. For comparison purposes, the 2003 figures do not include the first quarter of 2003, which had unique circumstances.

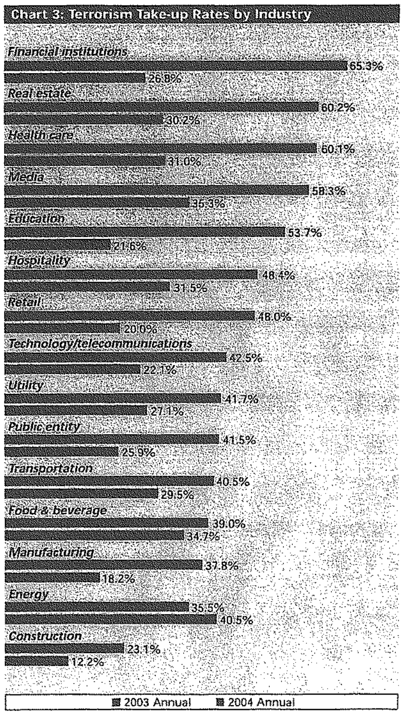
For a few companies, insurers quoted only a nominal terrorism premium of $1. These $1 premiums were omitted from the calculations of the median terrorism premium rates. In respect to the calculation of terrorism premium as a percentage of property premiums, standalone terrorism premiums were omitted.

Companies were assigned to regions based on the locations of the Marsh offices that serviced them. This was generally the Marsh office located closest to a company's headquarters. Many of our clients have multiple facilities spread across the country and around the world, meaning the potential risk for a terrorist attack may not be fully represented by where a company is headquartered. That having been said, the decision as to whether to purchase terrorism insurance is usually made at headquarters.

Take-up Rates by Industry

Among 15 major industry groups in Marsh's analysis, financial institutions, real-estate firms, and health care facilities had the highest property terrorism insurance take-up rates in 2004, each exceeding 60 percent (see Chart 3). Next were media companies, at 58 percent; educational institutions, at 54 percent; and hospitality firms and retail firms, at 48 percent. In contrast, about one-third of energy, manufacturing, and food and beverage organizations and 23 percent of construction companies bought the coverage.

Chart 3: Terrorism Take-up Rates by Industry



Industry Categories

This report examines property terrorism insurance purchasing patterns for 15 industry groupings. These industries were selected based on criteria that included sample population size, perceived exposures, take-up rates, and premium rates. Other industry groups that are part of the overall analysis—but are not reported on individually—include agriculture, automotive, aviation, distribution, nonprofits, professional services, and general services.

The industry groupings in this report included, but were not limited to, the following lines of business:

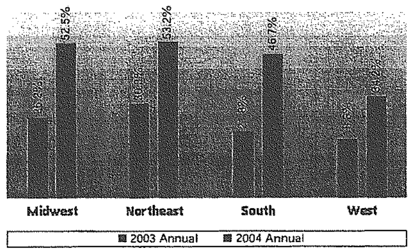
- **Construction**: contractors, homebuilders, and general contractors
- **Education**: universities and school districts
- **Energy**: oil, gas, and pipelines
- **Financial institutions**: banks, insurers, and securities firms
- **Food and beverage**: manufacturers and distributors
- **Hospitality**: hotels, casinos, sporting arenas, performing arts centers
- **Health care**: hospitals and managed-care facilities
- **Manufacturing**: all manufacturers, excluding automotive and aviation
- **Media**: print and electronic media
- **Public entity**: city, county, and state entities
- **Real estate**: real-estate and property-management companies
- **Retail**: retail entities of all kinds, including restaurants
- **Technology/telecomm**: hardware and software manufacturers and distributors, telephone companies, and Internet service providers
- **Transportation**: trucking and bus companies
- **Utility**: public and private gas, electric, and water utilities

Almost every industry sector saw a significant increase in take-up rates in 2004, with education, finance, and retail showing the largest increases. The sector with the highest take-up rate in 2003—energy—was the only one to experience a decline in 2004, a moderate 12 percent reduction.

Take-up Rates by Region

The property terrorism insurance take-up rate in 2004 was 53 percent in both the Northeast and Midwest, 47 percent in the South, and 34 percent in the West (see Chart 4). Perceived risk and price were likely major factors affecting the regional take-up rates. Almost half of the firms in the South, Midwest, and Northeast insured against the risk of terrorism—arguing against the oft-expressed opinion that terrorism is a concern only for major Northeastern urban areas.

Chart 4: Terrorism Take-up Rates by Region



Types of Coverage Companies Are Buying

The vast majority of companies—92 percent—purchased terrorism insurance as part of their property policies rather than as standalone placements. However, standalone policies are an important alternative or supplement to TRIA coverage for some companies (see Chapter 5). The primary purchasers of standalone policies tended to be large real-estate firms and financial institutions; although companies in the hospitality, media, and transportation industries also purchased significant, though lesser, amounts.

When companies purchase terrorism coverage as part of their property policies, they can purchase either TRIA coverage, noncertified acts coverage, or a combination of the two. In 2004, 70 percent of companies purchased both TRIA and noncertified acts coverage, up from 60 percent in 2003. About 25 percent purchased TRIA-only coverage, and fewer than 5 percent purchased only noncertified coverage.

The Cost of Terrorism Coverage

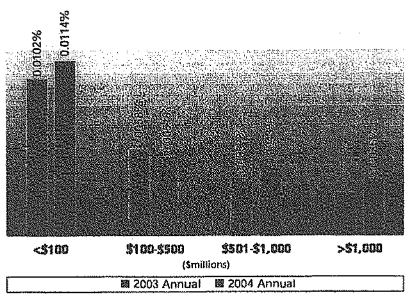
For this report, the cost of terrorism coverage was measured both as a premium rate—premium divided by TIV—and as a percentage of a company's overall property premium. The first method—premium rate—allows companies to track what they paid in absolute terms; the second measure shows how terrorism coverage affected a company's overall property insurance budget.

The median terrorism rate for 2004 was 0.0057 percent, essentially unchanged from 2003. However, there was a slight rise in the median percentage of a company's annual property program costs attributable to terrorism premiums—from 4.4 percent in 2003 to 4.7 percent in 2004. This occurred because terrorism rates did not decline as dramatically as other property rates in 2004, meaning that terrorism coverage represented a slightly larger percentage of overall property insurance budgets.

Cost by Company Size

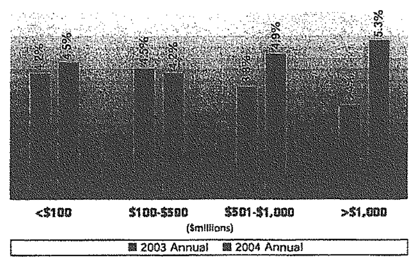
In both 2003 and 2004, median property terrorism rates decreased steadily as the size of the company increased (see Chart 5). The 2004 rates were higher than the 2003 rates in all but one TIV category. In 2004, median rates for the largest companies increased by 31 percent, for the second largest by 18 percent, and for the smallest by 11 percent. Only for companies with TIV between $100 million and $500 million did the median rate decrease, by 13 percent.

Chart 5: Terrorism Pricing—Median Rates by TIV



When cost as a percentage of overall property premiums was examined (see Chart 6), a different trend appeared.

Chart 6: Terrorism Pricing as Percentage of Property Premium by TIV



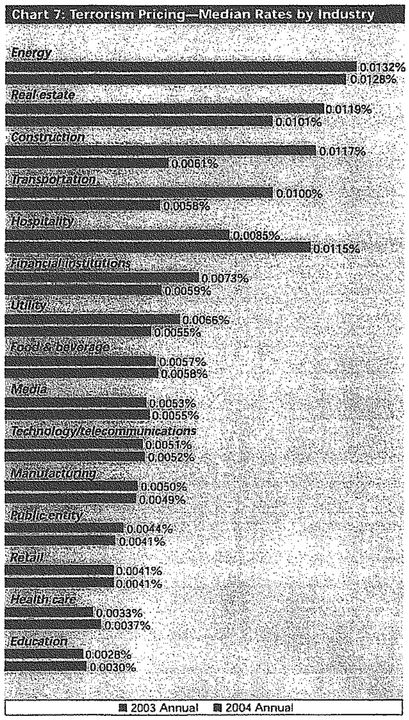
For larger companies in 2003, a smaller percentage of premium dollars could be attributed to terrorism coverage. In 2004, the opposite occurred—the largest companies spent 5.25 percent of their property premium budget on terrorism insurance, compared to only 4.5 percent in companies with TIV under $100 million.

Marsh believes this trend reversal can be explained in part by the fact that the largest companies tended to obtain the largest percentage price reduction on their standard property policies and not quite as large a reduction on their terrorism premiums. Thus, terrorism represented a larger share of the overall property premium budget for the bigger companies.

Cost by Industry

Comparing 2004's median terrorism premium rates by industry to those in 2003 showed that energy companies had the highest median rate in both years (see Chart 7).

Chart 7: Terrorism Pricing—Median Rates by Industry

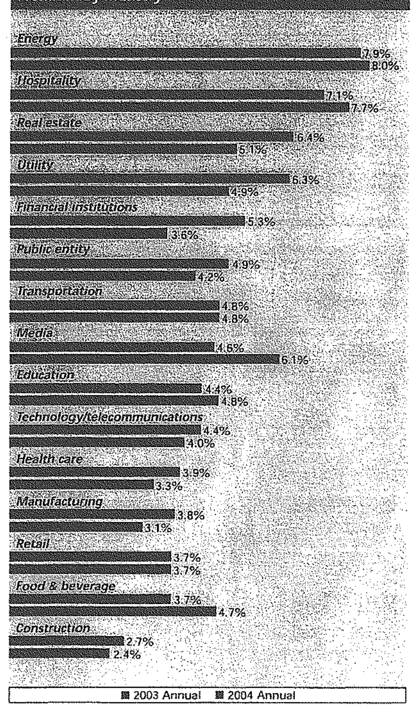


Real-estate and construction firms had the next-highest median premium rates in 2004, although their take-up rates differed greatly—60 percent for real estate and 23 percent for construction. The large difference in take-up rates between these two industries, despite their similar pricing in 2004, is likely due to their differing obligations to purchase terrorism coverage. Real-estate firms are frequently required by loan covenants to purchase terrorism coverage, while construction firms generally have *force majeure* contract clauses that release them from having to insure terrorism risks.

Transportation companies also saw a dramatic increase in terrorism insurance pricing in 2004, up 71 percent. In contrast, hospitality companies, which had the second highest rates in 2003, saw rates decline by 26 percent in 2004.

When looking at terrorism pricing as a percentage of overall property premiums, financial institutions had the largest percentage increase—49 percent—while media companies had the largest decrease—23 percent (see Chart 8).

Chart 8: Terrorism Pricing as Percentage of Property Premium by Industry



Cost by Region

Terrorism insurance was most expensive in the Northeast, based on premium rate (see Chart 9) and calculated as a percentage of property premium (see Chart 10). And while the median rate in the Northeast remained stable between 2003 and 2004, the cost as a percentage of property premium increased 28 percent—the largest increase in any region.

Chart 9: Terrorism Pricing—Median Rates by Region

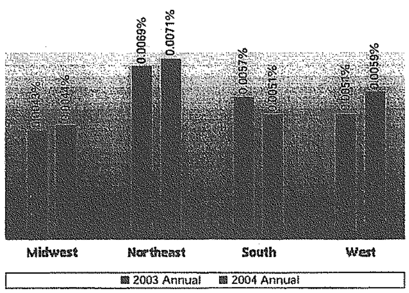
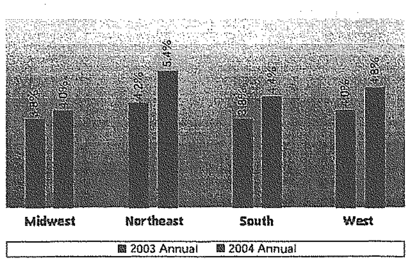


Chart 10: Terrorism Premium as Percentage of Property Premium by Region



The Midwest had both the lowest median rate and the lowest price as a percentage of property premium. The region's median rate did not change from 2003, and the percentage cost increased only about 5 percent. These lower costs may help explain the high take-up rates in the Midwest.

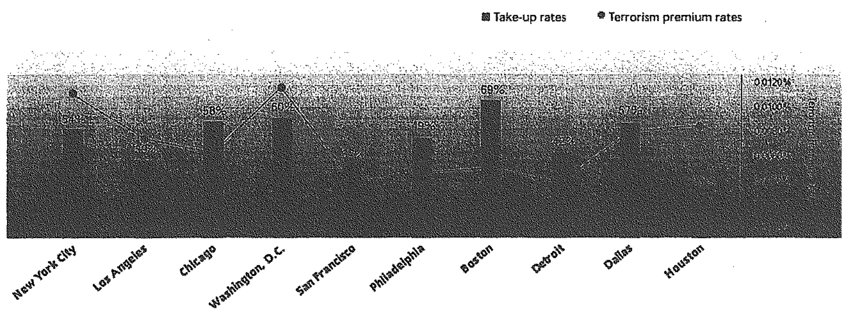
The median premium rate in 2004 decreased 11 percent in the South, but terrorism premium as a percentage of overall property premium increased there by 13 percent. The fact that the take-up rates more than doubled in the South likely indicates that some companies purchased terrorism coverage with the savings from rate reductions on their standard property programs; thus, the increase of terrorism premium as a percentage of overall property premium.

