S. Hrg. 109–593

THE DEPARTMENT OF THE TREASURY'S REPORT TO CONGRESS REGARDING THE TERRORISM RISK INSURANCE ACT OF 2002

HEARING

BEFORE THE

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

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINATION OF THE DEPARTMENT OF THE TREASURY'S REPORT TO CONGRESS ENTITLED: ASSESSMENT: THE TERRORISM RISK INSURANCE ACT OF 2002, FOCUSING ON ASSESSING THE LIKELY CAPACITY OF THE PROPERTY AND CASUALTY INSURANCE INDUSTRY TO OFFER INSURANCE FOR TERRORISM RISK AFTER THE TERMINATION OF THE TERRORISM RISK INSURANCE PROGRAM

JULY 14, 2005

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

29–888 PDF WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

RICHARD C. SHELBY, Alabama, *Chairman*

ROBERT F. BENNETT, Utah
WAYNE ALLARD, Colorado
MICHAEL B. ENZI, Wyoming
CHUCK HAGEL, Nebraska
RICK SANTORUM, Pennsylvania
JIM BUNNING, Kentucky
MIKE CRAPO, Idaho
JOHN E. SUNUNU, New Hampshire
ELIZABETH DOLE, North Carolina
MEL MARTINEZ, Florida

PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
TIM JOHNSON, South Dakota
JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
EVAN BAYH, Indiana
THOMAS R. CARPER, Delaware
DEBBIE STABENOW, Michigan
ROBERT MENENDEZ, New Jersey

KATHLEEN L. CASEY, *Staff Director and Counsel*
STEVEN B. HARRIS, *Democratic Staff Director and Chief Counsel*
MARK OESTERLE, *Counsel*
MIKE NIELSEN, *Professional Staff*
MARTIN J. GRUENBERG, *Democratic Senior Counsel*
STEPHEN R. KROLL, *Democratic Special Counsel*
SARAH A. KLINE, *Democratic Counsel*
DEAN V. SHAHINIAN, *Democratic Counsel*
JOSEPH R. KOLINSKI, *Chief Clerk and Computer Systems Administrator*
GEORGE E. WHITTLE, *Editor*

C O N T E N T S

THURSDAY, JULY 14, 2005

WITNESSES

THE DEPARTMENT OF THE TREASURY'S REPORT TO CONGRESS REGARDING THE TERRORISM RISK INSURANCE ACT OF 2002

THURSDAY, JULY 14, 2005

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

The Committee met at 10:01 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.

Thank you, Secretary Snow and Chairman Bernanke, for being here this morning. This is not the first appearance before the Banking Committee for either of you.

The purpose of this hearing today is to review the assessment of the Terrorism Risk Insurance Act of 2002, recently completed by the Treasury Department, and to begin consideration of how we should proceed in light of these findings.

From my perspective, there has never been a question as to the nature of the threat that terrorism presents to the United States. I have consistently indicated that we will face the challenge of terrorism into the foreseeable future.

In this regard, I do not believe the horrific events in London raise any new questions about the sustained threat of terrorism; it was already here. Rather, the most recent tragedy serves to press home the critical issue that has confronted us since September 11, 2001: What steps do we take to best protect the economy in the face of the constant threat that we live under and perhaps will live under for awhile?

In considering this matter, we should first draw from what we have learned from the program that has been in place for the last 3 years.

I think the lessons of TRIA are quite clear. TRIA has provided limited short-term benefits. But, it has also impeded the development of broader solutions for the larger problems confronting the insurance marketplace. I believe we must look to ways to restructure TRIA to avoid these negative consequences.

I think the Administration has made some helpful suggestions as to how to redesign the program to allow the development of a functioning marketplace. I look forward to hearing more on these ideas from the Secretary of the Treasury and the Chairman of the Council of Economic Advisers this morning.

Beyond today's hearing, I look forward to working with my colleagues to design a targeted, short-term problem that permits a transition away from a taxpayer-supported system.

In the end, I believe the best way to deal with the challenges we face is to encourage innovation along all fronts and to draw upon the great strengths of our market-based economy.

Senator Dole, any opening statement?

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Thank you, Chairman Shelby, Senator Sarbanes. Welcome, gentlemen.

As we are all painfully aware, the events of September 11, 2001, brought about changes in many aspects of American life. And just last week, we were all shaken by the terrorist attacks on London. Certainly, our thoughts and prayers continue to be with the victims and their families. The events in London remind us of how unexpected and vicious those attacks can be.

Terrorist attacks, particularly large scale events such as those on September 11, have significant effects on the ability of consumers and businesses to obtain insurance. Insurance coverage provides security and certainty for Americans and is extremely important to continued economic growth and job creation.

In November 2002, President Bush signed into law TRIA, to provide a Government backstop for excessive losses caused by acts of terrorism and to establish a temporary mechanism that the Government would use to provide assistance, should, heaven forbid, another large-scale terrorist attack occur in the United States. In my 8 years as President of the American Red Cross, I have seen time and time again how a good plan of action established in advance can make a dramatic difference after a disaster.

The Government Accountability Office, GAO, has recently determined that the insurance industry has made little progress to date in providing terrorism insurance without Government involvement. This finding is of great concern.

While the lack of any notable progress on this effort is disappointing, it is understandable, since we continue to lack sound methods to predict the likelihood of terrorist attacks. Insurance companies have developed highly sophisticated models that anticipate the likelihood of natural disasters, such as hurricanes in North Carolina. Such models suggest that there is a high probability that our Nation will experience a number of hurricanes over the next 15 years. However, acts of terrorism are man-made, and we have no way to foresee the possible frequency or size of such events. Hence, we have no way to price the risk involved. This uncertainty has hindered private market solutions to this problem.

TRIA was created to provide temporary coverage for large-scale insured losses and to ensure availability of terrorism coverage for consumers. God forbid we ever face a truly catastrophic nuclear or biological attack, one that has the potential to kill countless Americans over a very wide area, but we cannot ignore the possibility. Because this threat does exist, we should enact a long-term mechanism to protect against truly catastrophic losses. This should include large scale losses to group life insurance.

Mr. Secretary, I have reviewed your statements to the House Committee on Financial Services from yesterday, and I believe it is clear that you and the Administration understand the important role a Federal backstop continues to play in our Nation's economic growth and development. I look forward to working with you in the coming months to reform and strengthen TRIA so that we may maintain this important Government backstop while also encouraging innovation and creativity in the private insurance market.

This is an issue that has profound implications for the strength of our economy, and I stand ready, Mr. Chairman, to work with my colleagues as the Committee considers appropriate action.

Thank you.

Chairman SHELBY. Secretary Snow, welcome again. We are going to put your written testimony, both of yours, in the record without objection. You sum up briefly. I do want to remind you we have four or five stacked votes, as you know.

Secretary SNOW. I know.

Chairman SHELBY. And we are not going to leave now. We hope we can begin your testimony and then come back afterwards.

Secretary SNOW. Chairman, I can be very brief.

Chairman SHELBY. Take your time.

STATEMENT OF JOHN W. SNOW
SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary SNOW. Chairman Bernanke and I have agreed to divide our time to expedite our presentation.

Let me elaborate on the findings of the study that you asked us to undertake. Of course, the study was part of the original TRIA, and we were asked to look into the availability and adequacy of the insurance market in the absence of TRIA and what had happened in the intervening period.

Our findings are really fourfold: First, the industry capacity to provide coverage for terrorism risk has improved, and so has the take-up rate. Second, the study concludes that insurers are increasingly pricing terrorism risk insurance and the price of coverage with an explicit charge has decreased. I say this is important, because it has occurred in the face of rising deductibles, suggesting the capacity of the market to do more.

Third, industry surplus has increased dramatically, and industry profitability has increased dramatically. Fourth, many insurers reinsure a substantial part of their retained risk under TRIA; but, and this is an important point, overall reinsurance purchases have not increased substantially. We think that is clearly because of the crowding out effect of TRIA on the reinsurance business.

These findings from the surveys of insurers and policyholders point to the success of TRIA in achieving its short-term goals. It has effectively addressed, in our view, the market disruptions; ensured the continued widespread availability and affordability of property and casualty insurance; and allowed both insurers and policyholders time to adjust to the post-September 11 conditions.

TRIA provisions shifted an increasing share of expected terrorism losses back to the private sector. We think the private sector should be encouraged to assume more and more of these responsibilities, and we think it has the capacity to do that. Had there been no improvement in the capacity, we would have observed, I think, a pullback of terrorism coverage in response to the shift in the deductibles which put more of the cost back on the business.

The expansion of terrorism risk coverage, availability, and take-up, and the decline in the cost, even as the TRIA deductible has increased, highlight the improvements in the industry's ability to cover terrorism risk. If the program is to be continued, we have various suggestions as to how it should be done in a way to encourage innovation and create more capacity in the private sector. I will ask Chairman Bernanke to lay out the principles that we think should be followed.

Chairman SHELBY. Mr. Chairman.

STATEMENT OF BEN S. BERNANKE
CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. BERNANKE. Thank you.

Mr. Chairman, in 2002, with the economy being very uncertain and the insurance industry reeling from September 11, the enactment of TRIA was a sensible measure to try to provide some transitional aid for the industry. Today, the economy is much stronger and on a much better footing. Insurance companies have increased their surpluses. They have begun to be able to price and measure risk associated with terrorism, and we feel it is in the national interest to try to increase the share of terrorism risk which is borne by the private sector, both insurers and securities markets.

Therefore, we do not support continuation of TRIA in its current form. If it is to be continued, we would like to do it in such a way that it will encourage increased capacity in the private sector. In particular, some measures that we would propose for consideration would be to increase the size of the trigger event from the current $5 million to $500 million, restricting TRIA to large events rather than including relatively small events in the backstop; second, to increase private sector participation by raising dollar deductibles and copays to increase the share of risk borne by the private sector.

Third, we think that the program can be more effective if we eliminate certain lines of insurance which are not so subject to accumulation risk, for example, general liability, while focusing on lines such as property and casualty. And finally, we would like to consider some reasonable reforms to litigation that would make the delivery of compensation more efficient.

In summary, we do not support continuation of TRIA in its current form. If it is to be continued, we would like to see it done in such a way as to encourage greater private participation in the market for terrorism risk insurance.

Thank you, sir.

Chairman SHELBY. Senator Dodd, do you have any questions?

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Mr. Chairman, let me take advantage of the time here, if I can.

Chairman SHELBY. Sure.

Senator DODD. And make a quick opening statement, if I might, on this. And let me begin by thanking you immensely for doing this.

Chairman Shelby promised those of us who have been deeply interested in this issue that once the Treasury report was out that he intended to move promptly to consider a proposal regarding terrorism risk insurance. We have known each other a long time, and his word is his bond, and once again, you have demonstrated that by having this hearing as quickly as you have.

I appreciate the call from Secretary Snow. It was very generous in calling several of us here prior to the report coming out to give us a quick brief on what would be included in it. And I thank you for coming as well to be with us. Many of us worked very hard, as all of you know, 3 years ago, including the Chairman and Senator Sarbanes, to put together a good bill, and I think one of the reports that comes out here indicates, in fact, the bill that we adopted after a very difficult time of getting it done actually was successful in many ways.

So, I would like to especially thank the Secretary for his work in this area. This study not only documents the success of TRIA, which I think is important, but it also provides some important suggestions, Mr. Chairman. You and I briefly talked about that in the corridors and on the floor of the Senate that we should be considering, as part of our work, to extending the TRIA program.

I expect the Secretary's comments yesterday before the House Financial Services Committee and Congressman Oxley's comments as well, which I think are welcomed, and a lot of the events over the last number of days, particularly the tragedy in London, I think there is a heightened sense that this proposal deserves more consideration than it otherwise would have received—tragically; I wish that had not been the case obviously.

And I do not necessarily agree with some of the suggestions you have made, Mr. Secretary, but as we move through the process here, I look forward to certainly working with you and your colleagues and the Committee to see if we cannot extend TRIA and build on the success of the program.

Let me just, if I can, appreciate the significant work, but I would like to make a couple of points, if I could. First of all, any notion that TRIA has in some ways helped to create the problem is just not only misguided; but it is also dead wrong, in my view. Let us not forget that the root of this problem is the wanton acts of terrorism that were committed against our country. The tragic events of September 11 caused tremendous loss of life and severe economic damage.

This Congress worked hard to answer those attacks in a variety of ways. And TRIA was a critical part of our national response to a national problem. Without the passage of TRIA, we risk significant economic dislocation, job loss, and leaving our Nation vulnerable to future terrorist attacks. This report accurately concludes that TRIA was effective at achieving its main goal of ensuring affordability and availability of terrorism insurance.

Second, the notion contained in this report that TRIA has, in some way, crowded out the private reinsurance market is just plain wrong. I fail to see anything in this report, empirical or anecdotal, that supports that idea. In fact, this report contains no information from the reinsurance industry itself, but only from direct writers of insurance.

This omission is especially troubling, I might add, because fundamentally, the TRIA program acts as a Federal reinsurer in the absence of a private reinsurance market. How can a study on the effectiveness of a Federal reinsurance program be complete without an examination of the underlying reinsurance industry? The truth is that direct writers of insurance, those who deal directly with consumers, want more private reinsurance, and they simply cannot get it.

Last year, under TRIA, the total industry-wide retention level was around $31 billion. According to a survey conducted by the Reinsurance Association of America, there was approximately $4 billion to $6 billion of reinsurance currently available in the terrorism marketplace. That is a gap of somewhere around $25 billion, which means only a fraction of terrorism risk is being underwritten by reinsurers. Traditionally, depending on the risk tolerance of the individual insurer, most direct writers underwrite between 20 to 40 percent of the policies they write, while 60 to 80 percent is ceded to reinsurers.

TRIA, in my view, has done nothing to crowd out reinsurance; in fact, the opposite is true: There is simply not enough reinsurance in the current marketplace, and if reinsurers are unwilling to write greater terrorism risk with a Federal backstop to cap their maximum exposure in place, the expiration of TRIA will only exacerbate a lack of reinsurance.

Third, Mr. Chairman, I am concerned that this study falls short in its analysis of alternatives in developing the concept of capital market innovations. The report does little to describe current or potential innovations that could occur in the marketplace, and how the program is currently structured either promotes or inhibits such innovations.

While I recognize that this is a bit difficult to quantify, the fact that you conclude that the TRIA program has crowded out innovation begs the question: What types of innovation should or could develop in the terrorism insurance marketplace. I certainly would welcome your response to the question later in the hearing on that particular point.

