EXAMINING A LEGISLATIVE SOLUTION TO EXTEND AND REVISE THE TERRORISM RISK INSURANCE ACT (TRIA)

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

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EXAMINING A LEGISLATIVE SOLUTION TO EXTEND AND REVISE THE TERRORISM RISK INSURANCE ACT (TRIA)

Thursday, June 21, 2007

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Ackerman, Meeks, Moore of Kansas, Capuano, Hinojosa, McCarthy, Miller of North Carolina, Scott, Bean, Sires, Klein, Perlmutter, Murphy, Donnelly; Pryce, Capito, Baker, Shays, Gillmor, King, Royce, Barrett, Brown-Waite, Feeney, Garrett, Davis of Kentucky, Campbell, Bachmann, and Roskam.

Ex officio: Chairman Frank.

Also present: Representative Maloney.

Chairman KANJORSKI. The committee will come to order. I would like to welcome everyone here. It looks like we have a huge show at the subcommittee level, so we have to get on with the course of action. Now we anticipate a lot of requests this morning, so Ms. Pryce and I have agreed to limit each side's opening statements to 15 minutes. That rule does not apply to the chairman or the chairman of the full committee, but we will apply it to everyone else.

Of course this is a long-term sought hearing in the Subcommittee on Capital Markets and Insurance, regarding terrorism risk insurance. I think we can move along, and I recognize that a lot of members will have statements and desire in that regard. Without objection, all members' opening statements will be included in the record.

We meet this morning to examine an important piece of legislation. This past Monday, Congressman Capuano, Chairman Frank, and several others introduced H.R. 2761, the Terrorism Risk Insurance Revision and Extension Act of 2007. Again, I want to commend my colleagues for putting forth this bill that will amend the Terrorism Risk Insurance Act. Before we hear the views of our witnesses, I want to outline some of my thoughts on these matters.

Overall, I believe that this bill is a good product. I support 90 percent of the bill's contents. It will help to protect our Nation's

economic security in several ways. For example, H.R. 2761 extends TRIA for 10 years, and creates a Blue Ribbon Commission. These provisions strike the right balance between providing greater certainty to the marketplace and encouraging the private sector to develop its own solutions to these problems.

The bill also eliminates the distinction between foreign and domestic terrorism. Terrorism, regardless of its cause or perpetrator, aims to destabilize the Government. This change therefore has much merit.

In addition, H.R. 2761 lowers the event trigger to $50 million. This modification will assist small and mid-size companies in managing their exposures under the program. The legislation, moreover, adds group life insurance to the program. We need to protect the people who work in the buildings, not just the buildings in which they work.

Finally, this bill improves coverage for nuclear, biological, chemical, and radiological terrorism events. If the goal of TRIA is to protect the economic security of our Nation against terrorist threats, then Congress specifically needs to address the threats posed by NBCR terrorism. Our Nation needs to plan for a potentially devastating attack by NBCR means by putting in place an explicit program, rather than an implicit promise now and a chaotic response later. By providing fairly low insurer deductibles, smaller copayments for larger NBCR events, and greater legal certainty, H.R. 2761 aims to limit the exposure of insurers to this risk and promote a private market to price and distribute this product.

That said, I know that some parties in the insurance world have raised concerns about these NBCR provisions. I want them to know that I am very open to considering how we can improve them. We, however, should not ultimately decide to continue to study this problem. We need to act. While the aforementioned changes take important steps toward appropriately revising and extending TRIA, two other provisions contained on approximately five pages within H.R. 2761 take away from the final product. In my view, they create a certain Christmas tree for special interests, and provide special preferences. Before moving this bill to a markup, we ought to consider carefully the policy implications of these proposals.

H.R. 2761 includes a retroactive reset mechanism, where areas previously impacted by terrorist attacks would benefit from lower deductibles and triggers in any subsequent attack. By altering the equity of the current program, this provision, as currently constructed, has the potential to undermine the broad national support that TRIA presently enjoys.

After the 9/11 attacks, the terrorism insurance marketplace retracted nationally, and not just in the areas directly affected. During the 2005 debate on the first extension of TRIA, the House recognized the situation and passed a provision that would have provided reset relief nationally and prospectively. The reset provision in this bill is retroactive, regional, and much more generous than what we adopted in 2005. We should work to modify it in the weeks ahead.

In addition, the bill includes a section affecting the underwriting of life insurance for purposes related to past and future lawful foreign travel. I am sympathetic to the end that this provision seeks

to achieve, but I believe that it deserves separate consideration outside of the TRIA process. At least until Congress enacts an optional Federal charter, State legislators and insurance departments also probably have the best expertise to address this situation. In recent years, we have already seen 11 States do so by law or regulation.

In closing, a bill at its introduction represents only the beginning of the legislative process. I hope that we can continue to discuss these two matters and others. We should also strive to follow a balanced process, designed to obtain overwhelming bipartisan support for our final legislative product on the House Floor.

Ms. Pryce?

Ms. PRYCE. Thank you very much, Mr. Chairman. I want to thank you for holding this third hearing on TRIA. And also want to thank Chairman Frank and his staff for their continuing commitment to running this subcommittee in a bipartisan fashion. But I must say I am frankly disappointed that this TRIA bill that has been introduced this week has been done so with none of the Republican priorities included in the bill. I want to thank the Democrats for providing open lines of communication, but we have seen virtually nothing come of our ideas. So I am hopeful that today we can have a constructive conversation in discussing this bill and continue to work with the chairman toward a consensus document. I remain confident that if we continue to build in a bipartisan fashion on the work product of the last term we will have overwhelming support for TRIA. And as Chairman Kanjorski just noted, this is only the beginning of the process. Republicans are committed to a TRIA extension that embraces a responsible duration, a decrease in taxpayer financial exposure over time, and market reforms that increase insurance capacity.

I strongly agree with Chairman Kanjorski's statement at the last hearing that we must, "Choose a length of time that is long enough to provide greater certainty to the marketplace and short enough to encourage the private sector to develop its own solutions."

This bill is in essence a semipermanent expansion of a temporary program. Since its inception in 2002, TRIA has included several mechanisms designed to phase down the Federal taxpayer supported safety net over time. Every year, both the overall program trigger level and individual insurer deductible levels have been increased. The bill before us today proposes to freeze these increases, not allowing the Federal backstop to gradually contract. It is important that the industry have some skin in the game to ease transition to a private market response for terrorism insurance.

In addition to a raised trigger and deductibles, any extension of TRIA should also include a debate on tax deferred capital reserving. Our current Federal tax policy limits the capacity of the private market to provide coverage in the event of a significant attack. Currently, insurers that hold reserves for over 12 months can't expense the reserves and must pay income tax. Past versions of the House legislation included various risk pooling mechanisms and dedicated terrorism capital accounts. If there is any hope of lessening the burden on the Federal Government over the long term, we must get our tax policy right. Giving insurers the ability to increase private capacity is especially important, given the move to

require insurers to make available coverage for nuclear, biological, chemical, and radiological attacks.

Many view this as an uninsurable risk, which is made even more difficult for the private sector to cover when insurers are not given tools to properly reserve or price for the actual risk.

I look forward to hearing from our witnesses today whether the NBCR program outlined in this bill is a responsible and workable option. In closing, I want to thank the witnesses for coming today, thank the chairman for calling the hearing, and hope we can work together to improve this product before us, and pass a responsible extension of the Federal terrorism insurance program. We need appropriate reforms to make the program more dynamic, and allow the Federal safety net to contract or expand according to the evolution of the terrorist threat.

Thank you, Mr. Chairman, and I yield back.

Chairman KANJORSKI. Thank you, Ms. Pryce. Now we have two original cosponsors of the piece of legislation today, and one of them is the chairman of the full committee, Mr. Frank of Massachusetts.

The CHAIRMAN. Thank you, and the chairman of the subcommittee is a very thoughtful student of insurance. He will in that capacity be undertaking some very significant initiatives later this year involving what the appropriate role would be in private insurance, and while he and I have some specific disagreements here, I am very appreciative of his expertise and of the impact he has had, and we will work these out going forward.

Now as to the gentlewoman from Ohio, she said we are not sufficiently bipartisan. But that is not my fault. Bloomberg was a Republican when I started this process. Not being able to time the ups and downs of the mayor's calculation of his political advantage has put me somewhat temporarily in a more partisan position than I thought I would be. I would note, however, that there are Republican members of this committee who have been energetic and active in supporting this. In the end we may have some disagreements.

And I would say to the gentlewoman, I would divide the partisan question into a procedural and a substantive view. It is very important that we be procedurally bipartisan. I think we have managed to achieve that in this committee. We have had an open process on every bill, and I have the worn-out pant seats to prove it. But there are legitimate differences between the parties, and sometimes in an open way they will be litigated—or legislated. And here I want to make clear what mine is.

I disagree with the approach, and it is an honest disagreement, I think in principle, about whether or not there ought to be more of a market solution. I am a strong supporter of market solutions, as we are almost all in this committee. But I don't think Adam Smith is relevant to vicious fanatics trying to destroy this country. And I don't think we ought to allow them to pick and choose as to where it should be more expensive to do business in this country than elsewhere.

The main purpose of this bill is not to help the insurance companies. The insurance companies can walk away. Our problem here

is with the commercial real estate industry, particularly in big cities.

And let me touch on nuclear, biological, chemical, and radiological: I have to admit that I felt somewhat bizarre sitting in my office a couple of weeks ago with members of my staff, discussing what we would do in the aftermath of a nuclear attack. But here is the problem. If we do not provide this level of insurance, in my judgment, banks in many cases will not lend the money that is necessary for the construction of large commercial buildings. And that will have a negative effect on the economy as a whole, and it will have a particularly negative effect on certain of the cities.

So the gentleman from Pennsylvania is right, we want this to be national. New York gets the focus because New York was the victim of that vicious attack of 2001. But it's not the only big city where this could be a problem. And our job here is, I believe, not to allow vicious haters of our democracy and our system to be able to have an impact on our economy.

I do not want the market to have to deal with this. This is part of the war on terror. And I do not believe we should try to have a market solution to the war on terror. We don't have consumers at home paying for screeners at the airports. We have devoted significant tax money for that. I regard this as similar. The purpose of this is to say to those who would physically harm us because they disagree so much with our values and our system, we will not let you be a factor in our economy. And the market should do a great deal. Certainly we want a market-related insurance approach. We want people to have incentives to diminish risks.

I do not think it is reasonable to expect the builders of commercial office buildings to be able to diminish the risk of terrorism. I know they make an effort. They have those nice people who stand in the lobby and make us sign our names. Now the notion that a terrorist is going to sign his name, and therefore not blow up a building, does not persuade me. I think that is a very nice "make work" program, and I am happy for those people to have jobs. I think it has no more to do with preventing terrorism than this microphone.

In fact, we are talking about an inability to deal with these threats. And yes, I do favor, and this is reflected in this bill, along with many others, a nonmarket approach. I believe that the insurance market is a very good one. I believe the chairman of this subcommittee will be looking at how we can expand it. But I don't want a market solution as part of the war on terrorism. I don't want the market to tell us how we are going to defend ourselves against these vicious killers. And we do not, and here is the fear that I have, it is bad enough if an attack comes. We should do everything we can to neutralize the extent to which the fear of attack disarranges and interferes with the conduct of our economic affairs.

That is why I support this legislation, including the provisions that the gentleman from Pennsylvania correctly notes are somewhat controversial—not the travel one, we can deal with that separately—but the retroactive reset. Yes, one particular area was singled out.

And I think it is very important that we make clear to the terrorists, domestic or foreign, as this bill says, but obviously we are pri-

marily concerned about the fear appears to be worse from foreign areas, you will not influence the way we do business. We will not allow you to deter us, to inhibit us, to make us pick and choose as to where we carry out our economic activity. We will, as a united nation through a national piece of legislation, do everything possible to neutralize the extent to which fear of your savagery interferes with our way of life.

I thank you, Mr. Chairman.

Chairman KANJORSKI. Now the Chair recognizes Mr. King from New York, for 1½ minutes.

Mr. KING. Thank you, Mr. Chairman. I thank you very much for conducting this hearing. I want to thank the ranking member for the cooperation that she has given to me and my staff on this issue, and I want to thank Chairman Frank and Mr. Capuano for the initiatives they have taken. Coming from New York, and I know Mrs. Maloney is here, we have seen firsthand the devastation of the World Trade Center, having been attacked twice, the last time with $32 billion in damage. And this is absolutely essential. Now it is New York, tomorrow it could be any other large city in the country or any other area.

As the former chairman and ranking member of the Homeland Security Committee, I have a fairly sufficient knowledge of the extent of threats and plots against this country, how it is ongoing, and how, for our lifetimes, we are going to be threatened. And if we can't send a signal to the terrorists that we will stand by those who are attacked and do all that can be done to rebuild—and TRIA is essential to that—and that is why the reset provision is absolutely essential. Certainly the 10-year time frame, the duration is important for certainty.

I am going to actually introduce an amendment at the full committee hearing to have that extended to 15 years, because this is not a giveaway, it is not a gift. It is America standing by areas that have been attacked and could be attacked, and a signal to terrorists, as Chairman Frank said, that we are not going to allow a terrorist to determine our economy.

I am a conservative when it comes to the free market, but here we are not talking about people's own mistakes or accidents or behavior. We are talking about vicious actions by a vicious enemy who is out to destroy us. We have to send a signal to people in our own country and to the world that we are going to stand by those who are attacked and tell the terrorists they will not bring us down. Reset is essential. So is the certainty of 10 years, and I believe 15 years, and I look forward to this debate.

I thank the chairman for having this hearing, and I yield back.

Chairman KANJORSKI. The gentleman representing the middle of America, from Kansas, Mr. Moore.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. I thank you for holding this hearing today and for your work on producing H.R. 2761, the TRIA Act of 2007. According to the State Department's annual report on global terrorism developments, entitled Country Reports on Terrorism 2006, our country faces a global threat that is only increasing. Congress needs to extend the TRIA program as a means of protecting our Nation's economy in the aftermath of a future attack that we all hope will never happen. H.R. 2761 is a

good first step toward extending this program on a long-term basis, and I look forward to this committee's hearing today, and consideration of it in the future.

This bill recognizes the important role the Federal Government needs to play in ensuring that our Nation's businesses will have coverage for the riskiest exposures they face, including nuclear, biological, chemical, and radiological attacks, and that the Federal Government has the responsibility to ensure that the economy continues to function after an attack.

This legislation also recognizes the reality that without a Federal backstop for large scale terrorist attacks, insurers could face waves of insolvencies after an attack that could imperil our Nation's economy. While a permanent extension of TRIA would be preferable, the 10-year extension provided in this legislation will provide policyholders and insurers with much greater certainty than they have under the current program. The 7½ percent deductible for NBCR is a reasonable level, and a recognition, in the words of the President's Working Group Report of 2006, that no private market for NBCR terrorism risk insurance existed prior to September 11th, none exists today, and none is likely to exist in the foreseeable future.

I also hope and believe that the inclusion of a reset mechanism for areas that have been previously impacted by terrorism in this country will encourage the growth of the capacity and the continuation of coverage in New York City. This area suffered most directly from the horrible attacks of September 11th; 5 years into the TRIA program, a private reinsurance marketplace has not developed for terrorism risk, and these risks remain inherently uninsurable.

According to the testimony of Frank Nutter, the president of the Reinsurance Association of America, and one of the witnesses here today, the industry retention under TRIA, estimated at $35 billion, leaves plenty of room for the private reinsurance market to add capacity. The Federal Government has a responsibility and an obligation, in my opinion, to continue engaging in a public-private partnership with our Nation's insurers and policyholders to ensure insurance remains available before an act of terrorism and that the economy continues to function after an unthinkable terrorist attack. H.R. 2761 is a good bill and an important step in the right direction.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you. Now we will hear from the gentlelady from Florida, Ms. Brown-Waite, for 1½ minutes.

Ms. BROWN-WAITE. Thank you, Mr. Chairman. And I want to thank you for holding this hearing, and I certainly look forward to hearing from the witnesses who will be participating. I wasn't here when the original TRIA passed, but for the past 4 years, serving on this committee, I saw how it worked quickly and in tangent with the industry when it came to terrorism reinsurance, passing reinsurance fund after reinsurance fund.

Unfortunately, it has left constituents in Florida and homeowners around the Nation to their own devices, however, I do support TRIA. I voted in favor of it when Congress extended the program in 2005. Since its creation, not $1 of TRIA has been spent,

yet insurers have allocated additional capacity to terrorism risk. Prices have declined, and takeup rates have increased.

In 2003, only 27 percent of companies purchased terrorism insurance. In 2005, 58 percent of companies purchased that reinsurance. Deductibles have risen from 7 percent in 2003 to 17 percent in 2006. Even with this increase, the total cost of coverage has fallen 3 to 5 percent. If this type of success can come from a terrorism risk insurance fund, we have to question why anyone would not feel the same about a Federal catastrophic fund.

Unfortunately, this third extension is not being handled in the bipartisan manner that we previously were accustomed to. Nothing in the bill that has been introduced represents the agreement between the two parties. The provisions in the bill are the sum of the proposals of my colleagues on the other side of the aisle, obviously without any concessions to the minority party. The leaders on the Republican side offered very good, common-sense market reforms to gradually phase out TRIA and let the market continue to flourish. I hope this initial showing of partisanship is not indicative of how this committee will proceed as we extend TRIA.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Chairman KANJORSKI. Thank you. Now we will hear from Mr. Hinojosa for 1½ minutes.

Mr. HINOJOSA. Thank you very much, Chairman Kanjorski. I want to thank you for holding this very timely and important hearing on the reauthorization of the Terrorism Risk Insurance Act. I have supported the Terrorism Risk Insurance Act in the past, including the reauthorization of the Act. To help me decide whether to cosponsor the current bill under consideration, I look forward to hearing the testimony of today's witnesses. I plan to meet with outside groups interested in this legislation, particularly consumer groups and community-based organizations and associations that have traditionally been interested in terrorism risk insurance. I will also contact constituents in my congressional district to determine if they want me to cosponsor H.R. 2761, the Terrorism Risk Insurance Revision and Extension Act of 2007.

Again Mr. Chairman, I look forward to hearing from today's witnesses, and especially working with you, as our chairman, and your staff on the legislation as it moves through the committee and onto the Floor of the House of Representatives. And with that, I yield back.

Chairman KANJORSKI. Thank you, Mr. Hinojosa. And now we will hear from Mr. Royce of California for 1½ minutes.

Mr. ROYCE. Chairman Kanjorski, thank you very much for holding this hearing. Following the terrorist attacks in 2001, Congress at that time attempted to limit the volatility posed by another potential terrorist attack by passing TRIA, and it was designed at the time to ensure reasonable, predictably priced terrorism coverage by providing a temporary Federal backstop. Congress hoped at that time to encourage insurers to offer affordable coverage for the unprecedented financial risks posed by foreign acts of terrorism in the United States. And given the economic uncertainty at the time I, along with many of my colleagues here today, believed TRIA was a worthwhile endeavor. However, going forward, instead of allow-

ing the industry to develop as their ability to appropriately price the risk of terrorism improves, instead of looking at ways to get industry more fully in the market, I believe we are taking a step back with the proposed legislation. This bill fails to recognize the advances made in the industry since the enactment of this program and fails to look at, I think, some innovative ways to get the industry involved.

Ronald Reagan once quipped that the closest thing to eternal life on Earth was a Federal Government program. And unfortunately, it appears TRIA is headed down that path. I believe the Terrorism Risk Insurance Act has accomplished its original purpose, and gradually should be scaled down.

But again, Chairman Kanjorski, I want to really thank you for this hearing here today. I appreciate it.

Chairman KANJORSKI. Thank you, Mr. Royce. And now we will hear from the other sponsor of this legislation, Mr. Capuano of Massachusetts.

Mr. CAPUANO. I guess I have been called worse. Thank you, Mr. Chairman. And again I want to echo my thanks for having this hearing, and for being so involved with the discussion on this important matter. I wasn't going to have an opening statement, but I think it's important for me to at least say one thing. I don't think anybody really has any empirical data on which to base any decisions. Everything we have done from day one relative to TRIA is kind of guesswork at best. And so therefore, I want to go right to one of the conclusion statements by the Treasury Department, that it would be better to have no TRIA than a bad TRIA. In general, I guess I agree with that concept. However, I don't know how you define bad TRIA. And to me it would certainly be worse to have no TRIA than an uncertain TRIA.

I can't sit here and tell you that I am absolutely certain that anything in this bill is correct, and neither can you. And you can't tell me that anything in this bill is absolutely unequivocally incorrect. These are guesses. This is the best we can do in an uncertain world.

For instance, I have no false ideas that we can cover or even try to cover a massive nuclear attack. Maybe we can handle a small one, a dirty bomb. I don't know; no one knows. We don't know what our response is going to be. However, I do know without question what would happen if we have no TRIA bill come the end of this year. Jobs will be lost, construction across this country will halt, the insurance companies will not, regardless of the philosophical arguments of some, they will not offer terrorism coverage, therefore banks will not make loans, construction will halt, people will lose jobs, and on and on and on.

So for me, an uncertain bill is all we can ask for at this point in time, which is why I have been so insistent on various studies throughout this process. And up until this point, we haven't gotten studies on which we can base our opinions.

So that is why I felt it was important to have a statement. I generally don't do these, but I think it is important to say the truth. And the truth is that no one in this room, no one in this country, no one in this world, really knows with actuarial or empirical cer-

tainty what we are getting into. We are groping in the dark and we are trying to do the best we can without certainty.

That is why this bill is critically important. I don't want to pretend that anything here is somehow stuck in concrete. I know that several Members—whom I have the greatest respect for—have certain hesitancies about certain aspects. I agree with those hesitancies. I have fallen on the side that even with those hesitancies, I support the bill because something is essential. It is not just better than nothing, it is essential to the economy of this country. And I hope in a reasonably short period of time we can begin the process of getting that empirical data that we so desperately need to make intelligent decisions and to get to a point where the private sector will feel comfortable being involved with this without Government involvement.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Capuano. Again I want to congratulate you and your effort with Mr. Frank in putting this legislation together. We now have the gentleman from New Jersey, Mr. Garrett, for 1½ minutes.

Mr. GARRETT. Thank you, Mr. Chairman. You know, since I was last here, Congress extended the TRIA program, with some additional reforms and changes, for a 2-year period. And I supported that extension because I felt more time was really needed. And if you go all the way back since September 11th, insurers and reinsurers have cautiously reentered the terrorism insurance market, allocating more capacity year-to-year. And more commercial policyholders are becoming insured year-to-year. I view this increased private sector involvement and a decrease in Government involvement exposure to be a positive element.

But I just now recently have seen a copy of the legislation that the majority intends to move, and there are a number of changes that are being considered that are really alarming to me. And I am also greatly disappointed that in regards to an issue that this committee has historically acted on in a bipartisan manner, that the chairman of this committee has rebuffed in full, and without what I believe are proper considerations of a number of proposals that my colleagues on this side of the aisle have offered.

One main concern I have is the proposed length of duration of this program. If we extend this program for too long a time, I fear, quite honestly, that we will not revisit this important topic and continue to try and make improvements like we did after the last time the program expired. A short-term, temporary extension allows for periodic reassessment of market conditions to see if there is more room for a private sector participation, and allows for that gradual scaling back of the programs going forward as we observe how the private insurers and reinsurers continue to expand in the market.

Now given that the private sector continues to increase its capacity to cover terrorism risk insurance, I firmly believe that a short-term extension is more appropriate than creating some permanent revisionless program. I am concerned that if we redo it permanently, or for a long period of time, we will not revisit it, and the private sector will lose out. They will lose their incentive to look

for innovation and newer solution, and Congress also will lose out, for we will lose our incentive to revisit this important program.

With that said, Mr. Chairman, I do thank you again for having this hearing today, and I look forward to hopefully now going forward and working with you and the rest of the committee on the ideas that this side of the aisle has to improve this program. And with that, I yield back.

Chairman KANJORSKI. Thank you, Mr. Garrett. And now very quickly, Mr. Meeks of New York, for 1 minute.

Mr. MEEKS. Thank you, Mr. Chairman. And first I want to affiliate myself with what Mr. Capuano said. Every now and then there should be a bill that comes forward that makes good sense and everyone can agree upon. There is no better issue than TRIA to unite us, because TRIA has to be in place, not because of a major city or a rural town, it is because of the new world in which we live. We hope that no one will ever have to use this insurance, but we know that it has to be in place because it is a new world, a different world in which we live. And we do want to send a strong message that we are united as a country, and that we are going to protect our economy, our businesses, and our people, no matter what those from the other side may want because they are jealous of what we have here. And TRIA should be that uniting piece of legislation that sends a word out that we are going to make sure that we are going to hold, as best as we can, our economy up to the highest standards that it is, we are going to protect our businesses, and we are going to make sure that our people continue to work.

That is what this is. There may be some differences. And we are going to have markups and we will have talks and we will have our process in which we can do that. But we need to move forward as a united body, understanding the importance that this TRIA insurance means to our economy, to our employers, and to our employees. It unites us all, whether we are a Democrat or a Republican, and whether we come from the East or the West, the North or the South. Because we have to send a strong message that we are going to protect our people and we are going to protect our economy.

I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Meeks. And now from our Republican side, Mr. Davis of Kentucky, for 1½ minutes.

Mr. DAVIS OF KENTUCKY. Thank you, Chairman Kanjorski, and Ranking Member Pryce, for holding this hearing today. As a strong supporter of an extension of TRIA, I just want to take a moment to join with my colleagues on this side of the aisle in expressing our frustration and bewilderment at what I believe is a lack of good faith collaboration on H.R. 2761. Despite offering two pages worth of suggestions, only one minor Republican issue was included. No one on our side even saw a draft of the legislative text until just before it was introduced, thus preventing the opportunity for us to engage in a collaborative discussion.

I appreciate the comments saying that it is not a Democrat or Republican issue; it is an American issue. I agree with that wholeheartedly, but it is a shame that I think this is just another exam-

ple of feigning transparent and bipartisan governing and then failing to meet standards that we had in the last Congress for collaboration on such critical issues like this.

TRIA has always been drafted and debated in a bipartisan fashion, passed by unanimous or nearly unanimous bipartisan votes. I am truly appreciative of the commendable efforts thus far by Ranking Member Pryce and Congressman Baker on TRIA, and I am hopeful that the majority will at least work with us on the manager's amendment to include some of the Republicans' proposed changes, especially market reform changes that would continue to grow the private sector participation in the program.

And I would close with this one concern. Codifying for many, many years in advance something that would affect a market that is going to continue to adapt to changes, as well as the enemies of this country are adaptive and changing, our economy is changing, I think it is better to have a limited period of time, and in that limited period of time give us a chance and succeeding Congresses the opportunity to adjust this program so it fits the best needs of the country.

I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Davis. And now very quickly for a little less than 1 minute, Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman. Terrorism, without question, is today the single most significant risk facing our Nation's economic security, bar none. The gentleman from New Jersey made a statement that said that we should do it over a shorter period of time. The one thing we need in this effort, certainty for the industry and for our economic system, is stability. And simply because you are extending it for a 10-year period, could be even longer, 15 years, that gives some stability. It does not mean that you will not go back, if circumstances present themselves, and be able to adjust anything. We do it all the time here in the Congress.

We can't predict the future. But make no mistake about it, the industry, the American people, deserve certainty and deserve stability. Those are exactly the cornerstones of TRIA, and that is what is needed.

So Mr. Chairman, I really appreciate this hearing. Like I said, there is no more important piece of legislation. It is without question necessary for the Federal Government to ensure that insurance remains available and continues to require studies regarding the development of private markets for terrorism risk insurance. And I believe that Congress must work to provide a meaningful extension of TRIA, while at the same time creating a long-term market-based solution to this problem.

There is no perfect situation in the world, least of all us. We are all imperfect, but we move towards a goal for good. And that is what this TRIA extension does. I am proud to be a part of it. And I want to thank you, Mr. Chairman, for putting forth the leadership on this. Thank you. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Scott. Now we will move on to the reason we are here, the testimony of the panel. We will start with the government panel. First, we have the Honor-

able David G. Nason, Assistant Secretary of Financial Institutions of the United States Department of the Treasury. Mr. Nason.

STATEMENT OF THE HONORABLE DAVID G. NASON, ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS, U.S. DEPARTMENT OF THE TREASURY

Mr. NASON. Thank you, Chairman Kanjorski, Ranking Member Pryce, and other members of the subcommittee for inviting me to appear before you today to discuss terrorism risk insurance. The market for terrorism risk insurance in the United States was, of course, significantly changed by the terrorist attacks of September 11, 2001. Of course prior to September 11th, terrorism risk clearly existed in the United States. However, the scale of losses associated with September 11th, approximately $32 billion, along with the recognition that terrorist attacks could cause insured losses of such scale across multiple insurance products led to changes in the way the insurance industry views terrorist risk.

In response to this, Congress passed, and the President signed, the Terrorism Risk Insurance Act, or TRIA, in late 2002. TRIA established a temporary Federal program of shared public and private compensation for privately insured commercial property and casualty losses resulting from acts of terrorism. TRIA was again temporarily extended in 2005 for an additional 2 years.

My written statement provides an overview of the key features of TRIA, the extension act, and the President's Working Group Report on terrorism insurance. What I would like to focus on today is Treasury's view on the Federal Government's role and the market for terrorism risk insurance going forward, and H.R. 2761, which proposes a further extension of TRIA, and makes a number of changes to the program. As a basic principle, the Federal Government's role in any market, including the market for terrorism risk insurance, should be limited to those areas where the private market cannot function and broader costs are imposed on our Nation's overall economy.

Our view of TRIA is shaped by the belief that the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. In playing a role at a time when it was needed, TRIA appears to have been successful. Subsequently, there have been positive market responses by insurers and reinsurers to the reduction in the Federal role during each of the 5 years that TRIA has been in place, most notably by taking on additional terrorism risk exposure in each year of the program. And as insurance companies have increased their terrorism risk exposure as TRIA has been scaled back, prices for terrorism risk coverage have declined or remained stable. In some sense, we have conducted a market experiment under TRIA that has illustrated that the private sector is capable of taking on increasing amounts of terrorism risk as the Federal Government's role recedes.

Given the success achieved under TRIA to date, the obvious question is, should the Federal Government maintain a limited role in the provision of terrorism risk insurance? It is clear that some challenges still remain in the market for terrorism insurance almost 5 years after the passage of TRIA, and nearly 6 years after

September 11th. Insurers have made great strides in modeling loss exposure and managing concentration of risk; however, the ability of the insurance industry to model the frequency of attacks remains uncertain. As a result, insurers are cautious in allocating more capacity.

Based on where the market for terrorism risk insurance is today, our view is that the following three elements are critical if TRIA is to be reauthorized a second time: First, the program must remain temporary and short term; second, private sector retentions need to be increased; and third, the program should not be expanded.

First, it is important that the program remain temporary and short term given the positive market developments that we have seen in the last 5 years. We do not believe the Government's role should be permanent, nor should it be long term, which could lead to market complacency. We believe the 10-year extension in H.R. 2761 is not consistent with this critical element.

Second, it is also important to continue the trend of increasing the private sector's participation. Private sector retentions can be increased through deductibles, co-shares, or program triggers, and any extension of TRIA should not backtrack from current levels, but rather should reflect some real amount of increased private sector participation. As has been demonstrated by the increased willingness of insurance companies to take on terrorism risk exposure during the life of TRIA, there is ample opportunity to continue increasing retentions. A number of provisions of H.R. 2761 move away from this.

Third, the program should not be expanded to introduce new lines or types of coverage willingly provided by the private market. Treasury would oppose such efforts that move the program in the wrong direction.

Finally, there have been questions raised about the lack of coverage for chemical, nuclear, biological, and radiological, or CNBR, terrorism risks. Outside of workers' compensation insurance, coverage for CNBR risk has generally not been provided by insurers. However, TRIA does provide coverage for CNBR risk if insurers include such coverage in their policies. If policyholders were to demand CNBR coverage, and were willing to pay appropriate prices, we would expect some additional capacity for CNBR risk.

Nevertheless, outside of the debate surrounding TRIA, we should continue to consider the potential economic implications associated with the limited amount of CNBR coverage that is currently being provided. We appreciate the efforts of the chairman and members of the subcommittee in evaluating these issues associated with terrorism risk insurance and TRIA.

These three critical elements that we have set forth surrounding an acceptable extension of TRIA reflect the positive experience under TRIA to date, and are grounded in the basic principle of limited Government involvement in private markets. Without these critical elements, we would not be supportive of extending TRIA, as the program would be moving in the wrong direction. TRIA should be phased out in order to increase private sector participation. We look forward to continuing to work with Congress on this important issue.

Thank you for having me here today, and I look forward to answering your questions.

[The prepared statement of Assistant Secretary Nason can be found on page 175 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Nason. Now the second member of the panel, the superintendent of the New York Insurance Department, the Honorable Eric Dinallo.

STATEMENT OF THE HONORABLE ERIC R. DINALLO, SUPERINTENDENT, NEW YORK INSURANCE DEPARTMENT

Mr. DINALLO. Thank you, Chairman Kanjorski and Ranking Member Pryce. It is an honor to be here, and I am happy we are here discussing not whether TRIA is extended, but how exactly it should be extended. It is a fantastic accomplishment, and I want to commend and thank the subcommittee for its careful work, including incorporating some of the suggestions from the field testimony, and for coming all the way to New York and collecting that evidence. We greatly appreciate it.

But I know there is still some concern about the program and that it crowds out private sector involvement or that it is a form of a bad subsidy. And as I said in the field testimony, I think it is actually a program that makes private sector involvement possible, because it solves what I termed before the "blind pricing" problem, where there just simply is not enough data, especially the upper reaches of potential terrorist activity, for underwriters to accurately price it.

I showed that chart, which I have here again, but I won't bore you with the chart unless I am asked to during the question and answer period. But I think it is important to understand what it does. By cutting off the far end of the bell shaped curve, it permits that pricing. And it is at least possible that the positive market developments that we see now are due to the existence of the TRIA program. Taking it away will cause that pricing clarity to go away, and you will be back to the same unclarity and blind pricing problem that you had before.

I also don't think it is subsidy in the classic sense, because I don't think it encourages morally hazardous conduct, as economists say. We want people to collect in cities and work in concentrated areas, and so I think that it is not the kind of subsidy for the industry or for society that is viewed as a negative in encouraging ill behavior.

Having said that, I think the program should benefit all of the United States, and not just New York City. A lot of people seem to think that this has become kind of a New York City only issue, and I just can't disagree more. As we review some of the provisions today, I would like to recommend that they in fact be adjusted with that in mind. Specifically on the duration and the reset provision, I would make some modest suggestions that they be changed in a manner that incorporates more of the country. So for instance, I think on duration, longer is better. The two markets need the longest and best certainty. The insurance market needs it to be able to price accurately and include as much capacity as possible. Every time the renewal comes up, there is a hesitancy on the part of the insurance market, which I can feel as a regulator. I am sure you

have heard a lot of testimony on that, and I think a shorter period undermines that confidence. The other market, of course, of building and real estate needs the longevity because, as you have heard from your fellow members today, the loans are of such a duration, and the bonds that back them, that the markets need that kind of certainty.

My understanding is that for the large real estate bonds, they tend to cluster around 10 years and greater. So even with a 10-year longevity, as soon as the bond is in place, the insurance companies are going to begin to doubt whether the insurance will be there. The bonds similarly, and the bond markets and the financing, begins to doubt whether it will be there. And I think for the correctness of financing, you need as long of a period as possible, and more and more bonds are being used to finance the largest construction projects. Certainly that is what is going to happen with the Freedom Tower.

Finally, I think 15 years is better than 10, because I strongly believe that Oklahoma City should be included in the TRIA and the reset provision; I think that anything that has a definition of "impacted area" should be extended and the same benefits should be put in for Oklahoma City. And that would require you to go back, I think the horrible event was on April 19, 1995, and so I would look for an extension to sweep that up, because it is not just a New York City problem. It is not even just technically the largest cities in the country problem, as we saw there.

And similarly on pricing, I would even consider recommending that you lower it to $500 million, because again, I think the damage in Oklahoma City was $600 million. I believe the London subway bombings and the bombing in Madrid would also similarly not qualify on the money scale. And those to my mind, when you think about those kind of attacks, if those occurred here, I think many of you would concede that is exactly the kind of terrorism attack that would cause underwriters to sort of shun away from the jurisdiction. The reset provisions that give that kind of consideration I think should be in place for that magnitude, and so I would consider it.

To me, the reset provisions for numerocity are simply the opposite of what underwriters normally do, which is if you have car insurance, and you have had three accidents, they justifiably raise the premiums. That is the reasonable actuarial approach. And I think what the reset provision does there is sort of the opposite; it disrupts that. But here I think it is appropriate, because you want to do everything you can to invite and to create capacity when there is an act.

So to me, it is not just a New York City phenomenon. Likewise, the attack on the Pentagon, which I understand would be excluded because it was not a private insured event, but again I would expand the definition to be able to include that. It is not about whether private insurance had to step in specifically, it is about whether that jurisdiction is now viewed as a likely target for terrorism based on the past. They are trying to predict the future with the past. And so to the extent that the reset provision is controversial because it looks like it only favors New York City, because we were attacked in the World Trade Center twice, I would do every-

thing I could to recommend to you that you finesse it, so to speak, or change it to include a Virginia, a D.C., Oklahoma City, and like sizes that we know have already recently occurred that would not otherwise be subject to the billion dollar mark.

I would give the Secretary of the Treasury that kind of discretion. Whether you actually make a precise amount, I think you could give more discretion in that regard so that the Secretary could designate such events as qualifying for the reset provision. Because I could imagine an attack of less than $100 million dollars where the reset provision would be appropriate based on how the underwriters would approach and begin to actuarially evaluate the jurisdiction.

Finally, I commend the concept of the Blue Ribbon Commission. I think this is a very long-term program that needs to be evaluated along the way. I think there does need to be better self-help by the industry, and the Blue Ribbon Commission could certainly help evaluate and make recommendations and incentivize industry to that. I think that experience will to some extent improve the situation, and the Blue Ribbon Commission along the way can take that into account.

But I think experience, God willing, will be very limited in this area. That is exactly why you need TRIA, and why you have a limited pricing opportunity due to the lack of events. But to the extent the department can offer any help or expertise on the commission, we would be honored to assist, and I will be happy to answer any of your questions. Thank you.

[The prepared statement of Mr. Dinallo can be found on page 96 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Dinallo. I appreciate the testimony of both Treasury and the State of New York. I look at Treasury as being somewhat limiting, and the State of New York as saying we have not gone far enough, so we have a little bit of conflict there. However, putting all things aside, Mr. Nason, do you anticipate that whatever ultimately comes out of the subcommittee or the committee in the markup will be a product that will be able to be readily supported by the Administration? Or do you really see a conflict that we should take into consideration that we have to negotiate through every stage and every amendment with the Administration?

Mr. NASON. Thank you for that question. What I would say, I don't want to presuppose exactly what will come out of the committee, but the three main points that I articulated in terms of the length of the program, whether or not private sector retentions need to be increased, and an expansion of the program, those are the three key elements that we would like to see in any TRIA reauthorization legislation. So if those three issues were addressed—

Chairman KANJORSKI. Well, 10 years is too long. What is the Administration's position as to length of time?

Mr. NASON. Well, I don't have a particular number to give you here, but what we have seen in the past is that there was a significant improvement after 3 years, and there was a period of time to study. In the next 2 years, there was a period of time to study, and we have a significant data set after 5 years. So 10 years is too long, 2 years would give you another data set of information, and 3 years

would give you a data set of information. Those are the time periods that we would be looking at.

Chairman KANJORSKI. In terms of the other provisions that you are interested in, what would your suggestions be?

Mr. NASON. In terms of modifications to H.R. 2761?

Chairman KANJORSKI. Right.

Mr. NASON. Sure. The Administration does not believe that we need to add group life to the program. The President's Working Group Report and the Treasury's 2005 report are quite clear that it is a functioning market, so that is inconsistent with our view that we shouldn't expand the program.

I am concerned about the make available provision for CNBR, although I will acknowledge that is by far the most complicated issue associated with this debate. And if I could elaborate a little bit on how I feel about the CNBR provisions, or how we feel about the CNBR provisions, there are two ways we look at this.

First, I want to acknowledge that, of course, the President's Working Group Report, and the GAO report, say that there is no private sector capacity for these risks. That is clear, and I am not going to debate that.

But second, what we do see is that adding a make available requirement is inconsistent with the original intent of TRIA, which was to stabilize the environment to deal with economic dislocations. Commercial development is happening right now throughout the country, even in the urban areas, without a private market for CNBR risk. So I am concerned that adding that now is not necessary.

Just as important is that in our 5-year experience with TRIA, we have learned that it is not the most effective vehicle to create a market for CNBR risk, if a determination is made that one needs to be created. And the reason I say that is because, as I mentioned in my testimony, CNBR risk is already covered for workers' compensation. It could be covered if the insurance industry wanted to participate in the market. But because the insurance industry is unwilling to participate in the market, the changes to H.R. 2761, we are skeptical as to whether or not they would be effective. Because there is a very important distinction, changing the make available requirement is not mandating coverage. The statute does not mandate CNBR coverage; it just requires the insurance industry to make an offer. For most companies, it would be subject to pricing discretion.

Chairman KANJORSKI. Do you think that since we recognize a need for that coverage, we should make it mandatory?

Mr. NASON. No. What I said to you is I don't recognize that there is a need for coverage. I will acknowledge that there is no coverage. But the reason that you would want to mandate coverage is if you thought that the country wasn't moving and developing, and there are some risks that the country may be comfortable with being uninsurable. This very well may be one of those categories. But as I said in my testimony, it is something that needs to be considered. I am just concerned that with the TRIA structure, we haven't had a good experience with that thus far.

Chairman KANJORSKI. On the NBCR coverage, you would prefer that we wait until an event occurs?

Mr. NASON. No, I wouldn't say that at all. What I would say is that right now, TRIA has been pretty ineffective in creating a CNBR market, but we should think pretty creatively outside the debate about TRIA about what, if anything, the Government should do in preparation for an event of that kind.

Chairman KANJORSKI. So you are thinking a separate piece of legislation is appropriate for NBCR tasks?

Mr. NASON. It is something that the President's Working Group has tried to study. It is something we could have a dialogue with industry about. It seems clear to us at the Treasury Department that TRIA has not been particularly effective in dealing with the CNBR issue.

Chairman KANJORSKI. Well, we have not been challenged yet. I sit in on a lot of the discussions as to whether to include it or not include it, and the point is that most terrorist experts in the country think that our largest challenge of the future is to predict how we will be attacked. I sat through 9/11, and the 6 weeks thereafter, and saw a discombobulated Administration and Congress trying to get together to handle just 9/11. I imagine a dirty bomb attack on New York, Los Angeles, Chicago, or Oklahoma City would cause that same and maybe even more discombobulated reaction by the leadership of this country as well as the general population. So I cannot understand why the Administration's argument would be, do not do anything unless you can do it perfectly. In fact, the majority of terrorist experts feel that is going to be the next challenge if we have one.

Mr. NASON. If I in any way suggested that "Don't do anything," would be the Treasury's policy, that is not what I meant to say.

And I also would like to say, it is unfortunate to be talking about something of this magnitude in a clinical fashion. It is not something that gives me great comfort. All I was trying to say is that while it is an important issue, and it is a complicated issue, we are very skeptical about whether or not TRIA and changing the available provision would get you the market.

Chairman KANJORSKI. May I make an invitation to the Administration that, in the next several weeks, you prepare what you think would be ideal in this legislation. Then, we can have the advantage of that in a markup, and as we go to the full committee hearings for markup?

Mr. NASON. I would be happy to work with you and your staff on it.

Chairman KANJORSKI. I appreciate it.

The gentleman from New York. I heard an interesting figure yesterday by one of the talking heads in regard to the change of party affiliation by the mayor of New York and his prospective political future. The thing that struck me as most interesting was that there was a little bit of bragging going on that the mayor was very successful in creating a $4 billion surplus in the budget of New York, and I thought that was great. It immediately struck me that since we are struggling with a $275- to $300 billion deficit at the Federal level, maybe we should include in the legislation some provision to call upon the City of New York or the State of New York to make a major commitment or contribution to the program instead of a reset.

Mr. ACKERMAN. If I might suggest, Mr. Chairman, you might ask the mayor to do that personally. Ask the mayor to do it personally.

Chairman KANJORSKI. What is your thought on that, Mr. Dinallo?

Mr. DINALLO. I think the City and State did, in fact, put up quite a lot of resources and money to respond to 9/11. I think it is appropriate for jurisdictions to be responsible and to self-govern in the appropriate circumstances, but I don't think there is any reasonable doubt that the attacks on the World Trade Center and, in fact, the attacks on Washington, D.C., were not jurisdictionally based attacks. Those were attacks on America. Those were attacks based on trying to destroy the financial services economy of this country and strike at the heart of our capitalism. And therefore, I think that while it is not an unreasonable idea that, as was done there, local police, fire, emergency workers, and the Salvation Army should come in and do everything they can, I really don't believe that it would be appropriate to have a rule that basically said that each city—because I don't even know which city, God forbid, would be next—is responsible to put up billions of dollars that is mandatory because the next one may not have the surplus that Mayor Bloomberg, I suppose, is credited for so skillfully managing.

Chairman KANJORSKI. Yes. You understand, I am a very strong proponent of TRIA. I withheld my name as a sponsor of the piece of legislation based primarily on two areas identified in my statement, the Christmas tree effect of policies on foreign travel and, of course, the reset. It struck me that we have had almost an unspoken commitment between two sides of this committee and in the Congress in making a bipartisan effort that there would not be special favoritism either regionally or on economic class. This legislation probably moves to the extreme of sending a message to my constituents and the rest of the constituents of the United States that New York wants a special provision that no other area in the country will have. And quite frankly, we thought we were rather generous with New York in responding to 9/11 with the Federal response and getting involved in creating this legislation—

Mr. DINALLO. Yes.

Chairman KANJORSKI. —for future response. Can you understand why with the retroactivity—

Mr. DINALLO. Yes.

Chairman KANJORSKI. —of reset is so disturbing for me? I would have probably supported a prospective reset.

Mr. DINALLO. And I am here to do everything I can, Mr. Chairman, to try to urge you to change your perspective on this. I personally was disappointed when I realized, when my staff educated me, that, no, Oklahoma City would not be covered by this, and the Pentagon would not be covered by this. And therefore—I might say the Pentagon, I mean the jurisdiction around the Pentagon, and, you know, similar incidents, because I believe that on some level, our perspective has been skewed horribly by the magnitude and the cost magnitude of the World Trade Center coming down.

I think the next terrorism event will not be in that ballpark, so to speak. It will be in the more tens to hundreds of millions of dollars. And I am surprised that the reset provision—which I think is actually a good idea from a regulatory pricing point of view and

inviting of capacity—when the events occur, will not reach those kinds of events.

And, I mean, I don't know what power I have; I am just a simple State regulator. But I would urge you to take a look at this and say, why shouldn't Oklahoma be reached? I would imagine that if I were riding the subways in Washington, D.C., I would imagine that my sense of dread at times is equal to New York City because of what Washington, D.C., represents and because of the prior attacks. And therefore, if that is true, I would imagine the underwriters kind of price that in and shun it in a similar way, and that is the point of the reset provision. It is basically to correct for the natural market forces where they try to predict the future with the past and price accordingly. And I think the reset provision from that point of view is rational and ought to be extended so that it doesn't look like—which wasn't the intent, I believe, but it certainly looks like it is a New York-based provision, which I simply dispute, with all due respect, but agree with the appearance.

Chairman KANJORSKI. Very good. Now that you have frightened the economy in Washington, D.C.—no, this is a serious matter, and it is a difficult matter to discuss when we are talking about huge destruction of property and a total loss of thousands of future lives. All we are trying to do is put a mechanism in place that will forge the opportunity to go on and meet that challenge in the future.

But I appreciate that. I look forward to working with New York, both the State of New York and the City of New York. Of course, I am always aware of our 29 active members of the New York delegation who have been very successful in coming forth and putting this proposal together. We are going to work with them over the future years.

But now, since I have eaten up more than twice of the allotted time I should have, I would like to recognize the gentlelady from Ohio, Ms. Pryce.

Ms. PRYCE. Thank you, Mr. Chairman.

I want to once again thank the panel for the time you have taken with us.

Secretary Nason, I think that you testified that you have seen, or Treasury has seen, positive market adjustments in each of the 5 years since 9/11 vis-a-vis terrorism risk insurance. I wonder if you could elaborate a little on how you see the terrorism insurance marketplace evolving. Has it been fits and starts? You said 3 years and 2 years, and how this 10-year extended period, if we go that long or even further as has been suggested this morning, would affect that evolution.

Mr. NASON. Sure. I would be happy to do that. And I do want to say that we have seen a lot of progress with TRIA in the last 5 years, and the best way to explain that progress is that, to put it quite simply, as the Government's role has decreased, the private sector has been ready and willing to step up and fill that void. And that is indicated by the fact that there is more terrorism coverage throughout the country and in the major urban cities so more people are buying the coverage. But just as important, the prices for that terrorism coverage are either lower, or they are stable, which suggests that we are not getting to a point where the private sector is uncomfortable with providing that coverage.

