S. HRG. 109–566

THE TERRORISM RISK INSURANCE PROGRAM

HEARING

BEFORE THE

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

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

THE IMPLEMENTATION OF THE TERRORISM RISK INSURANCE PROGRAM, FOCUSING ON THE ROLE OF THE FEDERAL GOVERNMENT IN ENSURING THAT INSURANCE TO PROTECT AGAINST LOSSES FROM ACTS OF TERRORISM REMAINS AVAILABLE TO AMERICANS

APRIL 14, 2005

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C O N T E N T S

THURSDAY, APRIL 14, 2005

WITNESSES

THE TERRORISM RISK INSURANCE PROGRAM

THURSDAY, APRIL 14, 2005

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The Committee met at 10:04 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

I want to thank our witnesses for appearing, especially since this hearing had to be rescheduled from an earlier date last month.

Today, as everyone knows, we are here to discuss the Terrorism Risk Insurance Program, or TRIA, which was enacted in the aftermath of September 11. The stated purpose of this law, and I will quote, was to "establish a temporary"—I am going to say it again—"temporary" Federal program that provides for a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism.

Now, as we are gathered here 2½ years later, the program's scheduled termination date draws near us. I think we are at a point where we can determine what, if anything, more is required of this so-called temporary program. To make this determination, I think we need to look at both the past and the future. We need to understand where things stood in the insurance markets at the commencement of the program and where they stand today and in what direction they are headed.

Some of you will recall I did not vote for the TRIA program initially since I prefer market solutions to Government intervention. Nevertheless, I intend to approach this debate with a critical but, I hope, open mind.

Should we determine that the insurance markets are now over the initial shocks of 9/11, I think it would be best to dismantle the Federal backstop. But if we see that insurance markets are improving or still recovering but that they still lack the necessary capacity to provide coverage, I think more action may be required on our part. That begs the question of what form such action would take. If there is need for Government intervention in the markets, our priority must be to develop a program that protects taxpayers and the economy while helping to restore the efficient function of private markets.

I look forward to exploring these matters with the witnesses today. I think we have a distinguished panel. I also look forward

to receiving more detailed information that is, as you know, coming from the Department of the Treasury in the near future. I appreciate all of you being here today, and I will introduce the witnesses later.

Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Mr. Chairman, thank you very much for holding this hearing, and I look forward to working with you and Senators Sarbanes, Dodd, Bennett, Hagel, and others as we review the Terrorism Risk Insurance Act legislation this year to ensure that a Federal terrorism insurance backstop remains in place.

After 9/11, we enacted a number of measures to enhance or stabilize the security of our citizens and our economy, including the Terrorism Risk Insurance Act. TRIA provided a high-level Federal backstop that allowed private insurance and reinsurance markets to return and American businesses to overcome the shock of September 11. TRIA seems to have performed exactly as we intended, but as we all know, the program expires at the end of the year.

I am getting concerned that we are fast approaching a point where we need to take action. We cannot allow this program to expire without at least a short-term extension or place a longer-term solution on the legislative rolls—but as we consider whether or not to extend TRIA, we should look closer at the two main goals that we tried to accomplish with the law. First, as I just noted, we wanted to make sure that the markets and the economy functioned in the wake of 9/11 and in the face of the continuing threat of terrorism. The second important reason for this legislation was that many of us felt that we needed to have a policy in place to allow the economy to rebound more quickly in the unfortunate event of another terrorist attack here in the United States. Fortunately, and through the effort of many, many people, we have not seen such an attack, but we all understand there are ruthless and very clever people who are still at large planning such attacks.

Some opponents of an extension argue that TRIA should be a temporary program because by ending it, private terrorism insurance markets would be forced to stabilize and provide adequate capacity to meet the demand for coverage. Even if this had occurred—which it has not—they would ignore the second goal of the act. As policyholders and insurers look to enter agreements for the next several years, they are facing a very uncertain future. It is important to remember that we still live under a threat of attack. As a member of the Armed Services Committee, every day we review information that I will say gives us the distinct impression, again, that we are still at risk.

As you may also know, the Treasury Department is required to report to Congress by June 30 on issues associated with the act and its purposes. While I look forward to the conclusions of the Department's study, it will have little, if anything, to do with the second aim of the law, namely, having a policy in place in the event that there is another terrorist attack in America. It is this reason that most compels me to believe that we need to continue a Federal Terrorism Insurance Program.

I have joined Senator Dodd and Senator Bennett to introduce the extension bill, S. 467, and I am an original cosponsor, and I look forward to working with them.

In addition to extending TRIA to 2007, this legislation would establish a Presidential working group on financial markets to submit a report to Congress containing recommendations to address the long-term availability and affordability of terrorism risk insurance. So far the administration has been silent on TRIA. I believe it is essential that the administration lead rather than follow the process. I would encourage them to get actively involved in extending TRIA.

Furthermore, vacancies in key administrative personnel have led to a vacuum in leadership and communication needed for good policymaking, and I urge the administration to fill those positions.

I believe extending TRIA is exactly the right thing to do, and thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I look forward to the witnesses' testimony this morning.

Chairman SHELBY. Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman. I am going to take a minute or so, if I can.

Chairman SHELBY. Go ahead.

Senator DODD. I apologize for walking in a couple minutes late, but I have a slight passing interest in the subject matter.

Let me first of all thank you, Mr. Chairman, and thank Senator Sarbanes as well for your efforts in holding a hearing this morning, and thank our witnesses in advance for their willingness to be here and shed some light on this subject matter.

I recall that we spent quite a bit of time and effort 3 years ago to adopt the original piece of legislation creating terrorism risk insurance. And while we did not agree on everything, I believe that we managed to create a product that has been very successful over the past 3 years and did what we thought it would do.

I would like to, of course, welcome all of our witnesses here this morning and thank them for their thoughts. Most of the witnesses are likely aware that Senator Bennett and I as well as a majority of this Committee, including Senators Schumer, Hagel, Reed, Bunning, Bayh, Dole, Carper, Stabenow, and Corzine have introduced legislation to extend terrorism risk insurance for an additional 2 years. As a result, I would urge all of our witnesses who support our legislation to speak for as long as you would like this morning in your opening statements.

[Laughter.]

Senator DODD. As long as it is not over 5 minutes.

Senator DODD. In all seriousness, I would like to thank all of you for your testimony today. With the expiration of TRIA in December of this year, your input is especially important. And obviously waiting until December is what many of us worry about because of the

time that is necessary to gear up for this if we are going to get the job done.

In November of 2002, the Terrorism Risk Insurance Act passed both the House and the Senate by overwhelming margins and was signed into law by President Bush, as most will recall. Enacting TRIA was not an easy undertaking for those of you who went through this. Our Nation and this Congress faced a new reality that terrorism could occur on American soil. The September 11 tragedy resulted in disbelief, devastation, and economic dislocation. Previously, an attack on our country seemed unimaginable. Few believed any significant major terrorist attack would occur, no less than one horrific and devastating event as the one that occurred on 9/11.

As a Nation, we were forced to quickly face the tremendous loss of life and physical damage of that tragic event. And for the most part, we were able to quickly recover with the combined protection provided by insurance and from assistance from the Federal Government. However, understanding the more mundane long-term economic impacts of the terrorist attacks took us a lot longer.

We eventually came to the realization that our current domestic insurance marketplace was unable or would be unable to sustain a second terrorist attack of that magnitude, and that only with the backing of the Federal Government could we protect our Nation from future acts of terrorism and the economic impacts. And while recognizing that the Federal Government needed to play a role to ensure economic stability, the exact extent and nature of that role was not easily decided upon. But we did persevere. We negotiated and had a very frank exchange of views over numerous months, as the Chairman will recall. In the end, even though it was a time of laborious and difficult process, we produced a bipartisan bill that garnered 86 votes in this body and the strong support in the other body as well.

September 11 changed everything, most visibly, of course, National homeland security policy. But September 11 also fundamentally changed the way insurers look at terrorism risks, which suddenly started to resemble acts of war. As a result, after 9/11, the insurance market for terrorism nearly completely dried up. Coverage was unavailable. Many financial transactions were unable to proceed, and construction workers and other hard-working Americans suddenly found themselves economic victims of terrorism.

In short, we wrote TRIA for a very simple reason. Hundreds of thousands of American jobs and billions of dollars of business investment hung in the balance. TRIA was created as a 3-year Federal program to help make sure the part of the commercial insurance marketplace disrupted by 9/11 could work again. Most Americans do not even know that TRIA provides a crucial economic safety net for virtually every sector of our economy. Transportation, real estate, utilities, construction, travel, tourism, and financial institutions are just a few of the sectors that need TRIA to protect them against economic devastation that could come as a result of a terrorist attack.

Under TRIA, the Government shoulders a share of the financial risk of future attacks. This makes sense. These attacks are against us as Americans, against our democracy, our way of life, and even

our economic institutions. But TRIA also required insurers to offer terrorism coverage on commercial policies. In addition, insurance companies would have to bear an escalating financial burden in future years.

Mr. Chairman, TRIA is working, as I said at the outset. This public-private shared loss mechanism is making terrorism insurance available to all businesses at reasonable costs. Under TRIA, in the event of another terrorist attacks, private insurers will still shoulder tens of billions of dollars of terrorism-related risk. What TRIA does is act as a backstop to the private commercial property casualty insurance system. It gives the markets some certainty by establishing by law a limit to insured terrorism losses for the insurance industry and the Federal Government.

Acting Assistant Secretary Greg Zerzan from the Treasury Department recently stated, and I quote him, "By most indications, TRIA has been successful in achieving the fundamental goal of enhancing the availability and affordability of commercial property and casualty terrorism risk insurance, particularly for economic development purposes."

The Mortgage Bankers Association recently surveyed its 40 largest commercial, multifamily mortgage banking firms. A substantial majority, Mr. Chairman, of them believe that TRIA has made terrorism insurance both more available and less expensive. But the mortgage bankers also noted that failure to extend TRIA could hurt the commercial real estate market. If we let TRIA expire, we will see, I think, the same uncertain environment we saw before TRIA was enacted.

Former CEA Chairman Glenn Hubbard concluded in a recent economic impact study that letting TRIA expire would increase the overall cost to the Nation. Mr. Hubbard estimates that allowing TRIA to expire would result in a lower economic performance and greater economic disruption to the U.S. economy in the event of a terrorism attack. He concluded that if TRIA expires, even absent another attack, hundreds of thousands of jobs are at risk and tens of billions of dollars in economic development are in jeopardy. If we let TRIA expire, many business consumers will be unable to get the coverage they need. That can only hurt our economy, and I am sure and confident that all of the Members of this Committee share the goal of a growing economy.

Senator Bennett and I and other colleagues propose a 2-year extension of TRIA that will help avoid destabilizing the insurance market and in turn the National economy. In addition to temporarily extending the program, the legislation mandates that the President's working group on financial markets develop recommendations to address long-term solutions to managing terrorism exposure. It will give Congress, insurance, business, and Government officials time to gather all available relevant data. Collecting that data without fear of market disruption I think would help us develop a more permanent solution for managing our Nation's economic exposure to catastrophic terrorism.

TRIA, Mr. Chairman, has a history of bipartisan support, and I am extremely pleased to say that the robust support on both sides of this Committee panel still exists as we consider an extension of this program. It is my strong hope that we find a solution to this

problem in a bipartisan fashion. Protecting our Nation from terrorist attacks is neither a Democratic nor Republican issue. It is truly and fundamentally an American one.

Again, I thank you, Mr. Chairman, for letting me go on a little longer here in an opening statement, but having been the co-author of the original piece of legislation and the author of this one with Senator Bennett, I think it is important to lay out here. Again, I would like the idea of a more permanent bill, but I think we need to be realistic about where we are, and the idea of developing the data and establishing the basis and foundation for that I think are critically important. We have a chance to do it with a limited bill here, with a goal in mind, I would say very candidly to my colleagues here, of establishing a more permanent program down the road, knowing how valuable this is going to be, I think, in the 21st century for our economy.

I thank you for listening.

Chairman SHELBY. Senator Martinez.

STATMENT OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Chairman, I would look forward to listening to the panel discussion, and I have no opening statement. Thank you.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman, and I appreciate your calling this hearing in a timely way.

I rise in support of this legislation. It is extremely important to my city. We were very involved, our whole government structure in New York were very involved last time and intend to be now. And I hope we can move this rather quickly. I am going to make a few points.

First, I do hope we move it quickly. Last year, we had many delays, and it cost us a great deal of economic activity, particularly in the larger cities of the country, even though we knew that when you came right up to it and looked into the abyss, you had to do terrorism insurance. The alternatives are worse, much worse than they have been.

What are the two alternatives? One is that there will be no terrorism insurance, that the private market will not fill the gap. That on itself will prevent tens of billions of dollars of projects and hundreds of billions of dollars of economic activity from occurring.

The second is that the market will fill the gap, but only at such exorbitant prices and only in unique situations that virtually the same thing would happen: large numbers of projects would not go forward. So we should do it.

Those who say, well, maybe the private market now 2 years after a terrorist attack will fill the gap cannot happen, will not happen. Why? First, even though we are a few years from the horrible day of 9/11, it is on people's minds all the time. Not just on my mind as a member of New York City, or the Members of this Committee's minds as Senators, or all of your minds. It is on the rating agencies' minds. The rating agencies have said that come December 31, if there is no terrorism insurance, they are not going to be able

to give any kind of decent rating to any insurance offer. So things are gone.

These guys are insurers. They look for risk. They live with risk. They wake up in the morning with risk and go to bed at night with risk. So even if we can say, well, it is a few years away and the markets will settle down, that is not what rating agencies do. That is not what insurers do. And we will be back where we were before.

My first point is we have to do this. We have no choice, and we will do it.

The second question is when. Well, we can wait and delay and do it at the last minute. But we all know that major building projects take long planning, and very soon if we do not renew this, lots of projects are going to be delayed, not undertaken, postponed, and, again, we will suffer a significant economic loss.

You cannot call up your insurance company and say, Hey, I want to make sure that, you know, on December 31 you say write me a policy January 1. It will not happen. Right now, there are projects—I know; I speak to developers from all across the country—that are being planned, and they are not happening until we know what happens with terrorism insurance. So to wait, as we did 2 years ago until—I do not remember when it was, November, December—is going to cause us damage. We are going to do it. We should do it. Let's do it now.

And, third, I would make a pitch that we do this permanently. Why are we going to come back and do this every 2 years? Why are we going to disrupt the markets every 2 years? We need this.

In Europe, an American company building in Europe, we provide them terrorism insurance under OPIC, right now. Why is it if you build a building overseas we are doing it but not here? Point number one.

And point number two, we have had 3½ years since 9/11. Here is what Alan Greenspan said to a House committee a few weeks ago: "I have yet to be convinced that the terrorism insurance market can be made to work." If it is not going to work 3½ years after 9/11, it is not going to work 5½ years after 9/11.

Let's make it permanent or at least do it for a much longer period of time so that people can plan, that we do not come back, that every 6 months out of every 2-year cycle we get a halt in building, in construction, in planning, and the growth we all love about America.

I hope we will pass this and pass it quickly. I also hope we will do it for a longer period of time than the 2 years in the very fine bill that my colleagues from Connecticut and Utah have introduced.

One other note, Mr. Chairman. I want to welcome all of our witnesses, a good number of New Yorkers, but particularly Mr. Mills, the Insurance Commissioner of New York State, and somebody who was my worthy opponent in the November 2004 election. He did such a good job running against me, he is now seated at this table as Insurance Commissioner for New York State.

Chairman SHELBY. At least you are in the same room.

[Laughter.]

Chairman SHELBY. Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

I appreciate all of the witnesses being here today. For me, the most important question actually is not whether or not we pass legislation. That is an important question, and one we are going to have to deal with. But for me, the really important question is if we do decide to pass legislation, if we do, how do we do it? Do we do it right? Structuring this kind of a subsidy is important because we want to get the incentive structure—to the extent that we leave one behind, we want to get it right. This is a subsidy. This is a program that shifts risks from property owners to taxpayers. But for a lot of reasons, many people think this is important. People talked about the economic impacts and the environment, the investment environment, and the emotional everyone after September 11. So for a lot of reasons, we felt it was important to do at the time.

As we look at renewing it, I think it is important to ask the questions about if we pass legislation, how do we structure the legislation? And there are a lot of things we need to discuss, we need to better understand: the structure of the deductibles, the Federal cost share. We are at a 90-percent Federal share, up to $100 billion. Is that the right number? Should the private sector cost burden be greater? Should the deductibles be structured different? CBO raises questions about cost-based premiums, and is there a way to create better incentives for adding cost-based premiums into the system? And in a world where, I think as a few people have pointed out, price regulation is often the norm, how do you create good incentives? How do you take advantage of the incentives that the marketplace can potentially provide in the insurance market?

All of these things are important, and I think—I believe most of the Members of the Committee would recognize their importance in considering when we deal with this legislation, and I hope that the panelists will try to address these points as well. I am sure many on the panel are going to say from their perspective for good reason we think this is an important program and we should continue to have this program. But, again, more important in my mind is that you provide the Committee with substantive arguments for how we structure the program and raise concerns if you think that there are weaknesses in the programs that take us in the wrong direction, because I would hope that most of you, you know, are involved in industry, business and industry, and the regulation of that industry, competitive industries. You want industry to be healthy and to be competitive, and that means—I think it means in the long run minimizing the subsidy and allowing markets to do what they do well.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Sununu, for your incisive observations.

Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman, and I welcome the fact that you are holding this hearing. This is an issue that I think is one that needs to be addressed if we are to continue to see a relatively healthy economy. I think this is actually a very important

platform for making sure that occurs. I cannot disagree that we need to review a lot of the variables, some of us might even have different philosophical views about how we might approach this. But I must say that given how things move, this extension seemed to be a good idea until we dealt with some of those fundamental questions and I think how much of the risk is borne by Government in a world where we continue to be told that we are at risk.

I also want to compliment Senator Dodd for his leadership on this. This was not an easy product to put together in the first instance. I think the health of particularly the commercial real estate markets has benefited enormously from the leadership and the actions that are taken by Congress. We can always make things better, and we should examine that, and we should be looking for the long-term solution as opposed to interim solutions if we believe that we have a terrorism threat that will extend beyond some limited time frame. Otherwise, I think you are going to have a hard time seeing the marketplace fill that hole.

I look forward to all of our panelists' comments on both the variables that are involved here, the need to extend this, and the importance.

I have a full statement for the record.

Chairman SHELBY. Your full statement will be made part of the record, without objection.

Chairman SHELBY. Thank you, Senator.

Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I, along with everybody else here, appreciate your attention to this issue. It has been one of the most thorny issues that we have dealt with over the last 5 or 6 years, frankly, following the 9/11 attacks, and even in different contexts, trying to figure out what to do with catastrophic insurance before 9/11.

It seems to me that right now we are faced with—when I came into the hearing, I thought three options, and I heard another fourth option as I came into the hearing. One option is to simply do nothing and let the program expire at the end of 2005, as it is under current law projected to happen. The other would be to temporarily extend the program with no changes or with minor changes. A third would be to work out some kind of a new program involving participation by the Federal Government but a creative and effective solution working with the private sector in trying to build a more permanent but different program than we have right now. And then the fourth one which I heard when I walked in the meeting here was to just permanently extend the program to be done with it now and just have the Federal Government continuing the current role that it has assumed following 9/11.

My preference is to modify TRIA and work with the private sector. I have become convinced—I am one of those who believes we should do everything we can to move to a private sector solution to this and not have the Federal Government be the perpetual backstop. However, that is a very difficult proposition to accomplish in the current climate that we have, and I am one who has become

convinced that there is a Federal role here and that we need to find it.

I have had a lot of meetings with a lot of the industry participants over the years, and like I say, even preceding 9/11 as we were dealing with other catastrophic insurance issues that we deal with Nationwide. And these are not easy. And the arguments that are made about the economic implications of not being able to have an effective insurance program in place are real.

By the same token, the suggestion that the Federal Government should just step in and always be the permanent backstop without trying to do everything we can to build an effective solution with the industry participants is also a valid argument. And where I am on this is to continue working with the Committee and with others who are involved in this issue to try to find that permanent solution that we can adopt, but one which I do not believe is going to necessarily be with such a large Federal role as we have today.

Again, as I say, I have met with a lot of industry participants who have told me that we can get there if we have time and if we work together. And I am expecting that we will have good-faith efforts on the part of everybody, on the part of the Members of Congress, and on the part of the members of the industry who can work with us to find that solution that we have all been talking about, but which we haven't yet reached.

And so with that, Mr. Chairman, I am going to be very interested in hearing the testimony of the panel today. Thank you.

Chairman SHELBY. Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you very much, Mr. Chairman. Thank you for holding these hearings. I know your personal position is somewhat different from Senator Dodd's and mine.

Chairman SHELBY. Mine is closer to Sununu's and Crapo's, I think.

Senator BENNETT. All right. But one common factor that we have here is that we have a problem, and insurance companies do not take risks. They analyze risks, they spread risk, they create a circumstance in which risk can be ameliorated. But if they are in a situation where they cannot analyze it and spread it, they do not take it. And you cannot force them to.

The problem with TRIA is that we do not know the size of the risk. We cannot quantify it. We had no basis prior to 9/11 to have any kind of a number as to what it would cost if someone were to hijack an airplane and fly it into a building. That was so foreign to protocol with respect to hijacking. In fact, the instructions for pilots that were hijacked prior to 9/11 were very clear and very firm and part of their training, which was you do whatever the hijackers tells you to do in order to save the lives of your passengers. And, clearly, doing what the hijacker told you to do was following the book, and it cost the lives of the passengers and the pilots themselves, except in those instances where the pilots were simply killed, which is what I understand happened in the airplane that went down in Pennsylvania, when the passengers themselves took over the plane to the point of preventing it continuing on and possibly reaching reaching the Capitol.

That is the dilemma we have here. We do not know the size of the risk, and in that era of uncertainty, economic activity does not take place. Markets can handle up and markets can handle down, but markets cannot handle uncertainty. And it is not just an insurance company problem. It is the economy's problem. And if we cannot build some of the major capital assets that we need in our economy because no one will quantify the risks involved in case those centers become targets of terrorism, the economy as a whole is paying a price. If it turns out to pay the price in the form of a recession, the Federal Government pays a price because the greatest threat to Federal revenue is a recession. It is not tax cuts because tax rates assume there is some income to be taxed. And if a recession comes along, it does not matter what the rate is. If there is no income, there is no revenue.

I feel this is a significant economic challenge that we have to deal with, and we have dealt with it thus far by removing a degree of the uncertainty from the equation by virtue of having a Federal guarantee.

So the question is: What is the appropriate level of that guarantee? What is the nature of the terrorist threat before us? Do we understand it well enough that we can quantify it with some kind of certainty, at which point the insurance companies can then step in? Because once they have some degree of certainty as to how big the risk is, they can figure out a way to spread that risk and offer the appropriate insurance.

I think we are still in a period of sufficient uncertainty that the Federal Government has a role. I think the impact on the economy is significant that the Federal Government has to step up to it. I thank Senator Dodd for crafting a bill that I think is an excellent starting point for this, and I am happy to be a cosponsor of the bill. But I think it is important that we have these hearings and we look for additional alternatives and we be open to additional ideas as we go along.

Again, Mr. Chairman, I am grateful to you for your attention to this, your willingness to hold these hearings, and to our witnesses for their willingness to come share their expertise with us.

Chairman SHELBY. Thank you, Senator Bennett.

I would just note for the record that our colleague Senator Sarbanes is not able to be with us here today. He is attending a funeral in New York, and he wanted me to note that for the record.

I will introduce our panel: Mr. Douglas Holtz–Eakin, Director of the Congressional Budget Office; Honorable Howard Mills, Superintendent, New York State Department of Insurance; Mr. Ernst Csiszar, product and Chief Executive Officer, Property Casualty Insurers Association of America; Mr. J. Robert Hunter, Director of Insurance, Consumer Federation of America; Mr. Brian Duperreault, Chairman, ACE Limited; Mr. Franklin Nutter, President, Reinsurance Association of America; and Mr. Robert Lowe, Chairman of the Board and CEO of Lowe Enterprises.

Gentlemen, welcome to all of you. Your written statements will be made part of the record, and unlike what Senator Dodd told you, you do not have all day.

[Laughter.]

Chairman SHELBY. Try to sum up your testimony in 5 minutes or less. This just gives us a chance to have a dialogue with you.

We will start with you. Bring the microphone up close to you. This is a big room with a lot of people here.

STATEMENT OF DOUGLAS HOLTZ–EAKIN DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Mr. Chairman and Members of the Committee, the Congressional Budget Office thanks you for the invitation to appear today. Over the past several years, we have produced several analyses for the Congress in this area, most recently in January. My remarks today will be a brief summary of the most recent report.