In the West, both the median rate and the percentage of overall premium increased by about 17 percent in 2004. The West trailed only the Northeast in both measures. It is unclear whether these relatively high premium rates held down take-up rates in the West or whether the only companies that purchased property terrorism coverage were those with perceived greater exposures.

A Closer Look at Major Metropolitan Zones

It appears that a metropolitan area's experience with terrorism—and specifically with the events of September 11—has the most impact on pricing of property terrorism insurance. Further, the interaction of pricing and experience has an effect on take-up rates, as does the hard-to-define notion of "perception of risk" (see Chart 11).

Chart 11: Take-up and Premium Rates by Major Metropolitan Areas



- New York and Washington, D.C., are obvious financial and political targets that were attacked on September 11. Both have high premium rates and high take-up rates.
- Los Angeles and Houston are leading centers of culture and the energy industry, respectively, but neither was targeted on September 11. Each has high premium rates, but relatively low take-up rates.
- Boston and Philadelphia are Northeast cities that have relatively low premium rates and moderate to high take-up rates. Boston was the departure point for the September 11 planes that struck the World Trade Center, while Philadelphia has close ties to "neighbors" Washington, D.C., and New York City.

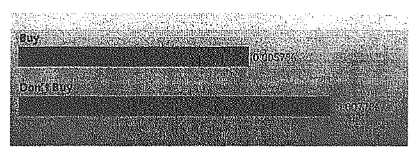
Take-up rates in these major metropolitan areas are not directly correlated with premium rates. Perception of risk is a significant intervening factor in the decision to purchase terrorism insurance.

Why Companies Do Not Purchase Terrorism Coverage

Marsh asked companies that did not purchase terrorism coverage in 2004 to explain their decisions (see Chart 12).

- About 90 percent of the 232 companies responding to this question said they did not purchase property terrorism insurance in 2004 because they did not perceive any risk.
- About 25 percent cited the price of terrorism insurance as a reason for opting not to buy coverage.

Chart 12: Buy vs. Don't Buy—Median Terrorism Premium Rate



- Nearly 20 percent of the companies that said they did not perceive any risk also cited price in their decision not to purchase terrorism coverage. [**Note**: Because multiple reasons were permitted from each of the companies responding to this question, the percentages add to more than 100 percent.]

A comparison of the terrorism premium rates quoted to companies that did not buy coverage with the quotes for companies that did buy coverage reveals a substantial difference. The median 2004 terrorism premium rate quoted to nonbuyers was 35 percent higher than for those that actually bought the coverage.

These findings were surprising because most companies that declined coverage said they did so based on their perception that they had no terrorism risk—not because of price. There appears to be a mismatch between some companies' perceptions of risk and some insurers' perception of risk, resulting in the declination of coverage by these companies.

Amount of Coverage Companies Are Buying

Insurers operating under TRIA must make available limits for acts of terrorism that are not materially different from the limits they offer for nonterrorism exposures. In early 2003, this requirement prompted some insurers to lower their fire limits, allowing them also to lower TRIA limits. However, this proved to be ineffective because their competitors were willing to offer substantial TRIA limits.

In 2004, most companies with TIV under $500 million that bought terrorism insurance purchased the equivalent of their full fire limits. Companies with TIV over $500 million that purchased terrorism insurance—especially those with layered programs—tended to purchase TRIA-only coverage on the lower layers. In some quota-share programs, the limits purchased for the largest companies tended to be skewed by the prevalence of captives, which often provide higher TRIA limits than does the commercial insurance marketplace.

The amount of noncertified coverage insurers are willing to offer varies considerably because it depends on each insurer's treaty reinsurance arrangements (see Chapter 7). Financial institutions purchased the most noncertified coverage, with median limits of $300 million.

The median standalone limit purchased was $100 million; the largest placement in Marsh's sample was over $1 billion.

The Standalone Insurance Market 5

After September 11 and prior to TRIA's enactment, the relatively small standalone insurance market became the main source of capacity for companies looking to obtain property terrorism insurance. Mainstream property insurers were generally unwilling or unable to provide the coverage.

With TRIA in place, the standalone insurance market continues to provide coverage, competing with "all-risk" property insurers that provide TRIA coverage. Standalone insurance markets also serve companies with needs not met by TRIA. Competition from "all-risk" insurers has forced the standalone insurance market to reduce rates—typically by 10 percent to 25 percent, sometimes by more. In 2004, capacity in the standalone property terrorism insurance market grew slightly.

The standalone property terrorism insurance market offers coverage for both TRIA-certified and noncertified risks, with no distinction made between the two. Other features of this insurance market include the following:

- Coverage for noncertified risks only: Some companies buy TRIA-certified terrorism coverage within their "all-risk" property programs to cover U.S. locations and use a standalone policy for noncertified risks.
- Coverage for gaps in other policies: In situations where the "all-risk" program limits cannot be filled by "all-risk" markets—typically, for noncertified risks rather than TRIA-certified risks—the standalone insurance market can be used to fill gaps in limits.
- Noncancelable coverage: Standalone policies are available that cannot be canceled by either party other than for nonpayment of premium.
- Coverage for international locations: Unlike TRIA coverage, standalone coverage is available for almost any location worldwide. Companies with overseas exposures often look to the standalone market to provide solutions not satisfied by local government terrorism insurance schemes such as Pool Re in the United Kingdom, GAREAT in France, Extremus in Germany, Consorcio in Spain, SASRIA in South Africa, and TIA in Australia.
- Reinsurance of U.S.-domiciled captives for terrorism: Some of the standalone insurance markets will reinsure captives for both the deductible and the 10 percent excess share of TRIA-certified losses that the federal government does not cover. Captives by their nature can also take advantage of the reinsurance market, which has greater capacity than the direct standalone market, and can take a financial approach to pricing rather than an underwriting approach. This tends to be more cost-effective.

If TRIA is extended, the standalone insurance market can be expected to continue to satisfy many companies that have needs not addressed by TRIA. If TRIA is not extended, demand for standalone coverage can be expected to increase dramatically. However, the standalone insurance market would be unlikely to have sufficient capacity to satisfy all of the expected demand at commercially reasonable prices. Standalone capacity is supplied on a first-come, first-served basis, meaning that if TRIA expired, then aggregation issues in major metropolitan areas would likely worsen. Without TRIA, organizations could be left with few options to address the potentially catastrophic and ongoing risk of terrorism and could face the possibility of being left with no insurance for this risk.

Market Capacity at Q1 2005

The standalone insurance market as of the first quarter of 2005 has a limited number of insurers, as follows:

Insurer (Group)	Insurer	S&P Rating*	Maximum Capacity in First Quarter 2005
AIG	Lexington, WorldSource, AIU, or StarrTech	AA+	$100 million
ACE USA	Illinois Union or Westchester	A+	$100 million
AXIS	AXIS Specialty Ltd.	A	$200 million
Berkshire Hathaway	National Fire & Marine	AAA	$500+ million
Hannover Re	International Ins. Co. of Hannover	A+	$10 million
Lloyd's	Various Syndicates	A	$400 million
Montpelier Re	Montpelier Re Ltd.	A–	$50 million
QBE	QBE	A+	$10 million

*As of 04/01/05 Theoretical Maximum: $1,370+ million

In the standalone property terrorism insurance market, overall capacity is relatively stable. However available capacity can vary considerably by insured, due to the following issues:

- Location of risk: The demand for coverage in major metropolitan areas has a substantial effect on the available capacity.
- Insurers' accumulation of exposure: Insurers have aggregation constraints on the risks they can take. Capacity can be limited in certain locations, particularly in major metropolitan areas such as New York City, where some insurers currently have severe aggregation issues.
- Concentration of exposure: Terrorists attack targets of opportunity. Although it is certainly possible that an attack could occur anywhere—including in a remote town or shopping mall—demand for coverage will likely be higher in metropolitan areas simply because there is a greater concentration of exposures.

If a company does not have sizeable exposures in locations where insurers have aggregation problems, then approximately $400 million to $500 million per risk—per insured—is the typical maximum standalone capacity available at a cost companies can find acceptable. For locations where insurance markets have aggregation issues—particularly New York City—the estimated insurance market capacity is approximately $300 million without accessing progressively more expensive capacity. For companies requiring limits above $500 million, capacity is available, but it can be extremely costly.

Standalone Pricing

Many factors can affect the pricing of standalone policies for terrorism risk, including:

- the location of the risk;
- the insurer's accumulation of aggregate exposure in specific areas;
- the limit/amount of coverage required;
- the insured's TIV;
- the extent of requests to broaden the standard coverage conditions;
- the insured's profile and ownership;
- the perception as to whether the company is a target;
- the nature of tenants, such as government agencies; and
- the terrorism loss history.

Coverage Comparisons and New Products

All of the current standalone insurance markets will use what are known as the T3/T3A policy forms—developed in the London market—although AIG and ACE also have their own forms.

The following chart compares some of the characteristics of standalone coverage and TRIA coverage. [Note: A detailed policy review would be required to fully understand coverage differences.]

New Product Developments

Among the new products being developed by brokers and standalone property terrorism insurers are:

Capacity commitment: This allows companies to reserve terrorism capacity and pricing now for an up-front commitment fee. If TRIA is not renewed or extended at the end of 2005 and the insured is faced with cancelled or limited terrorism coverage, the insured can elect to use the reserved capacity at the pre-agreed premium for its terrorism coverage.

ACE USA's Threat Protect℠: This policy covers lost income or evacuation expense triggered by a mandatory evacuation order of "your premises" (as defined in the policy) issued by civil or military authority due to a terrorist act or a threat of terrorism. It is offered as a standalone policy with an available limit of up to $25 million aggregate. There is a deductible of 24 hours, and the indemnity period is limited to 30 days.

AIG/Lexington's BioChem Shield℠: This endorsement can offer a sublimit of up to $10 million aggregate for biological/chemical terrorism; it excludes nuclear or radiological terrorism. It is offered as an endorsement to a standalone terrorism policy or to a company's "all-risk" program.

AIG/Lexington's Op Shield℠: This endorsement covers business-interruption and extra-expense losses triggered by a civil or military authority order to evacuate that arises from either a terrorist act or a threat of terrorism. It is offered as an endorsement to a standalone terrorism policy or to a company's "all-risk" program. Lexington can offer a sublimit of up to $25 million aggregate. There is a 72-hour waiting period, and the indemnity period is limited to 30 days.

Hiscox at Lloyd's: This syndicate offers nuclear, biological, chemical, and radiological terrorism coverage. A limit of up to $25 million may be available at Lloyd's with Hiscox as the lead market.

Comparison of Standalone Coverage and TRIA Coverage

Standalone Property Terrorism	TRIA as Part of "All-Risk" Property
Can cover foreign and domestic acts of terrorism.	Covers only foreign acts of terrorism.
Can cover locations inside and outside the United States.	Covers only U.S. locations and property as defined by TRIA
Limits typically aggregated or with one reinstatement.	Per-occurrence limits match property policy limits.
Account- and terrorism-specific deductibles.	Deductibles match property policy deductibles.
Location- and schedule-specific coverage.	Coverage for all locations, including unscheduled, depending on terms of property policy.
Noncancelable policy available.	Cancellation terms follow property policy.
Long-term policies—up to 3 years—available.	Policies typically written for one year.
Select markets.	All markets that meet insurer definition under TRIA.

6 Workers Compensation and Liability Coverages

Workers Compensation

Workers compensation presents unique challenges to insurers, brokers, and risk managers, largely because it is controlled by the states, which have not allowed exclusions for terrorism losses. Insurers and qualified self-insured employers *cannot exclude* coverage for acts of terrorism from workers compensation policies, as they can with other insurance lines. Nearly all states require employers or insurers to pay medical costs and wage replacement for workers injured on the job, without limits or exclusions. Because workers compensation provides lifetime medical care for on-the-job injuries, some computer models project that the worst-case cost of a terrorism incident could exceed $90 billion dollars. In contrast, some experts put the total workers compensation capacity for the entire insurance marketplace at $30 billion.

In view of TRIA's potential expiration, risk managers should be aware that insurers will carefully calculate and try to limit their exposure to high concentrations of risk. Multiline insurers will be particularly sensitive to site-specific accumulation of risk. This means that care should be taken to obtain insurance market alternatives for workers compensation programs likely to be affected. One major insurer has publicly stated it will limit its exposure to a predetermined amount and close its book once it reaches that amount. Other insurers may follow suit.

What will happen to the workers compensation insurance marketplace if TRIA is not extended? State regulators are unlikely to change their stance regarding covering employees for terrorism under workers compensation. Some insurers may feel they have no responsible choice but to limit their terrorism risk accumulation by nonrenewing some workers compensation coverage, as there is insufficient reinsurance capacity to protect the insurers from the essentially unlimited workers compensation exposure arising from terrorism.