And we have seen that the industry capacity, starting in 2003, which was around $12 billion, has increased in 2007 to about $36 billion. That is the deductible retention capacity, by a factor of three, so we have seen that the amount of private sector skin in the game has been increased significantly. We have seen that take-up—which means more people are buying coverage—has increased significantly. We have seen prices stabilize or decrease as the insurance industry has gotten better—has a better understanding of how to kind of manage their risk exposure for terrorism insurance. And that is exactly what we had hoped the private sector would do during each of the 5 years of the TRIA program.

And how I view the 10-year extension is that there are two things. One, a short-term program encourages the private sector to innovate because there is always an expectation the program may go away. It also encourages the insurance industry to innovate internally, because if there is no Government backstop, they are going to have to be able to manage their risk better. And we have seen an enormous amount of progress on the insurance company side as to how to manage their risk. It also gives the Congress and the Government an opportunity to kind of study where things are, and that is a very important aspect. If we have a 10-year program, you can make the argument that there will still be as much looking into the program, but the fact that the program resets and needs to be reauthorized, or there is a consideration about reauthorizing really creates—really compels people to study where we are. And I wouldn't want to give up on that opportunity.

Ms. PRYCE. Thank you.

And, Superintendent Dinallo—is that how you pronounce your name?

Mr. DINALLO. Yes.

Ms. PRYCE. Noting that the NAIC has in the past recommended that Congress change tax laws for insurers to avoid penalties and encourage the accumulation of reserves, and I mentioned that in my statement, would you support including in TRIA or in a separate provision out of a different committee, obviously, allowing for tax reserving or pooling? Will you be requiring your insurers in New York to increase their capital to back up risk? And how do you see that from your position as a State regulator?

Mr. DINALLO. I think I alluded to this a little bit in my prior testimony that I am definitely a supporter, and we in the Department are considering the regulation that will mandate the insurers do some kind of reserving around catastrophic and terrorist premiums, because I think it is important for the public to see, and for the Government to see, where the money is going so that we can point to it and say, here is the amount that is reserved for a rainy day, and if it is below the event, then presumably premiums will have to be raised because the reserve was sufficient to cover the event.

I don't know if it is necessary to give the industry the tax-deferred status that you are asking about. The problem would be, I think, many of the larger insurers could deal with it, and, in fact, have privately told me they could handle it. It might have a difficult impact on the smaller insurers, who might not have the capital to do the reserving. But then there is a fair argument that

maybe for catastrophic coverage and terrorism coverage, you only want certain players in the game anyway. So it kind of cuts both ways. I am wrestling with that right now.

Ms. PRYCE. So you don't necessarily go along with the majority of your Commission?

Mr. DINALLO. Well, I think what they are saying is that there ought to be a tax-deferred status, and I am saying I think it could go either way. I think it would help more of the underwriters, but I think the first step would be to mandate it, and maybe see who can handle it, frankly. But I think it is a really good mechanism for fiscal responsibility and for the public to be able to see why there is an increase in the premiums and where they are going.

The only thing I would like to just comment about, when you talk about how the companies are better managing their risk, the take-ups have improved, and pricing has improved, capacity has improved, I want to make sure we don't lose sight of what, I guess, is arguably the obvious. Arguably this is because TRIA is in place; in other words, you put in the backstop. I don't know if you recall the curve that I did, but you have cut off that right end of the curve. If you uncut off the right end of the curve, I would at least want to make the subcommittee aware that the pricing potential that you have put in place is erect.

Ms. PRYCE. Well, in my statement I actually had my staff change it from "phase out" to "phase down," and it is important that there is a Federal backstop. I am not one who proposes there be none at all, but I do think we need to look at it more often than 10 years.

I am aware of my time, and I yield back. Thank you, gentlemen.

Chairman KANJORSKI. Thank you, Ms. Pryce.

Now from the State of New York, our good friend, Mr. Ackerman.

Mr. ACKERMAN. The great State of New York. A word about New York. We are special. We are special like every other State is special. One of the things that make us special is the fact that we are in great measure one of the largest donor States to our Federal system, putting into this great country so much more in dollars than we receive back, much more than many other States, and we do not do that begrudgingly. We are happy to do that. We are proud to do that.

And one of the reasons that we are able to do that is because of the economy of the State of New York. Part of that economy makes our real estate very, very valuable. We don't want to be treated any differently than any other State, but we want to be treated as part of this country, and if there is an attack on New York, it is not because someone declared war on New York; it is because somebody has declared war on America.

Nobody is writing a check for hundreds of billions of dollars to the State of New York for fun or for free. There is no outlay of Federal dollars coming from this at the outset. The only way New York gets this great benefit of which we speak today is if we suffer another tremendous attack. If anybody thinks that makes us special, I hope and pray and don't wish anything bad upon you, but relieve us of that burden. If somebody could tell us how we can get rid of that target on our back, which we have not placed, but certainly do have, we would gladly give that up if somebody else would want to assume that risk.

There is no payday here from which we benefit. There is just relief in the case that we suffer, and only in case we suffer. This money appears only if there is an attack on New York or anyplace else that has an attack of that kind of dimension. This isn't something that we seek advantage over somebody else in the country. Believe that of us if you can. And our congressional delegation bipartisanly has supported, and will support, any disaster that takes place anywhere in the country. I don't know if New York has ever voted against aid or assistance in the history of this republic to anyplace else in the country. Nobody is sending us money unless there is a disaster.

I do have a question, Mr. Chairman, first of Secretary Nason, if I might. The Administration prides itself on being tough on terror, and the President said many things in addition to, "Either you are with us or against us." He said, in addressing the Congress of the Nation, "Terrorist attacks can shake the foundation of our biggest buildings, but they cannot touch the foundation of America. These acts shatter steel, but they cannot dent the steel of American resolve."

If, after listening to and reading the Administration's testimony, I think maybe the President meant to say that they can't dent the steel of American resolve. And unless terrorist acts are successful in manipulating the private market for terrorism insurance, in that case we fold. I don't know if that is the President's position, and it shouldn't be our position. You know, if we let the terrorists dictate the terms of the market and the terms of our real estate and the terms of where we build or how we build, then the terrorists have won. If they tell us we can't rebuild what they have destroyed where we want to build it, they have won.

They should not be dictating this. And the claim that the market will take care of the marketplace, these are extraordinary circumstances, and the reset position, if you blow up the subway system in—whether it is New York or some other great subway system in America, you are going to tell that municipality to rebuild the subway system in a different location? Rebuild your subway system in some other city or State? I mean, it makes no sense. How might you respond, Mr. Secretary?

Mr. NASON. Let me begin my remarks by saying that I agree with the President's sentiment in that quote, and I also agree with your sentiment that New York is special and needs to be treated as such, because it has experienced what it had to experience after September 11th. So I agree with that.

Mr. ACKERMAN. Let me just say, we are not treating New York special because of that. It is only if that happens again.

Mr. NASON. When I said that, I wasn't referring to the retroactive reset provision. I was saying that New York experienced something awful on September 11th, and I am not going to sit here and not acknowledge that. It did. And how I respond to that is in my testimony today, and the Administration's position on TRIA is not inconsistent with saying that these are difficult risks. Our position is simply that we shouldn't backtrack; we should continue to build on the progress that we have seen over TRIA in the last 5 years, and we should continue to build on that success. Those are

the three points that we made in our testimony, and that is our position on TRIA.

Mr. ACKERMAN. Superintendent Dinallo?

Mr. DINALLO. I agree with you that the reset provision has unfortunately been viewed as somehow a New York-only benefit, and I just have this—respectfully, as I have been able to do, both disagree with that and urge the subcommittee to consider some changes to extend it, to make it the fact as opposed to de facto pro-New York. I think that it should be expanded to—in a manner that would give benefit or acknowledgment to Oklahoma City, or the Virginia-D.C. area because of the Pentagon attack, and I think that is perfectly appropriate. And I do believe that the amount even is set high because I don't believe that the underwriters approach it from a question of exactly how much the loss was, but—within reason, but whether it is a likely target of attack, and in part they base that on the past, and that is like someone's driving record.

So I think that you are 100 percent right, Congressman. It is not about New York. It is about attacks on America, and for a lot of reasons, it is often concentrated in cities because they are considered somewhat symbolic of certain ways of life, and capitalism and financial services often, and because there are high concentrations of people in those areas. But, you know, the next place could be the heartland under a similar attempt to terrorize and get at other parts of America that are beautiful.

Mr. ACKERMAN. A final question for Secretary Nason. If the terrorists blow up Baltimore Harbor, where should we rebuild it?

Mr. NASON. I don't have an answer for that, sir.

Mr. ACKERMAN. Exactly. Exactly my point. But it shouldn't be the terrorists' choice.

Mr. NASON. Sure.

Chairman KANJORSKI. The gentleman from New York Mr. King.

Mr. KING. Thank you very much, Mr. Chairman. And, Mr. Chairman, I can understand why people might think that there is some special treatment here for New York, but let me just mention several things.

There is no doubt, under every threat and risk analysis that has been done and is being done, not only is New York number one on the list, no one else is even a close second. That is the reality. Believe me, it is an honor we could very much do without, but it is the reality we are going to have to face as far into the future as any of us can foresee.

As far as whether or not New York makes a contribution, I will just give you one specific example. The City of New York Police Department has 1,000 police officers, 1,000 police officers focusing entirely on counterterrorism. This is around the clock. They have more Arabic translators than the FBI. They are working in many ways undercover. They are in many ways public displays.

As far as the World Trade Center itself, one plot or threat we can discuss was the one that was made known last year, which was thwarted, the attempt to blow up the subway leading to the World Trade Center. That was just within the last year was stopped. Now, not only do we know that, terrorists know it, of course, but so do insurers, and so do real estate developers. This has a real impact on the economy of New York.

And, Superintendent Dinallo, if I could just ask you, I know in your prepared statement you made the point that to get a good rating on bonds to finance construction, it should be in coterminous with the length of TRIA, quite frankly.

Now, let me ask you very factually. Since those go at 10 years, what impact would that have, as opposed to 15 years, as far as getting the financing you need at a decent rating on bonds? And how will it impact the market?

Mr. DINALLO. My objective opinion is that 10 years is good, but 15 years is significantly better, because the bonds for large real estate development projects are clustered around 10 years. So if the median is 10 years, you are going to have quite a few that are beyond 10 years, and the ones that are 10 years are going to immediately be questionable, so to speak, upon the first day of issuance when there is only a 10-year—so right now if TRIA were passed today with the 10-year horizon, you would quickly be into 7 or 8 years, where you would have 10-year bonds being the preferable and the preferred way the market would approach it. But a TRIA life span less than that, and that would not be good for the market.

Mr. KING. I know that the rebuilding is being planned, some of it is under way, some of the World Trade Center is up. But how much—is there a sufficient insurance and reinsurance available? How difficult is it to obtain?

Mr. DINALLO. Well, the experts—the large commercial brokers that have been consulted on this say that the estimation is that there is $750 million available now, and the World Trade Center project alone is an insurable asset, so to speak, of $20 billion. So we are—right now we are well, well short. Now, much like settling the World Trade Center private litigation, which some people said, well, what is the big deal about that, it was already starting to go up, but what you really end up insuring, as we saw on 9/11, is the buildings themselves to a large extent and so right now the insurable interest, so to speak, and what is there is not very much. So a lot of the money and the work has been put in on the plans, the contractors building the foundation, the famous bathtub and other aspects. Where you are really going to need the insurance is when the actual tower goes up and World Trade Center site—I guess it is 2, 3, 4, 5 are put up.

So I think that the answer is that there is quite a lot to go, and there is a real capacity issue in lower Manhattan, which I personally believe again is starting to sound like New York is, you know—is, like my grandmother used to say, you know, crying poverty with a loaf of bread under each arm. But it is that way because we have suffered the attacks, and I think any other city that suffered these attacks would have a similar capacity problem.

Mr. KING. If I could just also then just ask one final question before my time runs out. On CNBR, we know whether it is New York, Chicago, L.A., or anyplace in the country, if they are hit with a nuclear attack, the Federal Government is going to come in to help alleviate the cost, to put in money. Doesn't it make more sense to try to get the insurance industry engaged up front rather than have just the Federal Government coming in to bail everyone out at the end?

Mr. DINALLO. Well, I agree. The observation that there has not been a lot of activity on the private side because of CNBR, I think, is because of the lack of it in the TRIA existent legislation. That backstop that we have discussed that I showed in my chart is essential to get capacity and rational pricing, because when you are talking about CNBR in particular, which was the far end of the curve that I showed, you are talking about potential events that have been estimated in the $750 billion range, and that from a pricing perspective just makes it essentially impossible to price unless you have certainty that at some upper level whether it is $50 million or $100 million, it is going to be cut off. And without that for CNBR, although we can all instinctively know the Federal Government—I thank them greatly—would step in, you need to have, from the pricing perspective, some cutoff.

Mr. KING. Thank you, Mr. Dinallo.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. King.

The gentleman from New York, Mr. Meeks, for 5 minutes.

Mr. MEEKS. Thank you, Mr. Chairman.

I am sitting here shocked, quite honestly, because never have I ever thought that this hearing or a large part of it would be having to defend the City of New York. To me, this issue is not about the City of New York; it is about protecting our country. New York happened to be a victim of terrorism, and to some degree, I am hearing, you could almost say, because the victim happened to be the financial center in this country, it doesn't matter that they are victims. So what? They were victimized, or New York was victimized because it is the financial capital of this country. It is representative of the United States of America. And so as opposed to saying, you know, or thinking that New York is just one that has all of this money and, as a result, it is receiving some treatment unfairly, it is shocking to me.

I am here, and I think that, you know, when we have a crisis anywhere in this Nation, what should be important is to make sure that we fix it. I don't think any member of the New York delegation objected to anything that goes—I mean, I agree, Oklahoma City should definitely be included here. Virginia and Washington, D.C., should definitely be included here. And if we have a crisis anyplace in this country, we have to come together. The tragedy that took place in New Orleans with Katrina, I don't think any member of the New York delegation said, "Oh, Louisiana should not receive funds because of that natural disaster." This should be something that is uniting us as a country because we are all one. In these kinds of incidents, it is not a New York City incident, it is not—when we had the tragedy in Oklahoma City, that was not an Oklahoma City incident. What took place in New Orleans wasn't a New Orleans or Louisiana incident. It was an American incident. And when we are talking about fighting terrorism, we are talking about fighting it as Americans.

When I look at this bill, I am not looking at this bill simply because of New York. God forbid something happens in Los Angeles. God forbid something happens in Chicago. I want to make sure that they are protected. I want to make sure that we as a Nation continue to move on and that our economies continue to strive.

Clearly this is not about New York, and so I am just taken aback that we are talking so much about, well, New York, this is exclusively for New York. But if, in fact, other cities are not included in this bill, then we should change it. And I will be the first to fight and support any amendment that includes every State if some States feel that they are left out, because this is what this is really all about.

My question, and I guess I will give it to you first, Mr. Superintendent, because it is just about the structure of CNBR. I have had a number of small insurers who are concerned about the structure, you know, because with the amount of money, it seems like both are small as far as deductibles are concerned. I was wondering, what would your comments be about how best to structure CNBR for small insurers?

Mr. DINALLO. Well, I think that is actually a fair issue. I think the small insurers do have a concern that is appropriate that if others make available a requirement, it could be too expensive. But right now, you know, I think what will happen is the work with the insurance regulators on what the correct price should be, and I don't see why the pricing would really be any different than what they are already giving for the terrorism coverage. The enormity of it is obvious, but the incident numbers would be about the same potentially. And I think that the way to deal with it is—what you have already done, you have given a lower deductible from 20 percent to 7.5 percent, which I think is a very good thing, and maybe it could be further modified to take into account the smaller insurers that I think have an argument that they will be impacted by it. But they are already now going to be impacted by offering terrorism coverage, the conventional terrorism coverage, and CNBR which has such an alarming aspect to it, but it really has an alarming aspect on the uppermost reaches, which I am kind of presuming for these discussions is going to be part of TRIA, so I don't see such a serious distinction.

Just to note on the financial capital center of the world being New York, I will just say one thing: Heading the Blue Ribbon Commission for the Governor on financial services competitiveness, you know, it will not be Chicago or Denver or Los Angeles that picks up and becomes the new—and, I mean, our competition on that is London and Asia and Paris. And so to the extent that people don't feel comfortable doing business in New York from a financial services perspective because of terrorism, it will go to other countries' benefits, not to other cities, I believe. And it is just going to be a tragedy for the country's economy, not for New York City specifically.

Mr. MEEKS. Thank you. And, Mr. Secretary, let me just ask one quick question. I see my time is almost out. And when we unfortunately talk about terrorism now, generally it is not something that we think about that is from a government necessarily. But we also—and we fear that some of these rogue nations could get their hands on a nuclear weapon. But in CNBR, let's say, for example, it did get in the hands of a country, and there was a nuclear attack or a biological attack from a country, which basically means there is an act of war, should TRIA be—does it trigger in then because it is an act of war?

Mr. NASON. The definition of whether or not a terrorist event would be a certified terrorist event is quite broad. With the facts that you have suggested right there, if an individual undertook such an attack, I have to believe that the process that we have in place at the Treasury Department would call that a certified act, because that would be acting on behalf of a foreign person or an interest. And you have to be comfortable with the fact that we are going to—we are going to cut the right direction if there is some ambiguity there.

Chairman KANJORSKI. Thank you, Mr. Meeks. I am going to take the prerogative of the chair for a moment because—not that I was offended—but I hear your plea that this seems to be a hearing directed at New York. I want to assure you that it is not.

I also want to assure you that for 5 years, we have had terrorism insurance provisions in the United States without reset provisions. According to the testimony of the superintendent, the program has worked rather well and we encourage it. As late as yesterday, after discussing this reset with a group of people, I heard the comment back from some people not formally representing New York, but in the business community of New York, that the reset is so important to New York that they would rather have no bill if it did not include the reset provisions.

Now, I want to put it very directly to you, Mr. Superintendent, is that your position or the position of New York?

Mr. DINALLO. No.

Chairman KANJORSKI. Because if it is, I could save an awful lot of time and go on to other legislation.

Mr. DINALLO. I would prefer you not save that time. As I said in my opening statement, I think you have done a remarkable job. I think the bill, with or without the reset provision, is a great achievement. I just—all I was trying to get at was—and I think Congressman Meeks's point is well taken—that I really was personally shocked when I realized that other attacks on this country were not covered by the reset provision.

I am just calling it like I see it. I have my staff here. I was appalled and surprised by the optics of it and apparently the de facto reality of it only being a New York benefit, and I would rather see it extended to other jurisdictions, and that the Secretary be given the opportunity to define self-insured out of it.

Chairman KANJORSKI. We appreciate that. Let me go one step further. We do not look at this as a benefit of New York to have a reset provision. This is all a question of who will pay when or if there is another attack. What is the fair allocation of this? Quite frankly, so that my friends from New York understand, look, what we are arguing about is the investors and the buyers of this insurance that are either going to save money or pay a little bit more if we do or do not have a reset provision. This is not going to affect one iota of people of the State of New York or the governmental institutions of the State of New York. It is going to affect really a very small group of real estate investors within New York and potentially bond buyers and mortgage holders of the property of the State of New York. We do not want to hurt them. On the other hand, we do represent the entire country, and we have made a representation in our response to terrorism insurance for the last 5

years that everybody has been treated fairly and equally in the country. This is the first time that we have this significant request for a change from fairness, and some of us are not comfortable with it. That is it.

Now we will move on to our next gentleman, Mr. Feeney of the great State of Florida, for 5 minutes.

Mr. FEENEY. Well, thank you, Mr. Chairman. You may be interested to know that I am originally from the great State of Pennsylvania.

Chairman KANJORSKI. I knew there was something good about you.

Mr. FEENEY. Like many transplants in Florida. And Florida had some experience in insurance markets collapsing. I was in the State legislature after Hurricane Andrew in 1992, and I will tell you, I view the TRIA issue through the lens of my experience as a policymaker in Florida. And the chairman of the full committee, Mr. Frank, said earlier that Adam Smith really isn't relevant to this conversation, given the nuclear threat, but I believe that Adam Smith is always relevant when we are talking about capital because nobody ever explained how and why capital moves better than Mr. Smith.

I would suggest that I was growing bias in favor of free markets, so I am very sympathetic to the Treasury's position here. Having said that, there are times when the markets collapse in insurance. We have seen that in Florida, hurricane responses, and there are times when the market simply is not capable of reacting quickly enough. And unfortunately the government's choice is either to allow a recession or a depression to occur or to find a way to transition from a catastrophic event, whether it is man-made or in this case—in this case man-made, or whether it is a natural event.

But my preference is always to give back to the private market. I believe that reinsurance ultimately ought to work in a terrorist threat because we have commercial buildings in Malaysia, in Hong Kong, and all over the Far East and Europe, in any developed countries that potentially could be targeted by terrorists. There is this huge need and market globally for terrorist reinsurance.

And so my goal, Mr. Nason, is exactly the same as Treasury's, even if I think some of the picture you have painted may be a little bit rosy in terms of the length of time it is going to take. I want to vote for a TRIA bill, but I want to only vote for one that is going to get us back towards a healthy market, whether that is 7 years or 10 years or 12 or 14 years.

Mr. Nason, could you give me some encouragement that we could craft a bill, and give me some ideas of what ought to be in that bill as we continue the transition from 9/11 and go back to a healthy market. What types of things would you suggest that we have in this bill other than the timeline which we have talked about?

By the way, the Ways and Means Committee hopefully will encourage commercial insurance companies to build up their reserves with favorable tax treatment. That is one way we can reduce the risk over time to taxpayers, and I think that ought to be done post haste. I don't know why the Ways and Means Committee hasn't made that a priority.

Could you give me some additional ideas of what we ought to have in this bill to move us steadily and surely towards private reinsurance dominating the market once again in the future?

Mr. NASON. I would be happy to do that, and I also wanted to say at the outset that we at the Treasury strongly support the chairman's views on the reset provisions and the fact that we have had a program that has worked quite well, and changing it in that way doesn't seem to be a step in the right direction.

In answer to your question, Congressman, what I would do is I would look at the extension act in 2005 as the template for what we would like to see going forward. There are some very clear things that we can do. We can continue to increase private sector retentions. They have gone up every single year that we have had the program. For some reason we have stopped that. We are not at all convinced that private sector capacity is at its maximum, so we don't see any reason why we shouldn't continue to increase private industry retentions. That is the first thing.

The second thing I would say is the trigger amount. There are three ways that you can increase retentions—increasing the deductible, copay, and triggers. This bill lowers the trigger amount; $50 million seems like a lot of money, $100 million seems like a lot of money, and it is a lot of money. But it isn't a lot of money when you consider the aggregate loss that a particular event may cause; $50 million or $100 million is essentially a small amount in terms of a loss that the insurance industry can handle from the private sector. So I would certainly not want to see the trigger levels decrease. I would want them to be—

Mr. FEENEY. The argument there is that if you penalize small companies, you may drive them out of the market. How do you respond to that?

Mr. NASON. I don't believe that to be true, and here is why: The trigger right now is $100 million. It is an aggregate loss for the entire event, not insurer by insurer. So what happens is if you had a $100 million event, then the TRIA program is triggered. Then you move to a separate calculation to figure out how much each separate insurance company's skin in the game is. It is very unlikely that for a $100 million event, you would have $100 million, $90 million, or $70 million of exposure for a particular small insurance company.

Mr. FEENEY. Ben Franklin started the first insurance company, and he knew at that time that you should diversify the risks that you have in your portfolio.

Mr. NASON. That is exactly where I was going to go, Congressman, because if that is the case, if a small insurance company has all its surplus tied to one disaggregated risk, that is bad risk management practice.

Mr. FEENEY. We had some companies after Hurricane Andrew that did exactly that in south Florida; they had 90 or 100 percent of their policies. So our regulators in some of our States learned what Ben Franklin taught us years ago.

I see my time is up. You understand what my goal is. I am not thrilled with the bill, although I understand the need for some sort of TRIA transition.

Chairman KANJORSKI. Thank you very much, Mr. Feeney.

We are going to pass on to the gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Chairman, let me be clear. I have some reservations about the reset provision, particularly the retroactivity of it. At the same time, on balance I support the concept of the bill for the very simple reason that I don't see it as a major item either way, if you want the truth. The prospective reset I do see as a major item. I think that is an important aspect of it. The retroactive one, financially I just don't see a major financial impact by it, number one.

Number two is, let us be serious. There is nobody here who has had more difficulty with the City of New York than me. Fenway Park is in my district.

Mrs. MCCARTHY. That is your problem.

Mr. CAPUANO. To get a little revenge, the Yankees still haven't won a world championship in this century. That is okay.

But at the same time I also realize, again, it doesn't take empirical data, just common sense, that New York has the highest chance, the highest likelihood of the next terrorist attack. There is no way around it. It is for 1,000 different reasons that we all know, you know, intuitively. And that being the case, a minor financial impact, which I am not even sure there will be one, but whatever minor financial impact there is shouldn't be enough to derail a necessary bill, number one.

Number two, it recognizes the reality that New York developers will probably have a more difficult time getting ahold of affordable insurance.

So for me, yes, I have some concerns. They are philosophical concerns. I share them. At the same time, they don't rise to the level of substantive concerns that I have on the retroactive aspect of it. I do, however, have some concerns about CNBR, nuclear, biological, chemical attacks. And I say that for the very simple reason that people, when they use the term—first of all, most people don't use the term, but those of us who come to use it always think in terms of the biggest, most catastrophic issues, a major nuclear attack on any major American property. I don't believe that we can cover that. I believe that Congress should be back in session doing pretty much what we did for New York if, God forbid, that ever happens. But each one of those situations presents a real possibility in today's world of a small attack.

For some reason, people have forgotten that we had an anthrax attack that wasn't widespread, didn't affect millions of people, but did impact this economy very greatly. We could have a dirty bomb that might impact only a small area of any one of our cities; that a chemical release like the one in London's subway, again, not the entire city, but a significant aspect of it. And I don't disagree that private enterprise should do it, but right now they are not doing it. It is effectively not offered. And I totally agree. I would love to hear either today or anytime suggestions on how we can get it to be offered without these provisions, these provisions that I said right from the beginning are not necessarily there because they somehow came down on the tabloids, and we decided that this is the way to do it, it is the best idea we have at the moment. If there is a better way out there to get CNBR coverage affordable and

available to our major developers, I, for one, am more than open to hearing how to do it.

So I want to make it clear, as I said right from the beginning, there is nothing in this bill, not the trigger, not the CNBR requirements, not the reset, that is somehow sacrosanct to those of us who worked on this bill. This bill, like everything else, is the best we can do in an area where nobody is a true expert, trying to cobble together enough people who would be satisfied with the bill to move it forward because something is better than nothing. And I would ask both gentlemen, if they have suggestions, specific suggestions, positive suggestions, on how we can improve this bill specifically relative to CNBR, I would love to hear them. I am not trying to put you on the spot today. I am not suggesting you are going to whip it out of your pocket and give it to us. But if you have them, please get them to us.

I won't speak on behalf of everyone else, I will speak for myself. I won't just reject it out of hand. If it works and it makes sense, I am more than happy to embrace it. And with that, if either of you can offer insight on those items, I would be happy to hear them.

Mr. NASON. Let me just say as a native New Englander, I share your angst about what the Yankees have done to our great community. I want to make something very clear. I in no way want to suggest that the CNBR issue isn't complicated, and I in no way want to suggest it isn't a problem. The only thing I was trying to suggest in my testimony and in my points is that right now if insurance companies were to offer CNBR coverage, TRIA will pay for it. Right now, TRIA will pay workers' compensation aspects of CNBR coverage.

All we are doing is changing our offering provisions; I am skeptical we will change the market. That doesn't in any way suggest that it is not an issue, and it doesn't in any way suggest that we don't consider it. I am not here to say because it is not perfect, it isn't good. I want to be clear that changing the make available provision in the statute is unlikely within the TRIA construct to create a large market for CNBR. That was my only point.

Mr. CAPUANO. That is a fair point, and I accept it. Again, I am not sure, I don't know. If there are suggestions on how to do it, that would be very helpful.

Mr. DINALLO. I have two comments. One is I really do believe that the problem for underwriters is, again, pricing rationally is the far end of the curve. If you see it in health insurance, you see it in life insurance, and you see it in property insurance. So I think by putting it in, you will encourage a lot more pricing incapacity, and you will see a difference. That is my belief.

The other is what Ranking Member Pryce was getting at, and Congressman Feeney, is that it is maybe the area for a small experiment, which is if you put in a requirement or the option for tax-free reserving coupled with—this is what I wanted to tell you before, I forgot—you have to also adjust FASB 5, because there is a good argument that if you put in tax-free reserving, they can't take advantage of it because FASB 5 requires that the reserving—having been a company and done this, it is very difficult—the reserving has to be probable and estimatable. So you have to have

enough data to give a probability to it and an estimation to the event, like a litigation, say, for instance. You reserve for a litigation. You have a concept that it is going to cost you $40 million to pay it, and you have a greater than 50 percent chance of losing it, so you could reserve for it. That is the basic rule.

On terrorism, it is very hard, obviously, because all this discussion we are having, is very hard to both estimate and give a probability to it, so you may have to put in a change and an exception in a sense under FASB 5 accounting rules to be able to reserve for terrorism or CNBR events. And if you go for the tax-deferred reserving, I am almost certain the companies—I have talked to them about this—will feel a lot more calm from an FEC perspective and enforcement perspective if you give them some latitude on reserving there because technically they could be in violation of the reserving requirements.

Mr. CAPUANO. Thank you, gentlemen.

Chairman KANJORSKI. The former chairman of the subcommittee, my good friend from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

I have had casual interest in the topic in years past and want to renew a broad observation as opposed to specific elements of the bill before us.

It seems that in the prior efforts on terrorism extension, that we gradually, but with certainty, increased private market skin in the game while gradually, but with certainty, reduced taxpayer exposure. Note, Mr. Nason, that in your testimony, or in answer to questions, you said that private sector retentions were up year over year throughout the existing programs. This is in a period of time when U.S. commercial real estate has enjoyed significant profitability. Now, that doesn't appear on its face to represent a dilemma that requires us to now move to a system where we are going to set a 10-year program clock, which in essence means you don't reopen this thing until it is about to need reauthorization, expand the required classes of coverage, you freeze the ability after 1 year to significantly price-risk appropriately.

Is that likely, Mr. Nason, to bring more private capital into the market? Or what in a very broad systemic analysis—and make it short—do you think the two differing approaches offer to the taxpayer and to continue commercial real estate success?

Mr. NASON. Thank you for that question. I can keep it very short. It is a step in the wrong direction. What we have seen over the last 5 years is exactly what we had hoped to see.

Mr. BAKER. Great answer. You can stop there. Let me give you one more follow-up. Given that, and some have said make a suggestion about what we should do. Well, we should go back to—I wasn't really that enthused about the 2005 version, but that is a starting point and make modifications. If you start there, and you really must do something, if you just had a mandate urge and you just had to mandate at all costs, how about this? How about you tell people you must carry, and you must offer, but let the market price the risk?

Now, what does that mean to New York and what does that mean to Pennsylvania and what does that mean to Baton Rouge? That means if you have a relatively low likelihood of exposure to

claims, you are going to have a relatively, comparably speaking, low premium. But if you are in New York, guess what? You are going to pay more. Guess what? Katrina victims are going to pay incredibly higher premiums for property and casualty coverage if you live below Interstate 10 in south Louisiana.

That is fair. I am not even going to get into all the reset business. I am just going to simply say you ought to get Government out of the pricing business, preempt the State regulatory constraints on the market, and if you are going to mandate, which if you got the votes you will, then at least let market function work in response to your dictatorial requirements. Otherwise, I feel almost with a high degree of certainty, that there will be withdrawals from the markets, either involuntarily because of small claims against the little guys who can't afford a $50 million trigger, certainly can't afford a $100 million dollar trigger. And why, on the face of it, would we not accept a pooling mechanism, where companies could voluntarily enter into circumstances for voluntary pooling for tax-free reserves to offset against the adverse consequences of that $50 million trigger? That seemed to me to be a harmless give. It is not in the bill.

So there are very specific suggestions that can be made to help move this bill along in a significantly less threatening way to the United States taxpayer. Otherwise just nationalize the whole business. Just put the taxpayers on the bottom line and say if we have a car wreck on Third Street in downtown Baton Rouge we are going to cover it. We seem to be sliding slowly down that big hill. But there is just no sensibility in telling anybody in this country you must do something, and by the way we are not going to pay for it.

I yield back.

Chairman KANJORSKI. The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. The September 2006 report from the President's Working Group on Financial Markets concludes that, "No private market for CNBR terrorism insurance existed prior to September 11th, none exists today, and none is likely to exist in the foreseeable future." That conclusion is consistent with that of the GAO Office on NBCR Risks released at the same time.

Do you believe that the threat of terrorism—I am addressing this to either or both of you—do you believe the threat of terrorism in the United States has disappeared since 2005, when Congress extended TRIA?

Mr. NASON. I do not, no.

Mr. DINALLO. No. I don't believe it at all.

Mr. MOORE OF KANSAS. Well, we would certainly be in agreement on that. Are you aware of the State Department's Country Reports on Terrorism 2006, which concluded that global terrorist attacks increased over the last year, and that al Qaeda has rebuilt itself? Are you familiar with that?

Mr. DINALLO. I am not precisely familiar with the report, but it sounds like a logical, if not data supported, fact.

Mr. MOORE OF KANSAS. All right.

Mr. NASON. I have the same views as the superintendent.

Mr. MOORE OF KANSAS. Do you consider the State Department's report based on statistics from the National Counterterrorism Center to be credible? And if so, doesn't that suggest the continued need for TRIA with a NBCR component? If there is in fact a terrorist threat that still exists, and I think we all agree that is the case, shouldn't there be a TRIA with a NBCR component?

Mr. DINALLO. When I testified previously, I thought that NBCR should be included in TRIA, as this bill has. And part of it was actually, to get at Congressman Baker's point, which was that those are the events that will be so far off the curve that actually even if you are an unlikely target, compared to say New York City, those events drive the pricing.

Mr. MOORE OF KANSAS. Mr. Nason, do you have a comment?

Mr. NASON. Yes. My comment is that of course I am not going to challenge the conclusion that there is a terrorism threat. My only comment is a more technical one, which is that I am not sure that the provisions in H.R. 2761 are going to get you the market for CNBR that you are looking for.

Mr. MOORE OF KANSAS. To the best of your knowledge, has a significant private market for terrorism reinsurance been created since 2005, and does a private terrorism reinsurance market look likely to exist in the future, particularly for NBCR risks?

Mr. DINALLO. No.

Mr. NASON. If there is not primary coverage for CNBR risks, it is unlikely there is going to be reinsurance for CNBR risks. That is right.

Mr. MOORE OF KANSAS. Final question. Does it make sense in your opinion for Congress to continue extending TRIA in 2-year intervals or other short-term intervals, or does it make more sense from an economic and financial standpoint, and as a matter of public policy, to extend TRIA for a longer period of time, ideally until a time when we don't have to worry about terrorism and threat of terrorism in the future? Are 2-year extensions the way to go?

Mr. NASON. As I mentioned earlier, I don't believe a long-term extension is necessary. I don't think it is necessary to secure financing for commercial development. And I do think it will encourage market complacency. And I do think it will make sure that we don't continue to study the effects of the program going forward.

Mr. DINALLO. I think 2-year extensions are highly disruptive to both the insurance market and the real estate market, which seems to be the primary market that we are discussing today. I think from a pricing perspective, it gives a lot of uncertainty to both of those activities, especially in that short of a period.

Mr. MOORE OF KANSAS. Thank you.

Chairman KANJORSKI. Thank you, Mr. Moore. Mr. Roskam?

Mr. ROSKAM. Thank you, Mr. Chairman. Just a couple of quick questions really. Could you both comment on whether you believe NBCR is an insurable risk? And I have heard from a whole host of folks in the industry who have come into my office and said you can't put a number on this. You can't put a price tag on this. You can't put any predictable model around this. And it just strikes me that that is a threshold question that is really before us today. Do either of you have an opinion?

Mr. DINALLO. The markets will price anything if people are willing to pay for it. I think it is an insurable risk. I think Congressman Capuano's comments are well taken. Not all NBCR events are going to be of the trillion dollar variety. Some could be very much less. In fact, arguably, the Oklahoma City event was a chemical attack. It was built basically out of chemicals bought at Home Depot at the time, I think. And so you could argue that you could have quite a sizable event, but not a, you know, a $750 billion event that is an NBCR. I think that because of the lack of a backstop, because of a lack of chopping off the far end of the curve, which those events are the ones that drive the farthest end of the curve, it is therefore essentially impossible for insurers to price. If you put the backstop in place, they will price even on NBCR, because they are only going to be responsible, as we discussed today, for a certain portion of the curve.

Mr. ROSKAM. Okay. So your view is it is insurable absent that further extension of the curve, or it is predictable, or it is measurable and you can get your hands around it, but you can't get your hands around the top end. Mr. Secretary?

Mr. NASON. My view is that—and I am not an insurance underwriter—but my view is that the markets have struggled with this issue for years and years. The market has had a difficult time dealing with CNBR from terrorist events and from accidental events. I would say the State regulators have had problems with dealing with the insurability of CNBR risks. And the fact is that they have permitted exclusions for these because it is a very difficult thing to deal with from their perspective. And my view right now is the best evidence we have on the uninsurability or difficult aspects of this is the fact that today, right now, if an insurance company decided to offer CNBR coverage it would be backstopped by TRIA, and none of them are offering it, or to a very, very small extent are offering it.

I am not an insurance underwriter, so I don't want to say whether or not it is, but the evidence that I said in those three buckets seems to suggest strongly that it is an issue the insurance industry does not want to take on.

Mr. ROSKAM. Do you both have an opinion about the sort of natural pressure that takes place between—with State regulators, in particular maybe, Mr. Commissioner, what kind of pressure are you under to—I don't know if you are elected, in which case there is a certain type of natural pressure. If you are appointed, you are insulated from some of that pressure, depending upon how the appointment is structured, but you know what I am getting at. How much pressure are we putting State regulators under to underprice the coverage of NBCR?

Mr. DINALLO. I happen to be appointed.

Mr. ROSKAM. Which in this context is a good thing.

Mr. DINALLO. But I work for Eliot Spitzer, so I am under tremendous pressure all the time. The answer I think is that one of the reasons to have regulated pricing is because it is appropriate for the regulator, in partnership with the industry, to set prices for which the industry can accept. And my point is particularly with NBCR, where you have a mixed industry, both small and large, and the small industry has appropriately objected, as this com-

mittee has heard, to the burden for NBCR, it may be the exactly right time for there to be a certain, as you say, pricing pressure or artificiality that it is not a perfect market for the pricing, because if you priced it to the extent that say a Travelers could handle, it is not going to be something as say some of the smaller regionals can handle, and therefore it is probably an appropriate opportunity for a regulated price.

Mr. ROSKAM. Regulated by who? Regulated by you as the regulator or in negotiation back and forth?

Mr. DINALLO. Yes, in the property area, at least in New York State, it would be a price, it would be—we would end up in a—I use this term very carefully—a negotiated but regulated price.

Mr. ROSKAM. So negotiated in that you both have this ability—you have the ultimate stick, but they have the ability to pull out of the marketplace.

Mr. DINALLO. That is right. There are two kinds. There is file and use, where they just put it on the table, which is what we have with health insurance, and then there is prior approval, which essentially ends up with a worked out price. I think here, at least for some of it, we would be in that.

Mr. ROSKAM. You can imagine the scenario where you would have a popularly elected insurance commissioner, and I don't know how many of those there are around the country, I would assume that there are some—

Mr. DINALLO. Yes.

Mr. ROSKAM. —and would be under tremendous pressure then, just in the force of a political campaign, to drive the actual cost of that down. Mr. Secretary, do you have an opinion on any of that?

Mr. NASON. Sure. I mean generally what I would like to say is that price controls lead to ineffective pricing and inefficient economic outcomes. So whenever you have a Government regulatory body setting prices, you generally will force people in and out of the market, because the pricing is not right for the people to participate in a market. The argument I would add to this is that—and it is relevant to the CNBR debate—we haven't seen a lot of CNBR coverage despite the fact that most of these products, at least for the bigger urban areas or the large developers, they could buy these products outside of the regulated market in the surplus lines market, where there isn't as much—where there isn't any price controls. So the fact that you have full price discretion in those markets and you still don't see a lot of movement in this area seems to suggest what we may get if we change the make available provision here.

Mr. ROSKAM. Thank you both. Thank you, Mr. Chairman. I yield back.

Chairman KANJORSKI. Thank you very much. Mr. Scott of Georgia.

Mr. SCOTT. Thank you, Mr. Chairman. Let me ask this question first of Mr. Nason. Given the gravity of this issue, given the need for certainty, given the need for stability, what are your arguments against a 10-year extension?

Mr. NASON. I would argue that the insurance industry right now is in a much more stable place than it was after September 11th. We have enormous amounts of policyholder surplus that are, if I

am not precisely right, I want to be right, but we are at or above pre-September 11th levels in terms of policyholder surplus. So there is a significant amount of stability within the insurance industry right now. Even taking that into account, our view is that in order to continue to promote more stability, TRIA should just continue to build on the path of progress that we have seen in the last 5 years.

Mr. SCOTT. So what length of extension would you recommend?

Mr. NASON. I am trying to be constructive here, and saying that short term is better than 10 years, because I see 10 years as long term. I don't have a magic answer for you, whether it is 2 years, 3 years, 4 years, or 5 years. What we do believe, and we believe it is very important, is that it constantly be reevaluated. So short term requires a constant reevaluation.

Mr. SCOTT. Why would you think if it is 10 years, it would not be reevaluated?

Mr. NASON. Evidence of looking at how other Federal Government programs have kind of evolved and expanded over time seems to suggest the rigorous analysis associated with reauthorization would provide us the type of rigorous analysis that we at Treasury would be looking for.

Mr. SCOTT. Have we ever had another Government program with the magnitude, the tragic consequences of inaction of these terrorist attacks? Do we have something of a comparable level that we have done to compare it to?

Mr. NASON. I am not exactly sure how to answer that question. There have been temporary programs that have been reauthorized over a period of time. I certainly would in no way mean to suggest that terrorism isn't a very serious subject.

Mr. SCOTT. How do you feel about this, Mr.—

Mr. DINALLO. Dinallo.

Mr. SCOTT. —Dinallo. What is your recommendation on the best amount of time?

Mr. DINALLO. My recommendation when I first testified on this was either a permanency or 15 years, because I don't think you are going to ever get the amount of data that you will need for accurate pricing at the far end of the event horizon. And so I think that you are always going to have this problem. And in some sense it is a good problem that you have that you don't have so many events that you can actually accurately price. But it is a very bad situation, because underwriters are not going to step in when they are, as I said, pricing blind. And it is not about the—this is—I can't think of any other way to phrase it—the averagely priced terrorism event. It is about the far end of the curve that moves the median, it moves the average pricing for the rest of the curve, for the overall premium pricing. Because they have to take into account the largest events, and that drives up the prices for the more average pricing.

And so I think that you are always going to be faced with this problem, because the potential for a trillion dollar event exists, and the potential for things well in excess of $100 million exists. So Congress in its wisdom has put in a backstop, which is a form of subsidy, I suppose, but it is one that just permits there to be any pricing at all rather than none at a rational price.

I actually agree with Mr. Nason that one could argue that the backstop could be raised a bit. In other words, it is not as if the industry has shown a lack of ability to pay for these events. We are talking about how they would price for these events. And you could go in and say, well, we are going to change the backstop to a higher amount and see how that changes the pricing. They just need—I believe, this is my opinion—they just need some backstop so they can accurately price, because essentially it has a close to infinite end to the curve and without anything in place for a long period of time they can't accurately price.

Mr. SCOTT. Now, finally, you mentioned 10 or 15 years. Which would you recommend if you had your choice?

Mr. DINALLO. I would recommend 15 years for three reasons: It is longer than 10 years; it would encompass Oklahoma City if you changed the floor on the reset provision; and the mean of bond pricing duration for large scale real estate projects across the country, not just in New York, is clustered around 10 years, which means 10 years is an unfortunate number, because just when you begin to put TRIA in place, you are going to create uncertainty on those bond pricing, because they are 10-year bonds. So I would do 15 years because you would net a large, large percentage of the bonds also, which would give certainty to the financial markets which fund the real estate projects that we have been discussing today.

Mr. SCOTT. Thank you, sir. I yield back.

Chairman KANJORSKI. Thank you, Mr. Scott. The gentleman from Connecticut, Mr. Shays.

Mr. SHAYS. Thank you very much. Mr. Chairman, I note this is your first panel, and you have another panel that is not small. I would just like to say that Mr. Nason, I read your entire statement, which obviously you couldn't have read at this hearing, and the theme is pretty clear. You come right back to your three critical elements: that programming be made temporary and short term; that private sector retentions are increased; and that there is no expansion of the program. It seems to me that if you weighted it, number two, from my perspective, outweighs number one and number three big time. And the challenge we had is last time around this committee was able to use a jurisdictional issue of allowing for greater reserves to be built up through our pooling mechanism in the committee. But really, the Ways and Means Committee needs to weigh in on this. For me, unless we are able to allow companies to build up reserves, we don't have any other alternative than to move forward with the legislation that we have. It seems obvious to me. We are just not going to not do something.

I would like you to comment.

Mr. NASON. We would—any advancement in the private sector's ability to take on this risk in a more efficient way, that would be a step in the right direction from our perspective. There seems to be a question as to whether or not those reserving mechanisms will actually get you the more capacity that you are looking for, but it is certainly something.

Mr. SHAYS. Why wouldn't it get you there? Because one thing we can say is that a terrorist attack doesn't happen, at least not now, every day. But the attacks on the Twin Towers were in 1993 and

2001, so, you know, based on that calculation, 2009 is going to be an interesting year. I mean it is not going to happen every day, but when it happens it is going to be something we are well aware of.

My point to you is if they build up reserves over a course of 10, 15, or 20 years, wouldn't that be something we would want? And what kind of effort is the Administration making with, particularly Ways and Means, to see that happens?

Mr. NASON. Well, building up reserves is something that we want, and I am happy to work with the folks on Ways and Means to talk about that. But as to your first question, why wouldn't it get us there? Well, unless you require that those tax-free build-up reserves to be segregated to deal with terrorism risk or restrictions of that nature, there is nothing that would prevent the insurance company from using the tax-free build-up to pay a bigger dividend or write more policies. So there is a tension in terms of you are giving them a benefit, but—if you are giving them a benefit to deal with terrorism insurance, and you want to make sure that benefit is yielded—

Mr. SHAYS. That is not hard to do. Everything plows back into the reserve. Everything.

Mr. NASON. All right. So with the proper constraints it certainly is worth talking with Ways and Means about. I certainly agree.

Mr. SHAYS. Well, I think it is certainly worth more than talking. It is one of your basic three points. It is worth fighting for. Otherwise, I am going to go with the committee bill. Do you want to make a comment?

Mr. DINALLO. I would just urge you—I actually support that. And I would just urge you again to keep—for the subcommittee and Ways and Means to keep their eye on the ball of FSMI 5, as I said before. You put publicly traded companies in an uncomfortable position if you offer them this reserving opportunity, which some have kind of gotten into lots of trouble for, as we know, improperly reserving, if they can't be given some latitude under FSMI 5 for the must be estimable and—well, estimable and probable requirement. So you need to, along with changing the tax law, you need to probably change FSMI 5. It is a small adjustment, which I am sure they would support, and I don't think the SEC would come down on them like crazy, but you should probably do that.

I would also just say it is sort of an interesting question, you might also ask people to do the following study. Tax-deferred reserving or tax-free reserving is also a form of subsidy, right? You are saving—I mean you are doing something that is favorable to the industry there. They are not paying out taxes or giving policy money back. It would be an interesting question to just ask what kind of a benefit or subsidy is that to the insurance industry.

Mr. SHAYS. Or a cost to the Federal Government.

Mr. DINALLO. Yes. I meant on taxes that they are not paying, yes.

Mr. SHAYS. Exactly. The opportunity costs.

Mr. DINALLO. I don't know. It is an interesting trade-off. Maybe across the whole insurance industry, tax-free reserving is less—

Mr. SHAYS. I hear what you are saying, and it is a very helpful response. The bottom line for me is we can't raise those three points, though, without having it mean something. And the only

way you are going to see point two in your recommendation of your three critical points is if they are allowed to build up reserves.

Mr. NASON. I agree there are lots of ways to address point two, which is what we did in the 2005 extension as well, which is just increasing retention. And one way of getting there would be increasing reserves. So I agree with that.

Mr. SHAYS. Thank you.

Chairman KANJORSKI. Thank you very much. The gentlelady from Illinois, Ms. Bean.

Ms. BEAN. Thank you, Mr. Chairman, and to our panelists for your testimony today. Mr. Dinallo, it is a pleasure to see you again. I know you were kind enough to testify for those of us who traveled to New York for a hearing on this subject earlier in the year, and I think you, at that time, and earlier today, had eloquently stated your case for a longer term extension, I think ideally 15 years, of this TRIA bill. So I appreciate that.

My question is for Secretary Nason relative to the CNBR risks, and what the private sector is willing to do or not do relative to those risks. From what I have heard in some of your responses to some other questions, it appears you are not contradicting the conclusion that I am coming to that when the President's Working Group in late 2006 indicated that there was no private market for CNBR terrorism risk insurance prior to September 11th, that none exists today, and none is likely in the foreseeable future, it sounds like you are not contradicting that or suggesting that one has since developed. Is that correct?

Mr. NASON. That is correct.

Ms. BEAN. Okay. So that being the case, who should cover those risks from such a catastrophe?

