Testimony of the
National Association of Insurance Commissioners

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

Regarding:
Extension of a Terrorism Risk Insurance Program

February 28, 2007

Michael McRaith
Director
Illinois Division of Insurance

Introduction

Chairman Dodd, Ranking Member Shelby, Members of the Committee, thank you for inviting me to testify today before this Committee, and thank you for addressing this important issue so early in the new session of Congress. My name is Michael McRaith. I am the Director of the Division of Insurance for the state of Illinois, and I am here to today on behalf of the National Association of Insurance Commissioners (NAIC) to provide our views on the role of the federal government in a terrorism risk insurance program.

While the risk of terrorism has become permanent, we have not yet devised a permanent solution to address this risk. Given the vital role that the Terrorism Risk Insurance Act (TRIA) and the Terrorism Risk Insurance Extension Act (TRIEA) have played in ensuring the affordability and availability of terrorism insurance, we should not allow TRIEA to expire without an appropriate federal backstop being in place on January 1, 2008.

Today, I would like to make three basic points:

- First, the availability of terrorism insurance has become crucial to a stable economy, but given the difficulty in accurately determining the frequency, severity, and loss costs for acts of terrorism, the private insurance market has shown little appetite to provide terrorism insurance coverage absent a federal backstop.

- Second, in the absence of private market innovations and solutions, Congress should act to sustain a viable private market for terrorism insurance by supporting a federal backstop that includes domestic and foreign acts of terror, group life insurance coverage, and a mechanism to address nuclear, biological, chemical, and radiological (NBCR) risks.

- Third, state insurance regulators are committed to working with Congress to consider changes to the current program that would better stabilize the terrorism insurance market and better protect the economy and consumers.

The Economy Depends on Terrorism Insurance

Today TRIEA is quickly approaching its expiration date, but the NAIC's commitment to the need for a federal backstop as an essential underpinning of our national economy has not changed. My fellow commissioners and I continue to believe the United States economy remains vulnerable to terrorist attack and requires insurance to help manage exposure to that very real, unpredictable, and volatile risk. Without a federal backstop, such insurance may become unavailable and unaffordable and we may revisit some of the same market disruptions and economic uncertainties we faced in the aftermath of the September 11 terrorism attacks. The uncertainty surrounding the expiration of TRIEA also affects our competitive position internationally. Other nations with serious terrorism problems, such as the United Kingdom, have permanent programs in place to ensure terrorism insurance is available. A long-term solution to the terrorism exposure here in the U.S. is necessary, and overdue.

TRIA and TRIEA have worked exactly as intended by making terrorism coverage available to those who need it. More businesses are insured for terrorism now than ever before, as evidenced by an increased "take-up" rate (that is, the rate at which companies have purchased terrorism insurance coverage) for terrorism coverage since the passage of TRIA. As mentioned in the President's Working Group on Financial Markets (PWG) report on terrorism insurance, the take-up rate has increased from 27 percent in 2003 to nearly 60 percent in 2005, while the cost for that coverage represents about 3 to 5 percent of the total cost of property coverage. Indeed, in areas of perceived high risk, the commercial real estate, construction, and financing markets depend on the availability of terrorism insurance coverage that likely would not exist without a federal backstop.

Terrorism Insurance Depends on Private Market Partnership with the Federal Government

Insurance depends on an estimation of future loss costs which, in turn, depend on an understanding of frequency and severity for a particular event. While insurers, reinsurers, risk modelers and others have made strides in improving their tools for deriving this information, it remains exceedingly difficult to accurately apply insurance principles to the risk of catastrophic terrorism. The notion of frequency, in particular, is especially difficult to estimate because acts of terror are not random. Terrorists can change tactics and actively work to disrupt our understanding of their actions and the frequency with which they choose to act. The events of September 11, 2001, dramatically illustrate this challenge. Even if an insurer could anticipate all the variables that contributed to that chain of horrific events, it still would have no way of knowing with what frequency it may or may not happen again. The events of September 11, 2001, also illustrate the severity of terrorism. The direct actions of just a small group of men resulted in nearly $21 billion in losses—the third costliest insurance event on record. When considering these events in the context of a nuclear, biological, chemical, or radiological (NBCR) event, the severity becomes even more troubling. The NAIC held a public hearing on terrorism insurance matters in March 2006 at which the American Academy of Actuaries provided a statement estimating that a large NBCR event in downtown Manhattan could cause insured losses (property/casualty and group life insurance) of $778 billion dollars.

