Statement

of

National Association of Mutual Insurance Companies

to the

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Committee on Financial Services

Subcommittee on Insurance, Housing and Community Opportunity

Hearing on

TRIA at Ten Years: The Future of the Terrorism Risk Insurance Program

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Introduction

Chairman Biggert, Ranking Member Guiterrez, and members of the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity, thank you for the opportunity to provide testimony on the Terrorism Risk Insurance Act (TRIA) and its vital role in helping protect our country and our economy as we continue to consider how to best handle the threat of terrorism.

My name is Darwin Copeman and I am president and chief executive officer of Jewelers Mutual Insurance Company. A mid-sized company founded in 1913 and headquartered in Neenah, Wisconsin. Jewelers Mutual is licensed in all 50 states and is the only insurance company in the U.S. that specializes exclusively in protecting the jewelry industry and individuals' jewelry. Our company participates in the TRIA program and understands first-hand its importance of this unique partnership between the private insurance industry and the federal government.

Jewelers Mutual is proud to be a member of the National Association of Mutual Insurance Companies (NAMIC) made up of 1,400 property/casualty insurance companies serving more than 135 million auto, home and business policyholders, with more than $196 billion in premiums accounting for 50 percent of the automobile/homeowners market and 31 percent of the commercial insurance market. NAMIC is the largest and most diverse property/casualty trade association in the country, with regional and local mutual insurance companies on main streets across America joining many of the country's largest national insurers who also call NAMIC their home. More than 200,000 people are employed by NAMIC members.

It is our firm belief that the threat of terrorism is not an insurable risk. As such, no self-sustaining private market for terrorism risk coverage is likely to develop. However, the presence of a robust private/public partnership that has provided stability and predictability has allowed insurers to actively participate in the market in a meaningful way. Without a program such as TRIA, many of our citizens who want and need terrorism coverage to operate their businesses all across the nation would be either unable to get insurance or unable to afford the little coverage that would be available. The result when the next terrorist attack occurs, will be more – not less – federal exposure as the government will be under extreme pressure to pay for *all* of the losses.

Therefore, we believe it is vitally important to our nation's finances, security, and economic strength that we maintain a long-term private/public partnership for terrorism risk insurance.

The Nature of Terrorism Risk

Before the events of September 11, the abstract possibility of a major terrorist attack on the U.S. was known, but largely dismissed by most people. At the time, terrorism was typically included in "all-risk" policies because the risk was deemed so small as to be incalculable. Overnight, the insurance industry's understanding of the nature of terrorism risk fundamentally changed.

What became immediately clear is that managing terrorism risk defies the normal underwriting practices of insurers. First, it was apparent that there was an absence of meaningful actuarial data that insurers normally rely on when considering whether coverage can be offered and, if so, at what price. In the case of natural catastrophe risk for example, a company can rely on decades of relevant event data that can be plugged into mathematical models to quantify risk – there is no comparable historical record on which to draw for large-scale terrorist events. Further, much of the relevant data that might be used by an insurance company is appropriately kept secret by the federal government for national security reasons. Without access to this type of information insurers cannot meaningfully calculate the likelihood, nature, or extent of a potential event, making pricing and reserving virtually impossible.

Second, like the risk from flooding, the risk is too highly concentrated to effectively pool across geographical locations and policyholder type, particularly in an age of mass-casualty terror. Acts of terrorism on the scale of 9/11 are what are known as a "clash events" meaning they cause significant losses across multiple lines of insurance. In the case of the attack on the World Trade Center, there were enormous insured losses in the property, liability, life, and workers compensation lines, among others. Naturally, these types of events directly threaten the solvency of both insurers and reinsurers and are not typically covered risks. In a fully free market, it would likely be the case that highly concentrated urban areas in particular would find it difficult to find or afford coverage for terrorism.