This would likely force many insureds out of the voluntary insurance marketplace and into the residual or involuntary market—the so-called insurance market of last resort—in many states. But that would only move the problem; it would not solve it. All states have some involuntary-market mechanism. About 40 percent have a state fund, with the remainder taking a pooling approach. In pool states, premiums and losses are shared by all insurers that provide workers compensation in proportion to their workers compensation insurance market share in the state. This could cause some insurers to write even fewer workers compensation policies or, perhaps, to exit perceived high-risk states entirely. Ultimately, this would not achieve the needed spread of risk.

In states with competitive state funds for workers compensation, every dollar of risk leaving the voluntary insurance marketplace would move to the state fund, again concentrating the loss exposure. The five states that have monopolistic state funds—North Dakota, Ohio, Washington, West Virginia, and Wyoming—have already concentrated this risk, but most of them are not perceived as high-risk areas for terrorism. [Note: West Virginia recently announced that it will move to an open, competitive workers compensation insurance marketplace by July 1, 2008.]

TRIA's limitation to certified acts of terrorism has prompted state regulators and insurers to give more attention to finding premium mechanisms for domestic terrorism and other potential catastrophic losses. Historically, rate makers had included a small, undifferentiated charge for potential catastrophic losses in their overall rates.

Pursuing a more explicit approach, the National Council on Compensation Insurance (NCCI) approved the Domestic Terrorism, Earthquakes, and Catastrophic Industrial Accidents Premium Endorsement (DTEC) for workers compensation effective January 1, 2005. The endorsement provides funding for some catastrophic losses, including acts of terrorism specifically excluded by TRIA, but not for TRIA-certified acts of terrorism.

The endorsement defines a $50 million workers compensation loss aggregate threshold for:

- domestic terrorism, defined as all acts of terrorism outside the scope of TRIA;
- earthquake, defined as a single event involving underground movement along a fault plane or volcanic activity; and
- catastrophic industrial accident, which qualifies if a single event results in the losses.

This endorsement's premium is calculated as rate multiplied by payroll. However, the premium is applied after the standard premium and is not subject to any other modifications, such as premium discount, experience rating, schedule rating, or retrospective rating.

Focused Attack vs. Generic Assault

The nature of a terrorist attack could have serious implications on workers compensation coverage.

A terrorist attack could be either a focused attack on a specific site—such as a business or government building—due to the nature of the work performed there, or it could be a generic assault on a locale, city, or so on. A focused attack on a building—as in the September 11 attacks on the World Trade Center and the Pentagon—would trigger workers compensation coverage for employees injured or killed.

In some jurisdictions, however, generic assaults resulting in injury or death to employees while at work may not be deemed compensable if the risk to the employees was not greater, due to their employment, than the risk to the general public. In other words, an act of terrorism that poisoned the public water supply and caused illness or death to employees would not have created a greater risk to those employees than it did to someone in a nearby restaurant or at home. Due to that fact, some states' workers compensation laws will allow for the denial of benefits.

Liability

The premium charges for TRIA quoted for primary auto liability and general liability (GL) policies have been relatively modest. As a result, insurance buyers have purchased TRIA coverage at much higher take-up rates in those lines than in property. Interestingly, auto and GL take-up rates are declining.

Marsh's Casualty Practice continually surveys primary auto liability, GL, and workers compensation renewals among our clients, compiling data from more than 1,400 companies for the annual *Casualty Cost of Risk* report. [**Note:** The 2005 issue of this report is due for publication in the second quarter of 2005. For a copy, contact your Marsh representative.] Marsh's latest figures showed TRIA take-up rates for auto in 2004 were 84 percent, down from 95 percent in 2003. GL take-up rates in 2004 stood at 81 percent, down from 93 percent in 2003. The actual rate charged as a percentage of premium for the overall coverage held steady at about 1 percent, implying that the reduction in the take-up rate does not appear to have been driven by the cost of the coverage, but by the perceived risk. In fact, insureds' widely varying perception of the risk is one of the reasons most often cited for the lack of universal acceptance of the coverage.

TRIA's Impact on the Insurance and Reinsurance Markets

7

Anticipating TRIA's possible expiration, some insurers may not be willing to continue to provide TRIA-like coverage without any requirement to do so. Others may be willing to continue TRIA-like coverage on their policies, but with added restrictions, such as reduced limit(s), restriction(s) on coverages or locations, higher deductibles, and/or additional premiums. These insurers may seek a TRIA exclusion or restriction in coverage at midterm if TRIA expires.

Many insurers are reviewing every account and watching their terrorism aggregation in major cities. If TRIA expires, Marsh expects reduced terrorism limits to be available after December 31, 2005, for accounts with exposures in major metropolitan areas.

In anticipation of TRIA's expiration, Insurance Services Office, Inc. (ISO) filed three new endorsements with state insurance commissioners for use with commercial policies with inception dates from January 1, 2005, through December 31, 2005. These conditional endorsements would supersede other terrorism endorsements or coverages attached to the policy. They will become effective if any of the following circumstances occur:

- TRIA is not renewed.
- A make-mandatory obligation is not made part of a TRIA extension, and there is:
  - an increase in the statutory deductible, which is at 15 percent for 2005;
  - a decrease in the government's reinsurance, which is currently 90 percent of the loss in excess of the insurer's deductible; or
  - a redefinition of terrorism within TRIA.

For property policies, the three filed endorsements either exclude terrorism, exclude terrorism if all losses exceed $25 million, or provide a sublimit for terrorism.

For GL policies, the ISO endorsement redefines "terrorism"—both "certified acts of terrorism" and "other acts of terrorism"—if either of the following is true:

- insured damage sustained, including business interruption, to all types of property exceeds $25 million combined for all persons and entities in the damaged property; or
- 50 or more persons are killed or sustain "serious physical injury."

Related incidents within a 72-hour period are added together to satisfy the above thresholds. When triggered, the response of the GL policy is constrained to a "terrorism aggregate limit," which is introduced by this endorsement's changing of the "Limits of Insurance" section of the policy.

As of this writing, the property endorsements have been approved in 46 states and in Guam, Puerto Rico, the Virgin Islands, and Washington, D.C. Florida, Georgia, and New York have not approved them, and Texas has approved them for certified acts only. Because Florida, Georgia, and New York have not approved the ISO conditional endorsements, property insurers may offer lower policy limits for accounts with exposures in these states. This may force an insured to seek multiple additional insurers willing to insure risks in these states in order to complete the placement with the required policy limits for terrorism.

In view of the approved filings, some insurers are adopting such endorsements, starting with the January 2005 renewals, where it is their intention not to continue terrorism coverage if TRIA is not extended.

In some cases, larger U.S. insurers have indicated they will continue to provide terrorism coverage after December 31, 2005, for policies that renew this year. The same is true for some foreign insurers that were not governed by TRIA but that nevertheless provided coverage to be competitive with U.S. insurers.

Other insurers were still developing their positions when this report went to press.

TRIA and Standard Fire Policy Statutes

The Standard Fire Policy (SFP) is mandated by statute in 29 states to cover direct losses from fire and lightning (see "SFP States" on page 23). It sets forth the conditions under which such a loss is deemed to have occurred. In some situations where terrorism is excluded under a property policy covering the peril of fire, the issue is whether losses are covered if they arise from a fire caused by a terrorist attack.

Regulators would likely consider any attempt to waive the SFP's substantive protections to be a violation of public policy, rendering them unenforceable. Any diminution in coverage—specifically, any restriction in fire coverage—may be declared null and void by the state.

Standard Fire Policy Exclusions

SFPs generally exclude losses arising from a fire caused by:

- enemy attack by armed forces, including military action taken resisting such attack;
- invasion or civil war;
- insurrection, rebellion, revolution, or usurped power;
- the order of any civil authority;
- neglect on the part of the insured to take reasonable measures to save the property; and
- theft.

There are also several "conditions suspending or restricting insurance," which are similar to exclusions. These include losses that occur:

- when the insured has increased the hazard;
- when the building is vacant; or
- as a result of riot or explosion, unless fire follows the explosion, in which case the loss caused by the fire, and not the loss caused by the explosion, is covered.

The SFP may be supplemented by endorsements extending coverage to additional perils, provided that such coverage is not inconsistent with the provisions of the SFP.

These statutes provide for an only actual-cash-value recovery; there is no time-element protection. In effect, if an insured's policy contains an exclusion for terrorism or if the insured decides not to purchase TRIA coverage, the SFP law for property in these 29 states may offer some protection to insureds, although ten of these—Connecticut, Louisiana, Michigan, Minnesota, Nebraska, New Hampshire, North Dakota, Oklahoma, Rhode Island, and Virginia states—have passed legislation to exclude acts of terrorism. An SFP state could compel the insurer to pay for the direct damage from a fire caused by an act of terrorism on an actual-cash-value basis, despite the presence of a terrorism exclusion in the insuring agreement.

Insurers and their trade associations have been lobbying the legislatures of the SFP states to limit fire coverage resulting from a terrorist attack. Insurers argue that their liability needs to be reduced for losses resulting from such fires in order to:

- protect their own solvency;
- ensure stable insurance markets; and
- compensate insurers, which generally have no reinsurance for this exposure.

Insurers also argue that it is unfair for them to remain potentially liable under statute for so-called fire-following losses when policyholders can reject TRIA or other terrorism coverage and pay no premium for fire-following coverage.

Recent reports indicate that insurers and their trade associations intend to focus legislative efforts during 2005 on Arizona, Idaho, Illinois, Iowa, Massachusetts, Mississippi, New Jersey, New York, Oregon, Pennsylvania, Washington, and Wisconsin.

SFP States

The Standard Fire Policy is mandated in the following states:
Alaska (personal lines only), Arizona, California, Connecticut*, Georgia, Hawaii, Idaho, Illinois, Iowa, Louisiana*, Maine, Massachusetts, Michigan*, Minnesota*, Missouri, Nebraska*, New Hampshire*, North Dakota, New Jersey, New York, North Carolina, North Dakota*, Oklahoma*, Oregon, Pennsylvania, Rhode Island*, Virginia, Washington, West Virginia*, Wisconsin.
*This state has passed legislation to exclude (or allow companies to exclude) acts of terrorism from SFP policies.

TRIA and Nuclear, Biological, Chemical, and Radiological Coverage

TRIA itself is silent on nuclear, biological, chemical, and radiological (NBCR) coverage. However, under TRIA, existing exclusions in policies issued prior to its enactment are preserved. Nuclear and radiological perils are standard exclusions in property and liability policies; hence, in most cases, insurers offering mandatory TRIA coverage can continue to exclude nuclear and radiological perils.

With regard to biological and chemical attacks, the issue is less clear. Before TRIA, primary insurance policies did not contain specific exclusions for chemical and biological events. However, many policies contained exclusions for pollution and contamination, which may exclude losses of a biological or chemical nature.

Workers compensation policies have no exclusions for NBCR. In the standalone terrorism market, limited coverage and policies may be available for NBCR events, up to a maximum of $25 million in limits. In the environmental market, which offers coverage for damage resulting from contamination, coverage may be available if policyholders accept insurers' offers of TRIA coverage.

TRIA's Impact on the Reinsurance Market

As a general rule, the reinsurance market works best at levels where there is a relatively high probability of loss. At levels of loss where there is an extremely low probability of occurrence, reinsurers charge minimum rates for placing their capital at risk. These minimum rates mean that a large portion of the ceding premium is not purchasing coverage.

From a reinsurance perspective, TRIA has had three major impacts:

1. It provides a large amount of reinsurance protection for primary commercial insurance exposures.
2. It provides an authoritative definition of a terrorism event. Before TRIA, there was no authoritative entity in the United States that certified whether an act of terrorism had occurred.
3. It provides a framework for the management of terrorism risk that differs from the conventional approach of insurers/cedents to purchasing catastrophic protection from reinsurers. In particular, the TRIA program covers nearly all lines of property and casualty/liability insurance—including workers compensation exposures—together, combining premiums of all lines to determine retentions and potential recoveries. Conventional private-sector reinsurance tends to be purchased separately for property and casualty lines.

Managing the Gaps in TRIA Coverage

TRIA does not provide coverage for:

- personal lines insurance;
- domestic terrorism for commercial lines insurance; or
- the deductible and excess share of TRIA-certified events.

Because TRIA is basically a commercial lines program, personal lines policies of insurers are fully exposed to both TRIA-certified and noncertified acts of terrorism. In general, insurers have addressed this risk by having full terrorism—certified and noncertified—included in their property/catastrophe reinsurance programs for personal lines, but excluding NBCR losses.

For commercial lines, coverage is needed for domestic terrorism. Most insurers address this exposure by adding coverage for domestic terrorism in their private market reinsurance programs. Similar to that for personal lines, such coverage normally excludes NBCR and may be subject to event limits or other sublimits. Reinsurance markets are now routinely providing this domestic terrorism coverage within occurrence programs for little or no additional cost.