The issue before the Committee and the Congress is whether to extend TRIA, and if extended, whether to modify it. This is obviously something that the Members have faced before, but one of the issues that now arises is whether circumstances have changed in a way that would lead the Congress to make a different decision.

Our report highlights two dimensions along which circumstances appear to be somewhat different. The first and most important consideration is that TRIA is explicitly a temporary program, and a primary consideration in the current environment is the degree to which elevated terrorism risks will be a more permanent feature of the landscape. If so, the more durable the presence of a higher risk, the less a simple extension of a temporary program appears to be merited.

Long-lasting terrorism risk does impose economic costs. Substantially eliminating those risks and those costs are largely the role of defense strategy, international affairs, and homeland security. Financial markets have a role in serving to manage whatever residual risks may remain. They do that in two ways. Financial markets convey important information about the costs of likely risks, aiding to the extent possible any mitigation efforts that might be possible in the economy. They also serve an important role in shifting the financial burden of those risks, when desired, through such strategies as diversification or direct purchase of insurance products. In the presence of a more durable source of risk, thinking about those roles of the private sector is important.

The second difference between now and the original enactment is that the financial insurance markets are in much better shape than they were then. Equity markets have rebounded since NOvember 2002. In bond markets, credit risk spreads have narrowed considerably. And in the property and casualty insurance industry, net worth has risen by roughly a third, and underwriting profitability has returned.

In the presence of TRIA's subsidy, prices for terrorism coverage have fallen and stabilized. They are down from about 10 percent of insurance premiums to about 4 percent. It now costs $50 to $80 to get $1 million of insured coverage. The industry has developed and implemented to some extent improved pricing models that distinguish between more and less risky locations. And roughly 50 percent of firms have voluntarily chosen to purchase insurance as part of their strategy to manage risks, roughly doubling the coverage that was available at the time of enactment.

Reinsurers have not been as active as some had anticipated over this period, but have provided some coverage of billions of dollars for terrorism risks from domestic sources that are not covered by TRIA.

What are the lessons of this experience for decisions going forward? Well, the Nation might adjust more quickly to a high, sustained level of risk if premium reflected the higher expected costs. This could be done by adding cost-based premiums to the TRIA program, as was mentioned by Senator Sununu.

Alternatively, one possibility would be to let the Federal reinsurance program expire and let premiums rise. Letting TRIA end would not increase the overall cost of terrorism. It is important to note that. It would change who bears the ultimate burden of that cost, and to the extent that mitigation of risks is possible, lower costs overall.

If TRIA expired, reinsurers would most likely continue their previous practice of not covering losses from nuclear, biological, chemical, and radiological attacks. And it is important to note that those exclusions would probably impact the workers' compensation market most directly. If insurers are unable to diversify that catastrophic risk—and State regulation would make that difficult—prices for workers' compensation policies could rise substantially, especially in the near term.

In the event that TRIA ended and there was an unexpectedly large terrorist attack, it is quite likely that insurance markets would again be disrupted and coverage would be unavailable for some high-risk properties. However, more generally, if TRIA expired, the availability and price of terrorism risk insurance would depend on several factors, one of which is the degree to which continued innovation in financial markets would produce new types of products, such as mutual insurance pools, and catastrophe bonds, or participation of new entities such as hedge funds in providing insurance capacity to the overall market.

Availability would depend on the willingness of private sector reinsurers to enter and take catastrophic risks. Recent developments are suggestive, but not conclusive, that the private financial markets could shoulder more of this burden.

The Congressional Budget Office is pleased to be here today. I look forward to answering your questions. Thank you.

Chairman SHELBY. Mr. Mills.

STATEMENT OF HOWARD MILLS ACTING SUPERINTENDENT, NEW YORK STATE DEPARTMENT OF INSURANCE

Mr. MILLS. Thank you, Mr. Chairman, Members of the Committee. I would like to note for the record that I also serve as the Chair of the Terrorism Insurance Implementation Working Group of the NAIC, and on behalf of the NAIC, I thank you for the opportunity to testify at this hearing.

Today I would like to make three basic points, Senators:

First, there is still a need for the Federal Government to provide appropriate financial back-up to the private insurance market in order to assure that segments of our Nation's economy do not falter due to a lack of insurance coverage for terrorism. The insurance

marketplace is not yet ready to fully cover acts of terrorism on its own because of capacity issues, as well as extreme difficulty in developing appropriate rates.

Second, Congress should act immediately to extend coverage under the Terrorism Risk Insurance Program or enact a comparable Federal backstop for acts of terrorism, at least through 2007, because the commercial insurance markets are not yet prepared to underwrite sufficient terrorism coverage without a Federal backstop. Further, a comprehensive, long-term plan is being developed but will not be ready in time to prevent market disruptions should TRIA expire.

Third, the CBO January 2005 Paper, "Federal Terrorism Reinsurance: An Update," contains some observations and opinions on how markets will react to TRIA that are not borne out by observations of how businesses and insurers have reacted to TRIA.

TRIA has been successful. It has brought stability to a uncertain market for insurance coverage for acts of terrorism. TRIA through its make-available requirements appropriately focuses on the insured's decision to buy coverage rather than on the insurer's decision to sell it. Although the take-up rate for terrorism insurance coverage mandated under TRIA has not been widespread, coverage is currently available for those businesses that want to purchase it and need it the most. TRIA has operated exactly how the Congress intended. Those who needed the coverage purchased it, and those who did not declined, with the decision, again, always being made by the insured.

The presence of the Federal backstop has provided an appropriate mechanism to the insurance industry, enabling insurers to offer coverage for acts of terrorism that otherwise would not have been offered in the wake of the tragic events of September 11.

Now, the Congress should know that insurers have filed contingency endorsements or sunset provisions in many States. In the event that Congress does not extend the TRIA Program this year, insurers will reinstate terrorism coverage limitations that were in effect prior to TRIA's enactment for many policies written for coverage that extends into 2006. Thus, we would be in the same position that we were in just after 9/11 in terms of terrorism coverage.

These filings I believe demonstrate that the insurance industry is not yet willing to assume the full risk of terrorist losses at this time. Congress should be aware that the private sector does not—does not—have unlimited capacity. NAIC data shows that 2003 was a profitable year for property and casualty insurers, with aggregated policyholder surplus increasing approximately 26 percent to $375 billion. It should be noted, however, that policyholder surplus decline each year from 1999 to 2002, and that $375 billion figure is only 4.3 percent higher than the $360 billion in policyholder surplus held in 1999. Less than half of those funds—and this is very important. Less than half of those funds are used to support commercial lines of writing.

The CBO study is flawed, with all due respect. It suggests that TRIA weakens incentives for the private sector, for owners of property, et cetera, to increase safety, to take preventative measures. And in New York State, and indeed all over the country, we see little evidence to support this conclusion that TRIA has resulted in

owners failing to take appropriate steps to protect their assets from terrorist attacks.

To the contrary, the evidence demonstrates that owners have invested heavily in security, strengthening disaster preparedness and response efforts in the wake of the 9/11 terrorist attacks, notwithstanding the existence of TRIA. The CBO report suggests that business owners would be asked to bear the lost costs, but you know much better than I that history has shown that Congress will step in after a disaster if asked to do so.

Insurance regulators strongly urge congressional action immediately to extend TRIA or to enact an alternative form of a Federal backstop system this year, immediately, in order to avoid market disruptions. And the market disruptions are inevitable if TRIA is not extended. The lack, the absence of the Federal backstop will cause significant and very harmful market disruptions.

The NAIC stands ready to assist the Congress in any way possible as you grapple with this very difficult issue, and, finally, I would like to state on behalf of the NAIC that we are not urging the extension of TRIA on behalf of the industry. We are urging the extension of TRIA on behalf of the consumers of insurance and on behalf of the health of the American economy.

Thank you.

Chairman SHELBY. Mr. Csiszar.

STATEMENT OF ERNST CSISZAR, PRESIDENT PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA

Mr. CSISZAR. Mr. Chairman, thank you for the opportunity for appearing before you this morning. I think it is important as we look at this to remember that I represent over 1,000 insurance companies in this country. These companies all are engaged in providing economic security to its customers. It is important to remember that economic security does not just revolve around terrorism. Not only is it important to cover terrorism, it is also important to remember that the day after a potential terrorist event, that homeowner's claim, that automobile claim still needs to be paid. We cover churches. We cover football stadiums in Alabama. We cover many different risks.

The problem, the fundamental problem with this is there is nothing more than our members would like to do than to find a thoroughly private, free-marketing, competition-based solution to this. There is nothing more that they would want. The problem with it is that fundamentally a terrorist event is uninsurable. So the only solution that we see is a combination of private and public partnership in which the Government plays its role as backstop and in which private industry plays its part, takes its role in at least contributing to that solution. But ultimately to think that there will be purely a private solution to the terrorist problem simply is not practical at this point. Let me explain why.

First of all, the models that we currently have are rudimentary, even if you look at the models that have been seasoned and tested, let's say weather-related models or earthquake models. For instance, no one predicted four hurricanes in Florida this year, but yet the data we have on hurricanes extends over the last 100 years

or so. With terrorism, we have no such data, so the best modeling cannot really cover all the contingencies that might occur.

Frequency and severity are the issue. Severity to some extent one can get one's hands around, but the severity is so severe that it brings in a capacity issue. The issue then becomes is there enough capital really to cover an event of such severity as one might foresee.

The frequency is almost entirely unpredictable. The irrational act of an irrational individual, impossible to capture from a frequency standpoint. I think that is reflected both in the fact that it creates capacity problems and it also creates a pricing problem. How do you price a product when you do not know what the frequency of that occurrence is and when you really have a difficult time predicting the size and scope, the severity of it?

What is different also is the fact that, as one looks through the mirror to the back, September 11, and say, well, you know, the industry coped with a $40 billion loss in a fairly reasonable manner. But there was reinsurance available. Today there is no reinsurance available.

I have heard about capital markets from my colleagues this morning, but I am afraid after 3 years the capital markets really have not stepped into it. And even if you look at our history with capital markets in terms of catastrophic bonds, bonds of a more general nature than terrorism-related bonds, that market is quite small. After 10 or 12 years' experience, $4 to $5 billion, the market has not been tested, and I do not think it can be described as really being liquid.

The reality of it is that, as Mr. Mills has said, TRIA has worked and TRIA has helped to take the uncertainty of this uninsurable event, to some extent diminish that uncertainty.

We at the PCI, I can tell you, we are prepared to work with you, and we are working. We have not been sitting on our hands. We have had studies from Tillinghouse. We have worked with the Treasury on renewals. We are prepared to do our part to try to find at least partially private solutions to the problem, but ultimately we come back to the fact that there has to be a backstop. We have established a number of principles, for instance, amongst our members. Certainly if we are to pursue a private solution, I would suggest that the market be allowed to work. Quite frankly, we now still have 19 States, for instance, where, regardless of the cause, fire related events have to be covered by mandate. We have three or four States that mandate terrorism coverage regardless of whether there is a Federal backstop. But the first principle that I would suggest for a private market solution is that the markets be allowed to operate freely, if that is the case.

Our second principle is that we are also looking at tax-exempt entities for pooling, for instance. We are looking at reserves, possibly combined with tax breaks on reserves. We are looking at how capital markets, their role can be enhanced. But fundamentally we keep coming back to the fact that there has to be some back-up role that the Government has to play in all of this.

Insurance is a foundation industry, and I urge you with the greatest sense of urgency to give consideration to the fact that this

is about jobs, this is about economic growth, this is all about what our country stands for.

Thank you very much.

Chairman SHELBY. Thank you.

Mr. Hunter.

STATEMENT OF J. ROBERT HUNTER
DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

Mr. HUNTER. Thank you, Mr. Chairman. I would like to congratulate you and thank you for holding off and waiting for the Treasury report before we move ahead with this, because I think it is absolutely essential, and I appreciate your courage. Thank you. Because it really is too early for us to know exactly some of the answers to some of the questions that are being raised here today, and Treasury has done a longitudinal-type review. We can see what happened at various stages, and I think it is very important that you have that before you make a final decision.

But there are some facts about TRIA that we can talk about. For one thing, the insurance industry has become financially flush compared to where it was when you enacted TRIA. It is no longer in need of a handout. On September 11, there was a loss of between $20 and $25 billion after taxes to the insurance industry, and the retained earnings for the industry that year fell by $28 billion. Since then, the industry has been unusually profitable, and the retained earnings now stand at $388 billion, an increase of almost $100 billion since the terrorist attacks.

Remarkably, last year, with four hurricanes, the industry earned $39 billion. The commercial segment of the industry has seen retained earnings grow by $49 billion compared to what they had before the September 11 attacks, enough to fund two such terrorist events just in the profits that they have retained.

While the industry has done wonderfully, taxpayers are shouldering a lot of the financial risk. So far the subsidy to the insurance industry, the actuarial value of the free reinsurance is $5.8 billion, and I do not think taxpayers should be asked to continue to shoulder that.

Chairman SHELBY. Say that figure again.

Mr. HUNTER. $5.8 billion for the program so far in actuarial value. I was the actuary, by the way, who had to calculate the reinsurance program because the Congress did require it. We faced the same kinds of problems with low-frequency, high-severity calculations. It is doable if Congress requires the calculation of the risk.

CFA opposes S. 647. If it becomes law, the industry will continue to get an unnecessary taxpayer subsidy at a rate of almost $1 billion a year for an amount that could be passed through to policyholders if it was charged for at an average surcharge of less than 1 percent of premium, about seven-tenths of 1 percent.

S. 647 also expands the financial risk by adding group life insurance. There is absolutely no evidence that group life insurance needs to be added, and wisely, the Treasury Department refused to do so. I think you should ask them why, and I think I know why. It is not necessary. Even the NAIC, usually very sympathetic to the

industry, refused to grant licensure and exclusion for terrorism coverage because they could not prove that group life needed it.

CFA opposes S. 647. Continuation of TRIA in anything like the current form undermines the development of private sector alternatives since insurers and reinsurers cannot compete with a zero premium policy. And as CBO also indicated, below-cost TRIA reinsurance undermines mitigation efforts.

This is not to say that private sector solutions have not been developed to complement TRIA. Stand-alone policies are plentiful. More TRIA policies are sold in conjunction with a stand-alone policy than just TRIA alone. These policies offer coverage such as domestic terrorism, acts outside of America, et cetera, and reinsurance is plentifully blacking up these coverages.

Some have said that regulation has hindered the development of private terrorism policies. Policies have been developed. I have yet to see anyone deny or any State turn down a rate filing.

I attach to my testimony quotes from the recent trade press articles indicating that insurers are preparing to handle the demand for terror coverage should TRIA expire, sometimes under the same terms and conditions with or without TRIA.

CFA, pending the Treasury Department's report, finds no compelling reason to extend TRIA beyond 2005. The dire predictions of what you hear might happen on January 1, 2006, are very reminiscent of what we heard would happen if there was no TRIA on January 1, 2002, and I had the same fears. But they did not happen.

If TRIA, however, is extended, we would make several recommendations.

First, you should ask that full actuarial rates be charged for the reinsurance.

Second, the program should target only high-risk cities.

Third, the retention levels should be raised to $50 billion after taxes, a level where GAO finds there may be need for such support, particularly if nuclear, biological, and chemical is covered.

CFA looks forward to receiving the Treasury Department, report analyzing its implications, and sharing our perspective on TRIA with you in light of what we expect to be significantly clearer information and more information. Mr. Chairman, we pledge a rapid response when we have that report.

Thank you.

Chairman SHELBY. Thank you.

Mr. Duperreault.

STATEMENT OF BRIAN DUPERREAULT, CHAIRMAN ACE LIMITED, ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION

Mr. DUPERREAULT. Thank you, Mr. Chairman. I want to thank you for holding this hearing. And I particularly want to thank Senators Dodd and Bennett for introducing this very important legislation.

I am from the insurance industry. I run an insurance company. TRIA works, it worked. It was very important. But it does not change the fact that terrorism is uninsurable. I echo what Mr. Csiszar said, it is uninsurable. We cannot tell what the frequency or severity is. We do not how many acts are going to occur. We cer-

tainly cannot tell the size. As to modeling, modeling has improved somewhat our understanding of how big it could be, but frankly, as Mr. Csiszar says, these models are always corrected after the fact, so you cannot be certain.

It is uninsurable by the size alone. I mean you can do scenarios in which a nuclear event or one of the larger weapons of mass destruction type events would cause losses of $250 billion. The capital that supports the commercial business is about $176 billion. So it would dwarf our capital. We cannot handle this risk period. It is uninsurable.

You know, even the deductible, the deductible now, roughly is 15 percent. It translates to something like $35 billion. Contrary to opinion here there is not much reinsurance market available for terrorism, certainly not for nuclear or biological, chemical, radiological. There might be 4 to 6 billion. I think it is probably closer to 4. That would leave a loss of about $30 billion for support of $176 billion. It would severely impair insurance companies.

So it is a significant problem for us, and the problem is now. You know, TRIA expires on December 31, but in fact, we have been issuing policies this year that extend past TRIA. That situation means that we are growing our exposure to a post–TRIA situation. We cannot let that continue. At some point we have to start to cut back on the capacity, and that is now, that is not at the end of the year. That is now when we have to start doing this.

Endorsements have been issued where we can issue an endorsement, but we do not have a free market here to the extent that we have freedom to exclude these risks. Workers Compensation, we must cover terrorism, period. In many States if there is a fire following an event, regardless of the cause, it is covered even if you have a terrorism exclusion. So we have got to start reducing our exposures now.

Chairman SHELBY. How about arson? Fires would not cover it if there is pure arson there, would it?

Mr. DUPERREAULT. Fire following an event is covered in many States.

Chairman SHELBY. Even for arson?

Mr. DUPERREAULT. No, you would have to prove fraud to get out of it.

I want to emphasize that the problem is now. It is not 6 months from now or 8 months now. It is now. And actions are being taken in the marketplace.

There is some mention of profit, and maybe we have made a windfall profit, or there is all this money. Frankly, you can have this risk. I do not want this risk. It is uninsurable. If an event happened tomorrow we would not have made any money. In fact, we would have a whopping loss.

The risk reward on this thing is imprudent for us to take, so we do not even want to be in this business. If we could not be in this business, we would not. That does not mean that there would not be some marginal coverages being placed, but that is not a market. That is an occasional peripheral kind of play, not a real market.

Has there been a capital market solution? The reinsurance market is a great indicator of capital market solutions. The reinsurance market did not come back. They are not restricted. They do not

have to issue these policies, and they are not. There is no cat bond market, there is not any. There is not even any for the other businesses, let alone for our business. Frankly, we are the capital market. We are the indication of whether there will be capital market solutions to this thing, and frankly, none have arisen.

We need a long-term solution. There is no question about it. We are prepared to work. We have ideas. We supplied those ideas. But I think one has to recognize that a long-term solution, if the problem is uninsurable, then the long-term solution cannot be an insurance industry solution. It has to involve the Government. One way or the other it has to involve the Government, and it is absolutely needed. If there is no TRIA or a longer-term solution, then we will revert to the situation that occurred right after 9/11, and that will be a market disruption that none of us want to see, and it will do what the terrorists wanted in the first place, and we cannot allow that to happen.

Thank you.

Chairman SHELBY. Mr. Nutter.

STATEMENT OF FRANKLIN W. NUTTER PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

Mr. NUTTER. Mr. Chairman, thank you very much. The Reinsurance Association of America represents domestic U.S. entities that principally assume reinsurance. Reinsurance serves many roles for insurance companies, the most notable of which and most relevant for this hearing is catastrophe risk. It is largely associated with Natural catastrophes, but certainly the World Trade Center losses and the other losses of 9/11 are a good example. Nearly two-thirds of the insured losses that occurred on 9/11 were passed through to the international reinsurance markets.

We believe that TRIA has worked well to fill a vacuum in reinsurance capacity. We too are encouraged by and endorse the leadership that Senator Dodd and Senator Bennett have provided with regard to an extension bill with a commitment to develop a long-term solution. We believe it will be essential that long-term solution include a public as well as a private role.

Several people have addressed the challenges associated with underwriting, terrorism risk, and I will not repeat that. It is important to understand that under the current legislation insurance companies have taken on greater and greater risk as a result of the increases in the retention required, the mandatory offer, the actions by some States not to work with the industry with regard to exclusions in policy forms. In addition, the industry is under increasing threat from independent rating organizations with regard to capital charges associated with the industry's exposure to terrorist risk.

The reinsurance market, modest as it has been, has largely should work with insurance companies to assess their risk associated with the retention that they have under TRIA. TRIA has not infringed the development of a private reinsurance market. In fact the opposite is true. By defining the loss parameters of terrorism risk, it has facilitated primary companies and reinsurers in developing some coverage in the reinsurance market.

Mr. Duperreault mentioned a figure of 4 to 6 billion dollars of reinsurance coverage that appears to be in place for U.S. terrorism risk. That is our estimate based upon a survey of brokers. Even if we are wrong by 50 percent, it is still 6 to 8 billion, which would be modest compared to the needs of primary insurers for terrorism risk reinsurance.

We think it is improbable that the private reinsurance market could ever replace the full coverage provided under the TRIA program.

Let me speak briefly to catastrophe bonds and catastrophe reserves, both of which have been mentioned. Catastrophe bonds are a well-established mechanism for transferring natural catastrophe risk. These capital market products have been in the market since about 1997.

Yet in 2004, based upon a knowledgeable industry estimate, only $1.14 billion of coverage for natural catastrophe risk was issued in cat bonds. Since 1997 only 59 transactions have taken place, again dealing entirely with natural catastrophe risk, with total limits under $9 billion. Only $4 billion of that is still outstanding. There is no reason to believe that the catastrophe bonds for terrorism will be a significant provider of capacity.

With respect to catastrophe reserves, which were mentioned earlier, this would require a change in accounting practice to allow companies to set up reserves for future unknown losses associated with risks and coverages that they have in place. There are a variety of reasons why this should be considered as part of a long-term solution, but no one should think that allowing insurance companies to have catastrophe reserves will provide any increase in capacity for terrorism, Indeed catastrophe reserves may be a substitute for the risk transfer such as with reinsurance.

We too look forward to working with the Committee, with the policyholder community, with others in the insurance community to find a long-term solution. We are encouraged by an extension that would allow that to develop and take place over the next 2 years.

Thank you.

Chairman SHELBY. Mr. Lowe.

STATEMENT OF ROBERT J. LOWE, CHAIRMAN OF THE BOARD AND CEO, LOWE ENTERPRISES, ON BEHALF OF THE COALITION TO INSURE AGAINST TERRORISM THE REAL ESTATE ROUNDTABLE AND THE UNITED STATES CHAMBER OF COMMERCE

Mr. LOWE. Mr. Chairman, I too add my thanks for your holding this important hearing.

I am the Founding Chairman of Lowe Enterprises. Our company is headquartered in Los Angeles, and we maintain offices Nationwide. Over the past 32 years, we have developed, acquired or managed more than $6 billion of real estate assets and we currently employ approximately 8,000 employees Nationwide.

I also am the Chairman of the Real Estate Roundtable. I testify today on behalf of the Roundtable and the Coalition to Insure Against Terrorism, or CIAT. CIAT's membership includes over 70 trade associations and businesses from across the country, and includes not only real estate related firms, but energy, transpor-

tation, professional sports leagues, theme park owners, and of course, the U.S. Chamber of Commerce.

As Chairman of the Real Estate Roundtable I have the privilege of working directly with the CEOs of major real estate ownership and financing companies throughout this Nation. We also count as membership the 15 major trade associations representing different aspects of the real estate industry, collectively an industry valued at about $5 trillion, and that employs nearly 9 million American workers, an industry that accounts for nearly 70 percent of all local tax revenues. Obviously, the real estate industry and the jobs associated with our industry is a cornerstone to the health of our economy.

I am here to say that a Federal terrorism insurance program is a cornerstone to maintaining a healthy, growing real estate industry. Our message is simple and straightforward. The reasons that prompted President Bush in 2002 to urge the establishment of Terrorism Risk Insurance Act unfortunately have not changed.

A survey we conducted during the aftermath of 9/11 showed an excess of $15 billion of real estate related transactions that were either stalled or canceled because of lack of terrorism insurance. Studies further show that approximately 300,000 jobs were lost during this period due to this economic slowdown.

Fortunately, in November 2002 the President and Congress joined together to act. Almost overnight TRIA provided capacity to the insurance markets, which in turn yielded economic confidence for transactions to resume, in particular stalled construction projects moved forward to the benefit of countless workers in the construction trades. I do not believe that the facts that brought about TRIA's enactment have changed. Obviously, the threat of terrorism in our Nation remains. A major even, without reasonable insurance, will once again significantly damage the transaction markets, result in delayed or canceled projects, the loss of thousands of jobs and reduced economic activity.