But, Mr. Chairman, I think we need TRIA now more than ever, and I certainly welcome a legitimate discussion of whether modest changes are needed in the extension of TRIA. However, I believe that letting TRIA expire is not an option. We simply cannot afford to risk the consequences, particularly with the overwhelming success of the current program.

We are at war. I do not know what more clearly needs to be stated. We have had 221 attacks against ourselves or allies since 1983. At some point or other, we need to wake up and move on these issues and see if we cannot establish a sound program. So, I would like to bring to the attention of the witnesses the strong bipartisan support for the extension of the terrorism risk insurance. Senator Bennett and I, with 32 of our Senate sponsors as well as a majority of the Committee, that is, Senators Schumer, Hagel, Reed, Bunning, Bayh, Dole, Carper, Stabenow, Corzine, and Johnson have introduced legislation to extend this Terrorism Risk Insurance Act.

TRIA has a history of bipartisan support, and I am pleased to say that the robust support on both sides of the aisle still exists as we consider an extension of this program. It is my fervent hope that we will find a solution to this problem and do it as quickly as we possibly can, and again, Mr. Chairman, I thank you immensely for acting as rapidly as you have by giving us this opportunity.

Chairman SHELBY. We have to go to the floor. That is where most of our colleagues are. And we are going to be in recess, say, for at least 45 or 50 minutes, and we will be back. I am sure there will be a number of Senators wanting to question you. We are in recess now.

[Recess.]

Chairman SHELBY. The hearing will come back to order.

Mr. Secretary, Chairman Bernanke, I am very sorry. It is just the nature of business in the Senate, as both of you know. We had five votes, and they take a little while. A lot of my colleagues are still over there, and that might be good news for both of you.

[Laughter.]

I understand, Mr. Secretary, you have to go in just a few minutes, and if nobody shows up, you might go sonner than that. I do have a number of questions for the record, and I do appreciate your indulgence.

I noted in my opening statement that the recent tragic events in London do not teach us any new lessons, but they do remind us of the threat of terrorism, because we know it here. We have experienced it here. The threat of terrorism has been an undeniable reality since September 11. But notwithstanding the fact that most people have long recognized this, some are now arguing that the events in London have changed the nature of the debate.

I do not think they have changed the nature of the debate at all. I was in London. I was there when this was going on. It just reminds us of what we already know: That we are all vulnerable to some degree. Chairman Bernanke, this Administration is extremely mindful that the threat of terrorism could remain for some time into the future.

Mr. BERNANKE. Yes, sir.

Chairman SHELBY. It is on record.

So in reality, the London bombings have not changed the Administration's perspective but rather have reinforced it. Would that be correct, Mr. Chairman?

Mr. BERNANKE. That is correct.

Chairman SHELBY. Is it appropriate to conclude that the Administration was mindful of the continuing threat of terrorism when it put together its recommendations with respect to the TRIA program, Secretary Snow?

Secretary SNOW. Yes, sir, Mr. Chairman.

Chairman SHELBY. And of course, it does not leave out the long-term economic interests of the country in any way, does it?

Secretary SNOW. Quite the contrary, Mr. Chairman. We think it advances the long-term economic interests.

Chairman SHELBY. Chairman Bernanke, in your testimony, you raised a very important point that bears repeating, "TRIA does not eliminate terrorism risks but merely shifts the burden to the taxpayer." With this in mind, should we not first look to the dynamic capability always of the market economy before exposing the taxpayers to the risk. Also, if we do pass an extension of some type of insurance, which probably will be the case, should it not be narrow in scope, because otherwise, the markets will never develop the product?

Mr. BERNANKE. I agree, Mr. Chairman. Under the current rules, if there were to be a major terrorist attack, the taxpayer would be on the hook for up to $70 billion. That is money that would not be available for humanitarian assistance, reconstruction, or economic rebuilding. Why not enlist the private sector to help support the reconstruction effort? And the reform of TRIA would increase the capacity of the private sector, the insurance markets, the securities markets, to provide funding in the event of such a tragedy.

Chairman SHELBY. Secretary Snow, in your testimony, you noted, "extending TRIA in its current form is likely to discourage the private market from development needed to deal with the risk of terrorism."

Secretary SNOW. Absolutely.

Chairman SHELBY. Would you elaborate for just a moment on the market distortions caused by TRIA, in your judgment?

Secretary SNOW. There are a number of market distortions; basically, the fact that the Government is playing a larger role, occupying more space in the reinsurance business, in the insurance business than would be the case if we allowed the market to work. If we allowed the market to work, I think we would see a lot of adaptations and adjustments. I think we would see a creativity and cost-effective means of covering terrorist risks.

I think we would see aaptations on the part of policyholders that would be beneficial in mitigating risks, and I think we would see credit markets adjusting as well so that the risks would be better distributed between the Government, the taxpayers, really, who always stand behind the Government and the private sector. The private sector can, and should do, more in carrying these risks.

Chairman SHELBY. Secretary Snow, you support—speaking for the Administration, both of you—eliminating certain lines of insurance from coverage under the program. Would you both elaborate on that a little?

Secretary SNOW. I can very briefly—yes, we do, lines like auto——

Chairman SHELBY. Life insurance?

Secretary SNOW. Group life? Group life, yes. The reason that we support the elimination of certain lines is that these lines do not create the cumulation, aggregation risks that are associated with terrorist events. We think those are lines that can be well-covered by the market. Of course, in response to the TRIA directive, we did a study on group life and concluded that the market was providing ample availability of group life insurance.

Chairman SHELBY. Okay; Chairman Bernanke, one of the interesting developments that has occurred since the enactment of TRIA has been the emergence of insurance coverage for domestic terrorism events, something that is not included under TRIA. What conclusions do you draw regarding the fact that this type of coverage is now available in the market notwithstanding the absence of a Federal program?

Mr. BERNANKE. Chairman Shelby, it is true that there is available insurance for domestic terrorism risk, which is not covered by TRIA, and that seems to indicate that the market does have some ability to price and evaluate that risk and to provide insurance for it. It may be somewhat different from the scale or magnitude or qualitative nature of some international risks. Nevertheless, it is encouraging in terms of what the industry has been able to do.

Chairman SHELBY. The report, Chairman Bernanke, assesses the likely capacity of insurers to offer terrorism insurance after termination of the program. You find that their modeling capacity and financial capacity has greatly improved. This is helpful, but it is only one option. Your report does not assess the likely response of markets outside of the insurance industry. These actions, I think, would be critical, because insurers alone will not solve the terrorism risk problem.

Could you comment, if you have any thoughts, on where else in the financial markets that we can expect to see innovations for bearing terrorism risks? And do you believe that our financial markets are sufficiently broad, liquid, and innovative to spread this type of risk, which is important?

Mr. BERNANKE. Yes, Mr. Chairman. First, I do think the insurance industry has quite a bit of way to go to expand its capacity to deal with these risks, and beyond the insurance industry, in the securities markets, there are a number of possible ways in which these risks could be shared across society. For example, use of real estate investment trusts would allow investors to hold portfolios of a number of different properties that would be well-diversified by geography and by risk. That would allow a way of diversifying this risk. Commercial mortgage-backed securities would be another such mechanism, as would portfolio diversification on the part of owners of buildings that would own portions of a number of buildings across the country. These are all ways to spread the risk among a number of different owners, as are potential innovations such as catastrophe bonds that would allow the sale of part of the risks in a secondary market.

I do believe that these markets are very deep; they are very liquid; they are very innovative; and given a chance, they will be very helpful in providing more coverage of these risks.

Chairman SHELBY. Mr. Chairman, the Treasury report also indicates that prices for terrorism risk insurance have not changed in a manner commensurate with the increase in insurers' risk exposure; for example, while insurer deductibles increased significantly, average prices only inched up, and prices in high risk cities fell considerably. What does this tell us about expected pricing if there were to be additional shifts in risk in the private sector?

Mr. BERNANKE. Mr. Chairman, I would be careful not to extrapolate too far from this data, but it does suggest that as more of the risk has been returned to the private sector, pricing and availability have not suffered. That suggests that the industry is building capacity and can continue to build capacity to meet these risks.

Chairman SHELBY. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. And I apologize again to both of you here for this interruption this morning with our votes. What is the play, Mr. Chairman?

Chairman SHELBY. The Secretary has to leave at 12:15, so I was recognizing you right now.

Senator DODD. Lucky guy.

Chairman SHELBY. He has been here an hour or so.

Senator DODD. I know. We apologize to you.

Let me, if I can, pick up on this in the report, Mr. Secretary. In your report to Congress at numerous points, you believe that a private market will develop over time for terrorism insurance. My concern is I do not see anything, any data in the report or any basis for that conclusion.

We have not received any testimony in this Committee, and the Chairman has been very gracious in listening to a lot of different people about this program and what should constitute a good program. Nor has there been any discernible activity in the marketplace, because certainly, there has been no guarantee that this program is going to exist in perpetuity. Given the history of developing the program in the first place, the reluctance to do much about it until this Treasury report came out. Even with that, concerns about whether or not we would go forward, how hard it was to get in the House; the argument, well, as long as this program is around, no market was going to develop. It seems to me, given the uncertainty about all of this, you would assume that one might begin to develop, at least, out there.

The reinsurance market, the Reinsurance Association of America, and I mentioned this in my opening comments to you, there is only about $4 billion to $6 billion in reinsurance available today. They state, "there is no evidence to support Treasury's suggestion that the expiration of TRIA will encourage the development of a private reinsurance market and other risk transfer mechanisms."

Just a few months ago, the Federal Reserve Chairman, Alan Greenspan, has said, and I am quoting him, that he has yet to be convinced the private market alone can adequately insure against the continuing threat of terrorism. That was in February 17 testimony. A recent report by Standard & Poor's rating services concludes that without terrorism risk insurance, "property and casualty insurers will cease to offer this coverage or will offer it only at extremely high rates."

TRIA is set to expire, as you all know, on December 31. And I again quote him here: "leaving insurers and ultimately policyholders without protection in case of another major terrorist attack." That is Standard & Poor's on February 3.

In an April 28 report, Moody's noted that insurance brokers report that up to 75 percent of policies written since January 1 have adopted a conditional endorsement that automatically voids terrorism coverage if TRIA is not renewed and that the number of conditional endorsements is expected to increase as the year progresses. These conditional endorsements appear to be, and I am quoting here, "these conditional endorsements appear to be an indication that unless TRIA is renewed, premium spikes or a sharp reduction in the availability of coverage may result." That is Moody's conclusion.

With all due respect, Mr. Chairman, what makes you believe that the market is ready? Where in the study can I find this information that the market is going to respond to this? And could you please tell us how you arrived at the conclusion that the private market can and will develop such a market?

Secretary SNOW. Thank you, Senator Dodd.

The study points out that we have had increasing coverage and take-up rates, even as the market has been allowed to play a bigger role. This is because the structure of TRIA was designed to give the market a bigger role over time with larger deductibles built in, going from 7 to 15 percent. And what we have observed, and I think this is laid out in the study, is that even as the market has taken a bigger role with those increasing deductibles, the coverage has expanded.

We have confidence that that trend would continue as we follow the reforms we have suggested of larger deductibles and also larger copays. So this is a case where I think the past is prologue.

Senator DODD. Would you disagree with me at all about what I said earlier that we talked about the $31 billion we are looking at here, the $4 billion to $6 billion presently out there, and thus, the $25 billion gap? Where is that being made up? I do not see any evidence of that.

I agree with you. The idea was earlier, and believe in time this will happen or at least hope it does, but I do not see any evidence that this was emerging at all. I do not see the data that shows that $25 billion gap is going to be closed.

Secretary SNOW. As I say, Senator, we do have experience with rising deductibles and we watched the market continue to develop and expand, even with those rising deductibles. I think that is pretty indicative that the market has more capacity, and the basic conclusion of the study is that capacity has expanded significantly. The take-up on terrorist coverage was 27 percent or so, mid-20's in 2002. It is now well over 50. The share of insurers who were pricing insurance back in 2002 was roughly 20 percent; today, it is about 55.

Senator DODD. Let me just make the case that TRIA has been working, but your numbers do not jibe here. I do not want to keep belaboring this point, but, I mean, I think the fact you made the point in this study, and I appreciate it, that TRIA actually is doing a good job. It did its job providing that product out there at reasonable prices, and that helped stabilize that market, and our concern—I am not for a permanent program at this point at all, as you and I have talked about here, and you do not want that either. I gathered in your conversation, that maybe an extension here is what we are talking about.

But I do not want to belabor this point too much with you. I just do not see that marketplace picking up the slack. If we do not get this done, I do not think there is any likelihood that you are going to have that gap that is going to be filled here.

Secretary SNOW. Yes, Senator, that is where we would differ. We think the market has more capacity, giving it more room to operate and giving it more incentives to operate. Reducing the implicit subsidy for reinsurance that exists today, which is pretty sizeable, is going to create more opportunities for the sorts of things that Chairman Bernanke just talked about: Mitigation on the part of policyholders, risk sharing through financial instruments, and broader reinsurance coverage.

Senator DODD. I mean, what if I am right, you are wrong? What happens to people out here? What happens out here? What happens to people if we have an event, and we do not have the coverage? What happens?

Secretary SNOW. You are postulating the thing that we are asserting will not happen. Coverage has expanded and will continue to expand, and we will get a better sharing of these risks between the taxpayers and the private sector. The private sector, incentivized appropriately, can do more, Senator. That is our basic proposal: And to continue the basic model that TRIA put in place, which was a temporary program with rising deductibles, and to include rising copays, both of which provide more room for the market to demonstrate what it can do.

Mr. BERNANKE. Senator, may I add?

Senator DODD. Yes, certainly.

Mr. BERNANKE. Just on the point of reinsurance, I think reinsurance rates differ by type of insurance. According to the Treasury study, commercial multiperil insurance has a 20 percent reinsurance rate, and workman's compensation has a 24 percent reinsurance rate. Twenty percent of $31 billion is $6 billion, which is about the number you cited. So it is not clear that reinsurance is unavailable for insurance up to the deductible.

The study also notes that small companies have been able to utilize reinsurance at a greater rate than large companies, which is consistent with their greater need to diversify and also suggests that reinsurance is not being rationed. So, I think I would agree with Secretary Snow that there is quite a bit of capacity out there, and that once we remove the free reinsurance being provided by the Government that market reinsurance will take part of its place.