From the insurers' perspective, a large unreinsured gap in terrorism exposure exists for certified acts below the 15 percent retention set by TRIA for 2005 and within the 10 percent co-participation above the retention. Ideally, cedents' preference is to have commercial certified terrorism covered within their standard property and casualty reinsurance programs, but this coverage is available only in limited sums and can be expensive, depending on the location and values of the original insured terrorism policies.

Reinsurers put limited capital at risk to terrorism exposures, given their lack of confidence in how to underwrite, model, or price for this peril. They typically seek to manage the risk by offering terrorism coverage in a standalone contract rather than within a normal "all-perils" catastrophe treaty, especially for insurers writing a national portfolio. Some regional insurers with exposures limited to rural or suburban areas have secured full terrorism coverage within their standard reinsurance programs.

In workers compensation, many cedents have been able to add the certified terrorism peril to their excess-of-loss catastrophe programs on an occurrence basis, excluding NBCR. Typical pricing for this is a 15 percent surcharge on ceded premium. Coverage for NBCR perils is available only through aggregate standalone coverage, with limited reinsurance markets willing to offer this full coverage.

Currently, approximately 15 percent of Guy Carpenter's major clients have purchased standalone terrorism reinsurance. Companies that have *not* purchased standalone terrorism reinsurance cite the following factors:

1. Terrorism coverage can be expensive, depending on the location of the original insured terrorism policies.
2. Cedents are comfortable with the extra coverage for terrorism added to their normal reinsurance contracts.
3. There is an inability to pass along the full cost in primary insurance policies.
4. There are limited capacity/limits available at affordable rates.
5. Exposure concentrations are controlled and/or are limited, particularly for clients with little exposure in targeted urban centers.
6. They are comfortable with the TRIA retention.
7. There is no coverage offered for NBCR.

Capacity

Typical estimates of capacity for a terrorism reinsurance program range up to $600 million on an occurrence basis for property and casualty/liability insurance. For some programs where the terrorism exposure is limited to a single state, it is feasible to secure more than $1 billion of capacity on one program. Such capacity may expand or contract based on price, type of risk, and overall reinsurance market conditions. The Reinsurance Association of America projects total private-sector reinsurance market capacity to be around $4 billion to $6 billion.

TRIA Sunset

If TRIA is not renewed, it is not realistic to expect the reinsurance market to expand from between $4 billion and $6 billion available today up to coverage limits in the $100 billion range that may be required. Given this reality, insurers may find themselves bare for the risk of TRIA-like terrorism as they write annual policies in 2005 that extend into 2006. Those insurers may seek to exclude coverage for terrorism in 2006 by using specific conditional endorsements. Insurers covering the workers compensation line do not have the option to exclude terrorism, so this line is likely to have the most insurance market disruption, absent an industry and/or state or federal government solution.

Modeling Terrorism

Quantifying the economic and human losses from terrorist acts poses major challenges for insurers, but it is not an insurmountable task. A variety of approaches exist for insurers to model terrorism risk—three of the more common are discussed below. Most models involve three techniques:

1. conducting exposure concentration analysis;
2. generating deterministic loss estimates; and
3. producing probabilistic loss estimates.

Exposure concentration analysis, also known as accumulation assessment, identifies and quantifies concentrations of exposures around potential terrorist targets. Target-based accumulation assessment locates potential targets—typically with high economic, human, and/or symbolic value—and aggregates an insurer's exposures at various distances from targets. To complement this approach, it is useful to search for clusters of exposure exceeding an economic threshold within a portfolio irrespective of perceived targets. This recognizes that some probability of attack exists at any location.

Deterministic modeling represents a compromise between the lack of accuracy in accumulation analysis and the vast uncertainty surrounding probabilistic models. By imposing an actual event's damage "footprint" at a specified target, a specific—yet hypothetical—scenario can be analyzed with some certainty. Major modeling firms offer an array of deterministic-analysis tools for conventional and NBCR (nuclear, biological, chemical, and radiological) attacks at target and nontarget locations. This approach can be effective where coarse screening studies show that exposures for an area or event could be high and a detailed assessment may reduce uncertainties and help decision making.

Probabilistic modeling, also known as catastrophe modeling, estimates loss based on a large number of events and their associated probabilities. A key factor is the estimated frequency of the event. Many insurers question the credibility of probabilistic terrorism modeling, as it requires predictions of human behavior. While credible probabilistic terrorism modeling remains elusive, Guy Carpenter has helped insurers explore possible terrorism losses using a judgment-based approach that goes beyond purely deterministic modeling.

Terrorism modeling is in its infancy. Insurers, reinsurers, and modeling companies are learning more each day, thus increasing their ability to manage terrorism risk in an educated and quantitative fashion.

TRIA and Captives 8

Using a captive insurer to access TRIA can be an effective way for businesses to manage their exposure to certain terrorist acts. Marsh's Captive Management Services group has worked with many clients to implement captive solutions using existing and new captives. Captives offer certain advantages over traditional insurance markets, including better control over costs, broader coverage, potential to recapture premiums if no losses occur, and the capability of covering exposures that commercial insurers find unacceptable or undesirable.

In various interpretative letters and regulations issued after the passage of TRIA, the U.S. Treasury Department made clear that TRIA applies to captive insurers that meet the Act's definition of an insurer. Captives that meet the definition are entitled to all of TRIA's benefits, but also are subject to its burdens. The key benefit to insurers is the substantial amount of protection the program provides—up to 90 percent of the policy limit. The key burdens are the requirement to make coverage available for certified acts of terrorism as part of any offer of coverage for a given line of insurance and to satisfy certain disclosure and reporting requirements.

Note that non-U.S.-based captives—such as those in Bermuda and the Cayman Islands—are not insurers licensed by a U.S. state and so are not qualified insurers under the Act. Accordingly, they can not derive any benefit from TRIA, nor are they subject to its requirements. It should also be noted that if TRIA is not extended, use of a captive to access TRIA's reinsurance will provide only a short-term benefit.

One of the most attractive features of using a captive insurer to cover losses from certified acts of terrorism is the ability and willingness of a captive to carefully tailor the policy form to its insured's needs. The clearest example of this is where captives have created manuscript policy forms with provisions to include protection for perils—such as nuclear, biological, chemical, and radiological—generally excluded by their "commercial insurer counterparts. The Treasury Department has issued guidance clearly stating that to the extent a subject insurer provides protection for certified nuclear-, biological-, or chemical-based acts, TRIA's reinsurance protection will apply. TRIA does not require that the nuclear, biological, and chemical perils be covered, and as a result, most commercial insurance policies continue to exclude these perils. The reluctance of commercial insurers to offer such protection has meant captives are one of the only viable means of securing such protection in meaningful quantity.

A key objective of TRIA was to ensure the availability of coverage. Nevertheless, provisions of the Act allow commercial insurers to avoid covering a given insured's terrorism exposure. For example, TRIA compels an insurer offering property coverage also to offer coverage for certified acts of terrorism. But the insurer can avoid offering terrorism coverage by not offering any insurance for the property. In some cases, commercial insurers have taken this option, leaving companies with no property coverage. Similar situations have occurred with other lines, including workers compensation. Captives have been used to fill the resultant gaps in coverage, thereby creating capacity and indirectly helping fulfill the Act's objectives.

Adding coverage for certified acts to an existing captive insurer generally requires the approval of the captive insurer's regulator, and the approval can usually be secured within a few days. Forming a new captive to provide such protection is more time-consuming—about 7 to 60 days—and requires the submission of an application for licensure along with associated supporting documents. Regulators typically approve a change in plan for an existing captive or license a new captive once they are satisfied that the captive's proposed plan of operation is prudent. In making this determination, regulators consider factors such as premium to be charged, net exposure to the captive, quality of commercial reinsurance to be used (if any), and the capitalization level of the captive.

The Treasury Department has taken a watchful stance regarding the use of captive insurers to access TRIA. The department has formally acknowledged the existence of captive insurers both in confirming the Act's applicability to them and in issuing some cautionary statements about the importance of not using captives to exploit TRIA inappropriately. In those cautionary statements, the Treasury has warned of concerns with three captive situations in particular—captives formed after TRIA's enactment, captives writing coverage only for certified acts, and captive transactions designed to circumvent the deductible requirement that TRIA imposes on each insurer before TRIA contributes.

To date, the Treasury Department has not used its discretionary authority to curtail the use of captives, seemingly opting instead to recognize the clear value captive insurers provide and how they can, when used appropriately, support TRIA's and captive owners' objectives. Still, given the Treasury's cautionary statements about the use of captives, users should carefully consider the objectives and appropriateness of their overall plan before implementation.

Marsh's Captive Management Services conducted a survey as of March 1, 2005, of a representative sample of our captive management client team leaders in the United States. The survey showed significant utilization of captive insurers for terrorism exposures. The survey size was large enough that it should reasonably reflect the use of U.S.-licensed captive insurers as a whole. Those captives operating in a manner making them unable to offer certain lines were excluded from the analysis. For example, risk retention groups were excluded from the property findings because such groups are prohibited by law from offering property coverage.

Marsh's survey found:

- At least one standalone terrorism agreement was in force among 17 percent of those surveyed. Of this group:
  - 88 percent had at least one policy in place covering only property-related certified acts of terrorism;
  - 18 percent had at least one policy in place covering only casualty-related certified acts of terrorism;
  - 4 percent had at least one policy in place covering only workers compensation-related certified acts of terrorism; and
  - 44 percent afforded protection for certified nuclear, biological, and chemical terrorism-related losses.
- Of captives with at least one standalone terrorism agreement in force, 24 percent purchased reinsurance to cover all or part of the captive's TRIA deductible, excess share, or both.

- To help place these results in context, consider that among the survey group:
  - 37 percent had at least one property policy in force;
  - 52 percent had at least one casualty policy in force; and
  - 43 percent had at least one workers compensation policy in force.

There are many potential benefits to forming a captive, but they need to be weighed carefully against the potential costs and risks. The decision to use a captive should be made in consultation with appropriate internal and external legal counsel and advisors.

9 Terrorism Risk Management

After the attacks of September 11, the security profession entered the public spotlight as never before. In addition to "traditional threats" such as criminal activity and workplace violence, corporate America is now faced with the threat of terrorism to its domestic headquarters and to its operations abroad. Although the threats themselves have not changed dramatically, the type and number of targets have. To thwart the element of surprise—to take the "terror" out of terrorism—an organization must identify its vulnerabilities and address them in advance with a holistic security plan.

The ultimate objective in managing terrorism risk is the prevention or mitigation of loss to an organization's assets caused by intentional human acts. Although there are no silver-bullet answers, today's security climate dictates that an organization should plan for operations under a variety of threat scenarios. There are now a number of so-called "contemporary methodologies" being presented within the security industry, each geared to a specific facility type, including ports, water utilities, refineries, and other critical infrastructure. However, the basic principles, practices, techniques, and concepts of physical security remain essentially the same as they have been for well over a quarter century. It is important to recognize that one size does not fit all; each facility will require a different plan that will need to be kept "live" and to be updated relative to changing global security conditions.

Defining the Threat

The motivation of foreign terrorists is usually religious ideology. Their weapon of choice is explosives, but terrorism experts generally expect them to use NBCR weapons in the future. Available explosives can either be conventional or may take the form of improvised explosive devices (IEDs). An IED is a "homemade" device that can be fabricated from almost any type of material and delivered through varying methods, including remote detonation using low-technology means such as cellular phones or garage-door openers. Although not likely to be the case in all future attacks, the use of suicide agents should also be considered.

Al-Qaida, in particular, is known for detailed preparation, including extensive target surveillance and planning that can span several years. Foreign terrorists aim to cause fear and thereby alter the normal comfort level and behavior of large segments of the target population far beyond those directly affected at the point of attack. In the attacks of September 11, for example, the use of commercial aircraft as weapons caused a fear of flying that had a substantial negative impact on the national economy which extended far beyond the airline industry. Al-Qaida's primary tactic to date has been to cause mass casualties among the civilian community.

Notably, this terrorist group weighs the difficulties of an attack against the likely consequences of the attack, say security experts at risk consulting firm Kroll, a Marsh sister company. It then selects targets by identifying attack scenarios that offer the highest probability of success and impact with the lowest amount of risk of failure. For this reason, a primary security goal for any potential target facility is to deter an attack by aggressively influencing the terrorists' target research and risk/reward assessment. This goal is best achieved by:

- implementing prudent security procedures and physical security measures;
- protecting sensitive information;
- exhibiting a vigilant and unyielding security posture; and
- training facility personnel to recognize and respond appropriately to suspicious incidents.

These steps also increase the likelihood that terrorists will be detected either during their surveillance or in the early stages of an attack.

Domestic terrorists and extremists share many traits with foreign terrorists; however, their motivation is usually political. Their objective is sometimes stated as being widespread social or political change in one or several particular areas of society. Their tactics have included the use of explosives, iconic murders or assassinations, and kidnappings. Their methods are intended to be executed without apprehension and often without immediate discovery during perpetration of the attack. Typical targets include abortion clinics and doctors as well as government agencies, particularly those related to taxation and firearms control.