I would like to share my personal situation. We have about $1 billion in current loan commitments which contain terrorism insurance requirements which are today supported by TRIA. This represents about $2 billion in project value. If TRIA is allowed to disappear, we most likely would be unable to reasonably replace the insurance perhaps at any price.

Let me give you a specific example. We have been working for 6 years on a major $320 million development project to construct an ocean-front hospitality project in the county of Los Angeles. It represents a much-needed facility in Southern California, approximately 1,000 permanent jobs and hundreds of construction jobs. It will produce in excess of $8 million of annual local and State tax revenues. We are ready to break ground late this summer. Without appropriate insurance our lender will not fund and we will be unable to break ground. Additionally, we have 8,000 employees in a dozen States. Our insurance staff advises me our Workers Compensation coverage is at risk without TRIA.

Last evening one of my associates on the Roundtable, who services 7,000 real estate loans, explained that their borrowers are having their insurance policies renewed only until the end of 2005. After that they will be in default. Another Roundtable member de-

scribed how his insurance provider has halted all new policies until the TRIA situation is clarified.

Yes, we must keep markets operating while terrorist threat exists. We must keep policies in place to make sure our economy keeps on track in the event of another terrorist attack.

In conclusion, on behalf of the Roundtable and CIAT, I urge this Committee to act quickly on extending the terrorism insurance backstop. American businesses are now in the market for terrorism insurance that extends into 2006, and are increasingly facing difficulties. Transactions will be unnecessarily stalled or canceled and jobs will be lost. Therefore I urge you to continue the momentum started with this hearing, stay focused on finding a solution to this problem, and approve legislation providing for a Federal terrorism insurance backstop. Personally I support an immediate extension which includes the mechanism to develop a sound long-term program.

Last, I add my thanks to Senator Dodd and to Senator Bennett, as well as the 15 other Members of this Committee for introducing Senate Bill 467.

Thank you.

Chairman SHELBY. Thank you, Mr. Lowe.

I will direct these first questions to the General Accounting Office, doctor, if I can, because you have done a lot of work in this area. The temporary TRIA program that is now in place does not, as I understand it, require insurance companies to pay premiums for the Federal reinsurance backstop that they receive. Is a premium free system sustainable if a program should go forward in the future, and what incentives or perhaps disincentive does a premium-free system create for insurance companies and insurance policyholders?

Mr. HOLTZ-EAKIN. Well, Senator, the TRIA program does not have premiums, and as a result it passes up the opportunity to convey to insurers and to the economy as a whole those locations which are placed at greater financial risk versus those which are a lesser financial risk. It thus passes up the opportunity to convey the information necessary to mitigate overall cost of any event.

Chairman SHELBY. Mr. Hunter, you have a view on that?

Mr. HUNTER. Yes. I think—I ran the riot reinsurance program, and we had to charge premiums, and it was just as difficult to create who is going to riot, when is it going to be, what is the frequency going to be, what is the severity going to be? And it was difficult, but we did it, and ultimately the taxpayers actually received about a quarter of a billion dollar profit when the program was finally terminated during the 1980's. I believe that a premium at least should be charged if the program is extended.

I understand why businesses who are receiving free insurance would want to see it continued that way, but I do not think Congress should do that.

Chairman SHELBY. Doctor, I think one of the questions that keeps popping up that does not go away, are there practicable mitigation strategies that are relevant to terrorist incidents? Are there things that could be done to reduce losses, and are people implementing these strategies? And if so, what are some of the exam-

ples, or what steps have been taken since the enactment of TRIA, if there have been?

Mr. HOLTZ-EAKIN. I think it is important to distinguish between those actions which might prevent a terrorist attack and actions which reduce losses from an attack. It is an overstatement to assert that economic policy and insurance premiums in particular are going to be the only means to wage a war against terrorism. However, conditional on attacks, the goal is to minimize economic cost. It is always better to, (A), locate activity in such a way that it puts less in harm's way where possible; and (B), there are steps that can be taken to reduce losses.

There was a recent report by the National Institute on Standards and Technology on the fact that in the World Trade Center Towers the fireproofing came off the supports. This suggests that steps could be taken to reduce costs such as amending building codes. However, nothing is a panacea.

Chairman SHELBY. Mr. Mills, what mitigation efforts have you seen in New York?

Mr. MILLS. Many, Senator, everything from companies locating data backup centers outside of the city to secure locations. The security efforts that the private sector has undertaken in the city of New York are extraordinary, and I am sure all of the Members of this Committee have had occasion to see that personally when trying to enter a high-rise in the city of New York. Local government of course has also invested heavily in security measures. Where my office is located, Senator, in downtown Manhattan, we have risers that come up out of the streets, not just the concrete barricades but the actual risers such as you have here in front of the Capitol to prevent vehicles from getting too close.

So we are seeing the industry making significant investments.

Chairman SHELBY. You are reacting to it big time.

Mr. MILLS. Yes, we are.

Chairman SHELBY. Mr. Duperreault, can you or do you offer rate discounts for terrorism insurance coverage to clients who proactively take steps to reduce their loss exposure?

Mr. DUPERREAULT. I think it is a natural process to evaluate the risk and determine who is more at risk and who is not. The answer is yes, and if it is an area that is low risk, they will have a low rate, and if it is a high risk, they will have a higher rate.

Chairman SHELBY. Doctor, I will go back to you in a minute. We have heard that the insurance industry lacks the financial capacity to deal with a catastrophic terrorist event, such as 9/11, or we hope not another one, but you never know. Your study, which is pretty comprehensive, discusses the possibility of obtaining greater amounts of capital directly from the securities or derivatives markets. Could you elaborate just for a moment on your concept? In other words, how much capital could be available? By what means could it be made available to backstop terrorism risk, those kind of things?

Mr. HOLTZ-EAKIN. I think that it is impossible to quantify, based on the brief experience we have under TRIA, what the total would be in the future. But it is clear that it would be a mistake to view this as exclusively an insurance industry issue. There are at the moment a wide variety of ways to address the financial risks of ter-

rorism. Shareholders can diversify their holdings among many different firms. Firms can diversify their operations among locations. There are opportunities to access derivative markets, which are worldwide in nature and enormously deep in capacity. Those markets could bear losses far greater than any single terrorist event.

Chairman SHELBY. Mr. Csiszar, I will direct this to you and to Mr. Duperreault. First, in your testimony, Mr. Csiszar, you indicate that you feel that there should be Federal support—and the words of yours following—giving insurers and insurance markets more freedom to negotiate terms and conditions of coverage. Would you envision that an element of such freedom would be the ability to set risk-based prices?

Mr. CSISZAR. Yes, absolutely, that would be part of it, yes.

Chairman SHELBY. Could you elaborate just for a minute on your testimony regarding the need for freedom in the marketplace, which we all espouse, by providing the Committee with a sense of some of the differences between current market conditions and more free markets for which you advocate?

Mr. CSISZAR. Let me give you several examples of that. First of all, I think, as Mr. Duperreault mentioned, the fire policy is an issue in 19 States, where coverage post event is mandated regardless of the cause of the event. In Florida, California and in Georgia, for instance, you have to cover terrorism whether there is a backstop or not.

Chairman SHELBY. This is mandated.

Mr. CSISZAR. Mandated. Workers Compensation is mandated, the coverage is mandated regardless of the cost.

Chairman SHELBY. Mr. Lowe got into that.

Mr. CSISZAR. Yes. So these are some examples of where a market-based system simply cannot accommodate because there is no market-based system.

Chairman SHELBY. Mr. Duperreault, you have any comments on this?

Mr. DUPERREAULT. Yes. I think the important thing to recognize there is that post—without TRIA those restrictions remain, and that handcuffs a company's ability to deal with this, and therefore, you know, if a State says you cannot issue a Workers Comp policy unless it covers terrorism, you only have one choice, you do not issue the policy.

Chairman SHELBY. That is what Mr. Lowe was concerned with among other things.

Mr. DUPERREAULT. And that is very important to understand.

Chairman SHELBY. Senator Dodd.

Senator DODD. Again, thank you, Mr. Chairman. This is very, very helpful, and I want to thank all of our witnesses for their testimony here today. I think it has been helpful in making the point. I think maybe not everyone here, but I suspect most of us here, if there were a private sector solution to this problem, we would not be here. And there are those who I think may make the case I suppose that maybe just the Federal Government should do all of this. I do not buy into that at all, but there are those who may embrace that view.

And I think what our witnesses are suggesting here and what a majority of us on this Committee are suggesting is that this is—

you need a hybrid here to get through this, to get this right, and eventually at some point there may, there may in time become a model that would develop where the Federal Government would no longer need to be involved in this issue at all. I do not think we are there yet.

One of the issues I wanted to raise with you, Doctor, if I could, is your suggestion that the catastrophic bond market might be a means by which this issue is—I do not know if you are familiar with the most recent General Accounting Office study that was done I think about a month ago here, but let me—and Mr. Chairman, I will ask unanimous consent that not all of this, but portions of it be included in the record. But I thought it was worthwhile to note—

Chairman SHELBY. Let us put it all in the record.

Senator DODD. It is a rather extensive study.

Chairman SHELBY. That is okay. You can refer to anything you want to.

Senator DODD. Let me just quote from it here. It says:

> Moreover the catastrophic bond market has generally been limited to coverage of natural disasters because the general consensus of insurance and financial market participants we contacted because they are developing catastrophic bonds to cover potential targets against terrorism attacks in the United States was not feasible at this time.

I am quoting now from the report. It goes on to say:

> Although several modeling firms are developing terrorism models that are being used by insurance companies to assist in their pricing of terrorism exposure, most experts we contacted said these models were too new and untested to be used in conjunction with a bond covering risks in the United States.

And last it goes on, Mr. Chairman, to say:

> Furthermore, a potential investor concerned such as risk of information about issue or underwriting practices or the fear a terrorist would attack targets covered by catastrophic bonds, could make the costs associated with issuing terrorism related securities prohibitive.

I would like to ask—all of you addressed to some extent this issue—but anyone want to comment on this at all, this question of the catastrophic cat bond issue?

Mr. HOLTZ-EAKIN. If I could characterize the nature of the comments in the report.

Senator DODD. Sure.

Mr. HOLTZ-EAKIN. It was not the case that we were suggesting that there was an existing capacity in the catastrophic bond market that would step in and replace traditional sources of capacity in the insurance market. That was not the intention. If it was interpreted that way, we will write better next time. The question is, going forward, to the extent the Congress decides to rely more heavily on private capacity, what are possibilities that would be available? This is one of them. As many members of the panel have mentioned, these products and traditional products do not exist in isolation. One of the key issues with catastrophic bonds is familiarity and expertise in the modeling, and that would develop more quickly and more expertly if there were greater incentive to do so.

Second, there is a regulatory environment that matters. Our understanding is that in many circumstances catastrophic bonds would not qualify as reinsurance. In the absence of a regulatory en-

vironment that supports it, it will not develop. And so, there are issues on all sides.

Mr. NUTTER. Senator Dodd, just to emphasize something I said in my testimony. Reinsurers are frequently the facilitators of catastrophe bonds. They use them. They work with clients to use them for natural catastrophes. It is a mature market. It has been around for a number of years yet, as I mentioned in testimony, it is actually very modest in providing capacity.

There really is very little evidence, as you suggest and the GAO has said, that catastrophe bonds for terrorism are likely to fill the gap or provide a substitute for TRIA's coverage. Should they be made part of the consideration of a long-term solution? Absolutely.

Senator DODD. I think there was a suggestion—and again, I think you point out, doctor, and rightly so, that there are an awful lot of other obstacles to all of this, and the problem is, in the interim trying to sort all of that out while we have this problem lurking before us here. In the absence of doing anything, the exposure is significant. That is the concern I think. In an ideal world, I think your point—probably would not disagree with your point. The question is, with the limited amount of time we have, the potential exposure we face, the economic implications of not doing anything, are too risky in a sense for us to take. That is my view anyway. That is why we are talking about this.

Let me ask you a question. One of the criticisms about this program, and it may have some value and I want you to respond to it, is that the current insurer retention levels are too low in the present TRIA bill, and that as a result the Federal Government is crowding out the reemergence of the reinsurance market. How do you respond to that?

Mr. DUPERREAULT. May I, Senator? I mentioned in my earlier remarks the deductible is close to the mid 30s, 35 billion is probably a good number given the current levels of premiums. That is the World Trade Center loss effectively. So we are to basically handle the World Trade Center loss. And if you compare that to our capital, as I pointed out earlier, for the industry at about 176 billion, that is a significant hit. The difference between today and that hit to us and the 9/11 hit was that there was a substantial amount of reinsurance available. There is not a substantial amount of reinsurance available today. So the net effect would be considerably larger for the industry than it would—than it was at 9/11.

To give you an example, my company paid—incurred losses in excess of $2 billion on 9/11. Our net loss was about a little under 700 million, so we had reinsurance that covered—for every $3 of payments, $2 came from the reinsurers. There is nowhere near that capacity now. So it is not just a 9/11 loss, it is a supercharged one, and it is one that cannot be handled by our capacity at these levels of deductible.

Senator DODD. Let me, Mr. Mills, if I may, in the last bill we talked about dealing with the Workers Compensation, the life issues, and we asked for studies should be done on this thing. But in your testimony you described the unique concerns, obviously, that exist within the Workers Compensation and group life lines. With respect to Workers Compensation you related nearly all State laws preclude any exclusion for specific types of risk including ter-

rorism risk. With respect to group life you raised risk concentration issues. I wonder if you will elaborate on this a little bit because I am sure we are going to be asked about this again as we come forward with this legislation. We have been down the road, one, of asking to be looked at. I do not know how the Treasury study's going to address this, if they are or not, but I think it is a very important question. Certainly we saw it in New York, the 9/11 attack, the Workers Compensation issue, the life issues, group life issues loomed very, very large, and I wonder if you might address this?

Mr. MILLS. We do support the inclusion of group life. We feel that is—

Senator DODD. I knew you did that. I just wanted you to elaborate.

Mr. MILLS. We separate from NAIC a bit in that area, but the concentration that we see in New York buildings is obviously a critical issue for us, and we feel it is something that we would like very much to see included as this goes hopefully forward.

Senator DODD. Now put on your NAIC hat.

Mr. MILLS. NAIC does have a different opinion on that. They have taken a position that may not necessarily be one that has to be included.

Senator DODD. Mr. Hunter, you are chafing here at the bit.

[Laughter.]

Mr. HUNTER. No. Well, my chafe was that I wondered who he was—was he speaking for New York or NAIC because I knew they had a different position.

Senator DODD. He made it clear.

Mr. HUNTER. So I was chafing over that. I do not think group life is necessary. I think Treasury has concluded that. NAIC has concluded that when they looked at whether it should be excluded or not. I think everyone who has made the study has concluded it should not be included.

Senator DODD. Any other comments on this?

Mr. NUTTER. Senator Dodd, if I could. This relates actually to your last question. The value of TRIA with respect to the reinsurance market is that it defines the box for these insurance companies. It sets the loss parameters and allows the reinsurer and the insurer to work out a catastrophe program addressing terrorism risk. Group life, as you know, is not included in the current program. Your bill of course proposes to do that.

It seems to me including group life would have the same positive dynamics on the market. It is now in the reinsurance market in limited supply. It is very expensive, and it is really very limited as far as an individual insurer is concerned. Including group life would probably have the same value, if you will, in defining the box, defining the loss parameters and allowing reinsurers to work with the companies to provide a risk transfer mechanism.

Senator DODD. Yes?

Mr. CSISZAR. Senator Dodd, if I could add to that from our members' standpoint, the feeling also is that personal lines should be included in this. For instance if you were to take just the example of a dirty bomb, Chernobyl is an example, and it certainly has im-

pact on all homeowners and automobile ownership as well, so we would ask that the consideration be given to personal lines as well.

Senator DODD. Mr. Chairman, maybe I was not clear, my staff tells me. Workers Comp obviously is included in the present; group life is not, if I did not make that clear.

Mr. MILLS. Senator, if I could just clarify one thing. The NAIC has actually not taken a position on the inclusion of group life. They do not oppose, but they have not taken a position.

Senator DODD. That is very clear.

[Laughter.]

Mr. MILLS. Thank you, Senator.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

The CBO report talks about TRIA undermining the incentives for mitigation. Do you insurance types agree with that? Have you seen a lessening, a mitigation since TRIA was enacted?

Mr. DUPERREAULT. No.

Senator BENNETT. I see some shaking heads. Who wants to speak up?

Mr. DUPERREAULT. I think if you look at every CEO running a major company in this country, you know that they are concerned about a terrorism risk and mitigation has taken place. They have taken action to protect their employees and their property, and it is almost insulting to talk about lack of mitigation. I think the motivation has been very high and many efforts have been taken. That does not mean that the terrorists' efforts, you know, their job is to work around those mitigation efforts, but it does not mean that mitigation has not been taking place.

Mr. LOWE. On behalf of the real estate industry, which obviously is a great consumer of this insurance product, I can assure you that we are paying our premiums and we are also doing everything we can do to prepare our properties for the unknown future risks. The Roundtable specifically has cooperated with the Homeland Security Department to develop a communication network that allows the Homeland Security to communicate directly with thousands of buildings around the country and vice versa, for those buildings to communicate directly to Homeland Security.

Last week we had 65 of our members participate in the simulation of a terrorist attack in the Northeast. One of our buildings in San Francisco specifically took part in those exercises. Our personnel—we ran about 8,000 hotel rooms around the country. Our personnel are trained weekly to be alert for problems, and very importantly, how to respond when the emergency occurs.

Mr. HOLTZ-EAKIN. Senator, if I could, on the CBO report, I think the important question about mitigation efforts is: Compared to what? Compared to a world in 2000 where terrorism risk was unpriced entirely? Certainly, no, we are not doing less than that. Compared to a world where terrorism risk was fully priced in the absence of free reinsurance? Incentives will be less than that.

Mr. MILLS. Senator, I would like to say again, reiterate that the evidence that we see is absolutely contrary to that contention. The private sector, the real estate sector in New York City, the Real Estate Board of New York has taken extraordinary steps to mitigate risk, but we are missing the point. The real point is, whatever ex-

traordinary steps the private sector takes—and they are taking those steps—this is still impossible to predict and impossible to entirely prevent. But to contend that the private sector is not doing all that they can I think is clearly false.

Mr. CSISZAR. Senator, if I could add to that as well, it goes beyond just New York State and New York City. Our members, for instance, right in Iowa, well, Iowa—and one of the studies identified Iowa as a problem child because of the number of fertilizer plants in Iowa. These fertilizer plants are taking active steps to mitigate the terrorist threat. I think it goes beyond just New York City and major centers. It goes directly into the heartland. I wholeheartedly agree with my colleague, Mr. Mills here, and disagree with the report.

Mr. HUNTER. I would just comment that you have to suspend the laws of economics to say that free insurance will give a greater or equal incentive to insurance priced at full actuarial rates. It just makes no sense.

Senator BENNETT. The only comment I would make, Senator Dodd has been Chairman/Ranking Member of the Rules Committee while I was Chairman/Ranking Member of Legislative Branch Appropriations, and we did not have any insurance problems, but we certainly have spent a lot of taxpayers' money on mitigation around the Capitol. You cannot be an intelligent CEO without paying attention to that.

Reference has been made to New York, San Francisco, Ohio and so on. I remember when there was an orange alert. I was in St. George, Utah, and the stores all sold out of duct tape. And I said, "I really do not think the terrorists are that likely to strike St. George, Utah, and you probably are safe without taping up your windows down here."

Let us talk about the availability of terrorism insurance with respect to businesses outside of the large cities. Is this primarily a big city problem or does it affect the economy everywhere?

Mr. MILLS. Senator, if I may, Senator, one of the things that we hear through the NAIC in the smaller markets, you have to realize when you are looking at a major urban center the market is there, the business is there. But where the lack of insurance may hurt the smaller markets because the market is just not that large enough that a lot of the writers will not want to assume any risk because the profit just is not there. So it will indeed affect all markets, not just the large, but the small.

Senator BENNETT. Give me an example.

Mr. MILLS. A shopping mall. One of the things that we know we have to do, what the Homeland Security people are doing, is trying to predict how the enemy thinks. And one of the most dangerous acts that has been identified as—you know, we all know New York, LA, are likely places that they would strike. What if a shopping mall in a small town anywhere in the Midwest of the United States is bombed?

Senator BENNETT. Try Utah.

Mr. MILLS. Try Utah. That would have a devastating impact on the market. That would be a huge disruption. A huge fear would strike the market and would cause a massive disruption. So I believe it affects all markets large and small.

Mr. NUTTER. Senator Bennett, if I could offer a comment. I am sorry if I interrupted you.

Senator BENNETT. No, no.

Mr. NUTTER. It seems to me your point goes to the heart of the insurance industry's difficulty in underwriting this risk. There is an information disconnect. The industry does not know about potential terrorist activities, and yet terrorists can very well act independent of prior experience. They can also act based upon their assessment of mitigation efforts that entities are taking. So it would seem that it is a broad problem and reflects the problem the industry has in trying to price and underwrite this risk throughout the country, not just in the major urban areas.

Senator BENNETT. Mr. Hunter, you—

Mr. HUNTER. Yes. I just wanted to say the modeling that is being used to underlie rate making does imply that there are four cities with a very high risk, five others with a middle size risk, and everywhere else is low risk. And obviously that does not mean there cannot be an event anywhere. It could. But in terms of risk, the low risk cities are being priced pretty close to what they would be without any TRIA.

Mr. CSISZAR. Senator, I—

Senator BENNETT. Do the rest of you agree with that, that they are being priced as if there were no TRIA?

Mr. DUPERREAULT. No, I would not agree with that.

Mr. CSISZAR. And I would also say that I am told that the football stadium in Alabama holds 90,000 people, and that is a terrorist risk, and that is—

Chairman SHELBY. Then you had better insure that.

[Laughter.]

Chairman SHELBY. First. And you have no risk there. The risk is a fight, is it not?

Mr. CSISZAR. Yes.

[Laughter.]

Chairman SHELBY. It depends on who wins.

Mr. CSISZAR. That is right.

Senator DODD. If Auburn shows up, it is a risk.

[Laughter.]

Chairman SHELBY. Auburn is doing quite well.

Senator BENNETT. Mr. Duperreault, you—

Mr. DUPERREAULT. Yes, if I could just comment a little bit on this question of pricing pre and post–TRIA. We do not know where these things are going to occur. If there is a market dislocation, there is going to be a market dislocation that affects the entire country. It is not going to be isolated to major cities. It will affect all cities because we do not know whether there is an event that was going to occur in a mall somewhere in Utah, or a stadium in Alabama. We do not know. So it will be a universal effect.

Senator BENNETT. All right. Just one quick comment, Mr. Chairman. Having lived through the Olympics in Salt Lake City, I discovered something very interesting which may or may not be true. We are back to the uncertainty circumstance. The Olympics were, as Senator Dodd discovered trying to get credentials for his 8-month-old daughter, pretty tight as far as security went. And I stood in the command center. We actually had two, the command

center of all of the units involved with security in the Olympics on the ground, and then one floor up we had a command center of all the intelligence agencies, and it was highly classified, and I will not tell you how many countries were there, but it was not just American intelligence agencies that were there.

I remember looking over this very sophisticated and somewhat complicated command center, and the fellow who was in charge of it said to me, "Senator, this is boring. Nothing is going on. And in the security business boring is good." We spent an awful lot of money, Federal money, local money, Olympic money, et cetera, to get that boring result.

But the interesting thing that applies here with respect to this question of risk is that we were told that al Qaeda avoids hardened sites, and one of the reasons there was no terrorism activity at the Olympics is that we did go to the extent we did for a hardened site. That is why I felt safe at the Republican Convention in New York City because I knew how hardened the site was so I figured they are not going to attack us. They prefer to go someplace that is not hardened where you do not expect it.

Now, they want something very splashy on television. They want something recognizable around the world. So they might go to the St. Louis Arch or some other symbol that could be recognized if they could blow it up. But I think that becomes your problem. If you harden, mitigate, if you will, certain parts of the country, you, if you are dealing with the mentality of al Qaeda, you make it far less likely that there will be an attack there, but if they want to attack America, they will then come to Salt Lake City when the Olympics are not there and blow up the Mormon Tabernacle because that is a symbol that people would recognize around the world from the Mormon Tabernacle Choir, and when we are not holding the Olympics we are not very hard in Salt Lake City. So I think that is the problem that we face.

Thank you for your indulgence, Mr. Chairman. I did not mean to overrun my time.

Chairman SHELBY. Thank you, Senator Bennett, and I also thank Senator Dodd, both of you, all your work on this.