Senator DODD. That is pretty speculative.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Secretary and Chairman Bernanke, I do not have the answer, but I have a very uncomfortable feeling that the problem is not being sufficiently analyzed. The payout if something happens is enormous, so the question becomes how are you going to provide for that? I mean, the magnitude is beyond other experiences, as I understand it.

Now, the likelihood may be small, but nevertheless, it is likely to be heavily concentrated. I am struck by the fact that the British, who are pretty good at analyzing things and figuring them out, they have had experience in dealing with terrorism over several decades. They have established a permanent public-private partnership for dealing with the question of insurance against terrorist attacks, Pool Re, an industry-supported reinsurance pool with a backstop by the Government.

Now, the *London Financial Times* reported on July 8 that, "a large portion of the insurance claims rising from the explosions that ripped through London is likely to fall on Pool Re, the government-backed mutual reinsurer for UK terrorism risks." Now, the Israelis, who have also had, of course, long experience in dealing with terrorism, also have a system where they provide a permanent government coverage.

I do not see these pickups coming. The Treasury report concludes that the immediate effect of the removal of the TRIA subsidy is likely to be less terrorism insurance written by insurers, higher prices, and lower policyholder take-up. Well, you may say that will be over a temporary period, and then, the market will step in and accomplish this. I am not quite clear how that is going to happen.

The President of the Reinsurance Association of America recently stated, "reinsurers continue to view terrorism as a risk that is uninsurable unless there are limits to protect against catastrophic exposure." And that seems to me to put the issue pretty well, because the exposure is huge.

Now, if you are going to set premiums to cover the exposure, they are going to accumulate a lot of money that they may never be called upon to use, because you may never have the incident. On the other hand, if you have the incident, they are really going to get socked and socked hard, as the British are now demonstrating.

It seems to me that the Government backup gets the rest of the market in a proper balance so that people are paying for some coverage, which deals with the beginnings of this thing, but they do not have to pay for the coverage of the catastrophic amounts. Otherwise, you are going to levy a charge. It may never be used.

Of course, you can say that is the case in all insurance, but the levels are a lot more reasonable than what is occurring here. How do we get around that problem? How is the private market going to pick up this very heavy risk, catastrophic potentially?

Mr. BERNANKE. Senator, if I could——

Secretary SNOW. Yes, go ahead, Ben. Maybe I should, because I am going to have to just leave in one minute.

Senator the world is a lot different——

Senator SARBANES. Well, I do not want to drive you out with my question.

[Laughter.]

Secretary SNOW. No, no, unfortunately, the conditions that drive me out preceded your arrival.

Chairman Greenspan has been cited. He is talking about a really mega-event, beyond, we would stipulate, beyond the capacity at the private market. TRIA contemplates that there are some events so large that Congress and the Administration would have to come back and look at it. Everyone would agree with that. We would all agree that there are events of some scale and size and risk that are large relative to the capacity of any individual insurance company.

Senator SARBANES. Now, do I take that to mean that you think there should be a bill, a further extension of some sort?

Secretary SNOW. I think there should be reform. I think that the reforms that we outlined are the right way to go. They would give us the ability to see the private market work better. They would encourage mitigation. They would encourage financial market developments. We would narrow the lines of coverage; and, we would give the market more of an opportunity.

Earlier, I said, Senator Sarbanes, that we have watched the market, even in the face of higher deductibles, expand and take on more of the responsibility. This is a matter of getting the risk sharing between the private sector and the Government into a better posture.

Senator SARBANES. But I take it you are asking the Congress to enact legislation; is that correct?

Secretary SNOW. Well, I am really saying that we should reform the current TRIA system if you extend it.

Senator SARBANES. Do you want it extended?

Secretary SNOW. I want the reforms.

Senator DODD. You cannot get reforms without extending it.

[Laughter.]

Secretary SNOW. Well, then, if you extend it, if you extend it, it should be reformed.

Senator SARBANES. What is your view of not doing anything?

Secretary SNOW. I think the system should be reformed. I think that is the prudential thing to do.

Chairman SHELBY. If I can, I think that what we are doing is the right thing, listening to the report, listening to your views, and we will certainly listen to your recommendations. But I personally believe that we do need a program here, and we need to have it narrow in scope, and we need to be careful in what we do, because if we do not, we will never develop the private markets.

Senator DODD. Mr. Chairman, can I ask, just before the Secretary leaves, because I am curious about this $500 million number here.

Secretary SNOW. Right.

Senator DODD. The problem is, again, going from $5 million to $500 million is a pretty large leap.

Secretary SNOW. Right.

Senator DODD. And rather than argue about the number itself, I would just be curious on how you arrived at that number.

Secretary SNOW. We arrived at that, Senator Dodd, through the Treasury experts consulting with industry experts, brokers, and industry participants. We looked at it as well, and we can give you the references to these people that we talked to. We looked at their current and existing limits on existing events, and we looked at the evidence of the last 3 years, as the market itself has evolved and developed in the face, as I say, of higher deductibles.

So it is judgmental; if you are asking me is it a judgment; yes, it is a judgment, but I think it is a well-informed and thoughtful judgment.

Senator DODD. Well, I would be, you know, I wonder what the effect would be on small insurers, because it is not all just big companies we are talking about. It would be a pretty heavy hit.

Secretary SNOW. Who also tend to insure smaller scale events, take on smaller scale risks.

Senator DODD. I would be very interested in the data that helped you arrive at that.

Secretary SNOW. We will submit that, and I apologize very much Mr. Chairman, Senator Sarbanes, Senator Dodd, for the prior commitment, Senator Hagel, and I would be delighted—

Chairman SHELBY. Mr. Secretary, you got time for a question if he has one from Senator Hagel?

Secretary SNOW. I always have time for Senator Hagel.

[Laughter.]

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Secretary, thank you.

Senator SARBANES. That is the right answer.

[Laughter.]

Senator HAGEL. He experienced some Cornhusker hospitality last week, and I understand they treated you well out there and that you were a big hit.

Secretary SNOW. Thank you, Senator.

Senator HAGEL. But you did not bring any linebackers or quarterbacks with you, I heard.

I am sorry I am late here, Mr. Secretary, but I understand in referencing the Treasury report, which came out, what, a week or 2 weeks ago, that Treasury report noted the lack of reinsurance coverage on group life and for group life companies, and it is my understanding, I watched a little bit of this on television here before I came, that you had responded to the Chairman saying that you, Treasury, do not recommend that we include covering group life in TRIA, and I do not know whether that has been covered.

Chairman SHELBY. Go ahead.

Senator HAGEL. And I apologize for taking you back through that, but if you could explain that essentially; what do we do here if we cannot find that reinsurance element, and what is your suggestion if we do not cover it under TRIA?

Secretary SNOW. Senator, under the original TRIA, Treasury was asked to do a study and determine what course of action was prudent with respect to group life. We were asked to look at two criteria: One was the availability of general insurance for group life, and two was reinsurance. We found, and we said that we should not cover group life unless it was a conjunction, it met both tests.

We found that there was general availability of group life, but that there was not general availability of reinsurance; and, since the test was the twofold test, we did not include group life. Then, going to the broader issue of the recommendation, we do not think group life presents the accumulation risk that terrorist risk insurance was intended to cover, so we do not recommend covering it. We think the marketplace can work well in that area if we move the Government out and thereby reduce the implicit subsidy and encourage a larger role for reinsurance. That is our basic view. I know you do not agree with it.

Senator HAGEL. I do not, but more to the point, we are going to have to address it and deal with the realities here of the market, and I am inclined, as I am sure some of my colleagues and others, to find a resolution and have to and work with you on this as well and, as you know, Senator Dodd and others have led the effort here, and I will continue to work with them, and I know you have to go, so thank you for allowing me a question. I appreciate it.

Secretary SNOW. Thank you.

We have given you our study, and we have given you the recommendations that we think follow from the study, and we look forward to working with the Committee and the Congress as you continue to consider this important issue.

Senator SARBANES. Mr. Chairman, as Secretary Snow departs, let me note Senator Schumer was not able to be with us, because he has some amendments on the floor that he is dealing with. He is obviously keenly interested in this subject, and he has a series of questions he wants to submit for the record.

Chairman SHELBY. Without objection, they will be made part of the record.

Senator SARBANES. I want to bring that to the Secretary's attention, because I know some of them are directed to the Treasury.

Secretary SNOW. Exactly, Senator Sarbanes, and Senator Schumer and I have talked about that, and I fully contemplate further conversations with him as I do with Senator Dodd, Senator Hagel, the Chairman, and you.

Thank you very much.

Chairman SHELBY. Thank you, Mr. Secretary.

Senator SARBANES. Mr. Bernanke, could I ask you a couple of questions before you go?

Mr. BERNANKE. Yes.

Senator SARBANES. Nice to see you here, and congratulations on your confirmation.

Mr. BERNANKE. Thank you, sir.

Senator SARBANES. Is this the first time you have appeared as Chairman of the CEA.

Mr. BERNANKE. It is.

Senator SARBANES. Good.

Chairman SHELBY. But not the first time he has been before us, been with us.

Senator SARBANES. No.

You noted in your testimony that the 60 percent of the policies included terrorism coverage in 2002 and conclude from that that it was generally available. I am interested in, first of all, whether you know the 60 percent of policies included coverage that was comparable in terms of limits and exclusions.

Mr. BERNANKE. No, sir, I am quoting the number from the Treasury study, and I merely made the point that insurance coverage did not dry up entirely. I do believe that TRIA was useful and did enhance the insurance market.

Senator SARBANES. Do you know the geographic location and risk profiles of the properties covered, the 60 percent by those policies?

Mr. BERNANKE. I do not. The Treasury study does, however, suggest that premiums between cities, large cities and other cities and premiums between so-called "high risk properties" and "less risk properties" did not diverge unduly over this period, suggesting some capacity to cover even higher risk areas.

Senator SARBANES. They may have taken the path of not providing the coverage rather than escalating the premiums, which they made the kind of judgment about the risk.

I guess the point I am trying to get at, and I am not suggesting a counteranswer, because I just do not know; I mean, it is not meant to draw a conclusion, but if the policies were in relatively low risk areas in effect, it would be difficult to draw the conclusion that terrorism insurance was generally available, would it not?

Mr. BERNANKE. Again, I would differentiate between 2002 and then the subsequent years. In 2002, there was a good bit of insurance being written, but I am not claiming it was the optimal amount or the desired amount. TRIA did help to strengthen the market. I think TRIA was a good bill.

As we looked over the next few years, though, we saw that generally, availability and pricing improved, and I believe the Treasury study showed that that was both the case in high risk as well as less high risk areas, despite the fact that the exposure to the private industry essentially doubled as deductibles went from 7 percent to 15 percent. So, I take that as evidence that the industry, over time has been building capacity, ability to price these risks, and ability to insure these risks.

Senator SARBANES. Why do you think the British and the Israelis do it the way they do?

Mr. BERNANKE. Senator Sarbanes, different countries use different methods. The OECD report suggests that only 5 of their 30 members have similar approaches. I would think that in the case of the London bombings, as tragic as they were, that preliminary estimates of the damages are on the order of 1 to 2 percent of a major hurricane, and therefore, it seems to me something that could have been handled strictly in a private market, and the British have decided to provide this backup; that is the approach they have chosen.

Senator SARBANES. So you do not see the catastrophic size as way out of bounds; is that correct?

Mr. BERNANKE. Senator, your point that you actually raised earlier, I think, is right on point, which is that I believe the insurance markets can handle substantial risks but not unlimited risks, and in particular, TRIA as currently written is capped at $100 billion, and presumably, a shock above $100 billion would require the Congress to reconsider the entire situation and make priorities about where its available funding would go.

What we are talking about here is creating more exposure to the private sector below this $100 billion risk. That number is a very high number, but it is not radically different from risks that are borne in other kinds of contexts.

Senator SARBANES. Do you think we need to pass legislation on this issue?

Mr. BERNANKE. On TRIA? I would like to see substantial, increased exposure to the private sector of terrorism risks. I would be happy with any legislation that accomplished that objective.

Senator SARBANES. Let me pursue the question for a minute, because sometimes, the easiest thing in the Congress is no action, you know? What is your view of a scenario in which the Congress failed to take action on this issue and the program simply expired?

Mr. BERNANKE. I think an expiration would probably require some transition period before it was finally expired to give the markets ability to adjust. I think the more likely outcome——

Senator SARBANES. That means you think we need legislation.

Mr. BERNANKE. I am comfortable with legislation that increases the exposure of the private sector to these risks.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel, do you have any questions for the Chairman?

Senator HAGEL. No questions.

Chairman SHELBY. Mr. Chairman, we appreciate first your indulgence in waiting, and we will continue to work with you on this issue that we think is very important.

I think it would be unacceptable for us to not do anything, and we are going to try to come with a bill, a meaningful bill, a responsible bill and hope that with time that the private market will assume more and more of the risks.

Senator SARBANES. Is the Council of Economic Advisers still banished, exiled, or still outside the Executive Office Building?

Mr. BERNANKE. I have a personal office that is in the Executive Office Building, which is very useful, and we use that to——

Senator SARBANES. But you are separated from all your staff.

Mr. BERNANKE. But my staff, unfortunately, are a block away. We make the best of that.

Senator SARBANES. Are they scheduled to come back in? Is it because refurbishing is going on?

Mr. BERNANKE. It is entirely because of refurbishing and reconstruction, and I do not think that is about to be completed. I think there is still some time.

Senator SARBANES. We are trying to be helpful to you on that issue.

Mr. BERNANKE. Senator, I would be happy to accept any help you are willing to offer on that front.

Chairman SHELBY. Mr. Chairman, how is the transition going from the Federal Reserve, a Member of Board of Governors, as you were, very active, to the Chairman of the President's Council of Economic Advisers?

Mr. BERNANKE. The new job is very exciting and gives me a wide range of opportunities to look at different issues like this one, and I want to thank you again for your speedy confirmation.

Chairman SHELBY. Senator Bennett, you are just in time.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Yes; thank you, Mr. Chairman. I apologize for being late. The votes disrupted all of our mornings. But I am still grateful for the opportunity.

I will not go into any particular details. I am sure they have been discussed at great length, and I will read the record with great interest. But let me just get your reaction to one thought that has occurred to me, and I have discussed it with Secretary Snow privately.