As Congress considers the ramifications of what a $778 billion dollar event would do to the insurance industry, it is important to have an understanding of the market's capacity. As the PWG report also noted, the capacity of the market has increased since 2001. Insurance capacity is generally measured by determining the amount of capital and surplus available to insurers to support their policy writings. Using that measure, NAIC data shows that in 2005 the total capacity for property and casualty insurers was $427 billion. It should be noted, however, that that number is the total capacity for the market for all property/casualty lines. Less than half of those funds are used to support commercial products in all lines of insurance, and the capacity of any one company is far less. Unknown frequency, coupled with the potential for severe losses, make it difficult for insurers to provide coverage for acts of terrorism.

Congress Should Continue A Terrorism Risk Insurance Program

TRIA and TRIEA are examples of a partnership between the private and public sectors to solve a problem that neither currently can handle alone. Given our economic dependence on terrorism insurance, and in the absence of a private market innovation to make managing this risk practical, the NAIC urges immediate action by Congress on a federal measure to ensure continued marketplace stability before TRIEA expires at the end of 2007. We believe the presence of the federal backstop has provided an appropriate mechanism 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, the federal backstop has been successful in bringing confidence to the insurance marketplace. Because some terrorism risks are largely uninsurable without a financial backstop, state regulators are very concerned that significant market disruptions will develop before the program's expiration, due in part to the timing of the business cycle for insurance renewals. With that in mind, we again applaud this Committee for holding today's hearing and addressing this important issue early in the legislative session.

As was the case when the initial program was set to expire in 2005, insurance companies and insurance contracts are affected already by the possible expiration of the current program. Terrorism insurance coverage, as companies offer it today, is typically contingent on a federal backstop, and companies will again place limitations on commercial policies to exclude terrorism coverage if a federal backstop no longer exists. These limitations will greatly reduce terrorism coverage in the states that have approved them. The few states that have not allowed insurers to file coverage limitations fear that, without a federal backstop, insurers will be unwilling to underwrite many businesses that want appropriate and reasonably priced terrorism insurance coverage. This could lead to availability and affordability problems down the road.

To address this situation, Congress should act to ensure the existence of a federal backstop program, and we believe it should not make a distinction between so-called domestic or foreign acts. Based on the feedback of insurers, reinsurers, and other stakeholders that we have gathered during the NAIC's many meetings and forums on the subject, there seems to be broad consensus that such a partnership between the private market and the federal government is necessary. As the private market continues to improve its tools and resources to understand and manage terrorism risk, there may be an opportunity for the private market to assume more risk, but given the potential for such enormous losses, a federal backstop at the extreme catastrophic level likely would still be necessary. However, we also recognize that the federal government may be reluctant to establish a permanent program; therefore, if Congress chooses to develop a temporary backstop, its duration at a minimum should be long enough to provide sustained stability to the commercial insurance cycle.

The NAIC Continues to Work on Terrorism Insurance Solutions

Following enactment of the Terrorism Risk Insurance Act (TRIA), the NAIC established a Terrorism Insurance Implementation Working Group of state regulators that has worked closely with the Treasury Department and insurance companies to successfully implement TRIA's provisions, as well as to monitor the impact it has had on the insurance marketplace. The Working Group continued that involvement in 2005 when the program was set to expire and supported its extension through the Terrorism Risk Insurance Extension Act (TRIEA).

Once again, the NAIC stands ready to assist Congress in developing an appropriate method for continuing a federal terrorism insurance backstop. The NAIC continues to discuss the challenges of terrorism insurance at its national meetings and in public hearings, and we are committed to maximizing the participation of the private market in this obligation. As Congress contemplates the expiration of the current program, there are a few issues and concepts that should be considered in the debate over a federal terrorism insurance backstop:

Length of Program

The duration of any successor program to TRIEA should be long enough to provide sustained stability that reflects the commercial insurance cycle as well as sufficient time and means for the private sector to build the appropriate capacity.

