Economic Impact of the Lack of Terrorism Risk Insurance

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Chairwoman Kelly, Representative Gutierrez, Members of the Subcommittee, I appreciate the opportunity to present to you the views of the Office of Economic Policy at the Treasury Department on the current and possible future impacts of the lack of terrorism risk insurance on the American economy. We appreciate the speedy action of the House in passing legislation last year that would have created a temporary federal back-stop to insured losses from terrorist attacks. We look forward to continuing to work with you to achieve our shared objective of restoring private insurance coverage for this risk. Terrorist attacks have the potential for significant nationwide costs and thus justify a carefully designed collective approach to insuring against the losses from such events, utilizing the already existing coverage and payment mechanisms of private insurance markets.

The terrorist attacks have had a negative impact on the ability of businesses and property owners to insure against risk.

Industry estimates of insured losses resulting from the attacks of September 11, over all principal lines of coverage, range from $30 billion to $90 billion, with the consensus estimates in the $36 billion to $54 billion range. These losses hit many major lines of the property/casualty insurance business including property, business interruption, workers' compensation, and liability, as well as life and health. Wherever the final figures settle, these will be the largest insured losses in history. By contrast, Hurricane Andrew, which led to significantly higher premiums and reduced availability of insurance in flood prone areas, caused, in today's dollars, $19.3 billion of insured losses in all lines, although it should be noted that the industry was much better capitalized on the eve of the September 11th tragedy than it was when Andrew hit.

Investment losses experienced by primary property/casualty (P/C) insurance and reinsurance companies, which had been growing prior to September 11, accelerated dramatically immediately after that date. Hence, unlike other insured events, the insurance losses from these terrorist attacks were highly correlated with investment losses at the time -- a difficult and risky situation for insurance and reinsurance companies.

In addition to these two types of losses actually experienced, the attacks revealed to the insurance industry a potential for huge future losses which it had not priced before and cannot yet readily model. Terrorism creates the possibility of a large loss, but it does so with an uncertain probability. This is unlike other insurable events where the law of large numbers operates to effectively pool risk, as in personal lines such as life, health, long-term care or automobile. It is more comparable to dramatic natural catastrophes, such as hurricanes or earthquakes, causing large losses. But unlike terrorism risk, natural catastrophes have

predictable patterns and probabilities quantifiable by sophisticated models, based on past weather conditions or seismic activity, that better allow the assumption and diversification of risk.

It is well known that primary insurers in most lines of coverage reduce their risk by laying it off to reinsurers. Reinsurance is a valuable, sensible, and well-established way of spreading risk. Many participants in the reinsurance market are large sophisticated organizations, are often foreign-owned and operate world wide, thus assuring that risks in any one country or type of business are spread around the world. As a consequence of the September 11 losses, which reduced their capital base, and the inability to model terrorism risk, at least at the present time, the reinsurance industry has almost entirely stopped assuming terrorism risk. Primary insurers have also withdrawn, and continue to withdraw, from covering this risk in states and lines of coverage where the law or insurance regulators have not prevented them from so doing.

I will be brief in summarizing the insurance market impacts; I understand that the testimony of the GAO will cover this in detail.

Primary insurers are being allowed by insurance commissioners in all states, with the prominent exceptions of New York, California, and Georgia, to exclude terrorism coverage above certain dollar amounts from smaller, regulated commercial policies. Most states, however, do not allow an exclusion from damage caused by fire following a terrorist attack. No states have allowed the exclusion of terrorism risk in personal insurance lines.

Terrorism is defined broadly in the exclusion as activity that involves the threat of, or actual use of, violence if the effect is to intimidate the government or disrupt some segment of the economy and the intent is to further political or ideological objectives. The definition includes the use of nuclear, chemical or biological weapons. It apparently does not make a distinction between the foreign or domestic origin of the act of terrorism.

Because state laws do not allow companies offering workers' compensation insurance to exclude terrorism risk, some primary insurers have chosen to drop the workers' compensation line completely, rather than underwrite terrorism risk absent reinsurance. Others are issuing it on a more selective basis, forcing many businesses into state sponsored insurance pools. In one case brought to our attention workers compensation insurance was not renewed because the insured had over 500 employees located in a tall office building in Pennsylvania.

Insurance brokers report that terrorism coverage for large commercial properties, whose insurance policies are unregulated, is difficult to obtain, and importantly, subject to limits of coverage that are much lower than customers want. And premiums for these properties have increased dramatically. In some instances the total policy cost with limited terrorism coverage is reported to be roughly double the cost of the P/C policy without the terrorism coverage. Stand alone coverage for terrorism risk is very limited and quite expensive where it is available. In fact, separate terrorism risk coverage costs more than the insurance covering all other risks while it provides a lower limit and responds to only one event.