If we do not have a formal TRIA program, and there is another September 11, that is, a major disaster that is in the $40 billion category, remembering what happened after September 11 around here, the Congress went to great lengths to assure everybody that they would be made whole. The speed with which the $40 billion for New York and Virginia went through here was really astonishing.

I believe that same thing would happen, I say, if there were an event, somebody flew an airplane or found a rogue cruise missile or whatever disaster you might think of in San Francisco to the TransAmerica Building, the California Senators would be here saying you have to help us, and every one of us would say yes, we will help you.

I remember one Senator saying at the Senators' meeting we had after September 11 consider me the third Senator from New York. I will fight as hard as you do for these appropriations.

Senator SARBANES. I hope they got it down and recorded it.

[Laughter.]

Senator BENNETT. Well, yes.

Now, my concern is, for those who say, well, let us not have the Federal Government involved in this; this is something the market should do because we do not want to put the taxpayers on the hook, that experience says to me the taxpayers are going to be on the hook, emotionally if not financially, but emotion will turn to finance really quick, as it did after September 11.

Now, I am not begrudging the $40 billion, but I can tell you that the emotion around here was so strong that if somebody had said $50 billion, no, it has to be $60 billion, there would not have been very many who would have stood up and said, well, I am going to look at the pocketbook rather than the problem in New York, and $60 billion is too much. I do not know whether $40 billion was the right number or not, but $40 billion is what we did.

All right; I am rambling, but let me get to the point. I think, paradoxically, that extension of this program with a specific number in it that will cause the industry itself to come in and backfill, if you will, up to that number actually would be better for the taxpayers than if there were no formal action, because then, we could say, well, the legislation is in place; there is a taxpayer involvement; but there is a $30 billion, a $40 billion, or a $50 billion, if you will, deductible from the taxpayers, that the market has now, in an orderly fashion, filled in.

If we do not put that deductible in place, the market will not fill in anything, and the taxpayers will be on the hook for the whole amount. React to that observation. Am I right or wrong? I mean, I think am right on the emotion, but am I right on what the market might do?

Mr. BERNANKE. Senator, I think I broadly agree with you. I think what we want to do is get the private sector more involved to provide more insurance and other types of mechanisms for sharing risk and compensating losses so that should an attack happen, the private sector will provide substantial funding for reconstruction and for compensation, leaving the Government without these huge obligations through TRIA but with the money available to do whatever is necessary on a prioritized basis for humanitarian assistance, for reconstruction, and for getting the economy back on its feet.

So, I think the purpose of TRIA is not to say we are throwing the country to the wolves; the point is to get both the private sector's insurance capacity and the Government's reserve for emergencies of all kinds—both of those things—available should an attack occur.

I believe I agree with the philosophy you are saying, and I think a big part of that, again, is to stop suppressing the private market and allow the private market to come back in to this process in a much bigger way than it is now.

Senator BENNETT. So if we set a Federal number at a reasonably high level, then, the private market says okay, we can fill up to that number. If we leave the high level off, the private market says we do not know quite where to go, and the taxpayers, I think, in the event of a real disaster would end up paying more than they would if we extend TRIA in a logical fashion.

Mr. BERNANKE. We have a $100 billion limit now on TRIA. Above that level, the Congress is going to simply reconsider the entire situation. We have a number of mechanisms already for dealing with emergencies such as FEMA, for example.

Senator BENNETT. Right.

Mr. BERNANKE. So what I would suggest is not that we try to preprogram how we respond to a shock of that size, but rather that we simply—by putting more of the cost onto the private sector—leave more capacity for the Government to respond ex post, after the fact, in the most effective way, given the circumstances.

Senator BENNETT. Okay; well, I am for extension of TRIA. I appreciate the Administration's indicating their support for extension, and we will argue over the details.

Thank you.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. I have nothing further.

Chairman SHELBY. Mr. Chairman, we appreciate your appearance here, and again, we apologize for the delay.

Mr. BERNANKE. Not a problem, sir.

Chairman SHELBY. We will see you again. Thank you, sir.

The hearing is adjourned.

[Whereupon, at 12:41 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record:]

PREPARED STATEMENT OF SENATOR MEL MARTINEZ

Thank you, Mr. Chairman, for holding this important hearing. You and your staff have conducted a very comprehensive examination of this issue. I also commend the work of the Treasury Department in preparing its report for the Congress. I am going to keep my opening remarks brief so that we can hear from our witnesses.

As we have observed in recent years, Federal and State governments have a responsibility to respond to catastrophic events. Whatever the type of assistance provided, the goal is the same—to return to normalcy and protect ourselves going forward by learning from what happened. On Monday, I spent the day in Florida traveling to several emergency operation centers across the panhandle visiting with constituents impacted by Hurricane Dennis. In Florida, we never know what the next hurricane could bring, but Floridians do everything they can to get back to life as usual as quickly as possible and to learn from the hurricane for future storms. To assist Floridians, Governor Bush declared a state of emergency for the counties hardest hit to initiate relief efforts.

On a much larger scale, Congress responded to the terrorist attacks on September 11 by passing a temporary program to help the private property and casualty insurance companies rebound after the unprecedented premiums they paid out in the last months of 2001. As Secretary of HUD, I participated in the efforts to assist lower Manhattan and its businesses recover and rebuild. What happened that day was unimaginable and after the immediate outpour of Government assistance, the Congress had to develop a way to protect the insurance industry against future events.

Over the last 3 years, the majority of property-casualty insurance policyholders took up terrorism insurance—because TRIA made it available and affordable—and the insurance industry has now reached a point where its surplus has returned to pre-September 11 levels—making them financially strong enough and better able to bear unexpected losses.

The Treasury report made clear that while TRIA has been effective in fulfilling what it was originally intended to do, the future existence of a TRIA program discourages the private markets from developing a long-term solution.

We exist in a world that will always have risk. Hurricanes, stock market investments and potential terrorist attacks all carry risk. It is our responsibility to determine how we hedge against those risks and who bears the financial risk that would accompany another terrorist attack.

I understand that terrorism poses a unique risk potential. We must find a way to allow the marketplace to develop while at the same time be mindful of the potential for catastrophic losses of such magnitude that may require Government intervention.

Thank you. I look forward to the testimony.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Chairman Shelby, Ranking Member Sarbanes, thank you for holding this important hearing today on terrorism risk insurance.

It has been almost 4 years since the September 11 attacks that prompted the passage of the Terrorism Risk Insurance Act. And while we have been fortunate here in the United States that no events have triggered the use of this Federal backstop, the bombings in London last week, the Madrid train bombing last year, and the nightclub bombing in Bali in 2002, each serve as painful reminders of the reality of the ongoing war on terror, and the fact that attacks can happen anywhere at anytime.

Prior to September 11, the risk of terrorism was not a factor when insurers wrote policies. However, in the post September 11 environment, the availability of affordable insurance for terrorism risks has become a necessity.

The war on terror involves protecting our homeland and protecting our citizens. Recent polls show that Americans believe that more attacks on the United States are very likely. In light of the current environment, it would be both unrealistic and premature to conclude that a Federal backstop is no longer necessary. Moreover, with less than 6 months before its expiration, it is irresponsible for the Administration to determine that extending TRIA is not warranted absent significant changes, and to suggest that it is appropriate to shift the burden of insuring against the risk of terrorist attacks solely to the private insurance market.

At this juncture, I believe we continue to need a program like what we have established with TRIA. This week, I joined with Senators Dodd and Bennett, and nine other Members of this Committee in cosponsoring S. 467 which extends the program, and would enable the Presidential Working Group on Financial Markets to make long-term recommendations for Congress to consider.

S. 467 would also direct Treasury to include group life products in the program. As I have reiterated over the past several years, it is critical that we create conditions that permit the private insurance markets to continue to offer group life insurance coverage to employees at high risk of attack. Moreover, the lack of affordable reinsurance for group life products calls into question the Administration's position that TRIA is crowding out innovation that would otherwise enable the industry to offer insurance for terrorism risk without a governmental backstop. Reinsurance has essentially evaporated for the group life sector, which Treasury specifically chose not to include in the terrorism risk insurance program, and thus was not hindered in its pursuit of market innovations. We should be working to create a marketplace where reinsurance can reemerge for group life products, rather than jeopardize the TRIA-facilitated appearance of reinsurance for products, like workers compensation, which are comparable to group life.

That said, I certainly appreciate that innovations within the insurance industry may be part of the long-term solution, and we certainly should facilitate that as we go forward. I think the time has come for Congress to review the current regulatory landscape of the insurance industry to ensure that it does not unnecessarily restrict innovation, and I am pleased that Senator Dodd's legislation is consistent with that objective—extending TRIA for a period of time sufficient for Congress to begin looking at modernizing the regulatory scheme for insurance while it also reviews longer term solutions to the challenge of insuring against acts of terror.

Because of the random and unpredictable nature of terrorism, I am not yet convinced that the private sector can adequately or accurately assess terrorism risk in the absence of a Federal backstop. Estimating the likelihood of attacks or the extent of loss is difficult, if not impossible. Now is not the time for the Administration or Congress to leave the private insurers to go it alone.

I look forward to hearing from today's witnesses.

PREPARED STATEMENT OF SENATOR JACK REED

Terrorism Risk Insurance is one of the most important economic and national security issues we face. Terrorism is still a very real threat in this country. The bombings last week in London serve as a reminder that enemies remain who are committed to threatening our security and our way of life. September 11 was not only an attack on the American people, but it was also an attempt to undermine our economy. Terrorist will undoubtedly try again.

We live with the threat of terrorism for the foreseeable future and Congress has a critical role in insuring that our economy is protected from the potential dislocations from a terrorist attack.

I am proud to be a sponsor of the Dodd-Bennett bill because I believe that we must extend the Terrorism Risk Insurance Act and protect our economy from the threat of terrorism.

Everyone agrees that the TRIA program has worked. TRIA helped stabilize the insurance markets after September 11 and has strengthened them since then. The question facing us today is how to proceed for the future and what form the TRIA program should take going forward. I think there are several facts that are critical to this debate. Terrorism is a major and continuing threat that we cannot ignore.

Protecting our national security is first and foremost the responsibility of the Federal Government. Other nations have looked at this problem and have chosen to provide a government backstop program. Unlike some other types of insurance coverage, regardless of how prudent a policyholder is or how much he acts to protect against a terrorist attack, the policy holders ability to protect themselves is limited.

While we all prefer to allow markets to function without Government intervention when possible, this is a classic market failure. Unlike the actuarial data for floods, earthquakes, hurricanes, and life expectancy, no one can quantify the likelihood of a terrorist attack because it is less predictable and there is no historical data to allow for an accurate assessment. If we cannot predict the likelihood and policyholders have a minimal role in protecting themselves, how can we create a market to insure against it? And perhaps most importantly, we cannot risk the potential economic dislocation of getting this wrong.

At a recent testimony, Chairman Greenspan said that there are certain instances in which markets do not work and there is no compelling evidence that the market can be made to work.

In a June 2005 Special Comment, Moody's stated "Almost universally, private market reinsurance is not being utilized to cover terrorism risk below companies' TRIA deductibles. Consistent with our 2003 survey, Moody's would still characterize the proportion of terrorism risk being shifted from primary insurers to private markets as low."

I believe there are some modifications that can and should be made to this program within the framework of the original program. However, we should not throw out the baby with the bath water. I am no more convinced that the private markets are any better equipped today to effectively insure against terrorism without a Federal backstop than they were after September 11.

We should reauthorize TRIA and examine the appropriate Federal role for the future. We have an obligation to the American people to protect our economy. I believe there probably will need to be a continuing Federal role because the markets will not be able to adequately insure against the risks of terrorism in a fair or affordable manner.

Mr. Chairman, I want to raise one more note of caution. We should reauthorize TRIA in a bipartisan and expeditious fashion without extraneous and controversial issues. As we learned in 2002, tort reform provisions will only impede the legislative process and threaten the extension of this important program. I have supported a number of legal reform measures, but we should keep this legislation clean and not weigh it down with unnecessary and contentious tort reform provisions.

I look forward to hearing the testimony of the witness.

PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER

Do you know that under the Treasury new trigger proposal many of our world's most recent terror attacks would not be covered? London would not be covered. Madrid would not be covered. I take issue with the fact that you only collected data until February 2005 several weeks short of the end of the first business quarter.

The bottom line is that I am absolutely open to a serious consideration of minor tweaks to improve the TRIA program. But, I am not willing to accept any drastic changes that are based on incomplete data, information driven by ideologues, or information that simply lacks empirical evidence. I mean you said it yourself, the program has been effective, it has been a success.

Mr. Chairman, as we move forward I want us to remember why this program was established in the first place. It was established to create a public/private partnership between business and Government that would provide a safety net to allow us to bounce back from a terrorist attack with little market disruption and minimal impact on our overall economy. That need has not changed. We know what happens when there is no terrorism insurance, because it happened in 2002. In that year, the President himself said that the lack of terrorism insurance cost our economy tens of billions of dollars and 300,000 construction jobs.

We, in government, have a responsibility to get this done to protect our Nation's businesses and workers.

We have a responsibility to find a long-term solution because terrorism is a long-term problem.

Until our Government can declare that we are no longer at risk of a terror attack, no longer in need of the Department of Homeland Security—we will continue to be in need of TRIA.

But most of all we have a responsibility to create policies to protect our policyholders—they are our businesses and property owners. We should not be in the business of placing the financial burden of fighting the war on terrorism on our private citizens.

If you look at the history of war in this country that has never been the case.

- During World War II we provided a program called the War Risk Insurance program that provided insurance for property damage here in the United States caused by German or Japanese attacks.
- During the Vietnam War we provided an insurance program to cover commercial airplanes that flew into and out of Vietnam.
- And, today we have a first dollar loss insurance program for the airline industry to cover losses caused by terrorism in the United States, which is expected to be reauthorized at the end of August.

London showed us that the reauthorization of TRIA should be one of this country's highest priorities.

Yesterday, during the House Financial Services Hearing, Secretary Snow seemed even more supportive of moving a TRIA in the coming weeks. Maybe in light of the recent attacks we all see there is a greater need for the reauthorization of TRIA sooner than later.

So Mr. Chairman one of the things I would like to take away from this hearing today is a commitment and a timeline to get this done in the next few weeks. Every day this does not happen—our businesses, workers and economy are at risk.

Thank you.