Doctor, should we move forward with a Government program? How can we also maximize market efficiencies? How can we—

Mr. HOLTZ-EAKIN. The key issue here, I think, is not to declare TRIA a success or failure in its incarnation. It was designed for a particular problem as a temporary backstop to restore capacity in the industry. Quite frankly, the data will not be there to say if this is the right design or not. You cannot distinguish between an economic recovery in general and better performance in a lot of the business investments. So that is problem number one, and no one at this panel will ever be able to have enough evidence to definitively decide whether this is the right solution.

The second problem is that going forward there are these long standing terrorism risks that will be elevated. Compared to a temporary program, I think that is the key design issue, and in a perfect world, a private market would recognize those risks, price them, and have capacity to insure against them. Or in a perfect world, a Government backstop would have prices that gave good in-

centives, and spread the risk efficiently using the taxing powers of the Government.

The real issue is looking at the downsides in both cases. What is the potential risk of a private sector that does not develop a capacity to price at least as well as possible and a capacity to insure the risks? And, what is the downside on the Government programs with poor risk management such as the Federal Savings and Loan Insurance Corporation?

The goal going forward is to make sure we minimize the risks of bad design. For example, the savings and loans crisis showed the risks of bad economic incentives embedded in a Government insurance program. This is the kind of thing you want to avoid.

Chairman SHELBY. I think we all recognize that the risk of terrorist attacks in the future somewhere are real, and it is unusual, and it is not something the insurance, the private market has had to deal with, at least to my knowledge, in the past, and it is hard to put the product together. I see that.

In the very near future, as most of you know, we will be receiving a report on the TRIA program from the Treasury Department. I believe that this document should be informative and helpful to our deliberations here in the Committee as we consider what if any steps to take next. It is my understanding that both the Government and the private sector, you, a lot of you, did a great deal of work to compile the underlying information that will form the basis of this study. We look forward to obtaining this study. Senator Dodd alluded to it earlier.

And we appreciate all of you appearing here today. I think it has been a good hearing.

Senator DODD. Mr. Chairman, just very quickly, a couple of things. Well, I want to underscore the point that Senator Bennett made and others of you have made here about where these attacks can occur. If you understand the work, so much behind it, not only—

Chairman SHELBY. We hope they do not ever occur, no.

Senator DODD. Of course not.

Chairman SHELBY. But they may.

Senator DODD. If you accept obviously having symbolic, but also fear. I mean fear is the major, I think, emotion that terrorists want to promote. So I always find it troubling that we always go and prepare for the next event based on the last event, and we underestimate the creative abilities of these people. I have heard it said by others and I agree with it, the attack on 9/11 was probably the most efficient and successful, quote, military, if you want to call it that, attack maybe ever executed. When you consider how limited amount of resources were involved and the amount of damage done and the ripple effects that it caused, you would be hard-pressed, I think in my mind, to talk about another event you could think of that has had that kind of an effect.

I think we underestimate. If we assume that just these large cities and big targets are the natural places, I think we make a tremendous mistake, tremendous mistake if we do that. I just wanted to make that point.

Second, I wanted to make the point that while I am impressed with what the private sector is doing to harden their facilities and

protect them against attacks, we have to go a long way yet. There have been studies—and I know the Chairman is aware of this as I am—done by reputable organizations that feel as though we have not done as well as we could be doing to provide the resources, the first responders and others to make us better prepared. I think that is an acknowledgement all of us would have to make, but we have to do a much better job in the coming years if we are going to close that gap.

But also I think it is important, and I think all of you implied this, but I think the record needs it stated. I think I know the answer to this, but I think that the record should have it. I want to ask you, Mr. Lowe, this because of your extensive experience as a real estate developer.

What impressed me at the time when we first did this bill, there was a very good argument made I thought by those who were talking about how long should this temporary program be, and you may have been one of them at the time, Mr. Lowe, suggested that a two- or three-year program really was not adequate, you needed more like a five- or six-year program. And I said, "What do you mean by that?" And they said, well, you need to understand that when you start talking about a large real estate development project, those are years in the execution. The time windows on these things are not short, and so getting the necessary capital, all of the work that needs to be done to put together a large real estate development project takes time.

And I wonder if you might in light of this—and I appreciate what the Chairman is doing, by the way, with the Treasury study; I am not in any way suggesting that we should necessarily jump ahead of that, but our concern would be if we got them—

Chairman SHELBY. We jumped a little ahead of it with the hearing, did we not?

Senator DODD. Well, we did, but that is good. I think we set the ground work, and I appreciate the Chairman doing that. But if we get too late into the fall, start getting close to this December 31st deadline, there are a lot of people saying what difference does it make? If we did it on December 30, it is done, it will be done by the time that the legislation would no longer be valid, effective.

Could you address that issue I think as someone who has had some experience in this thing, about the lead times necessary? And again, I am preaching to the choir here to many of you who understand this, but I think the record should reflect this.

Mr. LOWE. Business in general, the real estate industry certainly specifically, need predictability in the business and capital markets environment. We are making long-term decision daily that affect our projects, our employees and our customers. If we cannot depend upon, now 8½ months out, 1 year out, even 3 years out, we have trouble planning for our projects and our employees. That is why I concluded by personally recommending that your action, one, extend the program quickly, but do it in a way that builds in a mechanism that really encourages the public and private sector to get together and come up with a permanent long-term solution to this problem. It is not going to go away in 2 or 3 years.

Senator DODD. I understand that.

Mr. MILLS. If I may very quickly, Senator, I can tell you that the Real Estate Board has already reported to us already in anticipation of what might not happen, that multiyear builders risk policies are becoming increasingly unavailable.

Mr. DUPERREAULT. And, Senator, we are right now issuing endorsements that say there is no coverage past the expiration of TRIA on property risk where we can do it, so it is happening now. It is not going to happen six or 8 months from now, it is happening right now.

Senator DODD. Mr. Chairman, I thank you.

Thank all of you very much.

Chairman SHELBY. Thank you, Senator Dodd.

The hearing is adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow.]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

APRIL 14, 2005

I would like to thank Chairman Shelby for holding this important hearing. Many of us were on the Committee when we enacted the Terrorism Risk Insurance Act (TRIA), and I appreciate the opportunity today to revisit the program and review its implementation.

I reluctantly supported the legislation passed in 2002. I believe in free markets, and thus am loath to inject the Federal government into private markets. I became convinced that September 11, 2001 was indeed an extraordinary event that required a temporary backstop in order to give the markets time to adjust. I emphasize the word temporary here. I came around to supporting the TRIA legislation only after repeated assurances from the industry that this was a one time request-simply buying time for the private markets to regroup.

There is no ambiguity as to the congressional intent that the program should be temporary. In fact, in the conference report the purpose section begins, "The purpose of this title is to establish a temporary Federal program that provides for a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism .–.–. "

Now the industry is back with the same arguments. Once again, we are being told that the markets just need a little more time to adjust. I'm not sure why we should believe it this time, though. If this is to become a perpetual government program, like flood insurance, the industry should be honest about it.

I will be following today's hearing carefully, and I will be interested in hearing what progress the industry has made in once again letting the free market take control. Again, Mr. Chairman, thank you for convening this hearing. I look forward to hearing more about this topic.

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN
Director, Federal Terrorism Reinsurance

APRIL 14, 2005

Chairman Shelby, Senator Sarbanes, and Members of the Committee, I appreciate having the opportunity to discuss Federal terrorism reinsurance with you today.

My statement, which draws heavily on the Congressional Budget Office's (CBO's) paper Federal Terrorism Reinsurance: An Update (January 2005), will elaborate on several points:

- By increasing the availability of terrorism insurance at below-market rates, the Terrorism Risk Insurance Act (TRIA) has led to a rise in the percentage of companies that buy terrorism coverage, mainly in places thought to be at high risk of terrorist attacks.
- In the absence of TRIA, an unexpectedly large loss from a terrorist attack would be likely to produce another episode of scarce coverage, rising prices, and uninsured assets.
- Some important changes have occurred since TRIA's enactment in 2002, however. The most significant seems to be a growing sense that the threat of terrorism in the United States will continue for the foreseeable future. That conclusion suggests that investment and economic behavior needs to adjust further in response to the greater threat of losses from terrorist attacks. For example, with a continuing threat, it might be cost-effective for new structures to be designed, located, and built to better withstand such attacks. Existing structures might benefit from having their safety features retrofitted. And businesses could diversify the locations of their operations. The extended duration of the threat is thus relevant to the question of whether to extend TRIA in its current form, which subsidizes insurance and dampens incentives for such adjustments.
- At a minimum, the speed with which the Nation adjusts to a sustained high level of risk might increase if the premiums charged for terrorism insurance more closely reflected expected losses. That outcome could be facilitated by letting the TRIA program expire or by adding cost-based premiums to the program.
- It is easy to exaggerate the overall costs to the economy of reducing the Federal subsidy for terrorism insurance; in fact, those costs are likely to be small. One reason is that TRIA does not lower the total costs of terrorist attacks but rather shifts them from property owners to taxpayers. Indeed, total costs might be lower

without TRIA because efforts to mitigate risk could pay off in smaller losses from a terrorist attack.

- Alternatives to insurance would be likely to develop more quickly if premiums were higher. That is, the expiration of TRIA or the addition of cost-based premiums could stimulate the development of alternatives, including mutual reinsurance pools and capital instruments such as catastrophe bonds. Another alternative to traditional insurance is for owners of the largest assets at risk (and their creditors) to protect themselves by diversifying among properties and locations.

What TRIA Does

The Terrorism Risk Insurance Act, enacted in November 2002, created a temporary Federal reinsurance program to transfer most of the risk of financial loss from acts of terrorism to taxpayers. At the time, the attacks of September 11, 2001, had made insurers less willing to provide terrorism coverage because of uncertainty about the risk of future losses. Policymakers feared that a shortage of terrorism insurance could expose property owners to uninsured risk, slow down commercial construction, and reduce economic activity. Indeed, anecdotal evidence suggested that some large construction projects had been canceled or delayed in part because of the lack of terrorism coverage. Many analysts expected that, in time, insurers would reassess the risk of terrorism, raise capital, and re-enter the market. TRIA was intended to fill the gap in the supply of terrorism insurance, at least until private insurers could recover.

Under TRIA, companies that provide commercial property and casualty insurance are required to offer terrorism coverage. In return, the Federal Government agrees to pay 90 percent of an insurer's losses, above a deductible, in the event of an attack by foreign terrorists. Insurers would pay the deductible and the other 10 percent of losses—up to a total limit for the program of $100 billion. The government would then be required to recoup some of its costs by assessing surcharges on commercial insurance policies sold after the terrorist attack. Participating insurers pay no premiums for TRIA reinsurance, which increases their ability to insure against catastrophes at low prices. The law and the program it created are scheduled to expire at the end of calendar year 2005.

Effects of TRIA on Insurance Markets

TRIA has served its purpose of immediately expanding the supply of terrorism insurance. For owners of high-risk properties, the law has succeeded in increasing the availability and lowering the price of coverage for property and casualty losses from terrorism. As a result, TRIA has led to an increase in the percentage of companies that buy terrorism coverage. It has also given private insurers time to raise financial capital, improve their models of risk, and reenter the market.

The Treasury is scheduled to deliver a report to the Congress this summer that should provide additional information about the effects of TRIA. As part of that report, the Treasury is conducting a comprehensive survey of insurers and policyholders about their experiences under the program.

Effects on Prices of Terrorism Insurance

TRIA has contributed to the decline in the price of terrorism insurance, which has fallen by half since the beginning of 2003. In the third quarter of 2004, the typical premium for terrorism coverage represented about 4 percent of the total premium for a property insurance policy—down from more than 10 percent in the first quarter of 2003, according to insurance broker Marsh Inc. That drop occurred as insurers' own deductibles under TRIA were rising, which would normally cause insurers to raise premiums. TRIA is probably not responsible for the entire drop in rates in 2003 because private insurers were building capital and learning more about pricing terrorism risks. In 2004, the median cost of purchasing terrorism insurance ranged from $53 to $80 per $1 million of insured value.

Effects on Purchases of Terrorism Insurance

After the cost of terrorism coverage fell, the percentage of firms buying policies nearly doubled. A recent survey indicates that 44 percent of large companies bought terrorism coverage in the third quarter of 2004, compared with just 26 percent in the third quarter of 2003. Another survey found that 57 percent of commercial property owners purchased terrorism insurance in the third quarter of 2004 versus 24 percent in early 2003. A majority of firms with terrorism coverage are now also buying private insurance for events not covered by TRIA, including acts of terrorism by domestic groups.

Despite those increases, roughly half of all commercial properties still lack terrorism insurance, but that rate of coverage is not necessarily a sign of market failure. Factors other than price affect firms' decisions to buy insurance. For example,

many companies that do not buy terrorism coverage apparently do not consider themselves to be potential terrorist targets. (Coverage is higher in cities thought to be at greatest risk—such as New York, Washington, Chicago, and San Francisco—despite higher premiums in those cities.) Moreover, properties owned by shareholders who hold diversified portfolios of such investments are effectively self-insured. If some firms have decided that the costs of terrorism coverage outweigh the benefits, then universal coverage may not be a desirable policy goal.

Financial Condition of Insurers

Insurers' capacity to provide coverage depends on their net worth (assets minus liabilities) and the availability of reinsurance. The largest component of net worth is insurers' accumulated stock of retained earnings. The net worth of property and casualty insurers dropped by nearly $30 billion in 2001 but has since recovered (see Table 1). In addition, underwriting losses (the difference between insurers' income from premiums and their expenses) have declined significantly. In fact, property and casualty insurers are earning underwriting profits for the first time in nearly 20 years—$2.8 billion for the first nine months of 2004—despite losses from four hurricanes in the third quarter of 2004. The net worth of the industry rose to $369 billion on September 30, 2004, from $285 billion at the end of 2002. U.S. reinsurers have also seen a recovery in their net worth and net income (see Table 2). Of course, not all of that net worth will be available to back terrorism coverage because it will be needed to support other types of insurance.

Table 1.

Operating Results for U.S. Property and Casualty Insurers, 1994 to 2004

(Millions of dollars)

	Net Premiums Written	Net Underwriting Loss or Gain[a]	Pretax Operating Income[b]	Net Worth[c]
1994	250,709	-22,083	11,604	193,346
1995	259,803	-17,375	19,459	230,001
1996	268,730	-17,162	20,801	255,527
1997	276,568	-6,030	35,469	308,479
1998	281,621	-16,572	23,354	333,327
1999	286,934	-24,429	14,426	334,348
2000	301,000	-32,300	9,500	319,000
2001	323,510	-52,602	-13,800	289,606
2002	369,673	-30,840	5,581	285,386
2003	405,855	-4,635	33,727	346,987
2004[d]	321,225	2,848	31,216	369,018

Source: Congressional Budget Office based on A.M. Best Company, *Best's Aggregates & Averages: Property-Casualty* (Oldwick, N.J.: A.M. Best Company, 2000); A.M. Best Company, "2000 Property/Casualty Results: Insurers Not Out of the Woods" (Oldwick, N.J.: A.M. Best Company, April 16, 2001), for 2000 data; Insurance Services Office, Inc., "Decline in Surplus Tarnishes P/C Industry's Return to Profitability in 2002" (press release, Jersey City, N.J., April 16, 2003), for 2001 data; and Insurance Services Office, Inc., "Sharp Increase in P/C Industry's Net Income Propels Surplus Upward in 2003" (press release, Jersey City, N.J., April 14, 2004), for 2002 and 2003 data; and Insurance Services Office, Inc., "First Nine-Month Net Gain on Underwriting in at Least 19 Years Drives Increase in U.S. Property/Casualty Industry's Net Income" (press release, Jersey City, N.J., December 20, 2004), for 2004 data.

a. Includes dividend payments to policyholders.

b. Excludes the realization of capital gains and losses.

c. Insurers' capacity to issue insurance depends on their net worth (assets minus liabilities), or their capital and surplus. Surplus, the largest component of net worth, is an insurer's accumulated stock of retained earnings. Capital is shareholders' equity in a publicly owned insurance company.

d. Numbers are for the first nine months of 2004 (year-end results are not yet available).

Table 2.

Operating Results for U.S. Reinsurers, 1994 to 2003

(Millions of dollars)

	Net Premiums Written	Underwriting Loss	Net Income	Net Worth[a]
1994	17,839	-1,667	1,936	38,123
1995	21,408	-1,971	2,501	52,692
1996	21,518	-763	3,712	43,727
1997	22,113	-477	4,531	53,264
1998	21,723	-1,288	5,434	54,614
1999	22,803	-3,517	1,473	53,023
2000	27,252	-3,586	1,993	52,365
2001	27,196	-11,150	-2,982	41,900
2002	30,797	-5,618	1,307	46,681
2003	32,982	-566	3,173	62,148

Source: Congressional Budget Office based on Reinsurance Association of America, *Reinsurance Underwriting Review, A Financial Review of U.S. Reinsurers: 2003 Industry Results* (2004), p. 4.

Note: Comparable results are not available for the first three quarters of 2004.

a. Insurers' capacity to issue insurance depends on their net worth (assets minus liabilities), or their capital and surplus. Surplus, the largest component of net worth, is an insurer's accumulated stock of retained earnings. Capital is shareholders' equity in a publicly owned insurance company.

Modeling Insurance Losses

Among its other effects, TRIA has provided time for the insurance industry to improve its ability to predict losses from terrorism and thus price terrorism risk more accurately. Several competing models are now available that predict the risk of losses from terrorism by zip code or by individual location. The level of detail in those models allows insurers to distinguish the higher risk faced by city centers from the lower risk faced by outlying urban areas. Each model contains a list of potential terrorist targets and produces estimates of the severity of losses associated with different types of attacks.

Although substantial progress has been made in modeling terrorism losses, the new models are not as reliable as those for natural catastrophes, which are based on more than 100 years of data rather than on two major events in the past 12 years (the September 11 attacks and the 1993 bombing of the World Trade Center). Terrorism models are hampered not only by a lack of data but also by the absence of an established "theory" of terrorist attacks. However, a generally accepted model of risk is not essential for providing private insurance. Insurance against natural disasters is widely available despite a variety of estimates from competing models of losses from such events.

Notwithstanding concern by some actuaries that existing tools cannot predict losses from terrorism with the degree of accuracy necessary to set prices for coverage, insurers have one benchmark available for setting premiums. The Insurance Services Office (ISO), a company that provides data and analytic services to insurers, currently files advisory estimates of loss costs (expected annual losses over the long term) with insurance commissioners in each state. Once state commissioners approve an ISO advisory, insurance companies operating in that state can use the estimates as a basis for setting premiums without having to undertake the formal rate-filing process. In 2003, all 50 states approved ISO's estimates of loss costs.

Economic Effects and the Cost of TRIA

TRIA was explicitly designed to reduce the short-term adverse effects of terrorism on economic activity, at some cost to taxpayers. Assessing TRIA's success in offsetting the macroeconomic effects of terrorism is difficult because it is hard to know how the economy would have performed in the absence of the law. No claims have been filed under TRIA, but the program exposes taxpayers to substantial risks and

costs. In addition, the TRIA program may be increasing exposure to losses by delaying cost-effective adjustments to a continuing risk of terrorism.

Short-Term Macroeconomic Effects

TRIA is a temporary program adopted to avoid a contraction of economic activity. Faced with anecdotal evidence that some major construction projects had been halted because of a lack of terrorism insurance, the Congress acted to keep such projects moving by increasing the availability and lowering the price of terrorism coverage.

After TRIA's enactment, some recovery in retail construction occurred. But the law appears to have had little measurable effect on office construction, employment in the construction industry, or the volume of commercial construction loans made by large commercial banks. Various factors complicate that assessment, however—for example, the lingering effects of the 2001 recession could be masking positive macroeconomic effects of TRIA.

In addition, it appears that the shock to the insurance market from the September 11 attacks did not spill over to the general economy. Surveys indicate that in the six months after September 11, banks did not significantly tighten their commercial lending in response to the shortage of terrorism insurance. Commercial lending may have been little affected in part because firms have alternatives other than insurance for spreading risk. Lenders and investors can reduce their risk through diversification. Real estate investment trusts, which are essentially mutual funds for real estate holdings, and commercial mortgage-backed securities (CMBs) are especially useful for that purpose. In fact, the extent to which interest rates on CMBs exceeded comparable rates was smaller in the summer of 2002 than it had been before September 11, 2001. That result is consistent with the idea that investors were requiring only a small premium for bearing terrorism risk, partly because CMBs are geographically diversified.

Cost to Taxpayers

No claims have been incurred under TRIA, but that does not mean that the program has no cost. Indeed, the cost—in terms of risk and expected losses—of having the Federal Government provide terrorism reinsurance is approximately the same as the cost of having the private sector provide it. With a Federal program, however, that cost is shifted from owners of commercial properties (who pay for expected losses and the cost of risk-bearing through premiums) to taxpayers. The shift in the cost of risk and uncertainty would occur even if surcharges on future policyholders ultimately offset all Federal cash outlays under TRIA.

CBO estimates the expected value of Federal outlays from TRIA to be $630 million over the 2005–2015 period (assuming that the law is extended) and the value of governmental receipts from surcharges to be $320 million over that period. (Expected-value estimates reflect CBO's expectation of payments during the period based on the probability of various outcomes, from losses of zero up to very large amounts.) The outlay estimate does not include any charge for the risk and uncertainty borne by taxpayers. Thus, the budgetary estimates are less than the economic cost of such reinsurance.

Long-Term Effects

An increase in the risk of terrorism is analogous to an increase in the risk of natural disasters: it lowers the value of some properties in high-risk areas. Similarly, TRIA is equivalent to a policy of subsidizing property and casualty insurance in an area that appears to have an especially high risk of natural disasters. If the increase in risk is only temporary, then a Federal program to provide low-cost insurance might be justified as a means of avoiding an expensive and excessive effort to reduce losses.

If the increase in risk is long-lived and significant, however, such a program could increase the cost to the economy because it could delay action by owners of assets to mitigate risk and reduce losses. Since July 2004, when the report of the 9/11 Commission was published, a consensus appears to have emerged that the current elevated risk of terrorism is likely to continue for years. With a sustained change in the risk of loss, spreading that risk through insurance is only part of an economically efficient response. Taking steps to mitigate risk—such as moving operations to safer areas, installing better security systems, hardening buildings against external attack, establishing disaster-recovery procedures, and setting up systems to protect computerized information—is also important. Firms have been making addi-

tional investments since September 11 to improve their security and avoid losses, but the incentive to do so is muted by subsidized terrorism insurance.[1]

If the Federal Government continued to subsidize terrorism insurance, it could contribute to deferring the private sector's long-term adjustment to the increase in risk. Less adjustment would mean that losses from any future attacks would be greater than would otherwise be the case. However, the extent to which TRIA may actually be reducing efforts to mitigate risk is unknown.

Policy Implications

Three options for TRIA have been under discussion in the Congress. One is to allow the program to expire at the end of 2005, as scheduled under current law. A second is to extend the program as is. That approach was taken in H.R. 4772 in the 108th Congress. A third option is to modify TRIA. For example, H.R. 4634, which was reported by the House Committee on Financial Services on September 29, 2004, would have continued the program through 2007, raised individual insurers' deductibles from 15 percent this year to 20 percent in 2007, increased the industry retention level from $15 billion now to $20 billion in 2007, and extended reinsurance coverage to providers of group life insurance. CBO estimated that on an expected-value basis, that legislation would have increased outlays by $1.3 billion and receipts by $480 million over the 2005–2014 period. At least two terrorism insurance bills have been introduced in the 109th Congress—the Terrorism Risk Insurance Extension Act of 2005 (S. 467) and the Terrorism Insurance Backstop Extension Act of 2005 (H.R. 1153)—but CBO has not yet estimated their cost.

Letting TRIA Expire

If the perception that the risk of terrorism is likely to remain high is correct, then it would be desirable for property owners and businesses to take measures to reduce their exposure to risk and lower the cost of any attack. They would have a stronger incentive to take such measures if the insurance subsidies conveyed through TRIA were reduced or eliminated. Letting TRIA expire, however, might expose property owners to onerous premiums to cover losses for which they were not responsible.

Would Private Reinsurers and Investors Take Up the Slack? There are indications that private reinsurers would eventually fill some of the gap in supply left by the expiration of TRIA, but that outcome is not certain. Like domestic insurers, global reinsurers have increased their underwriting capacity since September 11, in part by adding capital. Global reinsurers also earned underwriting profits in 2003 for the first time in seven years, according to Standard & Poor's, and shareholders' funds (capital and shareholders' reserves) increased from $244.8 billion in 2002 to $338.3 billion in 2003. More recently, hedge funds have entered the reinsurance business. However, in 2004, the amount of coverage actually purchased in the private terrorism reinsurance market remained low—between $4 billion and $6 billion, by industry estimates.