Mr. NASON. There are two ways to look at it. There is a question as to whether or not the Government should participate in those markets, and there is a question about whether or not they should be uninsurable risks, as they have been for decades.

Ms. BEAN. And your own recommendation?

Mr. NASON. I believe it is something worth considering. What I am most concerned about is a hope, and it is just a hope, that the private market will evolve with some of the changes in H.R. 2761. I think that we need to have a broader discussion about what, if anything, to do about CNBR. And I don't think that changing the make available requirement is going to get you there. I wish I could give you an answer as to how to solve this problem, but it is a problem that has existed for decades.

Ms. BEAN. Thank you very much. I yield back.

Chairman KANJORSKI. Thank you. Mr. Donnelly?

Mr. DONNELLY. Thank you, Mr. Chairman. This would be for Mr. Nason. Do you think a TRIA period of 2 years would reduce the amount of investors in construction in a place like New York City or have an effect on values there? Would it create additional uncertainty?

Mr. NASON. Well, I will start with the end of the question, which is, would it create additional uncertainty? It might. What I would say is that if you look at what has happened in the last 5 years, we have had commercial development with the existence of a tem-

porary program. So I don't see construction stopping with a short-term extension of the TRIA program.

Mr. DONNELLY. So the extension to 10 years in your view would not—it would provide additional certainty for investors, but the 2-year program doesn't slow down the potential construction that would occur?

Mr. NASON. What I would say is the benefits—the negatives associated with a long-term program in terms of insuring market—basically insuring market complacency, insuring that we don't study this issue regularly outweighs the marginal amounts of uncertainty associated with 2 years simply because the facts are clear that commercial real estate is being developed with a short-term program.

Mr. DONNELLY. Thank you very much. I yield back, Mr. Chairman.

Chairman KANJORSKI. Thank you very much. And now to the ever patient lady from New York, who has been so involved in this program. To explain to the audience, we have not been ignoring the young lady, who showed up much earlier than most members, but because she is not a member of the subcommittee, she must wait until the end. Mrs. Maloney of New York.

Mrs. MALONEY. Thank you so much, Mr. Chairman. And I particularly want to thank you for responding to my request to come to New York and hear from our elected and business community about the tremendous need. And you did that very early on. It was very important. Our mayor, when he was a Republican, spoke passionately about the need for 15 years. And whatever party he is in, he is committed to this issue. Let me just put that straight. And he has called many of us repeatedly, expressing the need for 15 years. I want to underscore what our superintendent has testified so eloquently, that part of our homeland security is our economic security, and terrorists should not be able to dictate where we are going to build and expand in our country.

After that terrible event of 9/11, I thank all of my colleagues, and really this country, that responded to New York, who helped us in so many ways. But truly the most important way was TRIA, the antiterrorism risk insurance. Because before TRIA, respectfully, Mr. Nason, we could not build anything. All of our building stopped until we got TRIA. We weren't rebuilding. People were afraid to build without insurance. And what I am hearing from my constituents, and maybe we need to clarify that in another report, or more factual evidence, but what I hear from my constituents is that they cannot get insurance, and the insurance that they are getting now is predicated on an extension of TRIA. They are telling me that they get a policy that says TRIA will insure you until January, it is January of this year, when it expires. And if it expires, they have no more insurance. And they are paying through the roof for it. I have heard that some have even gone to London to get insurance, because even with the provision of getting it afterwards, they cannot get it. And I congratulate the Administration for really now supporting TRIA. At one point there was testimony and reports that we did not need it. And I congratulate Secretary Paulson and you and others that realize that we need this program. But I really

feel that we need it long term for the stability of our financial markets.

We heard in that testimony in New York that they could not rebuild lower Manhattan without a bill that gives at least 15 years, so that the bonds necessary to finance the rebuilding of Ground Zero can be issued. And I just would like to ask Superintendent Dinallo to really make clear the statement or clarify the need for a long-term stable solution. Really, we need to get a factual study, but what I am hearing from the real estate industry and from the trade organizations is that our people to this day cannot get insurance unless there is a guarantee that there is going to be a TRIA there, and if it is not there, then they don't get it.

So I would like you to clarify on that. And also I support his testimony to expand the reset. I think that was very, very important. I would like to ask him whether he thinks the reset should be made permanent.

Mr. DINALLO. On the 15 years, I would say that the most cogent driver of it is that you want these projects to be done by investment grade rated bonds that have a time horizon of at least 10 years. That seems to be the preferred method of financing, and it is increasingly the method of financing. So 10 years to me was just kind of an unfortunate number, because they are clustered, I am told, they are clustered around 10 years. And so you invite a lot more high grade bond investment if you are at 15 years, which is—I should have mentioned the grade quality of the bonds. I do believe that no matter what we do we will be back to this issue again. It will never be—"knock on wood" as one of the Congressman did—there will never be enough events that you would ever get accurate pricing such that you would ever seriously consider anything other than adjusting TRIA, which is what I think the Blue Ribbon Commission will ably do. So you could have it 15 years and still have the Commission weigh in with recommendations every couple of years. And you certainly are correct that without TRIA, there is not going to be a pricing possibility. And the longer you put it in place, I believe the more capacity you will attract to the market.

You had a second question, but I forgot. I apologize.

Mrs. MALONEY. Well, also the Blue Ribbon Commission, you mentioned your support for that. Could you indicate some of the issues you would like them to explore and possible people you would like to see appointed to it?

Mr. DINALLO. I think—well, I volunteered the department's expertise if it could be at all helpful. But what I was saying was, for instance, one of them we have hit upon today. I really believe that the tax-deferred reserving, for instance, is something that should be looked at, but it needs to be studied, the cost-benefit analysis needs to be done, and the proper adjustments to FSMI 5 and the tax code have to be put in place. And that might be an excellent thing, for instance, for the Blue Ribbon Commission to do.

Also whether reinsurance can be brought in, in a more robust way, is something that seems to be an issue here that should be discussed. And NBCR, I agree with Mr. Nason, it is a very complicated issue. And maybe that is something that in 2 years you see whether there has been takeup, and whether adjustments have to be made. You have to look at the markets and see whether you had

a negative impact on the small insurers through NBCR, because they seem to believe that is going to happen. And so I think it is a good way—to me what I heard about, I thought it was a rational compromise to putting in a long life span for TRIA, but saying but we are not just going to throw up this forever Federal program without adjustment, which I think is appropriate, and instead we are going to put in some experts to help adjust it along the way. And Congress, I would assume, would be able to deal with those changes not just every 15 years, but in a more regular periodicity.

Mrs. MALONEY. And also briefly on the reset provision, I certainly support your testimony to expand it, but do you believe it should be made permanent, the reset provision?

Mr. DINALLO. I think—I am in favor—I am a proponent of the reset provision applied nationally, encompassing all significant terrorist attacks. I don't think there should be a reset provision if someone throws a firecracker through a window. I think there should be a reset provision for all significant terrorist attacks. Because underwriters will rationally want to raise premiums and price higher for that jurisdiction based on experience. They are also mandated from a fiduciary duty point of view to do that. And I think that is really not how we should be dealing with terrorism coverage. It is not quite the same as car insurance coverage. If you have multiple accidents you should be paying a higher premium. But that goes to what kind of a driver you are for whatever reason, and the risk there needs to be accounted for by the insurance company. But here, if you have multiple terrorist attacks in a jurisdiction, well, I don't think that is something the jurisdiction should have to carry without something else that countervails the natural tendency of the reinsurers to shun away from that jurisdiction. I thought the reset provision was a good way to attract capacity and counterweigh against that natural shunning away based upon past events.

Mrs. MALONEY. My time has expired, but if I could just ask this one question of Treasury. Mr. Nason, you testified that Government has no role in NBCR, but you have no answer for how to deal with it. If Government has no role, and everyone agrees it is a huge threat, how do we deal with it?

Mr. NASON. I am not sure I testified that Government has no role. What I testified for is there is no current market for it. And what I also said is that I wish I had an answer for this to you, but this is a question that hasn't been answered for the decades where we have had nuclear risks. So I wish I had an answer for you, but I don't.

Mrs. MALONEY. Well, my time has expired. Thank you very much, Mr. Chairman, for your leadership. Thank you.

Chairman KANJORSKI. Thank you very much, Ms. Maloney.

Mrs. MALONEY. I thank particularly our superintendent from New York for your help on this issue. And thank you, Mr. Nason.

Chairman KANJORSKI. That completes the first panel. I want to thank the Secretary and the superintendent for being so patient with all of us. I want to note that there are probably members who may have additional questions of this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to

these witnesses and to place their responses in the record. Thank you very much, Mr. Secretary.

Mr. DINALLO. Thank you, Mr. Chairman.

Chairman KANJORSKI. We will get started with the second panel if we may. If I am counting correctly—do we have all eight in place? I think we do. Yes. Let me proceed with the introductions. We have the former Governor, the Honorable Mark Racicot, chief executive officer and president of the American Insurance Association. Then we have Mr. Christopher J. Nassetta, president and chief executive officer of Host Hotels and Resorts, Incorporated, and chairman of The Real Estate Roundtable, on behalf of the Coalition to Insure Against Terrorism. After that, we have Ms. Jill Dalton, managing director of global properties and multinational practice, Marsh, Incorporated, on behalf of the Council of Insurance Agents and Brokers.

Now I would like to call upon Mrs. Maloney to introduce her constituent.

Ms. MALONEY. Thank you, thank you so much. I am so thrilled that one of my friends and neighbors is here. I am delighted to introduce my constituent, Karen Emek. Dr. Emek is a partner in CBS Coverage Group, a major New York insurance agency, and she is widely regarded as an expert on insurance issues, and has literally testified before this committee many, many times. She has also played a leadership role in the industry for many, many years, most recently as the immediate past chair of the Independent Insurance Agents and Brokers of New York. She has been very involved in this issue of terrorism risk insurance, and is the author of numerous articles and testimony on the permanent solution to the problem, as well as TRIA as we know it.

I look forward, as always, to seeing her and hearing her testimony, and I thank you for this courtesy to allow me to introduce my constituent. Thank you.

Chairman KANJORSKI. Thank you, Ms. Maloney. And since she is your constituent, she must be brilliant.

Mr. Warren Heck is chairman and chief executive officer of Greater New York Mutual Insurance Company, on behalf of the National Association of Mutual Insurance Companies and the Property Casualty Insurance Association of America. Then we have, from the good Commonwealth of Pennsylvania, Dr. Howard Kunreuther, Cecilia Yen Koo professor of decision sciences and public policy, co-director of risk management and decision processes center, the Wharton School of the University of Pennsylvania. Mr. Frank Nutter, president, Reinsurance Association of America. And then finally, Mr. Dennis W. Smith, president and chief executive officer, Missouri Employers Mutual Insurance.

Welcome all. May I say that we are going to take your written statements and submit them in their entirety in the record.

Of course, as you heard, the last session carried on considerably longer than we thought it would. Although terrorism insurance is a very important subject, at 2:00 this afternoon, this room is being reserved for another hearing on housing. There are more people in housing than there are who buy risk insurance, therefore, they are going to throw us out of this room to allow the Housing Sub-

committee to proceed. So we are constrained to about an hour and 15 minutes.

With that in mind, I am going to ask my colleagues when they come up for questioning to certainly talk or ask questions for no longer than 5 minutes, and even rein them in from there.

The participants on the panel, I would ask you, knowing full well your full statement will be submitted for the record, to restrict your overall comments on your statement to 5 minutes so that we can move through the panel. That will give us approximately 40 minutes, and that will allow us approximately half an hour for questions after that.

May we start with the Governor?

STATEMENT OF THE HON. MARC RACICOT, CHIEF EXECUTIVE OFFICER AND PRESIDENT, AMERICAN INSURANCE ASSOCIATION

Mr. RACICOT. Thank you, Mr. Chairman. I would like to express AIA's deep appreciation for this committee's steadfast commitment to the TRIA program and the vital role it plays in protecting our Nation's economic security. I would also like to commend your recognition that more needs to be done to strengthen TRIA with respect to NBCR—nuclear, biological, chemical or radiological-related risk. I intend to offer brief remarks today to discuss three important aspects of H.R. 2761: Number one, the importance of a workable TRIA program to the health of the terrorism insurance market; number two, the critical need to address unique challenges posed by NBCR risk; and, number three, the need to preempt State regulatory constraints that impair, rather than enhance, private sector capacity.

First, the importance of TRIA and the urgent need for its extension. Every expert who has examined the program agrees that it has worked to make terrorism insurance more widely available and affordable. However, it is clear that we know more now about terrorism risk and terrorism insurance markets than we did in 2002. TRIA can be improved to better reflect 5 years of real world experience. To this end, several of the provisions of H.R. 2761 would improve the program's record of success. These include incorporation of domestic acts of terrorism, strengthening the program's duration, and maintaining the current per company retention levels for conventional terrorism attacks. We urge you to act decisively to keep these provisions intact. We also strongly advise that you advance the bill as quickly as possible in order to avoid the type of market disruption that thrives on uncertainty.

Second, the need for a more robust NBCR backstop. NBCR attacks are the 21st century equivalent of war, plain and simple, and they require a resolute response from our Government. A one kiloton bomb, which is about one-tenth of the size of the Hiroshima explosion, can be easily transported in a truck, a container ship, or even a backpack, and could devastate any U.S. city.

We support the bill's provisions to strengthen TRIA's NBCR provisions, and respectfully suggest that they could be made even more effective. The bill establishes a 7.5 percent insured deductible for NBCR events, in part to account for the inability of insurers to spread NBCR risk to any entity other than the Federal Govern-

ment. It also calibrates the co-shares paid by insurers depending on the magnitude of the loss above the per company retentions.

These are very positive steps. However, we believe that eliminating or further reducing the insurer co-share would help to build capacity to manage what remains a very difficult risk to understand and to quantify. The bill also recognizes that NBCR attacks may well exceed the current TRIA program cap of $100 billion. It therefore provides additional legal certainty to insurers by clarifying that the limits of an insurer's financial exposure to all losses, including workers' compensation and other State-mandated coverages, are limited to the carrier's applicable deductible and co-share payments. There are also provisions to reimburse insurers for payments exceeding the cap in certain defined situations.

It is indeed unfortunate that we need to grapple with scenarios where horrific terrorist attacks could result in losses that exceed the nearly unimaginable level of $100 billion. Nonetheless, we believe that H.R. 2761 deals with this situation in a fiscally responsible, sensible manner, and we highly commend the committee for the effort you have made in this regard.

Third and finally, it prevents States' regulations from undermining TRIA's goals. The current State regulatory system has made it more difficult for insurers to commit capacity to terrorism risk and provide policies that can be adapted to what policyholders really want. H.R. 2761 takes limited steps to preempt State regulation and terrorism risk insurance rates and forms that might undermine the program's basic objectives by reinstituting the year one limited rate form preemption of the original TRIA, but only for NBCR risk. This is a good start in our judgment, but insurers' experience during TRIA's first year of demonstration back in 2002 and 2003 reveals that the preemption was easily disregarded in some States. We believe that a stronger preemption would further improve the health of terrorism insurance markets.

The private property casualty industry system provided essential economic support in helping our Nation to recover from the tragedy of 9/11. Insurers and their policyholders have worked tirelessly to adjust to the new realities of terrorism risk. TRIA has played, and must continue to play, a critical role. At this important juncture, the program inevitably, in our judgment, must be extended and improved if we expect to preserve the economic security of this country.

Thank you, Mr. Chairman, for your efforts to do both through H.R. 2761.

[The prepared statement of Governor Racicot can be found on page 204 of the appendix.]

Chairman KANJORSKI. Thank you very much, Governor. Our second presenter will be Mr. Christopher J. Nassetta.

STATEMENT OF CHRISTOPHER J. NASSETTA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, HOST HOTEL AND RESORTS, INC., AND CHAIRMAN, THE REAL ESTATE ROUNDTABLE, ON BEHALF OF THE COALITION TO INSURE AGAINST TERRORISM

Mr. NASSETTA. Good morning, Chairman Kanjorski, and members of the subcommittee. Thank you very much for holding this

hearing and allowing me to testify today. My name is Chris Nassetta, and I am the CEO of Host Hotels and Resorts, one of the largest owner of hotels in the world. I also serve as chairman of the Real Estate Roundtable, and second vice chair of the National Association of Real Estate Investment Trusts. I am appearing today on behalf of the Coalition to Insure Against Terrorism, or CIAT.

CIAT represents a broad range of businesses and organizations from across key sectors of the U.S. economy, businesses that are the Nation's principal consumers of commercial property and casualty insurance. CIAT commends the sponsors of the Terrorism Risk Insurance Revision and Extension Act of 2007 for developing a proposal which is responsive to the major issues identified by CIAT and other stakeholders. We look forward to working with Congress and other stakeholders in completing this very important legislation.

Sometimes the subject of today's hearing is characterized as an insurance industry issue. I respectfully suggest that it is not. Instead, it is an issue of national economic security. It is ultimately an issue of jobs, and it is an issue of protecting the investments of pensioners, shareholders, bondholders, and individuals from across the Nation.

Since 9/11, you have worked hard to find solutions to the economic risks associated with terrorism. The terrorism insurance law you enacted certainly has been welcomed and very much appreciated. But the current law, as you know, is set to expire at the end of this year. Holding this hearing here today certainly demonstrates that you know that the essential facts that caused Congress to enact TRIA in 2002 have not changed. Terrorism continues to be an unpredictable threat, with potentially mammoth losses associated with it.

Insurers continue to say terrorism risk is uninsurable. Our economy continues to need terrorism insurance in order to function in the face of a continuing terrorist threat. American businesses must have adequate insurance and coverage to effectively manage economic risks and protect the economic value of their underlying assets. Without terrorism risk coverage, America's economic infrastructure would be totally exposed, and America's businesses, lenders, shareholders, pensioners, and bondholders would be forced to bear the full brunt of terrorism risk.

I support market solutions to problems, but the fact is that a meaningful private market for terrorism risk insurance has not existed and is not likely to develop. Terrorism risk is a national problem that requires a Federal solution.

I commend you for the work you have done in crafting H.R. 2761, and I am pleased to announce today that the Coalition to Insure Against Terrorism supports this legislation. This bill includes the key provisions proposed by CIAT over the past months. Perhaps most important to policyholders are four provisions. First, the program term would be extended to 10 years. We applaud you for recognizing that long-term extension affords policyholders with the certainty necessary for long-term projects and economic activity to move forward.

Second, the bill would eliminate the distinction between foreign and domestic acts. As the London bombings and the foiled Kennedy Airport plot demonstrate, we must be prepared for homegrown terrorism, as well as threats from abroad.

Third, the bill would give businesses the option to purchase insurance for the most catastrophic terrorism risks, the types of risks our Government warns us about repeatedly, by encouraging meaningful insurance against weapons of mass destruction through a mandatory make available program for nuclear, biological, chemical, and radiological—so-called NBCR—risks.

Fourth, the bill returns the program trigger to last year's level of $50 million, which should encourage smaller insurers to return or remain in this market.

In conclusion, we stand ready to assist this subcommittee and the Congress in enacting this very important legislation.

Thank you for the opportunity to testify here today, and I am happy to answer any questions you might have.

[The prepared statement of Mr. Nassetta can be found on page 183 of the appendix.]

Chairman KANJORSKI. Thank you, Mr. Nassetta. Our third presenter is Ms. Jill Dalton.

STATEMENT OF JILL M. DALTON, MANAGING DIRECTOR, GLOBAL PROPERTY AND MULTINATIONAL PRACTICE, MARSH, INC., ON BEHALF OF THE COUNCIL OF INSURANCE AGENTS AND BROKERS

Ms. DALTON. Good afternoon, Chairman Kanjorski, and members of the committee. Thank you very much. My name is Jill Dalton. I am a managing director at Marsh, and I am the leader of the terrorism specialty practice there. I am also very pleased here to be a representative of the Council of Insurance Agents and Brokers. And again thank you for your leadership on this issue. We are very glad that you are addressing the extension of the Terrorism Risk Insurance Act.

We have reviewed the draft bill that has been proposed, and for the most part, we support it. We like the 10-year term that is proposed because, as Mr. Nassetta said, our clients need the certainty of coverage in the long term.

Now, I know that when TRIA was first proposed that Marsh was a strong advocate for a short-term and a temporary solution. Instinctively, we don't necessarily support a large Government role in our business. So maybe this seems a little bit like a flip-flop, but the truth is that the assumptions we made in 2002 have not been realized. Back then, we thought that the reinsurance market would rebound with capacity, and we thought the risk would abate. It is really a simple equation of supply and demand. But we know now that the reinsurance market doesn't have nearly enough capacity to meet the demand, and there appears to be little appetite to expand the supply that they do offer.

We also know that the demand is high and is increasing. Marsh supplies data to the committee and our clients, which we have included in our written testimony, and based upon our data in 2006, 60 percent of Marsh's clients purchased property terrorism risk in 2006, and in the first quarter of 2007, it was 64 percent.

I would also like to point out that even with TRIA, not every client is able to buy all the coverage they want. Wisely, the insurers are carefully monitoring their accumulations, and they pay attention to the fire-following laws where they apply. Sometimes this means that underwriters offer reduced limits to our clients or they decline completely. And this is an especially big problem when terrorism insurance is required by lenders or through other contractual obligations.

Our data also debunks the myth that the risk of a terrorist attack is only a concern for large banks or real estate developers in the big cities. I will give you a few examples. In 2006, we saw takeup rates for educational institutions go up by 17 percent, and for energy concerns, it went up by 26 percent. Geographically, in the Midwest we saw takeup rates go from 58 percent to 63 percent, which is a meaningful increase.

So with the demand, the shortage of supply, and the fear of more events, which is heightened by the 2005 bombings in London, and more recently the arrests around the threats at Fort Dix and JFK, which were thankfully averted, we feel that the longer term program is needed, and so we thank you for your recognition of that.

We are also happy that the bill eliminates the distinction between domestic and foreign terrorism acts, and we are pleased to see the committee grappling with the difficult issue of the NBCR events. There definitely is a concern among policyholders that the next event could be a chemical or a biological attack, and if that happened tomorrow, it would be largely uninsured. We support this as an offer for make mandatory because even though it is included in the bill today, there is little or no offering for it. We recognize the insurers' concerns, which I am sure my colleagues down the row will talk about. So we are glad to see the committee's recognition of those concerns with the significantly reduced retention and the step down mechanism. It may not be enough to satisfy them, but again that is why we are here today, to talk about that. On this subject, the details of the bill will really matter. And as the committee goes forward, we hope that we can help out with that.

We think that separate pricing for our clients for NBCR and for conventional terrorism risk is very important. Our clients, we want to help them make informed decisions, and our objective is to make sure they have as many options as possible. We also want to see that this extension enhances capacity and doesn't undermine it.

To summarize, and to end up, we support the other provisions of the bill, the reduced trigger. We support the addition of group life. We support the changes to provide the legal certainty and to clarify the application of the cap. We as brokers know what can happen when a policyholder and an insurer have a disagreement over how these aggregates apply and how caps are applied. We support the formation of the Commission. And we will continue to provide our data, which we hope will help the group find a long-term, permanent solution that will benefit all the stakeholders.

So again Mr. Chairman, I want to thank you, and also Ranking Member Pryce, and the other members of the committee for your leadership, and for allowing me to appear before you today. Thank you.

[The prepared statement of Ms. Dalton can be found on page 78 of the appendix.]

Chairman KANJORSKI. Thank you, Ms. Dalton. Now, Ms. Emek.

STATEMENT OF SHARON EMEK, PH.D., C.I.C. PARTNER, CBS COVERAGE GROUP, INC., ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

Ms. EMEK. Good morning, Chairman Kanjorski, Ranking Member Pryce, and members of the subcommittee. My name is Sharon Emek, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America to present our association's perspective on terrorism insurance. I am currently a managing director and partner at CBS Coverage Group in New York, and also the immediate past Chair of the Board of the Independent Insurance Agents and Brokers of New York.

Members of the Big I, as we are known, serve as the intermediaries between consumers and insurance companies. We see the insurance market from both perspectives. We understand its capabilities and constraints.

I would like to begin by complimenting this committee and Congress for passing TRIA in 2002, and its extension in 2005. The Federal backstop created by these laws has worked well. However, as we all know, TRIA is again scheduled to expire at the end of this year. Without a long-term extension, we anticipate that coverage would become very expensive and not affordable to smaller and mid-sized businesses. And it is not just in big cities. It is crucial that all businesses have access to affordable insurance to protect them from this risk. Without affordable terrorism insurance, businesses are at risk of not only losing all their hard-earned assets, but putting all their employees and their families in economic jeopardy. And I personally have seen what can happen without proper protection in a catastrophe.

The Big I believes that a long-term private-public partnership remains essential to the challenge of keeping terrorism risk insurance available, and we fully support H.R. 2761's 10-year extension of the backstop. The terrorism insurance market is not ready to stand on its own by the end of this year, nor is it likely to be ready until such time as the threat of terrorism has significantly diminished.

All the experts have weighed in on the issue that terrorism does not fit within insurable criteria. The Big I believes that a long-term extension of TRIA is essential to maintain economic security in this country and to provide our businesses with certainty and the ability to do long-term planning. Businesses do not want to be left wondering whether they will still be able to obtain terrorism coverage in a few years. They need certainty, not only for peace of mind, but to carry out their business.

For example, some building projects in Manhattan require a 10-year builder's risk policy, and they need to know that terrorism risk will be covered.

H.R. 2761 also provides a number of provisions that would give insurers additional legal certainty, an important element to keep coverage affordable and to build more market capacity. Moreover, maintaining the current company deductibles and copays over the

extension period will keep small and regional insurance companies competitive, which is essential for maintaining available and affordable terrorism coverage. Accordingly, the Big I strongly supports these provisions of H.R. 2761.

We also believe that any long-term solution to protect the Nation's economy in the face of substantial terrorism losses must address potential losses from nuclear, biological, chemical, or radiological events. Although NBCR losses are perhaps the most catastrophic type of terrorist attacks, coverage for these types of losses is currently excluded from most terrorism insurance despite policyholders' desires for such coverage. H.R. 2761 would fill this gap and further enhance TRIA's vital public-private partnership by expanding its make available requirement to include NBCR.

The bill also recognizes the difficulties insurers face in providing this by providing a lower deductible and a step down mechanism to decrease insurer copayments for large NBCR events. We believe these provisions reasonably balance both consumers' needs for such insurance and insurers' difficulty in underwriting such exposures.

I would also like to stress the point that terrorism risk is not just a big city problem, which highlights the importance of maintaining a reasonable trigger level and the program to ensure coverage for all communities large and small. H.R. 2761 returns the trigger to $50 million, which is essential for small and regional insurance companies. It will create more capacity for these companies, enabling them to compete in higher concentrated risk environments. This will have a significant benefit for small businesses, whose offices and buildings are in these environments, as they will have more competitive premiums.

The Big I strongly supports this position. The Big I strongly supports the elimination of the distinction between domestic and international terrorism. Domestic terrorism, which presents many of the same characteristics as international terrorism, is a very serious threat, and coverage for this risk is largely unobtainable in the marketplace today. My business customers don't see a distinction between foreign and domestic terrorism and don't want this distinction in their insurance coverage.

H.R. 2761 wisely includes a number of provisions that facilitate long-term solutions over the course of the proposed 10-year extension, including reports from Treasury at regular intervals and a 19-member commission to propose solutions. The Big I strongly supports this approach, and is pleased that the views of the Independent Insurance Agents and Brokers will be represented on the commission. With the program's expiration only 6 months away, the need for action is urgent.

The Big I strongly supports H.R. 2761. This type of thoughtful approach is essential to insuring the affordability and availability of terrorism insurance.

We thank Representative Capuano and Chairman Frank for introducing this important legislation and thank Chairman Kanjorski and Ranking Member Pryce for holding the hearing today. We look forward to working with this committee and the House leadership to pass this bill.

Thank you.

[The prepared statement of Ms. Emek can be found on page 101 of the appendix.]

Chairman KANJORSKI. Thank you very much, Ms. Emek.

Our next witness is Mr. Heck.

STATEMENT OF WARREN HECK, CPCU, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GREATER NEW YORK MUTUAL INSURANCE COMPANY, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES AND THE PROPERTY CASUALTY INSURANCE ASSOCIATION OF AMERICA

Mr. HECK. Thank you, Chairman Kanjorski, and members of the committee. My name is Warren Heck, and I am chairman and chief executive officer of Greater New York Mutual Insurance Company. I am testifying today on behalf of the National Association of Mutual Insurance Companies, NAMIC, and the Property Casualty Insurers Association of America, PCI, who share many member companies in common. My views are informed by my firsthand experience as a major writer of terrorism risk insurance in New York City both before and after the horrific events of 9/11 and as chairman of NAMIC's TRIA Task Force.

Before turning to the point on which I wish to focus today, the mandatory inclusion of NBCR coverage, let me say that NAMIC and PCI strongly support all of the provisions of the new extension except for the NBCR provision.

I would also like to say something about the trigger, which we heard testimony on today. Earlier we heard that small and medium-sized companies do not have an exposure to the trigger, whether it is $50 million or $100 million, because it is an industry trigger, and nothing could be further from the truth of that. I speak to you as the chief underwriting officer of my company, a company that writes many, many properties in New York. We are the largest writer of co-op apartment buildings and office buildings, and those properties—as you know, New York has very large properties. We write properties up to $100 million on a single building. If we had a loss, a terrorism loss, that was under $100 million with a $100 million trigger, we would not have TRIA coverage. That would utilize at least a third of our surplus. So it might impair the company. And I just want to emphasize that the $50 million trigger is essential for small and medium-sized companies.

Getting into NBCR, most respectfully we do not believe that the bill should include NBCR coverage. Attacks utilizing weapons of mass destruction, NBCR, are the ultimate in uninsurable events and can have a qualitatively different consequence than non-NBCR risks. In contrast to the attacks on 9/11, for example, an attack in which a 10-kiloton-suitcase-type device was exploded 120 feet above the ground would kill everyone in the surrounding 30-mile radius and destroy or render unlivable all properties in that area. This type of threat presents dramatically larger and more concentrated risk exposure than any other threat we know of.

Providing our citizens with financial protection against attacks using weapons of mass destruction is fundamentally a duty of the Federal Government, not the insurance industry. For that reason, except for workers' compensation, all States allow, and most commercial property insurance property contain, nuclear exclusions.

All States also allow nuclear radiation exclusions, and most policies contain filed and approved nuclear pollution exclusions. That is how the private sector insurance industry and its regulators have historically handled NBCR risk.

As for the capital markets, while they have limited appetite for non-NBCR terrorism risk, they have zero appetite for NBCR coverage. In this regard, they take their signals from the reinsurance market. Given the market's response, NAMIC and PCI believe strongly that the Congress should not overturn State law and rewrite insurance contracts to include these uninsurable risks.

I would also note that demand for private NBCR coverage appears to be focused narrowly on large and commercial developments in a few at-risk cities. It does not appear to be widespread throughout the economy. Moreover, construction activity, as we heard today, has recovered from its post-9/11 losses without this protection. Rolling NBCR into terrorism coverage would likely result in significantly increased premiums and have the unintended effect of reducing the take-up rate for terrorism insurance.

Requiring any retention of the NBCR risk by primary insurers even when the Federal program bears most of the risk would be counterproductive if insurers cannot find private reinsurance and are unable to resolve a set of very serious operational concerns and issues. Importantly, because insurers would be immediately required to have capital sufficient to back this new risk and would face potentially reduced financial strength ratings, we would also expect to see an immediate diminution of capacity available to provide this coverage. Many small and mutual insurers would probably not be able to raise sufficient capital quickly enough to stay in business. The most likely outcome would be reduced, not expanded, capacity for all lines of insurance as insurers divert capital from other products to support this risk they would be required to bear.

In addition, creating new stand-alone NBCR coverage would lead to adverse selection in that only the most vulnerable risks would opt for the coverage.

NAMIC and PCI agree that we should address this issue of NBCR risk, but requiring retention of any level of NBCR risk by primary insurers, even with a significant level of Federal participation, could jeopardize the market for terrorism coverage. The 2005 RAND Center for Terrorism Risk Management Policy report concluded that NBCR attacks, "pose a challenge that may be most appropriately covered through a direct Government insurance program."

NAMIC and PCI recommend that rather than rushing in to add NBCR to an effectively working TRIA program, Congress should commission a study to include the complex economic, legal, moral, and practical issues surrounding the losses from weapons of mass destruction.

We also heard today something about the American Academy report of about a year ago in which they indicated that a nuclear attack in New York could amount to as much as $778 billion. We heard from several people testifying that the insurance industry can handle that. It is hard to understand how the industry can handle that when the industry has capital which totals about $750

billion. And, of course, we all know that capital is allocated to other lines; it is not only for terrorism.

Mr. Chairman and committee members, thank you again for the opportunity to talk with you today on this issue of vital importance to me, NAMIC and PCI, member companies, policyholders and the U.S. economy. The proposal before you goes a long way toward establishing an effective long-term terrorism insurance plan to maximize the ability of our country to recover from terrorist attacks. We urge you to remove the NBCR make-available requirement and to move the legislation forward. Thank you.

[The prepared statement of Mr. Heck can be found on page 109 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Heck.

Dr. Kunreuther, from the University of Pennsylvania.

STATEMENT OF DR. HOWARD KUNREUTHER, PH.D., CECILIA YEN KOO PROFESSOR OF DECISION SCIENCES AND PUBLIC POLICY, CO-DIRECTOR RISK MANAGEMENT AND DECISION PROCESSES CENTER, WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Mr. KUNREUTHER. Thank you, Chairman Kanjorski, and members of the subcommittee. It is a real honor to be here today, and I appreciate the opportunity to have a chance to share some ideas with respect to the new bill and some general principles.

I should say at the outset, our Wharton Risk Management and Decision Processes Center has been studying low-probability, high-consequence events over the last 23 years, and in particular, since 9/11, we have focused on the challenges associated with terrorism insurance.

What I would like to do in these 5 minutes is three things: One, to summarize a few key principles which should guide the analyses of insurance and other risk-transfer mechanisms for dealing with extreme events; two, to indicate what are some of the special features of terrorism that need to be considered in determining whether this risk is insurable through some public-private partnership; and three, to discuss how these principles and special features tie into the current bill. And I will be very brief here because my prepared statement includes a great deal more information.

First on principles, risk-based premiums, principle, number one. Insurance and reinsurance premiums should reflect the risk to the extent possible, for two principal reasons. One is it signals to people living in hazard-prone areas or wherever they may live what hazards they face and encourages them to engage in mitigation measures to the extent that this is feasible.

Second principle, equitability. Insurance and risk-transfer mechanisms should be fair to insurers, reinsurers, policyholders, and the general taxpayer where there is Federal participation.

Third principle: Insurers will want to minimize the likelihood of insolvency.

Fourth principle: There should be sufficient demand for coverage so that insurers can feel that they can market it.

Fifth principle: You should minimize gaming. There shouldn't be economic incentives for insurers or policyholders to take advantage

of provisions of the insurance or risk-transfer programs by undertaking strategic behavior.

Let us turn to terrorism. Terrorism really differs from other events that are insurable, like automobile or even natural hazards. It has certain characteristics. I want to highlight three of them here. One is the potential for catastrophic losses that we have heard about from many of our witnesses throughout the day, and clearly the committee is very aware of. It is very hard to put a probability on these events, and the losses can be catastrophic. The recent RAND study on nuclear bombs concluded that it can cause $630 billion in damage to commercial property and workers' compensation claims from that kind of an accident. So we have issues associated with the possibility of insolvency of some insurers if the private sector is going to handle this on its own.

Second, interdependent security. This is an issue that we have been spending a good deal of time on over the last few years. Interdependencies can cause problems even indirectly. I will give you one example that we are all aware of. In the case of the 9/11 attacks, security failures at Boston's Logan Airport led to crashes at the World Trade Center, and any protective efforts that could have been taken would have been useless given what happened. And so we do have this question of interdependency.

And the third—and this really differs from natural hazards. There is a shifting to unprotected targets. The terrorists may respond to security measures by shifting their attention to more vulnerable targets. They may choose those less protected targets simply because there may be heightened security in other areas.

There are other aspects as well, but I don't have time at the moment to go through them. What I would like to do is just highlight a few features of the bill and raise them for your consideration as you go forward with respect to these principles.

First, on risk-based premiums. Even though it may be difficult to achieve risk-based premiums for terrorism, State insurance regulators should not restrict rates unduly to the extent that insurers will not want to offer terrorism coverage. Currently, some States limit the premiums that insurers can charge for terrorism coverage.

Secondly, on equitability. There are several features of this bill that are very attractive on these grounds. First the notion of reducing the trigger from $100 million to $50 million really helps the small companies. We heard from Mr. Heck and other witnesses that this may be a very important aspect.

Second, including domestic and foreign terrorist attacks as issues for TRIA makes good sense because it is very difficult to necessarily distinguish between them.

The third consideration is equitability, which is one I know that the committee has considered, has been part of the other bills, is who should pay for the losses following a terrorist attack? We have done some studies on this in terms of the current TRIA legislation and have concluded that anything below a $25 billion loss, insurers will fully cover, between a $25 billion and a $40 billion loss, insurers and policyholders will share the costs with the proportions depending on how many policyholders purchase coverage. When the

losses are at $100 billion, the taxpayers will pay about 50 percent of the loss.

The final principle is to minimize gaming. If TRIA is reviewed on a regular basis, this reduces the likelihood of insurers engaging in gaming behavior.

Let me conclude with a few summary points. The extension of TRIA is an important and necessary solution to providing insurance protection to commercial firms. The current bill should address the five key principles that I put forward. The bill does create a Blue Ribbon Commission to propose long-term solutions for covering terrorism risk by the private industry. Such a commission in consultation with the Presidential Working Group and financial markets could explore the objectives of a terrorist risk-financing program, how to achieve them through alternative risk-sharing and risk-reducing mechanisms, such as more effectively deploying the capital of reinsurers, facilitating the use of terrorism insurance-linked securities, the reserving question that has been discussed this morning, mutual insurance pools, and developing incentive programs for encouraging mitigation and investment in security. Finally, the Commission could also examine how other countries cope with the terrorism risk to determine whether these approaches merit consideration for the United States.

Thank you very much for the honor to be able to testify here this morning.

Chairman KANJORSKI. Thank you very much, Professor.

[The prepared statement of Dr. Kunreuther can be found on page 124 of the appendix.]

Chairman KANJORSKI. Mr. Frank Nutter.

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

Mr. NUTTER. Mr. Chairman, I represent today the Reinsurance Association of America. It is an honor to appear before the committee. The Association represents property and casualty companies specializing in assuming reinsurance. We wish to applaud you, Mr. Chairman, and Ranking Member Pryce, for your leadership on this issue. We also thank the members of the committee that have sponsored this legislation.

Reinsurance is commonly referred to as the insurance of insurance companies. One of the most important purposes is to protect insurers from catastrophic losses resulting from various perils, including hurricanes, earthquakes, fires, and floods. To this end, reinsurers have assisted in the recovery after virtually every major catastrophic event in the country. With respect to the events of September 11th, two-thirds of the losses that were absorbed by the insurance industry were passed through to the reinsurance industry.

The RAA strongly supported the adoption of TRIA in 2002 and its extension in 2005. We believe the program is necessary and working well. The RAA supports H.R. 2761 as an important step toward the continuation of this Federal program.

We understand the committee's interest in understanding the impact certain features of the proposal may have on the growth of the private reinsurance market under the program and thus offer

the following observations. With respect to program duration, we applaud the bill's sponsor for acknowledging that a 2-year extension is commercially very difficult. An extended program will provide an opportunity for insurers to continue to build capacity. There is no reason to believe at this point that private reinsurance will significantly develop over the next 10 years, thus a continued public-private program for an extended period is appropriate.

With regard to the copays and deductibles, the RAA supports maintaining a 20 percent direct earned premium deductible and the 15 percent copay. We believe retentions provide plenty of room for the private reinsurance market to operate under the program.

With regard to the event size, the RAA supports lowering the event size to provide small companies with meaningful protection. The RAA supports the addition of group life as a covered line under this legislation.

With respect to NBCR and the mandatory offer, we have not taken a position on this, largely because reinsurance is not covered under the legislation. But it should be noted that there is even less private reinsurance for NBCR risk than for conventional terrorism risk. It is very difficult, and it will continue to be very difficult for direct companies to purchase private reinsurance to help them manage their 7.5 percent NBCR retention.

We support the creation of a Blue Ribbon Commission to study long-term solutions, and appreciate the committee's and the bill's supporters inclusion of reinsurance representatives.

We also support something that has been mentioned by several members of the panel, and that is that the committee should consider including a key market reform that addresses the challenges that the State regulatory system pose for direct companies in managing this risk. State regulation of terrorism insurance rates and forms can undermine the program's basic objectives and should be preempted.

Primary insurers seek private reinsurance to help reduce the large gap in terror coverage they face under the company retention and the loss-sharing provisions of TRIA. The industry retention under TRIA, which we roughly estimate to be $35 billion, leaves plenty of room for private reinsurance to operate. Five-and-a-half years into this program, the reinsurance market is only providing about $6 billion to $8 billion of reinsurance protection for primary insurance companies. Observations by some that TRIA may be infringing on the development of a private reinsurance market are, in our view, without basis. In fact, the opposite is true. TRIA has established definitive loss parameters that provide reinsurers with a defined layer in which to share the retained risk of loss the primary insurers face.

Favorable loss experience and surplus growth may moderately increase the supply of private reinsurance terrorism coverage, but not to the extent that it would fill the current capacity needs of the primary industry. NBCR capacity is believed to be about 15 to 20 percent of the non-NBCR capacity for terrorism provided by the reinsurance market, and when it is available, pricing for coverage that includes NBCR is reported to be at a significant premium and coverage amounts restricted.

One key question asked by policymakers is the role that capital markets may play in assuming terrorism insurance risks through the use of catastrophe bonds, which have been used increasingly by the financial markets to absorb and spread natural catastrophe risk. I have included in my statement the size of the catastrophe bond market. It should also be noted that nearly $32 billion of new capital is created in the reinsurance area since Hurricane Katrina, yet none of this new capital has been dedicated to terrorism risk because the capital markets lack any real appetite for terrorism coverage.

There is no reason to believe that terrorism bonds or capital markets are likely to be a significant provider of terrorism coverage in the foreseeable future. Due to the nature of the terrorism peril, the RAA believes that private-market mechanisms alone are insufficient to spread the risk of catastrophe terrorism loss in a meaningful way. The RAA believes that H.R. 2761 goes a long way towards establishing an effective long-term solution. Thank you.

[The prepared statement of Mr. Nutter can be found on page 192 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Nutter.

Our final presenter is Mr. Dennis Smith.

STATEMENT OF DENNIS W. SMITH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MISSOURI EMPLOYERS MUTUAL INSURANCE

Mr. SMITH. Thank you, Mr. Chairman. Chairman Kanjorski, and Ranking Member Pryce, thank you for the opportunity to come here. Having been a former State senator in Missouri, I can appreciate the complexity and difficulty of your decisions, so I applaud you.

Missouri Employers Mutual Insurance was established by the legislature in 1993. I am also the first vice president of the American Association of State Compensation Insurance Funds. There are 26 such funds in the Nation, the Commonwealth of Pennsylvania among them. Ohio, New York, Arizona, Texas, California, Colorado, Oklahoma, Louisiana, New Mexico and several others, all of those are ones that are represented on the committee, Mr. Chairman.

The State funds support the extension of TRIA, and the length of the extension you have proposed should bring stability to the marketplace. However, for reasons I will set out in my testimony, further changes to the trigger levels, copays, and deductibles are crucial to the ability of State funds to survive financially a catastrophic event.

State funds for insuring workers' compensation are very unique, in a very unique line. In that regard, most State funds are the markets of last resort in their respective States, therefore, they are always in the market. They cannot deny coverage. There are no exclusions. It is a statutory coverage including all terrorism events, NBCR and everything else. Injuries have a very long tail. Many single-claimant losses can result in multimillion-dollar cases, and can last for in excess of 40 years. So in that unique nature, Mr. Chairman, one of our requests is that you consider the possibility

of State funds or some element of them to be included on the Blue Ribbon Commission because of the unique nature.

As I said, Treasury Secretary Nason indicated that if we wrote risk in a certain area, concentrated risk in a certain area, that is not good insurance practice. I will submit to the committee, Mr. Chairman, that we do not have that choice by-and-large. We have to insure them no matter what. Should an event, NBCR or other terrorism, occur in a high-risk concentration area, solvency of the State fund would be threatened, and it would not be there for other normal injuries that occur on a regular basis.

Mr. Chairman, there is a trio of TRIA provisions that holds especially negative consequences for State funds in the event of a terrorism loss: high program trigger; high deductibles; and high copays. The current trigger of $100 million could consume the entire surplus of Missouri Employers Mutual and all or a substantial portion of other State funds surplus. The trigger of $50 million would therefore be an improvement. Nevertheless even this reduced trigger, along with deductibles and copays, would consume such a large percentage of our policyholder surplus, that they could threaten our solvency and our rating by the rating bureaus. Leaving the deductibles copays unchanged has the effect of substantially mitigating any potential relief offered by a lower trigger; therefore, I urge the committee to seek further trigger reductions as the legislative process moves forward.

What is the real exposure here? I think it was alluded to a couple of times that it would be difficult for an entity to have this kind of loss. We had modeling done by Guy Carpenter, who is a recognized international reinsurance broker, and they said a 2-ton bomb in one of our strategically placed sports venues that we have insured on a regular basis over the years in a large city in Missouri would create a $200 million workers' comp loss. That is just a 2-ton bomb, Mr. Chairman, not a 5-ton or not an NBCR event. That would, therefore, make us insolvent, and without these funds in place, the taxpayers of the State would be required to pick up the costs in the case of an insolvency. This is from an attack on the United States, we think, and not on our State in particular.

Mr. Chairman, in your consideration of extending the Federal terrorism insurance program, it is crucial to recognize the impact that high program triggers, and copays and deductibles will have on smaller insurers and on State fund insurers. We do not have the discretion to withdraw from our market if high triggers, copays, and deductibles create unreasonable financial risks for the size of our policyholders' surplus. Terrorism exposure under the current terms clearly puts safety and soundness of my company and other State funds at risk in the event of a catastrophic terrorist attack.

I urge the committee to adopt lower triggers along with lower copays and deductibles for both conventional terrorism and NBCR coverage. Such action will provide the meaningful backstop necessary to preserve the viability of this important coverage when it is most urgently needed.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Smith.

[The prepared statement of Mr. Smith can be found on page 210 of the appendix.]

Chairman KANJORSKI. Well, thank you to the whole panel for being concise. I think it would be reasonable to say that this panel supports the authorization and reenactment and an extension of TRIA; is that correct? Did I miss something? That is a good question. Are there any specific parts of it that are so onerous to any member of the panel that if they are included in the final legislation, you would prefer to have no legislation as opposed to those onerous parts, such as NBCR?

Mr. HECK. I could take a stab at that. You know, I have a great fear that the inclusion of NBCR mandatory make available is going to undermine the program. The program has worked very, very successfully. We see the availability is there. The take-up rate has been increasing. I think if you add NBCR, you are going to lose the smaller companies.

We all know that in an extreme event, there are going to be a lot of failures of insurance companies. It is not the kind of exposure that private industry can assume, I believe, in private enterprise, and if we had a product that we could put out on the market, charge a premium, and we think could work for us, we would certainly adopt NBCR. It just isn't something that private carriers can do.

Chairman KANJORSKI. I tend to agree with your position, with one or two elements. One, if we have such an attack on a large scale, a $750 billion event, I suspect that the country will be substantially shaken to its core, and potentially could fail to survive economically as a result of that event.

Secondly, the experience that we had after 9/11 was that it really did take 6 to 12 weeks to even get a piece of legislation structured and put together. Then ultimately, because of the ridiculous handling by the Administration, it took us 14 months to have it on the street and in place. If we get a nuclear-type attack or chemical-type attack, this will force us to pre-think how things should be handled. At least we will have had some thought out there as to how to respond to it without just waiting for the Congress to come together and act. That is basically our thinking.

Mr. HECK. Well, you know, I agree with that; however, I think we should implement something that is workable. And if you really think about what the industry can do, the industry could be a great help. It has thousands of personnel that are involved in adjusting claims. It can assist in recovery from a terrible, horrific event, but it doesn't have the capital to pay the losses. And to have companies fail at a time when there is such chaos in the country after a horrible event like, you know, a weapon of mass destruction killing people and destroying a lot of property doesn't seem to make sense. And in addition to that, I think we are going to lose a lot of policyholders from the take-up rate.

Chairman KANJORSKI. What would you think if we were able to lower the deductible to a de minimis level?

Mr. HECK. I don't think it is the deductible that is the problem, I think it is the coinsurance, because if you take 15 percent of a $750 million event—and, you know, we talk about the industry event. There are individual companies that are much smaller. They can't sustain that kind of a loss. So really it is the coinsurance that

is a problem. If you eliminated the coinsurance, that could be helpful.

Chairman KANJORSKI. Well, I am pleased to hear your—

Mr. KUNREUTHER. Can I make a very brief comment on this, Mr. Chairman? There are two key issues, it seems to me, that need to be put on the table with respect to NCBR. One is who is going to be providing that coverage? It may very well be that the larger firms are the ones who are going to have to deal with that. And we have heard it this morning. It may be very difficult for the small firms to do that.

The second point relates to the State regulatory agencies and what role they will play in terms of restricting rates, because to the extent that they say, you can't charge more than a certain amount, that could be a problem.