PREPARED STATEMENT OF JOHN W. SNOW

SECRETARY, U.S. DEPARTMENT OF THE TREASURY

JULY 14, 2005

Thank you, Chairman Shelby, Ranking Member Sarbanes, and other Members of the Committee. I appreciate the opportunity to discuss the Treasury Department report on the Terrorism Risk Insurance Act (TRIA).

As you know, President Bush signed TRIA into law in November 2002 to help safeguard America's economy following the terrorist attacks of September 11, 2001. The September 11 losses led the insurance industry to reduce its exposure to future losses largely by excluding coverage of terrorism risk in many policies. The pullbacks in terrorism coverage and the quotations of rapidly increasing premiums raised concerns that this period of adjustment to the reality of global terrorism risk in the insurance market could have a negative effect on the economy.

In response, TRIA was passed. It was meant to address any market disruptions and ensure the continued widespread availability and affordability of property and casualty insurance for terrorism risk, and to allow a transitional period for the private markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses, while preserving State insurance regulation and consumer protections.

TRIA required the Treasury Department to assess the effectiveness of the Terrorism Risk Insurance Program. It also required Treasury to assess the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the Program.

The report finds that TRIA has been effective in meeting its goals of supporting the industry during a transitional period and stabilizing the private insurance market. Consistent with TRIA's design to encourage the development of the private market, the Administration opposes extension of the program in its current form. Extending TRIA in its current form is likely to discourage the private market development needed to deal with the risk of terrorism. The Administration has outlined principles that any extension should recognize and we look forward to discussions with the Congress on them. Before I review the main findings of the report, however, I would like to discuss the approach that the Treasury Department took in the course of evaluating TRIA.

Treasury Approach to TRIA Evaluation

Treasury contracted with an outside survey research firm to conduct two independent, nationally representative surveys. One survey sampled insurers in the commercial property and casualty line, which is eligible for the Federal reinsurance provided under the program. The other survey sampled policyholders, businesses, and other organizations that purchased commercial property and casualty insurance in TRIA-eligible lines. Respondents were asked to provide information on an annual basis from 2002 (prior to passage of TRIA), to the first 2 months of 2005. The data therefore give a unique, comprehensive overview of the availability and affordability of terrorism risk insurance coverage in the private market.

From insurers, the surveys collected information on the amount of terrorism coverage written, the cost of terrorism coverage, terms and conditions on terrorism coverage, and the purchase of reinsurance. From policyholders, we collected information on take-up and cost of terrorism coverage, the characteristics of firms and other organizations that purchase terrorism coverage, special terms and conditions associated with that coverage, reasons why the mandatory coverage offer was declined, and loss-mitigation efforts.

To safeguard the confidentiality of the business information requested in these surveys, Treasury took great care to ensure that the data were assembled at arm's length from the Government. All identifying information was removed or masked prior to analysis by Treasury staff and officials.

I have been insistent throughout this process, consistent with Congress' direction to us in TRIA, that we draw upon as many sources of information and input as possible. Treasury has in fact consulted with a broad range of experts representing the insurance industry, the National Association of Insurance Commissioners (NAIC), policyholders, and taxpayer groups in developing the survey instruments. Preliminary survey instruments were reviewed by insurance industry representatives, NAIC representatives and others experts, including the American Insurance Association (AIA), and the Alliance of American Insurers (AAI) after consultation with its members. Members of the Coalition to Insure Against Terrorism (CIAT) also met with Treasury staff to review the policyholder survey.

We are very pleased with the extensive collaborative process that Treasury undertook to conduct this assessment, and believe that it reflects fully the extensive input of the industry and other groups. The completed survey results, and information derived from these other sources forms the basis of the report to Congress.

Structure of TRIA

TRIA established a temporary Federal program of shared public and private compensation for insured commercial property and casualty losses resulting from foreign acts of terrorism. TRIA represents a form of publicly provided and subsidized terrorism risk reinsurance, which essentially transfers risks associated with terrorism losses from the private to the public sector (taxpayers).

Under TRIA, companies that provide commercial property and casualty insurance are required to offer (make available) terrorism coverage on the same terms and conditions as offered in their non-TRIA coverage. To be eligible for TRIA reinsurance, an act of terrorism must be certified by the Secretary of the Treasury, with the concurrence of the Secretary of State and the Attorney General, and must have resulted in aggregate property and casualty losses of $5 million or more. TRIA defines an act of terrorism as (1) a violent act or act that is dangerous to human life, property, or infrastructure, that (2) has resulted in damage within the United States or outside of the United States in the case of an air carrier or vessel (as defined by TRIA) or on the premises of a U.S. mission, and (3) has been committed by an individual or individuals acting on behalf of any foreign person or interest, (4) as part of an effort to coerce the U.S. civilian population or influence the policy or affect the conduct of the U.S. Government by coercion.

The Federal Government would have to cover 90 percent of insured losses beyond an insurer deductible, up to $100 billion per year. In the first full program year (2003) the deductible was 7 percent of 2002 premiums, in 2004 the deductible was 10 percent of 2003 premiums, and in 2005 the deductible is 15 percent of 2004 premiums. The purpose of the graduated deductible amounts was to encourage development of private market capacity over time. Insurers are also liable for 10 percent of losses above the deductible threshold.

In the event that the Federal Government provides compensation for insured losses for an act of terrorism under the program, TRIA requires recoupment of at least a portion of the Federal compensation through policyholder premium surcharges. Recoupment is mandatory in cases where the aggregate industry insured terrorism losses (deductibles and copays) are below a specified aggregate retention amount. The annual aggregate retention amount was $10 billion for 2003, $12.5 billion for 2004, and is $15 billion for 2005. The Government is required to collect the difference between these recoupment amounts and the aggregate industry insured terrorism losses through an industry-wide surcharge, not to exceed 3 percent of the premium paid on a policy. If the aggregate industry insured terrorism losses exceed the aggregate retention amount, the Federal Government may require recoupment at the discretion of the Secretary of the Treasury, but the statute does not require recoupment.

To encourage the development of private market capacity over time, provisions in TRIA have gradually shifted more of the risk to the private sector.

Impact of TRIA on Insurance Markets

The Treasury Department report finds that the program provided support in a transitional period, during which the capacity of the insurance industry to write terrorism risk insurance has improved.

I will elaborate on four main findings in the report:

- Industry capacity to provide coverage for terrorism risk has improved, as has take-up of such coverage.
- Insurers are increasingly pricing terrorism risk insurance, and the price of coverage with an explicit charge has decreased.
- Industry surplus has improved.

- Many insurers reinsure a substantial portion of their retained risk under TRIA, but overall reinsurance purchases have not increased substantially.

Availability and Take-up of Terrorism Coverage

Results from both the survey of insurers and the survey of policyholders show that the availability and the take-up (purchase) of terrorism insurance increased while TRIA has been in effect.

Insurers now provide terrorism coverage on a greater share of commercial property and casualty insurance policies than in 2002 (the year before TRIA). While 60 percent of policies written in 2002 included terrorism insurance coverage, fully two-thirds of such policies included such coverage in 2004. Terrorism insurance was also more widely available in the market, as the share of insurers providing any terrorism coverage rose from 73 percent to 91 percent over the period.

Policyholders as well are now more likely to purchase terrorism risk insurance than in 2002. The data show a doubling in the take-up rate of terrorism risk coverage: From 27 percent of policyholders in 2002 to 54 percent of policyholders by 2004. The finding that just under half of policyholders do not take-up such coverage does not necessarily reflect a problem in the market. The decision to purchase terrorism insurance reflects a tradeoff between the benefits and cost of the coverage. Firms that perceive a low risk of terrorism attacks or that have some form of self insurance (for example, through diversified portfolios) may simply not place a high value on terrorism insurance. It is useful to note that TRIA did not mandate the purchase of terrorism insurance, but rather that such coverage be made available.

Pricing and Cost

Both insurer and policyholder surveys show that insurers increasingly began pricing terrorism risk insurance during the time TRIA was in effect. More than 75 percent of insurers providing coverage for terrorism risk in 2002 did not charge for it, but only 40 percent in 2004 provided coverage for free. These numbers are very similar to those reported by policyholders.

The average cost of terrorism insurance (measured as the share of total premiums paid for terrorism coverage) generally rose during this period. Overall, insurers reported costs ranging from 0.9 percent of premiums in 2002 to 1.8 percent by 2004. Among insurers who charged for terrorism insurance, the share of premiums charged for terrorism coverage first declined from 3.7 to 2.4 percent of premiums between 2002 and 2003, but then increased to 3.1 percent of premiums by 2004.

The average costs reported by policyholders increased from 1.2 percent of premium in 2002 to 1.6 percent in 2003, and further to 1.7 percent of premium by 2004. Among policyholders who reported paying for terrorism coverage, cost declined steadily over the period: From 4.0 percent of premium in 2002 to 2.8 percent in 2003 and further to 2.7 percent of premium in 2004.

Policyholders located in high-risk cities faced overall declining costs for terrorism risk coverage that varied from 2.8 percent of premiums in 2002, 3 percent in 2003 and 1.9 percent in 2004.

Industry Surplus and Reinsurance

Industry surplus, a key source of insurer capacity, has returned to pre-September 11 levels. Insurers are financially stronger and more able to bear unexpected losses than they were prior to the enactment of TRIA. Reinsurance, another important component of an insurer's capacity to absorb losses, has not increased substantially, however. Seventy percent of insurers reported purchasing reinsurance for terrorism risk in 2003, but only 65 percent in 2004 reported purchasing reinsurance in 2004. Preliminary data from the first months of 2005 are encouraging and suggest a rebound to 75 percent. Smaller and medium-sized insurers generally reported greater use of reinsurance for terrorism risk exposure (TRIA deductibles and copayments) between 2003 and 2005. During this same period, however, larger insurers reported less use of reinsurance for terrorism risk exposure.

Summary

The findings from the surveys of insurers and policyholders point to the success of TRIA in achieving its short-term goals. TRIA effectively "addressed market disruptions and ensur[ed] the continued widespread availability and affordability of property and casualty insurance for terrorism risk." While we do not ascribe a direct causal effect to TRIA, we note that insurer financial strength has improved substantially over this period. More generally, TRIA allowed both insurers and policyholders time to adjust to the post-September 11 view of terrorism risk.

TRIA provisions shifted an increasing share of expected terrorism losses back to the private sector, as the deductible was increased from 7 percent of premiums in 2002 to 15 percent of premiums in 2004. Had there been no improvement in capacity, we should observe a pullback of terrorism coverage in response to this shift in cost. The expansion of terrorism risk coverage availability and take-up, and the decline in cost even as the TRIA deductible has increased therefore highlights the improvement in the industry's ability to cover terrorism risk

Industry Capacity to Cover Terrorism Risk After TRIA

Congress also directed Treasury to assess the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after expiration of the program. TRIA provided a Federal backstop for terrorism losses that effectively subsidized terrorism risk insurance. It is reasonable to expect that the removal of the subsidy will result in adjustments in coverage and pricing. In the Treasury report, we present a framework to evaluate the impact of a TRIA sunset in more detail, and provide evidence from our surveys and from insurance industry statistics, data, and discussions with industry and other experts. Two important determinants of insurers' ability to effectively write coverage for terrorism in the near-term are the ability to model terrorism risk and the industry's financial capacity—including both surplus and access to reinsurance—to cover terrorism losses.

Modeling Terrorism Losses

To provide and price insurance efficiently, insurers should be able to quantify their exposure to losses from terrorism risk. The primary tool available for quantifying loss exposure is modeling terrorism risk. Our assessment of developments in risk modeling over the past few years is positive, but we note that challenges do remain.

Modeling terrorism risk has two critical components: The ability to identify and quantify the severity of an event in terms of insurers' losses, and the probability of the loss occurring. Our study concludes that insurers' ability to identify and quantify the severity of an event in terms of insurers' losses has improved greatly. In particular, insurers are much better able to assess their exposures or accumulations of risk for a given terrorist event on an overall and individual customer basis. The industry—particularly the primary insurance industry—has made great progress in tracking aggregate exposure by location to estimate exposure to losses from physical damage and considerable progress in tracking aggregates of employees down to the level of individual locations to estimate exposure to workers' compensation losses. Modelers have created and implemented sophisticated probabilistic loss estimates that are said to take account of terrorists' shifting goals and strategies. Insurers writing coverage for high risk exposures are able to use multiple methods of assessing terrorism risk. This is important because it allows insurers to more effectively underwrite coverage. We acknowledge that the industry faces some difficulty in assessing the probability of the loss from terrorism. The uncertainty surrounding their predictions reduces the usefulness of these models.

Financial Capacity

An insurer's capacity to write coverage is limited to the maximum coverage it could provide, while retaining its ability to meet current and future obligations to its base of policyholders. An important determinant of insurers' capacity to cover terrorism losses is financial strength, which incorporates both balance sheet strength and operating performance. The financial health of the insurance industry, especially surplus, has improved greatly in the past 3 years. Among insurer groups providing coverage in TRIA-eligible property and casualty lines, surplus was higher in the third quarter of 2004 than it was in the third quarters of 2001, 2002, and 2003. Between the 3rd quarter of 2001 and the 3rd quarter of 2004, surplus increased from $256 billion to $341 billion. Measures of the industry's capacity to cover terrorism risk, including the ratio of net premiums to surplus, the return on surplus, and the capital adequacy ratio (accounts for underwriting, investment and credit risk) have all improved since the losses following the September 11 attacks.

By purchasing reinsurance, insurers can write additional coverage without increasing their financial holdings. Our survey results show that reinsurance is available, and purchased, for a sizable portion of the retained risk under TRIA. Seventy percent of insurers purchased reinsurance for TRIA-eligible risks in 2003. The results also indicate, however, that over the time period covered by our study, purchases of reinsurance have not increased substantially.

Insurance Market Outcomes

The expiration of TRIA will change the business environment in which insurers operate and will therefore change their behavior. Insurers will likely consider factors such as the possibility of insolvency from terrorism losses given the levels of surplus available and the effect on credit ratings. Experience with natural catastrophe risk underwriting and assignment of agency ratings suggests that in order to avoid ratings downgrades, insurers may significantly alter their approach to terrorism risk insurance after TRIA's expiration. Among the changes insurers may institute are increasing the use of private reinsurance, building surplus by tapping into capital markets, and raising premiums or placing exclusions on some policies.