The experience of other countries provides little evidence about the role that private reinsurers can play. In Europe, public/private risk-sharing agreements on terrorism insurance are common. Typically, the government provides financial support for pools created by insurers. With a pool system, individual insurers pay the first layer of claims, private reinsurers cover middle layers, and a mutual reinsurance pool pays higher layers. Generally, the government picks up losses once a pool's resources are exhausted. For that reason, pure free-market tests of the willingness of private firms to underwrite terrorism coverage are difficult to find, leading to uncertainty about how much coverage the market would provide.

Although capital markets are currently absorbing some terrorism risk, the development of global financial instruments for spreading that risk would probably be more rapid without TRIA's subsidized prices. Further, international capital markets are larger than insurance markets and thus have greater capacity to absorb losses. Daily fluctuations in the overall value of traded capital assets worldwide often exceed the losses incurred on September 11, 2001.

In the absence of TRIA, catastrophe bonds—which fully or partly forgive the bond issuer from interest and principal payments in the event of specified catastrophes—might be used for terrorism losses, as they have been used to spread the risk of natural disasters. Two international catastrophe bonds have been issued that combine terrorism risk with other risks. However, before catastrophe bonds can play a major role, tax and regulatory accounting issues will have to be resolved.

[1] See Congressional Budget Office, Homeland Security and the Private Sector (December 2004).

How Would the U.S. Economy Be Affected? The immediate economic effects of letting TRIA expire are likely to be small. The economy is stronger now than it was in 2001 and 2002 and therefore is better able to offset the drag from an increase in costs for terrorism insurance. A study sponsored by the insurance industry concluded that failing to extend TRIA would reduce economic growth by 0.4 percent, household net worth by 0.9 percent, and the number of jobs by 0.2 percent in 2008, even without another terrorist attack.[2] That study predicted slower economic growth because of the effect that higher insurance premiums for property and workers' compensation insurance would have on businesses' operating costs. However, the study implicitly assumed that costs borne by taxpayers, unlike those borne by owners of commercial properties, do not have adverse effects on economic growth. The study also ignored TRIA's potential for delaying the economy's long-term adjustment to a higher risk of terrorism and the possibility that other policies could offset any economic slowdown.

Letting TRIA expire would not increase the expected cost of terrorism to the economy but rather would change the incidence of that cost. Under TRIA, the cost of terrorism risk is being shared by taxpayers and the owners of commercial properties. If TRIA expired as scheduled, more of the cost would be borne by private firms and insurers, but the total cost would be unlikely to rise.

How Would Insurance Markets Be Affected? One disadvantage of letting TRIA expire is that doing so increases the chances of a market disruption after an unexpectedly large loss, as has been the pattern for natural disasters. In particular, after a terrorist attack, the availability of insurance and reinsurance would drop, and premiums would be likely to spike. How long that effect would last is uncertain. But in the aftermath of catastrophic events that deplete capital, high prices and reduced availability of insurance can persist.

Reinsurers would also probably continue to exclude losses related to nuclear, biological, and chemical attacks from their coverage. That exclusion would be important mainly for the workers' compensation market, since primary insurers for that type of policy must cover losses from all causes. Without Federal reinsurance, insurers might be unable to diversify that catastrophic risk, at least in the near term, so premiums for workers' compensation policies could rise substantially. Thus, TRIA's expiration would most likely create shortages in the workers' compensation market. Because of the special challenges posed by that market, policymakers might consider the option of extending TRIA only for workers' compensation policies.

Another disadvantage of letting TRIA expire is that with higher prices, the prevalence of insurance coverage would probably decline. Thus, lawmakers might face the prospect of higher supplemental disaster assistance for uninsured losses in the event of a major attack. In the case of September 11, Federal assistance to businesses adversely affected by the attacks exceeded $6 billion, out of total Federal aid of more than $30 billion in response to the attacks.

Modifying TRIA

If the TRIA program was extended rather than allowed to expire, the government could take steps to reduce the program's adverse effects on risk mitigation. Charging premiums for Federal reinsurance would help encourage property owners to adjust to the higher level of risk. When TRIA was proposed, its supporters argued against premiums on the grounds that not charging them would have only small effects in the short run and would avoid the need to create a Federal entity to set premiums. However, if the primary goal now is to prompt the economy to adjust to a continuing threat of terrorism, then premiums might be set as close as possible to expected losses. Alternatively, to ensure that private insurers and reinsurers had room to compete with the government, policymakers could set premiums higher than expected losses (in other words, add "risk loads"). In addition, periodically raising the deductibles and coinsurance percentages that insurers must bear would gradually remove the government from the market.

[2] R. Glenn Hubbard and Bruce Deal, *The Economic Effects of Federal Participation in Terrorism Risk* (study prepared by Analysis Group, Inc., for the insurance industry, September 14, 2004).

PREPARED STATEMENT OF HOWARD MILLS

ACTING SUPERINTENDENT OF INSURANCE
TERRORISM INSURANCE IMPLEMENTATION WORKING GROUP
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

APRIL 14, 2005

Introduction

My name is Howard Mills. I am the Acting Superintendent of Insurance for the State of New York, and this year I am serving as chair of the Terrorism Insurance Implementation Working Group of the National Association of Insurance Commissioners (NAIC). We appreciate the opportunity to testify regarding the role of the Federal Government in ensuring that insurance to protect against losses from acts of terrorism remains available to Americans.

Today, I want to make three basic points:

- First, there is still a need for the Federal Government to provide appropriate financial back-up to the private insurance market in order to assure that segments of our nation's economy do not falter due to a lack of insurance coverage for terrorism. The insurance marketplace is not yet ready to take on the risk of providing coverage for acts of terrorism on its own.
- Second, Congress should act this year to extend coverage under the Terrorism Risk Insurance Program (TRIP), or enact a comparable Federal backstop for acts of terrorism, at least through 2007, because the commercial insurance markets lack the capacity and means to underwrite sufficient terrorism coverage without a Federal backstop.
- Third, The CBO January 2005 Paper-Federal Terrorism Reinsurance: An Update-contains some opinions on how markets will react to the Terrorism Risk Insurance Act of 2002 (TRIA) that are not borne out by observations of how businesses and insurers have reacted to TRIA.

TRIA Has Been A Success, But Challenges Remain

Following enactment of TRIA, the NAIC established a Terrorism Insurance Implementation Working Group of state regulators that has worked closely with the Treasury Department to successfully implement TRIA's provisions, as well as to monitor the impact it has had on the insurance marketplace. There are many who believe the United States economy remains vulnerable to terrorist attack. This is evidenced by an increased take-up rate for terrorism coverage observed in recent surveys. Indeed, those who need coverage the most are able to obtain it because of the existence of TRIA.

We believe the presence of the Federal backstop has provided a 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 in the wake of the tragic events of September 11th, TRIA brought certainty to the insurance marketplace.

The NAIC's Terrorism Insurance Implementation Working Group believes that TRIA has been successful in stabilizing the insurance market. In particular, TRIA's "make available" requirement has contributed to the overall effectiveness of the program during its first three years. American businesses—both large and small—have been offered choices they might not otherwise have had. Through the "make available" provision, TRIA has given them the opportunity to make an informed choice regarding the purchase of coverage for acts of terrorism.

During the first week of May 2004, insurance regulators began receiving contingency filings from Insurance Services Office, Inc. (ISO), the nation's largest insurance advisory organization. In the event Congress does not extend the TRIA program this year, these policy form filings would reinstate terrorism coverage limitations that were in effect prior to TRIA's enactment for any policies that extend coverage into 2006. In addition to protecting insurers from additional terrorism liability, these filings demonstrate that the insurance industry is not yet willing to assume the full risk of terrorism losses at this time. If triggered by the expiration of TRIA, these limitations will greatly reduce terrorism coverage in the states that have approved the endorsements. In those states that have rejected these coverage limitations, insurers will have to make the difficult choice of writing the coverage and accepting the potentially catastrophic terrorism exposure or not writing it at all. This could lead to availability and affordability problems down the road.

Industry Capacity Limitations

One of the elements that Congress should consider is the capacity of the insurance industry to accept the risk of losses from acts of terrorism. 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 2003 was a profitable year for property and casualty insurers, with aggregated policyholder surplus increasing approximately 26 percent to $375 billion. It should be noted however, that policyholder surplus declined each year from 1999 to 2002, and the $375 billion figure is only 4.3 percent higher than the $360 billion in policyholder surplus held in 1999. Less than half of those funds are used to support commercial products in all lines of insurance, including terrorism coverage. Moreover, the substantial losses incurred by insurers in responding to claims from four major hurricanes during 2004 will erode some of the recent surplus gains.

As part of considering whether the insurance industry has sufficient capacity to underwrite the risk of terrorism losses, Congress should consider whether the industry is willing to put its capital at risk. At present, we believe the answer is no.

In addition, insurers and the marketplace-at-large are finding it very difficult to accurately price coverage for acts of terrorism. Unknown frequency, coupled with the potential for severe losses, make insurers reluctant to provide coverage for acts of terrorism. Until insurers and their reinsurers become more comfortable that government efforts are adequate to protect citizens from terrorist acts, or at least become more predictable than they are today, they will be reluctant to accept complete risk transfers from American businesses for this exposure. In particular, businesses viewed by insurers as having a greater risk of terrorism losses, such as those located in America's financial and commercial centers, will have trouble finding terrorism insurance.

Congress Should Extend the Terrorism Risk Insurance Program

The NAIC urges immediate action by Congress on a Federal solution to ensure continued marketplace stability when TRIA expires at the end of 2005. Because some terrorism risks are largely uninsurable without a financial backstop, state regulators are very concerned that significant market disruptions will develop before TRIA's expiration. This is due in large part to the deadlines contained in TRIA, which do not match the business cycle for insurance renewals.

The commercial insurance business cycle operates in such a way that insurers and their policyholders were required to make decisions as early as September 2004 regarding coverage that extends well into 2006. At present, annual policy renewals with effective dates of January 2, 2005 or later must contemplate there will be no Federal backstop for any losses occurring in 2006. For this reason, state insurance regulators have observed widespread insistence by insurers that conditional policy exclusions for terrorism coverage be included in renewal policies. This is the same situation we encountered in the aftermath of September 11th, which prompted enactment of TRIA. While this particular dynamic is not present in the New York marketplace, the few states that have not allowed insurers to file coverage limitations fear that without TRIA, insurers will be unwilling to underwrite many businesses that want appropriate and reasonably priced terrorism insurance coverage.

To address this situation, Congress should promptly act to extend TRIA for two years. Time is needed for Congress to receive and review the report from the Treasury on June 30, 2005, and then have roughly fifteen months to digest and debate the future Federal role related to acts of terrorism before reaching another milestone for insurers and American businesses.

The NAIC stands ready to assist Congress in developing an appropriate method for continuing the Federal terrorism reinsurance backstop. The NAIC has begun to discuss a concept that would involve the Federal Government only for mega-catastrophes. It would encourage the use of the private sector to insure more moderate catastrophe risks using traditional methods such as reinsurance, access to financial market products, and risk diversification, along with changes in U.S. law that would allow insurers to build tax-deferred catastrophe reserves.

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 assistance from the Federal Government. The first 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, worker's 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 in court. Workers' compensation is currently included under TRIA.

State laws do not allow an insurer to exclude or limit worker's compensation coverage, except as permitted by state law. 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 second type of coverage causing insurers special concern is group life insurance, which is not currently included in TRIA. 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 on another instance, 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 worker's 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, the employer, the insurer, the insurance industry in general and the American economy would suffer if an insurer is only able to pay a fraction of the policy face amount in a mass casualty situation.

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. Although there is some level of private reinsurance available for group life coverage, it is not sufficient to cover catastrophic terrorism losses. While the NAIC has not taken a formal position on whether group life should be included in TRIA or another form of Federal backstop, regulators have heard these concerns expressed by group life insurance underwriters.

The CBO Report

In January 2005, the Congressional Budget Office ("CBO") issued a paper entitled "Federal Terrorism Reinsurance. An Update" that concluded, in part, that TRIA's "zero premium" coverage could serve to dampen incentives for owner's of assets to engage in loss control. The report stated that if the "government continued to subsidize terrorism insurance it would probably contribute to deferring the private-sector's long-term adjustment to the increase in risk," and this in turn would result in greater future losses than could otherwise be avoided. I wish to inform you that in New York State, and indeed, throughout the country, we see little evidence to support the conclusion that TRIA has resulted in owners failing to take appropriate steps to protect their assets from terrorist attacks. To the contrary, the evidence demonstrates that owners have invested heavily in strengthening disaster preparedness and response efforts in the wake of the 9/11 terrorist attacks notwithstanding the existence of TRIA.

For example, since 9/11, most large commercial and many multi-family residential buildings in New York 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 has also 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.

While 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. 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 terrorist attack. The steps taken to mitigate losses, however, may result in countermeasures by terrorist 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 in dealing with potential losses of this magnitude. Of course, loss control must be a part of any long-term solution in the private sector to manage terrorism exposures. Mitigation techniques do not, however, address the issue of financing the catastrophic losses should such losses 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

[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.

terrorism insurance will likely become less affordable or even unavailable to consumers. The insurance industry has not yet built the capacity to respond adequately to the terrorism exposure and extending TRIA for an additional period will allow the industry the time to appropriately accept increasing levels of this risk.

Conclusion

We strongly urge Congressional action to extend TRIA or enact an alternative form of Federal terrorism backstop this year in order to avoid market disruptions likely to occur in the absence of a Federal backstop program. Immediate action by Congress will help ensure the insurance market's continued role in supporting economic development. In addition, it will allow Congress adequate time to fully evaluate the Treasury Department's June 2005 report and recommendations.

The NAIC stands ready to assist Congress in developing an appropriate method for continuing the Federal terrorism reinsurance backstop. The extension of TRIA will provide American businesses with the essential insurance coverage needed to successfully operate in today's uncertain global environment.

NAIC Resolution to Extend TRIA

JUNE 12, 2004

RESOLUTION

Whereas, the Terrorism Risk Insurance Act of 2002 (TRIA) was adopted by Congress to provide a temporary Federal shared loss program for incurred losses resulting from certain acts of terrorism to protect American businesses by minimizing market disruptions and ensuring the widespread availability and affordability of property and casualty insurance for terrorism risks;

Whereas, the TRIA was adopted by Congress to allow a transitional period for private markets to stabilize, resume pricing of terrorism insurance, and build capacity to absorb any future losses, while preserving the benefits of state regulation and consumer protections;

Whereas, the presence of the Federal backstop has provided a measure of security to the insurance industry and has enabled them to extend offers of coverage for acts of terrorism in the wake of the tragic events of September 11th;

Whereas, insurance regulators do not believe the insurance marketplace is ready to take on the entire risk of providing coverage for acts of terrorism;

Whereas, insurance regulators have received contingent filings from advisory organizations and insurers that would reinstate the coverage limitations that were in effect prior to TRIA's enactment, in the event Congress does not act this year to extend TRIA;

Whereas, there are many who believe that the U.S. economy remains vulnerable to terrorist attack;

Whereas, the take up rate for terrorism risk insurance has increased in recent months;

Whereas, unknown frequency, coupled with the potential for substantial severity of a loss makes coverage for acts of terrorism one that insurers might choose to avoid if given the opportunity; and

Whereas, insurers and their reinsurers remain uncertain that the efforts of the U.S. Government are sufficient to protect citizens from terrorist acts, or at least have become more predictable than they are today, and as a result they will be reluctant to accept complete risk transfers from American businesses, particularly those businesses that they view as having a greater risk of loss from acts of terrorism.

Now, Therefore, Be It Resolved, That:

State insurance regulators urge Members of Congress to adopt a short-term extension of TRIA to avoid market uncertainty this fall. The short-term extension would provide sufficient time for the next Congress to consider longer-term solutions to the terrorism insurance risk and the nation's economic security. An extension of two years would provide Congress with the time it needs to evaluate the study and report required of Treasury on the effectiveness of TRIA and the insurance industry's capacity to provide terrorism insurance. It will also provide sufficient time to review and evaluate information provided by others.

Be It Further Resolved, That:

The NAIC urges Members of Congress to encourage the Secretary of the Treasury to extend the "make available" requirement into Year 3. This will avoid any market disruptions that would occur in the absence of the mandated coverage offer. Such action will ensure the insurance market's continued role supporting economic development.

PREPARED STATEMENT OF ERNST CSISZAR

PRESIDENT, PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA

APRIL 14, 2005

Introduction

My name is Ernie Csiszar and I am President of the Property Casualty Insurers Association of America. PCI is a trade association representing over 1,000 property/casualty insurers that write almost 40 percent of all the insurance policies in the United States. PCI was founded on the philosophy that consumers are best served

by free, fair, and well-regulated insurance markets in which a wide variety of financially healthy companies compete for business on the basis of price, product innovation and quality, and customer service.

I would like to commend the members of this Committee for recognizing that terrorism insurance is a national, economic, and homeland security issue, for your commitment to seeking a long-term solution to this problem, and for understanding the critical role of the federal government in solving this problem. I am here today to give you our views of this issue. I am also here to commit to you that PCI will work with this Committee to explore all aspects of this problem and all possible solutions in order find a program that will protect our nation's economic security and our policyholders.

The Importance of a Federal Role in Terrorism Insurance

Our members believe in the power of free markets and support competition-driven solutions to public policy problems. We think consumers are best served, wherever possible, by markets that are free, fair, and well regulated. That being said, there are some instances—terrorism insurance clearly being one of them—where there is clearly a need for federal involvement.

This fundamental point has been underscored recently when Federal Reserve Board Chairman Alan Greenspan said in his testimony before the House Financial Services Committee, "There are instances in which markets do not or cannot work, and....I have not been persuaded that a private market for terrorism insurance works terribly well."

We all know that the threat of a terrorist attack on our nation and our economy is still very real. CIA Director Porter Goss recently testified that an attack on our nation is "only a matter of time" and that our enemies continue searching for ways to make future attacks much more devastating than September 11, including the use of nuclear, biological, chemical, or radiological weapons.

We believe our nation must fight terrorism on all fronts, using military action, homeland security measures, and programs that protect our economic security. We believe that a public/private partnership, harnessing the power and security of the Federal government with the innovation and agility of private markets, is the best way to protect our economy.

The Impact of TRIA

I would like to offer several comments on the Terrorism Risk Insurance Act of 2002. TRIA was adopted in November 2002, more than a year after the September 11 attacks. It was debated significantly in the House and the Senate and emerged from long and thoughtful consideration of the issues involved, observation of the response of private markets to terrorism risk, and evaluation of alternative approaches. Ultimately, TRIA was not done in haste and reflects the well-considered wisdom of the Congress and the Administration. We believe it was a tremendous achievement by the 107th Congress.

TRIA provides essential support and confidence to private insurance markets. The program has created a degree of certainty about the maximum losses that any individual company or the entire insurance industry could suffer and, in doing so, has helped foster what market there is for terrorism insurance. According to the latest statistics, roughly 44 percent of all business insurance consumers buy terrorism coverage. Some have feared that TRIA would "crowd out" the development of a meaningful private market for terrorism reinsurance. On the contrary, we believe it gave the support needed to allow such a market to begin to develop. Without TRIA, we don't believe we would have seen the limited development that has occurred.

Our members write insurance policies for individuals and businesses in every state and virtually every community in our nation. Their commercial insurance policyholders—real estate developers, builders, manufacturers, retail stores, malls, apartment complexes, churches, mosques and synagogues, schools, and universities—have benefited enormously from TRIA. They know the threat of a terrorist attack is real and many have made a deliberate and considered decision to protect themselves from the economic risks of future attacks.

As you know, TRIA will expire at the end of this year. Given the many benefits it has provided, I am here to tell you that all of us—Members of Congress, insurers, and policyholders—must act now to develop a long-term solution to the problem of insuring terrorism risk.

We commend Senators Bennett and Dodd and their cosponsors for introducing S. 467 to extend TRIA for another two years. They have recognized the very serious nature of this problem and are working to solve it in a constructive way. We favor the modifications they have suggested—including a "soft" landing to allow policies

written in the second year to naturally expire, including group life insurance under the program, and keeping individual company retentions level.

At the same time, we also believe that a short-term extension of TRIA can and should be seen as the basis for developing a long-term solution to the terrorism insurance problem. I commit to you today the resources of PCI to work with members of Congress and the business community to develop an effective, market-driven system that establishes a long-term, public/private partnership to address the issue of terrorism insurance once and for all.

The Unique Challenge of Underwriting Terrorism Insurance

Our members are in the business of assessing, pricing, and underwriting risk. They work closely with their policyholders to reduce their exposure to all types of loss, including terrorism. Insurers have always risen to the challenge of underwriting and paying for catastrophic losses. Our industry paid nearly $35 billion in claims from the September 11 attacks, not to mention the enormous payments we have continued to make, as always, from “normal” natural disasters such as hurricanes and earthquakes.

When we tell you that terrorism risk is different from other catastrophes, we do so for several reasons. The differences arise mostly from differences in severity and predictability. The size of the potential losses from a terrorist attack dwarfs the financial resources of the insurance industry. The cost of the September 11 attacks was by far the largest insured loss in history. The amount of insurance industry capital devoted to insuring the lines of business most likely to be affected by terrorist attacks (commercial property, workers compensation, etc.) amounts today to approximately $148 billion or 40 percent of the total capital of the industry. Since September 11, insurers and catastrophe modeling experts have modeled many potential terrorist attack scenarios—these experiments convince us that there are many attacks, especially those involving the use of nuclear, biological, chemical, or radiological weapons, that are well beyond the financial capacity of our industry to withstand. CIA Director Goss’ recent testimony underscored our concerns.

Second, this risk is impossible for insurers to assess and price based on our current knowledge. Weather-related catastrophes are much more predictable. We have years of experience with sophisticated models that tell us not only where these losses are likely to occur, but on average how large they might be and how often they might happen. We know none of this about terrorism. Without a distribution of either the ultimate cost or the probability of loss, we don’t have a method to develop the appropriate charge for the coverage nor do we know what losses to expect.

These problems are the reasons that a vibrant, substantial, and healthy private market for terrorism reinsurance has not emerged since September 11. We are concerned that there appears to be a belief in some quarters that allowing TRIA to expire with nothing in its place will automatically spur the development of a significant private market that can handle all terrorism risk. We see no reason to expect that will happen.

Limits on the Private Sector Role

I have spoken above of our support for the greater use of private sector responses to this risk. At the same time, it is critical that policymakers also recognize the limits of the private sector response and why a federal role is essential. As already noted, insurers face significant problems underwriting this risk because of the enormous potential losses and because we don’t know size or frequency distributions for the risk.

In addition, private markets require that buyers and sellers are able to determine for themselves whether a product will be offered and under what terms and conditions. If there is to be a greater private role in solving the terrorism insurance problem, there must also be federal support for giving insurers and insurance markets more freedom to negotiate these terms and conditions. Let me offer some examples of the problems we face:

- In 19 states, insurers writing commercial property insurance are still required to cover losses from a “fire following” a terrorist attack, due to restrictions in 1940s-era laws enacted for a very different world. This is true even if insurers and policyholders would prefer to alter coverage.
- State regulators in three key states (New New York, Florida and Georgia) continue to refuse to allow insurers to exclude or limit coverage for terrorist attacks after the expiration of TRIA this year. This refusal continues even if the insurer and the policyholder both might want the flexibility of a free market.
- TRIA itself provides state oversight and control of the rates insurers can charge for terrorism coverage, with the result that insurers cannot truly experiment with

the appropriate price for this coverage and, if they try, must fear potential future requirements that they return supposedly “excessive” rates.

- No state allows an insurer writing workers compensation to exclude or limit coverage for losses caused by terrorism. The only way workers compensation insurers can avoid this risk is to stop writing certain insureds—i.e., to walk away from policies they think may pose excessive risk. However, even when they do so, they face exposure in many states to losses from those same policies through mandatory residual market pools and guaranty funds.

We understand the desire for consumer protection behind many of these requirements, however, we must emphasize that it is inconsistent to urge a more robust private sector response without giving the private sector the tools it must have to build that response.

Guiding Principles for a Long Term Solution to the Terrorism Insurance Problem

As you consider how to proceed, we believe there are several important principles to keep in mind when evaluating long term solutions to the terrorism insurance problem:

- Terrorism is the most significant risk facing our nation’s economic security today. It is critical that it be addressed. It requires uniform protection and a nation-wide response (not state by state). The fight against terrorism is a long-term battle and we should now build on the steps initially taken by Congress to provide a long-term solution.
- The insurance industry does not have the financial capacity to bear the total risk of terrorism losses due to the nature of the exposure and the scale of the risk. Addressing this risk to our nation’s economic security requires a partnership between the private sector (and its infrastructure) and the Federal government. This partnership must protect the public, the nation’s economy and insurers’ ability to meet their many obligations to their policyholders.
- A long-term solution should minimize cross-subsidies by line of insurance and by insurer, maximize incentives for sound economic underwriting and pricing, and cover exposures most seriously threatened by terrorism. There should be an equitable distribution of costs based on geographical location and risk of loss, which includes potential losses to life, property and agriculture, and critical economic infrastructure.
- The program should cover losses from both domestic and foreign terrorism events.
- The program should be consumer friendly and implementation costs kept reasonable by following standard industry business practices.