And then the third point that we are all aware of is that it is included in workers' compensation today, and the fact that it is included in workers' compensation requires some kind of treatment, I think, in terms of how one will deal with that. So I just want to put those three issues on the table

Mr. HECK. Can I make one point about that? If you look at all of the insurance companies, there are a lot of insurance companies in our country. The number that have either writings or capital structures, surplus of $1 billion or more, very, very small number. It is under 60. It is under 60 companies in the whole United States that have in excess of $1 billion in surplus and $1 billion in writings.

It is essential that we keep the small companies in the business of writing insurance, including workers' compensation. I believe when you eliminate all the large companies, the smaller companies—I read a statistic recently—have over 40 percent of all the workers' compensation business. So I don't think—and if you look at my company, it is a medium-sized company. We are the fourth largest writer of commercial multiperil in New York State. We insure a great amount of New York City. We couldn't stay in the business. So I think it is a serious matter if we eliminate the smaller companies.

Chairman KANJORSKI. No, I agree with you. That is one of the reasons we wanted to reduce the trigger mechanism, in order to get some coverage in there.

That is a segue into something else that I ask generally: reset. Are there any strong feelings, as I have, on reset? And if we were to change reset, would that cause you to not support the continuation and reauthorization of the legislation? Is there anybody that wants to address the reset issue? Or do you just want to be politically nice and put it on the shelf?

Ms. EMEK. I would be glad to address it.

We support the reset, and Superintendent Dinallo's point about making it cover Oklahoma City and other areas so that it is more equitable makes sense.

Chairman KANJORSKI. I appreciate you are generally in the New York area, so stay consistent. There is nothing wrong with that. But if we were to change it, make it only prospective or actually do away with it as it exists today, would that cause you not to want us to pass an additional extension?

Ms. EMEK. Absolutely not. We would totally still support passing the legislation. I would like to just add, the same thing holds true for NBCR. I think that is the first legislation. It is better to have something in place than to have nothing in place. We have to be proactive. We can fix it as we go along, as we see the take-up rates in NBCR. So the key here is to get this legislation passed as quickly as possible, and then we can fix things as we see things come up.

Chairman KANJORSKI. Very good.

Mr. RACICOT. Mr. Chairman, can I just offer one thought or comment about both of those questions?

Chairman KANJORSKI. Sure.

Mr. RACICOT. I believe that there is a certain misimpression about retention levels and deductibles contributing to capacity. Simply by increasing those numbers, cosmetically it appears at first glance that somehow private markets have more invested in the process. Literally the reason that you see more coverage available, more take-up rates and a decline in cost is because TRIA is in place and offers some boundaries to the potential insolvency or financial risk to the individual companies regardless of size. So it is a fact that the reset mechanism will, in fact, increase capacity for those very same reasons. But I don't know a company that I work with that writes to 20 percent of their direct written premium because they are placing 20 percent of their company at risk by doing so. So you can increase that to 25 percent or 30 percent if you want, but it will not provide one additional dollar. In fact, it may diminish what is available because they have to plan to that number.

And that is why this notion that somehow just simply cosmetically rearranging the numbers, which really have no relationship to anything to begin with, will somehow increase capacity is a fallacy. And that is the sad circumstance surrounding, I think, some of the testimony this morning we heard from Treasury. They make that assumption. They simply don't want to be confused by the facts.

Chairman KANJORSKI. Thank you very much, Governor.

I will pass it on to my good friend, Ranking Member Pryce, so we can keep to our time constraints.

Ms. PRYCE. Thank you very much, Mr. Chairman. And I want to add my thanks for the panel's patience. It has been a long morning and dragging into a longer afternoon.

I am sorry that I missed your testimony, Governor Racicot, and Mr. Nassetta. Is that how you say it? Nassetta. All right. It is the glasses.

Anyway, but I do appreciate the insights that we have all gathered today from your expertise.

Now, it is no mystery to anyone that many people on this side of the room up here believe that this is too long a bill in duration; that we as a Congress need to oversee these types of programs on a more regular basis; that 10 years doesn't even give us the institutional memory, as you once referred to it, Mr. Chairman, of having the same group of members even around when the next reauthorization comes.

And, Professor Kunreuther, you mentioned something in your testimony that I am curious about, and I am not even sure what it means, but you use the term "gaming." I mean, is that in the common parlance definition of gaming? Or what is gaming, and how would a shorter duration help us to eliminate gaming?

Mr. KUNREUTHER. Well, I appreciate the fact that term can be interpreted in many different ways, particularly the word, "game," so let me explain what at least we have done in terms of raising that question.

There are opportunities, particularly if a program is permanent, for some insurers, particularly depending upon their deductible surplus levels, to actually take steps by insuring very, very large blocks of property in one area where, after it actually exceeds the deductible surplus level, they only have to pay 10 percent of the loss because then it gets transferred on to other commercial policyholders. And we point that out, and I point that out in my written statement as to how that might actually work. But what essentially it does is it says you don't want to have a situation which is inequitable because everyone else is paying for the losses simply because one insurer is then only having to pay 10 percent and all the other policyholders pay more.

Now, that will logically not happen if it turns out a program is reviewed on a more regular basis or—and the Blue Ribbon Commission is a part of that whole process—if there is a way of taking a look at that. If there was a permanent program in place, there could easily be incentives for that to happen.

So we just point that out, not necessarily saying that it will happen. We have some caveats as to why it may not happen. But we also wanted to raise the issue in general that strategizing in the context of a program is something you would want to avoid. This is one example of that, and the fact that you could have a more regular review—and I don't want to come down on any terms of time period, but rather to say, you know, that it is a regular review, and also you have people looking at the program is an important element in terms of going forward.

And I would be happy to talk further with obviously you and other members about that at another time. I don't want to monopolize—

Ms. PRYCE. Okay. I think that is one of many reasons that we probably would prefer a shorter duration.

I am also very interested in anyone on this panel's impressions as to the reserving that would be required as a result of some of these mandates and how we might better prepare the insurance industry with the tools they need in terms of our tax code and whatever else we could do to make that more sensible. And whoever wants to go first may.

Mr. HECK. I could comment on that. I think if we had such a program to enable carriers over time to set money aside, we know that these extreme events are not frequency events, they are severity. They may not happen for 5, 10, or 20 years, and if companies have the ability to set reserves without paying taxes on those funds, they could accumulate enough money to pay a loss when it does occur. So it is something worth considering.

Ms. PRYCE. And so what if they don't have these reserves? Then who pays the loss? I guess I don't understand—

Mr. HECK. They take it out of their surplus. The money that goes into surplus is taxed money by the time it gets into its surplus, and so it accumulates at a very, very slow pace. If there is a way to revise the tax code so that companies can set reserves prior to declaring those moneys as net income, then they can set that money aside. So it is a way to build the reserve for an eventual event that could be catastrophic, and it is really a very good idea.

Ms. PRYCE. Anybody else care to comment on that?

Mr. NUTTER. If I could just offer a comment. There are several moving parts here. I just remind you that one of the things that Superintendent Dinallo mentioned is that you do have accounting guidance that also is at play here. The insurance commissioners and the NAIC have statutory accounting requirements which do not permit this now, and the premise for not having reserves of this nature is that they are so contingent in nature that it is so difficult to assess what the risk is, and the probability of loss, that it is difficult to set the reserves. So there is—

Ms. PRYCE. According to the accounting guidance?

Mr. NUTTER. According to the accounting guidance, that is right.

Mr. RACICOT. Congressman Pryce, just one other thought that you might keep in mind, and that is when you allocate capital to such reserves, you obviously are removing it from other possibilities, more diverse products, more coverages, more places, more time. So there is a competing imperative that one has to keep in mind as well.

Ms. DALTON. I would like to just also mention the impact that the rating agencies have on those reserves that do get set aside. They have an awful lot of influence in how the insurers behave and what kind of capacity they will set aside for catastrophic risks, whether it is terrorism or earthquake or flood.

And also another factor that is definitely impacting capacity is the fire-following laws in some of the States—

Ms. PRYCE. Which laws?

Ms. DALTON. The fire-following laws. Those laws also have—for example, in New York, have a very serious impact on how insurers allocate capacity.

Ms. PRYCE. Okay. All right.

Mr. KUNREUTHER. I would like to make a very brief comment that if you don't have reserves, then insurers will have to hold more capital, and as a result of that, premiums will go up. So I think there are these trade-offs. Without getting into the details on how the reserve system would work, the less opportunity insurers have for this, the more they will have to hold capital on their own, and the higher the premiums would have to be to reflect the fact they have that capital on hand.

Ms. PRYCE. Thank you.

My time has expired. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much. Ms. Pryce.

I want to thank the panel for their patience again; we appreciate it.

Professor, I just want to comment on the University of Pennsylvania. I am very prejudiced toward it because I have a peculiar his-

tory in my family. My father was a Wharton graduate, 1919, and law, 1922. My brother was a graduate in the 1960's of the Wharton School, and I have a nephew who went there. So I do not know that there is any other family, certainly in Pennsylvania, with three generations at the Wharton School and university law school.

Mr. KUNREUTHER. Thank you very much. We would love to invite you to visit us.

Chairman KANJORSKI. We will be, and particularly as we take up other insurance issues, which the committee is going to be very active on. I look forward to using your great wisdom. Thank you very much.

The committee stands adjourned. Incidentally, if members have additional questions, they can submit them in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to the witnesses, and to place their responses in the record.

Chairman KANJORSKI. The hearing is adjourned.

[Whereupon, at 1:50 p.m., the hearing was adjourned.]

A P P E N D I X

June 21, 2007

OPENING STATEMENT OF
CHAIRMAN PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON "EXAMINING A LEGISLATIVE SOLUTION TO EXTEND AND REVISE THE TERRORISM RISK INSURANCE ACT"

THURSDAY, JUNE 21, 2007

We meet this morning to examine an important piece of legislation. This past Monday, Congressman Capuano, Chairman Frank, and several others introduced H.R. 2761, the Terrorism Risk Insurance Revision and Extension Act of 2007. I again want to commend my colleagues for putting forward this bill that will amend the Terrorism Risk Insurance Act.

Before we hear the views of our witnesses, I want to outline some of my thoughts on these matters. Overall, I believe that this bill is a good product. I support 90 percent of its contents. It will help to protect our nation's economic security in several ways.

For example, H.R. 2761 extends TRIA for 10 years and creates a blue-ribbon commission. These provisions strike the right balance between providing greater certainty to the marketplace and encouraging the private sector to develop its own solutions to this problem.

The bill also eliminates the distinction between foreign and domestic terrorism. Terrorism, regardless of its cause or perpetrator, aims to destabilize the government. This change therefore has much merit.

In addition, H.R. 2761 lowers the event trigger to $50 million. This modification will assist small and mid-sized companies in managing their exposures under the program.

The legislation moreover adds group life insurance to the program. We need to protect the people who work in the buildings and not just the buildings in which they work.

Finally, this bill improves coverage for nuclear, biological, chemical, and radiological terrorism events. If the goal of TRIA is to protect the economic security of our nation against terrorist threats, then Congress specifically needs to address the threat posed by NBCR terrorism. Our nation needs to plan for a potentially devastating attack by NBCR means by putting in place an explicit program, rather than an implicit promise now and a chaotic response later.

By providing fairly low insurer deductibles, smaller co-payments for larger NBCR events, and greater legal certainty, H.R. 2761 aims to limit the exposure of insurers to this risk and promote a private market to price and distribute this product. That said, I know that some parties in the insurance world have raised concerns about these NBCR provisions. I want them all to know that I am very open to considering how we can improve them. We, however, should not ultimately decide to continue to study this problem. We need to act.

While the aforementioned changes take important steps toward appropriately revising and extending TRIA, two other provisions contained on approximately five pages within H.R. 2761 take away from the final product. In my view, they create a Christmas tree for special interests and provide special preferences. Before moving this bill to a mark up, we ought to consider carefully the policy implications of these proposals.

-more-

H.R. 2761 includes a retroactive reset mechanism where areas previously impacted by terrorist attacks would benefit from lower deductibles and triggers in any subsequent attack. By altering the equity of the current program, this provision as currently constructed has the potential to undermine the broad national support that TRIA presently enjoys.

After the 9/11 attacks, the terrorism insurance marketplace retracted nationally and not just in the areas directly affected. During the 2005 debate on the first extension of TRIA, the House recognized this situation and passed a provision that would have provided reset relief nationally and prospectively. The reset provision in this bill is retroactive, regional, and much more generous than what we adopted in 2005. We should work to modify it in the weeks ahead.

In addition, the bill includes a section affecting the underwriting of life insurance for purposes related to past and future lawful foreign travel. I am sympathetic to the end that this provision seeks to achieve, but I also believe that it deserves separate consideration outside of the TRIA process. At least until Congress enacts an optional federal charter, state legislatures and insurance departments also probably have the best expertise to address this situation. In recent years, we have already seen 11 states do so by law or regulation.

In closing, a bill at its introduction represents only the beginning of the legislative process. I hope that we can continue to discuss these two matters and others. We should also strive to follow a balanced process designed to obtain overwhelming bipartisan support for our final legislative product on the House floor.

Statement by Congressman Gary L. Ackerman to the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee

"Examining a Legislative Solution to Extend and Revise the Terrorism Risk Insurance Act"

June 21, 2007

Thank you, Mr. Chairman.

Mr. Chairman, as an original cosponsor of the Terrorism Risk Insurance Revision and Extension Act, I strongly support the legislation. I support the incorporation of domestic acts of terrorism and the inclusion of group life insurance into the Terrorism Risk Insurance Act. Most important of all, Mr. Chairman, I *strongly* support the inclusion of so-called "retroactive reset" language that lowers the deductibles and triggers for areas that have already suffered terrorist attacks. The inclusion of this reset language is absolutely vital to our country.

On September 11th, fundamentalist maniacs struck the Twin Towers, causing incredible, horrific destruction. Though the casualty toll was, and still is, devastating to us, and the financial losses went well into the billions, it took only days for New York – and the country – to commit ourselves to

rebuilding Ground Zero to demonstrate our resilience and resolve in the face of terrorists. Had retroactive reset language not been included in this legislation, the terrorism insurance market would simply have lacked the capacity to enable Ground Zero to be rebuilt. Without the inclusion of retroactive reset language, we would have given Osama bin Laden, or any other terrorist, a veto on where we can and cannot build in the United States. As a matter of principle, we simply can not allow terrorists to dictate either the place of our markets, or the prices in them.

I'm also very pleased that bill extends TRIA for 10 years, through the end of 2017. As we heard at our subcommittee's field hearing in New York City in March, a 10 year extension is the absolute minimum that many experts in the developing, insurance and reinsurance sectors feel is adequate. The fact that we are now starting with a base-text that includes a longer-term extension is a measure of Chairman Kanjorski's and Chairman Frank's commitment to meeting the concerns of the Members of the Committee. I want to sincerely thank them both.

One of the chief obstacles to any large-scale business plan is uncertainty, and this is particularly true for a multi-million or multi-billion

dollar real estate development project, the kind that breath new life into our cities. Designing, securing capital, and then contracting for construction, is a multi-year process. If we want these kinds of projects to go forward, then there is simply no alternative to providing a long-term terrorism insurance backstop. Ultimately, I think we need to reauthorize TRIA for at least 15 years, a period that will give banks, insurers, developers and reinsurers the commitment they need to take the risks that will keep our economy moving forward with confidence. When the full committee marks up the Terrorism Risk Insurance Revision and Extension Act, I hope all of my colleagues will support the bi-partisan amendment that will be offered by Mr. King, which would provide for a 15-year reauthorization.

Mr. Chairman, I look forward to hearing from our witnesses this morning, and I yield back the balance of my time.

U.S. Congresswoman
Ginny Brown-Waite
Representing Citrus, Hernando, Lake, Levy, Marion, Pasco, Polk, and Sumter Counties

Subcommittee on Capital Markets, Insurance, and Government Sponsored Entities

"Examining a Legislative Solution to Extend and Revise the Terrorism Risk Insurance Extension Act"

June 21, 2007

Statement for the Record

Mr. Chairman, I thank you for holding this hearing today and the witnesses for participating.

I was not here in Congress when this committee passed the first TRIA. I was still serving in the Florida Senate, but even being so far away, I was soon aware of the crisis facing the terrorism insurance market.

Now, just five years later, this committee is presented with yet another extension, this one for 10 years. While I support an extension, I remain curious as to why we are discussing relief for an event that happened almost 8 years ago, when constituents in Florida are still grappling with skyrocketing homeowners' and commercial insurance premiums. For the past 4 years, this committee has worked quickly and in tangent with the industry when it comes to terrorism reinsurance, passing reinsurance fund after fund, but has left constituents in Florida and homeowners around the nation to their own devices.

However, I do support TRIA; I voted in favor of it when Congress extended the program in 2005. Since its creation, not one dollar of TRIA has been spent, yet insurers have allocated additional capacity to terrorism risk, prices have declined, and take-up rates have increased. In 2003, only 27% of companies purchased terrorism insurance. In 2005, 58% of companies purchased terrorism reinsurance. Deductibles have risen from 7% in 2003, to 17.5% in 2006. Even with this increase, the overall cost of coverage has fallen 3-5% of total property insurance costs. If this type of success can come from a terrorism risk insurance fund, I question why anyone would not feel the same about a federal catastrophe fund.

Unfortunately, this third extension is not being handled in the bi-partisan manner we have been accustomed to in previous discussions. Nothing in the bill that has been introduced

represents an agreement between the two parties – the provisions in the bill are the sum of the proposals my colleagues on the other side introduced, without any concessions to the Minority Party. The leaders on the Republican side offered good, common sense market reforms to gradually phase out TRIA and let the market continue flourish, and none of those proposals were accepted.

I hope this initial showing of partisanship is not indicative of how this committee will proceed as we extend TRIA. And I also hope that as we work on this legislation to ensure business owners have access to terrorism insurance in the North East, we do not forget about the constituents in Gulf who are still suffering from obscene homeowners insurance premiums.

Thank you Mr. Chairman and I yield back the balance of my time.

Statement of Congressman Kenny Marchant
June 21, 3007
Financial Services Committee hearing on "Examining a Legislative Solution to Extend and Revise the Terrorism Risk Insurance Act"

Thank you Chairman Kanjorski for holding this hearing today on the extension of TRIA. I am a new Member of this committee. However I have voted for previous extensions on the floor because I know that because of the unpredictable and potentially devastating nature of terrorist attacks, a government backstop is currently needed. It is for these reasons and more that I believe it is of high importance to extend this program.

In addition, this has always been a bipartisan bill. My understanding is that when Republicans were in control of this committee, we always worked with the Democrats to craft a compromise. In fact, the first TRIA bill was passed out of this committee by voice vote, and every one since has passed almost unanimously. However, I am worried that this record of bipartisanship is about to end. The process the Majority has taken in writing this bill so far has been exclusive and has not shown the usual spirit of compromise. The Majority came to us with an offer, we made a counter offer. Our counter offer was completely ignored. Ironically for our side, the one low-priority item they did take from our list would actually increase taxpayer exposure.

I hope that the way this process has been handled so far is an anomaly. A bill like this is too important for partisan disputes.

THE
COUNCIL
OF INSURANCE
AGENTS &
BROKERS

Statement of

Jill Dalton, Managing Director and Leader of the Terrorism Specialty Practice, Marsh Inc.

On

The Terrorism Risk Insurance Act

Before the

House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

June 21, 2007
Washington, D.C.

Chairman Kanjorski, Ranking Member Pryce and members of the subcommittee, thank you for the opportunity to testify on this critical legislation. My name is Jill Dalton. I am a managing director in the Global Property & Multinational Practice of Marsh Inc. One of my roles is leader of Marsh's Terrorism Risk Specialty group.

Marsh is the world's leading insurance broker and risk advisor with over 26,000 employees that provide advice and transactional capabilities to clients in over 100 countries. The Council of Insurance Agents and Brokers represents the nation's leading, most productive and most profitable commercial property and casualty insurance agencies and brokerage firms. Council members specialize in a wide range of insurance products and risk management services for business, industry, government and the public. Operating in the US and internationally, Council members conduct business in more than 3,000 locations, employ more than 120,000 people, and annually place approximately 80 percent – well over $200 billion - of all U.S. insurance products and services including the administration of billions of dollars of employee benefits. Since 1913, The Council has worked in the best interest of its members, securing innovative solutions and creating new market opportunities. Marsh is The Council's largest member and, as you know, has been actively involved with this committee since immediately following 9-11. We are very appreciative to the Committee for including us and considering our views and those of our fellow members of The Council of Insurance Agents and Brokers.

In our position as the world's leading insurance broker, no other organization understands the markets as deeply as we do as respects terrorism risk – including the appetites, the capabilities and the financials that drive their behavior. Also, no other organization wanted the market to re-emerge to write terrorism more than us. And, unfortunately, we also understand the devastating effects of a terrorist attack as do many of our clients, the insurers with whom we place business and our competitors.

When TRIA was first discussed, we recommended a short-term and temporary solution as was stated by our former chairman, Jack Sinnott in his 2002 testimony. We instinctively do not support the federal government having a large position in our business and we thought that a short-term solution would be adequate. The Act has been successful in that it has given our clients options. However, the input we received from Guy Carpenter about the reinsurers' appetite for terrorism risk and the data from our Marketwatch reports and our customers' demand for coverage tells us we must think differently.

According to the Reinsurance Association of America there is approximately $6-8 billion of reinsurance capacity available in the market. While this is significantly more than what was available in 2002, it is not nearly enough to satisfy the demand. Without adequate support from the reinsurers the retail insurance companies cannot offer adequate capacity to policyholders.

And, our clients are demanding the coverage. The data from our 2006 Marketwatch report (which is attached) shows that nearly 60% of our clients bought the coverage in 2006. In the first quarter of 2007 that take-up rate was 64% compared to 57% for the

same period last year. And, the data also debunks the myth that this coverage is only purchased by those types of businesses (big banks and big real estate developers) that were most affected on 9-11 in large cities like NY.

It is true that business such as financial institutions and real estate firms have the highest take-up rates at 81% and 77% respectively. Yet, in 2006 we saw the take-up rates for other industries such as educational institutions, retailers and energy companies go up by more than 8%.

While it is true that businesses in the Northeast have the highest take-up rates at 66% for the year 2006 and 70% for the first quarter of 2007, for the second year in a row, every region which we measure had a take up rate greater than 50% in 2006. In the first quarter of 2007 those take up rates are at 60%.

And, it's true companies with total insured values greater than $100 million had a higher take up rate at 63%, but 49% of smaller companies (those with values under $100 million) also bought the coverage and this is not an insignificant amount.

There are even situations where, although take-up rates are high, not every client is able to secure all the coverage that they need or desire. This is due to the still limited capacity and the concerns of the insurers as respects their accumulations and the fire-following laws in some states which require coverage for loss by fire even if the cause of that such fire (i.e. terrorism) is excluded. For example, due to the high concentration of buildings and employees in mid-town Manhattan, some insurers will either offer reduced limits for fire perils or simply decline a risk due to the potential for a "clash" event affecting multiple policyholders and multiple lines of coverage and the potential for being legally forced to pay a fire-following terrorism claim under the NY State Standard Fire Policy Law despite an exclusion for terrorism. They will also, at times, depending on the exposure and their underwriting guidelines, decline to quote because they do not want to be required to offer terrorism coverage as mandated by TRIA.

On several of the specific points of the draft extension bill, our comments are as follows:

10 year extension

Initially, and as stated in previous Marsh testimony to the Committee, Marsh felt very strongly that the Terrorism Risk Insurance Act should be a temporary measure because the private market would eventually be able to take over. We believed that once insurers became more accustomed to the elevated terrorism exposures and developed underwriting customs and strategies, they would be able to offer terror coverage under the traditional underwriting mechanisms. We also thought reinsurers would begin to offer the coverage again. Unfortunately, in the years since TRIA was enacted, we have not seen this private sector growth.

We also felt, at that time, that the threat of terrorism losses would diminish. Unfortunately, that has not been the case and many feel that we are more vulnerable than

ever to another attack. Given the fact that our clients' facilities remain vulnerable to attack, they expect the federal government to support the protection of their properties and their employees as long as the threat remains viable. The actions by the Department of Homeland Security support this and are evidenced by the formation of the National Infrastructure Protection Plan (NIPP). The goal of the NIPP is to

> "build a safer, more secure, and more resilient America by enhancing protection of the Nation's critical infrastructure and key resources to prevent, deter, neutralize, or mitigate the effects of deliberate efforts by terrorists to destroy, incapacitate, or exploit them; and to strengthen national preparedness, timely response, and rapid recovery in the event of an attack, natural disaster, or other emergency."[1]

Representatives from the banking and finance sectors, including the insurance industry, have partnered with the Department of Treasury in this plan. The Department of Treasury also oversees TRIA, so there is a convergence of interests and authority. As long as the government sees a threat, policyholders, lenders and others see the need for coverage, and because the markets are neither willing nor able to provide the coverage without the Act, we believe that TRIA should be extended. Given the facts of the current insurance marketplace, we support the proposal for a 10 year extension.

Elimination of distinction between acts of domestic and foreign terrorism

We strongly support the elimination of the distinction between acts of domestic and foreign terrorism. We believe that if another event were to occur, it may be very difficult to determine who committed the act and it is further possible that it will be difficult to determine if the individual(s) were, as defined in the bill, *" ... acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the US or to influence the policy or affect the conduct of the US government by coercion."*[2] The bombing of the transit system in London was conducted by British citizens who may or may not have been acting on behalf of a foreign interest. Two months after the bombing, al-Qaeda claimed responsibility. Since Pool RE, the UK's terrorism plan, does not distinguish between foreign and domestic acts it was not relevant. However, the same certainty of coverage might not have applied had a similar loss occurred in the US. Given the fact that potential terrorist attacks may be made on behalf of religious groups in lieu of a secular entity, we feel that this distinction should be removed.

The exposures and loss potential for our clients and the insurers is the same regardless of who commits the act. It was never clear why the distinction was made in the original Act and we believe it should be removed.

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[1] Department of Homeland Security, Executive Summary, National Infrastructure Protection Plan, 2006
[2] Terrorism Risk Insurance Act of 2002

$50 million trigger

We recognize that the current trigger of $100 million is potentially onerous for smaller insurers to absorb. Marsh does business with many different insurers and we understand that most insurers want this trigger reduced so on that basis we support this lower trigger.

Maintain current recoupment formula

The current recoupment provisions in the Act allow for discretion on the part of the Department of Treasury based upon the size of the event, the location of the event, general economic conditions and insurance market conditions. We believe this a rational approach and that the discretion is warranted. We support maintaining the current flexibility.

Addition of Group Life

On this topic, we conferred with colleagues from our sister company at Mercer. We support the proposal to extend TRIA to cover group life insurance. In contrast to property and casualty insurance, there has been no appreciable reduction in the availability of group life insurance, but it often comes at a higher price because companies that offer group life coverage have had to increase risk charges and purchase increasingly expensive catastrophic reinsurance. We believe that including group life insurance in a TRIA extension could help reduce these costs and potentially make this important workplace benefit more widely available.

Keeping costs down is especially important given that employer-provided group life insurance represents nearly half of all life insurance in force. Because workers are likely to be concentrated geographically, any catastrophic event could affect many lives under a group plan and generate significant exposure to loss for the insurers of those groups. Group life is often the only life insurance coverage an individual has during his or her working years, so it is critical that group life insurers be able to pay promised benefits when due. Including group life in an extension of TRIA will help achieve this goal.

Require Treasury reports to Congress on market conditions and program operations at 3, 6 and 9 years out

We believe that it is sensible and responsible for Congress to receive regular updates on conditions in the insurance markets and we hope that our data will be of continued use. Marsh has communicated regularly with members of the Department of Treasury as respects market behavior and we will be honored to continue to provide this important information.

Mechanism for Treasury Reports and formation of Blue Ribbon Commission

We strongly support the bill's provisions requiring the formation of a Blue Ribbon Commission to devise a long term plan to deal with terrorism insurance coverage. We would welcome the opportunity to be a part of any commission that is formed. We think

that, like the House bill that was proposed in 2005, there should be a mandate to construct a plan whereby the insurance industry and the federal government can work together more efficiently to provide the coverage needed by consumers and businesses while eventually reducing the role of the federal government. This mandate should be posed to the insurance industry and the National Association of Insurance Commissioners with the formation of an oversight committee led by Treasury Department and with clearly identified benchmarks. The proposed timing of the reports at 5 years (interim) and 8 years (final) is logical. This is very similar to what is being implemented in the National Infrastructure Protection Plan and we view the insurance industry as a key provider of financing and infrastructure.

In our opinion, TRIA has been successful in that it has provided our clients with options for coverage and pricing. Secondly, it will be excellent method for distribution of federal funds if an event does occur. Compare this with the many stories in the media about the inefficient distribution of funds from FEMA to people and businesses in need. Months after the event, FEMA asked some recipients to refund money that was inadvertently paid out while others waited many months for their checks. It is taxpayer-efficient in that it uses virtually no taxpayer resources unless needed, and, if needed, the taxpayer is reimbursed for the expenditure of funds in an appropriately broad-based national mechanism that collects only what is needed to pay back the loss. It is a focused response to a specific problem. Many people assume that if TRIA is not extended and if there is another event, the federal government will likely bear the burden for the relief. Use of the commercial insurance market to adjust the losses and distribute these funds is one of the most efficient ways that the federal government and business can work together.

On making offering of Nuclear, Biological, Chemical and Radiological (NBCR) mandatory

For our clients, we strongly support the proposal for a mandatory offering of coverage for NBCR terrorism events. We recognize that insurers view this as uninsurable (except for Workers Comp where it is already provided) and we understand this position. If it is to be mandatory, the Act should be structured so that the federal government's share for these perils is greater than for other perils. This could be done with a lower deductible and/or a smaller or zero vertical participation. We are pleased that these recommendations are included in the draft bill – both the 7.5% retention (in lieu of 20% for conventional terrorism) and the step-down mechanism depending on the magnitude of the loss.

We are concerned that without such separate treatment, insurers may limit or reduce the All-Risk limits that they provide for perils such as fire, explosion and windstorm, and this could have the unintended consequence of creating a severe shortage of core property capacity due to aggregation concerns and possibilities of adverse selection for perceived target risks.

We also believe that, if mandatory, the offering for NBCR perils must be priced separately than the offering for the other perils and that policyholders can choose whether

or not it is to be purchased. If it is made mandatory, we expect the insurers' pricing to vary wildly and to be very high, which is what we experienced with TRIA pricing when the Act was first passed in 2002. It is important that policyholders are able to choose separately between purchasing conventional terrorism and NBCR terrorism.

- **Apply TRIA's original rate and form implementation standards** – clearly including NBCR into TRIA will entail significant administrative management and a transition plan will be necessary. The more time that brokers and insurers have to implement this change the smoother and less disruptive it will be for consumers and our clients.

- **Clarify that Pollution and Nuclear Exclusions Will Not Apply to NBCR Terrorism Events** - We support this clarification and feel it is a critical distinction. In effect, it is the existing pollution and nuclear exclusions that nullify the coverage now on most policies and without this clarification there could be ambiguities.

Provide Additional Legal Certainty to Insurers

If insurers view the current Act as ambiguous in certain areas and if it appears that there are inconsistencies, we are agreeable to amendments that will provide the Act with more legal certainty.

Modify Language to More Clearly Limit the Liability of Insurers and the Government to the $100 billion Cap

If the current Act is not clear on this point or how it is implemented, we support any language that will limit any confusion in the event of a loss and expedite payment to policyholders and repayment to insurers. We have always treated this cap as a true limit on liability and if this wording solidifies this language then it will be consistent with our communications to our clients.

Update Findings and Purposes to Reflect Group Life and NBCR changes

This is a logical amendment to make if Group Life is added into the Act.

Add a Reset Mechanism for Areas Impacted by Significant Terrorist Attacks to Lower the Deductibles and Triggers in Such Areas.

We believe that the deductibles and triggers for all the losses should be treated equally regardless of where they occur. We do not support lower deductibles or lower triggers in areas that may be more impacted by significant terrorist attacks. As we saw in the wake of the attacks on 9-11-01, many businesses around the country suffered financial losses due to their reliance upon the financial markets (as suppliers or customers) which were physically damaged in New York, and as a result of the actions taken by the government (i.e. the F.A.A. shutdown of all air travel). If deductibles are reset due to a significant event they should be reset universally for all areas. The wording in the current draft

could be construed to apply to losses occurring in New York City because of the events of 9-11-01 and not as a result of future events and we do not see that as equitable.

Modestly Rebuild Capacity by Providing Clarity that the $100 billion cap is Net of Insurance Industry Obligation

We support this clarification in that it will provide for the maximum payout for policyholders in the event of a loss and it eliminates certain ambiguity in the current bill.

Conclusion

The Council and Marsh agree with the Committee that protection for our nations' businesses against the risks of terrorism is extremely important. We commend you for your leadership by holding this hearing today and for strongly supporting the extension of this legislation which is so important to our clients and to the vitality of our nation's economy. If there is another event, we want and need the insurance industry to respond positively with financial support and technical expertise and to continue to be financially viable to compensate for other types of losses. With the continuation of TRIA and by incorporating these changes we feel it will be well-poised to do so.

ABOUT MARSH

Marsh, the world's leading insurance broker and risk advisor, has 26,000 employees and provides advice and transactional capabilities to clients in over 100 countries. Marsh is a unit of Marsh & McLennan Companies (MMC), a global professional services firm with approximately 55,000 employees and approximately $12 billion of annual revenues. MMC also is the parent company of Guy Carpenter, Kroll, Mercer Human Resource Consulting, Oliver Wyman, and Putnam Investments. MMC's stock (ticker symbol: MMC) is listed on the New York, Chicago, and London stock exchanges. MMC's Web Site is www.mmc.com. Marsh's Web site is www.marsh.com.

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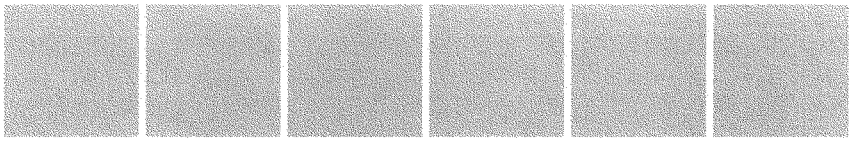
Research Report



Marketwatch: Terrorism Insurance— 2006 Market Conditions and Analysis

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Marketwatch: Terrorism Insurance— 2006 Market Conditions and Analysis

Introduction

Despite an ever-changing terrorism risk insurance market, businesses from every industry sector continue to purchase terrorism insurance—nearly 60 percent of businesses surveyed bought coverage. Until at least the end of this year, U.S. insurers are backed by the commitment of the United States government—through the Terrorism Risk Insurance Act (TRIA)—to provide reinsurance relief to help them manage the ongoing risk of terrorism. TRIA is set to expire on December 31, 2007, and although there is much optimism the Act will be extended, there is no guarantee of a federal backstop in the future. This has no doubt caused some market uncertainty.

Terrorism insurance and associated risk management strategies are dynamic and complex issues, with many interdependent factors contributing to managing the risk. Foreign relations, the effectiveness of homeland defense, and the ambiguous nature of terrorism risk make terrorism losses extremely challenging to predict and quantify. It is difficult for insurers to effectively price and to reserve capacity for their potential exposure to catastrophic terrorism losses.

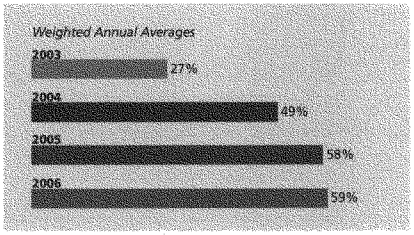
This report, an addendum to Marsh's ongoing *Marketwatch: Terrorism Insurance* series, is designed to help clients address terrorism risk. It is part of Marsh's ongoing effort to inform clients of developments in the terrorism risk insurance marketplace, including fluctuations in pricing. To date, a decision has not been made regarding the upcoming expiration of TRIA, but there is speculation the Act will be extended in some form. Marsh's Terrorism Risk Specialty will keep abreast of developments. A comprehensive *Marketwatch: Terrorism Insurance* report will be released once the Act's future has been decided. Marsh remains committed to helping our clients develop robust, comprehensive strategies to manage this risk.

Findings and Analysis: Property Terrorism Purchasing in 2006

The overall terrorism insurance marketplace remained very much the same in 2006 as it was in 2005. There has been a continuous increase in the take-up rate—the percentage of companies buying the coverage—over the four years that Marsh has been tracking the purchase of property terrorism insurance by our clients. A total of 59 percent of companies purchased or renewed their property terrorism insurance coverage in 2006, up slightly from 58 percent in 2005 (see Chart 1).

Take-up rates in the Midwest and West rose slightly in 2006, while the South and Northeast zones remained flat. Take-up rates rose slightly in 2006 among the smallest and largest companies in our sample but declined marginally for the others. The cost of terrorism insurance generally increased in 2006, albeit at a slower rate than for property insurance in general.

Chart 1: Terrorism Take-Up Rates by Year



Methodology

This chapter relies on data drawn from Marsh's offices across the United States. It focuses on Marsh's risk management and middle-market clients that buy property terrorism insurance and how much they are paying for it. Purchasing patterns are examined in the aggregate as well as on the basis of client characteristics such as size, industry, and region.

The 2006 data come from property insurance placements incepting during calendar year 2006. To account for skews within the regional and total insured values (TIV) data sets, the national annual figures were weighted to allow the findings to be extrapolated to the overall population. The study population does not include placements in the United States for foreign-based multinationals or for small-firm placements made through package policies.

The 2006 study was based on a sample of 1,437 firms with the following characteristics:

	Minimum	Median	Maximum
TIV	$500,000	$388 million	$175 billion
Property Premium	$2,000	$433,000	$57 million
Terrorism Premium	$1	$18,000	$11 million

Unless otherwise noted, the calculations include TRIA policies, noncertified policies, standalone policies, and placements made through captives.

For comparison purposes, the 2003 figures do not include the first quarter of 2003, which had unique circumstances.

For some companies, insurers quoted only a nominal terrorism premium of $1. These $1 premiums were omitted from the calculations of the median terrorism premium rates. In respect to the calculation of terrorism premium as a percentage of property premiums, standalone terrorism premiums were omitted.

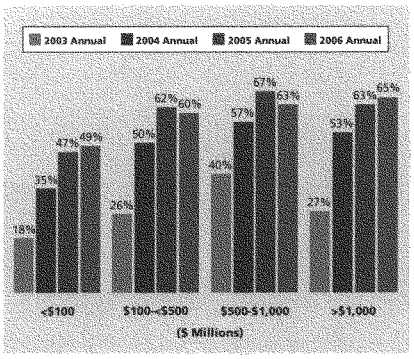
Companies were assigned to regions based on the locations of the Marsh offices that served them. Generally, this was the Marsh office most closely located to a company's headquarters. Many of our clients have multiple facilities across the country and around the world, meaning the potential risk for a terrorist attack may not be fully represented by where a company is headquartered. Having said that, the decision as to whether to purchase terrorism insurance is typically made at headquarters.

Take-up Rates by Company Size

Marsh's analysis established four categories of total insured value (TIV) as the measure of company size:

- Companies with TIV in excess of $1 billion are major accounts for insurers, paying large premiums due to size alone. They typically work with several insurers. Many of these companies used their existing captives or established new captive insurers to provide TRIA coverage.
- Companies with TIV between $500 million and $1 billion are large organizations that typically work with multiple insurers and have layered programs.
- Companies with TIV between $100 million and $500 million tend to have no more than three insurers involved in their insurance programs.
- Companies with TIV less than $100 million generally entail a smaller spread of risk, have lower overall premiums, and work with a single insurer.

Chart 2: Terrorism Take-up Rates by TIV



Take-up rates within all TIV ranges changed only modestly in 2006 from 2005. The take-up rates for smaller companies—with TIV values under $100 million—rose slightly but were still well below the other TIV ranges (see Chart 2). There was a distinct difference in take-up rates at the $100 million TIV breakpoint—63 percent of companies with TIV greater than $100 million purchased terrorism coverage; 49 percent of companies with TIV less than $100 million did so.

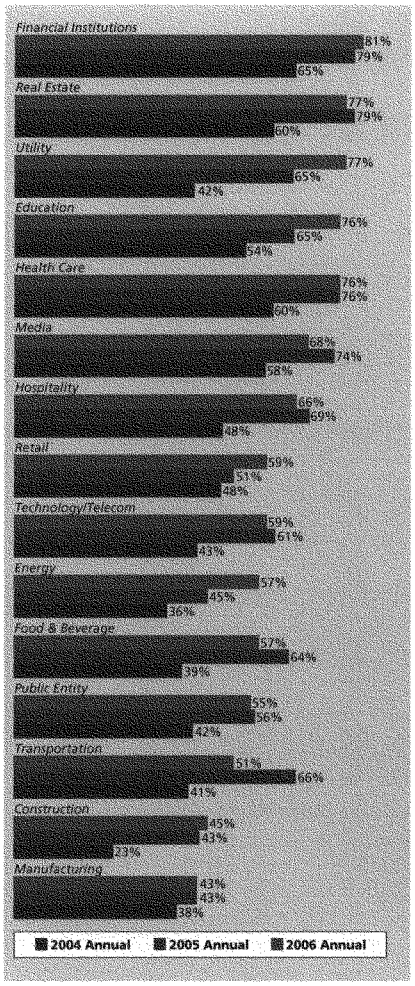
Industry Categories

This report examines property terrorism insurance purchasing patterns for 15 industry groups. These industries were selected based on criteria that included sample population size, perceived exposures, take-up rates, and premium rates. Other industry groups that are part of the overall analysis—but are not reported on individually—include agriculture, automotive, aviation, distribution, nonprofits, professional services, and general services.

The industry groupings in this report included, but were not limited to, the following lines of business:

- Construction: contractors, homebuilders, and general contractors
- Education: universities and school districts
- Energy: oil, gas, and pipelines
- Financial institutions: banks, insurers, and securities firms
- Food and beverage: manufacturers and distributors
- Hospitality: hotels, casinos, sporting arenas, and performing arts centers
- Health care: hospitals and managed-care facilities
- Manufacturing: all manufacturers, excluding food and beverage technology
- Media: print and electronic media
- Public entity: city, county, and state entities
- Real estate: real-estate and property-management companies
- Retail: retail entities of all kinds, including restaurants
- Technology/telecom: hardware and software manufacturers and distributors, telephone companies, and Internet service providers
- Transportation: trucking and bus companies
- Utility: public and private gas, electric, and water utilities

Chart 3: Terrorism Take-up Rates by Industry



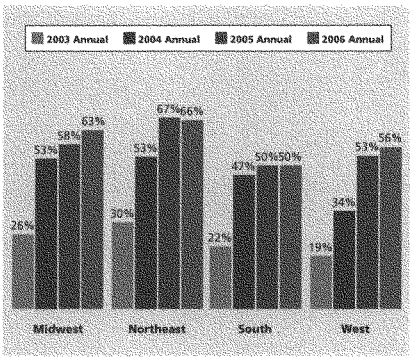
Take-up Rates by Industry

According to Marsh's analysis, the property terrorism insurance take-up rate increased significantly for 4 of the 15 major industry groupings and decreased substantially for 3 others. The take-up rates for the remaining 8 industry groups remained relatively flat. The take-up rates for utilities, educational institutions, retailers, and energy companies rose by more than 8 percentage points from 2005 to 2006. Conversely, transportation, food and beverage, and media companies had take-up reductions greater than 6 percentage points. Financial institutions, real-estate firms, utilities, educational institutions, and health care facilities had the highest property terrorism insurance take-up rates in 2006, each exceeding 75 percent (see Chart 3). In contrast, less than 45 percent of general manufacturing and construction companies bought terrorism coverage.

Take-up Rates by Region

The 2006 property terrorism insurance take-up rate rose most significantly in the Midwest and West. For the second year in a row, every region had a take-up rate greater than 50 percent (see Chart 4).

Chart 4: Terrorism Take-up Rates by Region



The Northeast still has the largest percent of companies purchasing property terrorism insurance, although the Midwest is not far behind.

Types of Coverage Companies Are Buying

The vast majority of Marsh clients—90 percent—that purchased terrorism insurance did so as part of their property policies rather than as standalone placements. However, standalone policies are an important alternative or supplement to TRIA coverage for some companies. The primary purchasers of standalone policies were hospitality companies, large real-estate firms, and financial institutions. Retail companies, public entities, and utilities, however, also purchased significant, though lesser, amounts.

When companies purchase terrorism coverage as part of their property policies, they can purchase either TRIA coverage, noncertified acts coverage, or a combination of the two. In 2006, the vast majority—more than 75 percent—of companies purchased both TRIA and noncertified acts coverage.

The Cost of Terrorism Coverage

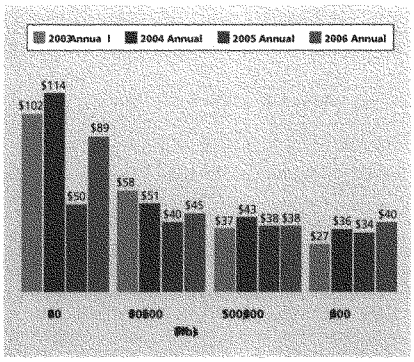
For this report, the cost of terrorism coverage was measured both as a premium rate—premium per million of TIV—and as a percentage of a company's overall property premium. The first method—premium rate—allows companies to track what they paid in absolute terms; the second shows how terrorism coverage affected a company's overall property insurance budget.

After significant price decreases in 2005, the cost of property terrorism insurance increased in 2006. Only the Midwest region saw flat prices. The median terrorism rate for 2006 was $47 per million of TIV, up from $43 per million of TIV in 2005. The median percentage of a company's annual property program costs attributable to terrorism premiums remained flat at approximately 4.2 percent.

Cost by Company Size

Property terrorism rates generally decrease as the size of the company increases (see Chart 5). Companies with TIV less than $100 million experienced the largest increases in price, from $50 per million of TIV in 2005 to $89 per million in 2006. For companies with TIV between $100 million and $500 million, the median rate increased $5 to $45 per million of TIV; and for those with TIV between $500 million and $1 billion, rates remained flat. For the largest companies—those with TIV more than $1 billion—the median rate rose slightly to $40 per million.

Chart 5: Terrorism Pricing—Median Rates by TIV



When examining cost as a percentage of overall property premiums (see Chart 6), 2006 saw modest reductions for all companies, except those with TIV between $100 million and $500 million. This indicates that the price for terrorism coverage did not increase as much as the overall property market rate increase experienced during 2006. Terrorism insurance does represent a larger proportion of the overall property insurance budget for larger companies than smaller firms. This trend can be explained in part because the largest companies tend to have greater terrorism exposures and lower property rates due to higher retentions and extensive loss control. Terrorism insurance rates do not tend to range as widely as property rates and are less subject to credits for higher retentions and loss-control efforts. Thus, terrorism represented a larger share of the overall property premium budget for the bigger companies.

Chart 6: Terrorism Pricing as Percentage of Property Premium by TIV

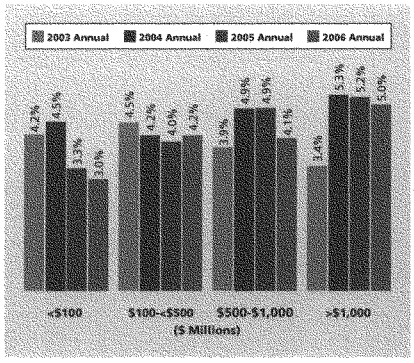
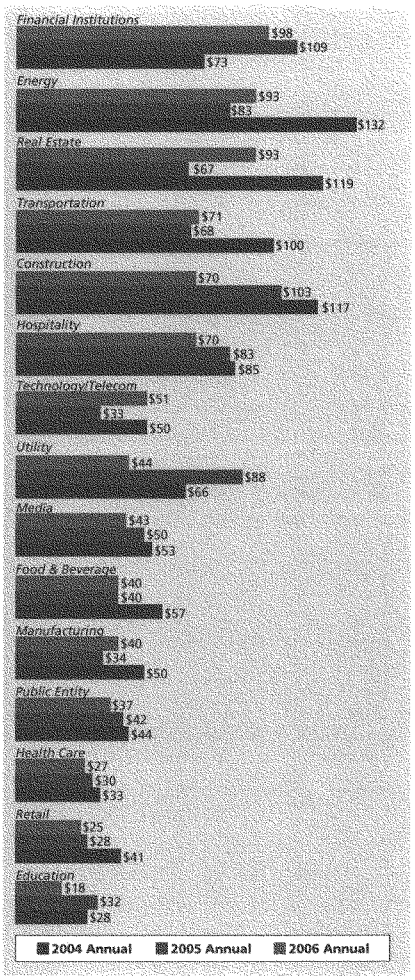


Chart 7: Terrorism Pricing—Median Rates by Industry



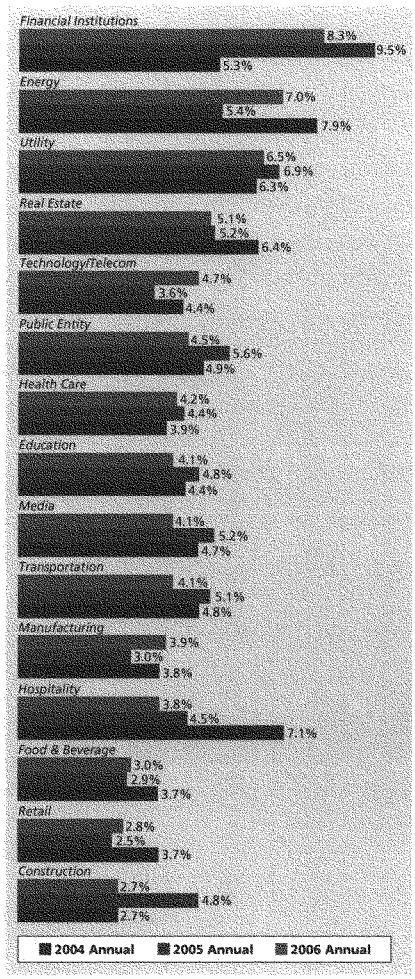
Cost by Industry

Comparing the 2006 median terrorism insurance premium rates by industry to past years' rates shows that the median rates decreased substantially for 6 of the 15 industry categories—financial institutions, construction, hospitality, utility, media, and education—and increased significantly for three—real estate, technology/telecommunicataions, and manufacturing (see Chart 7).