Our surveys included direct responses on the availability of coverage after the expiration of TRIA. Responding to questions about policies written in early 2005 that continue into 2006, nearly 50 percent of insurers reported that they are not writing coverage for terrorism risks in 2006 (after the scheduled expiration of TRIA) that is similar to the coverage they write under TRIA. One-quarter of policyholders with terrorism risk coverage indicated that their coverage excludes terrorism coverage after the expiration of TRIA.

TRIA's expiration will conclude the transitional assistance first provided to the insurance markets in the uncertain economic environment of 2002. While the immediate effect of the removal of the TRIA subsidy is likely to be less terrorism insurance and, higher prices, we expect that over time the private market will develop additional terrorism insurance capacity. We anticipate that the initial response of premiums in the market will spur the buildup of surplus as insurers tap into capital markets; and the development of additional private reinsurance and other risk shifting mechanisms.

Macroeconomic Effects

We do not believe that the elimination of the Federal terrorism risk reinsurance subsidy is likely to have a discernable macroeconomic effect. In late 2001 and 2002, there was concern that there could be macroeconomic effects associated with the transition between a world in which terrorism coverage was provided for a negligible price and one where terrorism risk was considered a nonnegligible risk. The economic climate during the discussion of TRIA and its enactment was highly uncertain. Industrial production had peaked in mid-2000, and by September 2001 had already fallen more than 5 percent. The terrorist attacks of September 11 created macroeconomic uncertainties that most analysts believed would translate into a further sharp downturn in economic activity that would last at least two additional quarters. Nonresidential building activity tumbled about 33 percent at an annual rate in the fourth quarter of 2001, and continued to experience declines well in excess of 15 percent in the subsequent three quarters. It was difficult at the time to assess whether the substantial declines in nonresidential building were due to the chilling effect of terrorist activity, terrorism insurance issues or the result of a cumulative unwinding of activity more typical of a recession and even the excesses of the late 1990's.

Helped by tax cuts and monetary stimulus, the economy has since improved substantially. GDP growth rose from just 2.3 percent in 2002 to 3.9 percent in 2004 (fourth quarter over fourth quarter). The unemployment rate, which was 6 percent in December 2002, fell to 5.1 percent in May 2005. However, despite the rising economy and the enactment of TRIA, nonresidential building has rebounded only slightly. Nonresidential building is currently 4.2 percent higher than the trough reached in the first quarter of 2003, but remains substantially below the previous peak. From our current perspective it appears that neither the potential lack of terror risk insurance nor a general economic downturn were responsible for weakness in nonresidential building activity.

Overall Assessment and Policy Recommendations

The risk of terrorism changed fundamentally and permanently after the events of September 11, 2001. In the words of the President:

> Our country is safer than it was on September 11, 2001, yet, we are still not safe. . . . We are a Nation in danger. We are doing everything we can in our power to confront the danger. We are making good progress in protecting our people and bringing our enemies to account. But one thing is for certain: We will keep our focus and we will keep our resolve and we will do our duty to best secure our country.

It is our view that continuation of the program in its current form is likely to hinder the further development of the insurance market by crowding out innovation and capacity building. Consistent with TRIA's original purpose as a temporary program scheduled to end on December 31, 2005, and the need to encourage further development of the private market, the Administration cannot support a straight extension of TRIA.

Any reform of TRIA should be consistent with several principles. It is the Administration's view that extension of the program should recognize the temporary nature of the program, the rapid expansion of private market development (particularly for insurers and reinsurers to grow capacity), and the need to significantly reduce taxpayer exposure. The Administration would accept an extension only if it includes a significant increase to $500 million of the event size that triggers coverage, increases the dollar deductibles and percentage copayments, and eliminates from the program certain lines of insurance, such as commercial auto, general liability, and other smaller lines, that are far less subject to aggregation risks and should be left to the private market.

It is also important to keep in mind that the program would cover damages awarded in litigation against policyholders following a terrorist attack. Current litigation rules would allow unscrupulous trial lawyers to profit from a terrorist attack and would expose the American taxpayer to excessive and inappropriate costs. The Administration supports reasonable reforms to ensure that injured plaintiffs can recover against negligent defendants, but that no person is able to exploit the litigation system.

The events of the past week in London have been an unwelcome reminder that the risk of terrorism is real and that the war on terrorism is one that will be waged over a long period of time on many fronts. Some believe the fact that terrorism risk is real suggests the need for a permanent and obtrusive Federal role in the market for terrorism risk insurance. I agree that the risk of terrorism is likely to remain a part of our lives for some time to come, but that is precisely why the Federal Government needs to encourage the development of the most creative and cost effective means of covering terrorism risks. The Administration looks forward to working with the Congress to achieve this end.

PREPARED STATEMENT OF BEN S. BERNANKE

CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

JULY 14, 2005

Thank you, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, for this opportunity to discuss the Treasury Department's report on the Terrorism Risk Insurance Act of 2002 (TRIA).

The Economic Climate in 2001 and 2002 was Uncertain

The terrorist attacks of September 11, 2001, which devastated thousands of lives and wreaked billions of dollars in losses, also came at a time of considerable macroeconomic uncertainty. By that time, our economy had already slid into recession. Payroll employment peaked in March 2001 and declined through the remainder of 2001 and 2002. Industrial production stalled in the second half of 2000 and had already fallen by more than 5 percent by September 2001. At the time of the attacks, stock prices had been falling for a year and a half. The terrorist attacks heightened concerns about the near-term strength of a number of sectors of the economy, including aviation, travel and tourism, the financial industry, and nonresidential construction. Nearly one million jobs were lost in the first 90 days after September 11.

As of late 2001, the prospect that terrorism risk insurance might be unavailable raised particular concerns. Prior to September 11, insurers underwriting property and casualty policies generally treated terrorism as a negligible risk. The industry had not developed models of the likelihood or severity of potential terrorist events and consequently did not have the capacity to price those risks. Moreover, the large payouts associated with September 11 and low returns to insurers' portfolios reduced the financial capacity of the insurance industry. Some observers pointed out that, if terrorism risk insurance were unavailable or prohibitively expensive, the capitalized value of existing commercial structures might decline, possibly creating significant financial problems for lenders and building owners. The willingness of builders to undertake new commercial construction, or their ability to obtain financing for that construction, might also be reduced, putting construction jobs and economic growth in jeopardy. These concerns contributed to the prevailing climate of uncertainty about the economy in 2002.

In retrospect, survey results in the Treasury's report suggest that the market for terrorism risk insurance did not dry up in 2002, to the extent feared. The insurer survey indicates that more than 70 percent of insurers writing in commercial property and casualty (P&C) lines wrote terrorism risk insurance in 2002, and that 60 percent of commercial P&C policies written in 2002 carried terrorism cover. The policyholder survey offers a somewhat different picture, but likewise indicates that terrorism risk insurance was available in 2002. Nevertheless, given the considerable uncertainties of the time, it was prudent for Congress to enact TRIA and for the President to sign it into law in November 2002. TRIA provided a temporary Federal backstop in terrorism risk insurance and allowed the insurance industry a transition period to adjust to post-September 11 realities.

Insurers Have Increased Their Capacity to Deal with Terrorism Risk

The tragic events in London last week underscore the ongoing risks posed by terrorism. In the period immediately after September 11, the ability of the insurance industry to handle terrorism risks was in considerable doubt. However, the evidence presented in the Treasury report suggests that, in the nearly 4 years since the attacks, private insurers have developed increased capacity to deal with such risks.

Insurer capital, known as policyholder surplus, has rebounded and now exceeds pre-September 11 levels. This surplus approached $341 billion in the third quarter of 2004, a 33 percent increase over the third quarter of 2001. The industry booked this increase of $85 billion over 3 years despite absorbing heavy hurricane losses last fall.

The industry has developed new analytical tools, including sophisticated models of loss exposure that allow insurers to limit and manage their accumulation risk from a terrorist attack. Better measurement of accumulation risk facilitates the spreading of the risk of loss from a terrorist attack across a broader set of insurers. The industry has also made progress in modeling the likelihood of terrorist attacks, although this is an area where considerable challenges remain.

The insurance industry's capacity to bear terrorism risk is not unlimited, of course. Some have raised concerns about the industry's ability to handle what might be termed a mega-event, resulting in insured losses of more than $100 billion. However, it is important to keep in mind that TRIA, as currently structured, provides reinsurance only up to $100 billion and does not specify how losses above $100 billion would be handled. TRIA states only that Congress would determine the source and procedure by which any payments in excess of $100 billion would be made. Likewise, should TRIA be allowed to expire and a mega-event were to occur, presumably Congress and the administration would evaluate the overall situation and determine how to respond to such losses.

TRIA's Effect on Pricing and Availability: Evidence from the Treasury Study

We cannot observe the counterfactual of what would have happened to the pricing and availability of terrorism risk insurance had TRIA not been enacted. But the Treasury study's survey results allow a comparison of pricing and availability immediately before and after TRIA's enactment, as well as changes to pricing and availability in the second year of TRIA's operation, as higher deductibles were phased in and the Federal provision of reinsurance was scaled back.

The survey results indicate that, after the passage of TRIA, the proportion of P&C policies carrying terrorism cover at a nonzero premium increased. This pattern tended to raise average premiums for terrorism risk insurance after the introduction of TRIA. On the other hand, policies that had nonzero premiums in 2002 exhibited a pattern of declining cost share for terrorism risk insurance (as a proportion of total P&C premiums) between 2002 and 2003. The net effect was a slight increase in the cost share of terrorism risk insurance across all policies after the introduction of TRIA, contrary to some expectations.

Between 2003 and 2004, TRIA's insurer deductible for Federal reinsurance increased from 7 to 10 percent of direct earned P&C premiums, shifting some exposure to terrorism losses from the Federal Government back to insurers. Yet, despite this increased exposure, the cost share of terrorism risk insurance across all policies rose only slightly, from 1.6 percent of P&C premiums in 2003 to 1.7 percent in 2004. It would be inappropriate to read too much into these results about the likely effects of allowing TRIA to expire. However, at least for the period during which TRIA has been in force, the surveys do not support the view that the cost share of terrorism risk insurance is highly sensitive to changes in the industry's risk exposure.

Regarding the availability of insurance, the insurer survey indicates that the proportion of commercial P&C policies carrying terrorism risk insurance grew by 7 percentage points between 2002 and 2003, and the policyholder survey found that takeup rates for P&C policyholders rose during that period as well. These results suggest that TRIA improved the availability of insurance during 2003. However, the proportion of commercial P&C policies carrying terrorism risk insurance remained stable through 2004, while take-up rates increased, despite the fact that TRIA's increasing deductible raised insurers' exposure to terrorism risks. Again, it is important not to extrapolate these results too far. However, at least after 2003, availability of insurance does not appear to have been closely linked to the industry's overall exposure to terrorism risk.

These insurer and policyholder survey results are consistent with the view that TRIA succeeded in providing a transition period for insurers. The data also appear consistent with the view that insurers have been able to cope with increased exposure to terrorism risks as the Federal provision of reinsurance has diminished.

The Economy Has Strengthened

The economy is more robust now than when TRIA was enacted. GDP growth has increased from 2.3 percent in 2002 to 3.9 percent in 2004 (fourth quarter over fourth quarter). The unemployment rate, which was 6.0 percent in December 2002, has fallen to 5.0 percent as of June 2005. Overall construction jobs (residential and nonresidential) are at a record high 7.2 million. Financial markets are also functioning well now, with more credit available at lower long-term rates. The economic uncertainties that partly motivated TRIA's adoption have receded and the economy is fundamentally stronger and more robust.

Conclusions

TRIA has succeeded in its limited role of providing a transition period for the insurance industry to adjust to the new realities after September 11, through a temporary Federal backstop. Continuation of the program in its current form is likely to hinder the further development of the insurance market by crowding out innovation and capacity building.

Consistent with its original purpose as a temporary program scheduled to end on December 31, 2005, and the need to encourage further development of the private market, the Administration opposes extension of TRIA in its current form.

Any extension of the program should recognize several key principles: The temporary nature of the program, the need to rapidly expand the development of private markets and capacity, as well as the need to substantially reduce taxpayer exposure. The last point bears emphasizing: TRIA does not eliminate terrorism risk but merely shifts the burden to taxpayers. It should be noted that, should a large terrorism event occur, the Treasury would face many competing priorities, and the responsibility to provide large insurance payments under TRIA could put a heavy strain on the Government's finances.

If TRIA is to be retained, it should be reformed in such a way as to increase the role of private insurers and significantly diminish the public responsibility for terrorism risks. The Administration would accept an extension only if it includes a significant increase to $500 million of the event size that triggers coverage, increases the dollar deductibles and percentage copayments, and eliminates certain lines of insurance from the program, such as commercial auto, general liability, and other lines that are much less subject to accumulation risks. The Administration also supports reasonable reforms to ensure that injured plaintiffs can recover against negligent defendants, but that also guarantee that no person is able to exploit the litigation system, exposing the American taxpayer to excessive and inappropriate costs. We look forward to discussing this very important issue further with Congress.

RESPONSE TO A WRITTEN QUESTION OF SENATOR JOHNSON FROM JOHN W. SNOW

Q.1. According to Secretary Snow's testimony, one of the recommendations the Treasury report makes is to eliminate from TRlA certain lines of insurance that are far less subject to "aggregation risks" and should be left to the private market. Based on this, how does Treasury define the term "aggregation risk"? Furthermore, which lines of insurance does Treasury deem to be qualified under the definition?

A.1. In general, aggregation or accumulation risk refers to the concentration of an insurance company's portfolio of risks, comprised of relatively small exposures on an individual basis, but which represents an enormous exposure when taken as a whole. This is because each individual exposure is located or "aggregated" in such a way that all are exposed to the risk of a single terrorist attack or simultaneous set of attacks. Two examples of geographic aggregation that would result in a high concentration of risk are providing workers' compensation insurance to the majority of employers in a skyscraper, or insuring several buildings in the same urban block. It appears that lines of insurance that are not subject to accumulation risk could be handled by the private sector without the assistance of the Government backstop provided by TRlA. Thus, one of the key features we suggested for any temporary extension of the TRIA program is the elimination from the program of lines of insurance that are far less subject to accumulation risk, such as commercial automobile and general liability.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM JOHN W. SNOW

Q.1. When the "TRlA" law was passed in 2002, we did not know half of what we know now about the enemy and its resolve. We all acknowledge that the war on terror will be with us for a very long time.