Components of an Alternative Solution

I want to emphasize the need for us to develop a long-term solution to the terrorism insurance problem. PCI believes that all reasonable ideas should be considered and, to that end, I’d like to offer several thoughts on such a design. Such ideas might include:

- Federal support for giving insurers and insurance markets more freedom to negotiate terms and conditions of coverage. This point has been discussed above and I would only add that if solutions are going to be based on free market principles, then the market must be allowed to work freely.
- Treating the unique exposures resulting from use of nuclear, biological, chemical and radiological weapons differently that those involving other terrorist tactics. These risks have never been part of the insurance industry’s assumed risk profile—there has never been a true, private market for this insurance and there is no reason to believe one will arise now in the face of the threats we face. Such attacks pose the risk of damage and losses far beyond the financial capacity of the insurance industry to sustain and may require a different approach to solve.
- There is also a need to recognize and, in the longer term, to deal with the exposure faced by homeowners and their insurers due to the risks of a devastating attack using nuclear, biological, chemical, or radiological weapons.
- We understand that some want to see individual company and/or industry-wide retention levels increase so that private insurers accept more of the responsibility for paying terrorism insurance losses. We have significant concerns about this and want to make clear that any such change must be coupled with a program that allows insurers to reduce their own individual retention levels. Moreover, such increases would have to be gradual so that each insurer can manage the increase in its own exposures. A sudden, ill-planned transition could have a catastrophic

impact on America's economy. Finally increasing the exposure of private markets must be coupled with more freedom to underwrite and a way to allow insurers to collectively access wider capital markets supported by the federal government.

- Enabling the industry to form a tax-exempt entity or entities to provide reinsurance or to allow companies to reduce their individual company retention level to some manageable level. The tax-exempt entity might also be allowed to issue post-event bonds or to use some other financing mechanism to pay for losses and allow the use of longer time horizons to absorb those losses.
- Allowing the accumulation of funds through the establishment of individual company tax-deferred reserves.
- Ensuring that market-based solutions are built on the concept of risk-based pricing. Cross-subsidies by line of insurance and by insurer should be minimized, and sound underwriting and pricing should be rewarded.
- Allowing group life insurers to gain access to the public/private partnership, given their very serious exposure to catastrophic losses from terrorism, and ending the arbitrary split now in TRIA between foreign and domestic terrorism losses.

Right now these are just ideas, not fully developed solutions. PCI has been reviewing the merits and consequences—including unintended ones—of each and the association is committed to working with you to explore these options and to create a solid, long-term public/private partnership to address this critical problem.

Conclusion

Our members again commend you and your colleagues for addressing this issue and for offering ideas for a solution. We believe terrorism is the most significant threat today to America's economic security and we applaud your efforts to address this very serious problem.

We believe TRIA represents the considered will of the Congress and has worked well at very low cost to the government. It has been a success and has promoted the ongoing development of private markets for terrorism coverage.

Finally, we want you to know that our members are committed to addressing this issue. We have been working closely and diligently with them, and will continue to do so, to identify and explore potential solutions to this problem. We look forward to continuing to work with you and your colleagues to find a solution.

Consumer Federation of America

TESTIMONY OF

J. ROBERT HUNTER,
DIRECTOR OF INSURANCE,
CONSUMER FEDERATION OF AMERICA

BEFORE THE

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

REGARDING

OVERSIGHT OF THE TERRORISM RISK INSURANCE PROGRAM

APRIL 14, 2005

Mr. Chairman and members of the Committee, I appreciate the invitation to appear before you today to discuss current issues surrounding the temporary Terrorism Risk Insurance Program. I am J. Robert Hunter, Director of Insurance for the Consumer Federation of America. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education. I am a former Federal Insurance Administrator under Presidents Ford and Carter and have also served as Texas Insurance Commissioner. As Administrator, I ran a program similar to TRIA in many respects, the Riot Reinsurance Program.

Before I begin, I would be remiss if I did not thank both Chairman Shelby and Ranking Member Sarbanes on behalf of America's consumers and taxpayers for not rushing into consideration of an extension of the Terrorism Risk Insurance Act last year, a full year before the Act was due to expire. You were right to wait, as the Act intended, for the mandated report from the Department of the Treasury that must be completed by July. Renewing TRIA before the Department completed this study could have put taxpayers on the hook for billions of dollars in terrorism losses that the insurance industry could otherwise afford, while thwarting the development of a vibrant private market for terrorism insurance and reducing incentives for businesses to undertake mitigation efforts.

I cannot blame the insurance industry for wanting to keep a federal subsidy that was always intended to be a temporary measure during a difficult period in our nation's history, the immediate aftermath of the attacks on September 11th. If Congress had enacted free health or auto insurance for lower income Americans, I would likely be here asking for that law to be extended. But Congress did not do that. Congress gave temporary free insurance (really reinsurance) to a financially well-off industry for a three-year period. This law should not be extended without a thorough examination of whether this temporary tool is still necessary, and if so, how it should be structured in the future. These are precisely the issues that the Treasury Department is studying.

TRIA Research in Advance of the Treasury Department Study

As you know, TRIA created a three-year program in which the federal government covers 90 percent of all terrorism-related insurance losses (up to $100 billion a year) after individual insurance companies pay an initial deductible. Insurers, who are required to offer terrorism coverage, must repay very little or none of the assistance they receive. The Act expires on December 31, 2005, unless renewed by Congress.

A great deal of information about the successes and failures of the TRIA program is already available, even before the Department of the Treasury issues its report:

1. CBO FINDINGS

The extremely balanced Congressional Budget Office report of January 2005 clearly and accurately points out the pros and cons of letting TRIA expire:

- Terrorism premiums would likely rise for those buying insurance in high-risk situations.

- The number of businesses buying insurance would probably decrease. (Only about half of all businesses are currently purchasing terrorism coverage.) Such a decrease would mean more taxpayer involvement in a post-terrorism attack situation.

- Mitigation efforts would increase. Efforts to lower the risk of terrorism attacks or reduce their effects would be encouraged by the market charging actuarial rather than taxpayer-subsidized rates for terrorism insurance. Steps such as hiring guards and placing metal or explosives detectors at entrances to higher risk buildings would be encouraged by the expiration of TRIA.

- Private sector alternatives to TRIA would be encouraged by the expiration of TRIA, such as reinsurance to replace the free TRIA coverage or the development of securitized responses, such as bonds similar to catastrophe bonds.[1]

- The economy might be affected somewhat, but not as much as the insurers contend. CBO indicates that the analysis presented to the public through press releases sent out by the insurance industry[2] overstates the potential costs to the economy if TRIA expires.

- The cost of insuring against terrorism would not change much for the nation. TRIA does not change the anticipated terrorism costs except, CBO states, to the extent it increases national costs because it undermines the incentives of insurers to insist on mitigation measures and insured parties to implement these measures in order to get lower premium charges. Not extending TRIA would merely shift roughly the same costs from taxpayers to private firms and insurers.

- There could be insurance market disruption if another large terrorism event occurs. CFA believes that Congress knows how to handle this sort of situation, given the success it had in stabilizing the insurance market after September 11, 2001 and during the riots in the nation's cities in the 1960s.

CBO also lists the pros and cons of altering TRIA by requiring that insurers be charged actuarial (or above actuarial) premiums for the coverage that is provided:

- Charging premiums would result in more mitigation by insurance purchasers because increased premiums would encourage the development of discount plans for safety precautions taken by insured businesses.

- Charging premiums would encourage the private sector to grow, since the private sector cannot compete with the free reinsurance provided by the taxpayers under TRIA.

- Charging premiums might result in less terrorism coverage being purchased. This would mean more taxpayer involvement in a post-terrorism attack situation.

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[1] Indeed, there is evidence that just the potential of TRIA expiration is causing insurers to develop and risk managers to seek alternative ways to cover the terrorism risk. (See Exhibit 2 for examples of this effect.)
[2] *The Economic Effects of Federal Participation in Terrorism Risk*, Hubbard and Deal, 9/14/04.

CBO sums up their report as follows:

"In sum, as the Congress considers whether to extend TRIA (and in what form), it is useful to consider what has changed in the two years since the law was enacted. The most significant development seems to be a growing sense that the terrorism threat to the United States will continue for the foreseeable future. That development suggests that the economy, especially the stock of physical capital, needs to be responsive to the prospective losses from terrorist attacks. For example, new construction might be designed, located, and built to withstand such attacks. Existing structures might need to be retrofitted with safety features. *Those needs argue against extending the TRIA program in its current form, which subsidizes insurance and dampens incentives for mitigation activities.* (Emphasis added.)

"*The macroeconomic costs of scaling back the federal subsidy for terrorism insurance are likely to be small.* One reason is that the capacity of insurance companies to provide terrorism coverage has improved recently. Another reason is that TRIA does not lower the costs of terrorist attacks but rather partially shifts those costs from property owners to taxpayers. As noted above, total costs might be lower without TRIA. However, the gains in economic efficiency from allowing TRIA to expire could require a significant trade-off: without the TRIA program, an especially large loss from a terrorist attack would be likely to produce another episode of scarce coverage, rising prices, and uninsured assets." (Emphasis added.)

Thus, CBO concludes that immediately gaining more safety and lowering terrorism costs through mitigation – current real gains stemming from TRIA's expiration– have little possible future downside, except for the possible insurer reaction *after* a terrorist event. CFA believes that the benefits of improved mitigation efforts and increased private sector involvement in insuring against terrorist risk that would be encouraged if TRIA expires far outweigh the potential costs of insurer reaction after some future event, particularly since Congress has shown that it knows how to offset that potential cost through prompt action after such events.

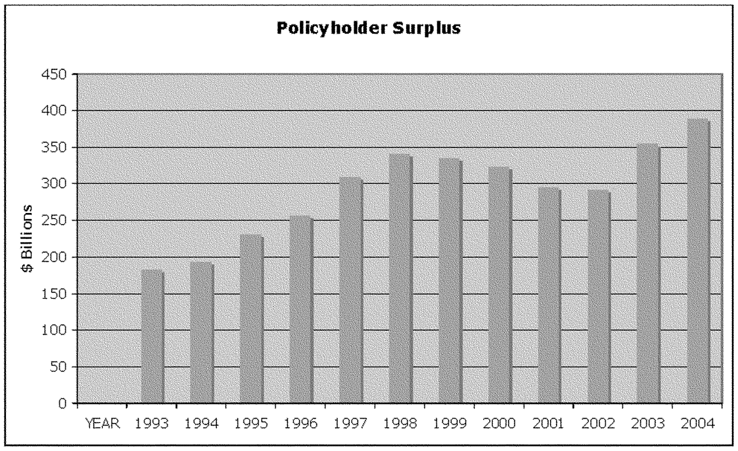
2. THE INSURANCE INDUSTRY IS HUGELY PROFITABLE AND DOES NOT NEED A FEDERAL SUBSIDY TO COVER TERRORISM LOSSES AFTER TRIA EXPIRES

TRIA temporarily subsidizes the insurance industry by offering free reinsurance to back up the sale of terrorism insurance. There may have been an argument that this industry needed support in 2002 – as industry retained earnings (surplus) and profits had slipped – but since then, the situation has changed radically (as CBO reported).

The profits of insurers selling TRIA-backed terror coverage are excellent, as is the financial solidity of the industry. A. M. Best estimates that policyholder surplus (retained earnings) reached $388 billion at year-end 2004.[3] In 2000, before the terrorist attack, this figure was $323 billion, and in 2001, after the attack, it was $295 billion. The attacks of September 11th caused an estimated $35 billion in claims before taxes, or $23 billion after taxes ($35 billion reduced by 35 percent, which was borne by taxpayers).

The surplus growth is shown in the following chart:

[3] Review and Preview, A.M. Best and Co., January 2005, page 19.



Best's estimates that the current property/casualty insurance premium writings-to-surplus-ratio is a very safe 1.2 to 1. By historical standards, this is a very wealthy and healthy industry. It does not need a continued taxpayer-funded handout.

The commercial lines segment of the industry was reported by Best's to have a surplus of $155 billion at year-end 2003, which Best's estimates grew by 10.3 percent in 2004 to $171 billion.[4] At year-end 2000, the surplus was $122 billion. This growth in surplus of $49 billion alone would be able to pay for losses for an attack of more than two times the size of the World Trade Center attacks of September 11th.[5]

Recently, several senators introduced S. 467 to extend the TRIA program. The bill is similar to last year's bill, S. 2764. The bill would extend TRIA for two years (to a total of five years), with increased insurer retentions in years four and five of $17.5 billion and $20.0 billion respectively. The fifth year would allow a "run-off" of coverage for policies written in 2007 to cover through the end of 2008, which represents a three-year extension of TRIA for all practical purposes, since insurers could write policies in such a way to run off at that third-year termination time. The bill would also require the program to reinsure group life insurance policies for the first time and set up a working group to seek a permanent solution to the terrorism insurance issue.

CFA opposes this bill. First, it is premature, as Congress needs the Treasury Department's mandated input prior to crafting solutions. With the information from Treasury almost available, there is no need to legislate without complete information about how TRIA has performed until

[4] Best's Aggregates and Averages, 2004 Edition, page 30 for 2003 data; 2004 growth in Best's Review/Preview, January 2005, page 20.
[5] An attack that resulted in losses of $49 billion after taxes would be $75 billion before taxes ($49/.65). This is 2.2 times the estimated $35 billion before taxes that the WTC event cost insurers and taxpayers.

now. Second, the bill unnecessarily expands coverage to group life insurance (see below). Congress should be reducing, not increasing, taxpayer exposure at this time of huge budget deficits. Third, as the bill would essentially extend TRIA for three years, it would reduce mitigation incentives and private insurance alternatives for too long a time. Fourth, the mandated study from the Treasury Department may address the issue of a permanent solution, so the establishment of a working group may not be necessary.

3. EXTENDING TRIA "AS IS" WOULD BE COSTLY TO TAXPAYERS

The attached Exhibit 1 shows the value of the TRIA program given by taxpayers to the insurance industry by year for the slightly more than three years that TRIA is authorized to cover risk. These data show that, under the current TRIA program of slightly more than three years, taxpayers have subsidized the insurance industry to the tune of $2.8 billion. Had insurers been required to pay premiums for this coverage, this $2.8 billion would now be available to the Treasury Department to pay for any attacks that might come during the rest of 2005.

What follows is a recap of Exhibit 1 findings:

Year	Large attack	Small attack	1:2 average	Old Cost 35% of $5.75	New Cost	Increase
12/02[6]				$0.2 B	$0.4 B	$0.2 B
2003	+125%	+94%	+90%	2.0	4.1	2.1
2004	+115	+78	+90	2.0	3.8	1.8
2005	+104	+62	+76	2.0	3.5	1.5

Cost of the original TRIA program (@ 100% coverage) $5.6 B
Cost of the original TRIA program (@ 50% coverage) $2.8 B

But that is history -- taxpayers have given this benefit to the insurance industry. The question now before Congress is what is the cost to taxpayers for continuing the program?

If TRIA were extended "as is":[7]

I estimate the following cost to taxpayers (assuming 50 percent coverage would continue to be bought by the market):

2006	+104	+62	+76	2.0	3.5	$1.5 B

But only 50 percent is purchased, so **the projected cost to taxpayers is $0.75B**

[6] Calculated as 1/12 of 2003.
[7] With the same regulatory requirements as for year three of current TRIA, with no coverage of group life insurance included.

<u>If TRIA were extended as proposed in S 467:</u>

I estimate the following cost to taxpayers (assuming 50 percent coverage would continue to be bought by the market):

2006	+98	+60	+72	2.0	3.4	$1.4 B

But only 50 percent is purchased, so **the projected cost to taxpayers is** **$0.7B**

This is an identical estimate to the CBO calculation of this cost: $0.7 billion.[8]

4. IF TRIA EXPIRES, THE ADDITIONAL COSTS TO POLICYHOLDERS ARE LOW (ON AVERAGE)

In 2003, Best's reported commercial premiums of $176 billion.[9] I estimate that 2006 commercial P/C premiums will be $206 billion (Best's estimates growth in premium of 6.4 percent in 2004 and 4.5 percent in 2005, with my estimated 5 percent growth in 2006)[10]. This means that if TRIA were to charge actuarial rates and the costs were spread across commercial policyholders, the surcharge for TRIA would be 0.7 percent ($0.7 billion divided by half of $206 billion, assuming that half of the buyers purchase the coverage). This small surcharge is extremely affordable. Of course, in the higher risk cities, the costs would be much greater, and they would likewise be much lower in the low-risk rural areas. As Congress is aware, TRIA represents a subsidy from rural to urban, particularly mega-urban, areas.

Taxpayers have already given insurers a multi-billion dollar free reinsurance program. This industry does not need a continued handout from taxpayers, particularly at a time of high industry profits and mounting federal deficits.

If any program is determined to be necessary after Congress reviews the findings of the Treasury report, the program should be paid for by full actuarial rate charges (or charges somewhat higher than that) to encourage private alternatives to develop. The charges will also have the benefit of encouraging mitigation steps to be taken that free reinsurance has undermined.

5. THE RISK OF TERRORISM IS BEING MODELED AND INSURANCE COMPANIES ARE USING THE MODELS – PROVING THEIR WORTH

The insurance industry argues that predicting terrorism risk for insurance purposes is impossible. The truth is, insurers are doing it already. Modeling terrorism risk is an imperfect science, but it is improving fast. A huge amount of research has been done in this area since TRIA was enacted, and several private companies have produced and are selling models to measure the actuarial and underwriting implications of the terrorism risk. The fact that insurers use these models is proof that they are of at least some value. Insurance companies pay significant dollars for the licenses to use these models. Businesses would not do that if they did not think the models were

[8] Federal Terrorism Reinsurance: An Update, January 2005, page 16.
[9] Aggregates and Averages, 2004 Edition, page 31.
[10] Review/Preview, January 2005, page 20.

valuable. For instance, many insurers use the Insurance Services Office (ISO) model for setting terrorism rates. ISO's research shows that the terrorism insurance risk is limited to a fairly small number of cities and that for the vast majority of the nation, the risk is low and the cost can be fully borne privately.[11]

6. GROUP LIFE COVERAGE SHOULD NOT BE ADDED TO TRIA

CFA strongly believes there is no meaningful evidence that justifies expanding TRIA to cover group life insurance. The Department of the Treasury studied the matter and refused to expand TRIA to cover group life. Even the National Association of Insurance Commissioners, a group well known to be very industry-friendly and particularly concerned about solvency and any possibility of undue risk, has refused to allow group life exclusions.

We believe that a major reason that both the Treasury Department and NAIC have rejected the appeals of life insurers for relief is that these insurers have not attempted all meaningful measures to spread their risk privately.

CFA has not received a single complaint from a consumer or business indicating that there is a problem in the life insurance market. Since there are no exclusions allowed by the NAIC, we would likely be hearing about rising costs if they were rising, but we are hearing no complaints at all.

To test this hypothesis, CFA did research using the NAIC complaint database.[12] The top ten group life insurance writers had 294 complaints under "group life" in 2001 and 361 in 2003 (2004 data will be posted on the NAIC website in late March). The increase in complaints (67) was virtually all related to Metropolitan Life Insurance Company, which had a growth in complaints of 65. Looking in detail at Metropolitan's complaints, we found zero complaints related to "terrorism" in either 2001 or 2003.[13]

If Congress extends TRIA in some form, it should narrow the coverage that exists in TRIA today and should definitely not expand TRIA to group life insurance.

Conclusions and Recommendations

Based on the relatively low risk of terrorism attacks and low rates in much of the country, as well as strong industry profitability and financial soundness and the growing capacity of insurers to offer terrorism coverage, CFA has tentatively found no compelling reason to extend TRIA beyond the end of 2005. Perhaps the Treasury Department's report will prompt us to revise this conclusion.

If Congress decides to go ahead and extend TRIA now, a move CFA would oppose, we suggest that you modify TRIA in the following ways:

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[11] For a complete discussion of the implications of ISO's research, see CFA's report, "The Terrorism Risk Insurance Act: Should it be Renewed?" at http://www.consumerfed.org/terrorism_insurance_report.pdf. The report was presented to this Committee at its hearing of May 18, 2004.

[12] The database can be accessed from the NAIC web page, www.naic.org at the Consumer Information Source (CIS).

[13] "Terrorism" is itemized as a complaint area in the NAIC complaint database.

- **Target only the cities where the risk of attack is moderate or high**. In fact, it is highly unlikely that the five cities at moderate risk of attack will need assistance, as 95 percent of all potential terrorism losses are being covered by the insurance industry today, according to the ISO models. Outside of the nine cities at moderate or high risk of attack, insurers are fully covering the risk that ISO's models have projected.[14] Areas with a **high risk** of attack are: New York City; San Francisco County; Washington, D.C., and Cook County, Illinois (Chicago). Areas with a **moderate risk** of attack are: Suffolk County, Massachusetts (Boston); King County, Washington (Seattle); Los Angeles County; Harris County, Texas (Houston), and Philadelphia County. The remainder of the country is at a **low risk** of attack.

- **Increase the retentions that insurers must pay for losses in these few cities**. CFA suggests industry-wide retentions of $50 billion after tax considerations[15] – a pre-tax deductible of $77 billion (roughly the surplus growth of the insurance industry since the year before the September 11 attacks) for the first year of any new program, increasing by $10 billion a year thereafter.

- **Increase the share of losses that insurers must pay above the deductible amount** from 10 percent to 15 percent, increasing by 5 percent a year.

- **Only provide taxpayer back up for truly exceptional terrorist events**, such as attacks with weapons of mass destruction.

- **Ensure that taxpayers pay no costs for backing up terrorism losses**. The Treasury Department should require that insurers pay premiums for the coverage that taxpayers are providing that are actuarially sound, if a not a little higher. Requiring insurers to pay rates that are slightly higher than estimated will, as CBO noted, encourage private insurance mechanisms to quickly compete by offering lower rates and will encourage mitigation efforts.

- **Beware of insurer attempts to use TRIA renewal as a pretext to deregulate insurance.** Insurers appear to be opportunistically seeking to cripple key aspects of insurance oversight under the guise of creating a uniform, national market for terrorism insurance. There is simply no connection between TRIA renewal and regulatory issues. There is no evidence that over-regulation has in any way hampered the ability of insurers to innovate and come up with viable private alternatives to TRIA. Indeed, some insurers are creating terrorism insurance alternatives today, such as stand alone policies and automatic coverage in some instances. Several insurers are prepared to offer stand-alone terrorism coverage should TRIA expire. Given the soft market, market sources say that some insurers stand ready to "give away" terrorism coverage to attract business.[16] Insurers are poorly regulated in most states regarding necessary consumer protections. Congress should not interfere with state

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[14] For details on the ISO model and the rates it calculates, see CFA's report, "The Terrorism Risk Insurance Act: Should it be Renewed?" at http://www.consumerfed.org/terrorism_insurance_report.pdf. The report was presented to this Committee at its hearing of May 18, 2004.

[15] $50 billion is the level of impact that the General Accountability Office (GAO) believes might produce adverse consequences. See "Catastrophe Risk -- U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks," GAO, February 2005.

[16] Liability and Insurance Week, March 21, 2005, page 2.

insurance regulation unless a balanced, thorough study of such action is undertaken separate and apart from TRIA issues.

- **Non-governmental alternatives to TRIA.** Private markets can handle most, if not all, of the terrorism risk. Stand-alone policies are ready to be used should TRIA expire. Except in the largest cities, terrorism coverage should be available at little or no increase in price should TRIA expire. TRIA itself has hampered the development of private alternatives such as normal reinsurance and securitization alternatives, such as catastrophe bonds. Expiry of TRIA will very likely result in the development of such mechanisms to cover terrorism risk. Creating private pools of like risks, similar to the pooling done in several other countries, is another method for covering terrorism risk that requires no federal role. There has been no need to create such private pools given the availability of free, taxpayer-subsidized TRIA reinsurance. TRIA also does not cover terrorist attacks involving most weapons of mass destruction (WMD), including attacks using biological, chemical or nuclear methods. This is one area where a federal role might be needed to create such coverage in the future. If a federal backstop for WMD is created, it should require actuarial rates for the reinsurance so that taxpayers are not subsidizing insurers that don't need the help. Finally, the federal government could assist in the development of private alternatives by allowing catastrophe reserves to build up tax-free on funds earmarked for the sole purpose of paying terrorism losses and nothing else, perhaps by placing such funds into fiduciary accounts not available except for the purpose of funding payments after terrorism losses are incurred.