Activists generally have ideological motivations, and their objective is to draw public attention to their cause—often by intentionally involving the media—and/or to change the policies or practices of the target organization. Common tactics include arson, vandalism, contamination of materials or products, and sabotage. Although tactics do not typically involve intentionally causing death or injury, major property damage is frequently wrought in an effort to interrupt business operations or to publicly embarrass an organization.

Mitigating the Risk

It is important to note that many facility types must operate under specific requirements, usually in the form of federal mandates. In some cases, the legal requirement will be for an "assessment" or similar study of a facility's security measures and potential vulnerabilities, often including recommendations for improvements, but without a legal mandate for the organization to implement any specific security measures. The nation's water utility operators are a good example of this, as they must follow requirements set by the Environmental Protection Agency. In other cases, such as those involving ports and maritime facilities under U.S. Coast Guard initiatives, federal regulations are more specific regarding certain security measures that must be implemented. In most cases, certain documentation must be submitted to the regulating governmental agency.

In the course of a facility threat assessment, a security professional will carry out an exercise known as "adversary characterization." This produces general, but useful, information in security planning, including the following:

- who: identification of people who are likely to carry out a threat to the assets;
- how: the tactics and techniques that may be employed in executing an attack;
- what: the tools, weapons, and materials available for terrorists' use in achieving their objective;
- when: any historical data related to the timing of an attack;
- where: the geographic considerations—on both a large and a very localized scale; and
- why: the adversaries' motivations for the acts and their end objectives.

The assessment will also evaluate existing facility security measures, threats, vulnerabilities, recommended upgrades, cost estimates, a general implementation schedule, and the basic tools necessary for the organization's staff to manage and maintain an adequate level of security over a period of time, usually up to five years.

Adequate security requires a combination of elements—technological (security systems), architectural (traffic patterns and protection at access portals), and operational (policies, procedures, training, and contingency plans). Included in the operational component is the development of an exercisable all-hazards emergency-response and recovery plan. All of these measures are interrelated and must work in unison to be successful in producing an effective security posture for an organization. Many businesses struggle with the decision to invest in security, but implementing even limited security measures on the front end is well worth the time and money that could otherwise increase tenfold in the event of an actual incident.

Conclusion 10

This report reviews the terrorism insurance marketplace in 2004 and provides a snapshot of trends in early 2005. As the take-up rate analysis in Chapter 4 demonstrates, concern about terrorism is not isolated to particular geographic regions or to large metropolitan areas. This is an exposure that affects a business's entire value chain—and, therefore, crosses all components of the economy.

During the spring and summer of 2005, there is expected to be significant debate on Capitol Hill on the merits of extending TRIA and continuing the government's involvement with terrorism insurance. The Treasury Department is scheduled to present its report about TRIA by the end of June. Marsh hopes this *Marketwatch* report will support constructive discussion of the issue. It is clear that the ambiguous and fluid nature of the risk makes it extremely challenging to predict, quantify, and address terrorism across all dimensions of risk management. With limited historical data and wide-ranging estimates on the value of catastrophic losses, it is difficult for the insurance industry to understand and quantify the true exposure and cost of the terrorism risk. In this context, TRIA has been quite successful It stabilized the insurance market and improved the availability and affordability of catastrophic terrorism insurance.

A second important goal will not have been accomplished, however: that by December 31, 2005, the insurance industry will have been able to amass the necessary capital and associated underwriting tools to enable it to insure catastrophic terrorism losses without government assistance. Given that worst-case scenarios show potential losses could top $100 billion and that standalone terrorism insurance market capacity in total stands at roughly $6 billion today, it could take decades for the insurance industry to build up the necessary capacity.

Without a continuation of some form of government reinsurance support, the insurance market will not be able to respond fully in the event of a catastrophic terrorism loss. Scarce capacity will likely cause rates to rise dramatically, and organizations in perceived high-risk locations in large metropolitan areas will be challenged to find affordable coverage—if they will be able to find it at all. With the current uncertainty surrounding TRIA's renewal and with few alternative financial instruments available, clients are already competing for the limited amount of terrorism capacity available in the standalone insurance market.

Acting in support of our trade association representatives from the Council of Insurance Agents and Brokers (CIAB), Marsh regularly communicates with staff members of the Senate Banking Committee and the House Financial Services Committee. Marsh found that many insureds are deeply concerned about the availability of coverage for terrorism when and if TRIA ends. Marsh therefore urges its clients to voice their opinions on TRIA—whether or not they support continuation of the program—to their own trade associations and other groups with a voice in Washington, D.C.

Marsh's obligation to clients is to remain active on this topic because it involves such fundamental uncertainty and potential damage. We will continue to maximize client protection by discussing risk management strategies, developing risk transfer solutions, and offering safety initiatives to mitigate or avoid loss.

TRIA has been a valuable component of the U.S. administration's war on terror—it helped stabilize the insurance market and, thereby, the U.S. economy. The Act should be continued in some form for the next few years to allow more time for the development of a permanent solution. In partnership with the government, it should be the duty of clients, brokers, insurers, and reinsurers to investigate all potential options and develop a robust, long-term terrorism risk management and risk-transfer solution.

About Marsh & McLennan Companies

Marsh & McLennan Companies (MMC) is a global professional services firm with annual revenues exceeding $11 billion. It is the parent company of Marsh Inc., the world's leading risk and insurance services firm; Putnam Investments, one of the largest investment management companies in the United States; and Mercer Inc., a major global provider of consulting services. More than 60,000 employees provide analysis, advice, and transactional capabilities to clients in more than 100 countries. Its stock (ticker symbol: MMC) is listed on the New York, Chicago, Pacific, and London stock exchanges. MMC's Web-site address is http://www.mmc.com.

Marsh

Marsh meets the global needs of its clients through a wholly owned network of more than 400 offices in more than 100 countries. In every country, Marsh combines a deep knowledge of local risk issues with the ability to tap global insurance and capital markets for solutions tailored to client needs. Since its founding more than 130 years ago, Marsh has steadily built its business beyond insurance broking to encompass a full range of services to identify, value, control, transfer, and finance risk.

Kroll

Kroll provides corporate advisory and restructuring, forensic accounting, valuation and litigation consulting, electronic evidence and data recovery, business intelligence and investigations, background screening, and security services. It serves a global clientele of law firms, financial institutions, corporations, nonprofit institutions, government agencies, and individuals.

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Guy Carpenter provides reinsurance broking, financial modeling services, and related advisory functions worldwide for insurers and reinsurers.

Mercer

Mercer provides clients with solutions linking the three most enduring dimensions of business success—business design, organizational design, and people strategy. It does this through a unique array of consulting expertise:

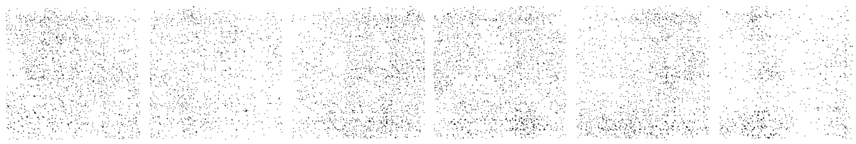
- Mercer Human Resource Consulting is the global leader in human-resource, employee-benefit, and compensation consulting.
- Mercer Management Consulting helps clients achieve sustained shareholder value through innovative business design.
- Mercer Oliver Wyman is a leader in financial-services strategy and risk management consulting.
- Mercer Delta Consulting works with CEOs and senior teams of major companies on the design and leadership of large-scale transformation.
- NERA Economic Consulting, the leading firm of consulting economists, devises solutions to problems involving competition, regulation, finance, public policy, and business strategy.
- Lippincott Mercer, the premier corporate-identity firm, helps clients create, develop, and manage their brands throughout the world.

Putnam Investments

Putnam Investments plays a key role in the financial-planning decisions of millions of individuals and thousands of institutions. With more than 60 years of investment experience, Putnam provides investment-management services to more than 2,700 institutional and 401(k) clients and manages more than 14 million individual-shareholder accounts.

Collaborative Solutions

The companies of MMC work together to offer multifaceted client solutions. In so doing, they bring to bear a unique range of perspectives on the toughest issues confronting clients, industry by industry. Risk management is the focus for many of these collaborative services. Through the expertise of Marsh, Kroll, Guy Carpenter, Mercer, and Putnam, the companies of MMC are uniquely positioned to offer clients risk solutions and advice across the full range of their strategic, financial, operating, and hazard risks.



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Marketwatch: Terrorism

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Independent Insurance Agents & Brokers of America, Inc.

TESTIMONY OF:

William G. Stiglitz, III
President-Elect

On behalf of the
Independent Insurance Agents & Brokers of America

Before the House
Financial Services Subcommittee
on
Capital Markets, Insurance, and Government
Sponsored Enterprises

July 27, 2005

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Independent Insurance Agents
& Brokers of America, Inc.

STATEMENT OF THE
INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES
July 27, 2005

Good morning Subcommittee Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. My name is Bill Stiglitz, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America (IIABA) to present our association's perspective on the future of the Terrorism Risk Insurance Act (TRIA) of 2002. I am an account executive with Hyland, Block, and Hyland, an independent agency based in Louisville, Kentucky, and I currently serve as the president-elect of IIABA.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, and we represent a network of more than 300,000 agents, brokers, and employees nationwide. IIABA represents small, medium, and large businesses that offer consumers a choice of policies from a variety of insurance companies. Independent agents and brokers offer a variety of insurance products – property, casualty, health, life, employee benefit plans and retirement products. Independent insurance agents and brokers sell nearly 80 percent of all commercial lines policies in the country. Members of the Big "I", as we are known, write the coverage for America's businesses and serve as the conduit between consumers and insurance companies, and therefore we understand the capabilities and challenges of the insurance market. From this unique perspective, we urge Congress to continue some form of a federal terrorism insurance backstop beyond the year-end expiration of TRIA.

Please let me begin by complimenting Chairman Oxley and Ranking Members Frank for moving expeditiously to consider the recent report issued by the Department of Treasury at a Full Committee hearing on July 13, 2005. The Big "I", and our 300,000 members, are especially encouraged that members of this Committee and Secretary Snow reaffirmed support for a continued federal role in assisting the private market in handling this risk of truly catastrophic proportions.

We also applaud Subcommittee Chairman Baker and Ranking Member Kanjorski for holding today's hearing. Clearly, the leadership of this Committee understands that the insurance market's ability to protect the American economy from the financial consequences of terrorism risk is a critical component of the nation's economic security and vitality during the ongoing war on terror. The challenge now before Congress is how to follow up the success of TRIA with an improved public-private partnership that will ensure consumers have continued access to terrorism insurance.

Background

It is well known that the insurance community performed admirably in the immediate aftermath of September 11th, 2001, honoring its commitment and providing the resources needed to quickly and fully pay claims and thus playing a pivotal role in the recovery-and-rebuilding process. However, even though the insurance marketplace responded effectively to the 9/11 losses, it was quickly apparent after 9/11, and remains so today, that insurers could not handle the risk of further large-scale terrorist events without a Federal backstop.

Indeed, Federal Reserve Chairman Alan Greenspan again last week made clear his view that private insurers alone cannot handle the risk of losses resulting from terrorist attacks. In testimony before this Committee, Chairman Greenspan acknowledged terrorism and geopolitical risk have become enduring features of the global landscape, and he stated, "the type of terrorism that is arising in the context of increasing technologies which were not available before has created the possibilities of huge losses. And there is no way for a private 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."

Not unexpectedly, insurers reacted in late 2001 and 2002 to the new perception of exposure and lack of scientific terrorism modeling with exclusion clauses and outright cancellations of coverage. This left agents and brokers in the always difficult position of being unable to meet consumers' needs for coverage. But beyond our own professional dilemma, it quickly became clear that the absence of coverage presented an immediate threat to our country's economy that had to be addressed – construction and other important economic activity were being impacted by the lack of coverage.

Fortunately, through the leadership of the Administration and many in Congress, particularly in this Committee, the government did respond to address problems in the marketplace with TRIA. Those of us in the market, however, do not need to be reminded of how acute the problem was before Congress and the President enacted the Terrorism Risk Insurance Act in late 2002. Economic activity, especially significant new construction projects, was beginning to be impacted by the inability of owners to satisfy demands of current or prospective lenders to demonstrate adequate insurance coverage. Fortunately, TRIA was put in place before the worst effects of this availability and affordability crisis further injured our national economy.

I would like to stress that the interest in, and the need for, a terrorism insurance backstop is NOT confined solely to big urban areas. IIABA represents agents and brokers selling coverage to consumers across the country on the front lines. Our collective experience establishes that terrorism insurance coverage is not just a big city or big State problem. It is a business customer problem throughout the country; this is truly a national issue. In fact, take-up rates under TRIA have continued to grow across the country, and we have seen terrorism coverage purchased by a wide and diverse variety of interests, from small towns in Mississippi to small and large businesses in New York City. As the intermediaries between those customers and the insurers, our members remain concerned that the needs of many policyholders will not be met with affordable and good quality coverage for this peril if there is no terrorism insurance program in place after December 31, 2005.

