United States Senate
Committee on Banking, Housing and Urban Affairs
Hearing on
"Oversight of the Terrorism Risk Insurance Program"

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On Behalf of the American Insurance Association

Chairman Shelby, Ranking Member Sarbanes, and members of the committee, my name is Brian Duperreault. I am Chairman of ACE Limited (ACE). I appear before you today representing ACE and our national property-casualty insurance trade association, the American Insurance Association (AIA).

I want to first thank the committee for its leadership on the important issues related to terrorism insurance. The Terrorism Risk Insurance Program - created by the Terrorism Risk Insurance Act of 2002 (TRIA) - is part of our nation's critical infrastructure, strengthening and securing our economy against the clear and present danger we face from terrorists bent on destroying our way of life. I would also like to particularly thank Senators Bennett and Dodd for recently reintroducing legislation to temporarily extend TRIA. Clearly the bill recognizes the critical importance of TRIA in stabilizing the market for terrorism risk insurance by making terrorism insurance broadly available to all businesses by requiring insurers to make terrorism coverage available in the policies they issue. A temporary extension will help prevent market dislocation and provides an opportunity for the industry to continue analyzing options for a long-term solution. Specifically, the Dodd-Bennett bill establishes a mechanism to consider long-term public/private solutions for managing terrorism risk. We continue to devote considerable time, energy and effort to work through ideas that could serve as long-term solutions, and we remain fully committed to working with Congress and the Administration to craft a workable long-term solution that all stakeholders can support. We endorse the Dodd-Bennett bill, especially as it contains a mechanism that will ensure development of a long-term public/private partnership, a goal that we all share and that we all continue to work toward.

On behalf of ACE and all of AIA's member insurers, I would like to urge you to continue providing a federal terrorism risk insurance mechanism to protect the United States from the potential economic devastation that can come from catastrophic terrorist attacks.

The ACE group of property-casualty insurance companies conducts business throughout the United States and in more than 50 other countries. We employ more than 4,000 employees here in the U.S., and trace our long, proud history in this country back to 1792, with the establishment of the Insurance Company of North America, the first investor-owned American insurance company. ACE is among the largest property and workers' compensation insurers for businesses and municipalities of all sizes. Our customers include a broad array of organizations that rely on a stable market for terrorism insurance. These customers include many financial institutions, energy companies, hotel chains and professional sports leagues.

Congress enacted TRIA to ensure that our nation could prepare for, and recover from, financial devastation caused by catastrophic terrorism attacks. The public/private "shared loss" program established by TRIA also helps prevent terrorists from accomplishing one of their key objectives – undermining America's economic security. TRIA has helped stabilize the private market for terrorism risk insurance, and has made terrorism insurance broadly available to all businesses that want and need this vital coverage. However, TRIA provides only a temporary backstop; it expires at the end of this year. Unfortunately, our nation's exposure to the terrorism threat will not expire at the end of this year. Every day, new information about this continuing threat is revealed.

For example, two weeks ago, the *Final Report of the Bipartisan Commission on the Intelligence Capabilities of the U.S. Regarding Weapons of Mass Destruction*, concluded, "We still know disturbingly little about the weapons programs and even less about the intentions of our most dangerous adversaries."

On February 16, Federal Bureau of Investigation (FBI) Director Mueller and Central Intelligence Agency (CIA) Director Goss testified before the Senate Select Committee on Intelligence at a hearing on "Current and Projected National Security Threats to the United States." The FBI and the CIA emphasized their concerns about the threats of nuclear, biological, chemical, and radiological (NBCR) attacks, with Director Goss specifically stating that "[i]t may be only a matter of time before al Qaeda or another group attempts to use chemical, biological, radiological and nuclear weapons." Director Mueller echoed this prediction, saying that he was "very concerned with the growing body of sensitive reporting that continues to show al Qaeda's clear intention to obtain and ultimately use some form of chemical, biological, radiological, nuclear or high-energy explosives material in its attacks against America." Certainly, the threat of terrorism will not diminish before December 31, 2005, when TRIA is currently scheduled to expire. What Congress does now to address these catastrophic threats, including NBCR, will serve as an economic legacy for future generations.