Terrorism insurance rates for financial institutions, energy, and real estate companies were the highest in 2006; rates for these groups exceed $90 per million of TIV. Rates decreased most dramatically for utilities, down 50 percent to $44 per million of TIV, and construction firms, which saw rates drop from $103 per million to $70 per million.

When looking at terrorism insurance pricing as a percentage of overall property premiums, financial institutions and energy companies had the highest median rates—8 percent and 7 percent respectively—even though financial institutions saw a 1.2 percentage point decrease from 2005 (see Chart 8).

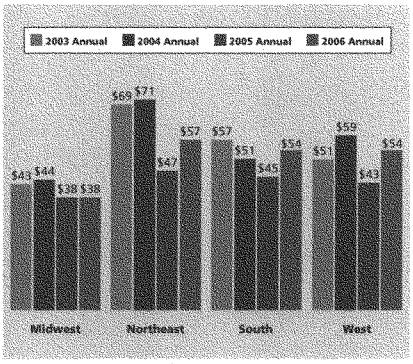
Chart 8: Terrorism Pricing—
As Percentage of Property Premium by Industry



Cost by Region

Terrorism insurance continues to be most expensive in the Northeast based on premium rate (see Chart 9), although the variation by region has narrowed. The median rate in the Midwest remained flat, compared to increases of 21 percent in the Northeast, 26 percent in the West, and 20 percent in the South. Interestingly, however, prices in the Midwest are significantly lower than in the other regions. The median rate in the Midwest stayed at $38 per million of TIV, while the Northeast, West, and South all experienced median rates between $54 and $57 per million. This can be explained in part by the industry sectors represented in the regions. For example, financial institutions and real estate entities—the two industry sectors with the largest median prices—are not as concentrated in the Midwest as in other regions. Conversely, health care, education, and retail, which have the lowest median rates, are well represented in all regions.

Chart 9: Terrorism Pricing—
Median Rates by Region



Conclusion

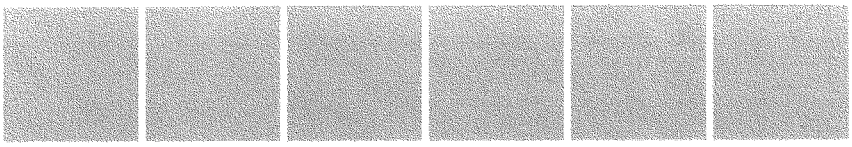
In 2005 terrorism insurance rates decreased virtually across the board. Due to the hardening of the property insurance market in 2006, we saw terrorism insurance rates increase, although not as significantly as for the overall market. On average, companies saw rate increases of 36 percent on their property programs. In many cases rate increases of more than 400 percent were experienced. This caused a ripple effect on pricing for terrorism coverage, and the result was clients experienced terrorism rate increases averaging just less than 10 percent. Therefore, although an increase in price was experienced, the increase was not as significant for terrorism coverage as for the overall property policies.

It was expected that as companies spent more on their overall property insurance programs they would cut back on their terrorism purchases. Surprisingly, this did not happen. Despite a changing and uncertain marketplace, terrorism take-up rates continued to climb to record levels during this period as companies of all sizes, in all industries, and in every region continued to purchase terrorism coverage. In fact, nearly 6 out of 10 companies have decided that property terrorism insurance is a coverage worth purchasing. Even in the face of significant property price increases, more companies, rather than fewer, opted to purchase terrorism coverage in 2006.

As previously mentioned, TRIA is set to expire at the end of the year; while this has caused uncertainty, it has not affected the property terrorism insurance market to the same extent as in 2005, when the original Act expired. There is tremendous optimism that an agreement will be reached and TRIA extended in some form. Unlike in 2005, we are not seeing as many insurers insisting on sunset clauses. Such clauses would terminate coverage for terrorism if TRIA is not extended. We expect that as the year progresses, we may see markets add the endorsements more often. This is especially true for those risks with exposures viewed as target risks, including those in urban areas and/or those in areas with high concentrations of values. Insurance markets have probably become accustomed to writing this coverage. Additionally, because of comments made by Congressional leaders, insurers have expressed confidence that an extension will be enacted, another likely reason for the lack of sunset clauses.

Clearly, the demand for terrorism risk insurance is there: companies across the United States have demonstrated this through the purchase of such insurance. Much depends on whether TRIA is extended, and in what form. Many Congressional leaders, including the chairs of the Senate Banking Committee and House Financial Services Committee have publicly stated their support of an extension and that they want it addressed early in 2007. Marsh's Terrorism Risk Specialty will keep abreast of developments in the property terrorism risk insurance market, and specifically with regard to TRIA. A more comprehensive, detailed *Marketwatch: Terrorism Insurance* report will be published once a decision has been made with respect to the future of the federal backstop.

MARSH



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Marketwatch: Terrorism Insurance—2006 Market Conditions and Analysis
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STATEMENT OF ERIC R. DINALLO
SUPERINTENDENT
NEW YORK STATE INSURANCE DEPARTMENT

BEFORE A HEARING OF

THE HOUSE FINANCIAL SERVICES COMMITTEE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

REGARDING

EXAMINING A LEGISLATIVE SOLUTION TO EXTEND AND REVISE THE TERRORISM RISK INSURANCE ACT

WRITTEN TESTIMONY

JUNE 21, 2007

I would like to thank Chairman Kanjorski & other members of the Capital Market Subcommittee of the House Financial Services Committee for inviting me to testify on the extension and revision of the Terrorism Risk Insurance Act.

I am grateful that we are not discussing if there should be an extension of TRIA, but what that extension should look like. Insurance is an essential support for all of the activities of modern life, especially for all commercial activity, such as construction and operation of real estate. We cannot allow terrorist attacks and the threat of attacks to destroy economic activity.

When you are evaluating specific proposals for inclusion in TRIA, I respectfully suggest that the question you should ask is how can we make this program most effective in helping protect against terrorist attacks and in reducing the long-term impact of attacks.

It is important that the bill promote as much private sector involvement as possible to spread risk, to take advantage of risk assessment and claims payment expertise, and because that approach encourages businesses to as much as possible take mitigation steps. We have seen in New York that many private sector buildings have taken security measures, such as installing barriers. Obviously, it is primarily the government's job to prevent terrorists attacks. But just as clearly, to succeed, we must have as much private sector cooperation as possible.

Some concern has been expressed that TRIA crowds out private sector insurers. In fact, we have seen the opposite. The program makes private sector involvement possible. The private sector will not offer insurance without it. On the other hand, with the federal backstop providing a cap, it has been possible for the private sector to price risk and therefore offer coverage.

I know that there is concern that the program should benefit all of the United States, not just New York. I completely agree. All provisions must be available to any place in the U.S., and should provide additional support to any place that actually suffers an attack.

But we must keep in mind that terrorists have already hit the World Trade Center in New York City twice. Why? New York City is the world financial capital. The terrorists saw those attacks as a way to hurt the entire country.

New York is suffering now from the impact of those attacks and, in particular, despite the real benefits of TRIA, insurance and reinsurance are still hard to obtain, especially for Ground Zero. We would hope that you would consider that fact when finalizing the legislation.

Now I would like to discuss our view on key issues regarding the bill.

On duration, we strongly urge 15 years. There is appropriate concern about how this bill affects the private sector. The question of duration is key in that regard. Any business person will tell you that they really need long-term stability, especially from government.

Competition and change in the marketplace engender innovation and creativity. But uncertainty in the rules of government programs can cause costly distractions.

This is especially true in real estate development, where major projects take years to plan, design and build and financing must be in place for the long-term. Fifteen years more closely fits the period needed for planning, completing and financing major projects. For example, it is hard to get a good rating on bonds needed to finance construction if insurance does not match the length of the bond.

I understand that opponents say a long term renewal means you cannot adjust if the market changes. The bill calls for setting up a blue ribbon commission to study long-term solutions. I strongly support that proposal and my Department is available to assist the commission. I believe the commission should be empowered to make recommendations for change when needed by changes in the market. But you are creating a serious problem if you create uncertainty for the businesses that depend on this program.

There is also controversy over the proposal for a **reset.** I support the reset because it makes the most efficient use of government help by focusing it where it is most needed—locations actually hit by an attack that are having trouble getting insurance as a result.

This is not a theoretical problem. We face it right now in New York. There is not enough insurance being offered to cover current real estate development projects, especially at Ground Zero. I do not think that any American wants to see the World Trade Center site left not rebuilt. That would send the wrong message.

I think there is an easy way to think about the reset. If you have lots of auto accidents, your insurance premium increases. That is appropriate. It is based on the experience that people who have lots of accidents are likely to have more. And the driver can over time reduce his or her premiums by driving carefully and avoiding accidents.

But the victims of a terrorist attack are not bad drivers. They did not do anything wrong. But without this provision, their insurance will cost more or even become unavailable, just when they are faced with paying the costs of the attack. Victims should not be further punished by having insurance premiums increased or insurance unavailable.

Opponents say this reset only helps New York. The fact is that right now, only New York has had two attacks, and only New York has had a major loss on private property. But this provision would apply in the future to any place that is attacked.

Opponents say that insurance rates will go up throughout the nation after another attack, so the reset should apply to all, not just the place targeted. That may be incrementally true, but we have seen that capacity will disappear or rates will go up most and stay up longest in the target area. So it seems appropriate that aid should be focused there.

The point is that a general reset will not work to bring insurance back where it is most needed. The purpose of a reset is to encourage insurers to make insurance available and help an area rebuild after a terrorist attack.

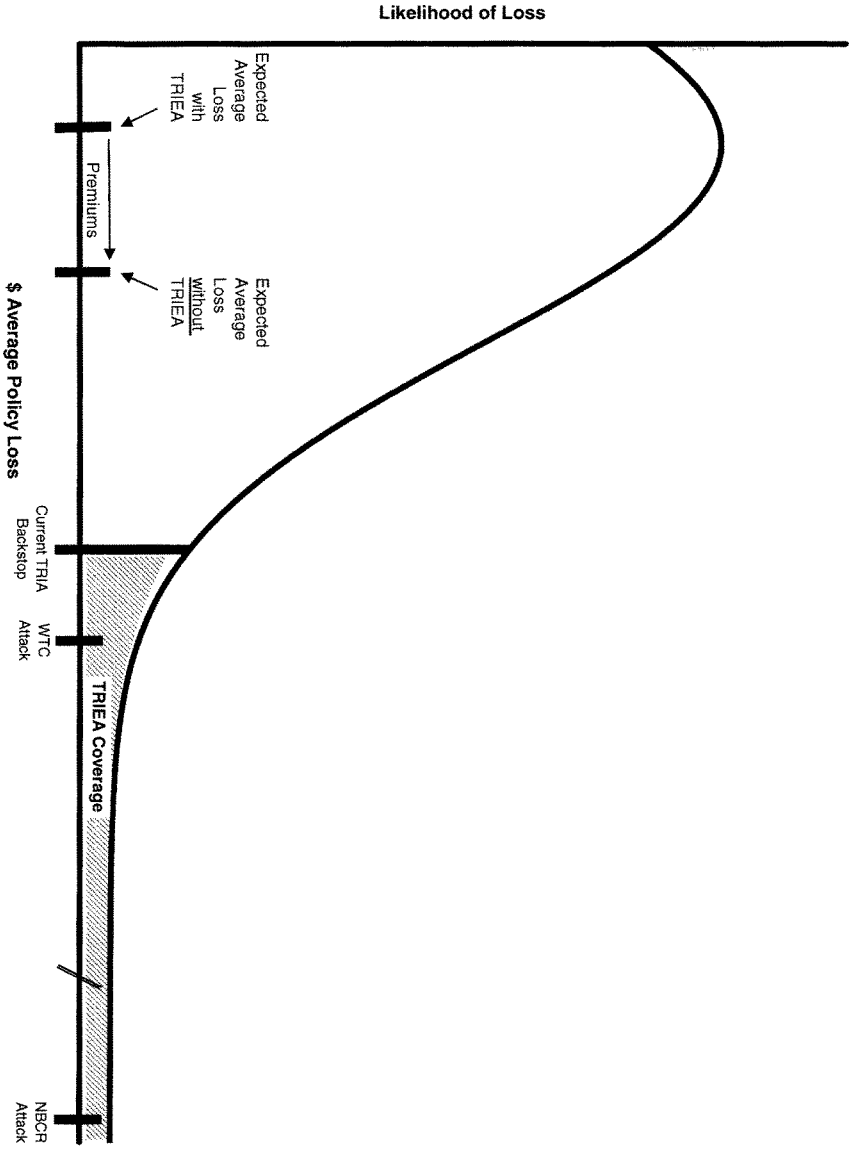
I think it is very important that you added coverage of nuclear, biological, chemical and radiological attacks, known as **NBCR**. It is essential that the industry and regulators begin to learn how to cover these risks. The inclusion of NBCR is structured to leverage the private market's ability to issue policies and settle claims, while recognizing the market's difficulty in underwriting this risk by reducing the threshold of retention. So it is appropriate that you lowered the deductible from 20% to 7.5% for this type of coverage, since the cost of a potential attack is much greater and harder to accurately predict.

There is now no private sector involvement, except for workers compensation. So, again, this does not crowd out the private sector, but makes some potential private sector involvement possible.

There are some reasonable questions being raised about impact of the mandatory make available provision on small insurance companies. That is something we would be happy to work with you on to determine some mitigation.

Again, we support the continued long term extension of TRIA because it will help stabilize the U.S. economy and help keep insurance affordable and available in areas that are terrorist targets.

Before concluding, I would like to thank the subcommittee for including in the current draft of this legislation many of the issues raised by the insurance industry, the business community and regulators, such as continuing TRIA, substantially increasing the time before the next renewal, adding coverage for acts committed by domestic terrorists, adding group life insurance and adding NBCR. I hope that we can continue to work with you to produce a bill that ensures insurance coverage will be available no matter what the terrorists attempt to do.


Likelihood of Loss
Expected Average Loss with TRIEA
Premiums
Expected Average Loss without TRIEA
$ Average Policy Loss
Current TRIA Backstop
WTC Attack
TRIEA Coverage
NBCR Attack

Independent Insurance Agents
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STATEMENT OF THE
INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

June 21, 2007

Good morning, Subcommittee Chairman Kanjorski, and Ranking Member Pryce. My name is Sharon Emek, and I am pleased to be here today on behalf of the Independent Insurance Agents and Brokers of America (IIABA) to present our association's perspective on terrorism insurance. I am a managing director and partner at the CBS Coverage Group, a regional full service insurance agency with locations in New York City, Plainview, Saratoga and West Hampton Beach, NY.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, representing a network of more than 300,000 agents, brokers, and employees nationwide. IIABA represents small, medium, and large businesses that offer consumers a choice of policies from a variety of insurance companies. Independent agents and brokers offer a variety of insurance products – property, casualty, health, life, employee benefit plans and retirement products – and sell nearly 80 percent of all commercial lines policies in the country. Members of the Big "I", as we are known, write the coverage for America's businesses and serve as the conduit between consumers and insurance companies, and therefore we understand the capabilities and challenges of the insurance market. From this unique perspective, we urge Congress to develop a long-term solution for terrorism insurance that enables the private sector to serve consumers and that limits federal intervention and protects taxpayers.

Please let me begin by complimenting Members of this Committee and Congress for recognizing the importance of a federal role in terrorism insurance and enacting the Terrorism Risk

Insurance Extension Act (TRIEA) of 2005. This extension Act and the original law, the Terrorism Risk Insurance Act (TRIA) of 2002, have worked to ensure that terrorism insurance is available and more affordable, protecting our nation's economic security.

We applaud Representative Capuano and Chairman Frank for introducing H.R. 2671, the Terrorism Risk Insurance Revision and Extension Act of 2007 (TRIREA), which, if enacted, will continue to keep terrorism coverage both available and affordable. We also applaud Subcommittee Chairman Kanjorski and Ranking Member Pryce for holding today's hearing to examine this legislative solution. Clearly, the leadership of this Committee understands that the insurance market's ability to protect the American economy from the financial consequences of terrorism risk is a critical component of our national security. Your efforts are crucial to finding long-term solutions for the economic and physical risks associated with terrorism, and we thank you for your continued leadership.

Background

It is well known that the insurance community performed admirably in the immediate aftermath of September 11th, 2001, honoring its commitment and providing resources needed to quickly and fully pay claims and thus playing a pivotal role in the recovery-and-rebuilding process. However, even though the insurance marketplace responded effectively to the 9/11 losses, it was quickly apparent, and remains so today, that insurers cannot handle the risk of further large-scale terrorist events without a federal backstop.

Not unexpectedly, insurers reacted in late 2001 and 2002 to the new perception of exposure and lack of scientific terrorism modeling with exclusion clauses and outright cancellations of coverage. This left agents and brokers in the always difficult position of being unable to meet consumers' needs for coverage. But beyond our own professional dilemma, it quickly became clear that the absence of coverage presented an immediate threat to our country's economy that had to be addressed – construction and other important economic activity were being impacted by the lack of coverage.

Fortunately, through the leadership of Congress, particularly those on this Committee, and the Administration, the government did respond to address problems in the marketplace with TRIA. Those of us in the market, however, do not need to be reminded of how acute the problem was before Congress and the President enacted the Terrorism Risk Insurance Act in late 2002. Economic activity, especially significant new construction projects, was beginning to be impacted by the inability of owners to satisfy demands of current or prospective lenders to demonstrate adequate insurance coverage. Fortunately, TRIA was put in place before the worst effects of this availability and affordability crisis further injured our national economy.

However, as TRIA neared expiration at the end of 2005, many insurance policies covering businesses of all sizes and types extended past the program's December 31, 2005 sunset date. With the risk of catastrophic attacks on U.S. soil still very real, and the capability of both insurers and reinsurers to offer comprehensive terrorism coverage for an uninsurable risk still very limited, Congress wisely passed TRIEA, which provided a two-year extension of the federal backstop under TRIA with some modifications to encourage the private sector to take on additional risk.

The current public-private partnership created by TRIA, and extended in TRIEA, has worked well and generally as intended, allowing businesses across America to continue operating and growing,

and preserving jobs in the process. TRIA and TRIEA have saved our economy millions of dollars by making terrorism insurance broadly available to all businesses that want and need this coverage at virtually no cost to the federal government. Prices have come down, capacity has grown, and demand is up in many geographic areas.

Unfortunately, the program is scheduled to expire at the end of this year, and there is no reason to believe that the threat of terrorism is on the decline, or that the private insurance markets alone can adequately meet our nation's need for coverage. As such, IIABA supports efforts to develop a long-term solution to this problem, and we again thank the Committee for holding this hearing to review H.R. 2671.

Post-TRIA Availability of Terrorism Risk Insurance

The original enactment of TRIA in 2002 and its extension in late 2005 have been successful in stabilizing the insurance marketplace and have helped eliminate the market disruptions and uncertainties that were witnessed in the immediate wake of September 11th. A failure to reauthorize the federal program could have meant economic hardship for countless small and large communities across this country and would have had an especially devastating impact on financial and commercial centers, such as New York. As a result of the enactment of TRIA and TRIEA, our members are currently able to offer consumers options with respect to terrorism coverage.

However, months before the extension of TRIA in December 2005, these interested policyholders were concerned that exclusions and sunset clauses would eliminate their coverage as insurers prepared for the termination of the TRIA backstop. Although TRIA was extended, these policyholders – including small and mid-sized businesses – continue to worry about the impact of terrorist events in this country and their access to insurance coverage to help them get back on their feet should another event occur. This concern is evident in the increased take-up rates for terrorism insurance as consumer demand for terrorism insurance continues to grow.

Policyholder concerns are fueled not only by memories of the exclusions that they faced immediately after September 11th and in the months before TRIA's original expiration, but also by their experiences in the post-2005 hurricane market. Substantial insured losses during that hurricane season have diminished the insurance industry's capacity for catastrophic losses in general. Under pressure from rating agencies to limit exposure, insurers are reevaluating their exposure to catastrophic losses in general and terrorism losses in particular. As underwriters continue to focus on the aggregation of losses, our members and the policyholders they serve remain concerned about how many insurance companies, particularly small and monoline insurers, will continue to write terrorism risk insurance if the federal backstop expires.

Long-term Availability and Affordability of Terrorism Risk Insurance Coverage

In addition to the potential magnitude of losses from a future terrorist attack, a number of other factors will determine the long-term availability and affordability of terrorism risk insurance coverage, including: (1) the ability to accurately predict the severity and, most importantly, the frequency of terrorism given the increased threat; (2) the effectiveness of mitigation efforts; (3) the insurance market's capacity for substantial catastrophic losses combined with policyholder take-up rates for terrorism coverage; and (4) whether or not insurers are required to "make available" coverage for terrorism risk. Although most of these factors are considered in the context of many types of perils,

their impact on the availability and affordability of terrorism is unique due to the nature of terrorism risk.

While modeling has shown us that the size and severity of a terrorist attack could easily threaten the capacity of the insurance market, the risk cannot be assessed in traditional ways. Insurers lack confidence in modeling terrorism risk due to the lack of past statistical records for such risk.[1] Unlike other types of catastrophic risks, insurers and actuaries know very little about where or when terrorism might occur; how it might occur; how often it might occur; or the nature, effects, and costs of such an attack. Much of the information that does exist is available only to governmental agencies that fiercely guard it for security and law enforcement reasons. As a result, underwriters shied away from terrorism risk before the creation of the TRIA backstop. Indeed, since the enactment of TRIA, insurers have proven unable to introduce wide-ranging, new products for insuring terrorism risk. There is currently no indication that the ability to accurately predict and underwrite terrorism risk will improve significantly in the future and certainly not before the Act's expiration later this year.

The unpredictable nature of terrorism also hinders the ability of the consumers who agents and brokers serve to effectively mitigate against acts of terrorism. Although policyholders may invest in increased security measures to thwart the efforts of terrorists, the effectiveness of these measures is limited due to the proven adaptability of terrorists. Moreover, the incentives offered by insurers frequently fail to match the expense of such measures.

While our members remain opposed to federal intervention in the insurance market in general, they nevertheless acknowledge that the terrorism risk insurance coverage currently available to the policyholders whom they serve would not exist without TRIA. This is a clear case of marketplace failure, and in those rare instances, limited federal involvement in a reinsurance capacity is warranted. Once the backstop expires, the challenges discussed above will likely paralyze the private insurance market's ability to make terrorism risk insurance coverage available and affordable for policyholders. Federal legislation is necessary to ensure that policyholders continue to have access to such coverage and that the insurance market's capacity to cover terrorism losses continues to grow.

Continued Need for a Federal Backstop

IIABA believes that a long-term private-public partnership remains essential to the challenge of making terrorism risk insurance available after the expiration of the Act at the end of this year. Although some potential solutions might allow for the reduction or even elimination of federal involvement in the years to come, it may be difficult to eliminate such a role in the immediate future without disrupting the market. Indeed, it will take decades for the industry to close the gap between the estimated $6 to 8 billion in current reinsurance capacity and potentially hundreds of billions of dollars in losses from a terrorist attack.[3] As such, public participation is necessary to encourage

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[1] *See* Letter from Dennis Fasking, Chairman, Extreme Events Committee, American Academy of Actuaries, to Rep. Richard Baker, Chairman, Subcommittee on Capital Markets, U.S. House of Representatives (August 2, 2005), *available at* http://www.actuary.org/pdf/casualty/tria_080205.pdf.

[3] *See* Marsh, *Marketwatch: Terrorism Insurance 2005* 33 (2005), *available at* http://www.marsh.dk/files/Marketwatch_Terrorism_Insurance_2005.pdf.

private markets to get in and stay in the business of insuring terrorism risk. [4] We remain optimistic that the industry and policymakers can develop solutions that will reduce the role of the federal government (and taxpayers) over time and enable the private market to build up greater capacity and ultimately shoulder more of the burden.

Despite our optimism that the federal government's role in terrorism insurance can be reduced over time, the terrorism insurance market is not ready to stand on its own by the end of this year and is not likely to be ready for a number of years to come. Accordingly, now is the time to enact a long-term extension of the federal terrorism insurance backstop with mechanisms for building more private market capacity.

The creation of an effective and long-term mechanism is essential for managing the risk posed by terrorist events. Without some form of an extension, terrorism coverage will be extremely difficult – if not impossible – for most to obtain after December 31, 2007, and the impact will likely be felt before then. Such an outcome would be especially troubling for small and medium-sized businesses, which are already challenged by the current environment and are not in a position to self-insure. The vast majority of businesses in this country are of this size, and the lack of some form of a terrorism insurance program could have devastating effects on the national economy.

H.R. 2671's 10 year extension of the federal backstop is a reasonable length given current market capacity and meets our definition of a long-term extension. In addition, H.R. 2671 provides a number of provisions that would give insurers additional legal certainty regarding their liability under the program cap. These provisions are important to keeping coverage affordable and building more market capacity. Accordingly, IIABA strongly supports these provisions of TRIREA.

Insurance Coverage for NBCR Events

We believe that any long-term solution to protect the nation's economy in the face of substantial terrorism losses must also address potential losses from nuclear, biological, chemical or radiological (NBCR) events. Other than coverage included in statutorily mandated lines (e.g., workers compensation), little coverage is available for NBCR events. Although NBCR losses are perhaps the most catastrophic types of terrorist attacks, coverage for these types of losses is currently excluded from most existing terrorism risk insurance coverage.

The difficulties of developing adequate capacity to cover terrorism losses and diversifying risk are aggravated in the context of NBCR events. Currently, there is essentially no reinsurance capacity for NBCR losses. NBCR terrorism risk is even more difficult to predict and underwrite than non-NBCR terrorism risk. Moreover, as discussed during the NAIC Terrorism Insurance Implementation Working Group's public hearing on terrorism insurance availability last year, it could take many years to quantify the damages from a NBCR attack.

Based on our experience in the market, we know that policyholders desire a long-term solution to the availability of terrorism risk insurance, including coverage for NBCR events. Policyholders want certainty for their business planning and operations, and they clearly do not want to be subject to

[4] Countries such as the U.K., France and Spain, which have a longer history of protecting against terrorist threats, have long accepted that government must play a role in insuring against terrorism losses.

on-again, off-again terrorism insurance mechanisms, and exclusions for NBCR losses. Terrorism is perhaps the greatest threat to our nation's economic future, and we believe that the reality of potentially large losses from NBCR events must be addressed to protect our economy, as well as policyholders and taxpayers.

Given the potential magnitude of NBCR losses, a catastrophic attack in a line not currently covered under the TRIA program (e.g., NBCR) would almost certainly lead to a substantial government bailout. In light of the potentially enormous burden that taxpayers could face as a result of NBCR risk, it is imperative that policymakers work to help develop the private insurance market's capacity for losses. At the same time, as demonstrated with non-NBCR coverage under TRIA, we do not expect the private insurance market to view NBCR risks as insurable or move toward developing capacity to cover such risks without encouragement from the federal government. However, even with this encouragement, the magnitude of potential exposure from a NBCR event is so great that many insurers, especially those that are small and medium-sized, may have trouble underwriting this risk.

Despite the obstacles, public participation is a vital requirement for any long-term solution for increasing private market capacity to cover NBCR events. H.R. 2671 would further enhance TRIA's public-private partnership by expanding its "make available" requirement to include NBCR coverage. The bill also recognizes the difficulties that insurers will face in providing this coverage by including a lower deductible for NBCR events, a step-down mechanism to decrease insurer co-payment for larger NBCR events, and rate and form interim implementation standards to ease the transition in the first year of the extension. We believe these provisions reasonably balance both customers' need for such insurance and insurers' difficulty in underwriting such exposures.

Reasonable Trigger Level

We would like to stress that the interest in, and the need for, a terrorism insurance backstop is not confined solely to large urban areas or to large businesses. IIABA represents agents and brokers selling coverage to consumers across the country. Our collective experience establishes that terrorism insurance coverage is not just a 'big city' or a 'big business' problem. It is a business customer problem throughout the country; this is truly a national issue. As take-up rates have gone up across the country, we have seen terrorism coverage purchased by a wide and diverse variety of interests, from small towns in Mississippi to small and large businesses in New York City. As the intermediaries between those customers and the insurers, our members support reasonable trigger levels that meet the needs of the communities, large and small, which rely on terrorism coverage, as well as those of the insurers, both large and small, that provide coverage. TRIREA's $50 million trigger is a reasonable level that would keep terrorism coverage both available and affordable and protect the communities that our members serve. The Big "I" strongly supports this provision.

Elimination of Foreign vs. Domestic Terrorism Distinction

Although domestic terrorism is excluded from the current federal terrorism risk insurance program, we support the elimination of the distinction between domestic and international terrorism in any extension of the program. Domestic terrorism, which presents many of the same characteristics of international terrorism, is a very serious threat and coverage for this risk is largely unobtainable in the marketplace today. IIABA believes that such distinctions are likely to prove irresolvable in the aftermath of an attack. Distinguishing between domestic and international terrorism can be difficult (if

not impossible) as the anthrax incidents of 2001 and the London Underground bombings of 2005 demonstrated. In short, IIABA continues to believe that the terrorism peril should be treated on a seamless basis without such distinctions. Accordingly, the Big "I" supports TRIREA's elimination of this distinction.

Long-Term Solutions

Although potential terrorism losses in the United States have been estimated at over $100 billion, current reinsurance capacity is only estimated at $6 to 8 billion.[5] As former Federal Reserve Chairman Alan Greenspan and other notable experts have asserted, the private insurance market is simply not in a position to handle the unpredictable nature and possible immense size and scope of terrorist attacks.[6] Despite the warnings of these experts, a specific plan for developing a private reinsurance mechanism to spread catastrophic risk from terrorism has yet to emerge.[7]

Recognizing the lack of specific plans for building capacity, H.R. 2671 wisely includes a number of provisions that facilitate long-term solutions over the course of the proposed 10-year extension. The bill proposes reports from Treasury, at regular intervals, regarding market and program conditions. This requirement will allow both the industry and policymakers to assess the development of market capacity on a regular basis and encourage the development of long-term plans well before the expiration of the 10-year extension. Additionally, the bill proposes a 19-member commission to propose long-term terrorism risk solutions and issue reports on an interim and final basis, both well before the extension expires. The Big "I" strongly supports this approach to developing long-term solutions and is pleased that the views of independent insurance agents and brokers will be represented on the commission.

Conclusion

IIABA applauds Congress for not ending TRIA abruptly in 2005 and for having the foresight to try to "phase-out" the program only as markets are able to develop. With the program's expiration only six short months away, the need for action is urgent. If a solution is not in place well in advance of the end of this year, insurance markets may once again face significant disruption and uncertainty, and we anticipate that insurers would exclude terrorism risks from policies where authorized. Our members, along with many in the insurer and policyholder community, recognize that we must find a long-term and market-based solution to our nation's terrorism insurance problem and are committed to this process.

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[5] *See* Franklin W. Nutter, President, Reinsurance Association of America, Testimony at the Public Hearing of the Terrorism Insurance Implementation Working Group of the National Association of Insurance Commissioners 5-6 (Mar. 29, 2006), *available at* http://www.naic.org/documents/topics_tria_testimony0603_RAA.pdf. Some industry representatives, however, fear that capacity is much smaller. *See* Warren W. Heck, Chairman and CEO, Greater New York Mutual Insurance Company, Testimony at the Public Hearing of the Terrorism Insurance Implementation Working Group of the National Association of Insurance Commissioners 4 (Mar. 29, 2006), *available at* http://www.naic.org/documents/topics_tria_testimony0603_NY_Mutual.pdf.

[6] *Greater N.Y. Mutual CEO Makes Case for Terror Coverage*, Insurance Journal, July 27, 2005.

[7] In fact, the Department of Treasury's (Treasury) June 30, 2005 report to Congress concerning the terrorism risk insurance program did not analyze this problem. *See* U.S. Dep't. of Treasury Office of Economic Policy, *Report to Congress: Assessment: The Terrorism Risk Insurance Act of 2002* 5 (June 30, 2005).

The Big "I" strongly supports H.R. 2761, the Terrorism Risk Insurance Revision and Extension Act of 2007. This type of thoughtful approach, which recognizes market capabilities and restraints, is essential to ensuring the affordability and availability of terrorism insurance as well as market capacity in both the short-term and long-term. We thank Representative Capuano and Chairman Frank for introducing this important legislation and thank this Subcommittee for holding this hearing today. We look forward to working with this Committee and House leadership to pass this bill.

STATEMENT OF WARREN HECK
CHAIRMAN AND CEO

GREATER NEW YORK MUTUAL INSURANCE COMPANY,
INSURANCE COMPANY OF GREATER NEW YORK
STRATHMORE INSURANCE COMPANY
AND GNY CUSTOM

ON BEHALF OF

THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

AND

PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA

AT THE HEARING ON

EXAMINING A LEGISLATIVE SOLUTION TO EXTEND AND REVISE THE TERRORISM RISK INSURANCE ACT

BEFORE THE

HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE AND GOVERNMENT-SPONSORED ENTERPRISES

WASHINGTON, D.C.

JUNE 21, 2007

Chairman Kanjorski, Ranking Member Pryce and Members of the Committee, my name is Warren Heck. I am Chairman and Chief Executive Officer of the Greater New York Mutual Insurance Company (GNY) and its wholly owned stock subsidiaries, Insurance Company of Greater New York, Strathmore Insurance Company, and GNY Custom.

I am pleased to have the opportunity to comment on legislation to extend the Terrorism Risk Insurance Program. I am testifying on behalf of the National Association of Mutual Insurance Companies (NAMIC) and the Property Casualty Insurers Association of America (PCI), who share many member companies in common. My views are informed by my first-hand experience as a major writer of terrorism risk insurance in New York City, both before and after the horrific events of 9/11, and as Chairman of NAMIC's TRIA Task Force.

I am convinced that the ability of New York City to regain its economic strength and its very soul after the terrible devastation wreaked on it and its residents on 9/11 is due, in substantial part, to the wisdom of this Committee and the Congress in enacting the Terrorism Risk Insurance Act (TRIA) in 2002. The Act not only helped rescue the City; it played a major role in preventing a national economic catastrophe and getting the country back on its feet economically. I am convinced that the recovery would not have occurred as swiftly as it has, nor continued as strongly as it has, absent adoption of TRIA and its extension in 2005, the Terrorism Risk Insurance Extension Act (TRIEA).

For all the good it has accomplished, the Terrorism Risk Insurance Program has been unable to do the impossible—to create a self-sustaining private market for what are fundamentally uninsurable events. When insurers have no historical track record of the frequency of particular events and a single such event could be large enough to wipe out much of the capital of the entire industry, then the only way insurers can responsibly write such a product is if the federal government limits insurers' exposure to acceptable levels.

On the other hand, those who do not have to take such risks—reinsurers and the private capital markets—provide a true test of private market capacity. Their answer has been loud and clear: they have little interest in assuming terrorism risks and absolutely no appetite for assuming risks from weapons of mass destruction—the nuclear, biological, chemical and radiological (NBCR) perils. The lack of appetite is not because the federal program is crowding out private sector innovation. There is plenty of demand for reinsurance to cover TRIEA deductibles and to cover NBCR risk. It is because the private sector understands the uninsurable nature of these risks.

That is why NAMIC, PCI and I firmly believe that if the Congress does not adopt a long-term private/public terrorism risk insurance program, many of our citizens who need terrorism coverage to operate their businesses all across the nation will be either unable to get insurance or unable to afford the little coverage that is available. The result, when the next terrorist attack occurs, will be more, not less, federal exposure because as sure as night follows the day, the federal government will pay for those losses. Absent a strong, balanced terrorism risk insurance program, there will be very limited private sector coverage, resulting in an even greater burden on limited federal resources.

Greater New York Mutual Insurance Company's business and post 9/11 experience

Let me describe briefly our experience as a medium-sized insurer of commercial properties in New York, where we have been on the front line of this problem ever since 9/11. I think our experience helps demonstrate the need for a long-term program.

Our company is a multi-line regional commercial lines company operating in New York, New Jersey, Connecticut, Massachusetts, Pennsylvania, Maryland, New Hampshire, Delaware, Virginia, Washington, D.C., and Illinois The majority of our business is in New York, New Jersey and Connecticut, where we have done business for many years. Our companies have had an A+ rating from A.M. Best for many years, and an A rating from Standard & Poors.

In New York State in 2006, our companies wrote direct written premium of $190,920,362 of which $171,055,970 was Commercial Multi Peril, making us the fourth largest writer of Commercial Multi Peril business in New York State. In New Jersey in 2006, we wrote direct written premium of $74,337,700 of which $60,081,494 was Commercial Multi Peril, making us the fifth largest writer of that business in the State of New Jersey. For many years, we have been the largest writer of co-op apartment houses in the boroughs of New York, particularly Manhattan, and the leading writer of apartment buildings in the state.

Although I have served as President and Chief Operating Officer of the company for 18 years and Chairman and CEO for the past six years, I have also continued to serve as Chief Underwriting Officer, in which role I manage the underwriting activities of our companies. This has enabled me to have first-hand knowledge and understanding of the needs of our policyholders and producers, particularly with respect to the terrorism exposure.

As a result of the terrorist attack on 9/11, and prior to the passage of TRIA in late 2002, most primary insurance carriers operating in New York City began to non-renew their commercial property and workers' compensation business, or reduce limits of coverage to levels below what was needed by the business community. Most primary companies refused to insure property on buildings with values in excess of $20 million, and would not insure any risk that had more than a limited number of employees in a single building. The extreme hard market for property and workers' compensation coverage in New York State, particularly in New York City, was worse than other places because New York State prohibited carriers from excluding coverage for terrorism, and reinsurance companies universally excluded terrorist acts in property and casualty treaties. The only alternative was to offer less coverage or not write the business at all.

The few companies willing to provide coverage increased their prices because of the significant terrorism exposure. However, many of those companies began to cut back when concentrations of values and employees became too large. The lack of insurance capacity had a negative impact on the New York economy resulting in the postponement of many construction projects, lack of or inadequate property coverage for many commercial office buildings, and significant increases in pricing of commercial multi-peril business.

With the passage of TRIA, the fear that a worst-case terrorist event could render our company insolvent was somewhat reduced, making it possible for our company to continue to do business in New York City and other urban areas. TRIA placed a ceiling on individual company

terrorism losses, which permitted our company to quantify its terrorism exposure and find a way to address the situation.

We devised a new underwriting strategy and guidelines that permitted underwriters to insure skyscraper office buildings and apartment houses up to $50 million or more depending upon risk accumulations in a given area of the city and proximity to so-called target buildings. We also do not insure commercial tenants in a property where the company insures the building. With respect to workers' compensation coverage, as long as employee counts were not too concentrated, our company considered offering coverage. We also implemented a computer system to geo-track risk accumulations to the street level as well as the number of employees in a given building, and risk concentrations by zip code. Since the passage of TRIA, we have purchased very expensive stand-alone terrorism reinsurance to cover as much of our TRIA deductible and co-insurance (which still excludes NBCR protection) as we could reasonably afford. Without the passage of TRIA and TRIEA, our company could not have kept its market open in the same way in New York City and retained the insurance capacity needed to write new business and grow its direct written premium.

The need for a long-term private/public terrorism risk insurance partnership

More than five and a half years out from 9/11, with no other terrorist attacks on U.S. soil, terrorism reinsurance availability remains extremely limited, and without TRIA and TRIEA, the primary insurance market would have dried up in large urban centers. In states that mandate that insurers offer terrorism risk coverage, insurers would have had to make the difficult decision to either offer terrorism coverage or leave those markets. These problems flow from the simple, inescapable fact that terrorism insurance is a classic uninsurable risk.

In order for the private market to function efficiently, it needs to be able to make actuarial judgments based upon an historical record of frequency and severity of an event. Years of data make it relatively easy to estimate auto insurance costs. Homeowners' insurance costs are somewhat less predictable because of the uncertainty and timing of calamities such as windstorms, earthquakes, and wildfires, but we can model natural catastrophic events because we have long historical records and sophisticated geological studies and hurricane forecasting methods to help us predict the future. We can also differentiate among risks based on such factors as location and the mitigation efforts of homeowners.

When it comes to terrorism risk insurance, we have no basis for estimating frequency. President Bush and other leaders of our government tell us that there *will* be—not *may* be—another terrorist attack on our soil. They cannot tell us when or where attacks might occur or their likely nature. Harder still from an insurance perspective, we cannot predict its severity. Will it look like 9/11 or last year's foiled attempt to blow up multiple airplanes over the ocean? What we do know is that our enemies want to inflict massive casualties and that terrorists have the expertise to invent a wide range of attacks, including those involving the use of chemical, biological, radiological and even nuclear weapons. While exploding a small nuclear weapon in a major city could do incalculable harm to hundreds of thousands of people, as well as to businesses and the economy, exploding multiple bombs in one or more places with no nuclear, chemical, biological or radiological (NBCR) components could also wreak massive damage. The damages could

reach into the hundreds of billions of dollars, levels that only the federal government could have the funds to pay.

Since 9/11, we have been working on improvements to our modeling technology in an attempt to quantify our terrorism exposures and reduce our concentrations in New York City. As previously mentioned, we have also geographically diversified our writings by expanding into suburban regions in other states. However, there is no guarantee that, for example, limiting one's exposure in New York City by underwriting risks in the U.S. heartland will succeed, as low-tech attacks such as those in Madrid and London could cause enormous economic harm if replicated in shopping malls in the South and Midwest. Even greater harm could be caused in these areas if terrorists attacked chemical plants or the food supply.

Smaller and medium-size insurers, which comprise a large portion of NAMIC and PCI member companies, face additional problems because they frequently operate in only a few counties in a state, in only a few states, or specialize in specific industries or markets. They lack the financial resources to withstand a terrorist attack in their home areas. They cannot easily shift their business focus to other lines of insurance or to other parts of the country. In some instances, their only recourse might be to abandon a niche market they were created to serve. In addition, many of them today are in financial jeopardy because, when they write commercial insurance with the federal obligation to include terrorism coverage, they cannot get reinsurance to cover the higher deductibles in TRIEA. They simply have too much of their capital at risk from a single event.

Workers' compensation can present highly concentrated risks, particularly in those states with a strong state fund presence. State funds (competitive or monopolistic) handle significant amounts of workers' compensation coverage for businesses in 27 states. Many of these companies serve as residual, or guaranteed, markets and must accept all applicants. While larger, multi-line commercial insurers may be able to limit the scope or aggregation of risks that they are willing to cover in a specific area, these state funds or single-state writers find themselves with tremendous risk concentration. The California State Fund best exemplifies this concentration of risk. It is the single largest writer of workers' compensation business in the United States despite the fact that it only operates in one state.

Also relevant to this discussion is the fact that insurers do not operate in free markets. State laws prohibit workers' compensation policies from excluding terrorism related losses, thus leaving many regional workers' compensation specialists in an extremely vulnerable position. Many of them have a high concentration of risk, a mandate to take all customers, and an inability to exclude terror-related events that could potentially inflict catastrophic levels of human and economic devastation in particular areas or regions. Because of rate regulation in many states, insurers also are not free to charge what they might believe is an appropriate price for the risk involved. In other words, even if insurers had the ability to assess the severity and frequency of terrorism risk, in many instances rate regulation would prevent them from charging premiums commensurate with the risk were assuming.

Even if an insurer were able to diversify its risk exposure through modeling and procure sufficient private reinsurance to cover the TRIEA deductibles, the notion that the private market

can protect itself through good modeling is flawed. Absent a terrorism insurance program, a $778 billion terrorist event—the high estimate from the American Academy of Actuaries for a single terrorist event in New York City—would wipe out more than the total property/casualty insurance industry surplus for all lines (both commercial and personal), which stood at about $490 billion at the end of 2006. This would mean that the industry would be unable to meet its obligations to its other insureds for the many different coverages they provide beyond terrorism insurance—such as auto and homeowners—that are protected by that surplus.

While the private market cannot cover events of such magnitude without either bankrupting insurers and reinsurers or wiping out so much insurer surplus that they could not meet their obligations on other lines of insurers, the private market has been able to cover lesser, clearly defined losses. TRIA and TRIEA were both reasonable attempts to limit the maximum exposure of insurers so that the private market can play a role in terrorism risk insurance. These statutes made a private/public bargain: Insurers would offer terrorism coverage in return for a guarantee from the federal government that it would pick up losses beyond the insurers' capacity. The purpose is not to protect insurers; it is to make sure that the economy can recover in as orderly a fashion as possible from the next terrorist event.

What would have happened to the property and casualty insurance market had there been no federal program to insure terrorism? My experience tells me that it would have been similar to what happened after 9/11. Insurers would have excluded terrorism risk unless required by states to offer it or withdrawn entirely from perceived terrorism-exposed areas. In urban centers such as New York City, there would likely have been high demand and a low supply of terrorism insurance, forcing prices to increase (if permitted by state law) for the limited amount of terrorism insurance that would have been available, thereby inhibiting development and economic growth. In short, we would have seen classic economic shortages for an essential product, with prices skyrocketing and many consumers going unserved.

Some have argued (unpersuasively) that the TRIA program has served to inhibit the development of a comprehensive private market solution to the problem of terrorism risk. They recommend drastically curtailing the program, or allowing it to expire, in order to unleash the power of the free market to provide increased reinsurance capacity and innovative financial mechanisms for spreading terrorism risk. But this advice ignores the fact that terrorism insurance does not operate in a free market in the United States. For example, state regulators in New York, which many view as the state most likely to be a terror target, have prohibited companies from excluding coverage for terrorism. In addition, New York aggressively regulates the rates insurers are allowed to charge for coverage. There is no similar regulation requiring the reinsurance market to provide protection to the direct market, nor are reinsurers subject to rate regulation. Far from increasing private reinsurance capacity and spawning market innovation, a government retreat from the terrorism insurance market would present small and medium-size companies with a difficult choice: leave the marketplace for terror target-area risks or face the prospect of a financial disaster that could result if they write coverage. To the extent that companies choose to leave the market, competition would be significantly reduced.

Would the capital markets provide the necessary additional risk-bearing capacity if TRIEA expires and private reinsurance capacity fails to materialize? There simply is no reason to

believe the capital markets would replace the missing insurance capacity, just as there is no evidence that TRIEA has crowded out private market capacity. Terrorism risk has presented a real opportunity for reinsurers and they have not chosen to take on very much of this risk. The Reinsurance Association of America has indicated that worldwide capacity for terrorism risk in the United States is approximately $6 to $8 billion without NBCR, far below the amount needed. The capital markets have taken their cue from the reinsurance market. There have been very few terrorism catastrophe bonds issued and a visit last year by some insurers to Wall Street revealed that the potential market for such instruments might reach $1 - $2 billion annually, at best, over the next five years. Moreover, there is no capital market appetite whatsoever for bonds for NBCR events.

NAMIC and PCI support most of the provisions of the new bill but strongly oppose adding a mandatory NBCR component

NAMIC and PCI have strongly supported enacting a new long-term extension of the TRIA program and, for that reason, commend the Subcommittee for moving this issue forward and for developing the draft legislation we are discussing today. NAMIC and PCI believe that the legislation would accomplish many of the objectives we support, but we oppose adding mandatory NBCR coverage. Let me discuss the key provisions.

Creating a 10 year program will avoid disruption in the marketplace

NAMIC and PCI support the bill's long-term program. The threat of terrorist attacks is an ongoing one that we will face for many years to come. It makes sense to have a program whose length reflects that reality. Moreover, absent an extended reauthorization, the markets would see the kind of disruption that occurred at the time TRIA was scheduled to expire in 2005, with companies scurrying to address the uncertainty, often asking state officials to permit them to provide exclusions in future contracts and sometimes making plans to withdraw from certain markets or restrict coverage. The situation was chaotic for all concerned, both companies and policyholders, and a 10 year program would avoid such disruptions again.

Maximizing private sector participation: Setting the event trigger at a level that will enable small and medium-sized insurers to offer coverage and maintaining deductibles and copayments at present levels or reducing them further

NAMIC and PCI have deep concerns about the effect of the current TRIEA program's escalating event trigger level on the ability of small and medium-size insurers to participate in providing terrorism risk insurance. We have provided research to the Subcommittee staff, to the Treasury Department, and others demonstrating the very significant risk higher triggers pose for medium and smaller insurers. We believe that a $50 million trigger, as proposed in the bill, would enable most small and medium-size insurers to continue to write terrorism risk insurance. A lower trigger would enable even more insurers to participate and would preserve competition for the benefit of consumers.

For small and medium-size companies, the event trigger is the key to their ability to continue to provide coverage. Too high a trigger would drive them from the market because of the extreme

risk to their capital base. As a medium-size insurer in New York that covers some very large buildings, I can tell you that a trigger in excess of $50 million would severely limit GNY's ability to offer as much coverage as it now offers. I simply could not justify to policyholders or state solvency regulators my company's decision to take such a large risk relative to the size of the company's surplus. Furthermore, my company would risk a downgrade in our financial strength rating and action by solvency regulators who closely examine our exposure to terrorism risk, including estimated potential insured losses resulting from simulated terrorism events.