Treasury Report

The Treasury Department and the Administration should be commended for providing Congress with an exhaustive report with much information that will inform the legislative process which must be completed before year-end. While the Treasury report offered many important findings, we have come to a slightly different conclusion regarding the future need for a terrorism backstop based on the marketplace evidence and our own collective experience with insurers and policyholders in the market.

We agree with the report's bottom-line – that "TRIA has achieved it goals of supporting the industry during a transitional period and stabilizing the private insurance market." TRIA's public-private partnership has worked well and generally as intended, allowing businesses across America to continue operating and growing, and preserving jobs in the process. TRIA has saved our economy millions of dollars by making terrorism insurance broadly available to all businesses that want and need this coverage at virtually no cost to the Federal government. Prices have come down, capacity has grown, and demand is up in many geographic areas.

However, as 2005 wears on, more and more of the renewal insurance policies covering businesses of all sizes and types will extend past TRIA's December 31, 2005, sunset date. Because State insurance regulators have approved conditional terrorism exclusions in most States to protect insurance company solvency after TRIA, IIABA members are concerned that policyholders will face potentially harmful gaps in coverage beginning at year-end.

As access to insurance coverage diminishes, we continue to hear from the Federal government – reinforced by the recent events in London and Egypt – that there remains a risk of further catastrophic terrorist attacks. Where insurers have received State approval for coverage exclusions after TRIA expires, that risk will shift back onto the shoulders of policyholders and investors, including commercial bondholders. Where insurers have not secured terrorism exclusions either due to State law – such as in mandatory workers' compensation coverage – or because regulators will not approve them in some States, the insurers themselves will remain significantly exposed to terrorism losses and potential insolvency. As a result, entire sectors of the U.S. economy could be impacted by future terrorist attacks in the absence of a terrorism insurance program, and economic activity may be dampened without there ever being an attack.

These concerns are consistent with the Treasury report's finding which states, "Overall, our assessment is that the immediate effect of the removal of the TRIA subsidy is likely to be less terrorism insurance written by insurers, higher prices and lower policyholder take-up." And, since Treasury's findings – including rising take-up rates, the ability to return to "pricing" these risks, and increases in the property-casualty insurance industry's surplus position – have all occurred under the

TRIA program, our members believe that there remains tremendous uncertainty as to whether private insurers and reinsurers will actually be able to fill the gap without a program in place.

In our view, the Treasury Department's findings support the need for an appropriate Federal role to encourage a workable insurance mechanism in the event of cataclysmic terrorism losses since continued access to affordable terrorism insurance is crucial to the economy's vitality. The report is also consistent with the IIABA position that the Federal government's role in the insurance market be limited, while State insurance regulation is preserved. In fact, to the extent that the private sector is able to handle this risk and Federal government involvement is phased out, we believe that all stakeholders and the market will ultimately benefit.

Going Forward

The challenges facing the commercial insurance market with respect to terrorism risk insurance are both critical and stretch well beyond TRIA's current end date. IIABA members, along with many in the insurer and policyholder community, recognize that we must find a market-based solution to our nation's terrorism insurance problem. To that end, property-casualty insurers, agents/brokers and commercial insurance policyholders are working to identify options for managing terrorism risk that would encourage greater private sector involvement.

IIABA is looking forward to working with Congress, the Administration and other stakeholders to fashion a successor program to TRIA. However, the litmus test for the IIABA is that any solution must work for the consumers with whom IIABA members work. As such, the ultimate test for IIABA support of any proposal will be whether the program works for the marketplace.

Both Congress and stakeholders are at something of a crossroads with two basic choices: either re-authorize TRIA for, say, two years with some modifications in the direction of the changes indicated in Secretary Snow's letter, or enact a more comprehensive modification by adding a more permanent structure for private-industry mutual pool reinsurance to phase out the Federal role over time. Both options have some attraction. Short-term extension legislation may have fewer political complications, although it may be difficult to find the right balance of increased deductibles and triggers for the marketplace. On the other hand, developing an intermediary, private-sector funded layer of coverage would help reduce Federal involvement in the marketplace and create a long-term, market-based solution for a problem which we have every reason to believe will be with us for years to come. IIABA is committed to working with the Committee on parallel tracks to develop both options so that we are in the best possible position to enact the solution which proves most viable in a timely manner.

We also hope that any solution will draw on the experiences of the current program in order to assist the private markets in handling this risk. While the TRIA backstop program has helped calm the marketplace, there are problems that it did not solve even in the short term that we hope that policymakers will examine as we look beyond TRIA's expiration. For example, despite the fact that TRIA does backstop losses arising from nuclear, biological, chemical, or radiological acts of terrorism, commercial customers generally are unable to get that type of coverage in the market today. It leaves a lot of the business community greatly exposed to that type of attack -- one which the leadership of this nation keeps talking about as the most likely and the most damaging. Indeed, the lack of NBCR coverage even while the backstop is in place is powerful evidence that the private markets are not yet fully capable of handling the terrorism risk exposure without some backstop.

Conclusion

In conclusion, we urge Congress to respond to immediate issues in the marketplace so that our country's economic security is not clouded by the uncertainty of what lies beyond 2005. With the risk of catastrophic attacks on U.S. soil still very real, and the capability of both insurers and reinsurers to offer comprehensive terrorism coverage for an uninsurable risk still very limited, we urge Congress to address these issues as soon as possible. IIABA applauds the leadership of this Committee for exploring more market-based solutions to the problem of insuring against terrorist attacks. Whether the Committee opts for a reformed TRIA extension, or a more comprehensive long-term approach, the IIABA stands ready to work with the Administration, Members of this Committee, and other Members of Congress to provide stability in the commercial marketplace prior to an attack with minimal cost to, and intervention from, the Federal government.

Thank you for the opportunity to testify today.

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WILLIAM G. STIGLITZ III
IIABA President-Elect
Louisville, Kentucky

William G. Stiglitz III was elected to the Executive Committee of the Independent Insurance Agents & Brokers of America (IIABA) in October 2000, and was inaugurated as president-elect in 2004 at IIABA's convention in Orlando. He will become the Association's president in 2005. Mr. Stiglitz is an account executive with Hyland, Block & Hyland, Inc., in Louisville, Ky.

As president-elect, Mr. Stiglitz is concentrating his efforts on the long-range strategic plan. He is working toward IIABA providing lobbying and legislative aid for the states, while also continuing to push for the education of agents on technological advancements.

A past president and state national director for the Independent Insurance Agents of Kentucky (IIAK), Mr. Stiglitz served on the state's Board of Directors and the Government Affairs Committee. Nationally he served as planning liaison to the Executive Committee and as a member of the Dues Task Force. He also is a past president of the Louisville Board of Independent Insurance Agents.

Mr. Stiglitz graduated from Centre College in Danville, Ky., and served in the U.S. Army in Vietnam. He entered the insurance business in 1970 when he joined his uncle in the Miller & Scholtz Agency. Miller & Scholtz merged with Hyland, Block & Hyland in 1992.

He and his wife of 33 years, Pat, have two children: Garrett, who works as an account executive at Hyland, Block & Hyland, and Kate, a middle school teacher in Louisville.

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October 2004

TERRORISM RISK INSURANCE ACT

REAUTHORIZATION

STATEMENT FOR THE RECORD OF

EDWARD R. HAMBERGER

PRESIDENT & CHIEF EXECUTIVE OFFICER

ASSOCIATION OF AMERICAN RAILROADS

TO THE U.S. HOUSE COMMITTEE ON

FINANCIAL SERVICES

HEARING ON THE TERRORISM RISK INSURANCE PROGRAM

July 27, 2005

The Association of American Railroads (AAR), whose members account for the vast majority of freight railroad mileage, employees, and revenue in Canada, Mexico, and the United States, strongly supports legislation that would extend for two years the Terrorism Risk Insurance Act (TRIA), which became law in November 2002.

TRIA's main purpose — to ensure that U.S. business activity did not materially suffer from a lack of available terrorism insurance — was largely achieved through the establishment of a public/private shared loss program that provides a federal backstop to the private insurance system for insured losses resulting from acts of terrorism. TRIA was designed as a temporary bridge to address market disruptions; ensure the continued widespread availability and affordability of property and casualty insurance for terrorism risk; and allow for a transitional period for private insurance markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses.

Since TRIA's enactment, terrorism risk insurance has been more readily available, as insurers have passed on the benefit of the federal backstop to consumers. However, so far there has been insufficient progress toward the development of reliable methods for pricing terrorism risk or of mechanisms that would enable insurers to provide affordable terrorism insurance to businesses without government involvement. Because the circumstances facing the terrorism insurance market today are so extraordinary and because the potential costs associated with a major terrorist act are so high, it is logical and appropriate for the federal government to continue to assume the role of insurer of last resort, at least until a more long-term solution can be found.

Like other industries, railroads recognize their responsibility to obtain and pay for appropriate insurance coverage if possible. But like other industries, freight railroads are facing a potential insurance crisis. Since the September 2001 terrorist attacks, insurance premiums for freight railroads have increased dramatically, and railroads' insurers have informed them that premiums would be at least 35 percent higher without the federal backstop that TRIA provides. Moreover, on policyholder disclosures, railroad insurers state that the continuation of their coverage depends on the renewal of TRIA.

Thus, if Congress does not extend TRIA before it expires at the end of 2005, premiums for coverage for death, injury, and loss or damage resulting from acts of terrorism will likely increase drastically and/or ceilings for terrorism coverage will be severely reduced. Under the worst case scenario, terrorism insurance might not be available at any price.

TRIA has worked well: it has made terrorism insurance both more available and less expensive for railroads and other industries and firms. Unfortunately, because the United States remains under the constant threat of further terrorist attacks, catastrophic terrorism remains an uninsurable risk in the traditional insurance marketplace, and the commercial insurance sector continues to lack the necessary capacity to handle catastrophic terrorism losses on its own. Consequently, a market-based reinsurance program for terrorism insurance has not yet developed and the continued need for a federal backstop that provides stability and certainty remains.

While a federal backstop is critical for many U.S. industries, it is especially important for freight railroads. Railroads are absolutely indispensable to the economic well-being of our nation. They account for more than 40 percent of intercity freight ton-miles (more than any other mode). Without freight railroads, our economy would quickly cease to function. As common carriers, by law freight railroads must transport goods that are tendered to them, including chemicals that are considered hazardous. In addition, the Department of Defense depends on railroads to ship munitions and other supplies by rail.

Moreover, some 97 percent of the 22,000 miles over which Amtrak operates is owned by freight railroads, and dozens of active and proposed commuter rail operations operate (or hope to operate) at least partially over freight-owned tracks. In light of the bombing of passenger trains in Madrid in March 2004, freight railroads are particularly concerned that passenger railroads that use freight-owned facilities have access to terrorism insurance (and are required to purchase it). Without such insurance, if a terrorist incident occurred involving a passenger train that used freight-owned facilities, the effect on the freight railroad, as the only insured party, could be catastrophic and potentially bankrupting.

TRIA does not reduce industries' incentive to operate safely. Railroads in particular are fully aware of their obligations to operate safely, and they devote enormous resources to this purpose. Among many other things, they have developed a comprehensive Terrorism Risk Analysis and Security Management Plan, and railroads today are among our nation's safest industries.

Nevertheless, there can be no 100 percent guarantee against terrorist assaults involving railroads. If an incident were to occur and the railroads had inadequate coverage for claims, the railroads' financial condition and their ability to meet the transportation needs of our nation could be irreparably compromised.

The AAR respectfully urges this committee and Congress to pass legislation quickly so that insurance and re-insurance for acts of terrorism are available on reasonable terms.

Written Testimony of
SHELLEY HEARNE, DrPH
Executive Director
TRUST FOR AMERICA'S HEALTH

Submitted to:

UNITED STATES HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES COMMITTEE
CAPITAL MARKETS SUBCOMMITTEE

JULY 27, 2005

Terrorism Insurance

For information, please contact:
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Mr. Chairman and members of the Subcommittee, thank you for the opportunity to submit testimony on the Terrorist Risk Insurance Act and helping to reduce the risk of bioterrorism to corporate America. As a non-profit, non-partisan organization dedicated to saving lives by protecting the health of every community and working to make disease prevention a national priority, Trust for America's Health (TFAH) believes appropriate public health activities offer significant opportunities to prevent or mitigate against the impact of a bioterrorist attack.

Catastrophes caused by terrorism or natural disease outbreaks can result in incalculable human suffering. They can also economically cripple a nation, an industry, a community, or a company.

The horrific of events of September 11, 2001 led to the tragic loss of approximately 3,000 corporate employees and emergency responders and had enormous economic consequences. The total economic loss has been estimated at roughly $80 billion, of which $32.5 billion was insurable.[i] Overall, the 9/11 attacks were by far the most costly event in the history of insurance.[ii] The insurance industry paid the $32.5 billion in insured losses from business interruption, property, workers' compensation, aviation liability, and other liability costs.[iii]

Unfortunately, 9/11 does not represent an isolated incident. Cataclysmic events, encompassing both intentional attacks and natural health emergencies, have periodically wreaked havoc on corporate America and altered the way numerous industries operate. It is imperative to recognize and prioritize preparations against this continued threat to American lives and dollars. The recent devastating events that took place in London, underscore the very real continuing threat of terrorism, and its tremendous toll of human suffering and adverse economic impact.