We urge you and your colleagues to continue to focus on the fundamental importance of a federal backstop. As TRIA's end date nears, insurers are making decisions now whether or not to write terrorism insurance without the certainty of a federal backstop. There are those who suggest that TRIA should be allowed to expire and that the "free market" should respond to fill the need for terrorism insurance. However, property-casualty insurers do not operate in a free market environment. In the existing state regulatory structure, insurers:

- cannot exclude or limit terrorism coverage in certain commercial lines such as workers' compensation insurance or statutory "fire-following" coverage for property insurance policies in many states; and,
- cannot exclude terrorism coverage in certain states absent a government backstop.

And, in virtually all of the states, there is no "free market" because of a complex system of government price and product controls that artificially suppress terrorism insurance rates and deny product choices to consumers.

Under these regulatory conditions, failure to provide a federal backstop is tantamount to conscripting insurers to cover terrorism risk when they cannot adequately price for this potentially ruinous exposure and, if provided a truly free market, may prefer to avoid entirely. The insurance industry simply does not have the capacity to be the nation's insurer of all terrorism risks. Unfortunately, insurers are faced with a conundrum – take on this uninsurable risk at pricing suppressed by the states – or stop writing insurance altogether. This is not a free market; it is a *forced* market, and it is one important reason why the federal government should continue to play a role in managing this exposure.

The insurance industry can play a vital role in a post-attack recovery. Indeed, we are proud of our ability to put thousands of "boots on the ground" immediately after the tragedy of September 11. We stand ready to provide those claim evaluation and processing services again. The insurance industry also offers a wide-ranging network of contacts with U.S. businesses that can be used to communicate with our policyholders to further assist in post-event reconstruction. However, insurers simply can't afford to gamble our solvency on the bet that there will never again be a major terrorist attack on the United States.

The "all or nothing" proposition facing the industry benefits neither insurance customers nor the economy. As Standard & Poor's recently noted, "[m]any policyholders are now inking deals for property-casualty coverage that exclude terrorism coverage after TRIA expires. . . . [F]or every day that such coverage is in effect between January 1, 2006, and the day their policies end, they will be without terrorism coverage if TRIA is not extended." This will, in turn, have a severe, negative effect on the national economy, including job loss, stalled commercial transactions and delayed construction projects. Market stability provided by a federal backstop will be replaced by the market uncertainty that characterized the post-September 11, pre-TRIA economy. Accordingly, we urge Congress to act as soon as possible to provide a continuing federal backstop and to consider long-term solutions for managing our nation's economic exposure to catastrophic terrorism.

The United States is in a critical phase of the global war on terrorism. This war involves urgent national security issues coupled with a long-term commitment from the government, industry and public to reduce and, hopefully, eliminate threats and risks associated with terrorist activity. As a key component of national economic security, the challenges facing the private terrorism insurance market are similarly critical and stretch well beyond TRIA's expiration.

While I do not use the term "war" lightly, we are certainly engaged in a war, and terrorism and war share certain features that make it extremely difficult, if not impossible, for private markets to bear their risk. War and terrorism are not fortuitous. Acts of terrorism, like acts of war, are premeditated, planned and executed with a specific purpose by individuals (in the case of terrorism) and governments (in the case of war) that actively seek to defy predictability, discernable pattern or advance warning. In addition, war, like today's brand of catastrophic terrorism, is waged against America, not against particular businesses.

In this context, we also urge you to further consider several underlying characteristics of terrorism risk in the United States that make catastrophic terrorism uninsurable as you debate the best way to secure our economy against terrorists in the years to come.

First, while the private sector has made significant progress in terms of accumulation management of terrorism risk, we continue to lack both the necessary capacity and sufficient marketplace data to handle catastrophic terrorism losses on our own. Under certain plausible event scenarios, estimated insured losses from future catastrophic terrorist attacks on U.S. soil could exceed $250 billion.[1] These levels greatly surpass the entire commercial property-casualty industry's estimated capacity

[1] *Tillinghast Towers Perrin, Workers' Compensation Terrorism Reinsurance Pool Feasibility Study, Summary of Study Findings and Conclusions, p. V (2004) ("Terrorism experts have developed plausible scenarios in which the estimated total insured losses from a single event could exceed $250 billion.").*

of about $176 billion. Importantly, this capacity is not just dedicated to terrorist attacks; it is needed to back all commercial risk in order to cover claims from such things as natural disasters or workplace incidents unrelated to terrorism. In 2004 alone, hurricanes took approximately $25 billion of industry capital for losses.