Congress wisely built in a Treasury study to be finalized prior to the expiration of the program. That study will be in your hands soon. Once you have it, consideration should be given to fashioning a program, if one is needed at all, to address any real need identified by Treasury.

CFA looks forward to working with the Committee on fashioning a response to the Treasury report once it becomes available.

I would be pleased to answer any questions you may have.

EXHIBIT # 1

This chart compares what taxpayers were responsible for when the World Trade Center was attacked to what taxpayers pay under TRIA, for two types of attacks: mid-sized (about $25 billion in insured losses) and larger (about $40 billion in losses).

In the case of the World Trade Center attacks, taxpayers picked up 35 percent of this loss (the federal corporate write-off rate).

	Large Attack	Mid-Sized Attack
Taxpayers:	$40 billion * .35 = **$ 14 billion**	$25 billion * .35 = **$9 billion**
Insurers:	$40 billion * .65 = **$ 26 billion**	$25 billion * .65 = **$16 billion**

Year 1 of TRIA (2003):

Under the current TRIA (Year 1):	**Large Attack**	**Mid-Sized Attack**
Insured Loss	$40 billion	$25 billion
Estimate of total insurer deductible	$8 billion[1]	$8 billion[1]
Repayment to Taxpayers	$1.8 billion[2]	$1.8 billion[2]
Losses subject to sharing	$32 billion	$17 billion
90% taxpayer share	$28.8 billion	$15.3 billion
10% insurer share	$3.2 billion	$1.7 billion
Taxpayers =	**$31.55 billion (79%)**[3]	**$17.5 billion (70%)**[4]
Insurers =	**$ 8.45 billion (21%)**[5]	**$7.5 billion (30%)**[6]
Insurer Savings Under New Law =	**68%**	**53%**
Taxpayer Increase in Liability =	**125% (+$17.55B)**	**94% (+$8.5 B)**

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1 Estimated by applying a $40 billion loss to insurance companies based on their size.

2 90 percent of the difference between $8 billion in insurer deductibles and $10 billion, the "cutoff" amount under the law, above which no payback is required.

3 Taxpayer share and 35 percent (tax write-off rate) of insurer deductible, insurer share of losses and insurer payback. *[$28.8 billion - $1.8 billion + ($8 billion + $3.2 billion + 1.8 billion) * .35]*

4 [15.3 billion – 1.8 billion + ($8 billion + 1.7 billion + 1.8 billion) * .35]

5 Insurer deductible, insurer share of losses and insurer payback less the 35 percent federal tax write-off allowed. *[($8 billion + $3.2 billion + $1.8 billion) * (1 - .35)]*

6 [$8 billion + $1.7 billion = $1.8 billion) * (1 - .35)]

Year 2 of TRIA (2004):

Under the Current TRIA (Year 2):	**Large Attack**	**Mid-Sized Attack**
Insured Loss	$40 billion	$25 billion
Estimate of total insurer deductible	$10 billion[7]	$10 billion[7]
Repayment to Taxpayers	$2.25 billion[8]	$2.25 billion[8]
Losses subject to sharing	$30 billion	$15.0 billion
90% taxpayer share	$27 billion	$13.5 billion
10% insurer share	$3.0 billion	$1.5 billion
Taxpayers =	**$30.08 billion (75%)**[9]	**$16.06 billion (64%)**[10]
Insurers =	**$ 9.92 billion (25%)**[11]	**$8.94 billion (36%)**[12]
Insurer Savings Under New Law =	**62%**	**44%**
Taxpayer Increase in Liability =	**115% (+$16.08B)**	**78% (+$8.5 B)**

Year 3 of TRIA (2005):

Under TRIA:	**Large Attack**	**Mid-Sized Attack**
Insured Loss	$40 billion	$25 billion
Estimate of total insurer deductible	$12 billion[13]	$12 billion[13]

[7] Estimated by applying a $40 billion loss to insurance companies based on their size.

[8] 90 percent of the difference between $10 billion in insurer deductibles and $12.5 billion, the "cutoff" amount under the law, above which no payback is required.

[9] Taxpayer share and 35 percent (tax write-off rate) of insurer deductible, insurer share of losses and insurer payback. *[$27 billion - $2.25 billion + ($10 billion + $3.0 billion + 2.25 billion) * .35]*

[10] [13.5 billion – 2.25 billion + ($10 billion + 1.5 billion + 2.25 billion) * .35]

[11] Insurer deductible, insurer share of losses and insurer payback less the 35 percent federal tax write-off allowed. *[($10 billion +$3.0 billion + $2.25 billion) * (1 - .35)]*

[12] [$10 billion + $1.5 billion = $2.25 billion) * (1 - .35)]

[13] Estimated by applying a $40 billion loss to insurance companies based on their size.

Repayment to Taxpayers	$2.7 billion[14]	$2.7 billion[14]
Losses subject to sharing	$28 billion	$13 billion
90% taxpayer share	$25.2 billion	$11.7 billion
10% insurer share	$2.8 billion	$1.3 billion
Taxpayers =	**$28.63 billion (72%)**[15]	**$14.6 billion (58%)**[16]
Insurers =	**$11.38 billion (28%)**[17]	**$10.4 billion (42%)**[18]
Insurer Savings 3rd Year of Law =	**56%**	**35%**
Taxpayer Increase in Liability =	**104%(+$24.63 B)**	**62% (+$5.6 B)**

[14] 90 percent of the difference between $12 billion in insurer deductibles and $15 billion, the "cutoff" amount under the law, above which no payback is required.

[15] Taxpayer share and 35 percent (tax write-off rate) of insurer deductible, insurer share of losses and insurer payback. *[$25.2 billion - $2.7 billion + ($12 billion + $2.8 billion + 2.7 billion) * .35]*

[16] [11.7 billion – 2.7 billion + ($12 billion + 1.3 billion + 2.7 billion) * .35]

[17] Insurer deductible, insurer share of losses and insurer payback less the 35 percent federal tax write-off allowed. *[($12 billion +$2.8 billion + $2.7 billion) * (1 - .35)]*

[18] [$12 billion + $1.3 billion + $2.7 billion) * (1 - .35)]

EXHIBIT # 2

A PRIVATE MARKET FOR TERRORISM INSURANCE EMERGES: EXCERPTS FROM BUSINESS INSURANCE MAGAZINE

From: "Market contemplates a world without TRIA -- Responses vary to possibility that federal backdrop won't be extended," Business Insurance, March 21, 2005.

"D. Terry Fleming, director of the division of risk management for Montgomery County, Md., said that he's already talked to his property insurer, which he declined to identify, about how terrorism would be covered when he renewed the coverage midyear.

"'They told us they would offer the coverage whether or not TRIA was extended,' said Mr. Fleming. They were offering full limits for the same price as they were last year. Because of our loss experience, they gave us a very competitive rate. We're very happy with what happened-definitely…

"'The renewals that we have just bound, which include major real estate holdings in key central business districts, were renewed with full terrorism (coverage) and the understanding by the underwriters that coverage would continue for the full 12 months, regardless of what happened on Dec. 31,' said Alexandra Glickman, area vice chairman and managing director of the real estate and hospitality services division of Arthur J. Gallagher & Co. in Glendale, Calif…

"'The market response at this point is anything but uniform,' agreed Aaron Davis, a vp with Aon Corp.'s Aon Risk Services in New York. 'Certain carriers have committed to offering terrorism capacity beyond the expiration of TRIA. Other carriers are offering terrorism on a sublimited basis, and a majority of the carriers are still relying on conditional exclusions that will allow them to either exclude the risk altogether or sublimit it, or reprice the terrorism premium post-Dec. 31.'

"American International Group is 'in a little different position than some other companies,' noted Richard Thomas, senior vp and chief underwriting officer for AIG's domestic brokerage group in New York. 'Under TRIA, we have a very large retention in 2005. Our retention this year is just under $3.3 billion for terrorism. In other words, we would have to sustain slightly less than $3.3 billion from a terrorism event before we could recover from TRIA. With a retention that size, we're underwriting to that. Our underwriting today contemplates managing our aggregate exposures for workers compensation and property insurance in the various target areas where we have insureds. Obviously, if TRIA is not extended, we'll continue the practice of monitoring our aggregate exposure by target locations, and there will be a cap on that,' he said…

"Randy Schreitmueller, a vp at Johnston, R.I.-based Factory Mutual Insurance Co., which does business as FM Global [*said*,] 'What we've done to prepare-we are going forward with a set of provisional renewal conditions. Basically, what it boils down to is terrorism sublimits in the event that TRIA expires.' The sublimits depend on geographic location, and they vary from $100 million to $250 million. The lower limits apply to locations in major city centers…

"'We don't see our individual capacity contracting. We currently have in place the discipline to operate in year three of the program or post-TRIA,' said Mr. Schupp. 'There's just so much capacity

to go around. Right now, some of that capacity is federal capacity provided by TRIA. If that goes away, yes, there will be exclusions as the industry adjusts to a lower amount of capacity.'

"'We're working with insurance companies to try to come up with alternatives' if TRIA expires, so that underwriters can reserve some capacity for terrorism coverage, at a price, said Marsh's Mr. Blumber.

From: "Standalone terrorism coverage available, affordable. Some say standalone capacity could be exhausted if TRIA is allowed to expire," Business Insurance, March 21, 2005.

"If the Terrorism Risk Insurance Act expires at the end of the year, risk managers will not be left completely without options if they want to buy terrorism coverage.

"Standalone terrorism coverage, which is not supported by the government backstop, is available for risk managers and the price of the coverage, though sometimes high, is not always prohibitively expensive, observers say.

"However, while there is sufficient capacity to meet most of today's demand for standalone coverage, the expiration of TRIA could fuel demand to such a level that standalone capacity might be exhausted, some observers say.

"When Caesars Entertainment Inc. made its first foray into the standalone terrorism insurance market, for example, Lance Ewing, vp-risk management, found the market to be responsive and the pricing satisfactory.

"'I found the standalone to be much easier with regard to the purchase of' terrorism insurance, he said.

"High limits for a price

"The standalone terrorism insurance market has grown significantly in the last two years, observers say. New York-based American International Group Inc. and Lloyd's of London have traditionally been the main players in the standalone market and still provide a significant portion of the capacity.

"AIG's Lexington Insurance Co. unit provides up to $100 million in terrorism capacity for property risks and up to $25 million for casualty coverages, said Charles Benda, practice leader for Lexington's homeland security practice, who works in New York and Boston.

"Lloyd's entities offer about $400 million in terrorism limits, said Ben Garston, partner of London-based MAP Underwriting and chair of Lloyd's Market Assn.'s Terrorism Insurance Business Panel.

"But recent increases in capacity in the standalone market have come from Pembroke, Bermuda-based AXIS Capital Holdings Ltd., Hamilton, Bermuda-based ACE Ltd., Bermuda-based Montpelier Re Holdings Ltd., and a few other players. Omaha, Neb.-based Berkshire Hathaway Inc. can also provide significant capacity-upwards of $500 million-although its pricing tends to be prohibitive, brokers say.

"The influx of new capacity means standalone terrorism coverage with limits of less than $500 million is generally easy to secure, but securing limits above that level can be difficult and expensive, brokers say.

"Policyholders can buy as much as $1.25 billion in capacity, if they are willing to pay the price, but that kind of demand is rare, said Will Farmer, director of Aon Crisis Management in London. 'Generally smaller limits have been the norm and Berkshire Hathaway has been barely active in the market in the last 12 months,' he said.

"Generally, pricing for terrorism coverage has fallen significantly from the levels that were charged shortly after the Sept. 11, 2001, terrorist attacks because of the increase in capacity and a better understanding of the exposure, brokers say. 'I think the standalone market has become more competitive with TRIA,' said Robert Blumber, managing director of Marsh's property practice.

"Underwriters develop quotes for specific risks based on a variety of factors, including the location of the insured property, size of the organization and their aggregation of risks in particular geographic areas. 'There's no way to quantify the average premium,' Mr. Benda said.

"A building in Manhattan, for example, could potentially have a premium of 0.20% to 0.25% of its value while the premium for a building in a more remote area could be 0.02% to 0.04%.

"Standalone terrorism policies cover terrorist attacks committed for political, religious and ideological purposes and they offer broader coverage than TRIA-backed policies because they cover acts of both foreign and domestic terrorism.

"The policies exclude chemical, biological and nuclear risks because this type of terrorist attack 'would probably involve so much property we wouldn't be able to pay all the claims,' said Mr. Garston of MAP.

"Some insurers, however, do offer coverage endorsements that extend terrorism coverage…

"Brokers are already looking at alternatives, such as reserving standalone capacity, if TRIA expires. The standalone market has offered products that provide an option for coverage-at 20% of the annual premium-that insureds can pick up if TRIA expires, Mr. Farmer said. 'I think the smart buyers are trying to reduce uncertainty now by spending money so that whatever happens with TRIA, they'll be in reasonable shape,' he said.

From: "Little terror demand in Canada," Business Insurance, March 21, 2005

"…the Canadian market functions without government reinsurance… While sufficient capacity is available in the Canadian market-provided by foreign insurers such as New York-based American International Group and Hamilton, Bermuda-based ACE Ltd.-the demand for terrorism insurance tends to be limited to companies with properties in major metropolitan areas such as Montreal, Vancouver and downtown Toronto, and to owners of sporting facilities."

STATEMENT OF BRIAN DUPERREAULT

CHAIRMAN, ACE LIMITED

ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION

APRIL 14, 2005

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 would like 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 will 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 whereby a government backstop is absent.

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 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),

[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.").

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.

Fourth, 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.

PREPARED STATEMENT OF FRANKLIN W. NUTTER

PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

APRIL 14, 2005

Good morning Chairman Shelby, Ranking Member Sarbanes, and members of the Committee. My name is Frank Nutter and I am President of the Reinsurance Association of America. Incorporated in 1969, the RAA is a national trade association based here in Washington, D.C. We are the sole organization representing the U.S. property and casualty reinsurance industry. Our membership consists of U.S. domestic reinsurers and reinsurance brokers.

Reinsurance is commonly referred to as the insurance of 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 common purposes is to transfer losses from catastrophic events such as hurricanes, earthquakes, and in the case of September 11, acts of terrorism. To that end, reinsurers have financially responded to virtually every major U.S. catastrophe over the past century. For natural disasters typically one-fourth to one-third of the insured losses are passed on to reinsurers and in the events of September 11, 2001, two-thirds of the losses were absorbed by the reinsurance industry.

As the Committee has called this hearing to discuss "the Oversight of the Terrorism Risk Insurance Act (TRIA)," I am here to share with you the reinsurance industry's perspective on TRIA. The RAA strongly supported the adoption of TRIA in 2002. We believe the program is working well to fill a vacuum in reinsurance capacity, keep premiums paid by consumers at affordable levels, provide insurance coverage to support economic activity, and to minimize disaster assistance should there be other terrorist acts in the U.S. We support the recent introduction of a TRIA extension bill by some Members of this Committee. The RAA believes that an extension is appropriate and will provide the industry and Congress a window of time to consider long-term solutions for managing catastrophic terrorism risk.

My comments are intended to provide the Committee with: (1) a better understanding of the significant challenges the reinsurance industry is facing in providing private terrorism reinsurance capacity, and (2) why the reinsurance industry strongly believes that a public/private partnership is necessary on a going forward basis to help stabilize the commercial insurance markets that underpin our free-market economy.

Creation of TRIA

As you are very well aware, TRIA was enacted in response to the tragic attacks 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 industry.

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 in an unwavering manner to the catastrophic losses associated with 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, on its own, the U.S. insurance and reinsurance industry does not have adequate capital to assume the potentially unlimited exposure to loss arising from insuring against catastrophic terrorist attacks. The industry cannot predict the number, the scale or the frequency of future terrorist attacks that we may face as our nation continues to execute the "war on terror."

TRIA was created to provide a federal backstop, which was essential to allow the primary insurance industry to provide terrorism coverage to our nations' businesses. The RAA believes that TRIA has principally fulfilled its purpose of allowing primary insurers to provide terrorism insurance coverage that is widely available and affordable to U.S. commercial policyholders in both urban and rural areas. By limiting insurers' exposure to catastrophic terrorism losses, TRIA has improved the market for such coverage and has had a stabilizing influence on the economy.

Reinsurance Challenges to Underwriting Terrorism Risk

Over the last several years, reinsurers have worked hard to develop a better understanding of terrorism risk. Reinsurance companies have created task forces, consulted military and intelligence experts, hired specialty risk modeling firms, invested in research and development, and developed new underwriting standards all with the intention of trying to determine if a private market could develop to absorb this risk. Despite these efforts, a key struggle in the development of a private market is that terrorism risk is not conventional. It has characteristics unlike any other peril or insured risk:

1. The number one plan of terrorists is to inflict maximum damage. These are not random or fortuitous acts.
2. Terrorists learn from their attacks and thus will attempt to defeat loss reduction methods used by policyholders, insurers and reinsurers.
3. The potential size of loss is enormous, with total destruction of multiple insured properties likely.
4. The potential size is compounded by the aggregation of losses arising from multiple clients and from multiple insurance products covering the occurrence. This is difficult to predict and thus difficult to measure.
5. The frequency of loss is unpredictable, with little historical track record to project future loss experience.
6. Risk of loss is inter-dependent. Individual policyholders can take all appropriate risk management actions, but still be rendered vulnerable by actions of others outside their control.
7. Unlike natural disaster risk, reinsurers achieve virtually no spread of risk with terrorism coverage. Hurricanes in Japan and Florida are not correlated. Premiums can be collected and risk assumed knowing that one loss will not lead to another. Writing terrorism coverage in Europe and North America may well lead to closely related loss events, thus minimizing any benefit of risk spreading around the world.
8. Terrorism events can lead to major disruptions in the financial markets. At a time when reinsurers will be liquidating assets to pay claims, the asset values themselves will be declining due to the likely downturn in the markets. This is not the case with natural disasters.
9. The U.S. government warns us that we are in a war on terrorism, which may increase the risk of loss.
10. Nuclear, biological, chemical and radiological weapons can create large losses of property and life. These extreme loss scenarios would cause losses that outstrip insurer financial resources and are uninsurable.

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

Reinsurers' Role Under TRIA

TRIA provides a large amount of reinsurance-like protection for primary commercial insurance exposures. For 2005, 90 percent of the commercial terror loss for primary insurance companies is covered up to an industry total of $100 billion, subject to individual company retention of 15 percent of 2004 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 TRIA funding is available. The primary industry is under increasing financial risk and exposure to acts of terrorism because of: (1) the significant retentions under TRIA, (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 TRIA, some insurance companies have to absorb losses greater than the losses they sustained during the World Trade Center attacks before the federal funding is provided. This is precisely where the private reinsurance industry role fits under TRIA.

Primary insurers are actively seeking private reinsurance to help reduce the large un-reinsured gap in terror exposure they face from the retention and loss-sharing provisions under TRIA. Reinsurers are being asked to "buy down the primary company retentions."

Some have expressed the concern that TRIA has infringed on the private reinsurance market. This is absolutely not the case. In fact, the opposite is true. By establishing definitive loss parameters, TRIA has provided a defined layer for reinsurers to participate in sharing the retained risk of loss that primary companies face under the federal terrorism program.

Reinsurance Terrorism Capacity

Working with their client primary companies to manage their substantial retained exposure under TRIA, reinsurers have been willing to put limited capital at risk to manage terror-related losses. Reinsurers typically seek to manage the risk by offering terror coverage in a stand-alone contract rather than within a traditional all peril catastrophe treaty contract, especially for insurers writing a national portfolio. Some regional carriers, with exposures limited to rural or suburban areas far from target risk cities and business centers, 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.

With regard to workers' compensation, some insurers have been able to add the terrorism peril to their reinsurance programs, but this coverage typically excludes nuclear, biological, chemical, and radiological (NBCR) losses. It is important to point out that there is very little reinsurance appetite for NBCR risks. When it is available, pricing for coverage including NBCR is at a significant premium and coverage amounts are restricted. This presents a major problem for primary insurers since states do not allow them to exclude this peril.

The RAA surveyed both reinsurance brokers and reinsurance underwriters to estimate how much terrorism reinsurance capacity the private reinsurance marketplace is providing. The survey suggests terrorism capacity for a reinsurance program may range from $300 million up to $600 million on an occurrence basis for property and workers' compensation. This coverage includes TRIA "covered acts" as well as domestic terrorism and personal lines exposure. Overall, our estimates are that the global reinsurance capacity available in the United States for 2005 is about $4-6 billion for stand-alone and treaty reinsurance. Some experts predict that given favorable loss experience this supply could increase to $6-8 billion in private reinsurance coverage within several years. This projected growth is still very modest and will not fill the capacity needs of the primary industry, with or without TRIA.

We understand some in Congress are disappointed that the private reinsurance market has not provided more capacity. Most market participants believe, as we do, that reinsurers may never be able to provide enough capacity to replace TRIA.

Although much progress has been made trying to model terrorism loss scenarios, forecasts of the frequency and the magnitude of terrorism losses are extremely problematic. Reinsurers are only able to provide limited capacity for terrorism because the potential losses would otherwise place these companies at risk of insolvency. To that end, it is important to point out that the global reinsurance industry does not have the capital necessary to absorb losses of up to $100 billion which are contemplated by TRIA. Reinsurers' capital is necessary to support all outstanding underwriting commitments reinsurers face, including natural disasters, terrorism, workers' compensation and other casualty coverages.

Capital Markets Limited Impact Under TRIA

We know some Members of Congress and the Congressional Budget Office have suggested the possibility of the capital markets assuming terrorism risk. Catastrophe bonds are a known mechanism for using financial markets to absorb and spread natural hazards risk. Indeed, reinsurance companies are one of the most frequent users and facilitators of catastrophe bonds. Yet, hurricane and other natural

disaster "cat" bonds are currently in limited use. According to a Marsh McLennan Corporation (MMC) Securities Corp. 2005 report, total cat bond issuance in 2004 was only $1.14 billion, a decline from 2003. The report notes that since 1997, when cat bonds first were issued, the total number of transactions has only been 59 with total issuance limits of $8.66 billion of which only $4.04 billion is outstanding. This is a very small amount in comparison to the industry's catastrophe exposure. Although many in the industry had hoped the cat bond market would provide significant additional capacity for natural disasters, it simply has not. Factors such as cost, complexity, regulatory and accounting issues, high risks, lack of analytical capacity and liquidity concerns are often cited as reasons the catastrophe bond market has not developed further.

Acts of terrorism present much greater underwriting and pricing challenges 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.

Likewise, some have suggested allowing tax-free catastrophe reserves might be a solution to increase the industry capacity for terrorism risk, but, as GAO reported, this proposal is controversial. The GAO notes that Treasury officials are concerned that not only would such a proposal lower federal tax receipts, but there would be no assurance that the increase in capital would result in the allocation of more capacity toward terrorism risk or other catastrophe risk. GAO also notes that it would be difficult to determine the appropriate size for such reserve because the modeling used to determine terrorism risk is not sufficiently reliable. Furthermore, both proponents and opponents of catastrophe reserves alike agree that insurers might substitute the reserves for other types of capacity such as reinsurance. So in effect there would not be an increase in capacity.

Private/Public Partnership Necessary to Address Terrorism Risk

Mr. Chairman, even without a federal backstop, the reinsurance industry remains committed to working with primary insurers to cover terrorism exposure. Our companies will continue to explore private market solutions to terrorism risk. Due to the nature of this peril, however, we believe that private market mechanisms are insufficient at this time to spread the risk of catastrophic terrorism loss in a meaningful way. Without a federal backstop we would expect less coverage available at the policyholder level, rising prices for terrorism cover and more limited private reinsurance capacity.

The RAA continues to work with task forces from both our reinsurance companies and the primary industry national trade associations to determine what the most effective and less intrusive federal role would entail beyond TRIA. Key to these ongoing discussions is the participation and consensus from the policyholder community. No single solution has emerged but we welcome the opportunity to work with the Congress and all private sector stakeholders to craft a public/private partnership to address this most important national issue.