Corporate America's Great Risk: Lives and Dollars

On December 31, 2005, an important piece of federal legislation will sunset. In the aftermath of the 9/11 attacks, the federal government enacted the Terrorism Risk Insurance Act of 2002 (TRIA), which created a temporary federal reinsurance program to limit the loss for insurers from acts of terrorism. Under TRIA, the federal government would pay for 90 percent of the insurance industry's terrorism losses once claims reach a specified deductible. The TRIA program covers losses up to a maximum of $100 billion.

While TRIA offers protection for insurers (often referred to as a "backstop" for its potential losses), the legislation contains many holes. TRIA does not cover terrorism by domestic groups. And, it allows private insurers to exclude losses from nuclear, biological, chemical, and radiological attacks (NBCRs). As a result, most commercial property insurance policies do not cover NBCRs. In its April 27th letter to Congressional leadership, The Financial Services Roundtable recommended that a study be convened to assess o "how to deal with the threats posed by [NBCRs.].

Further, workers' compensation statutorily covers acts of terrorism in every state except one.[iv] Employers are also liable for costs of employee health care expenses related to consequences of an attack or outbreak, such as incidents requiring all employees be tested for exposure to a suspected biohazard or even fulfilling health care needs for employees who may be harmed or ill outside of work hours.

TFAH is concerned about the recent Treasury Department's report in opposition to extension of TRIA "in its current form." The report finds that the "immediate effect of the removal of the TRIA subsidy is likely to be less terrorism insurance written by insurers, higher prices and lower policyholder take-up." Prior to issuance of the report, the Aon Consulting group had cautioned that such a decision could be devastating to the insurance industry: "TRIA's importance as a backstop cannot be overstated. Its expiration will cause an immediate and significant diminution of the available supply of terrorism capacity that is likely to leave the market hard pressed, if not unable, to meet the potential demand for risk transfer capacity."[v] A recent General Accountability Office (GAO) study states that, "in the absence of TRIA, we have reported that reinsurers may not return to the terrorism insurance market."[vi] In other words, <u>many companies may enter 2006 without any protection against any kind of terrorism.</u>

In summary, TFAH believes that the public health community and corporate America should immediately convene a group to discuss the issue and make specific recommendations around either the extension of TRIA or alternatives. The primary goal would be to delineate the scope of the dangers, to determine steps to mitigate bioterrorism disasters, and to consider the federal government's role as a risk-sharing partner.

Issues relating to occupational safety and securing a safety net for America's employees by providing a "financial backstop" for workers' compensation and health care benefits also should be addressed. If TRIA protection were taken away, many insurers could consider canceling many employers' workers' compensation policies, particularly in dense metropolitan areas like New York City.[vii] Employers would also have to consider the impact to their health insurance policies. Since their risk would increase, premiums, particularly for backstop or reinsurance policies held by large corporations (that often self-fund their health insurance policies as extra insurance for major and unexpected problems), could end up rising dramatically. The GAO offers, "natural catastrophes and terrorist attacks can place enormous financial demands on the insurance industry, result in sharply higher premiums and substantially reduced coverage."[viii]

As this protection to corporations (as well as to city, county and state governments, which are also major employers) may well disappear, it appears imperative that the issue be considered immediately. Issues of coverage of assets, property, and people (employees through workers' compensation, death benefits, and health insurance) must all be addressed.

Quantifying the Economic Risk of Bioterrorism and Infectious Epidemics

The insurance market has deemed the risks of bioterrorism and epidemics as nearly impossible to predict. In a January 2005 report, the Congressional Budget Office (CBO) stated, "the probability of events such as terrorist attacks cannot be known."[ix] Without an understanding of the probability, Charles Benda, the practice leader of American International Group, Inc.'s (AIG, one of the largest insurers in the world) homeland security subsidiary, believes that "there's no way to quantify the average premium."[x]

The CEO of a leading insurance company, Ed Liddy from Allstate Corp, may have articulated the best guess. At a speech March 22, 2005, he stated that nuclear, biological or chemical terrorist attacks "could literally destroy the entire capital base of the insurance industry."[xi] As a point of reference, the capital base for the insurance industry in 2003 was $347 billion.[xii]

According to a study by Towers Perrin Consulting, one anthrax attack in New York City could lead to $90 billion in workers' compensation losses, which is three times greater than the entire $30 billion workers' compensation industry.[xiii] Health insurance costs for major events would likely exceed companies' coverage policies, even including reinsurance that large corporations hold, forcing dramatic increases in premiums throughout the industry. In severe cases, it could result in company bankruptcies, and then the costs for care would be absorbed into a program like Medicaid, which the federal government and the states would have to pay for. And, if an incident exposed government employees, such as first responders, to health threats, the state and local governments' health insurance policies would have the same potential consequences.

Quantifying risk requires not only estimating what can be lost, but also calculating the probability that a loss will occur. Traditionally, insurers are the experts at understanding uncertainty. For example, when setting a policy, automobile insurers consider the number of accidents that have occurred in a certain area. They will then spread the risk of an accident by pooling all drivers from that area into one policy. The insurance industry has determined ways to pool almost every risk, from life to homeowners' insurance.

Overall, acknowledging the great uncertainty, it is not unreasonable to utilize the Liddy estimate of $347 billion as a starting point for bioterrorism and disease outbreaks, an unsettling figure when examining the risk.

Industries and companies in the U.S. and throughout the world are vulnerable to the impact of bioterrorism and major disease outbreaks. Protecting the corporate sector from these threats is essential for economic security and national well-being. As just a few examples:

- The agricultural sector faces enormous risks, as acts of bioterrorism could easily destroy major industries, such as cattle or citrus.

- The tourism industry is also at tremendous risk, as the SARS outbreak demonstrated.

- An economic downturn or any fear could easily lead to a drop in consumer confidence, which would dampen sales for almost all consumer goods.

- In catastrophic incidents, hospitals and health care providers would be overwhelmed by patients, possibly to the point of closure, while the emergency responders and health care providers could be placed at risk themselves.

Prior Costs of Bioterrorism and Infectious Epidemics

Bioterrorism:

- In 1978, the Arab Revolutionary Council engaged in bioterrorism, using mercury to poison Israeli oranges. A dozen children in Holland and West Germany were hospitalized as a result. Ultimately, this act helped sabotage the Israeli economy, resulting in a 40 percent reduction in orange exports.[xiv] At the time, oranges accounted for about a tenth of all Israeli exports.[xv]
    - The U.S. produces over 20 percent of the world's citrus, or approximately 15.6 million tons in 2004.[xvi] U.S. citrus exports were roughly $1 billion, while U.S. consumers spent well over $3 billion on citrus products (orange and grapefruit juice and fresh fruit).[xvii] We estimate that a simple mercury attack like the one carried out by the Arab Revolutionary Council could easily lead to over $1 billion in losses for the citrus industry.

- In 2001, anthrax attacks through the U.S. postal system occurred over the course of several weeks. Letters containing anthrax bacteria were sent to five media offices and two U.S. Senators, leaving five individuals dead and at least 36 sick. The party responsible for this terrorist attack is still unknown. The economic loss from the events, along with investment in additional screening protections of our mail, totaled hundreds of millions of dollars.
    - One of the leading risk consulting firms, Risk Management Solutions (RMS), believes an attack on downtown New York City could result in 173,000 casualties. In this scenario, anthrax is weaponized and dispersed in aerosol form, resulting in inhalation of anthrax by approximately one million people. Incredibly, RMS estimates economic losses of $91 billion from workers compensation alone.[xviii] (As a reminder, workers' compensation statutorily covers any acts of terrorism.)
    - According to the *New York Times,* the U.S. Department of Homeland Security (DHS) has developed 15 potential mass-casualty terrorism and natural disaster emergencies for disaster planning. The scenario involving an anthrax attack demonstrates how devastating such an occurrence could

be. If terrorists were to spray aerosolized anthrax from a van in three cities initially, followed by two more cities shortly afterward, casualties could well exceed 13,000, and result in a loss of billions of dollars.[xix]

Epidemics:

- In 2001, foot-and-mouth outbreak in Britain devastated the agricultural economy. Overall, the estimated economic loss associated with the outbreak was $6 billion to $18 billion, and led to the destruction of four million animals.[xx] Over the last few decades, the United Kingdom has also battled bovine spongiform encephalopathy (BSE), better known as "mad cow" disease. As of March 2005, 149 people who were infected with the disease have died, and nearly four million cows have been slaughtered.[xxi]

    - If a significant outbreak of BSE in the US occurred, the FDA estimates that there would be a loss of $15 billion, resulting from a 24 percent decline in domestic beef sales and an 80 percent decline in beef and live cattle exports. Slaughter and disposal costs of at-risk cattle could be additional $12 billion.[xxii]

    - A recent report estimated that an outbreak of foot-and-mouth outbreak in California would lead to economic losses of $6 billion.[xxiii] The Homeland Security report on the 15 potential mass-casualty scenarios also included a plot in which terrorists would infect farm animals with foot-and-mouth disease at several locations, according to the *New York Times.*

- In 2003, Severe Acute Respiratory Syndrome (SARS) swept through Southeast Asia, infecting over 8,000 people and leaving 774 dead.[xxiv] Its reach demonstrates the tremendous speed in which disease can spread. Originating in China, the SARS outbreak eventually infected individuals from 29 nations around the world. Overall, the economic losses, due to lives lost, quarantines, and lost tourism dollars, may have been $30 billion to $50 billion, according to some estimates.[xxv] In Toronto alone (many thousands of miles away from the initial outbreak), more than 27,000 people in and around the city were forced into quarantine during two outbreaks, which led to an estimated economic loss of nearly $1 billion.[xxvi]

    - The Homeland Security report on 15 disaster planning scenarios includes a situation similar to the Toronto experience, according to the *New York Times*. The hypothetical scenario is as follows: an influenza pandemic (such as the avian flu) begins in south China and spreads within months to four major cities in the U.S., leaving an estimated 87,000 dead, and 300,000 hospitalized and economic losses of $70 billion to $160 billion.

Quantifying Corporate America's Vulnerability

How much is at risk? Documented experiences, from 9/11 to epidemics like foot-and-mouth disease, have led to tens of billions of dollars in losses. Simple and plausible extensions of these experiences could have the same disastrous effects. The six events from the table below alone have a combined experienced or estimated economic loss of roughly $369 billion.

Summary of Experienced or Potential Losses from Terrorist or Natural Catastrophes

Threat	Scenarios	Industries Most Affected	Potential Losses	Estimated Cumulative Economic Losses
Bioterrorism: Mercury attack on agriculture	Mercury attack on the citrus products, similar to the 1978, by Arab Revolutionary Council on Israel.	Citrus, agricultural, and consumer goods.	Roughly $1 billion. (TFAH estimate)	$1 billion
Bioterrorism: Anthrax attack on cities	Terrorists spray aerosolized anthrax from a van in three cities initially, followed by two more cities shortly afterward.	Insurance, financial, and tourism.	Casualties could well exceed 13,000; loss of billions of dollars. (Homeland Security) Loss from workers compensation alone would be $91 billion.	$1 billion + $91 billion = $96 billion
Epidemics: SARS or Avian Flu	Influenza pandemic begins in south China and spreads within months to four major cities in the United States.	Insurance, financial, and tourism.	Estimated 87,000 dead, and 300,000 hospitalized; economic losses of $70-$160 billion. (Homeland Security)	$96 billion + $160 billion = $256 billion
Epidemics: Foot-and-Mouth Disease	Terrorist plot to infect farm animals with foot-and-mouth disease.	Agricultural and consumer goods.	If it were to occur in California, economic losses of $6 billion. (Ekboir 1999)	$256 billion + $6 billion = $262 billion
Epidemics: Mad Cow Disease	An outbreak of mad cow disease in the US.	Agricultural and consumer goods.	A loss of $15 billion, resulting from a 24% decline in domestic beef sales and an 80% decline in beef and live cattle exports. Slaughter and disposal costs, additional $12 billion. (FDA)	$262 billion + $15 billion + $12 billion = $289 billion
Terrorism: Plane Attacks	Four hijacked planes attack major financial institutions and national defense buildings.	Insurance, financial, and commercial property.	Roughly 3,000 lives, and an estimated loss of $80 billion, $32.5 of which was insurable. (CBO, Wharton)	$289 billion + $80 billion = $369 billion

Enormous Savings from Public Health Protection

According to a Centers for Disease Control and Prevention (CDC) study, the savings gained from public health preparedness would be enormous. The study considers a hypothetical anthrax attack. If public health officials identify an anthrax attack on a city of 100,000 persons, and distribute antibiotics to the exposed persons within 24 hours, the number of lost lives will be roughly 5,000 and economic losses will reach $128 million. However, if it were to take public health officials six days to identify the attack, an estimated 33,000 people would die, and economic losses would reach $26.2 billion.[xxvii]

In other words, according to the CDC, basic improvements to public health protection in the face of a plausible emergency could save 28,000 lives and $26 billion.