Owners of large commercial properties and holders of mortgages on such properties (pension funds, trusts, etc.) are reluctant to discuss the extent and nature of their insurance coverage because few property owners want to make public the fact that they are uncovered or inadequately covered. This makes it especially difficult to gage the extent of the coverage and cost problems, but we have indications that they are widespread on many types of properties, especially those currently thought to be most at risk from terror attacks.

The effects of conditions in the market for terrorism risk insurance are being heightened by rising rates for types of insurance coverage unrelated to terrorism risks, where the insurance market is tightening. Insurance brokers, who deal in most commercial P/C coverage, report that median rate increases are 30-50 percent and mean rate increases are 40-70 percent. Industry sources report that rates had begun to rise and coverage shrink well before September 11 as part of the classic underwriting cycle. This cycle is generally started when insurance company earnings on investments decrease, reducing their capacity to underwrite insurance. Insurance industry capital losses as a result of September 11, however, have exacerbated the cycle, as has the increased risk for primary insurers remaining after excluding allowable terrorism risk coverage. While some increase in premiums might be expected in response to the low earnings in the insurance industry before September 11 and the attacks themselves, the recent increases have been so dramatic that they harm the Nation's economic recovery.

These insurance difficulties in turn are affecting the financing of new real estate projects and sales of existing properties.

Reports to us indicate that financing is limited for new construction and/or acquisition of high-profile properties which are at risk for terrorist attack and inadequately insured. Lenders are carefully screening the location and size of buildings. Some are simply refusing to lend on trophy properties that are not fully insured. Others will lend on underinsured properties, but only if the owner will provide recourse. In one case, a large construction project in the Midwest known to be financially viable prior to September 11 is now at risk of being abandoned because of gaps in the available terrorism coverage. Eventually the market might be able to price for the new risks facing such properties. Both the severity and timing of changes to date, however, make them harmful to the economy.

The impact on existing properties at risk is equally troubling. While, technically, properties without adequate insurance are in default of financing covenants, lenders may well not foreclose but, rather, raise their fees to cover their own risk. Rating agencies have indicated that they will substantially increase subordination levels on new issues of commercial mortgage backed securities whose collateral properties have inadequate insurance coverage. They are also in the process of establishing risk criteria that would lead to the downgrading of securities collateralized by properties inadequately insured and at an elevated risk of attack. Those deemed high risk by the agencies include trophy assets, symbols of America, structures for large gatherings of people (arenas, stadiums, and convention centers), critical infrastructure (major bridges, tunnels, and transportation hubs), and critical energy-providing structures. It also includes structures that are tall, located in a central business district, or with a highly visible tenancy.

Ratings downgrades would, of course, have a major negative impact on the value of such securities, which are widely held by mutual funds and pension plans. Spreads between the yields

for large property commercial mortgage backed securities and Treasury securities have in fact widened recently, especially for properties with greater exposure to terrorism risk. And we have received reports that the volume of commercial mortgage backed securities issued since the beginning of the year has fallen.

We have particular concern about the impact of high premium rates and lack of insurance availability for smaller projects being built near what is considered potential terrorist targets. Hospitals, municipal entities and other nonprofits where trustees feel a fiduciary responsibility may well forgo terrorism coverage if they see the cost is equal or greater than what they're paying for all other perils.

Of equal concern to us is the steep rise in rates for commercial and other insurance policies for all developers, because this rise has the potential to cause significant impact on the economy and is likely to last for the next year or two. While low interest rates may be offsetting some of the increased insurance costs right now, we cannot count on that situation to remain constant.

Finally, the full effects of the terrorist attacks on insurance conditions have yet to be felt, because about a third of the reinsurance treaties and many primary insurance contracts negotiated prior to September 11 have not yet expired. Many real estate lenders are still deciding how to adjust their lending strategies to the lack of coverage for their properties. Others may delay bringing properties to markets in hopes of improvement later. These impacts are difficult to quantify and document because they are dispersed, and the affected policyholders may be reluctant to publicize that they are having trouble finding financing for real estate projects, or that outstanding debt secured by inadequately insured property risks a ratings downgrade. In this regard, I understand that the SEC is considering whether to require businesses left without commercial terrorism risk insurance after the September 11 attacks to disclose the loss to investors as a material risk factor.

The implication of these insurance market conditions and economic consequences makes it critical for Congress to enact a federal terrorism risk insurance backstop for at least four reasons.