Domestic Terrorism

Any successor program to TRIEA should not make a distinction between domestic and foreign acts of terrorism. Both types should be covered. The effects of a terrorist act could be potentially devastating regardless of whether it is perpetrated by an American citizen or foreign national.

Tax-Deferred Catastrophe Reserves

Modifying the U.S. tax code to allow property/casualty insurers to set aside catastrophic reserves on a tax-deferred basis is one concept that potentially could allow for more private market terrorism insurance capacity. If companies are encouraged or required to retain more of the premiums they collect for catastrophic scenarios, the government's role could be lessened over time. Currently, when a policyholder pays a premium for terrorism insurance, in the absence of terrorism losses, that money is subject to the normal market mechanisms where some is retained, but much of it is paid out in the form of taxes and shareholder dividends. By establishing tax-deferred reserves that could be used only for catastrophic losses of a certain magnitude, companies could be encouraged or required to hold a portion of that money and let it grow over time. Tax-deferred reserves would put more of the responsibility for covering the cost of insured terrorism losses on policyholder dollars, which are correlated with risk, rather than taxpayer dollars, which are not correlated with risk. Although challenges exist in how these reserves are structured and monitored, they are common throughout the world for various catastrophic policies.

Workers' Compensation and Group Life Insurance

There are two major types of insurance that cause insurers special concern about whether they can continue to underwrite them without some form of partnership with the federal government. The concentration of risk involved in both lines is significant and can not be addressed solely by the private market. The first such line is workers' compensation, which is a property/casualty product that provides coverage for work-related injuries, illness, and death. It covers lost wages, provides unlimited medical benefits and, in most states, provides rehabilitation benefits to get injured workers back on the job. In the event of death on the job, workers' compensation provides monetary death benefits to the surviving spouse and children. It also provides employers with liability coverage if an employee pursues legal action against an employer. Workers' compensation currently is included under TRIEA.

State laws do not allow an insurer to exclude or limit workers' compensation coverage, except as permitted by state law, so acts of terrorism are required to be covered regardless of the presence of a federal backstop. As a result, an insurer underwriting this risk without adequate reinsurance is subject to a large potential loss if there are a significant number of employees at a single location. The American Academy of Actuaries estimates that "a modest-sized insured with 200 employees could easily generate a terrorism related event of $50 million. This presumes death of all employees and typical death benefit of $250,000 per employee.[1] The absence of a federal backstop program could cause significant instability to the workers' compensation market with respect to terrorism losses.

---

[1] American Academy of Actuaries, P/C Extreme Events Committee May 4, 2004 Report, P/C Terrorism Coverage: Where Do We Go Post-Terrorism Risk Insurance Act?, Page 14.

The second type of coverage causing insurers special concern is group life insurance, which is not currently included in the federal backstop. Like workers' compensation, this insurance coverage is vulnerable to risk concentration problems. For example, if a business has 1,000 employees at a given location, the pricing employed by life insurers for group products probably assumes that three or four employees might die in a given year. If instead, a location with 1,000 employees is hit by a terror attack and all of them die, the insurer has an enormous financial exposure from a single occurrence.

Unlike workers' compensation, there is no statutory requirement for group life that prohibits an insurer from limiting available coverage for acts of terrorism in some fashion. However, insurance regulators are not inclined to approve exclusionary or limiting language in those states that have approval authority over the wording in group life insurance contracts. Further, employers are reluctant to purchase coverage for their employees that contains such exclusionary language. Although there is some level of private reinsurance available for group life coverage, it is not sufficient to cover catastrophic terrorism losses. Given the potential solvency threat that a major act of terrorism could present to group life insurers, the NAIC adopted a resolution in June 2005 urging Congress to include group life coverage in any federal backstop program.

