American Insurance Association

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

HEARING ON

"EXAMINING THE TERRORISM RISK INSURANCE PROGRAM"

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WRITTEN STATEMENT OF

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ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION

My name is Charles Clarke, and I am Vice Chairman of Travelers, where I have held various executive and management positions since joining the Company in 1958. I am appearing today on behalf of the American Insurance Association. AIA represents approximately 350 major insurance companies that underwrite about one-third of the U.S. commercial insurance market covered by TRIA and TRIEA; the membership includes half of the top ten commercial lines writers in the U.S. Terrorism insurance is among the highest priority public policy and marketplace issues for our members.

We appreciate the opportunity to testify this morning and commend the leadership shown by this Committee, and Chairman Dodd in particular, in steadfastly supporting enactment and extension of the TRIA program. Your leadership in this area is widely acknowledged, and we are grateful for it.

The Terrorism Risk Insurance Act (TRIA), as modified and extended through TRIEA (also known as the TRIA Extension Act), provides a federal backstop for commercial property-casualty insurance in the event of a catastrophic terrorist attack on U.S. soil. Since its enactment in 2002, TRIA has achieved its goals of making terrorism risk insurance widely available to U.S. businesses – even for urban areas, high-risk industries, and iconic properties – and stabilizing the private marketplace for a risk that has many features that make it uninsurable. Unfortunately, despite the government's success since 9/11 in interdicting several terrorist plots and preventing another major strike in the U.S., most experts agree that it is not a matter of if, but when, another catastrophic attack will occur on U.S. soil. A continued, vibrant federal terrorism risk insurance program therefore remains vital to the national security and economic well-being of our nation for the foreseeable future.

<u>Terrorism Remains an Uninsurable Risk</u>

The characteristics that make terrorism an uninsurable risk remain as strong today as they were immediately following September 11, 2001. These include the: 1) difficulty of predicting the likelihood of a major terrorist attack; 2) concentration of insured lives and property values in business centers; 3) magnitude of potential loss from an extreme terrorist attack, particularly those that involve the use of unconventional weapons; 4) limits of mitigation in reducing terrorism losses; 5) lack of available public information necessary to analyze the risk; and, 6) legal, regulatory, and financial hurdles inherent in the current state-regulated insurance system. While TRIA and its extension do not erase any of these criteria that make the risk uninsurable or otherwise constrict the free market, they put a box around the volatility associated with terrorism risk and, therefore, facilitate both coverage availability and affordability.

In the past, AIA has testified about each of the aforementioned aspects of terrorism risk. They remain fundamentally unchanged because the nature of terrorism remains largely unchanged. If anything, the threat is growing over time, as terrorists have more time and resources to identify potential targets and plan for an attack.

Rather than repeating past testimony, I would like to discuss some themes arising from the recent report of the President's Working Group on Financial Markets (PWG), and offer some suggestions for framing long-term federal terrorism risk insurance legislation, utilizing the existing TRIEA framework.

The PWG Report

As you know, the PWG issued its TREIA-mandated report on October 2, 2006. The report reinforces the past, present, and future absence of a private market for chemical, nuclear, biological, and radiological (CNBR) terrorism risk insurance, but expresses more optimism about the private sector's ability to manage "conventional" terrorism risk. These conclusions are correct as applied to CNBR terrorism risk. However, they are unsupported with respect to "conventional" attacks, insofar as private sector capacity remains severely inadequate to bear the risk of a catastrophic "conventional" terrorist attack in the absence of a federal backstop.

CNBR attacks pose insurmountable challenges for insurers

As mandated by Congress, the PWG report looks specifically at the market for CNBR terrorism risk coverage and concludes that no private market for CNBR terrorism risk insurance existed prior to September 11, none exists today, and none is likely to exist in the foreseeable future. More specifically, the report finds that, unless mandated by state law, coverage for CNBR risk has not been generally available, and reinsurance capacity for CNBR terrorism has been virtually non-existent. Looking to the future, the report observes that "there may be little potential for future market development" in this area. These conclusions are entirely consistent with those of a contemporaneous report by the Government Accountability Office on CNBR terrorism risk.

I would like to comment a little more fully on insurers' concerns regarding the CNBR issue.

First, while the loss estimates are staggering—exceeding $700 billion in the case of a nuclear attack in New York City—questions remain about whether CNBR terrorist attacks can even be modeled, given the huge number of variables involved. Among the special difficulties in modeling CNBR terrorism risk are the timing of losses (damages could take years, if not decades, to quantify) and their geographic range (the potential for widespread dispersal of contaminants makes it difficult to limit losses by managing aggregate exposures).

Second, insurers have almost no ability to spread CNBR terrorism risk to reinsurers or the capital markets. While reinsurance for conventional terrorism losses remains scarce, the situation is far worse for CNBR terrorism risk, insofar as most of the available reinsurance coverage specifically excludes coverage for CNBR losses. Similarly, the capital markets—which to date have expressed no real appetite for investing in terrorism risk bonds or similar instruments—cannot be expected to be willing to take *any* significant position in CNBR terrorism risk.