Third, there is no clear way to determine the possible severity of a given attack, particularly those using nuclear, chemical, biological, or radiological (NCBR) weapons. There is no real loss data to rely on to understand the extent of damage from such weapons. That said, several years ago, the Rand Corporation found that "a radiological attack in an urban core would likely lead to catastrophic levels of uninsured business interruption and property losses." The American Academy of Actuaries estimated potential losses from a NCBR attack in New York City at $778 billion, which is more than *three times* the commercial property/casualty industry's claims-paying capacity.[1] These estimates underscore the uninsurability of such an event.

Fourth, the existence of interdependencies in local, national, and global systems further complicates any effort to accurately price terrorism risk insurance. At the very highest level, the nation's foreign policy decisions and the effectiveness of its homeland defense have a direct impact on the likelihood and success of an attack. At the policyholder

[1] Insurance Information Institute, "Terrorism Risk: A Reemergent Threat." April, 2011, p. 15.

level, the vulnerability of one organization is not simply dependent on its own security decisions, but also on the decisions of other organizations and agents beyond its control. Further, interdependence does not require geographical proximity – one need only consider the 2001 anthrax scare utilizing the U.S. Postal Service to grasp that breakdowns in systems far away can have a serious impact on potential losses.

Finally, and most importantly, is the human element. The fact that human beings plan and strategically execute terrorist events means that these events are not fortuitous; they are caused deliberately and do not occur randomly. Because of this, there is no way to determine the probability that a particular property or asset will experience a terrorism-related loss. Part of the difficulty in assessing terrorism risk stems from the fact that, because of response measures taken in the wake of an attack, the next event is unlikely to follow a similar pattern. Unlike criminal acts such as robbery where the goals are predictably targeted, the goal of maximizing death and destruction can be accomplished in countless ways, anywhere, and at any time.

All of the above factors lead us to conclude that it is unlikely that insurers will ever have the necessary tools to predict when, where, and how terrorist events will occur. Immediately following 9/11, there was hope that, given time, more accurate modeling could be developed and utilized to help insurers manage this type of risk. And indeed, much has been done to develop tools to manage aggregate loss exposures that are based on a predetermined event of a certain magnitude in a given area. However, models that attempt to predict the frequency or severity of an attack are not considered reliable. Given that modeling is typically effective only in determining the likelihood that particular events will occur and the fact that the data inputs will always be extremely limited, improved modeling will not solve the fundamental challenges of offering terrorism coverage.

Similarly, the nature of terrorism risk does not allow insurers and risk managers to create effective mechanisms to mitigate the risk of loss due to terrorism. Unlike in other types of coverage where a policyholder might get a premium discount for storm-proofing her home, it is not at all clear how a commercial property-owner could reduce the probability of experiencing a terrorism-related loss. With the interdependencies mentioned above the possible scenarios are endless – a company might spend a significant sum of money to secure a facility while a neighboring company does not and is then used as a staging area for an attack. Additionally, the presence of human volition drastically reduces the value of preventative measures, given that a terrorist usually will plan an attack with those measures in mind. Again, terrorism is not comparable to a random event – a hurricane cannot study wind-damage mitigation efforts and then think up new ways to get around them. The only truly effective mitigation tools – if there are any -- reside within the government's national security apparatus, and as noted above, these are understandably kept secret.

No amount of innovation in catastrophe modeling and risk mitigation will change the factors that fundamentally distinguish catastrophic events randomly caused by natural forces, from catastrophic events caused by the calculated machinations of human

beings. In any discussion about terrorism risk or the TRIA program, we must be clear about the unique nature of the terrorist threat.

The difficulty facing risk managers who wish to purchase private insurance coverage for terrorism-related events can be seen in the recent experience of the city of Chicago. To manage the liability risk associated with hosting a two-day NATO summit in mid-May, the city sought, and was able to easily acquire from domestic insurers, liability coverage for slip-and-fall accidents, automobile damage, and medical coverage. But city officials also feared that this important international gathering could be the target of a terrorist attack. They therefore attempted to purchase additional coverage for any liability the city might incur specifically related to terrorism. Insurance brokers acting on the city's behalf were unable to find a single standard commercial insurer that was willing to provide the needed coverage at any price. The city was finally able to purchase a policy from Lloyd's of London, which is known for insuring unusual risks. According to a report in the Chicago Tribune, the policy, which provided $100 million in terrorism liability coverage for just two days, cost the city $1.3 million. That premium represented more than 10 percent of the total cost of hosting the NATO summit.