While other commercial risks can be spread through reinsurance, reinsurers have no significant appetite for terrorism risk. Reinsurance plays a critical role in the financial management of catastrophic losses by limiting primary insurer liability on specific risks, increasing insurer capacity and stabilizing insurers' financial results. As a result of this lack of appetite to reinsure terrorism risk, current terrorism reinsurance capacity, according to the Reinsurance Association of America, is limited to between $4 billion and $6 billion. Only a small amount of this limited reinsurance capacity is available for NBCR terrorism risk. Because of this withdrawal of the largely unregulated global reinsurance network from the terrorism risk – a sign of the "free market's" negative evaluation of the terrorism risk – U.S. insurers have few external partners with which to spread this catastrophic risk.

Moreover, private market mechanisms remain insufficient to spread the risk of catastrophic terrorism in a meaningful way. In a 2004 Workers' Compensation Terrorism Reinsurance Pool Feasibility Study, Tillinghast Towers Perrin cited "lack of capacity" as the primary reason why a voluntary workers' compensation terrorism reinsurance pool would not be a viable mechanism to handle mega-terrorism risk. This conclusion is not surprising because pooling does not introduce new capacity for the terrorism risk – it merely moves it around for marginal increased efficiency. This conclusion is not unique to workers' compensation insurance, but would apply to the ability of a pool to address catastrophic terrorism in other lines of business, such as property insurance, including business interruption coverage.

The same conclusion holds true for other capital market tools. For example, some academics have discussed catastrophe bonds as a source of new capital for terrorism risk. To date, however, there have been only two bonds underwritten, and those included terrorism as a small component of risk among a number of traditional natural catastrophe exposures; in fact, one was only to cover the risk of event cancellation. Despite the confidence of a few theorists who feel that catastrophe bonds represent promising, untapped sources of profit-seeking capital that could be used for terrorism risk, the reality is that debt and securities markets remain unconvinced and reluctant to provide such capital instruments. Put simply, investors are simply unwilling to gamble capital on an unforeseeable, unique event such as a catastrophic terrorist attack when there are other attractive, much less risky, investment alternatives.

Second, the threat of catastrophic terrorism remains real and unabated. The Bush Administration has repeatedly alerted Americans to the increased possibility of terrorist attacks. Since September 11, 2001, the United States has been on a constant, elevated state of alert for terrorist activity. Recently, as noted above, top intelligence and law enforcement officials from the Administration have reported that terrorists are regrouping and planning possible new attacks against the United States.

Third, private sector information about terrorism risk is incomplete. Contrary to traditional evaluation of insurance risks, information availability and sharing about terrorism risk is asymmetric. Insurers and policyholders do not have – nor should they have – access to classified generalized or specific threat information in the hands of the U.S. government. Therefore, insurers cannot properly evaluate the many complex risks associated with terrorism. This "information vacuum" makes all risk transfer and management decisions about terrorism a dicey proposition.

The relative infancy of terrorism modeling also contributes to the risk's uninsurability. While modeling firms have worked diligently to produce terrorism risk models to predict terrorism events in the United States, they have not been able to model accurately for the frequency of terrorist attacks, the terrorists alone control that variable. These models instead focus only on predicting the impact terrorism has on its victims. Office towers can be built or retrofitted to withstand earthquakes in Los Angeles or hurricanes in Miami (making them more insurable), but few businesses would want to turn their offices into hardened bunkers. Even then, terrorist excel in adapting to overcome such loss mitigation measures, or turn their attention to "softer" targets.

Unfortunately, natural catastrophe modeling – which is a much more mature science – does not aid the terrorism modeling process. Past natural catastrophes are predictive of the nature, frequency and severity of future natural catastrophes. Most natural disasters also occur with at least some prior warning. Because of this element, insurers can track when and where natural catastrophes are likely to strike, the type of damage they will cause, and which areas are most vulnerable, and can exercise loss control measures to protect against catastrophic loss.

In contrast, past terror attacks are not predictive of future terror attacks, and the full range of possible methods of attacks can never truly be known. Terrorists rely on surprise to maximize the impact of an attack, so the attack usually comes without warning. In fact, whether an event is a "terrorism" attack might not be known until after it occurs. This "man-made" threat, which is limited only by the imagination of a terrorist, is one that simply cannot be forecast. In addition, terror attacks can be opportunistic or carefully planned for years – or both, which can change the outcome of the attack and the resulting losses.

