TESTIMONY

OF

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EXAMINING THE TERRORISM RISK INSURANCE PROGRAM

BEFORE

SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

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My name is Jamie Veghte and I am Executive Vice President and Chief Executive Officer of Reinsurance General Operations and Chief Executive Officer of XL Reinsurance America. I am testifying on behalf of the Reinsurance Association of America (RAA), which represents the U.S. property and casualty reinsurance industry. XL Re is a global reinsurance company that unites XL Capital Ltd.'s global reinsurance companies under a single banner, including XL Re America, based in Stamford Connecticut, XL Re Ltd, XL Re Europe Limited, and XL Re Latin America Ltd. XL Re is ranked among the 10 largest reinsurers worldwide. Our clients include most of the world's 500 leading insurance companies. XL Re is proud to have provided reinsurance protection to our clients in response to many of the catastrophic events that have occurred in the United States and around the world.

Before I begin my testimony, I want to thank Chairman Dodd and the members of this Committee for the leadership shown on the terrorism insurance issue. Your leadership has been instrumental to the adoption and continuation of the successful, and necessary, TRIEA program. The reinsurance industry commends you for the hard work and tremendous support you have provided on this most important issue.

Reinsurance is commonly referred to as insurance for insurance companies. Reinsurance plays a critical role in maintaining the financial health of the insurance marketplace and ensuring the availability of property and casualty insurance for U.S. citizens. Reinsurance can be used by insurers for several reasons. One of the most important purposes is to protect insurers from catastrophic losses from various perils, including hurricanes, earthquakes, fire and floods. To that end, reinsurers have financially responded to every major U.S. catastrophe for more than a century. In this context, it is important to note that two-thirds of the insured losses from the September 11 terrorist attack were absorbed by the reinsurance industry.

XL Re and the RAA strongly supported the adoption of the Terrorism Risk Insurance Act (TRIA) in 2002 and the Extension Act (TRIEA) in 2005. We believe the program is necessary and working well to: 1) fill a vacuum in reinsurance capacity for acts of terrorism; 2) keep premiums paid by policyholders at affordable levels; 3) provide insurance coverage to support economic activity; and 4) minimize the need for disaster assistance should there be future terrorist acts in the U.S. Today, my comments are intended to provide the Committee with a better understanding of the status of the current private reinsurance market for terrorism risk and explain why the reinsurance industry strongly believes that a public-private partnership is necessary to help stabilize the commercial insurance markets that fortify our free-market economy.

The Need for a TRIA/TRIEA Program

As you are very well aware, TRIA was enacted in response to the tragic events of September 11, 2001. In the history of our nation, no hurricane, earthquake or other catastrophic event so fundamentally changed the American landscape and the insurance and reinsurance industries.

These attacks forced all Americans to confront the previously unforeseen realities associated with a catastrophic terrorist attack on U.S. soil. Although the insurance and reinsurance industry responded unwaveringly to the catastrophic losses of September 11, the events shook the financial foundation of the industry and forever changed the way it views this risk. The simple fact is that the U.S. insurance and reinsurance industry cannot underwrite or model the scale, size or frequency of future terrorist attacks in our nation. The insurance and reinsurance industry cannot provide significant terrorism coverage, especially nuclear, radiological, biological and chemical (NRBC) risks, without TRIEA's public-private partnership.

Will this change in the future? If terrorism risk lessens in the world, the need for a public-private backstop should also moderate. But absent the lessening of the risk of terrorism, the RAA does not see a time in the foreseeable future when the frequency or severity of terrorism risk can be successfully modeled and underwritten.

TRIA was created to provide a federal backstop which was essential to allowing the primary insurance industry to provide terrorism coverage to our nation's businesses. XL Re and the RAA believe that TRIA/TRIEA has fulfilled its purpose of allowing primary insurers to provide terrorism insurance coverage to commercial policyholders in both urban and rural areas. By limiting insurers' exposure to catastrophic terrorism losses, TRIEA has improved the market for such coverage and has had a stabilizing influence on the economy.

Private Reinsurers Still Face Significant Hurdles in Underwriting Terrorism Risk

Following the terrorist acts of 2001, insurers and reinsurers have worked hard to develop a better understanding of terrorism risk. Companies have consulted military and intelligence experts, hired specialty risk modeling firms, and invested in new research and development.