Insuring Nuclear, Biological, Chemical, and Radiological (NBCR) Events

In 1995, domestic terrorists in Japan orchestrated a sarin nerve gas attack in the Tokyo subway system that killed twelve people, injured nearly one thousand, and caused massive disruptions. This was the work of just ten men with only a few liters of sarin gas. Our country has thankfully avoided a massive NBCR terrorism event, but we would be naïve to assume that such an event is beyond the realm of possibility. Indeed, this body knows all too well the reality of biological attacks. Just weeks after the events of September 11, two Senate offices and several media outlets were contaminated by anthrax-laced letters that resulted in five fatalities and seventeen people becoming ill. These events were relatively small in scale and complexity, and as noted previously in this testimony, a large-scale NBCR event in a densely populated urban area like Manhattan could result in insured losses of $778 billion.

In September 2006, the U.S. Government Accountability Office (GAO) released a report concluding that NBCR risk does not match the principles of insurability, and there is little appetite in the private market to insure it even with the presence of a federal backstop. Private insurers currently structure their policies to exclude NBCR events, except where coverage is expressly required under state law, such as with workers' compensation coverage. However, the potentially catastrophic nature of NBCR risk poses a serious threat to policyholders and the economy and we must consider how to finance the losses from such events. We encourage you to consider inclusion of NBCR events resulting from acts of terror in any federal backstop. The inclusion of NBCR should be structured in such a way to leverage the private market's ability to issue policies and settle claims while recognizing their difficulty in overcoming the challenge of insurability. The threshold of retention for NBCR risk should be much lower than for other risks but set at such a level to create a financial responsibility on the part of the private market so that they have a vested interest in that aspect of coverage.

Responsibility of Policyholders and Insurers

Some have argued that federal involvement in terrorism insurance has stymied the development of private market solutions and personal responsibility on the part of commercial policyholders. State insurance officials see little evidence to support this conclusion. To the contrary, the evidence demonstrates that policyholders have invested heavily in strengthening their disaster preparedness and response efforts in the wake of the September 11 terrorist attacks notwithstanding the existence of a federal backstop.

For example, since September 11, many large commercial and many multi-family residential buildings in urban cities and elsewhere regularly subject entrants to security checks before permitting entry. Sensitive locations may even require visitors to submit to background checks prior to entry. Structural design also has changed substantially in response to the terrorist threat not the least of which is the ubiquitous use of barriers to thwart vehicle-borne explosive devices.

Although risk mitigation and loss control efforts are important tools to reduce exposure, the sad fact is that such measures can do little to avoid the catastrophic consequences of a successful large-scale terrorist attack. Policyholders can take steps to reduce their exposure and potentially minimize individual losses, but the insurance industry so far has been at a loss to develop an effective mechanism to apply the principles of insurance to the truly catastrophic nature of a potential terrorist attack. The country has taken such steps to improve airport and aircraft security and to harden many of our commercial enterprises and government facilities, but we still remain vulnerable to a terrorist attack with a potential magnitude that dwarfs the insurance industry's capacity to respond. The steps taken to mitigate losses also may result in counter measures by terrorists that could lead to attacks on buildings or infrastructure that we might not have previously considered targets. This inescapable reality demonstrates the need for a federal backstop to help deal with potential losses of this magnitude. Clearly, loss control must be a part of any long-term solution in the private sector to manage terrorism exposures, but such mitigation techniques do not address the issue of financing the catastrophic losses should they occur. No amount of mitigation can result in foolproof guarantees that losses will not occur. Terrorism coverage in today's world is an integral part of any businesses' risk management efforts. Without a federal backstop we could face market disruptions, and terrorism insurance likely will become less affordable or even unavailable to consumers.

Conclusion

State insurance officials strongly urge Congressional action to ensure a sustained and stable marketplace for terrorism insurance by providing a federal backstop program. Such a program should cover foreign and domestic events, expand coverage to group life insurance, and provide a mechanism to leverage the private market strengths in covering NBCR risks. Terrorism insurance is crucial to a healthy American economy, and in the absence of private market capacity, federal involvement is essential.

The NAIC stands ready to assist Congress in developing an appropriate federal terrorism insurance program. Thank you for inviting me to testify and for considering the views of state insurance regulators as you move forward on this crucial issue.