<u>Fourth</u>, while insurers strongly support risk mitigation efforts and are working with policyholders on terrorism risk analysis, mitigation alone cannot remove the terrorist threat or significantly reduce losses from certain types of terrorist attacks, such as those involving NBCR weapons.

Also, unlike other risks, terrorism is a wholly interdependent risk that defies traditional loss control methods. Loss control or mitigation techniques employed by one commercial business may not be sufficient to protect that enterprise from catastrophic loss. The World Trade Center is the most compelling – but not the only – example of the interdependent nature of terrorism risk. The World Trade Center was a model of security and disaster planning after the 1993 truck bombing, yet nothing done at the World Trade Center could have prevented planes leaving airports in other cities with hijackers aboard, and nothing done at the World Trade Center could have prevented planes being used as weapons from flying into the towers, and destroying them along with neighboring buildings. The interdependent nature of terrorism risk, with vulnerability measured by the weakest link in the chain, minimizes the effectiveness of even the best business-by-business loss control programs.

Finally, the challenges facing insurers with respect to catastrophic "conventional" terrorism risk are greatly magnified by the potential for NBCR terrorism. NBCR terrorism demonstrates that even the severity component of a terrorist attack is difficult to predict. Potential terrorism scenarios now routinely include discussion of NBCR events. Recent intelligence reports by the Administration have centered on the possibility of a so-called "dirty" bomb or a suitcase nuclear explosive; weapons capable of producing precisely the type of catastrophic terrorism that is difficult to quantify and whose emergence threatens the solvency of the property-casualty insurance industry. The anthrax attacks perpetrated through the U.S. postal system, (including the U.S. Senate's own mail facility), even though limited in scope and severity, only serve to underscore the random quality and myriad potential consequences associated with such events. As a result, insurers remain reluctant to provide NBCR coverage for terrorism risks in their policies beyond that required by state law.

Key federal officials have also acknowledged the difficulty of private markets addressing the risks associated with terrorism. Just weeks ago, Federal Reserve Chairman Alan Greenspan told the House Financial Services Committee that, "there are regrettable instances in which markets do not work, cannot work." Chairman Greenspan added: "You cannot have a voluntary market system and the creation of markets, especially insurance markets, in a society subject to unanticipated violence … And while I think you can get some semblance of terrorism insurance [without government involvement], I have not been persuaded that this market works terribly well."
Having established the characteristics of catastrophic terrorism that render it uninsurable, AIA and its members also understand that TRIA was designed as a temporary stabilizing mechanism, and that a long-term shared responsibility program must be developed, enacted, and implemented. The Dodd-Bennett bill paves the way to such a program by tying a short-term extension to mandatory study of a long-term public/private solution, utilizing the Presidential Working Group on Financial Markets to facilitate that discussion.

We also have been working diligently with the rest of the industry and the policyholder community to identify potential long-term options for shared responsibility in managing catastrophic terrorism risk. While our progress has been slowed during the implementation phase of TRIA and by impediments to the free market that are a product of our state insurance regulatory structure, the structural elements of a long-term program can be gleaned from our experience in a post-September 11th world. That experience has shown us that catastrophic terrorism poses the greatest threat to the insurance industry and the economy at large, led by the dynamic uncertainty of NBCR events.

To be workable, we believe any long-term public-private partnership to manage terrorism risk must recognize the need for public – rather than private market – responsibility for NBCR risks. In addition, we believe there should continue to be a risk-sharing mechanism for catastrophic terrorist attacks using conventional weapons that go beyond available industry capacity. Both of these conceptual elements of a long-range program would be aided by a true "free market" environment for terrorism risk insurance – an environment that fosters more opportunities for insurers to provide coverage and more options for policyholders to obtain coverage. While a free market environment for terrorism risk insurance may not change the underlying characteristics of catastrophic terrorism that make it uninsurable, it will supply the flexibility that the current regulatory structure lacks.

ACE and AIA stand ready to work with Congress and other interested stakeholders to translate these long-term concepts into legislation, but our commitment should not prevent this committee from moving legislation as quickly as possible in order to avoid the expiration of a federal backstop. The committee's important work today on the future of terrorism risk insurance will ensure that terrorists fail in their mission to undermine this nation's economic security.