Despite these considerable efforts, the basic facts have not changed: terrorism risk poses great challenges as an insurable risk. A key struggle in the development of a private market is that terrorism risk is not conventional. The Federal government, in fact, is telling us that we are at war on terrorism. War, by its nature, is not insurable.

Terrorism risk also has characteristics regarding frequency, severity and correlation that make it unlike any other insured peril or risk:

Frequency

1. The frequency of loss is unpredictable, with little historical track record to project future loss experience. In addition, the insurance industry does not have access to all existing information about terrorism, targets and potential attacks due to national security interests.
2. Terrorists learn from their attacks and thus will attempt to defeat loss prevention and mitigation methods used by policyholders, insurers and reinsurers. This also suggests that history will never be a reliable predictor of future terrorism losses.

Severity

1. Terrorist acts are willful and intended to inflict maximum damage. They are not random or fortuitous acts.

2. The potential size of loss is enormous, with total destruction of multiple insured properties likely. The introduction of nuclear, biological, chemical and radiological weapons can greatly magnify losses to property and life. As an example, the American Academy of Actuaries has modeled potential insured losses totaling $778 billion stemming from an NRBC event in New York City. These extreme loss scenarios would cause losses that far outstrip insurer financial resources and therefore are uninsurable.

Correlation

1. The potential size of loss is compounded by the aggregation of losses arising from multiple clients and multiple insurance products implicated in the same occurrence.

2. Unlike natural disaster risk, reinsurers achieve virtually no spread of risk with terrorism coverage. Hurricanes in Japan and Florida and earthquakes in the far west are not correlated. Premiums can be collected from each risk knowing that one loss will not lead to another. Terrorism risk in Europe and North America, however, may be highly correlated and thus minimize any benefit of risk spreading geographically.
3. At the same time, terrorism events can lead to major disruptions in the financial markets. In the event of a large loss, reinsurers may be liquidating assets to pay claims. The asset values themselves may be under market pressure due to investors' concerns over the terrorist attack.

Reinsurance company underwriters must consider all of these factors and more when deciding whether to assume terrorism risk. The result has been the development of a very limited market for terrorism reinsurance.

Private Reinsurers' Function under the TRIEA Program

In the event of a certified terrorist attack, TRIEA will provide reinsurance-like protection for primary commercial insurance exposures. For 2007, 90 percent of the commercial terror loss for primary insurance companies is covered up to an industry total of $100 billion. This coverage is subject to an individual company retention of 20 percent of 2006 direct earned premium on commercial lines. These individual company retentions, and the 10 percent co-pay for losses above the retention, require commercial insurance companies to absorb significant losses before TRIEA funding is available. The primary industry is under increasing financial risk and exposure to acts of terrorism because of: (1) the significant and rising retentions under TRIEA; (2) the mandatory offer of coverage required of insurers under the program; (3) state regulatory action or refusal to act on rates and exclusions; and (4) the scrutiny of independent rating agencies. In certain instances under TRIEA, some insurance companies will have to absorb losses greater than those losses sustained during the terrorist attacks of 2001 before federal funding is provided.

Primary insurers seek private reinsurance to help reduce the large gap in terror exposure they face from the company retention and the loss-sharing provisions under TRIEA. Private reinsurance is sought to "buy down" the primary company retentions under the Act. The industry retention under TRIEA, estimated at $35 billion, leaves plenty of room for the private reinsurance market to provide capacity. Yet, five years into the program the reinsurance market has provided only $6 - $8 billion of this retention. Observations by some that TRIEA may be infringing on the development of a private reinsurance marketplace are without basis. In fact, the opposite is true. TRIEA has established definitive loss parameters that provide reinsurers with a defined layer in which to share the retained risk of loss that primary companies face under the program.

Market Observations on Reinsurance Terrorism Capacity

Working with client companies to manage their substantial retained exposure under TRIEA, reinsurers have been willing to put limited capital at risk to manage terrorism-related losses. Reinsurers typically seek to offer terrorism coverage in a stand-alone contract, rather than within a traditional all perils catastrophe contract, especially for insurer clients writing a national portfolio. Some regional carriers, with exposures limited to rural or suburban areas, have secured terrorism coverage within their standard reinsurance programs, usually with some limitations as to the nature of the subject risk or size of subject event.