It should be noted that the $100 million liability limit under the city's Lloyd's policy is equal to event "trigger" under TRIA, so that in effect, the TRIA backstop for losses in excess of that amount was irrelevant to this transaction. Yet the city's $100 million policy limit would not even begin to cover the potential property losses from a large-scale terrorist attack launched in downtown Chicago. Based on Chicago's NATO summit experience, it seems reasonable to conclude that in the absence of TRIA, few if any private insurers would be willing to provide the much larger amount of property coverage that would be needed to insure a large office building or hotel. Indeed, Chicago's experience suggests that, if anything, Congress should consider lowering the event trigger when it begins the work of extending the TRIA program beyond its 2014 expiration date. If the current trigger had been set at, say, $50 million, Chicago would probably have found numerous domestic insurers willing to offer the coverage it needed, and at a much lower premium.

The story of Chicago's search for terrorism liability insurance is noteworthy because it forcefully illustrates that the real beneficiaries of TRIA are not insurance companies, but the many entities that need the financial protection from terrorism that can only be provided by terrorism insurance that is both available and affordable. These beneficiaries consist not only of commercial enterprises, but include America's cities and other government entities as well.

The TRIA Program

The 9/11 attacks caused roughly $40 billion in insured losses. Soon after the events, reinsurers and insurers moved to exclude terrorism coverage from their new and renewing policies. There were certain at-risk areas of the country that saw extremely hard markets in property and workers compensation coverage. In states like New York

which prohibited carriers from excluding coverage for terrorism and with reinsurance companies universally excluding terrorist acts in property/casualty treaties, most carriers' only alternative was to offer less coverage or not write the business at all.

The few companies willing to provide coverage increased their prices because of the significant terrorism exposure. However, many of those companies began to cut back when concentrations of values and employees became too large. Again using New York as an example, the lack of adequate insurance capacity and significant increases in pricing of commercial multi-peril business resulted in the postponement of many construction projects. It was estimated at the time to have delayed or cancelled $15.5[2] billion in real estate transactions and cost 300,000 construction workers their jobs.[3]

Given this economic uncertainty and the insurance industry's uncertainty about its ability to properly manage terrorism risk, Congress passed and President George W. Bush signed into law the Terrorism Risk Insurance Act of 2002. The bill established TRIA as a temporary federal government program that created a private-public partnership to share in the compensation for privately insured commercial property/casualty losses resulting from acts of terrorism. The program was designed to guard against further economic dislocation and to allow the insurance industry a transition period to develop the capacity to adequately provide terrorism insurance without government involvement. At the time, some analysts thought that it might be possible to develop a truly private market for terrorism given time to build capacity and to study the risk. However, it was soon realized – for the reasons discussed above – that without the program American businesses would be hard pressed to find or afford the coverage they needed and so TRIA was extended for two years in 2005 and again in 2007 for seven years. Both extensions included modifications that required a greater share of the potential losses be borne by the private sector.

Essentially, the program is a federal backstop for commercial property/casualty insurance that acts as reinsurance in the event of a certified terrorist event. A private insurance company pays for losses up to a certain level and then the government covers the majority of the losses up to a ceiling of $100 billion, after which neither the government nor the company is required to pay further. The private sector insurers' share of the losses is made up of several components:

1. A deductible – currently 20% of the prior year's direct earned premium on all lines of business covered in the TRIA program – up from 7% when the program first began.
2. Share of the losses above the deductible – the insurer still pays 15% of all losses above the deductible – up from 10%.
3. Industry aggregate retention – Federal government is required to recoup any losses from private industry up to $27.5 billion – up from $10 billion.

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[2] Real Estate Roundtable, "Survey Confirms Economic Toll of Terrorism Insurance Gap: Over $10 Billion of Real Estate Projects Affected Across U.S.," September 4, 2002.
[3] President George W. Bush, "President Reiterates Need for Terrorism Insurance Agreement," October 3, 2002.