So if it is a long-term war and this is what the Administration and the intelligence community tells us often, why don't we need a long-term solution to the terrorism insurance problem? A long-term solution that will provide our economy with the stability to keep growing and protect our citizens and their businesses from catastrophic loss when another major terrorist event occurs.

Do you agree that the insurance industry took a long time to come back from the combined effects of terrorism and natural disasters?

If so, why do you think they can now handle these disasters on their own? Furthermore, do you believe it is responsible to speculate when our economy will take huge hits from any future attacks?

A.1. As reflected in its statutory purposes, TRIA was intended to be a temporary, short-term Federal program to address market disruptions following the September 11 terrorist attacks; to ensure the continued availability and affordability of terrorism risk insurance; and, to allow a transitional period for the private insurance markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses. The Treasury study found positive signs of private market development since the September 11 attacks. Even as the TRIA deductible has risen over time (increasing the private market's participation), terrorism risk insurance take-up has continued to increase, insurers have written coverage on a similar or greater number of policies, and pricing has fallen where insurers have charged for the coverage.

In the Treasury report, we conclude that the TRIA has been effective in achieving its objectives. Insurers are much better able to assess their exposures and are increasingly pricing terrorism risk insurance. Insurer surplus, a major source of insurer capacity to write coverage, has improved from pre-September 11 levels. The insurance industry's recovery from September 11 and its resiliency show that the private market functions well over time and returns stronger and capable of handling catastrophes—both natural and man-made.

The risk of terrorism is likely to remain a part of our lives for some time to come, and that is precisely why the Federal Government needs to encourage the development of the most creative and cost effective means of covering terrorism risks. Over the long-term, the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. It is time for the Federal Government to step back and allow more opportunities for private sector development. I have faith in the power of markets to provide the resources and flexibility needed in a way that will be more efficient and lower cost than any permanent government provision of insurance.

Q.2. Mr. Secretary and Mr. Chairman, during World War II we provided a program called the War Risk Insurance program that provided insurance for property damage here in the United States caused by German or Japanese attacks. During the Vietnam War we provided an insurance program to cover commercial airplanes that flew into and out of Vietnam. And, today we have a first dollar loss insurance program for the airline industry to cover losses caused by terrorism in the United States.

My question is two-fold.

First, is there a difference between war and terrorism? What is it? Why does the Administration seem to be saying that the private insurance market can provide insurance against terrorism but not against war? If we are in a "War against Terror" why do not we provide the same type of economic protections that we have historically provided when we are at war.

Second, what is the Administration's position on the first dolIar loss program for airlines? And, what is the difference between such a program for airlines and a reinsurance program for buildings and people that those airlines fly into? Clearly the reinsurance program is less costly than a first dolIar loss program.

During your review did you study any mechanisms like this to deal with the economic risks posed by this ongoing war on terrorism?

A.2. As passed by Congress, TRIA does not provide a backstop the insurance industry for losses caused by acts of war, except in the case of workers' compensation insurance.

The insurance industry itself treats war risk and terrorism risk differently. War risk has been subject to long-standing exclusions for losses caused by war, warlike action by a military force, insurrection or similar unrest, while terrorism risk had not been excluded prior to September 11. Terrorism risk was insurable despite decades of international terrorist attacks, and remained insurable even after the 1993 bombing of the World Trade Center and the 1995 bombing of the Alfred P. Murrah Federal building in Oklahoma City. What the insurance industry was not prepared for was a catastrophic terrorist attack of the magnitude of September 11. Yet our report showed an expansion of terrorism risk availability and purchase, even as the deductible increased, which highlights the improvements in the industry's ability to cover terrorism. Even without the TRIA backstop, insurers are providing coverage for terrorist acts that would not be eligible for TRIA program coverage. Our report showed that about 40 percent of insurers reported writing polices covering noncertified terrorism risk. The private market itself is the best indicator as to why the two risks are treated differently.

TRIA required Treasury to assess the effectiveness of TRIA and the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the program. The Treasury report finds, in accordance with its purpose, the program provided support in a post-September 11 transitional period, during which the capacity of the insurance industry to write terrorism risk insurance has improved. It is our view that continuation of the program in its current form is likely to hinder the further development of the terrorism insurance market by crowding out innovation and capacity building. Our report did not evaluate the extent of private market provision of war risk insurance.

In connection with its work in this area, Treasury evaluated other past and present Federal insurance programs, such as the terrorism coverage provided through the Federal Aviation Administration's war risk insurance program. Though structured differently, the provision of terrorism coverage through the FAA program is temporary (currently expiring at the end of this year). The FAA program is not inconsistent with our overall view that in the long-term the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance—even for air carriers—will come from the private sector. As Transportation Secretary Norman Mineta reported to Congress in March 2003, war and terrorism risk insurance is generally available from private insurers for U.S. airlines and other segments of the aviation industry, though at significantly higher costs than prior to the September 11 attacks.

The Administration will continue to monitor the improvement in the cost of available private war and terrorism coverage and the likely economic effect upon air carriers and other parts of the aviation industry before making any decisions concerning the continuation of terrorism coverage through that program.

Q.3. Mr. Secretary, one of the things that concerned me the most about the Treasury report is that there is virtually no focus on the policy consequences for policyholders.

To me the most important people in this debate are the consumers of terrorism insurance. They are largely responsible for growing the U.S. economy. They do so by running businesses, owning property, employing workers.

Businesses are even committed to doing so in my hometown of New York City—even though it is a high-risk area that has proven to be a most desirable target to terrorists.

Yet, Treasury seems to want to throw these people back on the mercy of a purely private marketplace that, before TRIA was enacted, wouldn't write terrorism insurance to any of them. The Treasury report seems to be putting their faith in a private market specifically the reinsurance industry—that shows no sign of being able to fill the coverage gap as this Administration decides to pull away.

It seems that you express this belief, based on no empirical data. You say with a great deal of confidence that the reinsurers will come back even though this conclusion is inconsistent with a statement by the Reinsurance Association of America that "the expiration of TRIA is no likely to stimulate much additional capacity."

Are you both aware of the fact that reinsurers continue to view terrorism as a risk that is uninsurable. And, that there is only $4 to $6 billion of reinsurance in the current market, well short of the aggregate industry retention level.

What evidence does Treasury rely upon to conclude that private reinsurance would be more available if the retention level is raised, especially if the reinsurance market has not come back under the current TRIA level?

Are you willing to bet that the economy will not be negatively affected with the changes you are proposing?

A.3. One of the statutory purposes of TRIA is to protect policyholders by addressing market disruptions and ensuring the continued widespread availability and affordability of insurance for terrorism risk while preserving State insurance regulation and consumer protections. In evaluating the TRIA program, Treasury paid particular attention to the impact on policyholders. We found that the purchasing (or "take-up") of terrorism risk insurance increased significantly among policyholders between 2002 and 2004. We found the cost of terrorism risk insurance, as reported by policyholders, declined over the period, both nationally and for policyholders located in high-risk cities. We were pleased to find that insurers resumed pricing terrorism risk insurance, even for policyholders located in high-risk cities, as insurers built capacity to absorb any future losses.

As we note in the Treasury report, these changes correlated with TRIA but were not necessarily a result of TRIA. Other factors, such as the general insurance underwriting cycle likely had some effect on these insurance market outcomes during this period.

In the Treasury report, we concluded that TRIA was effective for the purposes it was designed to achieve. But this does not imply continuation of the program, even for policyholders in high-risk cities. As has been demonstrated before with natural catastrophes, once insurers have rebuilt capacity and come to understand a new risk, private markets resume coverage. The sunset of TRlA should encourage further development of the private markets.

It is reasonable to expect that the removal of the subsidy provided by the program will result in adjustments in coverage and pricing. We expect that innovators in the private markets, spurred by the likely initial response of increased premiums, will continue to develop additional terrorism risk insurance capacity.

As noted in the Treasury report, we found a modest net increase in use of reinsurance over the period, particularly among smaller and medium-sized insurers, as insurer retentions increased. We would not expect to see evidence that private reinsurers were providing coverage for insurers' TRIA-eligible losses during the time that TRIA is in effect. By providing, in effect, subsidized reinsurance, TRIA has crowded out private reinsurance markets.

Q.4. How did Treasury determine the amount of the recommended trigger?

In your June 30 letter to Congress, you state that the Administration would accept an extension of TRIA only if it includes an increase of the event size that triggers coverage from $5 million to $500 million. This is a big increase—how did you arrive at the $500 million number? As you may know, many terror attacks would not be covered under this new trigger.

- The London Bombing would more than likely not be covered.
- The Madrid Bombings would not be covered.
- The bombing of Pan Am flight 103 would not be covered.

The Rand study showed that most terrorist are willing to do smaller attacks like the bombings I just spoke of. They are not usually as dramatic as September 11.

Is the proposed $500 million trigger appropriate in these cases, especially when the goal should be to build a public-private partnership?

A.4. It is our view that any reform of TRIA should be consistent with several principles, including the rapid expansion of private market development, and the need to significantly reduce taxpayer exposure. Raising the minimum event trigger is recommended because the private market now has the capacity to provide coverage for losses in this range. If Congress docs not act to remove the Federal Government from intruding into this range, we will further hinder the development of the private markets.

The conclusion with regard to the size of the minimum event trigger reflects our consultations with the insurance industry and our own research into recent market conditions. We considered the levels of coverage generally available for individual exposures. Individual exposures are important because they are a "limiting case." If individual exposures can be covered to this amount, then any event of this size can be covered.

Reinsurance Available at this Level

Private reinsurance capacity for this relatively low level of loss is readily available. As Treasury reported, survey data indicates that in 2004 some 70 percent of insurers writing property coverage purchased reinsurance for a portion of their TRIA deductibles and copayments.[1] Today, it is reported[2] that about $300 million of commercial reinsurance capacity is available for individual insurer programs, including chemical, biological, radiological, or nuclear (CBRN), on an aggregate basis, and up to $600 million, excluding CBRN, on an occurrence basis, and more than $1 billion is available for a single reinsurance program in which the terrorism exposure is limited in a single State. The market for stand-alone reinsurance coverage has become cheaper as more capacity and competition has entered.

Many Insurers Unaffected

Terrorism risk insurance coverage from insurers with deductibles above $500 million today—the 13 largest insurers representing about half the market in TRIA-eligible lines—is likely to be unchanged by the increase in size of the minimum event because they are providing this level of terrorism risk insurance today without TRIA compensation.[3]

Other Insurers Already Providing this Level of Coverage Without Backstop

We expect that any primary coverage gaps in terrorism risk insurance could be provided by the stand-alone markets, which are typically used to cover gaps in all-risk coverage for example, noncertified acts of terrorism such as terrorism attacks on policyholders' locations abroad that do not otherwise fit within TRIA's definition of "act of terrorism." The stand-alone terrorism risk insurance markets routinely offer property terrorism insurance for international terrorism risk that is not eligible for TRIA compensation. Overall capacity has been relatively stable since January 2004. Most recent Treasury consultations with brokers show the maximum coverage amounts available for any risk in the stand-alone market for individual exposures is over $1 billion.

Q.5. Mr. Secretary, the Treasury report spends a lot of time comparing the availability of terrorism insurance in the pre-September 11 world with the one that has existed for the first 2 years that TRIA has been in effect. That strikes me as a false and misleading comparison.

Terrorism insurance was pretty much offered for free pre-September 11, so of course everyone had it. Everyone who wants terrorism insurance now has it because the Federal program requires insurers to make it available.

But the reason why TRIA became law was because we experienced, post-September 11, a whole year (2002) when—according to the President—terrorism insurance increasingly was impossible to

[1] U.S. Department of the Treasury, "Assessment: The Terrorism Risk Insurance Act of 2002," Report to Congress, June 30, 2005, pages 111–112.

[2] The information reported in this paragraph is drawn from the following sources; Benfield Group Limited, "Outrageous Fortune: Reinsurance Market and Renewals Review," Benfield Industry Analysis and Research, January 2005, pages 38–39. Marsh, "Marketwatch: Terrorism Insurance 2005," Marsh Research Report, 2005, pages 24–25.

[3] Although the increased event minimum means that fewer losses will count toward their TRIA deductible, this would affect these large insurers only in the case where they experience significant losses from several such attacks during the year, or moderate losses from each of a great number of attacks.

get, $15 billion in construction projects were cancelled or idled and 300,000 jobs were lost.

So, isn't the real point that terrorism insurance would not be widely available without the Federal program? And isn't that one big reason why we need it?

A.5. The data in the Treasury report, in fact, cover 2002 through 2005, and therefore reflect adjustments in the market following September 11. The data for the report was collected in three annual series or "waves" of surveys: The first covered the policy years 2002 and 2003; the second wave covered 2004 and the third survey wave covered the first two month of 2005. The survey data reflect adjustments in the market to the September 11 attacks. All conclusions in the report refer to the data from these three waves of surveys.

Survey data from 2002—which captured what was happening in the marketplace prior to the enactment of TRIA—indicates about 73 percent of commercial property and casualty insurers provided some terrorism coverage in TRIA-eligible commercial property and casualty lines, not including workers' compensation (terrorism is not permitted to be excluded by State law so 100 percent of workers' compensation insurers provide coverage). The policyholder survey indicated that roughly 27 percent of policyholders reported some terrorism coverage. The average cost of terrorism coverage reported by policyholders was about 1 percent of the premium for the entire policy.

In its study, Treasury found that the availability and affordability of terrorism risk insurance has increased during the time that TRIA has been in place. It is our view that, we have reached the point at which it is now time for the Federal Government to allow further private market development in this area.

Q.6. As you both know, many reports have been conducted on the need for terrorism insurance. The Rand Corporation issued a report expressing the urgent need to continue TRIA. The Organization for Economic Cooperation and Development (OECD)—a UN-specialized agency—recently made its own report on terrorism insurance stating "private markets are not yet able to fully cover the extremely large losses that could result from terrorist acts in the future."

It also states that "despite improvements in market conditions, the losses associated with very large scale terrorist attacks may, under current conditions, remain beyond the capability of the private insurance and reinsurance industry to price and to absorb alone. The future evolution of the terrorism threat, and the ensuing capacity and willingness of the private market to cover resulting losses, is uncertain."

Most of the OECD's 30 member countries—except the United States—currently have some type of long-term Federal terrorism risk insurance program.

Do you have a response to the OECD report's conclusions?