The RAA surveyed reinsurance brokers and reinsurance underwriters to estimate how much terrorism reinsurance capacity is written in the private reinsurance market. This coverage generally includes TRIEA "covered acts" as well as domestic terrorism and personal lines exposure where requested. The most recent RAA survey of market participants estimates the global reinsurance capacity available in 2007 for risks located in the United States is about $6 to $8 billion for TRIEA certified, stand-alone and treaty reinsurance. Favorable loss experience and surplus growth may moderately increase the supply of private terrorism reinsurance but not to the extent that it would fill current capacity needs of the primary industry to meet its retentions under TRIEA.

Regarding losses from nuclear, radiological, biological, and chemical events (NRBC) generally, there is very little reinsurance appetite for this risk. According to the RAA, knowledgeable market participants believe NRBC capacity to be 15 to 20 percent of non-NRBC capacity for terrorism risk. And when it is available, pricing for coverage that includes NRBC is at a significant premium and coverage amounts are restricted. With regard to workers' compensation, some insurers have been able to add the terrorism peril to their reinsurance programs, but this coverage typically excludes NRBC events.

XL Re and the RAA believe that in the foreseeable future, reinsurers will be unable to provide enough capacity to replace TRIEA coverage. Although progress has been made in modeling terrorism loss scenarios, forecasts of the frequency and the severity of terrorism losses are extremely problematic. Reinsurers can provide only limited capacity for terrorism because the magnitude of these potential losses would otherwise put these companies at risk of insolvency. Reinsurers' capital is necessary to support many other outstanding underwriting commitments made by reinsurers, including natural disasters, workers' compensation and other casualty coverages.

Capital Markets' Limited Impact On Terrorism Risk Capacity

A key question asked by many policymakers is what role the capital markets can play in assuming terrorism insurance risk through the use of catastrophe bonds. Catastrophe bonds have been used by the financial markets to absorb and spread natural hazards risk. Indeed, reinsurance companies are one of the most frequent users and facilitators of catastrophe bonds. Hurricane and other natural disaster "cat" bonds have grown in use. According to the data from Benfield Group Ltd., natural catastrophe bond issuance in 2005 included more than 10 transactions totaling $2.4 billion in capacity. Since Hurricane Katrina, another $4.5 billion in capital has been dedicated to natural catastrophe bonds. Since the Fall of 2005 the total amount of additional capital raised for new reinsurance startups and capital replenishment of existing reinsurance is more than $32 billion. Yet, none of this new capital has been dedicated to terrorism risk. The capital markets lack any real appetite for terrorism risk. Although a few new companies have expressed an interest in providing terrorism insurance, their capacity is limited and market presence untested.

Acts of terrorism present much greater underwriting and pricing challenges than natural catastrophe risk to the insurance and reinsurance industry and, of course, to those issuing and investing in catastrophe bonds. There is no reason to believe terrorism bonds are likely to be a significant provider of terrorism coverage in the foreseeable future. The capital markets face the same problems as insurers: inability to assess frequency of attack; a lack of predictive experience; correlation of loss to other exposures such as a stock market decline; and potentially devastating financial loss. In addition, rating agencies have to-date been unwilling to rate terrorism-only bonds.

A Continued Public-Private Partnership Is Necessary to Address Terrorism Risk

Due to the nature of the terrorism peril, the RAA believes that private market mechanisms alone are insufficient at this time to spread the risk of catastrophic terrorism loss in a meaningful way. Without some form of a federal role we would expect less coverage available at the policyholder level, rising prices for terrorism cover and even more limited private reinsurance capacity.

XL Re and the RAA continue to work with industry and policymakers to determine the most effective federal program. Key to these ongoing discussions is the participation and consensus from the policyholder community. XL Re will continue to work with our clients on the most effective and efficient program design. We welcome the opportunity to work with this Committee, the Congress at large, the Administration and all private sector stakeholders to craft a public-private partnership to address this most important national issue.

Thank you for the opportunity to provide testimony on this important issue.