Protection measures include investments in basic bioterrorism and public health defenses. A December 2004 report released by TFAH found that, despite incremental progress, three years after September 11, 2001, many basic bioterrorism and public health emergency detection, diagnosis, and response capabilities are still not in place. The report examined 10 key indicators to gauge state preparedness and determine America's overall readiness to respond to bioterrorist attacks and other health emergencies. Over two-thirds of states and D.C. achieved a score of six or less.

The Sunset of TRIA and the Need for Immediate Action

To restate our recommendations, Corporate America, public health advocates, and policymakers must take bold action to prevent and prepare for events that can change the country forever.

1. The public health community and corporate America should immediately convene to discuss the issue and make specific recommendations around either the extension of TRIA or alternatives in the event the legislation is not renewed.

2. The primary goals would be to delineate the scope of the dangers, to determine steps to mitigate bioterrorism disasters, and to consider the federal government's role as a risk-sharing partner.

3. Issues of occupational safety and securing a safety net for America's employees by providing a "financial backstop" for workers' compensation and health care benefits must also be addressed.

Corporate America has a natural, yet typically unacknowledged, alliance with public health and a preventative approach to health care. Equipping the nation with effective detection, monitoring, and prevention tools lowers the probability of a devastating terrorist attack while increasing the nation's ability to effectively diagnose and minimize damages if an attack occurred.

Supporting public health also helps lower risk for the insurance industry, which will be more likely to tackle the challenges of bioterrorism if a functional health system offers a reassuring and necessary backstop. Reducing risk through a more effective public health preparedness would help lower premiums for the insurance industry, government, and corporate America.

In this confusing age where destructive human and natural acts touch everyone's lives, Trust for America's Health (TFAH) calls on corporate America and government to recognize the importance of public health as a vital protector. The lives of employees and the wellness of corporate America depend on it.

Thank you once again for this opportunity to offer our testimony of this very important issue.

APPENDIX A:

WHAT DOES PREPAREDNESS LOOK LIKE? WHAT SHOULD AMERICANS EXPECT?

Numerous evaluations of the nation's public health system, including those conducted by the CDC, IOM, and GAO, have found serious deficiencies.[xxviii]

A 2003 IOM study on the public health infrastructure found:

_ "Vulnerable and outdated health information systems and technologies;
_ An inadequately trained public health workforce;
_ Antiquated laboratory capacity;
_ A lack of real-time surveillance and epidemiological systems;
_ Ineffective and fragmented communications networks;
_ Incomplete domestic preparedness and emergency response capabilities; and
_ Communities without access to essential public health services."[xxix]

This raises the question: What are the components of a basic system capable of protecting a community's health?

24x7 Emergency Response Capabilities Must Include:

_ Rapid **detection** of a bioterror act or other emerging disease threats;
_ Intensive **investigative** capabilities to quickly determine the bio- or chemical agent used in an attack or to diagnose a new disease;
_ Mass **containment** and treatment strategies, including plans, surge workforce and equipment, and pharmaceuticals needed for **wide-scale vaccination or antidote administration** and **isolation and quarantine** when necessary;
_ Streamlined and clear **communications** channels so that health workers can communicate with each other and be able to accurately and swiftly inform members of the public about 1) the nature of an attack or emergency; 2) their risk of exposure and how to seek treatment when needed; 3) any actions that they or their families need to take.

What It Will Take to Achieve Adequate Preparedness:

_ ***Leadership, Planning, and Coordination:*** An established chain-of-command and well-defined roles and responsibilities for seamless operations between different medical and scientific functions during crisis situations.
_ ***Expert and Comprehensive Workforce:*** Highly trained and full staffs of experts, scientists and other public health professionals.
_ ***Modernized Technology:*** State-of-the-art laboratory equipment and information collection and health tracking systems.
_ ***Pre-Planned, Safety-First Rapid Emergency Response Capabilities and Precautions:***

Tested plans and safety precautions to mitigate potential harm to communities and public health professionals and first responders.
_ ***Immediate, Streamlined Communications Capabilities:*** Coordinated, integrated communication among all parts of the public health system and with the public.

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Statement of the
NATIONAL ASSOCIATION OF REALTORS
for the
House Financial Services
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
on the
Future of Terrorism Insurance

July 27, 2005

Introduction

The NATIONAL ASSOCIATION OF REALTORS ("NAR") is pleased to provide these comments to the Subcommittee on the issue of terrorism insurance. NAR is the nation's largest professional trade association with over 1 million members who belong to over 1,500 REALTOR® associations and boards at the state and local levels, as well as various institutes, societies and councils designed to enhance their expertise in real estate. NAR's commercial members are involved in all aspects of commercial real estate, including property management, investment, and brokerage.

Over the past few years, terrorism insurance has helped provide needed stability to our nation's economy. It is often a critical component in the financing of various real estate development projects, including office buildings, residential condominiums and retail centers, and its continued availability and affordability plays an important role in the economic health of the commercial real estate market.

NAR's commercial members would be directly and indirectly affected by the inability of property owners to obtain affordable terrorism insurance. For example, if existing or future development projects are stalled or cancelled due to the lack of terrorism insurance, commercial real estate brokers, managers and investors would suffer from reduced activity and related revenues.

For these reasons, NAR supports the extension and appropriate modification of the *Terrorism Risk Insurance Act of 2002* ("TRIA") and urges Congress to act swiftly to ensure the continued availability and affordability of terrorism insurance coverage.

The Initial Need for TRIA

Before the horrific attacks of September 11, 2001, terrorism insurance was neither specifically included nor excluded from a business owner's property and casualty (P&C) insurance policy – notwithstanding the tragic events of Oklahoma City and the 1993 World Trade Center bombings. Coverage for such events was generally provided under one's P&C policy. The insurance and reinsurance industries, at the time, did not foresee internationally-based terrorism to be a significant or continued threat to American society or business. Everything changed, however, after 9/11.

Immediately after the terrorist strikes, understandably, the market for terrorism insurance dried up. Reinsurers were no longer willing to provide terrorism coverage for properties in medium to high-risk areas and expose their companies to huge financial losses. Primary insurers, without the ability to reinsure themselves against such losses, were generally unwilling to offer coverage in those areas as well. Those insurers that did offer separate coverage for terrorism to their P&C policyholders charged very high premiums and set high deductibles, payout limits and numerous exclusions.

As a result, many property owners in medium to high-risk areas were either left uninsured (leaving them exposed and in technical default of their loan agreements) or forced to pay high rates for very little coverage. Some property owners had to purchase several layers of coverage in order to sufficiently insure their buildings or purchase separate insurance to cover their deductibles. In addition, many construction and other development projects were put on hold because they were unable to obtain adequate terrorism insurance as required by their lenders.

TRIA's Main Provisions

In order to increase the availability and affordability of terrorism insurance, NAR and the Coalition to Insure Against Terrorism ("CIAT") worked closely with Chairman Oxley and other members of your Committee to get the federal "backstop" provided under TRIA enacted into law in November 2002. The program has several key elements:

(1) It is set to expire at the end of 2005;

(2) Its "make available" provision requires insurers to offer terrorism insurance to its P&C policyholders (though it does not establish pricing or require policyholders to pay for coverage) – this provision was due to expire at the end of 2004 but was extended by the Secretary of Treasury for an additional year;

(3) Only terrorist events that are committed by "foreign" individuals or interests and incur more than $5 million in property damages are covered;

(4) Nuclear, biological, chemical and radiological attacks are covered only the extent insurers decide to provide such coverage;

(5) Insurers are subject to certain deductibles (for 2005, the amount is 15% of the previous year's premiums);

(6) Treasury will cover 90% of damages that exceed the deductible amount up to $100 billion per year; and

(7) Treasury is required to recoup a certain amount of its losses through policy surcharges (for 2005, the amount is $15 billion) – recoupment above such amount is up to the discretion of Treasury.

TRIA's Effectiveness

Since TRIA became law, terrorism insurance coverage has become more readily available and affordable for property owners in medium to high-risk areas. Though far from perfect, TRIA has helped stabilize the commercial real estate market with regard to such coverage. Many of our members, as well as others in CIAT, have commented on the law's positive effects on their businesses.

Commercial property owners, brokers, managers, leasing agents and lenders throughout the country have all benefited from having sufficient and affordable terrorism insurance in place. Development projects and related loans are no longer held up due to inadequate coverage; leasing of office, industrial and multi-family properties has gone uninterrupted; and lenders no longer have to "force-place" coverage on their clients in order to satisfy loan agreements.

Treasury Secretary John W. Snow in his statement to your Committee last week said that "The [Treasury] Report finds that TRIA has been effective in meeting its goals of supporting the industry during a transitional period and stabilizing the private marketplace". He also stated that "Results from both the survey of insurers and the survey of policyholders show that the availability and the take-up (purchase) of terrorism insurance increased while TRIA has been in effect."

Commercial Real Estate Remains Vulnerable to Terrorist Attacks

Despite the valiant efforts by the U.S. Department of Homeland Security, security firms and property owners since 9/11 to better secure our nation's private sector, we all realize that it is not possible to guarantee security at all locations all of the time due to our relatively free and open society. Recent terrorist attacks in London, Madrid and Israel prove that it is very difficult to thwart well-prepared, well-funded and determined terrorists from doing harm. Many security analysts believe that it is only a matter of time before suicide bombers and other terrorists refocus their deadly agenda on U.S. targets.

A study conducted by the RAND Corporation's Center for Terrorism Risk Management Policy finds that "soft" targets, such as office buildings and retail centers are increasingly at risk from both Al Qaeda and domestic radical terrorist groups. This shift in emphasis comes from the realization that the "hard" targets, such as "iconic" office buildings (e.g., Empire State Building, Sears Tower), government centers and embassies have become more secure and harder to penetrate, and that attacking more vulnerable soft targets would still allow Al Qaeda to cause significant civilian casualties and economic disruption.

The RAND study also notes that the take-up rates of terrorism coverage are still relatively low – approximately 50%. It believes that many of those that forego terrorism insurance do so because they do not perceive themselves to be at risk and are unwilling to pay premiums for such coverage. Notwithstanding, these property owners are still at some degree of risk since they own vulnerable soft targets – even if they are located in "low-risk" areas of the country.

The Continued Need for a Modified TRIA

Everybody agrees that TRIA was designed to be a temporary program in order to give the insurance and real estate industries time to develop a private sector solution. Unfortunately, such a solution has not yet been developed. Therefore, we believe that TRIA should be temporarily extended in such a way that would better encourage the private sector to develop and implement a long-term solution, while at the same time addressing the law's current weaknesses (e.g., lack of coverage for domestic-based and nuclear, biological, chemical and radiological events).

TRIA should not be allowed to expire at the end of this year as it would cause insurers to discontinue terrorism insurance coverage for many of it policyholders and/or hike related premiums (which in turn would drive down take-up rates). A decline in such coverage and take-up rates would put the commercial sector at greater financial risk at a time when the threat of terrorist attack remains as amorphous as ever.

The National Association of Insurance Commissioners ("NAIC") warns that "significant market disruptions could develop with TRIA's expiration on December 31, 2005" and "the removal of [TRIA] could return the insurance market to the uncertainty experienced in the aftermath of September 11, 2001". NAIC is currently working closely with the federal government to create a long-term strategy and comprehensive program to deal with terrorist attacks.

In addition, Federal Reserve Board Chairman Alan Greenspan recently testified to your Committee that "The type of terrorism that is arising in the context of increasing technologies which were not available before has created the possibilities of huge losses. And there is no way for a private system to handle that."

Treasury's Report Underestimates TRIA's Importance

The Treasury Department in its recently-released report recommends that TRIA should be allowed to sunset at the end of the year – even though it recognizes that its expiration would likely lead to "less terrorism insurance written by insurers, higher prices and lower policyholder take up." Treasury Secretary Snow claims that TRIA has "crowded out" private insurance and that insurers would fill in the gap once TRIA expires. We respectfully disagree with his assertion since reinsurers and insurers are no more willing to take on significant, unpredictable and immeasurable risks now than they were immediately after 9/11.

Treasury has stated that it would allow TRIA to be extended only if it were significantly modified (e.g., raising the deductible and copayment amounts, increasing the damage amount of a qualified terrorist event from $5 million to $500 million). We agree that gradually raising the deductible and copayment amounts would be an effective way to help transition risk from the federal government to the private sector. However, we also believe that increasing the amount of a qualified event to $500 million would be too drastic and ultimately harm the program's effectiveness since aggregate damages from many terrorist events fall below that amount.

Conclusion

NAR believes that TRIA should be temporarily extended and appropriately modified in order to give the private sector and federal government additional time to develop a long-term solution. We, therefore, urge Congress and the Administration to work together to draft and enact effective legislation as soon as possible to avoid disruption in the commercial markets.

Thank you for this opportunity for us to express our views on this very important matter.

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