Third, CNBR terrorism losses threaten the solvency of insurers in the absence of a federal program. The lack of private reinsurance means that insurers must retain the virtually limitless costs of CNBR terrorism risk in the absence of a federal backstop. As the PWG report recognizes, a large-scale CNBR event could result in losses that would overwhelm an insurer's capital and surplus, and therefore its claims-paying ability. Moreover, a widespread CNBR event could paralyze the economy and shut down sources of outside capital that insurers might otherwise access to pay claims.

Practical realities of managing "conventional" terrorism risk are at odds with certain economic theories.

With respect to conventional terrorism risk, the PWG report is at odds with several practical realities involving modeling, reinsurance capacity, and insurer surplus.

First, despite the PWG report's optimism, improvements in insurer modeling will not create significant new capacity for the foreseeable future. As the report notes, these improvements are helping insurers to estimate their aggregate loss accumulations at specific locations, based on assumed event scenarios, thus better understanding and more efficiently managing their terrorism risk. However, there is no logic to the implication that an insurer's ability to model losses from a hypothetical event *increases* capacity. Rather, improvements in modeling improve efficiency in the allocation of *existing* capacity, which could create availability problems in highly concentrated areas.

Second, TRIEA has not reduced the demand for private reinsurance. In fact, demand outstrips supply. Additional capacity generally is not available at prices that are affordable for insurers or their policyholders. Like insurers, reinsurers lack sufficient confidence in the models and therefore are unwilling to put a substantial amount of their capacity at risk. This is the reason that private reinsurance capacity has grown only incrementally since the September 11 attack, and not much additional improvement can be expected, according to reinsurance experts.

Private terrorism reinsurance costs more than the amount of terrorism premium that primary insurers are able to obtain from policyholders, due to state rate regulatory restrictions, state restrictions on coverage limitations and exclusions in certain lines of insurance, as well as the policyholders' interest in purchasing coverage. As a result, insurers are buying as much reinsurance as they can afford and/or self-insuring their retentions by exposing more of their capital to risk and thus requiring capital commensurate with the increased risk.

Third, increases in policyholder surplus augment financial capacity but do not offset the need for a federal backstop or enable insurers to utilize higher retentions. The financial condition of the insurance industry has improved since the September 11 attack, and policyholder surplus has increased beyond pre-attack levels. This does not mean, however, that insurers are in a better position to assume significantly more terrorism risk, since this surplus must be available to meet all of an insurer's potential claim obligations. Moreover, many insurers—particularly those with large, diversified client portfolios—manage their terrorism accumulations to a level that is significantly less than their very substantial TRIEA retentions (due in large part to the manner in which individual insurer retentions are calculated as a percentage of commercial lines premium, rather than premium associated with terrorism risk). Removing the backstop or raising retentions would not alter this situation, but could impair solvency in the event of a large scale terrorist attack and create insurance availability concerns outside of terrorism risk.

Solutions

Since the days immediately following 9/11, AIA has been working diligently with Chairman Dodd and others in Congress, the Treasury Department and the White House, the policyholder community, and our colleagues in the insurance industry to develop the most operationally effective and fiscally efficient federal program for the public-private management of terrorism risk.   Meaningful solutions must augment existing capacity and spread loss beyond current private sector parameters, while at the same time encouraging the growth of private sector capacity and protecting the taxpayer.

Recognizing that CNBR terrorism risk is uninsurable in the private market, we believe that Congress should consider recalibrating the current TRIEA backstop to provide increased federal financial participation in the event of a CNBR attack. With regard to conventional terrorism risk, we believe that the current backstop has worked and should remain in place. At the current levels (20 percent of subject premium in 2007), the TRIEA backstop would be accessed only in the event of a truly catastrophic conventional attack – most likely a "swarm" or other multiple venue attack – that exceeds the dimensions of the 9/11 strike.

Additionally, experience has shown that the distinction between foreign and domestic terrorism is artificial. Since TRIA was first enacted, events such as the London Underground bombing have reinforced the practical difficulty of making this distinction and underscored that it is meaningless from an economic perspective, and impractical from an insurance perspective.

In an effort to stimulate capacity, Congress should give consideration to a program trigger that provides meaningful protection for small companies. Additionally, the state regulatory system poses significant challenges in managing this risk. We believe that state regulation of terrorism risk insurance rates and forms that can undermine the program's basic objectives should be preempted.

Finally, we strongly support Chairman Dodd's view that the program should be made permanent, or at least remain in place until the U.S. has won the war on terrorism—our ultimate goal.

We look forward to working with you to address these important concepts. Thank you again for your unwavering commitment to a strong national economy through a strong TRIA program.