Any increases in company deductibles or insurer co-payments could also drive medium and smaller-size companies out of the market. We applaud the authors of the legislation for their willingness to maintain them at existing levels (20 percent), but strongly urge that you consider lowering them further.

Why should Congress care about maintaining a market for smaller carriers? The answer is simple. Consumers benefit from competition. Large companies do not operate in all areas and markets. Small and medium-size insurance carriers, those with annual direct written premium of less than $1 billion, inject competition in markets where little or none would otherwise exist, provide coverage that would otherwise be unavailable in certain regions, and serve specific niche markets that many larger carriers have avoided since 9/11.

In 2004, of the 2,100 property and casualty insurance companies operating in the United States, only 40 had writings in excess of $1 billion and only 58 had policyholder surplus in excess of $1 billion. Of the 1,027 companies that write TRIEA-covered lines of business, 94 percent have less than $1 billion in surplus. Small and medium-size companies represent 85 percent of all companies writing workers' compensation, with 27 percent of the premiums.

A high event trigger or higher deductibles and co-payments would force small and medium-size companies to exit the market, which would erode capacity for consumers rather than build it. A smaller private insurance market would further expose the federal government to greater costs should another terrorist attack occur.

A $50 million trigger will probably be low enough to assure small and medium-sized companies continued involvement in the sale of terrorism risk insurance, although it will be a stretch for some smaller companies. Indeed, their prospects for participating in the market would be enhanced if the trigger was lowered even further to $10 or $20 million. A realistic event trigger will prevent the problems that would occur if a higher trigger forced insurers to abandon markets where large insurers would not take up the slack, resulting in serious harm to policyholders in those markets. While the cost to the federal government of a long-term trigger of $50 million or less would be negligible, the cost to these companies of a higher trigger would be too much for them to assume and the cost to the economy could be overwhelming.

Ending the distinction between foreign and domestic terrorism will assure protection against all terrorist events and avoid any delays in payments while bureaucrats debate the source of the attack

NAMIC and PCI also endorse the provision ending the distinction in existing law between foreign and domestic terrorist events, with only the former covered. Events subsequent to 9/11 have demonstrated that there are many home-grown terrorist cells around the world, including some in the United States. The damage to our nation would be just as great whether the source of a particular terrorist attack is foreign or domestic. Moreover, an attack could involve both foreign and domestic elements or it might be very difficult to identify conclusively where the perpetrators are from. That is why both NAMIC and PCI recommend that legislation include both kinds of terrorist events so that the country does not run the risk of finding itself in some bureaucratic limbo while we sort out the source of the destruction. We applaud the bill's provision to do so.

Finally, I'd like to turn to the very important issue of providing additional, mandated coverage for NBCR perils. This is a matter of very grave concern to the Subcommittee, to our industry, and to the public. We have reviewed it and considered many aspects of the issue and know that the Subcommittee has as well. We do, however, differ strongly with the approach taken in the bill draft outline we have seen.

Considering NBCR coverage, we believe the approach taken should respect existing contracts and expand the work of the bill's commission to consider the unique nature of NBCR risks, but should not mandate that insurers provide coverage for acts of terrorism that utilize weapons of mass destruction.

Attacks utilizing weapons of mass destruction (NBCR) are the ultimate in uninsurable events and they can have qualitatively different consequences than non-NBCR attacks. In contrast to the attacks on 9/11, for example, an attack in which a 10 kiloton suitcase-type nuclear device was exploded 120 feet above the ground would kill everyone in the surrounding 30 mile radius and destroy or render unlivable all properties in that area. This type of threat presents dramatically larger and more concentrated risk exposures than any other threat we know of. Providing our citizens with financial protection against attacks using weapons of mass destruction is a fundamental duty of the federal government.

With the exception of workers compensation, all states allow, and most commercial property insurance policies contain, nuclear exclusions. All states also allow nuclear/radiation exclusions and most policies contain filed and approved nuclear and pollution exclusions. That is how the private sector insurance industry and its regulators have historically handled NBCR risk. As for the capital markets, while they have limited appetite for non-NBCR terrorism risk, they have no appetite for NBCR coverage. In this regard, they take their signals from the reinsurance market. Given this market response, NAMIC and PCI believe strongly that the Congress should not overturn state law and re-write insurance contracts to include these uninsurable risks. I would note that the demand for private NBCR coverage appears to be focused narrowly on larger commercial developments in a few at-risk cities. It does not appear to be widespread throughout the economy; moreover, construction activity has recovered from its post-9/11 losses without this protection.

Even if we assume that substantial and widespread demand exists, is it possible to reconcile the public interest in economic development with a threat that presents the ultimate uninsurable

event? It is one thing for the Congress to require insurers to "make available" terrorism risk insurance for non-NBCR events, where all but the most severe attacks could more likely be handled by insurers within the parameters of TRIEA. It would be quite another for the Congress to impose a new TRIEA-type regime for NBCR events. This presents an extremely complex set of questions and challenges that cannot and should not be taken up without careful study and deliberation.

Rolling NBCR into terrorism coverage will likely result in significantly increased premiums and would likely have the unintended consequence of reducing the take-up rate for terrorism insurance. Requiring any retention of NBCR risk by primary insurers (even where the federal program bears most of the risk) makes little sense if insurers cannot find private reinsurance and if we are unable to resolve a set of very serious operational concerns and issues.

In addition, because insurers would immediately be required to have capital sufficient to back this new risk (and would face potentially reduced financial strength ratings), we would also expect to see an immediate diminution of capacity available to provide this coverage. Many small mutual insurers would probably not be able to raise sufficient capital quickly enough to stay in this business. The most likely outcome would be reduced, not expanded, capacity for all lines of insurance, as insurers divert capital from other products to support this new risk they'd be required to bear. In addition, creating new, stand-alone NBCR coverage would lead to adverse selection, in that only the most vulnerable risks would opt for coverage.

In any case, it is unclear how NBCR coverage could possibly be priced, let alone with any actuarial certainty. The unknowns include when and where such an event might occur, how often, involving what types of weapons, and with how much resulting loss.

Perhaps the most logical way to meet the country's economic needs for NBCR coverage was contained in a 2005 RAND Center for Terrorist Risk Management Policy report on *Trends in Terrorism*, which found that NBCR attacks "pose a challenge that may be most appropriately covered through a direct government insurance program."

- Terrorist attacks using weapons of mass destruction are not the business of private insurers; they are the responsibility of government. They require a qualitatively different response, not simply a mandate to offer coverage through a private insurance policy, because of the magnitude and breadth of the destruction and their impact on the very fabric of life. NAMIC and PCI believe this is a very serious issue demanding national attention and the commission established in the bill is the proper place to begin this review. Among the issues or questions we would propose that the commission consider are: Is the need for NBCR protection limited to commercial properties, or does it extend to personal homeowners coverage as well?
- If there is a need, how should it be addressed and is it best handled by a direct federal program?
- Is there an appropriate and cost-effective role for the private sector? If so, what is the most effective role for private industry? What are the roles of federal, state, and local governments?:

- If an offer of this protection is mandated and insurers cannot find private reinsurance for this new exposure, would a "make available" requirement threaten the solvency of many insurers unless they significantly reduce their writings in TRIA lines? If that occurred, would the "make available" requirement have the unintended consequence of reducing private sector capacity?
- What limits on NBCR losses would be necessary to make sure that the industry can meet its obligations to its other policyholders, once this mandate is applied to them?
- If there are limits on private sector insurance losses, how can one draft them to prevent insurance commissioners, the courts and/or the Congress from overriding them?
- If there are private sector limits, how would insurers determine which claims to pay and which to decline?
- If there are private sector limits, who, if anyone, would be responsible for paying the losses above those limits?
- Would the federal government pay the losses of people who did not insure their properties?
- How long would it take for insurers to educate and train claims adjusters, underwriters, and loss control personnel?
- How long would it take to develop standards for claims, underwriting, and loss control for a risk never insured before?
- How long would it take to develop coverages and policy forms for a risk never insured before?
- Traditionally, property insurance policies do not provide coverage for damage to land or clean-up. Given the potential magnitude of NBCR event, how and by whom will these costs be financed?
- How can site access and safety concerns for claims adjusters and other insurance personnel be addressed?
- How should the exposures faced by American homeowners (whose insurance policies typically exclude this risk) be addressed? This issue has been raised recently raised by the Financial Services Roundtable and would seem to merit consideration by the commission envisioned in the bill.

NAMIC and PCI recommend that the mandate of the commission be expanded to study these and other complex legal, moral and practical issues of national import. Again, we understand and believe that this is a grave national issue that must be addressed, but we do not believe it can be resolved simply by adding a make-available requirement to this legislation. We believe it deserves significant additional study and review and should be the focus of the commission discussed above.

For a more detailed description of NAMIC's and PCI's views regarding NBCR coverage, I am attaching a copy of a joint May 23, 2007 letter from the leaders of the two organizations to Chairmen Frank and Dodd.

Mr. Chairman and Members of the Committee, thank you once again for the opportunity to present testimony on this issue of vital importance to me, NAMIC and PCI member companies and the U.S. economy. We think the proposal that is the subject of today's hearing goes a long way toward establishing an effective long-term terrorism insurance plan to maximize the ability of the country to recover from terrorists attacks. We commend you for your good work and stand ready to assist you in any way we can going forward.

May 23, 2007

Senator Chris Dodd
444 Russell Building
Washington DC 20510

Congressman Barney Frank
2252 Rayburn H.O.B.
Washington DC 20515-2104

Senator Dodd and Congressman Frank:

On behalf of our combined membership and the millions of policyholders they serve, we wish to express our appreciation to you and the members of your staff who are working diligently to craft legislation to ensure that America's business community will continue to have affordable insurance coverage for acts of terrorism when the current Terrorism Risk and Insurance Extension Act (TRIEA) expires at the end of this year.

We are concerned, however, about the possibility that the legislation that emerges from this process will include a requirement that insurers offer commercial property and liability coverage for attacks utilizing nuclear, biological, chemical, and radiological (NBCR) weapons of mass destruction. We believe it would be a serious mistake to add mandatory NBCR coverage to the federal terrorism insurance program. The reasons are several.

From an insurance standpoint, NBCR events are qualitatively and quantitatively different from events arising from the use of conventional terrorist weapons. Indeed, even before the atrocities of September 11 exposed the vulnerability of the United States to large-scale terrorist attacks on American soil, insurance companies and insurance regulators had long regarded losses caused by nuclear incidents as uninsurable. That is why the insurance laws of every state allow standard commercial property and liability policies to exclude coverage for accidents at nuclear power facilities and intentional detonations of nuclear devices. In addition, virtually all personal homeowners insurance policies exclude this coverage for the same reasons.

During the 1950s, Congress recognized that private insurers' inability to assess the risk and provide coverage for losses resulting from nuclear accidents required Federal assumption of this risk. A deliberate terrorist attack using NBCR weapons, strategically executed to inflict the greatest possible harm, would likely produce losses many times greater than those arising from an accident at a nuclear power plant. Given the private sector's inability to provide coverage for nuclear accidents, it stands to reason that intentional terrorist attacks using weapons of mass destruction would be regarded by terrorism risk analysts as categorically uninsurable. Indeed, the Government Accountability Office, the President's Working Group on Financial Markets, and the RAND Center for Terrorism Risk Management have all concluded that virtually no private market exists for NBCR insurance or reinsurance and that these risks meet every classic definition of uninsurability.

These conclusions are borne out by the fact that in the nearly six years since the attacks on September 11, 2001, virtually no private reinsurance has been offered for this coverage nor have the capital markets developed any alternative risk transfer products for NBCR events. That this state of affairs is unlikely to change is reflected in a 2005 RAND report's observation that NBCR attacks "pose a challenge that may be most appropriately covered through a direct government insurance program."

What would be the consequence of requiring insurers to offer NBCR coverage under a renewed TRIA program? At the outset, insurers would need to quickly raise large amounts of capital to cover an utterly unpredictable risk whose potential loss costs are staggeringly high and variable—somewhere between $27.3 billion and $778.1 billion, according to projections by the American Academy of Actuaries. To rapidly accumulate the necessary capital, insurers would have to obtain it either from private market sources or from policyholders. Since 9/11, private capital markets have demonstrated no willingness to securitize this type of risk. That leaves rate increases on existing policyholders as the only source of the needed capital. Moreover, since there is no way to predict when the capital will be needed, the only reasonable approach would be to raise all of the required additional capital immediately. According to RAND, such price increases will probably reduce the overall take-up rate for terrorism insurance, as many policyholders would be unable or unwilling to afford the higher rates, with the net result that fewer businesses have access to insurance coverage after an event.

In addition to unrealistic capital requirements likely to affect many insurers, we believe adding NBCR risk to the terrorism insurance program will be especially problematic for many medium and smaller insurers. These carriers are likely to be faced with assuming a risk and an operational exposure of great danger and complexity for which they have no previous insuring or claim adjustment experience. There are a number of operational issues that have not been addressed by insurers or the government, including: (1) the accuracy of catastrophe loss models for property and liability terrorism risk; (2) regulatory controls on insurer pricing for this risk; (3) possible correlations between this risk and others that an insurer may have in place; (4) issues arising from possible "mixed attacks" involving both NBCR and non-NBCR exposures; (5) proper protection of claim site workers (a very serious issue in the 9/11 attack); (6) procedures for claim site access, which may require months or even years of waiting; and many other issues. Our point in raising these operational issues is not to suggest that they should not be addressed. To the contrary, we believe that the complexity of this issue demands careful study and analysis, rather than a premature and counterproductive mandate to provide NBCR coverage now.

In conclusion, our organizations are united in strongly urging Congress to resist the temptation to demand that commercial property and liability insurance contracts provide coverage for NBCR-related terrorism risk. Because we recognize how serious this issue is, we recommend instead that Congress enact legislation to create a commission to study all of the risks associated with NBCR attacks, the many operational questions involved, the various ways that such events might be financed, and the role of the federal government versus the private sector. Upon completing its work, such a commission would be in an excellent position to make recommendations to Congress concerning how best to address this issue.

Sincerely.

June T. Holmes
Interim CEO
Property Casualty Insurers Association of America

Charles Chamness
President & CEO
National Association of Mutual Insurance Companies

Testimony of Howard Kunreuther

Cecilia Yen Koo Professor of Decision Sciences and Public Policy
and co-director of the Wharton Risk Management and Decision Processes Center
The Wharton School, University of Pennsylvania

before

The Subcommittee on Capital Markets, Insurance, and Government Sponsored
Enterprises of the House Financial Services Committee
"Examining a Legislative Solution to Extend and Revise
the Terrorism Risk Insurance Act"

June 21, 2007

Mr. Chairman Kanjorski, Ranking Member Pryce and Members of the Subcommittee, I appreciate your inviting me to testify on "Examining a Legislative Solution to Extend and Revise the Terrorism Risk Insurance Act." My name is Howard Kunreuther and I am the Cecilia Yen Koo Professor of Decision Sciences and Public Policy at the Wharton School, University of Pennsylvania and Co-Director of the Wharton Risk Management and Decision Processes Center. The Wharton Risk Center was founded in 1984 and its mission is to examine alternative strategies for dealing with low-probability high-consequence events (i.e. extreme events) based on an understanding of the decision processes of consumers, firms and public sector agencies.

Since the terrorist attacks of 9/11, the Wharton Risk Center has focused on the roles of the public and private sectors in providing adequate risk financing against terrorism threat here and abroad. The Center produced several studies and a large report on *TRIA and Beyond: Terrorism Risk Financing in the U.S.* in August 2005, which has been undertaken in consultation with key interested parties from the private and public sectors and other academic/research institutions. This report was discussed with Congressional staff during the fall of 2005 at the time the *Terrorism Risk Insurance Act of 2002* (TRIA1) was being evaluated to determine whether it should be extended in some form.

A National Bureau of Economic Research (NBER) working paper, "Looking Beyond TRIA: A Clinical Examination of Potential Terrorism Loss Sharing" that was written with my Wharton Risk Center colleague Erwann Michel-Kerjan appears as *Appendix A*. The NBER paper, written after TRIA1 was extended by Congress for two years in December 2005 when it passed the *Terrorism Risk Insurance Extension Act* (TRIA2), provides an extensive series of analyses as to who will incur the costs following different terrorist attacks scenarios.

My testimony today will focus on the following three questions that I feel should be considered as one determines the specifics of a terrorism insurance bill:

1. What are the key principles that should guide the analyses of the role of insurance and other risk transfer mechanisms for dealing with extreme events?

2. What are special features of terrorism that need to be considered in determining whether this risk is insurable through some type of private-public partnership?

3. How do these principles and special features of terrorism relate to the current design of the *Terrorism Risk Insurance Revisions and Extension Act of 2007* (TRIA3)?

1. Key General Principles

The following principles are ones that should guide the development of insurance and other risk transfer programs for providing financial protection

Risk-based Premiums: Insurance and reinsurance premiums should reflect the risk. The premiums will then signal to individuals and firms the hazards they face and encourage them to engage in cost-effective mitigation measures to reduce their vulnerability to catastrophes.

Equitability: Insurance and other risk transfer programs should be fair to insurers, reinsurers, policyholders, and the general taxpayer where there is federal participation.

Minimize Likelihood of Insolvency: Insurers and reinsurers should determine how much coverage and what premium to charge against the risk so that the chances of insolvency are below some predefined acceptable threshold level.

Sufficient Demand for Coverage: The demand by individuals and firms for insurance coverage with risk-based premiums should be sufficiently high so that insurers can cover the fixed costs of introducing a program for providing coverage and spread the risk broadly through their portfolios.

Minimize Gaming: There should be no economic incentive for some insurers or policyholders to take advantage of provisions in the insurance or risk transfer program by undertaking strategic behavior.

2. Special Features of Terrorism[1]

The above principles work well for some risks where there is considerable historical data and scientific information, such as automobile accidents, fire and life insurance and even natural hazards. The terrorism risk presents special challenges in this regard, which makes it difficult for private insurers to provide widespread protection to commercial enterprises against losses from a terrorist attack. The factors listed below increase the amount of capital that insurers must hold to provide terrorism risk insurance coverage. The associated cost of holding that capital means that insurers will have to charge higher premiums for the coverage to be profitable.

Potential for Catastrophic Losses from Terrorism

Following the 9/11 events, insurers were concerned that catastrophic losses from future terrorist attacks would have a severe negative impact on their surplus and possibly lead to insolvency. Empirical evidence provided by experts on terrorism threats supports their concerns. Attacks using nuclear, biological, chemical and radiological (NBCR) weapons have the potential of inflicting very large insured losses, especially on workers' compensation and business interruption lines. The bombing of a chlorine tank in Washington, DC could kill and injure hundreds of thousands of people. Plausible scenarios elaborated by Risk Management Solutions, one of the three leading modeling firms examining catastrophe risks, indicate that large-scale anthrax attacks on New York City could cost between $30 and $90 billion in insured losses (Towers Perrin, 2004)[2].

A recent RAND study examined the impact of NBCR attacks on the losses to insurers and other interested parties from different scenarios.[3] The report presents the results of simulations for six attack scenarios: two conventional ones (1- and 10-ton truck bombs) and four NBCR scenarios such as a 5-kiloton nuclear bomb and an attack using a radiological device in the same metropolitan area. The report concludes that a 5-kiloton nuclear bomb would inflict losses of $630 billion dollars to commercial property and workers' compensation. The 2006 GAO report, written for the Chairman of the House Committee on Financial Services, concludes that "Given the challenges faced by insurers in providing coverage for, and pricing, NBCR risks, any purely market-driven expansion of coverage is highly unlikely in the foreseeable future."[4]

It is worth noting that other countries have included NBCR in coverage provided by their national terrorism (re)insurance program [e.g. United Kingdom (U.K.) and France]. But that inclusion comes at a cost. For example, when the protection of

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[1] A more detailed discussion of these points appears in Wharton Risk Center (2005). *TRIA and Beyond: Terrorism Risk Financing in the U.S.*, p. 207 (Philadelphia: The Wharton School, University of Pennsylvania).

[2] Towers Perrin (2004), "Workers' Compensation Terrorism Reinsurance Pool Feasibility Study", March.

[3] Dixon, L. Lempert, R., LaTourrette, T., Reville, R. and Steinberg, P. (2007), *Trade-Offs Among Alternative Government Interventions in the Market for Terrorism Insurance* (Santa Monica, CA: RAND Center for Terrorism Risk Management Policy)

[4] U.S. Government Accountability Office (GAO) (2006), "Terrorism Insurance: Measuring and Predicting Losses from Unconventional Weapons is Difficult, but Some Industry Exposure Exists," GAO-06-1081, Washington, DC, September 2006..

companies operating in the U.K. under Pool Re was extended at the end of 2002 to "all risks," a category that now includes damage caused by chemical and biological as well as nuclear contamination, reinsurance prices charged by the pool against insurers doubled everywhere in the U.K.[5]

The 9/11 events, as well as the anthrax attacks in the month thereafter, also demonstrated a new kind of vulnerability: the use of networks as "weapons of mass disruption" (Michel-Kerjan, 2003)[6]. Terrorists can use the capacity of a country's critical networks to have a large-scale impact on the nation. In any given network (e.g. transportation) — every aircraft, every piece of mail, every marine container — can become a potential weapon. The impact of a supply chain disruption on the retail industry could be financially catastrophic should the federal government order a major port to be shut down in the wake of potential or actual threats from contaminated containers. As a point of reference, a 10-kiloton nuclear bomb planted in a shipping container that explodes in the port of Long Beach, California, could inflict total direct costs estimated to exceed $1 trillion, not to mention the ripple effects on trade and global supply chains that could even produce a global recession (Meade and Molander, 2006)[7].

Are these scenarios likely? According to experts in nuclear security and non-proliferation, they might very well be. A 2005 survey of 85 non-proliferation and national security experts led by Senator Richard Lugar put the likelihood of a nuclear attack somewhere in the world within the next ten years at 20% and the likelihood of a radiological attack at 40% (Lugar, 2005, p. 6).[8] It should be noted, however, that the report does not focus on the likelihood of attacks on any specific country.

Interdependent Security

The vulnerability of one organization, critical economic sector and/or country depends to some extent not only on its own choice of security investments, but also on the actions of other agents. This concept of *interdependent security* implies that failures of a weak link in a connected system could have devastating impacts on all parts of it, and that as a result there may be suboptimal investment in the individual components (Kunreuther and Heal, 2003; Heal and Kunreuther, 2006)[9]. The existence of such interdependencies provides another challenge in determining how much terrorism insurance to offer and what premium to charge.

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[5] Michel-Kerjan, E. and B. Pedell. (2006), "How Does the Corporate World Cope with Mega-Terrorism? Puzzling Evidence from Terrorism Insurance Markets", *Journal of Applied Corporate Finance* (Morgan Stanley), 18 (4), December 2006.

[6] Michel-Kerjan, E. (2003), "New Vulnerabilities in Critical Infrastructures: A U.S. Perspective", *Journal of Contingencies and Crisis Management*, vol. 11: 3, pp. 132-141.

[7] Meade, C. and Molander, R. (2006), "Considering the Effects of a Catastrophic Terrorist Attack," *Rand Corporation*, Santa Monica, CA, August 2006.

[8] Lugar, R. (2005), "The Lugar Survey on Proliferation Threats and Responses." U.S. Senate, Washington, DC.

[9] Kunreuther, H. and Heal, G. (2003), "Interdependent Security," *Journal of Risk and Uncertainty*. 26: 2/3, pp. 231-249; Heal, G. and Kunreuther, H. (2006), "You Can Only Die Once: Interdependent Security in an Uncertain World." in *The Economic Impacts of Terrorist Attacks*, edited by H.W. Richardson, P. Gordon, and J.E. Moore III, Northampton, MA: Edward Elgar Publishers.

Interdependencies do not require proximity. In the case of the 9/11 attacks, security failures at Boston's Logan airport led to crashes at the World Trade Center (WTC). The failure was embedded within the security protocols promulgated by the Federal Aviation Administration and not with the application of those protocols, i.e. checking for bombs in passengers' luggage but not profiling. There was nothing that the Port Authority of New York and New Jersey and firms located in the WTC could have done on their own to prevent these aircrafts from crashing into the Twin Towers. Any protective efforts they might have undertaken would have been rendered useless by the absence of action at a distant site.

Shifting Attention to Unprotected Targets

Terrorists may respond to security measures by shifting their attention to more vulnerable targets. Sandler (2003), Keohane and Zeckhauser (2003) and Bier, Oliveros and Samuelson (2007)[10] analyze the relationships between the actions of potential victims and the behavior of terrorists. Rather than investing in additional security measures, firms may prefer to move their operations from large cities to less populated areas to reduce the likelihood of an attack. Of course, terrorists may choose these less protected regions as targets if there is heightened security in the urban areas. Terrorists also may change the nature of their attacks if there are protective measures in place which would make the likelihood of success of the original option much lower than another course of action (e.g. switching from hijacking to bombing a plane).

Dynamic Uncertainty and Time Scale

Since terrorists are likely to design their strategy as a function of their own resources and their knowledge of the vulnerability of the entity they wish to attack, the nature of the risk is continuously evolving. The likelihood and consequences of a terrorist attack are determined by a mix of strategies and counterstrategies developed by a range of stakeholders that change over time. This *dynamic uncertainty* makes the likelihood of future terrorist events extremely difficult to predict (Michel-Kerjan, 2003)[11].

A factor that is associated with dynamic uncertainty is the *timing of an attack.* Given the eight years that separated the first World Trade Center bombing in 1993 and the large-scale terrorist attacks during the morning of September 11, 2001, one could conclude that terrorist groups plan their attacks far in advance and perpetrate them when the public's attention and concern with terrorism have receded.

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[10] Sandler, T. (2003), "Collective Action and Transnational Terrorism", *The World Economy.* 26 (6), pp. 779–802; Keohane, N. and Zeckhauser, R. (2003), "The Ecology of Terror Defense", *Journal of Risk and Uncertainty.* 26: 2/3, pp. 201-229; Bier, V., Santiago O. and Samuelson, L.. (2007), "Choosing What to Protect" . Risk Analysis June. (in press)

[11] Michel-Kerjan, E. (2003), "Large-scale Terrorism: Risk Sharing and Public Policy." *Revue d'Economie Politique.* 113 (5), pp. 625-648.

Information Sharing

An important feature of terrorism is who manages knowledge of risk, and how the relevant data are obtained. The sharing of information on terrorism risk is clearly different than the sharing of information regarding other potentially catastrophic events. There are large historical databases and scientific studies in the public domain for natural hazards. Insurers, property owners, businesses and public sector agencies all have access to these findings. However, data on terrorist groups' activities and current threats are normally kept secret by federal agencies for national security reasons. For example, the public still has no idea who manufactured and disseminated anthrax in U.S. mailings during the fall of 2001. Without this information, it is difficult for modelers to make projections about the capability and opportunities of terrorists to undertake similar attacks or other disruptive actions in the future.

Government Influencing the Risk

Finally, there are also more fundamental aspects of the threat of terrorism. International terrorism has always been viewed as a matter of national security as well as foreign policy. It is obvious that the government can influence the level of risk of future attacks through appropriate counter-terrorism policies and international cooperation as well as through adequate crisis management to limit consequences should an attack occur. Some decisions made by a government as part of its foreign policy can also affect the will of terrorist groups to attack this country or its interests abroad (Lapan and Sandler, 1988; Lee, 1988; Pillar, 2001)[12]. Government success or failure to adequately address a large-scale crisis such as one that would emerge in the aftermath of a large terrorist attack would have a direct impact on many individuals, commercial enterprises and their insurers.

3. Designing a Bill for Terrorism Insurance

The above principles and special features of terrorism have important implications for designing a Congressional bill for extending TRIA2. The Wharton *TRIA and Beyond* report concludes that there is a role and responsibility for government in collaboration with the private sector to provide protection against terrorism losses. There are several reasons for this public-private partnership:

- Federal government policy and actions significantly influence the risk of terrorism.
- The creation of a pure government program would exclude the insurers' expertise as well as its financial and operational capacity to provide coverage, assess losses when they occur, and process claims in an expeditious fashion.
- Although insurers' equity capital has increased recently, the private market has limited capacity to provide coverage for extreme losses from terrorism. This is, in

[12] Lapan, H. and Sandler, T. (1988), "To Bargain or Not to Bargain: That is The Question," *American Economic Review*, 78 (2), pp. 16-20; Lee, D. (1988), "Free Riding and Paid Riding in the Fight Against Terrorism," *American Economic Review*, 78 (2), pp. 22-26; Pillar, P. (2001), *Terrorism and U.S. Foreign Policy*. Brookings Institution Press. Washington, DC.

part, due to federal tax policy, which significantly increases insurers' and reinsurers' costs of accumulating the large amounts of capital necessary to back the sale of terrorism and other catastrophe insurance.

- The mandatory coverage of terrorism losses for workers' compensation policies in all states and for any losses from fires that occur following a terrorist attack in approximately 11 major industrial states leaves insurers exposed to possible large losses that could lead to insolvencies for some of them.
- The expectation that the federal government will provide considerable assistance to uninsured victims of a terrorist attack could distort consumer and firm incentives for buying insurance and investing in loss reduction measures.
- Federal disaster assistance following a major attack will likely be significantly greater with a commensurately higher cost to taxpayers if there is no predefined public sector role in a terrorism insurance program.

I now discuss each of the principles that should guide the analyses of the role of insurance and other risk transfer mechanisms for dealing with the terrorism risk as they relate to the *Terrorism Risk Insurance Revisions and Extension Act of 2007* (TRIA3).

Risk-based Premiums

It should be clear from the above discussion that there are limited data for estimating the likelihood of a terrorist attack and the resulting consequences should such an event occur. Experts utilize a *scenario-based approach* to estimate direct consequences (e.g. physical damage, lives lost) as well as indirect impacts (e.g. losses due to business interruption) from a range of terrorism-related events. However, while the majority of modeling companies and insurers use estimates of recurrence times and probabilities with natural hazards, scenarios do not generate a sufficiently rich set of outcomes to represent the full range of possible terrorism threats. There is an opportunity for insurers to improve their estimates of the likelihood of a terrorist attack to the extent that available information from agencies such as the Department of Homeland Security, the State Department and the Department of Defense can be shared without violating privacy and security considerations.

Even though it may be difficult to achieve risk-based premiums for terrorism, state insurance regulators should not restrict rates unduly to the extent that insurers will not want to provide coverage. Currently, some states limit the premiums that insurers can charge for terrorism coverage. These restrictions may lead insurers **not** to offer property insurance to certain firms if they feel that such coverage will be unprofitable in the long-run.

Equitability

TRIA3 maintains a similar loss-sharing arrangement between the federal government and insurers for an event that is certified by the Secretary of the Treasury as an "act of terrorism" as in the current Act. Today an "act of terrorism" is defined as one

"committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the U.S. or to influence the policy or to affect the conduct of the U.S. Government by coercion," and one in which aggregate insured losses are at least $100 million. The proposed legislation removes the foreign person or interest restriction and reduces the total insured loss trigger to $50 million.

The rationale for a decrease in the loss trigger is that small insurers could suffer severe losses from a terrorist attack, losses that might severely deplete their surpluses or that might lead to insolvency if the current $100 million trigger level were maintained. This proposed reduction to $50 million in total insured losses would thus satisfy the principle of equitability by keeping small firms in business assuming that they would have difficulty obtaining affordable reinsurance premiums to protect themselves from losses between $50 million and $100 million.

By providing financial protection to those who suffer losses from any terrorist attack, whether by a foreigner or someone from this country, the insurance program is more equitable. Under TRIA2, an attack like the Oklahoma City bombing of 1995 that killed 168 people and was the most damaging attack on domestic soil prior to 9/11, would not be a certified event because it would be considered domestic terrorism. It makes good sense to include all "acts of terrorism" as certified events as proposed in TRIA3. In fact, the distinction between what would be a "certified" event covered by TRIA2 and a so-called "domestic" terrorist event may be difficult to establish. For example, are attacks on the U.S. soil similar to the ones perpetrated in London on July 7, 2005 considered domestic or international? We know today that some of the terrorists were British citizens who were trained to kill in Pakistan. The frontier between domestic and international is likely to be a gray area in many cases.

A third area of equitability relates to who should pay for the losses following a terrorist attack. Both TRIA2 and TRIA3 hold that if the insurance industry suffers terrorism losses that require the government to cover a portion of their claims, then these outlays shall be fully or partially recouped *ex post* by levying a surcharge on all commercially insured policyholders, not just the policyholders who had purchased terrorism coverage. This implies that if losses are sufficiently high, the responsibility for recouping these payments rests with all firms who have purchased insurance in any of the TRIA-covered lines.

Using data collected on the top 451 insurers operating in the United States, Kunreuther and Michel-Kerjan[13] examined the impact of the 2006 TRIA2 design on loss sharing between the key stakeholders: victims, insurers and their policyholders, and the taxpayers. By simulating the explosion of a 5-ton truck bomb in major cities in the United States, we conclude that under the current program, taxpayers are not likely to pay anything for losses below $25 billion. For a $40 billion loss, insurers and policyholders

[13] Kunreuther, H. and Michel-Kerjan, E. (2006), "Looking Beyond TRIA A Clinical Examination of Potential Terrorism Loss Sharing," Working Paper No. 12069 (Cambridge, Mass.: National Bureau of Economic Research, February).

would handle between 75% and 95% of the loss depending on the proportion of policyholders who purchased some type of terrorism insurance (i.e. the property take-up rate). In one scenario, all commercial policyholders would end up paying $6.3 billion as the result of the mandatory recoupment, whether or not they had purchased terrorism insurance. Only for terrorist attacks where insured losses were $100 billion or more would taxpayers have to pay 50% of the claims.

Minimize Likelihood of Insolvency

Due to the uncertainty in the likelihood of terrorism losses, insurers use a survival constraint to determine the extent of coverage that they are willing to offer. The essence of the survival constraint is to write coverage so that an insurer's aggregate exposure (E) under an assumed scenario will not exceed a certain percentage of its policyholders' surplus (S). One can determine how much any particular insurer will have to pay for claims by calculating its deductible D under TRIA2 (in 2007 it is 20% of the direct-earned premiums collected for TRIA2-lines in 2006; it was only 7% in 2003 under TRIA1) and then calculating its deductible/surplus (D/S) ratio. Those insurers with large deductibles (D) relative to their surplus (S) are the ones most at risk if they are providing terrorism coverage to most of their policyholders. In 2003, 36 out of the 451 largest insurers had a D/S ratio above 20%; there were 80 such insurers in 2004 and 162 in 2005 (including 8 of the 30 largest insurers). Such ratios would likely be viewed as extremely high by rating agencies.

In states such as California and New York, where only a few companies insure the largest portion of the workers compensation market, these insurers are likely to bear the largest portion of the losses as well. Should a large-scale terrorist attack occur and inflict mass casualties, their losses could then greatly exceed their TRIA2 deductible. Under TRIA2, 85% of the losses above their deductibles would initially be covered by the federal government and eventually be paid by all policyholders and taxpayers. Since workers' compensation providers are not able to exclude terrorism from their policies, if TRIA2 is not renewed some of these insurers are likely to become insolvent after a large terrorist attack unless they were to be able to obtain protection against catastrophic losses from the private sector and/or reduce their exposure to such losses by downsizing their portfolios.

Sufficient Demand for Coverage

By requiring insurance companies to offer terrorism coverage to their commercial policyholders, TRIA1 and TRIA2 have made terrorism insurance largely available. Data from one of the largest insurance brokers (Marsh Inc.) provides a sense of the evolution over time of the proportion of their clients who have purchased some type of terrorism insurance (i.e. the take-up rate).

At a national level, the Marsh survey indicates a significant and fairly continuous increase of the take-up rate over the four years that the broker has been tracking the purchase of terrorism insurance by its clients that are mainly large companies. According

to its latest report on demand for terrorism insurance,[14] the overall terrorism insurance marketplace remained the same over the past two years with 59% of companies purchasing coverage in 2006, up slightly from 58% in 2005. These data suggests that most of the surveyed companies which wanted such coverage have now purchased it. The remaining companies are self-insured, except for terrorist losses that would be covered by workers' compensation or by fire insurance in the states that cover losses from fire due to terrorism.

Minimize Gaming

TRIA3's requirement that the program be reviewed on a regular basis reduces the likelihood that insurers will engage in gaming behavior. To illustrate, certain very large insurers with low deductible/surplus ratios could strategize by significantly increasing their terrorism underwriting, then collecting large amounts of premiums for terrorism insurance but would be financially responsible for only a small portion of the claims[15]. Commercial policyholders (whether or not they are covered against terrorism) and the federal government would absorb the residual insured losses. How significant this strategy might be depends on several factors, including market share and the loss-sharing design under the program.

There are several reasons why insurers might *not* be willing to assume the large aggregate exposure implied by such a strategy. First, a larger amount of terrorism exposure increases the likelihood that an insurer will experience medium to large losses below its TRIA deductible in high-risk areas. In this case, insurers may decide to limit their aggregate exposure by estimating the likelihoods of different terrorist attack scenarios and reduce their aggregate exposure by utilizing their survival constraint in a manner similar to the processes they follow for other catastrophic risks.

Second, when an insurer provides coverage against terrorism, it also provides insurance against all other events that could cause damage or losses to their property and/or claims from their workers' compensation coverage. An insurer's decision on whether to write more terrorism coverage thus depends upon its aggregate exposure from a much broader set of risks (e.g. fire, theft, job injury).

Insurers may also be concerned that Congress will amend TRIA3 if legislators observe the type of strategizing described above. Suppose insurers who expanded their coverage were to be held responsible for 50% of their losses above their TRIA3 deductible. These insurers will very likely want to cancel some of their commercial policies for fear of incurring large claim costs after a terrorist attack. One reason why these insurers have not followed such a strategy today is their knowledge that TRIA2 is a

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[14] Marsh (2007), *Marketwatch: Terrorism Insurance—2006 Market Conditions and Analysis* (New York: Marsh Inc.)

[15] Kunreuther, H. and Michel-Kerjan, E. (2006), "Looking Beyond TRIA A Clinical Examination of Potential Terrorism Loss Sharing," Working Paper No. 12069 (Cambridge, Mass.: National Bureau of Economic Research, February).

2-year program. This is one reason for having a provision in TRIA3 that the program will be reviewed on a regular basis to determine whether it is fulfilling its intended purpose.

4. Summary and Conclusions

The extension of TRIA2 is an important and necessary solution to providing insurance protection to commercial firms. TRIA3 should address the five key principles for providing financial protection against extreme events: ***Risk-based Premiums, Equitability, Minimize Likelihood of Insolvency, Sufficient Demand for Coverage*** and ***Minimize Gaming.*** At the same time the provisions of the bill needs to reflect the special challenges that the terrorism risk presents for insurers who are required by law to offer coverage to commercial enterprises.

TRIA3 modifies the current program by addressing some of the above principles such as equitability, minimizing the likelihood of insolvency and creating sufficient demand for coverage. One also needs to be cognizant of the possibility of gaming when the legislation is reviewed on a regular basis. The bill also creates a Commission on Terrorism Risk Insurance to propose long-term solutions for covering terrorism risks by the private insurance industry. Such a commission in consultation with the Presidential Working Group on Financial Markets could explore the objectives of a terrorism risk financing program and how to achieve them through alternative risk sharing and risk-reducing mechanisms such as more effectively deploying the capital of reinsurers, facilitating the use of terrorism insurance-linked securities, mutual insurance pools and developing incentive programs for encouraging mitigation and investment in security.

The commission could also examine how other countries cope with the terrorism risk to determine whether these approaches merit consideration for the United States. The insurance infrastructure would undoubtedly play a key role in such a program, but it should be viewed as part of a broader strategy for dealing with terrorism. For example, the public and private sectors could provide economic incentives in the form of lower taxes, subsidies or lower insurance premiums to encourage those at risk to adopt higher security and loss reduction measures. It also is likely that there will be a need for well-enforced regulations and standards that complement these incentive programs.

Appendix A

2006 NBER Paper on

"LOOKING BEYOND TRIA:
A CLINICAL EXAMINATION OF POTENTIAL TERRORISM LOSS SHARING"

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NBER WORKING PAPER SERIES

LOOKING BEYOND TRIA:
A CLINICAL EXAMINATION OF POTENTIAL TERRORISM LOSS SHARING

Howard Kunreuther
Erwann Michel-Kerjan

Working Paper 12069
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NATIONAL BUREAU OF ECONOMIC RESEARCH
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Looking Beyond TRIA: A Clinical Examination of Potential Terrorism Loss Sharing
Howard Kunreuther and Erwann Michel-Kerjan
NBER Working Paper No. 12069
February 2006
JEL No. H56, G22, G28

ABSTRACT

The Terrorism Risk Insurance Act of 2002 (TRIA) established a public-private program to cover commercial enterprises against foreign terrorism on US soil. It was a temporary measure to increase the availability of risk coverage for terrorist acts by requiring insurers to provide coverage. Initially established to sunset on December 31, 2005, a two-year extension has been voted by Congress and signed by the President in December.

This paper provides an extensive series of empirical analyses of loss sharing under this program in 2005, and a prospective analysis for 2006. Using data collected on the top 451 insurers operating in the United States, we examine the impact of TRIA on loss sharing between the key stakeholders: victims, insurers and their policyholders, and the taxpayers. By simulating the explosion of a 5-ton truck bomb in major cities in the United States, we conclude that taxpayers are likely not to pay anything for losses below $15 billion. For a $25 billion loss, insurers and policyholders would handle between 80 and 100 percent of the loss depending on the property take up rate. Only for terrorist attacks where insured losses were $100 billion would taxpayers have to pay 50 percent of the claims. Recent modifications of TRIA will transfer an even larger part of the risk to the private sector.

We also show that if TRIA were made permanent in its current form some very large insurers could strategize by collecting large amount of premiums for terrorism insurance but only would be financially responsible for a small portion of the claims. Commercial policyholders from all insurers (whether or not covered against terrorism) and the federal government would absorb the residual insured losses, raising equity issues. The paper also reviews a set of possible long-term alternatives or complementary options to the current design of TRIA that could be important features of a more permanent program.

We conclude that more than four years after 9/11, the question as to who should pay for the economic consequences of a terrorist attack on the US has not yet received the attention it deserves. Congress or the White House should consider establishing a national commission on terrorism risk coverage before permanent legislation is enacted.

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1. Introduction

The evolution of international terrorism is now well accepted. Still mainly organized as local political actions twenty years ago, it has continuously expanded to include a large portion of extremist religious and other groups seeking to inflict fear, mass-casualties and maximum disruption to western nations' social and economic continuity and operating internationally[2]. Indeed, the world's 14 worst terrorist attacks (based on the number of casualties) all occurred after 1982, more than three-quarter of which took place between 1993 and 2004. A large portion of all terrorist attacks in the world during this period have been directed against U.S.-related interests and personnel. The Madrid train bombings on March 11, 2004, the coordinated London bus and underground bombings of July 7, 2005, and the bombings in Amman, Jordan in November 2005 -- attacks against three countries that were allies of the United States in the war in Iraq -- suggest that the United States remains a principal target for several international terrorist groups adhering to al-Qaeda's ideology.

Although the U.S. has been successful since 9/11 in preventing terrorist attacks on its own soil, the impact to the economy of another mega-attack or series of coordinated attacks serious concerns the government, the private sector and citizenry (Kunreuther and Michel-Kerjan, 2004 and 2005)[3]. With security reinforced around federal buildings, the commercial sector constitutes a softer target for terrorist groups to inflict mass-casualties and stress on the nation. These threats require that the country as a whole develop strategies to prepare for and recover from a (mega-)terrorist attack. Insurance is an important policy tool for consideration in this regard.

Quite surprisingly, even after the terrorist attack on the World Trade Center in 1993 and the Oklahoma City bombing in 1995, insurers in the United States did not view either international or domestic terrorism as a risk that should be explicitly considered when pricing their commercial insurance policy, principally because losses from terrorism had historically been small and, to a large degree, uncorrelated. Thus, prior to September 11, 2001, terrorism coverage in the United States was an unnamed peril included in most standard all-risk commercial and homeowners' policies covering damage to property and contents.

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[2] Enders, W. and Sandler, T. (2006), *The Political Economy of Terrorism*, Cambridge University Press.

[3] Kunreuther, H. and Michel-Kerjan, E. (2004), "Challenges for Terrorism Risk Insurance in the United States", *Journal of Economic Perspectives*, Fall 2004, 18 (4), pp 201-214.

Kunreuther, H. and Michel-Kerjan, E. (2005), *Insurability of (mega)-Terrorism*, Report for the OECD Task Force on Terrorism Insurance, in OECD (2005), *Terrorism Insurance in OECD Countries*, Paris: Organization for Economic Cooperation and Development, July 5.

The terrorist attacks of September 11, 2001, killed over 3,000 people from over 90 countries and inflicted insured losses currently estimated at $32.5 billion that was shared by nearly 150 insurers and reinsurers worldwide. Reinsurers (most of them European) were financially responsible for the bulk of these losses. These reinsurance payments came in the wake of outlays triggered by a series of catastrophic natural disasters over the past decade and portfolio losses due to stock market declines. Having their capital base severely hit, most reinsurers decided to reduce their terrorism coverage drastically or even to stop covering this risk.

Hence, in the immediate aftermath of September 11, 2001, U.S. insurers found themselves with significant amounts of terrorism exposure from their existing portfolio with limited possibilities of obtaining reinsurance to reduce the losses from a future attack. The lack of availability of terrorism insurance soon after the 9/11 attacks led to a call from some private sector groups for federal intervention. For example, the U.S. Government Accountability Office (GAO, formally General Accounting Office) reported in 2002 that the construction and real estate industries claimed that the lack of available terrorism coverage delayed or prevented several projects from going forward because of concerns by lenders or investors (U.S. GAO, 2002)[4].

In response to such concerns, the Terrorism Risk Insurance Act of 2002 (TRIA) was passed by Congress and signed into law by President Bush on November 26, 2002[5]. It constitutes a temporary measure to increase the availability of risk coverage for terrorist acts[6]. TRIA is based on risk sharing between the insurance industry and the federal government. While today it is unclear what type of long-term terrorism insurance program, if any, will emerge for dealing with the economic and social consequences of terrorist attacks[7], it is of prime importance to understand how different types of attack would translate into different loss.

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[4] U.S. General Accounting Office (GAO) (2002), "Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities." Testimony of Richard J. Hillman before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives, February 27.

[5] The complete version of the Act can be downloaded at: http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/claims_process/program.shtml

[6] U.S. Congress (2002). *Terrorism Risk Insurance Act of 2002*. HR 3210. Washington, DC, November 26.

[7] Works related to terrorism insurance in the U.S that were published in the last year (other than by the authors or cited elsewhere in the text) include Cummins, D. (2005), "Should the Government Provide Insurance for Catastrophes". Paper presented at the 30th Annual Economic Policy Conference, Federal Credit and Insurance Programs, Federal Reserve Bank of St. Louis, October 20-21; Jaffee, D. and Russell, T, (2005), "Should Governments Support the Private Terrorism Insurance Market?" WRIEC conference, Salt Lake City, August 2005; Jaffee, D. (2005), "The Role of Government in the Coverage of Terrorism Risks", Chapter 7 in OECD (2005), *Terrorism Risk Insurance in OECD Countries,* July 5; U.S. Department of Treasury (2005), *Assessment: The Terrorism Risk Insurance Act of 2002*, Washington, DC, June 30; Chalk, P. Hoffman, B., Reville, B. and Kasupski, A-B. (2005) *Trends in Terrorism*, Santa Monica, CA: RAND Corporation, June; U.S. Government Accountability Office (GAO) (2005), *Catastrophe Risks, U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks.* GAO-05-199, Washington, D.C., February 28; CBO (2005), *Federal Terrorism Reinsurance: An Update*, Washington, DC, January; Brown, J., Cummins, D, Lewis, C. and R. Wei (2004), "An Empirical Analysis of the Economic Impact of Federal Terrorism Reinsurance", *Journal of Monetary Economics* 51, pp. 861–898; Smetters, K. (2004), "Insuring Against Terrorism: The Policy Challenge," In Litan, R. and Herring, R. (eds), *Brookings-Wharton Papers on Financial Services,* pp. 139-182.

This paper provides an extensive series of empirical analyses of loss sharing under the TRIA program for 2005 that was undertaken as part of a nine-person team research initiative we co-directed at the Wharton School last year, in collaboration with numerous firms in the insurance industry and other critical sectors, federal and international organizations that resulted in the Wharton Risk Center *TRIA and Beyond* report.[8] President Bush signed into law a two-year extension of TRIA on December 22, 2005, the Terrorism Risk Insurance Extension Act (TRIEA) that expanded the private sector role and reduced the federal share of compensation for terrorism insured losses. We also present some analyses for the years 2006 and 2007 based on the new loss-sharing design (See Appendix 2 for a side by side comparison TRIA 2005 vs. TRIEA).