Further, an event must hit a certain “trigger level” in order for there to be any Federal involvement. The trigger is currently set at $100 million which is up from $5 million when the program was first started. Insurers are required to offer coverage for acts of terrorism on the same terms and conditions as other coverages, although this does not include coverage for NBCR attacks.

With the passage of TRIA, the fear that a worst-case terrorist event could render companies insolvent was somewhat reduced, making it possible these companies to continue to do business in higher-risk, urban areas. TRIA placed a ceiling on individual company terrorism losses, which permitted them to quantify their terrorism exposure and find a way to write the coverage.

TRIA Is Needed to Increase Private Industry Participation in Terrorism Insurance Market

In its 2010 report, the President’s Working Group on Financial Markets concluded that the availability and affordability of terrorism risk insurance has improved over the last several years. The marketplace has increased capacity and prices have in general declined. However, the report also concluded that only about 60 percent of commercial insurance policyholders are buying terrorism coverage, a take-up rate that has remained flat for six years. Also, despite the fact that marketplace capacity has increased in general, it has remained very constrained in certain markets where policyholders have difficulty obtaining sufficient coverage.

Clearly private industry has at least a limited capacity to offer coverage for terrorism. However, we must recognize that the entire marketplace as it stands today has grown up in the presence of the TRIA program. We cannot hastily conclude that because the private sector can handle a portion of the risk, it could figure out a way to handle all of it. For one, capital is the key to availability, and insurance industry capital remains insufficient to absorb the cost of a large-scale terrorist attack. Further, capacity could disappear altogether for subsequent attacks. Simply put, the private sector’s capacity is dwarfed for most modeled terrorism events and cannot be exposed beyond a reasonable level without failing in its primary purpose - supporting the economy by protecting against non-terrorism related losses and events. For example, in the case of workers compensation, in 2010 Marsh & McLennan have cited industry-wide capacity at only $30 billion, while the “worst case scenario” single loss is $90 billion.

Additional capital is needed in order to address this problem effectively. The private market is unable to absorb terrorism risk without a federal component. Even without a federal component, the government would bear the ultimate risk of uninsured losses as businesses and citizens turn to the federal government for assistance – the presence of a well-managed partnership program between the government and private insurers serves to ultimately *reduce*, not increase, federal liability for terrorism losses. The

purpose of the partnership is not to protect insurers, but to make sure that the economy can recover in as orderly a fashion as possible from a terrorist event.

We would add that an effective public-private partnership also depends on participation by insurers of all sizes and structures. Any discussion of increasing private sector involvement in the TRIA program must be had with an eye toward ensuring participation by smaller and mid-sized insurers. Event trigger and deductible levels are key to the ability of these insurers to continue to provide coverage. Large increases in the trigger, company deductibles, or insurer co-payments could drive medium and small insurers out the market, reducing competition and further constraining availability of terrorism risk coverage. There have been no changes in the market that would change this calculus.

Difficulties in measuring risk, raising sufficient capital, and the limits on ability to constrain risk exposure, all point to the continuing need for a public-private partnership. Given that we cannot predict the severity or frequency of terrorist events, having a cap on what a company knows that it will have to pay allows it to at least begin to manage its risk exposures. Without a program, we would see a drastic reduction in both the availability and affordability of terrorism risk insurance like we did in the aftermath of 9/11.

Conclusion

It is much easier to argue the feasibility of a fully private market for terrorism insurance when no losses have been incurred since TRIA was enacted. Suffice it to say, the memory of the market immediately following 9/11 ought to give pause to anyone pushing to end the private/public partnership that has worked to provide commercial policyholders with the coverage they need. The result when the next terrorist attack occurs will be more – not less – federal exposure. In order to encourage private sector involvement in the terrorism insurance marketplace – and thereby protect and promote our nation's finances, security, and economic strength – we must maintain a long-term private/public partnership for terrorism risk insurance.