Why does the Treasury Department think that private markets in the United States are better prepared than other nations to handle this incalculable risk, particularly when some of the some of the other member countries like the United Kingdom and Spain have more experience dealing with this terror attacks?

A.6. The OECD Report does not conflict with Treasury's report on TRIA. We see a number of areas of agreement between the two reports—for example we agree with their conclusion that terrorism risk modeling faces some challenges and that financial markets so far have not been a source of capacity. We certainly agree with their conclusion that countries should rely on private sector solutions as far as possible and avoid crowding out private sector initiative.

We evaluated the permanent state-run programs in other countries, such as in the United Kingdom and Spain, but we believe that in the long-term the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. The power of the markets will provide the resources and flexibility needed in a way that will be most efficient.

While there may be some short-term adjustments to a reduced government role, it is our view that over the long-term the industry will continue to build capacity and that the private market can and will work. Treasury's Report pointed to a number of positive developments: The increased pricing of terrorism risk insurance; greater availability of reinsurance; and improving market conditions even as insurer retentions under TRIA have increased through the life of the program.

Q.7. Mr. Secretary, I want to ask you about your report's findings on how policyholders have been taking terrorism insurance—the so-called "take-up rates" issue. The report says that take-up rates only improved "somewhat" from 2002–2005 (Executive Summary), or that rates have been "increasing steadily." However, the report's hard statistics show that 27 percent of surveyed policyholders reported taking terrorism in 2002, increasing to 39 percent in 2003, and finally increasing to 54 percent in 2004.

A doubling of the take-up rate in just 2 years' time is a phenomenal rate of growth that shows how successful the TRIA program has been for policyholders. Why does the Treasury report downplay this great success?

A.7. Treasury was pleased to find that policyholders have been able to obtain larger amounts of coverage for their risks during the period. The Treasury report highlights this in the Executive Summary, which states, "Between 2002 and 2003, after the enactment of TRIA, take-up of terrorism risk insurance increased from 27 percent of policyholders to 39.5 percent. In 2004 54 percent of policyholders reported having terrorism risk insurance coverage." Further, in my prepared written testimony I reiterated that, "data show a doubling in the take-up rate of terrorism risk coverage: From 27 percent of policyholders in 2002 to 54 percent of policyholders by 2004."

The rise in take-up rates should not be attributed solely to TRIA. If market development factors were not at work, one might expect that the increase in insurer retention would have a negative effect on take-up rates but that is not what we observed. The increase in take-up rate occurred as the TRIA deductible increased from 7 percent in 2003 to 10 percent in 2004, to 15 percent by 2005. The key market development that might drive take-up of such insurance is the increasing awareness and understanding of terrorism risks.

Q.8. Doesn't sound national security include a strategy for economic security?

Your report concludes that, if we allow TRIA to expire, there will be a significant shortage of terrorism coverage and coverage that is available will be more expensive. All issues of price aside, is not it a national security issue if our commercial buildings and public spaces such as stadiums are left uninsured? In other words, does not having a safety net in place help to deter terrorists who are out to "hit us where it hurts" economically in this case?

A.8. Our fundamental position is that TRIA should not be extended in its current form. TRIA was expressly intended to be temporary. What we have said is that the existing TRIA program, unless reformed, will hinder further development of the private market. This is why the Administration opposes a straight extension of the program in its current form.

Extending TRIA in its current form is likely to discourage the private market development needed to deal with the risk of terrorism. The most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. Encouraging our private markets is the best way to make the country more economically secure.

Q.9. Treasury's report expresses confidence that private insurers now can take care of all the needs of policyholders. How is this true in the case of chemical, nuclear, biological, or radiological (CBRN) terrorism—including detonation of a "dirty bomb"? The market does not even cover this under the TRIA regime. What makes you think that CBRN will be covered by the private marketplace when it is not even covered with TRIA in place?

A.9. As Treasury has stated throughout the temporary Program, TRIA does cover certified terrorist acts involving chemical, biological, radiological, or nuclear (CBRN) weapons if the coverage is provided in the primary or excess property and casualty insurance policy issued by the insurer. To that extent, the CBRN coverage decision has been left to the market.

As reflected in the Treasury report, we found that CBRN risk has been covered to some degree. The insurer survey found that, on average, 35 percent of insurers reported including CBRN risks in some of their policies in 2003 and 2004 (and all of their workers' compensation policies as State law requires it be covered.) There has been a distinct shift in the size of insurers writing the coverage, however; while the number of smal1er insurers providing this coverage declined, the number of larger insurers providing it increased. From 2003 to 2004, there was an increase of 12 percent in the number of insurers with assets of $1 to $10 bil1ion who reported writing some coverage, and about 17 percent in the number of insurers with assets of over $10 billion who wrote some coverage, compared with a decrease of roughly 6 percent in the number of insurers with assets of under $1 billion who wrote some coverage.

Yet, though the coverage was available, our study revealed that only a very small percentage of policyholders purchased CBRN terrorism risk coverage—less than 3 percent, other than workers' compensation policies (that are not permitted to have exclusions.)

Ofthe 97 percent of policyholders that did not purchase CBRN coverage, our study revealed that they did not do so mostly because they believed that they were not at risk. Another reason was that some (15 percent) felt that the premiums were too high. Only about 5 to 8 percent of the nonpurchasers reported that they could not find adequate CBRN terrorism coverage.

RESPONSE TO A WRITTEN QUESTION OF SENATOR JOHNSON FROM BEN S. BERNANKE

Q.1. According to Secretary Snow's testimony, one of the recommendations the Treasury report makes is to eliminate from TRIA certain lines of insurance that are far less subject to "aggregation risks" and should be left to the private market. Based on this, how does Treasury define the term "aggregation risk?" Furthermore, which lines of insurance does Treasury deem to be qualified under the definition?

A.1. In general, aggregation or accumulation risk refers to the concentration of an insurance company's portfolio of risks, comprised of relatively small exposures on an individual basis, but which represents an enormous exposure when taken as a whole. This is because each individual exposure is located or "aggregated" in such a way that all are exposed to the risk of a single terrorist attack or simultaneous set of attacks. Two examples of geographic aggregation that would result in a high concentration of risk are providing workers' compensation insurance to the majority of employers in a skyscraper, or insuring several buildings in the same urban block. It appears that lines of insurance that are not subject to accumulation risk could be handled by the private sector without the assistance of the Government backstop provided by TRIA. Thus, one of the key features we suggested for any temporary extension of the TRIA program is the elimination from the program of lines of insurance that are far less subject to accumulation risk, such as commercial automobile and general liability.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM BEN S. BERNANKE

Q.1. When the "TRIA" law was passed in 2002, we did not know half of what we know now about the enemy and its resolve. We all acknowledge that the war on terror will be with us for a very long time.

So if it is a long-term war and this is what the Administration and the intelligence community tells us often, why do not we need a long-term solution to the terrorism insurance problem? A long-term solution that will provide our economy with the stability to keep growing and protect our citizens and their businesses from catastrophic loss when another major terrorist event occurs.

Do you agree that the insurance industry took a long time to come back from the combined effects of terrorism and natural disasters?

If so, why do you think they can now handle these disasters on their own? Furthermore, do you believe it is responsible to speculate when our economy will take huge hits from any future attacks?

A.1. As reflected in its statutory purposes, TRIA was intended to be a temporary, short-term Federal program to address market disruptions following the September 11 terrorist attacks; to ensure the continued availability and affordability of terrorism risk insurance; and, to allow a transitional period for the private insurance markets to stabilize, resume pricing of such insurance, and build capacity to absorb any future losses. The Treasury study found positive signs of private market development since the September 11 attacks. Even as the TRIA deductible has risen over time (increasing the private market's participation), terrorism risk insurance take-up has continued to increase, insurers have written coverage on a similar or greater number of policies, and pricing has fallen where insurers have charged for the coverage.

In the Treasury report, we conclude that TRIA has been effective in achieving its objectives. Insurers are much better able to assess their exposures and are increasingly pricing terrorism risk insurance. Insurer surplus, a major source of insurer capacity to write coverage, has improved from pre-September 11 levels. The insurance industry's recovery from September 11 and its resiliency show that the private market functions well over time and returns stronger and capable of handling catastrophes—both natural and man-made.

The risk of terrorism is likely to remain a part of our lives for some time to come, and that is precisely why the Federal Government needs to encourage the development of the most creative and cost effective means of covering terrorism risks. Over the long-term, the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. It is time for the Federal Government to step back and allow more opportunities for private sector development. I have faith in the power of markets to provide the resources and flexibility needed in a way that will be more efficient and lower cost than any permanent government provision of insurance.

Q.2. Mr. Secretary and Mr. Chairman, during World War II we provided a program called the War Risk Insurance program that provided insurance for property damage here in the United States caused by German or Japanese attacks. During the Vietnam War we provided an insurance program to cover commercial airplanes that flew into and out of Vietnam. And, today we have a first dollar loss insurance program for the airline industry to cover losses caused by terrorism in the United States.

My question is two-fold.

First, is there a difference between war and terrorism? What is it? Why does the Administration seem to be saying that the private insurance market can provide insurance against terrorism but not against war? If we are in a "War against Terror" why do not we provide the same type of economic protections that we have historically provided when we are at war.

Second, what is the Administration's position on the first dollar loss program for airlines? And, what is the difference between such a program for airlines and a reinsurance program for buildings and people that those airlines fly into? Clearly the reinsurance program is less costly than a first dollar loss program.

During your review did you study any mechanisms like this to deal with the economic risks posed by this ongoing war on terrorism?

A.2. As passed by Congress, TRIA does not provide a backstop to the insurance industry for losses caused by acts of war, except in the case of workers' compensation insurance.

The insurance industry itself treats war risk and terrorism risk differently. War risk has been subject to long-standing exclusions for losses caused by war, warlike action by a military force, insurrection, or similar unrest, while terrorism risk had not been excluded prior to September 11. Terrorism risk was insurable despite decades of international terrorist attacks, and remained insurable even after the 1993 bombing of the World Trade Center and the 1995 bombing of the Alfred P. Murrah Federal building in Oklahoma City. What the insurance industry was not prepared for was a catastrophic terrorist attack of the magnitude of September 11. Yet Treasury's report showed an expansion of terrorism risk availability and purchase, even as the deductible increased, which highlights the improvements in the industry's ability to cover terrorism. Even without the TRIA backstop, insurers are providing coverage for terrorist acts that would not be eligible for TRIA program coverage. Treasury's report showed that about 40 percent of insurers reported writing polices covering noncertified terrorism risk. The private market itself is the best indicator as to why the two risks are treated differently.

TRIA required Treasury to assess the effectiveness of TRIA and the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of the program. The Treasury report finds that, in accordance with its purpose, the program provided support in a post-September 11 transitional period, during which the capacity of the insurance industry to write terrorism risk insurance has improved. It is our view that continuation of the program in its current form is likely to hinder the further development of the terrorism insurance market by crowding out innovation and capacity building. Our report did not evaluate the extent of private market provision of war risk insurance.

In connection with its work in this area, Treasury evaluated other past and present Federal insurance programs, such as the terrorism coverage provided through the Federal Aviation Administration's war risk insurance program. Though structured differently, the provision of terrorism coverage through the FAA program is temporary (currently expiring at the end of this year). The FAA program is not inconsistent with our overall view that in the long-term the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance—even for air carriers—will come from the private sector. As Transportation Secretary Norman Mineta reported to Congress in March 2003, war and terrorism risk insurance is generally available from private insurers for U.S. airlines and other segments of the aviation industry, though at significantly higher costs than prior to the September 11 attacks.

The Administration will continue to monitor the improvement in the cost of available private war and terrorism coverage and the likely economic effect upon air carriers and other parts of the aviation industry before making any decisions concerning the continuation of terrorism coverage through that program.

Q.3. As you both know, many reports have been conducted on the need for terrorism insurance. The Rand Corporation issued a report expressing the urgent need to continue TRIA. The Organization for Economic Cooperation and Development (OECD)—a UN-specialized agency—recently made its own report on terrorism insurance stating that "private markets are not yet able to fully cover the extremely large losses that could result from terrorist acts in the future."

It also states that "Despite improvements in market conditions, the losses associated with very large scale terrorist attacks may, under current conditions, remain beyond the capability of the private insurance and reinsurance industry to price and to absorb alone. The future evolution of the terrorism threat, and the ensuing capacity and willingness of the private market to cover resulting losses, is uncertain."

Most of the GECD's 30 member countries—except the United States—currently have some type of long-term Federal terrorism risk insurance program.

Do you have a response to the GECD report's conclusions?

Why does the Treasury Department think that private markets in the United States are better prepared than other nations to handle this incalculable risk, particularly when some of the some of the other member countries like the United Kingdom and Spain have more experience dealing with this terror attacks?

A.3. The GECD Report does not conflict with Treasury's Report on TRIA. We see a number of areas of agreement between the two reports—for example we agree with their conclusion that terrorism risk modeling faces some challenges and that financial markets so far have not been a source of capacity. We certainly agree with their conclusion that countries should rely on private sector solutions as far as possible and avoid crowding out private sector initiative.

The Administration evaluated the permanent state-run programs in other countries, such as in the United Kingdom and Spain, but we believe that in the long-term the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. The power of the markets will provide the resources and flexibility needed in a way that will be most efficient.

While there may be some short-term adjustments to a reduced government role, it is our view that over the long-term the industry will continue to build capacity and that the private market can and will work. Treasury's report pointed to a number of positive developments: The increased pricing of terrorism risk insurance; greater availability of reinsurance; and improving market conditions even as insurer retentions under TRIA have increased through the life of the program.

Q.4. Mr. Chairman, do you believe that terrorist attacks are attacks on our Government in most instances? That when they attack the World Trade Center, they are attacking a symbol of America and not the securities firms or other businesses that inhabit those buildings?

A.4. Terrorist attacks are attacks on our Government, our businesses, and our citizens. However, terrorist goals do not factor into the economic justification of TRIA. The economic justification for Government to subsidize terrorism risk insurance should be motivated by the existence of a positive public benefit that is not taken into account by private parties. In the case of terrorism risk insurance, there was a case to be made after September 11 that heightened fears triggered a temporary disruption of terrorism insurance services. However, the recent increase in terrorism insurance take-up rates suggests that this motivation for TRIA no longer exists, at least not to the degree it did in the period immediately following the attacks. Moreover, as long as the private market is willing to provide terrorism insurance, the accurate pricing of such insurance by private counterparties will help businesses react efficiently to this very real risk.