The paper is organized as follows. The next section focuses on the loss sharing process between insurers, policyholders and taxpayers for 2005 and 2006. Using data collected on the top 451 insurers operating in the United States, Section 3 examines the impact of the deductible on insurers' losses from terrorist attacks and provides also a simulated analysis for the 30 largest insurers (70% of the market) for 2006 and 2007. Section 4 presents the financial impacts of terrorist attack simulations on the different stakeholders based on the explosion of a five-ton truck bomb or the crash of a commercial aircraft against one of the top 477 tallest high-rises of the country. Section 5 presents the results of a loss-share analysis for three major cities: Los Angeles (California), Houston (Texas) and New York City (New York) by combining the simulations with market share data for different line of insurance coverage in these cities. Section 6 provides a discussion as to how loss sharing between the relevant stakeholders is likely to evolve in 2006 and 2007.

In Section 7 we present a conceptual analysis as to what would happen if TRIA were made permanent. Using data on insurance markets, we show that it would be possible for some very large insurers to game the system. They would collect large amounts of premiums for terrorism insurance but only be financially responsible for a small portion of the risk. Commercial policyholders from all insurers and the federal government will absorb the residual insured losses. Such strategizing raises important equity issues as to who should pay for terrorism losses[9]. We conclude the paper by reviewing a set of possible alternatives or complementary options to the current design of TRIA that could become important features of a permanent program.

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[8] This study undertaken in collaboration with numerous firms and federal bodies was designed to understand the importance of the insurance infrastructure in our national security agenda. For more details see the Wharton Risk Management and Decision Processes Center report *TRIA and Beyond*.

[9] Analyses in section 4, 5 and 7 focus on 2005, which is the most recent year data are available for. It will be possible for us to undertake similar analyses for 2006 later on this year.

2. Loss-Sharing Design

Eligibility for Coverage

Under both TRIA and TRIEA, insurers are obliged to offer terrorism coverage to all their commercially insured clients. Firms are not required to purchase this insurance unless mandated by state law, as is the case for workers' compensation lines in most states[10]. The stated coverage limits and deductibles must be the same as for losses from other events covered by the firm's current policy[11]. This implies that if there are restrictions on a standard commercial insurance policy, then terrorism coverage will also exclude losses from these events. Thus the risks related to a terrorist attack using chemical, biological, radiological and nuclear weapons (so-called CBRN) are covered under TRIA only if the primary policy includes such coverage[12].

Commercially insured losses are eligible for coverage under TRIA and TRIEA only if the event is certified by the Secretary of Treasury (in concurrence with the Attorney General and Secretary of State) as an "act of terrorism." As stated under TRIA an "act of terrorism" has to be "committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the U.S. or to influence the policy or to affect the conduct of the U.S. Government by coercion" (TRIA, 2002). This distinction has been maintained under TRIEA. Therefore, an attack like the Oklahoma City bombing of 1995, which killed 168 people and had been the most damaging attack on domestic soil prior to 9/11, would not be covered under TRIA and TRIEA because it would be considered "domestic terrorism."[13] Under TRIA a condition for certification was that total losses from the attack must be greater than $5 million. TRIEA establishes a "per event trigger" for federal participation: aggregate insured losses must be at least $50 million from March 31, 2006 to January 1, 2007 and $100 million for losses occurring in the 2007 Program Year.

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[10] Workers' compensation coverage is mandatory for a large majority of employers in all states other than Texas where it is optional. Employers must either purchase insurance or qualify to self-insure. Workers' compensation laws do not permit employers or insurers to exclude coverage for worker injuries caused by terrorism, including those caused by acts involving nuclear, biological and chemical agents.

[11] In most instances, this "make available" requirement means that insurers are required to offer a policy without a terrorism exclusion or limitation. Once an insurer has satisfied this offer requirement, the insurer is permitted to offer other terrorism coverage options, such as a policy with a sub-limit.

[12] The extension of TRIA based on Senate bill S. 467 directs the President's Working Group on Financial Markets to study long-term availability and affordability of coverage for terrorism losses, including (1) group life and (2) nuclear, biological, chemical and radiological events. The President's Working Group has to submit a report of its findings to the House Financial Services and Senate Banking Committees by September 30, 2006.

[13] The distinction between what would be a "certified" event covered by TRIA and a so-called "domestic" terrorist event may difficult to establish. For example, would attacks on the U.S. soil similar to the ones perpetrated in London on July 7, 2005 be considered domestic or international? We know today that some of the terrorists where British citizens who were trained to kill in Pakistan. The frontier between domestic and international might be a grey zone in a lot of cases.

While this paper focuses on commercial terrorism coverage, one should note that individuals at risk are also covered against terrorist attacks. Life insurance policies typically cover loss of life from terrorism attacks with the proceeds paid to the TRIA and TRIEA does not provide insurers with special protection against any of these individual risks (i.e., life, homeowners, automobile)[14].

Structure of the Partnership

Under TRIA's three-year term that ended on December 31, 2005, there was a specific risk-sharing arrangement between the federal government and insurers for a certified event. The same logic applies under TRIEA. Figure 1 depicts the public-private loss sharing for an insurer when total insured losses are less than $100 billion. If the loss suffered by an insurance company i is less than its deductible (ID_i), the insurer does not receive any reimbursement from the federal government. This situation is illustrated by an insured loss of L_1 in Figure 1 where the insurer's payment is represented by the oblique lines. If the insured loss due to a certified terrorist attack is greater then its deductible, as depicted by L_2 in Figure 1, the federal government will initially reimburse the insurer for 90 percent of the losses above its deductible, and the insurer will end up paying only 10 percent of it up front. The federal payment is represented by horizontal lines in the figure. This federal backstop provision is equivalent to free up front reinsurance above the deductible. As will be discussed later, the federal government will recoup part or all of this payment from all commercial policyholders.

The insurer's deductible is determined as a percentage of its total direct commercial property and casualty earned premiums of the preceding year for TRIA TRIEA lines (that is, lines covered by the act), and not just the premiums of clients that purchase terrorism coverage. In 2005 the premium was set at 15 percent -- if an attack had occurred in 2005, insurers would have been responsible for losses equal to 15 percent of the direct commercial property and casualty revenues that had been earned as premiums in 2004.[15] If an attack occurs in 2006, insurers will be responsible for losses equal to 17.5 percent of the direct commercial property and casualty earned premiums in 2005 (20 percent in 2007). This deductible plays a very important role in determining loss sharing between insurers and the federal government and can be very large for many insurers. Using data provided by A.M. Best on their estimates of TRIA retentions for major publicly held insurance companies for 2005, we determined this deductible to be

[14] After initial discussions in 2002 about the possibility of having life insurance benefit from TRIA protection, Treasury decided not to extend TRIA to group life. It concluded that since insurers had continued to provide group life coverage after 9/11 even though the availability of reinsurance was reduced, there was no need to include this coverage as part of the TRIA program. Government Accountability Office (GAO) (2004), "Terrorism Insurance: Effects of the Terrorism Risk Insurance Act of 2002", GAO-04-806T, Washington, DC, May 18. Whether group life will be included in the future will mainly depend on the conclusion of the President's Working Group to be released by the end of September 2006. It is worth noting that the extension of TRIA reduces the spectrum of coverage; for example, TRIEA excludes commercial automobile insurance, burglary and theft insurance, surety insurance, professional liability insurance; and farm owners multiple peril insurance. [D&O insurance is still covered]

[15] In 2003 the deductible under TRIA was 7% of direct commercial property and casualty earned premiums the previous year and 10% in 2004.

$3.6 billion for American International Group (AIG) and $2.5 billion for St. Paul Travelers. Four other companies on the list of top 10 insurers, based on TRIA-line direct earned premiums had TRIA deductibles between $800 million and $2.1 billion in 2005. These are Zurich, Liberty, Chubb, and ACE. In the next section of the paper we provide an extensive analysis of this issue both for the Top 30 and Top 451 insurers in the U.S.

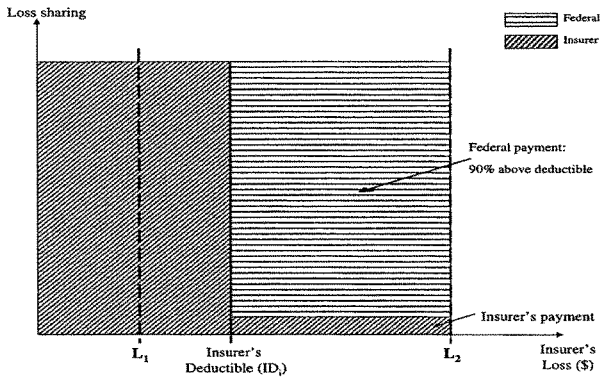

Figure 1. Loss-Sharing under TRIA and TRIEA Between an Insurer and the Federal Government
[Note: If the insurance company *(i)* loss is less than its deductible (ID_i), the insurer is not reimbursed by the government (e.g., for an insured loss of L_1). If the loss is greater than the deductible (L_2), the government reimburses the insurer for 90 percent of the losses above its deductible, and the insurer pays 10 percent.]

If the insurance industry suffers terrorism losses that require the government to cover a portion of companies' claims, then these outlays will be fully or partially recouped *ex post*. More specifically, the federal government will recoup the portion of its payment between the total insurers' outlays and a market aggregate retention amount, which is defined by the law ($15 billion in 2005; $25 billion in 2006; $27.5 billion in 2007); that is called the "mandatory recoupment". This mandatory recoupment[16] is obtained by levying a surcharge on all commercially insured policyholders, whether they had purchased terrorism insurance or not. If the insured losses exceed $100 billion during the year, then the U.S. Treasury will determine how the losses above this amount will be covered[17].

This federal recoupment surcharge "may not exceed, on an annual basis, the amount equal to 3 percent of the premium charged for property and casualty insurance

[16] The law is ambiguous as to what will happen if the total insurers' outlays are above this market aggregate retention.

[17] The TRIA legislation states that "If the aggregate insured losses exceed $100,000,000,000, (i) the Secretary shall not make any payment under this title for any portion of the amount of such losses that exceeds $100,000,000,000; and (ii) no insurer that has met its insurer deductible shall be liable for the payment of any portion of that amount that exceeds $100,000,000,000. Congress shall determine the procedures for and the source of any payments for such excess insured losses." §103(e)(2)(A). TRIEA does not modify this.

coverage under the policy."[18] Insurers play the role of intermediaries by levying this surcharge against all their property and casualty policyholders[19], whether or not they had purchased terrorism insurance, and transfer the collected funds to the Department of Treasury. In other words, taxpayers would have paid insured losses between $15 billion and $100 billion in 2005. In 2006, they will pay insured losses between 25 and 100 billion of dollars. The law indicates that the federal government could also recoup part of that payment (so-called "discretionary recoupment") but is not clear on that process; in this paper we assume that this is not the case.

Figure 2 depicts the repayment schedule in 2006 between the insurers (the area comprising blue oblique lines), all commercial policyholders (solid gray area) and the taxpayers (area comprising of horizontal lines) after the federal government has reimbursed all insurers for 90 percent of their claims payments above their deductible level (for those suffering loss above their TRIEA deductible). In the example we consider here, since the total insured losses L are greater than $25 billion but total payments by insurers are below the market aggregate retention of $25 billion, we assume the government recoups a portion of its payments from commercial policyholders with the remaining amount paid by U.S. taxpayers.

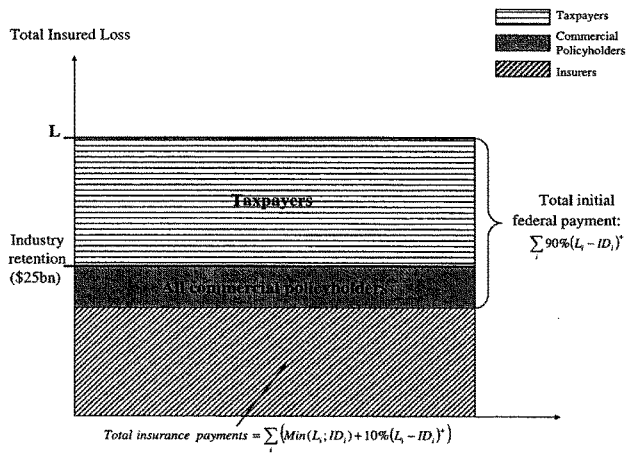

Figure 2. Loss Sharing under TRIEA between Insurance Industry, All Policyholders and Taxpayers in 2006

[Note: In this example, because the total insured loss L exceeds $25 billion, but total payments by insurers are below the market aggregate retention of $25 billion, we assume the government recoups a portion of its payments from commercial policyholders with the remaining amount paid by U.S. taxpayers.]

[18] TRIA, Section 103(e)(8)(C).

[19] There is no statement in the legislation or its interpretation that specifically indicates that only the commercial policyholders are taxed. We have discussed this point with insurers and reinsurers. They have assumed that because TRIA applies only to commercial enterprises, the Department of Treasury will tax only commercial entities after a terrorist attack.

3. Empirical Analysis of Insurer Deductible/Surplus Ratios

We conducted a series of empirical analyses on the impact of TRIA and TRIEA on loss sharing between those directly targeted by a terrorist attack, their insurers and other interested parties such as commercial policyholders and U.S. taxpayers[20]. In this section and the next two others, we concentrate our analyses on the following two aspects: the effect of the program's deductible feature, and the effect of different terrorist attacks on losses and loss-sharing.

We first examined TRIA and TRIEA's deductible feature and its effect on the level of exposure to a terrorist attack insurers might have. We found that the larger an insurer's Deductible/Surplus (*D/S*) ratio, the more exposed the insurer is to losses from any given terrorist attack. We determined how the *D/S* ratio for the top 451 insurers operating in the country[21] has changed over the three years of TRIA's operation (2003-2005). Data necessary to do a similar analysis for 2006 (TRIEA line insurers' direct earned premiums) are not available yet. For that reason, we also computed the *D/S* ratios for 2006 and 2007 for the top 30 insurers under the deductible increases to 17.5 percent in 2006 and to 20 percent in 2007 but using extrapolated figures from the last three years. We then compared *D/S* over the five-year period 2003-2007 for each insurer (see Appendix 1).

We then analyzed in the next sections the impact of different simulated terrorist attacks on the losses experienced by the victims, insurers, policyholders, and taxpayers, and the likely differences in large urban areas. We differentiated workers' compensation from other TRIEA-covered lines. While we have the data to undertake such analyses for large cities throughout the country, in this paper we provide the results only for one or two cities in three states: Texas (Houston and Dallas), California (Los Angeles and San Francisco) and New York (New York City).

The notion of policyholders' surplus

We start with our analysis of the impact of the deductible feature of TRIEA. Insurer *capital* represents the net worth of the company (assets minus liabilities). Capital enables the insurer to pay any losses above those that were expected. It serves as a safety net to support the risk an insurer takes on by writing insurance, and it helps ensure that the insurer will be able to honor its contracts. As such, insurers' capital supports the personal safety nets of homeowners, business owners, workers, dependents of heads of households and others who rely on insurance to provide financial compensation to rebuild their lives and businesses after covered losses occur.

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[20] The analyses undertaken in this paper are based on data provided by A.M. Best and Risk Management Solutions, discussions with key stakeholders concerned with terrorism insurance, and by responses to a questionnaire designed by the Wharton Risk Center and distributed to insurers by the American Insurance Association and the Property Casualty Insurers Association of America in 2005.

[21] The top insurers were those ranked by 2004 TRIA-line direct earned premium (DEP); that is the measure used to calculate insurers' 2005 deductible under TRIA. These insurers all had a total TRIA-line DEP equal to or above $10 million in 2004.

Insurer capital is traditionally referred to as "*policyholders' surplus*" (also called "surplus" for short). Despite the connotation of the term "surplus," there is nothing superfluous about it -- it is, in fact, an essential component supporting the insurance promise. The cost of that capital is an insurer expense that must be considered in pricing insurance, along with expected losses, sales and administrative expenses for policies written. Consider, for example, insurance for property damage caused by hurricanes. An insurer's expected losses are relatively low, because in a typical year the policyholder will not suffer a hurricane loss. However, losses could also be quite high -- far in excess of those expected at the time policies are priced -- as illustrated by the 2005 hurricane season. In the event of a serious hurricane, a substantial portion of the loss must be paid from insurer capital. For terrorism coverage, maximum losses are extremely high relative to expected losses, which makes the capital issue critical.

The evolution of the D/S ratio under the three-year TRIA terms: 2003-2005

Given the obligation of insurers to offer terrorism insurance to all their commercial policyholders under TRIA, the amount of loss that an insurer will eventually bear is based on its deductible. As described in the previous section of this paper, the insurer's deductible under TRIA (and TRIEA) is determined as a percentage of its total direct earned premiums (DEP) during the preceding year for TRIA lines. For each of the top 451 insurers A.M. Best provided us with the premiums written in TRIA commercial lines[22], to allow us to determine what the deductible (*D*) of each of these insurers had been under TRIA. Although we do not know the insurers' exact terrorism exposure[23], we will assume that they are providing this TRIA-based coverage to a large proportion of their policyholders in the urban areas we consider here. We can also distinguish P&C from workers' compensation market shares. Our interest is in determining how vulnerable insurers are to the possibility of suffering a large loss relative to their surplus. Those insurers with large deductibles (*D*) relative to their surplus (*S*) are the ones most at risk if they are providing terrorism coverage to most of their policyholders.

Figure 3 depicts the evolution of the *D/S* graphically for our sample of 451 insurers for these same three years (2003, 2004 and 2005). For each year, we plot the number of insurers whose *D/S* ratio lies between different percentage ranges in increments of 5 percent (e.g., [0% and 4.99%]; [5% and 9.99%], etc).

Of the total, 294 insurance companies providing terrorism insurance in the U.S. had a *D/S* ratio lower than 10 percent in 2003, compared with 139 insurers in 2005. If we consider higher *D/S* ratios, more than half of the firms had a *D/S* ratio greater than 15 percent in 2005 compared with less than one-sixth of the insurers in 2003. In 2003, only 36 insurers had a *D/S* ratio above 20 percent. There were 80 such insurers in 2004. In

[22] The original sample was made of all insurers with a TRIA-line total earned premium higher than $10 million in 2002, 2003 and 2004. Because the number of these insurers varied from one year to the next (establishment of new companies, mergers, bankruptcies, etc.), we selected a consistent sample of 451 insurers over the three years 2002-2004 that we used to determine the evolution of the *D/S* ratio under TRIA 2003-2005.

[23] This information would obviously be highly valuable but is not yet publicly available.

2005, 162 insurers (more than 35 percent of the sample) had a *D/S* ratio greater than 20 percent.

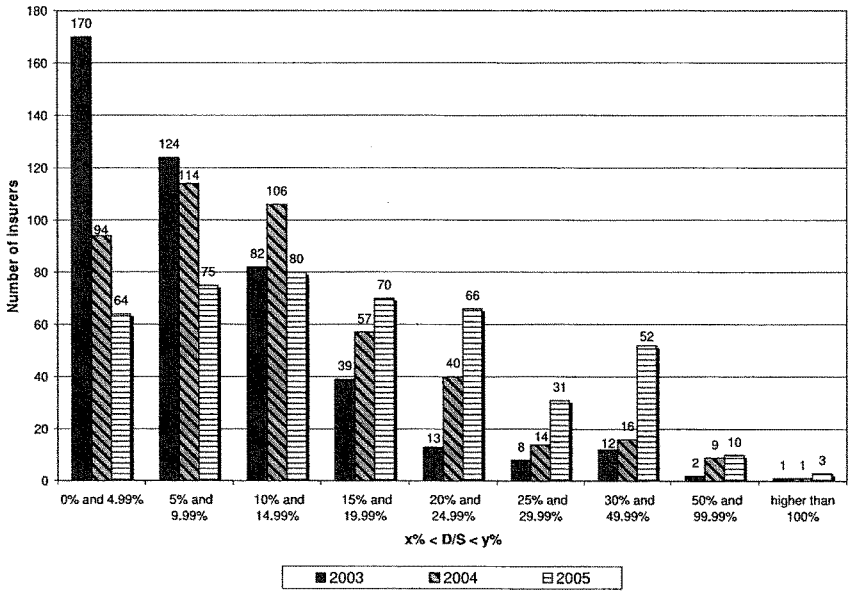

Figure.3. Change in *D/S* Ratio for the Top 451 Insurers under TRIA (2003-2005)

Focus on the Top 30 insurers – TRIA & TRIEA, 2003-2007

Insurers writing policies in an urban area know that there is some chance that the loss from a terrorist attack could reach or exceed their deductible (*D*). We focus our second series of analyses of the impact of TRIA on insurers for the 30 largest companies based on direct earned premiums in TRIA lines the preceding year. These companies wrote premiums that comprised 70 percent of the total insurance market[24].

This analysis is based on the TRIA deductibles of 7 percent (2003), 10 percent (2004) and 15 percent (2005) of the direct earned premiums (DEP) for TRIA line policies during the previous year. The data show clearly that there has been a major shift over the past 3 years as the TRIA deductible percentage has increased. For example, as shown in Figure 4, only 5 insurers had a *D/S* ratio exceeding 10 percent in 2003 while more than half were in this category in 2005. Of the top 30 insurers, 8 of them have a *D/S* ratio exceeding 20 percent in 2005, while only 1 was in this range in 2003.

It is interesting to see how the extension of TRIA affects the *D/S* ratio of these 30 insurers for 2006 and 2007. We thus also analyze an increased deductible up to 17.5% of

[24] The top 30 insurers' TRIA line direct earned premiums in 2004 were about $147 billion of dollars out of the $210 billion provided by the top 451 insurers of our sample in that same year.

TRIA-line direct earned premiums (DEP) in 2006, and to 20 percent in 2007. However, in order to determine "*D/S* (2006)" and "*D/S* (2007)" for each of the 30 companies under this scenario, we need to know what would be their TRIA-line DEP and their surplus in 2005 and 2006, respectively. As these data are not available yet we do extrapolate from the past. We base our analysis on the annual percentage change in these two numbers over the three-year period (2002-2004) for each of the thirty companies[25]. We then extrapolate these figures for the next two years to estimate direct earned premiums (DEP) for TRIA lines and surplus (*S*) for 2005 and 2006.

Figure 4 depicts the number of insurers (y-axis) whose *D/S* exceeds pre-specified values of *x* percent (x-axis); years 2003, 2004 and 2005 are exact figures, 2006 and 2007 result from our prospective analysis. Should this estimation be right, 18 of the top 30 insurers would have a TRIEA deductible higher than 10 percent of their surplus in 2007; for 13 of them that would be higher than 20 percent (vs. 8 in 2005 and 1 in 2003), including for 6 of the 10 largest insurers (Appendix provides the complete set of results). Moreover, none of theses 30 insurers had a D/S ratio higher than 50% in 2005. there will be 3 such insurers in 2006 (50%, 56% and 66%, respectively) and 2007 (the D/S ration increased dramatically up to 57%, 70% and 100%).

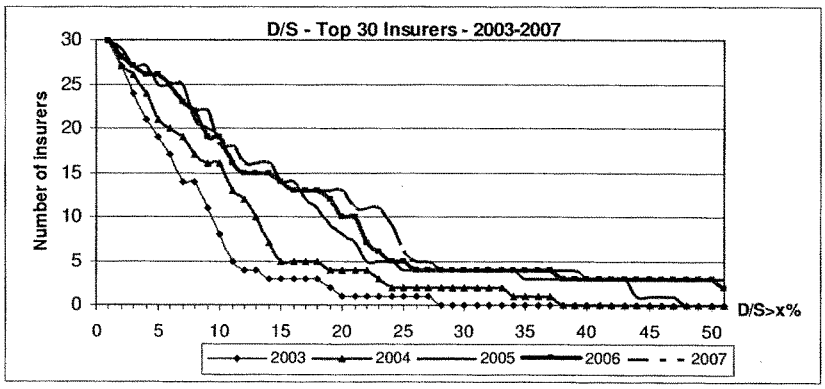

Figure 4. Number of the Top 30 Insurers whose *D/S* Exceeds Pre-specified Values of *x* Percent

4. Constructing Terrorist Attack and Loss-Sharing Scenarios

Due to the difficulty in estimating the likelihood of a terrorist attack, insurers utilize scenarios to determine their maximum exposure to a range of possible attacks that

[25] This can be done for the largest companies as changes are "relatively" stable over these three years and consistent with the market. However, extrapolating that for the other 431 smaller insurers does not work well because for most of them there is a huge difference between (2004/2003) and (2003/2002): taking the mean of it is not likely to reflect what the evolution has really been from 2004 to 2005.

vary by location and mode of attack[26]. However, few insurers consider the likelihood of these scenarios occurring in determining their exposure[27].

Given insurers' interest in determining their exposure using deterministic scenarios, and to more fully understand the nature of the economic and human losses from a terrorist attack on business property, we constructed a set of scenarios to analyze the impact of financial losses between the non-insured victims, the insurers and the taxpayers under TRIA and TRIEA. We also utilized these scenarios to analyze the effect on the distribution of losses should TRIA have not been renewed so that the private market (e.g., insurers, property owners and/or employers) would be responsible for all the losses.

As discussed earlier, there are no easy answers to these loss allocation questions -- they will be determined by the nature and location of the terrorist attacks and the number of insurers providing coverage. For example, if the attack is a relatively small one on a single building, and if large insurers with high deductibles cover the target building, then there will be little, if any, federal government involvement in loss payments. However, if a few smaller companies with low TRIA deductibles cover the target building, then the federal government will pay a significant portion of their losses, and then will partially or fully recoup these payments later from all policyholders purchasing commercial insurance.

Evidence indicates that most insurers focus on damage from two-to-ten-ton truck bombs in determining the losses they could suffer from a terrorist attack[28]. As an element of comparison, the attack in the front of the Alfred P. Murrah Federal Building in Oklahoma City in 1995 was perpetrated with a two-and-a-half-ton truck bomb. One reason for this focus is that A.M. Best uses this type of scenario in analyzing the impact of a terrorist attack on insurers' balance sheets. Although other scenarios could be used to evaluate losses from a terrorist attack[29], we analyze the effect on property damage and workers' compensation losses of a five-ton truck bomb exploding in each of the United States' 447 largest commercial high-rise buildings.[30].

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[26] When asked the question "Does your company consider scenarios in its catastrophe/exposure management process?" 92 percent of the insurers who responded to the Wharton questionnaire answered "Yes". One company responded to the above question by noting: *"Our company uses deterministic terrorist attack scenarios, and the associated Probable Maximum Loss (PML) estimates of these scenarios, to establish and manage exposure concentrations within major metropolitan areas and/or surrounding landmark properties."*; see Wharton Risk Center (2005).

[27] As illustrated by the following responses to the question: "Do you take estimates of the likelihood of the various known scenarios into account when making underwriting decisions?":

"Not really. There is little historical data to predict future events."

"Likelihood is very unpredictable for terrorist acts."

"Our company does not believe that estimates of the frequency of terrorist attacks are credible at a country, regional or specific property level."; see Wharton Risk Center (2005).

[28] For example, 90% of the Wharton questionnaire discussed above indicated that they were using that type of scenario in evaluating their exposure: 7 of the 10 insurers responding to the questionnaire indicated that they used 5-ton bomb scenario and 2 insurers indicated they used a two-ton truck bomb scenario. See Wharton Risk Center (2005). *Ibib.*

[29] For example, the RAND Corporation has undertaken a detailed study on the impact of aircraft attacks on high rises in the United States.

[30] We are grateful to Andrew Coburn from Risk Management Solutions who provided us with these data.

Scenario Methodology

Figure 5 describes the methodology for allocating losses from a specific scenario to the potential victims as well as to the insurers and the federal government immediately after a terrorist attack.

The loss allocation process can be divided into several steps:

- *Step 1:* Identify the nature of the terrorist attack: What's the target (represented by the target picture in figure below)? What mode of attack? Is the attack considered a "certified" or "non-certified" event? What are the direct losses potentially by insurance?
- *Step 2:* Determine losses covered by insurance. What was the insurance take-up rate at the target location? What portion of the losses is actually covered by insurance (by line)?
- *Step 3:* Determine what proportion of losses is assumed by each of the affected parties. Who's paying what? What insurers are responsible for what part of the insured losses? How the loss-sharing process under TRIA and TRIEA does operate? (the table at the top of the figure below)

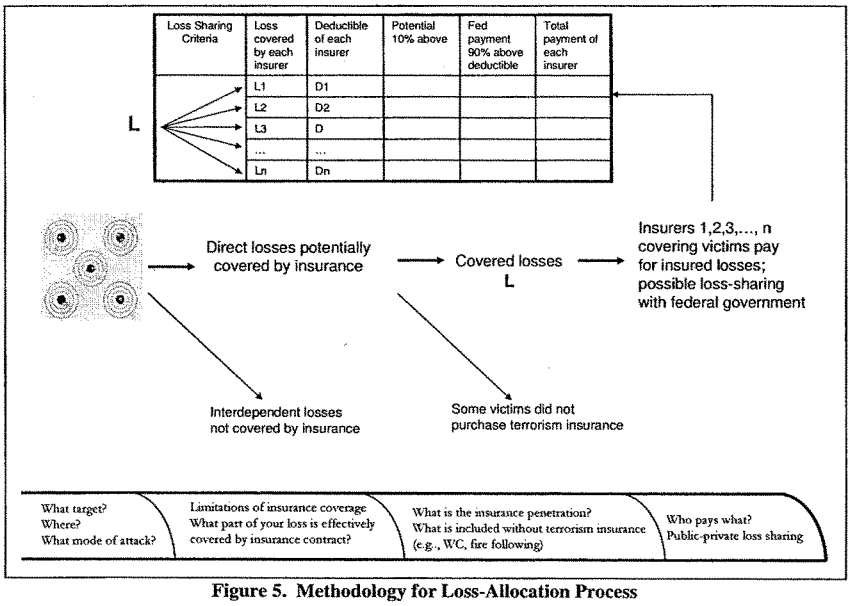

Figure 5. Methodology for Loss-Allocation Process

Figure 6 provides the distribution of loss for each of 447 commercial high-rise buildings on two major insurance lines covered by TRIA (and TRIEA): property (including business interruption) and workers' compensation. The explosion of a five-ton truck bomb would inflict not only disastrous damage to the specific building that terrorists want to target, but also to other adjacent structures. The impact would mainly

depend on the type of building and the number of employees who work there[31]. For example, the distribution of losses described in Figure 6 indicates that a five-ton truck bomb on Building A would inflict $4.7 billion in workers' compensation losses and $3.9 billion in property losses[32]. An attack on Building B, in a different city, would inflict $6.8 billion in workers' compensation losses and $8.7 billion in property losses. The maximum combination of property and workers' compensation losses is estimated to be between $15 and 16 billion for a single event (Buildings B and C).

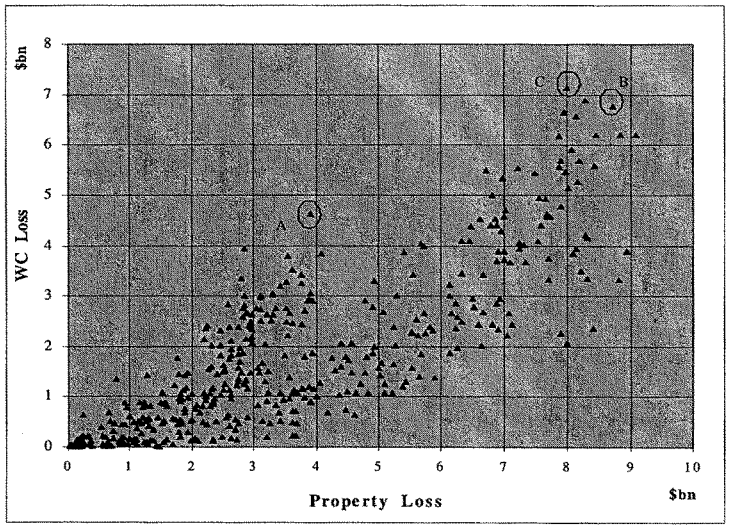

Figure 6. Projected Property Losses and Workers' Compensation Losses from Five-Ton Bomb Attacks to 447 High-Rise Buildings in the United States (in $ billion)
[Each triangle represents one specific high-rise building used in the simulation;
Triangles A, B, and C are three specific buildings we discussed in the core of the text]

Similar simulations can be run using a scenario of an aircraft crashing against each of the 447 high-rise buildings (Figure 7). Such a simulation reveals that the magnitude of loss for property and workers' compensation for each of the 447 simulations would be lower. Workers' compensation maximum losses are likely to be capped at $3 billion[33] and property at $8 billion for different buildings. As with the truck bomb scenario, if simultaneous attacks were to occur in different locations, the losses would be additive.

[31] For the simulation, we assume that the attack would occur at 10 a.m. on a Wednesday -- a time when most employees would be in the building.
[32] For obvious reasons we do not reveal here the nature of any of these targets.
[33] The insured WC losses due to the 9/11 attacks were $1.3 billion.

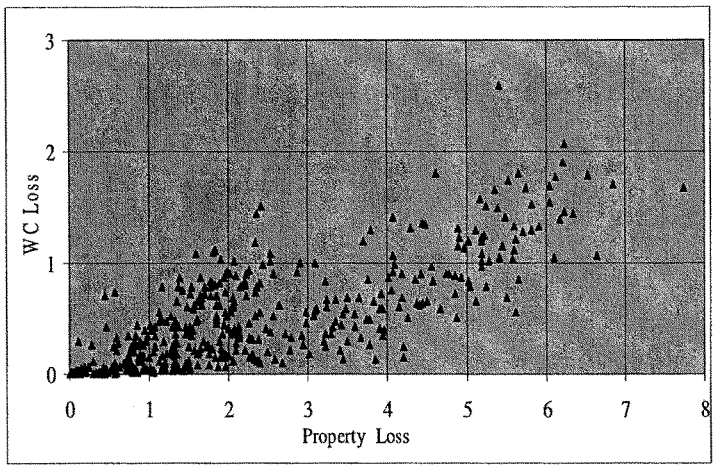

Figure 7. Projected Property Losses and Workers' Compensation (WC) Losses from Aircraft Attacks to 447 High-Rise Buildings in the United States (in $ billion)
[Each triangle represents one specific high-rise building used in the simulation]

5. Effect of Location and Attack Size on Loss Sharing under TRIA

How would losses from foreign terrorist attacks on U.S. soil be distributed across the relevant affected parties? This question can be answered differently, depending on different risk-sharing scenarios that vary with respect to location, magnitude of damage and terrorism risk insurance take-up rate.

Assumptions

We make a number of assumptions to examine these losses. Because data are not available on individual insurer's terrorism exposure, we utilize *market shares* of insurers to allocate losses from a terrorist attack between the 451 largest insurers that comprise 97 percent of the market with respect to 2004 TRIA-line direct earned premiums (DEP)[34]. Market shares appear to be the most reasonable proxy for analyzing loss sharing across the affected parties. In addition, we separate property insurance lines from workers' compensation lines. In the case of property coverage we utilize premiums written for nationwide commercial coverage. With respect to workers' compensation (WC) coverage we have access to insurers' market shares in the relevant states and therefore allocate losses using these data[35].

[34] Since data are not available on individual insurers' terrorism exposure, market share appears to be the most reasonable proxy for analyzing loss sharing across the affected parties.

[35] For each of the three states on which we focus our analysis, there are major competitive workers' compensation insurers: New York State Insurance Fund, State Compensation Insurance Fund of California and Texas Mutual Insurance Company. The State Compensation Insurance Fund of California covers half

We first undertake a comparative analysis of loss distribution between the affected parties as we vary location, level of loss and take-up rate under a scenario in which the terrorist attacks take place in 2005 with TRIA in place. In this scenario, insurers will pay their entire loss up to their TRIA deductible (D: 15 percent of the TRIA-line DEP in 2004) and then an additional 10 percent above D, with the federal government paying the other 90 percent[36]. Under TRIA the federal government would levy a surcharge against all policyholders purchasing commercial insurance to recoup part of its payment within the total insurers' payments and the insurance industry retention ($15 billion in 2005) ("mandatory recoupment").

Effect of Attack Location

The effect on loss sharing of two 5-ton truck bomb attacks varies greatly depending on the location of the attack (Table 1). Under our simulation, we compare the total property loss ($15 billion) and workers' compensation loss ($10 billion) in three major cities (New York City for New York, Los Angeles for California, and Houston for Texas). We also assume that half of the property damage to commercial enterprises in the buildings is covered by either terrorism insurance or fire-following insurance, and that all the workers' compensation losses are covered by insurance. This scenario results in a $17.5 billion in insured loss out of the $25 billion total. A sensitivity analysis relative to the insurance take-up rate is undertaken later in this subsection.

Table 1. City Comparison of Simulated Scenario Involving five-ton Truck Bombs ($25 billion in losses: 50 percent coverage for property; 100 percent coverage for workers' compensation [WC]); 2005 TRIA

City Comparison	Not-insured [37]	Total insured	Loss Sharing: Insurers' Payments	All Policyholders[38]	Final Government Taxpayers
New York, NY	$7.5bn	$17.5bn	$13.27bn	$1.73bn	$2.5bn
		Insured loss sharing	*76%*	*10%*	*14%*
Los Angeles, CA	$7.5bn	$17.5bn	$13.1bn	$1.9bn	$2.5bn
		Insured loss sharing	*75%*	*11%*	*14%*
Houston, TX	$7.5bn	$17.5bn	$14.5bn	$0.5bn	$2.5bn
		Insured loss sharing	*83%*	*3%*	*14%*

of workers' compensation lines in the state while the major insurers in New York and Texas cover 40 percent and 20 percent respectively of the total WC coverage in their states.

[36] We assume that insurers have not purchased reinsurance. If they have, then the amount of their loss would be somewhat reduced. We assume a zero deductible for the policyholder on their terrorism insurance policy. This assumption simplifies the analysis but does not affect the qualitative results.

[37] Retained by policyholders who suffered the losses but were not covered against terrorism.

[38] The federal government recoups the 90% portion of the insured loss it initially paid above insurers' payments up to an industry aggregate of $15 billion in 2005 (see Section 2 on TRIA design).

Under this scenario, the insurers and policyholders will absorb $15 billion of the $17.5 billion insured loss in each of the three cities. However, the distribution of payments between insurers and all policyholders differs across metropolitan areas (due to different workers compensation market shares). In both New York and California, two or three large insurers provide a very large portion of workers' compensation coverage for the entire state -- they will have a much higher loss relative to their TRIA deductible than workers' compensation insurers in Texas, where there is less concentration of coverage in one company. Hence, the federal government will initially pay more in New York and California (the 90 percent portion above the deductible of the few key workers' compensation insurers), and then recoup part of that payment against all policyholders. In all three cities, the federal government covers $2.5 billion of the loss, which is shared by all U.S. taxpayers[39].

Effect of Size of Loss

Changing the size of the loss from $0.5 billion to $100 billion affects the distribution of payments (Table 2). We detail the effect in one specific metropolitan area (New York, NY), using the same assumptions as in the previous section: half of the property damage to commercial enterprises in the buildings are covered by either terrorism insurance or by fire-following insurance, and all the workers' compensation losses are covered by insurance.

Table 2. Impact of Varying Losses from 5-ton Truck Bomb Attacks on New York City (50 percent insurance coverage for property; 100 percent coverage for workers' compensation [WC]); 2005 TRIA

Loss Scenarios	Not-insured[40]	Total insured	Loss Sharing: Insurers' Payments	Loss Sharing: All Policyholders[41]	Loss Sharing: Final Goverment Taxpayers
Total: $0.5bn Property: $0.25bn WC: $0.25bn	**$125mi**	**$375mi**	**$375mi**	**$0**	**$0**
		Insured loss sharing	*100%*	*0%*	*0%*
Total: $5bn Property: $2.5bn WC: $2.5bn	**$1.25bn**	**$3.75bn**	**$2.97bn**	**$780mi**	**0$**
		Insured loss sharing	*79.2%*	*20.8%*	*0%*
Total: $15bn Property: $9bn WC: $6bn	**$4.5bn**	**$10.5bn**	**$8.23bn**	**$2.27bn**	**$0**
		Insured loss sharing	*78.3%*	*21.7%*	*0%*

[39] The U.S. Department of Treasury has the authority to collect the $2.5 billion through surcharges if it elects to do so, but here we only allow a recoupment for losses between the insurer's payments and the $15 billion market retention in 2005.

[40] Retained by policyholders who suffered the losses but were not covered against terrorism.

[41] The federal government is assumed to recoup the portion of insured loss it initially paid above insurers' payments up to an industry aggregate of $15 billion in 2005.

Total: $25bn Property: $15bn WC: $10bn	**$7.5bn**	**$17.5bn**	**$13.27bn**	**$1.73bn**	**$2.5bn**
		Insured loss sharing	*75.9%*	*9.9%*	*14.2%*
Total: $40bn Property: $28bn WC: $12bn	**$14bn**	**$26bn**	**$20.6bn**	**$0**	**$5.4bn**
		Insured loss sharing	*79.2%*	*0%*	*20.8%*
Total: $40bn Property: $12bn WC: $28bn	**$6bn**	**$34bn**	**$18.7bn**	**$0**	**$15.3bn**
		Insured loss sharing	*55%*	*0%*	*45%*
Total: $100bn Property: $50bn WC: $50bn	**$25bn**	**$75bn**	**$34.1bn**	**$0**	**$40.9bn**[42]
		Insured loss sharing	*45.5%*	*0%*	*54.5%*

The figures reveal that, if losses from terrorist attacks do not exceed $15 billion, the insurance companies and policyholders will bear all of the losses. We considered two cases for which the total loss is $40 billion. In Case 1, property loss is $28 billion and workers' compensation is $12 billion. In Case 2, the dollar figures are reversed: property loss is $12 billion and workers' compensation is $28 billion. Even if the total loss is the same, the loss sharing differs considerably between these two cases. While taxpayers would end up paying $5.4 billion in Case 1, they would pay $15.3 billion in Case 2. The difference is due to both the level of insured loss and the distribution of loss among insurers who have different deductibles under TRIA. In other words, a $1 billion loss due to property damage is shared differently than a $1 billion loss of workers' compensation, because the insurers are different. If the terrorist attacks lead to losses of $100 billion, under a scenario in which losses are half property, half workers' compensation, then the U.S. taxpayers will bear 54.5 percent of the total insured losses.

6. Increased Burden on Insurers and Commercial Enterprises (covered or not against terrorism) in 2006 and 2007

How are these results likely to be modified this year and in 2007? There is no definitive answer to that question now. The design of the program requires one to specify direct earned premium under TRIEA lines collected the previous year (i.e., 2005), and these data will not be available before mid-2006.

Some have use the "total industry DEP/deductible" as a proxy to measure how terrorism losses would be shared between insurers, all policyholders and taxpayers. However, our data analyses have shown that the loss shares differed very significantly depending on whether one considered such an–incorrect–aggregate approach or the more

[42] Including $18.3 billion that would represent the 90% federal payment above the New York Insurance Fund's TRIA deductible.

granular insurer-based one on which TRIEA is really based[43]. What can be done at this time is to understand under in what directions loss sharing is likely to evolve under the revised design of the terrorism insurance program.

Effect of the Increased Industry Market Retention on Loss Sharing

While most of the debate has been focused on the increase in insurer deductible, the major change in TRIEA is the increase of insurance industry retention from $15 to $25 billion in 2006. In Table 3, we utilize the results of the analyses summarized in Table 2 but modify the retention level to reflect this change (results are indicated in [ ]).

For total insured losses under $15 billion there is, of course, no difference. For the $25 billion loss scenario, however, the $2.5 billion that would have been paid by taxpayers in 2005 is now paid by policyholders. The difference is even more significant for the two $40 billion scenarios: commercial policyholders, whether they are covered against terrorism or not, pay $4.4 billion and $6.3 billion respectively. For the same $100 billion scenario than the one used before, there is no difference because insurers already pay $34.1 billion in claims, which is above the $25 billion retention -- in that case there is no mandatory recoupment by the federal government.

Table 3. Impact of Varying Losses from 5-ton Truck Bomb Attacks on New York City 50% Insurance for Property Coverage; 100% Insurance for workers' compensation; 2005 ; $15 billion industry market retention [$25 billion industry market retention]

Loss Scenarios	Not-insured[44]	Total insured	Loss Sharing: Insurers' Payments	Loss Sharing: All Policyholders[45]	Loss Sharing: Final Goverment Taxpayers
Total: $0.5bn Property: $0.25bn WC: $0.25bn	**$125mi**	**$375mi**	**$375mi** **[$375mi]**	**$0** **[$0]**	**$0** **[$0]**
		Insured loss sharing	*100%*	*0%*	*0%*
Total: $5bn Property: $2.5bn WC: $2.5bn	**$1.25bn**	**$3.75bn**	**$2.97bn** **[$2.97bn]**	**$780mi** **[$780mi]**	**$0** **[$0]**
		Insured loss sharing	*79.2%*	*20.8%*	*0%*
Total: $15bn Property: $9bn WC: $6bn	**$4.5bn**	**$10.5bn**	**$8.23bn** **[$8.23bn]**	**$2.27bn** **[$2.27bn]**	**$0** **[$0]**
		Insured loss sharing	*78.3%*	*21.7%*	*0%*
Total: $25bn Property: $15bn WC: $10bn	**$7.5bn**	**$17.5bn**	**$13.27bn** **[$13.27bn]**	**$1.73bn** **[$4.23bn]**	**$2.5bn** **[$0]**
		Insured loss sharing	*75.9%*	*9.9%*	*14.2%*
			75.9%	*[24.1%]*	*[0%]*

[43] While still imperfect because we consider each insurer's market share in the location where we simulate the attack, not the real coverage provided by that insurer for the specific target.
[44] Retained by policyholders who suffered the losses but were not covered against terrorism.
[45] The federal government is assumed to recoup the portion of insured loss it initially paid above insurers' payments up to an industry aggregate of $15 billion in 2005.

Total: $40bn Property: $28bn WC: $12bn	**$14bn**	**$26bn**	**$20.6bn** **[$20.6bn]**	**$0** **[$4.4bn]**	**$5.4bn** **[$1.0bn]**
		Insured loss sharing	*79.2%*	*0%*	*20.8%*
			[79.2%]	*[16.9%]*	*[3.9%]*
Total: $40bn Property: $12bn WC: $28bn	**$6bn**	**$34bn**	**$18.7bn** **[$18.7bn]**	**$0** **[$6.3bn]**	**$15.3bn** **[$9bn]**
		Insured loss sharing	*55%*	*0%*	*45%*
			[55%]	*[18.5%]*	*[26.5%]*
Total: $100bn Property: $50bn WC: $50bn	**$25bn**	**$75bn**	**$34.1bn** **[$34.1bn]**	**$0** **[$0]**	**$40.9bn**[46] **[$40.9bn]**
		Insured loss sharing	*[45.5%]*	*0%*	*[54.5%]*

Effect of the Increased Deductible and Market Conditions

As discussed earlier, TRIEA increases the insurer deductible, as a percentage of the TRIA-line DEP in the previous year, from 15 percent in 2005 to 17.5 percent in 2006, and to 20 percent in 2007. While this represents a difference in 2.5 point of percentage each year, this translates into a 17 percent increase in 2006 and another 14 percent increase in 2007 (in absolute value). Between 2005 and 2007, for a given DEP level, there will be a 33 percent increase in the insurer's deductible under TRIEA.

The increased insurer deductible is affected by market conditions as well, if one expects TRIAE-line premiums to evolve over time. For example, the total TRIA-line premiums for our 451-insurers sample evolved as follows: $170.9 billion in 2002, $197.2 billion in 2003 (a 17 percent increase from the previous year), and $210.6 billion in 2004 (a 7 percent increase from 2003). After the 2004 and 2005 hurricane seasons, it would not be surprising the see the market hardening so that a 10 to 15 percent annual increase in TRIEA-line premiums for 2005 and 2006 appears to be a reasonable assumption.

Suppose now that the portfolio of a representative insurer X follows the same evolution of the aggregate sample. If annual TRIA-line DEP in 2004 of insurer X were $100 million then its terrorism coverage deductible under TRIA for 2005 would have been $15 million. Assuming a 13 percent increase in TRIE-line DEP in 2005, then insurer X's deductible under TRIEA for 2006 would be $19.775 million (i.e. .175 ($113 million)). This represents a 31.8 percent increase in its terrorism deductible from the previous year in absolute value. If premium increases follow a similar pattern between 2005 and 2006, then insurer X's deductible under TRIEA for 2007 would be $25.54 million (i.e. .20 ($127.69 million)).

This reflects a 70 percent increase over its deductible in 2005. The impact on the precise amount of terrorism loss sharing can be determined after data from 2005 becomes available. What is clear is that insurers and policyholders will pay a much greater loss

[46] Including $18.3 billion that would represent the 90% federal payment above the New York Insurance Fund's TRIA deductible.

share in 2006 and 2007 than under the 2005-attack scenario due to the higher deductible and higher market retention and hence the general taxpayer will incur a smaller portion of the loss.

7. Private Efficiency, Public Vulnerability: Will Insurers Strategize if the Current Program is Made Permanent?

We can use the scenario methodology to analyze the question as to how insurers will react if the program is made permanent in its current form. Will insurers' exposure to terrorism losses change from what it currently is under TRIEA and, if so, what would be the impact on loss sharing between the affected parties following a large-scale terrorist attack on U.S. soil?

To examine this question, we assume that TRIEA officially becomes a permanent program with the insurer's deductible at 17.5 percent of their TRIEA-line DEP from the previous year. All insurers know that they will have to pay for all losses they incur below this deductible (*D*) and 10 percent of the loss above it, the remaining 90% eventually paid by other parties (taxpayers, policyholders). An insurer with a very low deductible/surplus ratio would have a rationale for this insurer to take advantage of the small percentage it will have to absorb if its loss exceeds the TRIA deductible. Any insurer with a low deductible/surplus (*D/S*) ratio would have an economic incentive to write a large number of policies in a concentrated area subject to a terrorist attack (e.g. Times Square, Wall Street area) due to the positive correlation in these losses. In other words, the insurer knows that if one of these buildings is damaged or destroyed, the surrounding ones are also likely to suffer severe damage.