1. The lack of coverage and high premium rates imply a drag upon our economy and a burden to the nascent recovery, including the potential for a loss of even more jobs. Some are now arguing that the lack of a dramatic economic impact resulting from Congress' failure to enact a federal terrorism risk insurance backstop prior to January 1 means that the legislation is not necessary. This argument reflects a fundamental misunderstanding of the nature of the problem and the drag that terrorism risk is placing on an economy that is in the early stages of recovery. As I've indicated, the insurance industry has been significantly destabilized, with coverage well below "equilibrium", and prices for coverage well above normal levels. Investors in new properties and lenders on properties on which contracts have expired are paying disequilibrium costs, either directly, because of the spikes in renewal policy costs, or indirectly, because they are the ones now bearing this risk.

The economic impact is therefore two-fold: first, the decreased returns and higher risk experienced by businesses and developers are a disincentive to future investment over this

interim period. Second, as suppliers of capital in turn seek to lay off the cost, the impact is passed through to consumers and workers. Further, it will increase as more and more insurance contracts come up for renewal. In brief, the impact is just like a "tax" increase on productive capital. What is the ultimate impact on consumer prices and jobs? While it is always difficult to estimate accurately, we know that in the long run, in our open and elastic capital markets, workers and consumers will bear the brunt of the burden.

2. The cost of lost and postponed investment opportunity is potentially large for future economic growth. Many real estate lenders are still deciding how to adjust their lending strategies to the lack of coverage for their properties. Many developers may be delaying bringing properties to capital markets in hopes of improvement in insurance conditions later, which in turn is now dependent on government action. Thus capital is not committed to worthy projects--that would have received financing and created jobs had insurance markets been in a better equilibrium.

3. Inaction paralyzes the private sector. Furthermore, the lack of government action, one way or another, is itself costly as insurers, financiers, and businesses wait to see what new institutions the government might set up before themselves committing to creating new insurance mechanisms, even ones significantly less efficient than a robust private insurance market. Moreover, economic activity itself could adjust in the design and location of building projects. Planning and decision making would be much better if they knew the insurance environment they faced. We can do better by our investors, consumers, and workers than this.

4. The economic impact of another terror attack could be even greater than the September 11 attack. Finally, there is a real concern about the potential costs to the federal government and the economy in the event of another attack, with no backstop program in place to stem the tide of uninsured and underinsured properties. Private insurance covered a significant percentage of losses arising from the September 11 attacks. Following the attacks, insurance companies quickly stated that they would pay claims on the World Trade Center and other losses (including business interruption) incurred because of its destruction. The ability of the insurance industry to make this simple and credible promise was likely instrumental in calming investors after the attacks and giving business confidence that funds would be available to resume business operations, particularly in New York City.

The subsequent rapid disbursement of payments has been vital in speeding New York City's recovery according to a report commissioned by that city's Chamber of Commerce. Nearly half of the projected payouts are expected to be made within a year of the attack. Such rapid disbursement will be possible only because a payment scheme (via well-established insurance conduits) was in place prior to the attacks. Trying to devise such a scheme on short notice and in the aftermath of another terror attack would be considerably less effective and would slow recovery.

But without a backstop program in place to encourage participation by private insurance that might well happen. In the event of a major terrorist strike, many of the losses would likely be borne by the federal government. We would expect defaults on commercial mortgages and other losses. It might be difficult to resist the call for federal assistance to compensate uninsured

property owners and businesses victimized by the terrorist strike. Compensation for losses by private insurance industry has worked smoothly and efficiently. It is highly unlikely that a federal payment system, hastily conceived in the aftermath of a major attack, could perform as well.

We need action now.

As the President has stated strongly, our enemies are persistent, clever, and should not be underestimated: future incidents may be quite different from the attacks we have already experienced. Our enemies have stated that their intent is to cause economic harm, as well as physical harm, to us. We firmly believe that our Nation's battle against the scourge of terrorism will ultimately be successful. We also believe that private markets will stabilize--capital levels will be restored and insurers' ability to price this risk will improve. But we now know how difficult and costly it can be for an economy to adjust to terrorist events. We bear responsibility for assuring that our citizens are adequately protected against terrorism. This includes our citizenry's ability to obtain insurance in the interim against this insidious threat, as well as reducing the costs of restoring their financial well-being were another event to occur. And we want to encourage economic growth. Hence, we have proposed a federal insurance backup.

Congress should act before the economic damage caused by lack of terrorism risk insurance takes too great a toll. We want to work with you to create the best possible support for our economy, job creation, and consumers.