PREPARED STATEMENT OF ROBERT J. LOWE

On Behalf of The Coalition To Insure Against Terrorism
And The Real Estate Roundtable
And The United States Chamber of Commerce

April 14, 2005

Good morning, Chairman Shelby, Ranking Member Sarbanes and members of the Committee. My name is Robert J. Lowe. I am Chairman of the Board and Chief Executive Officer of Lowe Enterprises. I am also the current Chairman of The Real Estate Roundtable.[1] I am appearing today on behalf of the Coalition to Insure

[1] The Real Estate Roundtable and its members lead an industry that generates more than one-third, or $2.9 trillion, of America's gross domestic product, employs more than 9 million people, represents capital investment of over $4.6 trillion, and produces 70 percent of the taxes raised by local governments for essential public services. Our members are chief executives from the nation's leading private and publicly-held income-producing real property owners, managers and investors, the key executives of the major financial services companies involved in financing, securitizing or investing in income-producing properties, as well as the elected heads of America's 15 leading real estate trade associations.

Against Terrorism, or CIAT, which includes The Roundtable, the United States Chamber of Commerce, and 73 other major trade and professional associations and businesses, representing the nation's major consumers of commercial insurance lines. A list of the 75 CIAT member organizations accompanies this statement.*

Over the past 32 years, Lowe Enterprises, which I founded, has developed, acquired or managed more than $6 billion of real estate assets nationwide. Our privately owned firm currently employs over 7,000 people, with a management team of approximately 250 men and women.

The members of CIAT were pleased to work with all the members of this Committee to help develop and enact the Terrorism Risk Insurance Act of 2002 (TRIA). We thank the members of this Committee for their continuing leadership in addressing this national problem.

Today we urge the Committee to act promptly to provide continuity to the terrorism insurance market for next year. Most immediately, that means the Committee should take up and approve S. 467, which would extend TRIA for two additional years beyond the current scheduled expiration on December 31, 2005 and set up a presidential commission to report back to Congress and the Administration on a more permanent solution to the long-term need for terrorism insurance protection. CIAT also supports developing the new more permanent structure this year, if possible; but in order even to keep that option open, we believe this Committee must move forward on S.467 now. The American economy is already being adversely affected by the anticipated year-end expiration of TRIA. If we want to avoid a repeat of the near-paralysis of major construction and interruption of other business activity which we experienced in 2001-2002 before TRIA was in place, then Congress needs to act well in advance of year-end.

CIAT remains committed to working with you, Chairman Shelby, Senator Sarbanes, the entire Committee, the rest of Congress and the Administration to find a longer term solution to the terrorism insurance problem so that the terrorism insurance needs of the country's businesses can continue to be met. We wish to express CIAT's special thanks to Senator Bennett and Senator Dodd for their introduction of S.467.

As consumers of commercial property and casualty insurance, policyholders are pleased with the success of TRIA and the terrorism insurance program it instituted. With virtually no cost to the taxpayer, the terrorism insurance program has worked as intended. It put the economy back on track after 9/11 and restarted the stalled construction industry putting some 300,000 people back to work. Since then it has allowed businesses across America to continue operating and growing, saving countless jobs in the process. Although there are still some gaps in coverage, TRIA has made terrorism insurance broadly available to all businesses that want and need this vital coverage.

The terrorism insurance program has achieved two major national goals envisioned by bipartisan leaders in Congress—including many on this Committee—and shared by the Administration. The terrorism insurance program has helped enormously to keep the economy going in the face of terrorist threats. The terrorism insurance program also serves as an important tool to minimize the severe economic disruption that almost certainly will occur from a future terrorist attack.

As you know, the terrorism insurance program created by TRIA was intended to be a temporary measure to "backstop" the market until the private insurance markets could fully assess and price the risk. Unfortunately, the situation the Nation is in today does not make that possible. Our most senior government officials tell us that the threat of terrorism remains undiminished. Our Nation has had a great deal of success at dealing with and deterring terrorist threats over the past three years. Paradoxically, that success makes it impossible for the government, the insurance industry, or insurance policyholders like CIAT members to determine where, when, or with what frequency future terrorist attacks might occur. As a result, the private insurance and reinsurance markets are no more able to assess risk or price terrorism insurance policies than they were able to do prior to TRIA's passage. What that means for policyholders like the members of CIAT is highly troubling. Our Nation's businesses, large and small alike, will not be able to get adequate terrorism insurance in a purely private marketplace if the TRIA program ends. That was our experience in 2002, when there was no program and the reinsurance industry was not writing policies. And that will surely be our experience if a terrorism insurance program is not permitted to continue beyond this year, at least for a limited time.

The risk of further catastrophic terror attacks appears to be as acute as before. Just weeks ago CIA Director Porter Goss told the Senate Intelligence Committee

*Held in Committee files.

that al-Qaeda is intent on finding ways to circumvent U.S. security enhancements to attack the homeland. He said, "the terrorist threat to the U.S. in the homeland and abroad endures . . . [i]t may be only a matter of time before al-Qaeda or other groups attempt to use chemical, biological, radiological or nuclear weapons." In the same hearing, FBI Director Robert Mueller expressed concern about the risk posed by radicalized Muslim converts inside the United States and said that he worries about a "sleeper operative" who may have been in place for years, awaiting orders to launch an attack: "I remain very concerned about what we are not seeing," he said.

Just this week indictments against three men were unsealed which show they are charged with plotting to blow up major financial center buildings in New York, New Jersey, and Washington, D.C. Both the United States and the U.K. intend to prosecute these individuals.[2] These new indictments illustrate the continuing threat which our nation faces.

While the highest levels of government tell us that the threat of terrorism in the United States continues, not surprisingly the insurance and reinsurance markets have not reestablished an ability to handle this problem alone. Federal Reserve Chairman Alan Greenspan, in one of his recent appearances before the House Financial Services Committee, said he has yet to be convinced the private market alone can adequately insure against the continuing threat of terrorism. Chairman Greenspan said, "[t]here are regrettable instances in which markets do not work, cannot work," and added "I have yet to be convinced" that the terrorism insurance market can be made to work. Even with the terrorism insurance program in place, the most severe risks cited by the CIA Director Goss—chemical, biological, radiological and nuclear attacks—are almost wholly uninsured today, aside from workers' compensation.

The business continuity issue becomes more urgent with each passing month this year. Commercial insurance policies covering businesses of all sizes and types will extend past the December 31, 2005, sunset date of the terrorism insurance program. Insurance regulators in most states already have approved conditional terrorism exclusions for these policies which will be triggered when TRIA expires. As explained in detail below, with each passing week, commercial policyholders and the capital markets concerned with asset values are seeing and more renewal policies which provide for a "sunset" of terrorism coverage at year's end if TRIA is not renewed. Thus we already have an answer to the central question—we know that the market will not be adequate next year without some Federal backstop.

All these factors—the likelihood of future terrorist attacks; our success in thwarting more attacks to date; the impossibility of assessing where, when, and how terrorist attacks may occur; and the severe consequences for the economy without the continued availability of coverage—combine to make it imperative for Congress to act promptly to provide for the availability of terrorism insurance beyond this year.

The bill introduced recently by Senators Bennett, Dodd and other members of this Committee, S. 467, sets an appropriate course by extending the current TRIA program for a short period of time while also setting up a commission to work on a long-term solution. We look forward to working with Members of Congress to develop, adopt and enact legislation that makes certain that the nation's citizens and businesses are able to secure truly comprehensive coverage against terrorism after 2005, and that we as a nation have a reasoned and supportable policy in place to enable the economy to recover, should another terrorist attack occur in the U.S.

Five Reasons Why America Needs A Terrorism Insurance Backstop

The Unique Nature of the Risk

Terrorism is a man-made risk—intentional, organized and adaptive. It is unlike any of the other, usually natural or fortuitous, risks that the insurance industry typically underwrites. Terrorism is much more akin to war risk, both in its man-made characteristics (intentional, organized, and adaptive) and its potential for massive, unpredictable destruction. Experience has shown that war risk insurance is not (and will not be) readily available on most ordinary commercial property and casualty insurance policies; most such policies carry war-risk exclusions and have done so for decades.[3] Thus, there is little reason to believe that insurers, or their reinsurers, will develop any time soon the ability, much less an appetite, to write terrorism insurance on a wide scale without some government role.

[2] See Associated Press wire story, "Three Men Are Indicted In Financial-Building Plot," (April 12, 2005).

[3] "War Risk Exclusion Legal History Outlined," Massmann, Susan, *National Underwriter (Property & Casualty-Risk & Benefits Management Edition),* September 24, 2001.

While war-risk exclusions on most policies have been tolerable to insurance buyers (and their lenders) because the advent of, or at least the proximity to, military operations is relatively uncommon and generally avoidable,[4] exclusion of terrorism risk from commercial policies today would be a significant deterrent to economic activity because of uncertainty and unavoidability of the risk. This is what we saw in the months between the September 11 attacks and the establishment of the TRIA program. Lack of coverage in those months significantly impaired economic activity and chilled financial markets and lending sources for large-scale development, until TRIA created the ability for insurers to fill the gap (or most of it).

There is another reason the current terrorism risk is so difficult for private markets to handle without some government role. Insurers have few data points (e.g., the attacks on September 11) by which to attempt to model the risk. With other potentially large catastrophic risks such as hurricanes and other natural phenomena, there is significant historical data on past events which can be used to model the frequency, severity, and locations (or paths) of future events. This modeling in turn can be overlaid with historical loss data and with policyholder location or density information to calculate each insurer's maximum probable loss for certain statistically probable events. With terrorism, however, there is a deficiency of data about potential attacks.

This deficiency of data is exacerbated by an important additional fact. The Federal government is the most informed source of information about terrorism risks; presumably assessing such risks are a primary focus of our national intelligence organizations. That is, the Federal government may well be in possession of such intelligence or other information regarding likelihood or nature of future terrorists acts, but it is unlikely that the government would share such information with the insurance and reinsurance industry as well as their customers.

Given the unique nature of the risk, the paucity of useful data to model future events and the controls in place on relevant information concerning terrorism, it is entirely understandable that the insurance and reinsurance industries have not yet developed an ability to underwrite intelligently on their own the complete amount of terrorism insurance necessary for the U.S. businesses to operate effectively and the U.S. economy to achieve its full potential.

The State of the Insurance Market

In the debate over a terrorism insurance mechanism three years ago, there was much concern expressed about government intervention in a "free market" of insurance. Free market principles are a laudable starting point for most economic policy discussions. The insurance industry, however, is a sector which the courts and legislatures have long recognized as "affected with the public interest" and therefore subjected to heavy government regulation. Indeed, it is one of the most pervasively regulated of all industries. Both entry into and exit from the industry is strictly controlled by government licensing and regulation. While there seems to be real competition for some of the easy-to-write lines of insurance, both the form of product and often the price in most lines of property and casualty insurance are subject to state-by-state regulation (and sometimes Federal creation). The latitude of insurer actions in many aspects of their business is to a large degree a function of state solvency regulation. It is also an industry where various government actions (both state and federal) require or encourage the pooling of certain risks, and where, in many cases such as workers' compensation insurance, the insurable risk is itself created and defined by government mandate. So, to assume that there is a market otherwise unaffected by government action or that unfettered market forces will somehow be prepared to respond to the threat of terrorism in the absence of a federal backstop seems to ignore the reality of that industry.

The state-by-state nature of insurance regulation and therefore market conditions means that, in the absence of Federal backstop, availability of coverage and industry response to a catastrophic event may be quite variable from jurisdiction to jurisdiction. In the event of a multiple-jurisdiction attack following TRIA's expiration,

[4] Where the lack of private war-risk coverage has been commercially significant, e.g., for ocean shipping or commercial aircraft that must either traverse or come near war-risk zones, the U.S. government has traditionally provided a standby war-risk insurance program which is triggered when commercial markets withdraw or dramatically raise prices. See, Merchant Marine Act of 1936, 46 U.S.C. Sec 1202, et seq.; FAA Aviation War Risk Insurance Program authorized at 49 U.S.C. Sec. 44302, et seq. Moreover, when the threat of war damage to the general U.S. economy has become pronounced, the U.S. government has also intervened to keep economic activity moving. During World War II, for example, Congress created the War Damages Corporation which, with the participation of private insurers, provided a universal war risk add-on to virtually all property insurance policies, both commercial and personal lines, during WWII. *See* discussion of War Damages Corporation on page 7, infra.

the regulatory patchwork could result in businesses in one location with effective coverage and those in another location without coverage or with coverage from an insolvent carrier.

This is not to say that there is no role for private capital or entrepreneurial spirit in this line of the insurance business. TRIA proved that the presence of some form of Federal backstop enables the private sector to respond in various ways to their customers' needs (if far from completely in the case of nuclear, biological, chemical and radiological risk). All of the responsible studies and reports produced since TRIA was put in place show that the private insurance and reinsurance sector do not have the capacity to underwrite this risk without the Federal backstop. Reinsurers this year have available terror-related capacity of only $4 to $6 billion dollars.[5] To provide some context, the World Trade Center attack resulted in insurance payments exceeding $32 billion. Moreover TRIA does not appear to have "crowded out" the development of private capacity. To the contrary, all data show that private reinsurance capacity has not even been able to cover the primary industry's collective deductibles and retention layers which the TRIA backstop leaves to the private sector. Any thought that reinsurers will commit additional resources now to terrorism coverage in the absence of a backstop defies logic. More time, and perhaps a re-thinking of the division of risk between the Federal backstop and the private sector, is needed in order to better develop private capacity for terrorism coverage.

The Proper Role of Government

When terrorists target symbols of a nation's economic, political and military power, they are attacking the nation as a whole, not just the symbol itself. We need to recognize that the terrorism risk is different from other types of insurance for other reasons. By its definition, terrorism is an effort to effect changes in government policy and public attitudes. Terrorists target places and properties on American soil in an effort to change U.S. government policy and our behavior as a society. While we may not be able to truly understand the motivation of such actors, whether it is our way of life or our government policy which they attack, it does seem that the risk has little to do with the particular policyholders who need protection. How is a business owner in Baltimore or an insurer in Birmingham expected to cope with that threat without some role by the government? We look to the Federal government to protect us from this threat militarily; why not, in some limited way, economically?

Other leading nations on the forefront of the war against terrorism have found it necessary to adopt national programs to help manage this economic risk. Most involve a mix of both government and private sector roles. These include government programs in at least the following countries: the United Kingdom, Germany, France, Spain, South Africa, Austria, and Israel. Recently the Government Accountability Office released a report entitled, *"CATASTROPHE RISK: U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risk,"[6] which gives a detailed description of the governmental guarantees provided for terrorism coverage in the first four European countries mentioned above. In every one of these cases, the program extends beyond the current expiration of TRIA.*

A Matter of Fairness

The Federal terrorism insurance backstop does not exist in a vacuum. TRIA was part of a comprehensive set of policies which comprise the war on terrorism which President Bush rightly declared after the September 11 attacks on our country. These in turn fit with already existing policies, some of which found heightened purpose in the post-9/11 world. The PATRIOT Act is one example of the new set of actions launched after 9/11. Like TRIA, much of the PATRIOT Act was originally authorized for three years, and the Administration is now calling for renewal of those provisions because the war on terrorism is far from complete. Just as the PATRIOT Act will be re-examined this year in light of three years' experience, we do not insist that an automatic extension of TRIA is the only appropriate response to the continuing insurance market failure. However, some Federal insurance backstop mechanism is surely a necessary component of this continuing war to protect America's economy from these enemies.

An example of a pre-existing government policy which has found new importance in the post-9/11 world is the Overseas Private Investment Corporation (OPIC).

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[5] R. Glenn Hubbard and Bruce Deal, *The Economic Effects of Federal Participation in Terrorism Risk* (prepared by Analysis Group Inc., September 14, 2004), p. 40, available at www.iii.org/media/lateststud/TRIA. See also Congressional Budget Office, Federal Terrorism Reinsurance: An Update (Congressional Budget Office, January 2005), p. 17.

[6] *CATASTROPHE RISK: U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risk,* GAO-05-199 (February 2005).

Founded in 1971, and recently reauthorized through 2007 by Congress, OPIC provides insurance against political risks—including terrorism—for U.S. businesses' overseas operations. Currently, OPIC provides insurance and financing to U.S. investors for projects in approximately 150 developing countries and emerging markets. Among the most recent projects insured by OPIC are the construction financing of $250 million for a natural gas pipeline in Israel and a $300 million development of Egypt's natural gas industry. To take another example, OPIC recently issued long-term government-backed political risk coverage (including for terrorism and other "political violence") for a commercial facility in Uzbekistan. It would be a sad and hard-to-explain irony if TRIA were to expire this year and no Federal terrorism insurance role was in place within the U.S. next year, but OPIC continued to provide next year Federally-backed terrorism insurance for U.S. businesses and facilities abroad. Such a development would mean that American businesses and facilities just down the street from the Capitol, as well as anywhere else in the Nation, could be left without sufficient and adequate terrorism insurance, but that, thanks in part to the Federal government, U.S. businesses doing business outside the U.S., ranging from operations in Afghanistan to Zimbabwe, would have all the terrorism insurance coverage that they require.

OPIC is an example of a long-standing program which serves continuing U.S. foreign policy objectives. To be sure, there are some domestic Federal insurance programs which deal with long-standing marketplace failures, most notably Federal flood insurance and some forms of crop insurance.[7] However, there are also examples of Federal insurance programs which were authorized to deal with immediate and acute problems at the time, which were then de-commissioned when the emergency subsided. These include the Federal crime insurance[8] and Federal riot reinsurance programs[9] which were established in response to the insurability problems arising out of the urban disturbances in the late 1960s. Both of these programs were administered by the Federal Insurance Administration, an office within FEMA, but were allowed to expire by the 1980s.

The precedent which perhaps most closely parallels the current case of terrorism risk is the War Damages Corporation ("WDC") which was authorized by Congress within days after the December 1941 attack on Pearl Harbor. This government-owned corporation provided direct war risk coverage to both personal and business property owners throughout the United States and its overseas possessions for the duration of World War II. Approximately 8,700,000 polices were issued for property values totaling $117 billion. WDC collected premiums of approximately $221 million, returning most of this to the U.S. Treasury as profit.

WDC conducted its business with remarkable efficiency by authorizing private insurers to attach the war risk rider to existing multi-peril insurance policies, and working with representatives of the industry to develop policy forms and pricing guidelines within a matter of months after its authorization; the first policies were issued effective July 1, 1942. The WDC premium insurance program was terminated in March 1946 and WDC assets were liquidated before June 30, 1949, although its capital stock was not returned to the United States Treasury until the 1950s. Net income of approximately $211 million had been remitted to the Treasury by 1947-48, even after payment of all claims (mostly arising in the Philippines or from the 1944 explosion of the destroyer USS Turner in New York harbor) and after sharing commissions and profit-incentive payments with private insurance industry which had acted as its agents.[10]

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[7] The National Flood Insurance Program was created in 1968 (42 U.S.C. δδ 4001-4129) and reauthorized as recently as 2003 (Pub. Law 108-3, Jan. 13, 2003). The Federal Crop Insurance Corporation was created in 1938 (Pub. Law 75-430, Feb. 16, 1938) and is currently overseen by the Risk Management Agency under USDA.

[8] The Federal Crime Insurance Program was established by the Housing and Urban Development Act of 1970 (Pub. Law 91-609, Dec. 31, 1970) to provide limited burglary and robbery coverage to property owners unable to buy private insurance coverage on property located in "blighted or deteriorating areas." The FCIP was abolished in September 1996.

[9] The Federal Riot Reinsurance Program was established by the Urban Property Protection Reinsurance Act of 1968 (12 U.S.C. Sec. 174- 9bbbb-21). This provided federal riot reinsurance to insurance companies which participated in State-administered residual market or "FAIR Plans." The riot reinsurance program was terminated in 1983 with funds on hand of over $100 million.

[10] See, e.g., "A Documented Account of the Establishment and Activities of War Damages Corporation," (1950) in the Records of the War Damages Corporation held at the National Archives.

Sunset Clauses In Insurance Policies Are Already Hurting Our Homeland's Economic Security

The threat of terrorism will be with us for the foreseeable future; in the words of President Bush, delivered on February 14, 2005, "We must not allow the passage of time or the illusion of safety to weaken our resolve in this new war."

If TRIA is allowed to expire, and is not replaced with another form of Federal backstop, the nation will be more exposed economically than was the case after September 11. There will be a scarcity of terrorism insurance and what is available will be at an exorbitant price. There is no doubt that without a Federal backstop, fewer businesses will have such terrorism coverage than today with TRIA in place or before 9/11. In fact, the evidence is already in front of us. Most major insurers already appear to be imposing "sunset" clauses in their policies being renewed this year. Appendix 1 to this testimony is a selection of the sunset clauses from many of the largest insurers in the U.S. and globally. All of these documents come from renewal quotation packages actually received by policyholders or their brokers in recent weeks. These sunset clauses make it clear that there will be no terrorism coverage under the policy after 12/31/2005 unless Congress renews TRIA. In some cases, there is no promise to provide the coverage even if Congress acts—presumably the policyholder and insurer will have to take some action in these cases to restore the coverage if TRIA is renewed between now and year-end. With each passing week, more and more of these "sunset" disruptions are being built into the nation's business insurance picture, and more economic effects are being felt. The extent of the problem is illustrated by Appendix 2, a chart showing the actual results of an April renewal program of $1 billion of property insurance for a major real estate company with assets throughout the U.S., which shows substantial holes in its terrorism coverage after December 31 of this year.

Multi-year construction and financial markets which depend on commercial mortgage-backed securities are being affected adversely by the year-end sunset of terrorism coverage. Appendix 3 is a chart showing a limited sampling by the Real Estate Board of New York of construction project in just two areas of the country-metropolitan New York City and South Florida. In all eighteen projects sampled, the builders' risk insurance either was subject to a sunset clause, renewal was overdue/delayed, or the policyholder was required to secure dramatically more expensive stand-alone terrorism cover from a limited market to satisfy lender requirements.

Aon is the world's second largest insurance brokerage firm. Aon has been actively tracking the terrorism insurance market and, in particular, TRIA coverage with the potential expiration of TRIA on December 31. We understand that an update to Aon's 2004 Terrorism Mitigation & Risk Transfer Overview will be published later this month based upon first quarter 2005 performance. Aon estimates that 80% to 90% of the available TRIA property insurance capacity will resort to the use of Absolute TRIA exclusions or low sub-limits for top tier metropolitan areas/target risks effective January 1, 2006. In short, insurance market behavior during the first quarter 2005 indicates that there will be a substantial shortfall in terrorism capacity both for existing properties and for new projects. At the same time, Aon confirms that lenders are requiring terrorism coverage for the full loan values or for a stipulated amount within loan covenants—whether or not TRIA is reauthorized. We will be pleased to provide the Committee with copies of the Aon report when published.

The important commercial mortgage-backed securities (CMBS) marketplace ($432 billion outstanding) is also at risk of credit downgrades. As one prominent publication[11] put it, "the possibility [of TRIA non-renewal] re-ignites the threat of downgrade for certain CMBS transactions and has the more macro and ominous potential of reducing property valuations and the attractiveness of commercial real estate as an investment vehicle. Without TRIA and with little confidence that reinsurers and primary property and casualty insurers will offer affordable terrorism coverage without a Federal backstop, it's highly probable that at least two of the major rating agencies will place certain CMBS transactions on watch for possible downgrade." The extension of TRIA would serve to remove a significant credit risk from the CMBS marketplace. Moreover, it would help the market avoid the ratings volatility experienced from late-2001 through 2002 as it related to terrorism insurance.

This sunset problem not only dampens economic activity now and for as long as the non-renewal persists, but, in the event of another attack, there will be substantially less insurance coverage in place—and therefore fewer and less insurance industry payments than were available for the 9/11 losses. This means, most likely, that—in the absence of a program like TRIA—the government's costs, one way or the other, following a new event similar in size to 9/11, would actually be greater

[11] "CMBS CREDIT UPDATE" (March 1, 2005), RBS Greenwich Capital CMBS Strategy.

than after September 11th. Continuation of some form of Federal backstop which maximizes the involvement of the private insurance and reinsurance industry is in fact the policy which is best able to encourage economic activity in the near term while minimizing the government's own exposure in the event of another catastrophic event.

Planning the day before for the day after an attack should be viewed as equally important to efforts to protect ourselves against such an attack.

Conclusion

CIAT is unanimous in its belief that the Federal government must continue to provide a reinsurance backstop beyond 2005 if we are to avoid major disruptions to the economy. Indeed, these disruptions are already beginning to occur as major insurers cut off coverage at year-end in absence of a clear signal from Congress. We urge this Committee to act promptly to approve the Bennett and Dodd bill, S.467, which already has as co-sponsors a majority of this Committee. Committee approval will advance the process towards a longer term solution. Only a seamless continuation of the Federal backstop in some form in the meantime will avoid the more severe economic impacts, some of which already are emerging with the widespread use of sunset clauses in current renewal policies. Chairman Shelby, Ranking Member Sarbanes, CIAT thanks you for holding this hearing and for giving us the opportunity to testify. We look forward to working with you and the rest of the Committee on this important subject in the coming weeks.