Determining Terrorism Coverage Using an "E Gaming Strategy"*

To examine how the aggregate exposure/surplus ratio affects the amount of coverage an insurer will want to provide if TRIEA is extended indefinitely, we use the following notation:

E* = maximum insured terrorism exposure (i.e. worst case scenario)

E = actual dollar claims incurred by an insurer from a worst case scenario

DEP = direct earned premiums written for TRIA lines of coverage

D = aDEP = TRIA/TRIEA deductible determined by the percentage a (e.g. a = 17.5% in 2006)

S = current surplus

X = E/S = aggregate exposure for terrorism/surplus ratio

Y = D/S = deductible/surplus ratio

Given the difficulties in estimating the probability of a terrorist attack, rating agencies focus on deterministic scenarios in evaluating an insurer's credit rating. We focus our estimates on insured losses from a five-to-six truck bomb scenario in determining the maximum exposure an insurer will be willing to accept. If an insurer

experiences insured losses of E^*, it determines its dollar claims (E) with one of two equations:

$$E = E^* \quad \text{if } E^* \leq D \tag{1}$$

$$E = D + .1\,(E^* - D) \quad \text{if } E^* > D \tag{2}$$

A possible line of analysis would be to suppose that the maximum amount of terrorism exposure (E^*) that an insurer wants to write is determined by a desired aggregate exposure/surplus (E/S) ratio given by x (e.g. $x = 10\%$). To determine the value of E^* the insurer first computes $D/S = y$ and compares the value of y with x.

- *If* $y \geq x$, the insurer knows that its claims are determined by the first equation (1) (i.e. $E = E^*$), because it is responsible for the entire loss on its own given that $D/S > x$. The insurer thus sets $E^* = xS$.

- On the other hand, if $y < x$, the insurer knows that its claims are determined by the second equation (2), and the government will cover 90 percent of the insured loss above its TRIA deductible, given the federal backstop provision of TRIA. In this case, the insurer computes $E/S = D/S + .1\,(E^*/S - D/S)$ which can be written as $x = y + .1(E^*/S - y)$ or $E^* = (10x - 9y)S$ (3)

To illustrate this strategy with a simple numerical example, we assign the values of $D = 10$, $S = 200$, $y = .05$ and $x = .10$ Since $y < x$, E^* is determined by (3) as follows:

$$E^* = (1\text{-}0.45)200 = 110$$

If an insurer were responsible for the entire loss, then $E = E^*$ for all values of E^* so that $E^* = xS$. For this example, $E^* = .10(200) = 20$, which is considerably lower than the scenario in which the insurer is responsible for only 10 percent of the loss, as it was under TRIA and still is under TRIEA in 2006.

To examine the impact of a permanent TRIA-like program on the amount of terrorism coverage written by insurers, we assume that each insurer is concerned with maintaining an aggregate exposure from deterministic scenarios at 10 percent of its surplus (S)[47]. E, then, is be the *ultimate exposure* of the insurer; that is, what it will pay after sharing part of the loss with other parties.

E^* represents the *aggregate exposure* that an insurer is willing to risk if it is responsible for ten percent of the loss above $D = 15$ percent (e.g., the arrangement under TRIA in 2005) and it wants to set a value of $E/S = D + .1(E^* - D) = 10\%$.

We define an E^* *gaming strategy* as the decision by an insurer to increase significantly the amount of coverage it provides in order to take advantage of the 90% risk-sharing arrangement with the government, and at the same time to collect a significant amount of terrorism insurance premiums[48].

We focus on the locations where a large terrorism loss is more likely. To make the data analysis manageable, we have limited our sample of insurers to those who already

[47] This assumption represents a very prudent behavior. Indeed, 17 of the top 30 insurers already have a D/S ratio equal or higher than 10 percent in 2005.

provide the largest terrorism coverage in urban areas. We focused on the top 30 insurers based on TRIA-line direct earned premiums in 2004 and then eliminated the 7 companies who are small business and personal lines writers. This group of 23 large insurers actually accounts for about two-thirds of the TRIA-lines direct earned premiums. For the sake of simplicity, we then make the assumption that these 23 insurers cover 100 percent of the insured losses in the city we consider. We then analyze how losses would be shared under TRIA and compare this with a design of a "permanent TRIA."

For each insurer, we can determine its aggregate terrorism coverage in urban areas. For insurers with a *D/S* ratio greater than 10 percent, insurers limit their exposure to 10 percent of their surplus ($E^* = E$). Those with *D/S* less than 10 percent could offer much more coverage than under TRIA, particularly those with very small *D/S* due to a large surplus ($E^* > E$). Figure 8 depicts the difference that fixing a threshold of *E/S* = 10 percent would have on insurers' decisions regarding how much terrorism coverage to offer, depending on whether the insurer had a *D/S* ration higher than 10 percent (Insurer (a); left part of the graph) and those with *D/S* less than 10 percent (Insurer (b); right part of the graph). In both cases, there are two bars. The solid gray one on the left indicates the *D/S* ratio of the insurer in 2005, the one made up of oblique lines on the right indicates exposure based on the constraint that *E/S* = 10 percent.

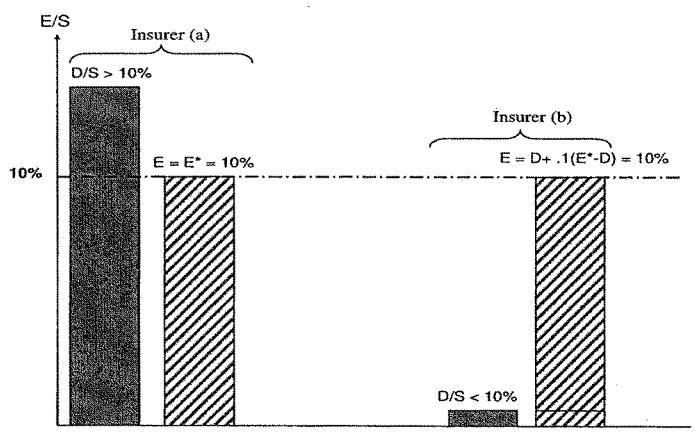

Figure 8. Insurer's Exposure Limited to 10% of Its Surplus

The aggregate exposure for each of these two types of insurer is depicted in Figure 9. An insurer with considerable business in non-TRIA lines such that its surplus is high but its deductible is quite low will take advantage of the structure of TRIA's program (if it is made permanent) by increasing its aggregate exposure considerably from the current level, up to E^*. For example, insurer (b) on Figure 9 will only pay 10 percent of any loss above its deductible (*D*; the portion represented by oblique lines) with the other 90 percent paid by taxpayers and possibly all policyholders under the federal government's recoupment arrangement under TRIA (the area represented by horizontal lines).

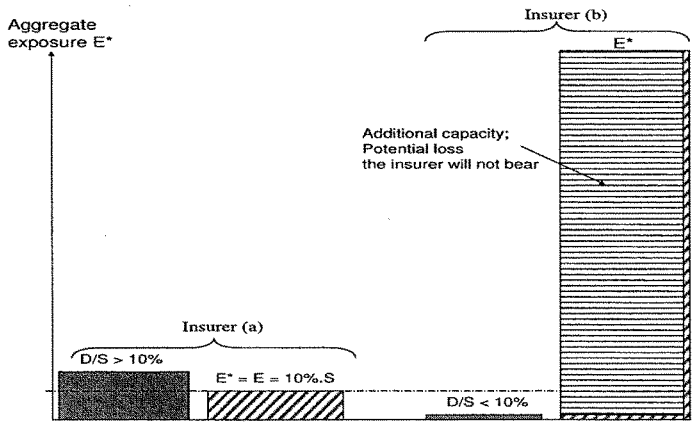

Figure 9. Aggregate Exposure of Insured Losses; Additional Capacity Provided by Insurers with D/S<10%

An important difference from the analyses undertaken in the previous section of the paper is that market share is now based on each insurer's E^*. In this case, we assume that E^* is composed of both property and workers' compensation coverage. As a result the market shares of insurers providing terrorism coverage would be quite different if a TRIA-like program were made permanent. In particular, the New York State Insurance Fund would likely not be the major provider of workers' compensation coverage anymore, as its surplus is much lower than other large insurers; the company is therefore constrained in how much terrorism insurance it will be willing to write.

Using E^*, one can then determine how the coverage from a terrorist attack would be spread across insurers. Because insurers with low *D/S* ratios are willing to write considerably more property coverage at relatively low prices in metropolitan areas if TRIA is made permanent, all commercial enterprises will expect to be insured against property losses (we assume a 100 percent take-up rate)[49].

Allocation of Losses Across Affected Stakeholders

As mentioned earlier, data for 2006 are not available yet, so we provide the analysis by making the design of TRIA-2005 permanent. We discuss in this section who pays for the losses under TRIA in 2005, and should TRIA be made permanent, for two scenarios in New York City: a $25 billion and $100 billion terrorist attack using five-ton

[49] It is unclear how terrorism insurance will be priced under this scenario. Insurers with low *D/S* ratios competing for business in urban areas will have an economic incentive to reduce their price as they expand their coverage, because they know they will be only responsible for 10 percent of any loss greater then *D* -- something an insurer with more limited surplus cannot do. As a result, the major providers of coverage will be winnowed down to only a few insurers.

truck bombs. Under TRIA in 2005, the allocation of losses is based on each insurer's market share of total property-casualty premiums for commercial coverage, and insurers are assumed **not** to be using an *E* strategy*. The now 100 percent take-up rate when TRIA is made permanent results in a shift of non-insured losses ($7.5 billion and $25 billion, respectively) to either all the policyholders or the government/taxpayers (Table 4). On first glance it seems counterintuitive that insurers will pay less for terrorism losses when their take-up rate is 100 percent rather than 50 percent. The reason is that insurers with low *D/S* ratios will increase their exposure very significantly, as shown in Figure 9. Following a terrorist attack, these few insurers will be initially responsible for the largest part of the losses.

Under TRIA in 2005, these losses would have been spread over a much larger number of insurers, who collectively would have absorbed more of the loss because it would fall below their values of *D*. In other words, under a permanent TRIA program these few insurers will end up paying a very limited portion of their exposure (they actually pay *E* not *E**), while the federal government will cover 90 percent of the loss above their *D* levels. As with the other analyses, we assume that the federal government will pay for any losses above the $15 billion industry market retention without recoupment of any of their expenditures under the TRIA federal backstop provision.

Consider the insurance scenario with a $25 billion loss. Because the total loss will increase from $17.5 billion (with a 50 percent take-up rate) to $25 billion (with a 100 percent take-up rate), the general taxpayer's share of the loss will increase from $2.5 billion to $10 billion – that is a 300 percent increase from the current TRIA program. The difference between the $15 billion insurance industry retention and insurers' payments of $13.3 billion will be charged against all policyholders who will experience a 288 percent increase in payments. The difference in market shares induced by a few insurers playing an *E** strategy would result in a 37 percent decrease in insurance industry payments, even if all losses caused by the attacks are now covered (Table 4).

In the more extreme case of a $100 billion loss, when some insurers decide to significantly increase their aggregate exposure after learning that TRIA is renewed indefinitely, the insurance industry would pay considerably less in claims even though the take-up rate on property coverage is assumed to be 100 percent. More specifically, due to their higher exposures when TRIA is extended indefinitely, the insurers will receive a larger subsidy from the federal government than they would under TRIA today. Furthermore the insurance industry loss with either a 50 percent or 100 percent take-up rate is greater than the $15 billion market retention rate. We assume that taxpayers cover the loss above this amount so there will be no recoupment of the subsidy by the federal government and the commercial policyholders will not be taxed at all. Hence the insurers actually pay less when total insured losses are $100 billion than when they are $75 billion (Table 4). Indeed, the larger total insured loss due to the increased coverage amount is passed on to the U.S. taxpayers who now absorb $79.3 billion in loss payments compared with $51 billion under TRIA in 2005.

Table 4. Distribution of Losses under TRIA-2005 and if TRIA is Made Permanent
($25 billion Loss in New York City)

		Insured Loss Sharing			
	Non-insured	Total insured	Insurers' Payments	All Policyholders[50]	Final Fed. Gov Taxpayers
SCENARIOS					
TRIA-2005 – 50% take-up rate on Property Insurance – 23 insurers					
Total: $25bn Property: $15bn WC: $10bn	**$7.5bn**	***$17.5bn***	***$13.3bn***	***$1.7bn***	***$2.5bn***
		Insured loss sharing	*76%*	*9.8%*	*14.2%*
TRIA Extended Indefinitely – 100% take-up rate – 23 insurers					
Total: $25bn Property: $15bn WC: $10bn	**$0**	**$25bn**	**$8.4bn**	**$6.6bn**	**$10bn**
		Insured loss sharing	*46%*	*14%*	*40%*
Change in final payments			**-37%**	**+288%**	**+300%**
TRIA-2005 – 50% take-up rate (TRIA-line premium market) – 23 insurers					
Total: $100bn Property: $50bn WC: $50bn	**$25bn**	**$75bn**	**$24bn**	**$0**	**51bn**
		Insured loss sharing	*32%*	*0%*	*68%*
TRIA Extended Indefinitely – 100% take-up rate– 23 insurers					
Total: $100bn Property: $50bn WC: $50bn	**$0**	**$100bn**	**$20.7bn**	**$0**	**$79.3bn**
		Insured loss sharing	*20.7%*	*0%*	*79.3%*
Change in final payments			**-14%**	**0%**	**+55%**

If one wants to design a program that encourages insurers to write coverage, then a permanent terrorism insurance program like TRIA or TRIEA will be successful due to the very large subsidy the government provides to any insurer whose losses exceed *D*. The very large insurers with low *D/S* ratios will provide most of the coverage and pay very little after a terrorist attack compared with their aggregate exposure. They would keep all their premiums and transfer the loss to all commercial policyholders and taxpayers. This points to an inequity in this system, because the policyholders of those insurers who do not suffer any loss are responsible for the same amount of repayment to the government in the form of a surcharge as are policyholders in companies that suffered large losses and were subsidized by the government.

[50] The federal government is assumed to recoup the portion of insured loss it initially paid above insurers' payments up to an industry aggregate of $15 billion in 2005.

Rationale for Limiting Aggregate Exposure

There are several reasons why insurers may not be willing to assume the large aggregate exposure implied by an E^* gaming strategy. First, a larger E^* increases the likelihood that an insurer will experience medium to large losses below its TRIA (or TRIEA) deductible with the more structures insurers cover in high-risk areas. In this sense insurers may decide to limit their aggregate exposure by estimating the likelihoods of different terrorist attack scenarios occurring. Insurers may then reduce their aggregate exposure by utilizing their survival constraint in a manner similar to the processes they follow for other catastrophic risks. Second, when an insurer provides coverage against terrorism it also provides insurance against all other events that could cause damage or losses to their property and/or claims from their workers' compensation coverage. When an insurer decides whether to write more terrorism coverage, it needs to consider its aggregate exposure from a much broader set of risks (e.g., fire, theft, job injury).

Insurers may be concerned that Congress will amend a permanent TRIA-like program if legislators observe the type of strategizing described above. Suppose insurers who expanded their coverage by focusing on E^* were to be held responsible for 50 percent of their losses above their TRIA deductible. These insurers will very likely want to cancel some of their commercial policies for fear of incurring large claim costs after a terrorist attack. One reason why these insurers have not followed an E^* gaming strategy today is their concern that a TRIA-like program will not be renewed in its current form.

8. The Way Forward: A Perspective on Long-term Options for Terrorism Risk Financing

Although TRIA has provided an important and necessary temporary solution to the problem of providing terrorism insurance to commercial firms, we do **not** believe it or its successor TRIEA is an equitable and efficient program in the long run. We now turn to a set of alternative options that involve the private and public sectors for providing protection against terrorism losses on a more permanent basis. These alternatives are not mutually exclusive. Some combination of these and perhaps other options should be considered in the design of a program that provides protection against terrorism losses while at the same time encouraging risk-reducing measures by those who are potential targets for a future attack.

Deploy Capital of Potential Target Firms

Modern enterprise risk management has shown that it often makes sense for a firm to use its own capital to absorb risk, rather than insuring against a loss. In these circumstances, the firm can manage the risk through its own capital management strategy. For example, the firm may lower its debt financing in relation to equity to be able to tolerate more risk. Other more focused strategies include the use of structured debt (e.g., warrants, convertible and forgivable debt) and more recently the use of contingent capital (i.e., financing that is contingent on the occurrence of specified

events). Thus, we would envision that a large part of terrorism risk is, and will continue to be, absorbed by the firm's own capital, so that it is, in fact, self-insured.[51]

Those institutions providing long-term debt financing to developers could possibly underwrite potential losses from terrorism and charge higher interest rates to reflect the additional risk. Equity capital investors could hold more diversified portfolios, so no single investor would suffer a large and disproportionate diminution in the total value of assets in the event of an attack.

Deploy Capital of Reinsurers

One potential private market solution that has been discussed is to increase the transfer of risk through reinsurance (Congressional Budget Office, 2005).[52] Since reinsurance portfolios normally cover sizable losses in the tails of the distribution, reinsurers normally need to hold relatively large amounts of capital compared with primary insurers. During the past several years, most major reinsurers experienced reductions in capital, in part due to the 9/11 attacks, and several of them were downgraded by rating agencies. They decided not to allocate much of their scarce capital to terrorism risk, instead focusing their capital on other lines.

Results from the survey of reinsurers undertaken, as part of the Wharton Risk center *TRIA and Beyond,* by the Reinsurance Association of America indicate that the reinsurance industry's capacity for providing terrorism coverage under the TRIA program in 2005 was in the range of $5--6 billion. According to those surveyed, if a TRIA-like program were not in place, reinsurers would either maintain the same amount of reinsurance coverage or reduce the amount they provide.

More detailed analysis needs to take place as to the role that private reinsurance could play in providing protection against catastrophic losses from terrorism. One possibility would be a TRIA-like program without individual insurer deductibles that would only provide payments once losses exceeded a large aggregate threshold[53]. This approach would stimulate the demand for reinsurance and would avoid some of the distortions associated with individual insurer deductibles and inclusion of captives in the program[54].

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[51] For more details on strategies that firms can use to self-insurance against risks see Doherty, N. (2000), *Integrated Risk Management,* New York: McGraw-Hill.

[52] Congressional Budget Office (2005), *Federal Terrorism Reinsurance: An Update*, Washington, DC, January.

[53] Notably, the leading reinsurance companies reentered several European markets for terrorism insurance after 9/11. Most of them did so because their exposure was limited and that they were all part of a pooled reinsurance tranche of a national program. See Michel-Kerjan, E. and Pedell, B. (2005), "Terrorism Risk Coverage in the Post- 9/11 Era: A Comparison of New Public-Private Partnerships in France, Germany and the U.S.," *The Geneva Papers on Risk and Insurance*, 30: 1, pp. 144-170. This article also discusses programs in Spain (established in 1954) and the United Kingdom (established in 1993; modified in 2003).

[54] End of 2004, nearly $35 billion in terrorism coverage capacity was provided by industry captives in the states of Vermont and Hawaii only (the two largest on-shore captive states in the U.S—700 and 150 licensed captives end of 2004, respectively). For a detailed discussion on captives in the context of terrorism insurance in the US, see Wharton Risk Center, Chapter 9 (2005).

Another complementary option would be to base any federal reimbursement of terrorism losses on net (i.e., after reinsurance) losses without requiring reinsurers to make terrorism coverage available. Such a change might significantly increase the scope of reinsurance and associated risk spreading. The terms of reinsurance would reflect the federal backstop (i.e., the reinsurer's ability to be reimbursed for losses), thus reducing reinsurance prices. Primary insurers would be free to either buy reinsurance if available at the right price or keep similar exposures as under the current system.

Reduce Tax Costs for Insurers and Reinsurers to Hold Capital

U.S. federal tax policy increases the costs of private-sector arrangements for spreading catastrophe risk, thus reducing the supply of insurance and alternative risk-spreading vehicles. Insurers cannot establish tax deductible reserves for events that have not occurred. More importantly, providing insurance against rare but potentially enormous losses requires insurers to hold large amounts of equity capital, which is primarily invested in marketable securities. Investors can readily purchase the same types of securities directly or through investment funds, in which case the returns on the securities are subject to personal taxes only. When held by an insurer to back the sale of its policies, the returns are taxed twice -- at the corporate level and at the personal level -- because insurers cannot hold such capital in tax-deferred accounts. For the securities to be used to back policies, the premiums must therefore be high enough to compensate investors for the extra layer of taxes. The total cost can be very large for the amounts of capital that must be invested to back the sale of insurance for rare but potentially extreme events, such as large losses from terrorist attacks.

The private sector's capacity to offer coverage for losses from terrorism (and other extreme events) would therefore expand if insurers and reinsurers were allowed some form of tax-deferred reserves for terrorism coverage. Such a policy could reduce the costs to insurers and reinsurers of holding the large amounts of capital necessary to provide coverage. This should increase supply and reduce premium rates. A tax-deferred reserve approach should be weighed carefully in light of a number of potential benefits and possible drawbacks: a short-term reduction of tax revenues, the disadvantage of industry-specific tax rules, and the challenges of designing a system that meets the objectives of expanding capacity to insure losses from terrorism (and possibly other extreme events) without allowing significant unrelated tax deferral.

Facilitate the Use of Terrorism Catastrophe Bonds [55]

A catastrophe bond transfers the risk of a large loss from the insurance/reinsurance industry to the financial markets. A significant market for catastrophe bonds to cover losses from terrorist attacks has not emerged since 9/11. To date, only three terrorism-related catastrophe bonds have been issued and these were part of multi-event coverage for other risks such as natural disasters and pandemics. For

[55] This section is based on Kunreuther, H. and Michel-Kerjan, E. (2005) "Insuring Mega-Terrorism: Challenges and Perspectives". Report for the OECD Task Force on Terrorism Insurance. In OECD: *Terrorism Insurance in OECD Countries*, July 5.

example, the first bond was issued in Europe in August 2003. The Fédération Internationale de Football Association (the world governing organization of association football [soccer]), which is organizing the 2006 World Cup in Germany, developed a $262 million bond to protect its investment. Under very specific conditions, the catastrophe bond covers losses resulting from both natural and terrorist extreme events that would result in the cancellation of the World Cup game without the possibility of it being re-scheduled to 2007.[56]

The lack of interest in new financial instruments for covering terrorism risk may be due to concern by investment managers that potentially a large loss from a catastrophe bond would hurt their reputations (and possibly their compensation). Another reason why there has been no market for terrorism catastrophe bonds might be evident in the reluctance of reinsurers to provide protection against this risk following the 9/11 terrorist attacks. Financial investors perceive reinsurers as experts in this market. Upon learning that the reinsurance industry required high premiums to provide protection against terrorism, investors were only willing to provide funds to cover losses from terrorism if they received a sufficiently high interest rate.[57]

Most investors and rating agencies consider terrorism models as too new and untested to be used in conjunction with a catastrophe bond covering terrorism risks. The models are viewed as providing useful information on the potential severity of the attacks but not on their frequency. Without the acceptance of these models by major rating agencies, the development of a large market for terrorism catastrophe bonds is unlikely[58]. In addition, institutional, tax and regulatory constraints have discouraged the growth of terrorism-related and other catastrophe bonds.

A study should be undertaken to analyze behavioral, institutional and regulatory obstacles to the development of a more robust market for terrorism catastrophe bonds, as well as the steps that would need to be taken to modify the current situation.

Mutual Insurance Pools

Another alternative would be to allow insurers to form an insurance pool to deal with specific lines of coverage, perhaps with some federal backing for large losses. In effect, a group of companies would provide reinsurance to each other. For example, firms insuring high-risk assets in the United States and around the world could form their own mutual insurance pools. This solution has the advantage of spreading the risk over a large number of insurers who join these pools, but it is unclear whether this alternative would provide adequate coverage against mega-terrorism. Pool solutions developed in several other countries should be analyzed in more detail to determine their potential application to the U.S. market[59]. The pool does not have to provide coverage for the entire country, but can be focused in certain types of risks and/or industries.

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[56] Congressional Budget Office (2005), *Federal Terrorism Reinsurance: An Update*, Washington, DC, January. Kunreuther and Michel-Kerjan (2005), "Insurability of mega-Terrorism: Challenges and Perspectives", in OECD (2005); ibid.

[57] Kunreuther, H. (2002) "The Role of Insurance in Managing Extreme Events: Implications for Terrorism Coverage", *Risk Analysis*, 22: 427-37.

[58] U.S. General Accounting Office (GAO) (2003), *Catastrophe Insurance Risks. Status of Efforts to Securitize Natural Catastrophe and Terrorism Risk.* GAO-03-1033. Washington, D.C.: September 24.

[59] See OECD (2005), Terrorism Risk Insurance in OECD Countries, July 5.

Publicly Administered Mutual Insurance

The need for federal protection against terrorism risks and those of other extreme events comes from the combination of two defects. The loss probability is highly uncertain and the maximum possible loss is considered to be large relative to the amount of private reinsurance and catastrophe bonds available to insurers. One strategy for addressing these two problems is to construct a type of publicly administered mutual insurance arrangement.

Two key conditions must hold for this arrangement to be feasible. First, although losses on individual properties can be highly correlated and aggregate damages can be large, the losses cannot be perfectly correlated. For example, the arrangement could absorb a severe attack on Houston, New York, or San Francisco, but not necessarily if the three cities were attacked simultaneously. Second, buyers need not agree on what they think the loss probability is in each site, but they must be able to agree (in the simplest case) that it is the same, or (in a more complex case) on what the relative likelihoods are. For example, all buyers might agree that a large-scale assault is twice as likely in Houston and New York as in San Francisco.

The insurance would work as follows for the case of a mutual insurance program protecting insurers providing terrorism coverage in these three cities. Each insurer would choose a level of protection through the mutual pool and pay an estimated premium. If no attack occurs on either site after a predefined period of time, any excess premiums above a certain threshold are returned to these insurers in proportion to their original purchase. Suppose a loss does occur in Houston, for example, and if its magnitude is less than resources accumulated by the pool to that point, all claims are paid. But if total insured losses exceed claims, insurance buyers are assessed an additional amount to cover claims. In this example, New York and San Francisco policyholders furnish the capital to cover excess claims in Houston. In effect, this arrangement uses as its source of excess capital the undamaged assets of pool participants who have not suffered a loss. Such an arrangement might be voluntary, but it might be made compulsory as well, with the *ex post* assessments proportional to the additional coverage that was made mandatory.

Federal Reinsurance with Explicit Premiums

Another possible response to the limited capacity of private insurers and reinsurers to furnish coverage against catastrophic losses is a federal reinsurance program with explicit premiums. The most obvious technique for pricing federal reinsurance would be for the government to calculate a premium. It would make its own estimate of the probability of a major attack and the extent of the damages, calculate the expected value of the loss, add a modest amount for administrative expenses, possibly tack on a "risk premium", and offer unlimited amounts of coverage for sale at this premium.

Under a federal reinsurance program, in years without any major terrorist attack, no benefits would be paid out. But if an attack occurred, these government's collected funds would be used to cover the catastrophic portion of the losses against which insurers had purchased federal reinsurance. If the losses protected by federal reinsurance exceeded the premiums collected, the government would have to finance these claims from other

sources of taxpayer revenue. Over time, if the premiums accurately reflected the risks of terrorist attacks, the government reinsurance fund would be replenished.

Considering Covering both Domestic and Foreign Terrorism[60]

Another question that needs to be addressed is whether the arbitrary distinction that the current U.S. terrorism risk insurance program makes between so-called "foreign" and "domestic" terrorism reflects the current nature of the terrorism threat[61]. This poses at least two major problems.

First, the evolution of international terrorist activities from more locally organized and even national groups to global organization makes it difficult to distinguish between a domestic and foreign terrorism, as illustrated by the July 2005 bombings in London, UK[62]. Some of these terrorists had been trained to kill in Pakistan. Should one thus conclude that they were "acting on behalf of a foreign person or foreign interest"? On the other hand, they had been living in London for years, studying or working there. Should one conclude they acted on behalf of their own ideology? In that case, should we conclude that the nearly 800 casualties were victims of domestic terrorism? Had these events been more devastating and occurred in the U.S., would they have qualified for TRIA coverage? Today this gray zone is likely to inflict legal costs to both victims and insurers, and considerably delay claims payments to victims of the attacks.

Second, the decision to exclude domestic terrorism from TRIA and its extension because it was not considered a serious threat needs to be reevaluated in the light of the current threats posed by extremist groups in the United States[63]. Data on domestic terrorism from the U.S. Federal Bureau of Investigation reveal that over 350 acts of domestic terrorism have been perpetrated on the U.S. soil during the period 1980-2001. Although the annual number of such attacks decreased during the 1980s and mid 1990s, it started increasing again in the past ten years averaging 15 attacks a year nationwide

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[60] We appreciated discussions on this domestic terrorism issue with James O. Ellis III (Memorial Institute for the Prevention of Terrorism in Oklahoma City), Mark Potok (Southern Poverty Law Center) and with Henry Schuster (CNN).

[61] TRIA stipulates that a terrorist attack would be certified as an act of terrorism only if it is perpetrated by "an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion."

[62] For an insightful analysis of the London bombing in that regard, see the series of articles in The Economist (2005), "In Europe's midst", July 16.

[63] For discussions on the nature of these groups and their operation, see Ellis III, J. "Terrorism in the Homeland: A Brief Historical Survey of Violent Extremism in the United States", Memorial Institute for the Prevention of Terrorism, Oklahoma City; Hoffman, B. (1998) *Inside Terrorism.* New York: Columbia University Press; Stern, J.. (2003). *Terror in the Name of God: Why Religious Militants Kill.* New York: Harper Collins. Potok, M. (2004), "The American Radical Right: The 1990s and Beyond." in Eatwell, R. and Mudde, C. (eds) *Western Democracies and the New Extreme Right Challenge,* Routledge; Frey, B. (2004) *Dealing with Terrorism: Stick or Carrot,* Edward Elgar Publishing; Chalk, P. Hoffman, Reville, R and B. Kasupski, A-B. (2005) *Trends in Terrorism,* Santa Monica, CA: Rand Corporation, June.

during the period 1996-2001[64]. It is likely that this increase has been galvanized by anti-globalization imperatives[65].

Consideration should therefore be given as to whether it is desirable to include domestic terrorism as part of the events covered in a national terrorism insurance program. The analysis should consider whether the economic rationale for government involvement in covering the risk of large losses from domestic terrorism is any different from foreign terrorism, as well as the problems associated with the arbitrary distinction made by TRIA between "foreign" and "domestic" acts.

Developing Incentive Programs for Encouraging Mitigation

Moreover, further analysis is needed to link mitigation and insurance coverage in a more systematic way. It would be important to develop incentive programs to adequately reward private sector investment in security, for example by lowering the price of terrorism risk financing and/or by providing any other economic incentives (e.g., more favorable tax treatment). It is worth noting, however, that the absence of a link between insurance and investment in security is not specific to the United State[66] -- most industrialized countries have not yet implemented such incentive programs either.

9. Conclusions

Today, four and a half years after 9/11, the question as to who should pay for the economic consequences of a terrorist attack on the United States has not yet received the attention it deserves. As stated by the White House in its 2002 National Strategy, homeland security is "the concerted effort to prevent attacks, reduce America's vulnerability to terrorism, and minimize the damage and recover from attacks that do occur"[67]. To succeed, security must be a comprehensive national effort.

The new law extending TRIA for two additional years directs the President's Working Group on Financial Markets to study long-term availability and affordability of coverage for terrorism losses. This group must submit a report of its findings to the House Financial Services and Senate Banking Committees by September 30, 2006. As we have already advocated[68], Congress or the White House should consider establishing a broader national commission on terrorism risk coverage before permanent legislation is enacted. Indeed, the challenges associated with terrorism risk financing are fundamental, and they will not be solved overnight. In addition to the insurance industry, there is a need to include representation on such a National Commission from sectors of the economy who are affected by the terrorism risk such energy, transportation, real estate

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[64] U.S. Department of Justice, Federal Bureau of Investigation (2002), "Terrorism 2000/2001", FBI, Counterterrorism division, Publication 0328.

[66] Auerswald, P., Branscomb, L., LaPorte, T., and Michel-Kerjan, E. (eds) *Seeds of Disaster, Roots of Response. How Private Action Can Reduce Public Vulnerability*, Cambridge University Press, forthcoming.

[67] The White House (2002), *National Strategy for Homeland Security*. Washington, DC., July.

[68] See Kunreuther, H. and Michel-Kerjan, E. (2005), "Terrorism Insurance 2005. Where Do We Go from Here?" *Regulation. The Cato Review for Business and Government*, Washington, DC: The Cato Institute, Spring 2005 pp. 44-51. See also The Economist (2005), "In Europe's midst", July 16 and The Economist (2005), "Horrible Business: Terror Insurance", November 19.

and health. U.S. Treasury representation should be supplemented by key individuals from federal agencies, such as the Department of Homeland Security and the Department of Defense who are concerned with national security issues.

Such a National Commission could explore the objectives of a terrorism risk financing program and how to achieve them through alternative risk sharing mechanisms. In addressing these issues there is a need for collaboration with the homeland security/intelligence community to measure what potential threats are. A National Commission could also examine how other countries cope with the terrorism risk to determine whether these approaches merit consideration for the United States. The insurance infrastructure would undoubtedly play a key role in such a program, but it should be viewed as part of a broader strategy for dealing with terrorism. For example, the public and private sectors could provide economic incentives in the form of lower taxes, subsidies or lower insurance premiums to encourage those at risk to adopt higher security and loss reduction measures. There will likely be a need for well-enforced regulations and standards to complement these incentive programs.

The design of a terrorism insurance program reflects society's view as to who should pay for the losses from the next attack[69]. Hurricane Katrina is likely to impact on how citizens, firms and policymakers envision the role and responsibility of the public and private sectors in providing adequate protection to victims of large-scale disasters and the importance of understanding how actions taken before a disaster impacts on the need for financial assistance after a catastrophic event occurs[70]. Similar questions need to be posed with respect to the terrorism risk. A well-designed terrorism insurance program has the potential of encouraging mitigation measures while at the same time alleviating the need for large-scale public sector involvement following the next attack.

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[69] Indeed, other countries have implemented programs quite different from TRIA; see Michel-Kerjan, E. and Pedell, B. (2005), "Terrorism Risk Coverage in the Post- 9/11 Era: A Comparison of New Public-Private Partnerships in France, Germany and the U.S.," *The Geneva Papers on Risk and Insurance*, 30: 1, pp. 144-170. See also Organization for Economic Cooperation and Development (2005), *Terrorism Insurance in OECD Countries*. Paris: OECD, July 5.

[70] Daniels, R., Kellt, D. and Kunreuther, H. (eds) (2006), *On Risk and Disaster: Lessons from Hurricane Katrina*. University of Pennsylvania Press.

APPENDIX 1
Deductible over Surplus Ratios: 2003 to 2005 and Prospective Analyses 2006-2007

Using data provided by A.M. Best, we undertook an analysis of the top 463 companies[71] ranked by their 2004 TRIA lines direct earned premiums (larger than $10 million). For each insurer, we had the following data:

- Total direct earned premiums all lines;
- Total direct earned premiums (DEP) for TRIA lines;
- Surplus (*S*).

We determined the deductible over surplus (*D/S*) ratio for the three years of TRIA operation: 2003, 2004 and 2005. Table A provides the data for determining the *D/S* ratio for 2005 when D = 15 percent and it also shows these ratios for 2004 and 2003 when D = 10 and 7 percent, respectively, for the top 30 insurers (ranked by total TRIA DEP in 2004). Note that in 2003 only three insurers in the top 30 had a ratio *D/S* ratios equal to or higher than 15 percent, while this number increased to 14 insurers in 2005.

Prospective Analysis: Impact of TRIA Extended to 2007 on *D/S* ratios

Below we show how the extension of TRIA would impact on the *D/S* ratio for the top 30 insurers in the U.S. for 2006 and 2007. The new deductible is increased to 17.5 percent of TRIA-line DEP in 2006, and 20 percent in 2007.

Methodology The study is undertaken for the top 30 insurers. In order to determine *D/S* (2006) and *D/S* (2007) for each company under these two scenarios, we need to know what would be their TRIA-lines DEP and their surpluses in 2005 and 2006, respectively. We base our analysis on the annual percentage change in these two numbers over the three-year period (2002-2004) for each of the thirty companies. We then extrapolate these figures to estimate DEP for TRIA lines and surpluses (*S*) for 2005 and 2006. Table A presents the result of this analysis. With the deductible increased to 20 percent in 2007, 6 of the 10 largest insurers will have a *D/S* ratio that will be 20 percent or greater.

[71] The original sample of insurers with a 2004 total TRIA-line direct earned premium above $10 million was made of 466 insurers; but partial data were missing for 3 of them. As discussed, among these 463 insurers, our 2004 selected sample is made of the 451 insurers that also appear in the 2002 and 2003 data sets.

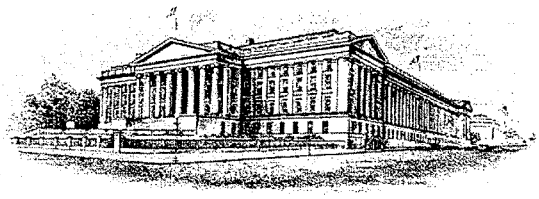
Table A. 2003-2007: Prospective *Analysis* D/S Ratios for the 30 Largest Insurers, 2003-2007
D=17.5% DEP in 2006 and 20% DEP in 2007 (all amounts in $ million)

Name	Projected 2006 TRIA Line DEP	Projected 2006 surplus	Projected. Deductible 07	D/S 2007 (20%)	D/S 2006 (17.5%)	D/S 2005 (15%)	D/S 2004 (10%)	D/S 2003 (7%)
AIG	32,663	110,524*	6,533	6%	5%	4%	3%	2%
St. Paul Travelers	20,069	16,907	4,014	24%	21%	17%	12%	8%
Zurich/Farmers	18,170	13,647	3,634	27%	25%	23%	18%	13%
Liberty Mutual	13,101	13,307	2,620	20%	18%	16%	12%	9%
CA State Comp Ins Fund	9,024	3,156	1,805	57%	50%	43%	37%	27%
CNA Insurance	9,024	7,436	1,805	24%	21%	17%	13%	8%
Chubb	9,365	13,608	1,873	14%	14%	14%	11%	9%
Hartford Insurance	9,901	18,006	1,980	11%	10%	10%	7%	5%
ACE INA	7,766	3,963	1,553	39%	37%	33%	22%	18%
Nationwide	5,376	12,159	1,075	9%	8%	7%	4%	3%
TOP 10:				Mean ratio	Mean ratio	Mean ratio	Mean ratio	Mean ratio
- Total	134,459	212,713	26,892					
- Average	13,446	21,271	2,689	23%	21%	18%	14%	7%
State Farm	4,898	68,565	980	1%	1%	1%	1%	1%
Allianz of America	3,524	4,626	701	15%	15%	15%	10%	9%
W. R. Berkley	5,510	4,639	1,102	24%	22%	20%	14%	11%
Great American P&C	3,592	3,109	715	23%	21%	20%	13%	10%
FM Global	3,006	6,500	601	9%	10%	11%	10%	8%
XL America	3,560	2,824	712	25%	23%	20%	14%	10%
Cincinnati Insurance	2,600	7,622	520	7%	8%	8%	8%	6%
Berkshire Hathaway	2,941	84,182	588	1%	1%	1%	0%	0%
Auto-Owners	3,032	4,346	606	14%	11%	9%	6%	4%
Safeco	2,560	4,699	512	11%	10%	9%	7%	5%
Progressive Insurance	3,059	6,508	611	9%	8%	6%	3%	2%
Old Republic General	2,501	2,215	500	23%	19%	15%	10%	6%
HDI U.S. Group	1,957	561	391	70%	57%	46%	33%	19%
Allstate Insurance	1,942	20,531	388	2%	2%	1%	1%	1%
Fairfax Financial (USA)	1,299	4,832	260	5%	6%	7%	5%	6%
Markel Corporation	1,990	1,967	398	20%	19%	18%	13%	10%
Arch Capital Group U.S.	3,323	663	665	100%	66%	42%	23%	3%
GE Global	1,478	8,467	296	3%	3%	3%	2%	2%
White Mountains	996	3,181	199	6%	6%	7%	4%	4%
Erie Insurance Group	1,724	3,967	345	9%	7%	6%	4%	3%
TOP 30								
- Total	189,951	456,717	37,982	_____ Mean (average) ratios _____				
- Average	6,332	15,224	1,266	20%	18%	15%	11%	6%

* This represents shareholders' equity rather than policyholders' surplus that seems more appropriate here.

APPENDIX 2
Brief side by side comparison between TRIA 2005 and TRIEA 2006-2007

	TRIA	Extension of TRIA (TRIEA / S. 467)	
	2005	2006	2007
Program trigger (« per event » in 06-07)	$5 million	$50 million	$100 million
Insurer's deductible (% DEP previous year)	15%	17.5%	20%
Federal share (% above insurers' deductible)	90%	90%	85%
Industry aggregate retention/recoupment threshold	$15 billion	$25 billion	$27.5 billion
Annual Program Cap	$100 billion	$100 billion	$100 billion



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10:00 a.m., June 21, 2007
CONTACT Jennifer Zuccarelli, (202) 622-8657

TESTIMONY OF
TREASURY ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS
DAVID G. NASON

BEFORE THE U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES

WASHINGTON - Thank you, Chairman Kanjorski, Ranking Member Pryce, and other members of the Subcommittee for inviting me to appear before you today.

The market for terrorism risk insurance in the United States was significantly changed by the terrorist attacks of September 11, 2001. Of course, prior to September 11, terrorism risk clearly existed in the United States. We experienced the 1993 bombing of the World Trade Center, the 1995 Oklahoma City bombing, the 1996 Centennial Olympic Park bombing, and the "Millennium Bomber's" December 1999 attempted bombing of the Los Angeles International Airport. Despite these events, most commercial property and casualty insurance companies continued to provide coverage for terrorism risk in the insurance policies sold to their commercial policyholders.

The terrorist attacks of September 11 resulted in insured losses of approximately $32 billion, which at the time was the largest single insured loss event in U.S. history. The recognition that terrorist attacks could cause losses of such scale spread across multiple insurance products and concentrated in a relatively small geographic area, caused the insurance industry to undertake a broad reassessment of the likelihood and potential losses associated with terrorism. Immediately following September 11, commercial property and casualty insurers sought to exclude coverage for terrorism risk in many policies. Reinsurance contracts also began excluding coverage for terrorism.

In the months after September 11, there were increasing concerns about potential economic disruptions caused by the unwillingness of many insurance companies to provide terrorism insurance. In response, Congress passed and the President signed the Terrorism Risk Insurance Act (TRIA) in late 2002. TRIA established a temporary federal program of shared public and private compensation for privately-insured commercial property and casualty losses resulting from acts of terrorism. The TRIA legislation stated that the purposes of the legislation were to address market disruptions, to ensure the continued widespread availability and affordability of commercial property and casualty insurance for terrorism risk, and to allow for a transition period for the private markets to stabilize and build capacity while preserving State insurance regulation and consumer protections. While TRIA was largely successful in achieving its original purposes, given some remaining uncertainty surrounding the development in the

market for terrorism risk insurance, TRIA was temporarily extended in 2005 for an additional two years by the Terrorism Risk Insurance Extension Act of 2005 (the "Extension Act").

Today, I would like to provide an overview of the key features of TRIA and the Extension Act, the key findings of the President's Working Group on Financial Markets' (PWG) 2006 report to Congress on terrorism risk insurance, and some principles for the federal government's role in the market for terrorism risk insurance going-forward. Our view of TRIA is shaped by the belief that the most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. The Administration believes that three elements are critical if TRIA is to be reauthorized for a second time: the program remains temporary and short-term; private sector retentions are increased; and there is no expansion of the program. Treasury cannot support efforts that move the program in a direction that is inconsistent with these key elements.

The Terrorism Risk Insurance Act and the Extension Act

TRIA essentially established a government reinsurance program. Much like typical provisions found in reinsurance, the TRIA program requires that insurers first retain a portion of terrorism risk exposure themselves (referred to as "deductible") with the insurer and government then sharing in the losses above the initial retention (referred to as "co-share" or "co-pay"). Unlike a typical reinsurance policy, however, there is no up-front premium charged for the reinsurance coverage provided under TRIA; but instead, any federal expenditure can be collected, or recouped, after a loss through surcharges applied to premiums paid by commercial policyholders regardless of whether their insurers had received TRIA payments. Some key features of TRIA and the Extension Act include the following:

Private Sector Retentions

An insurer's "retention" under TRIA generally refers to the amount of terrorism risk exposure that an insurer retains. An insurer's retention is comprised of its insurer deductible, its co-share of the insured losses above its deductible, or all of its losses if an attack results in industry-wide losses below an event size threshold, called the "Program Trigger." An insurer's retention under TRIA is a key provision that governs the amount of terrorism risk exposure held by the private sector. The general structure of TRIA and the Extension Act requires increases in private sector retentions over time to encourage development of private market capacity to provide terrorism risk insurance over time.

An insurer's deductible is company specific and is calculated based on the size of the insurer's prior year's premium revenue from the types of insurance covered by TRIA. Insurer deductibles have increased throughout the TRIA program – from its 2003 level of 7 percent of an insurer's prior year's direct earned premiums, to 10 percent in 2004, and 15 percent in 2005. The Extension Act further increased insurer deductibles to 17.5 percent in 2006 and 20 percent in 2007. In the event of a certified terrorist act, each insurer will cover 100 percent of the insured losses up to its deductible before being eligible for federal payments under TRIA. Tying an insurer's deductible to its revenue helps ensure that the amount of insured losses the company itself is responsible for is commensurate with its size and assets. Some of the largest insurers that participate in the program have deductibles in the billions of dollars.

Once an insurer pays insured losses up to its deductible, insured losses above its deductible amount would then be shared between the insurer and the federal government. The federal share of insured losses above the insurer's deductible had been 90 percent through the first four years of the TRIA program, and was reduced to 85 percent in 2007 – thus increasing the private sector's share from 10 percent to 15 percent. This provision of TRIA encourages proper claims adjustment as insurers will have "skin in the game" in deciding and settling insurance claims, much the same as provisions included in private sector reinsurance contracts.

In addition to the deductible and co-share, an insurer retains all of its losses if industry-wide aggregate losses are below the minimum event size eligible for payments under TRIA, or what has come to be known as the "Program Trigger." Under TRIA, in order for an event to be certified as an act of terrorism, the losses suffered by the insurance industry as a whole must exceed at least $5 million in the aggregate. As originally structured, certified acts of terrorism resulting in losses above $5 million would have been eligible for federal payments under TRIA, essentially making the certification and the event's eligibility for federal payments under TRIA equivalent. The minimum event size qualifying an event for federal payments under TRIA was raised beginning in 2006 by the Extension Act, which specifically added the concept of a Program Trigger to TRIA. Under the Program Trigger concept, the Treasury Secretary is directed not to compensate insurers under TRIA unless the aggregate industry insured losses exceed certain "trigger" amounts: $50 million in 2006 and $100 million in 2007. Once the threshold is met, program payments can then be made to an insurer once it has paid claims and met its company-specific deductible.

Lines of Coverage

Insurance coverage under TRIA is limited to commercial property and casualty insurance, which was the primary area of concern in terms of dislocations associated with the September 11 terrorist attacks. TRIA does not apply to personal insurance, such as homeowners, automobile, or life insurance. While TRIA did not specifically define commercial property and casualty insurance, it did specifically include excess insurance, workers' compensation insurance, and during the first three years of the TRIA program, surety insurance. In addition, TRIA specifically excluded certain types of insurance:

- Federal or private crop insurance;
- Private mortgage insurance, or title insurance;
- Financial guaranty insurance offered by a monoline financial guaranty insurance corporation;
- Insurance for medical malpractice;
- Health or life insurance, including group life insurance;
- Federal flood insurance; and,
- Reinsurance or retrocessional reinsurance.

In implementing the definition of commercial property and casualty insurance, Treasury relied on the lines of business ("lines") under which insurers report their premiums in annual statement filings pursuant to forms and rules adopted by the National Association of Insurance Commissioners (NAIC). The specific lines that were included in the program were established by Treasury through regulation, in consultation with the NAIC. With respect to implementing the program, policies whose premiums are reported to the NAIC on designated commercial lines qualify for TRIA coverage.

The Extension Act scaled back the scope of the program so that TRIA no longer covers:

- Commercial automobile insurance;
- Burglary and theft insurance;
- Surety insurance;
- Professional liability insurance (but not directors' and officers' liability insurance); and,
- Farmowners' multiple peril insurance.

Terrorism risk insurance for these lines of insurance, which was covered only during the first three years of the program, was successfully transitioned back to the private market without any signs of market disruption.

Certified TRIA Events

The TRIA program covers losses from certified acts of terrorism. In order to qualify as an act of terrorism, an event must be certified by the Secretary of the Treasury with the concurrence of the Secretary of State and Attorney General of the United States as being:

- a violent act, or an act dangerous to life, property or infrastructure;
- resulting in damage within the U.S., or to a U.S. air carrier or U.S. flag vessel, or on the premises of a U.S. mission; and,
- committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the U.S. or to influence the policy or affect the conduct of the U.S. government by coercion.

Terrorism coverage is often described as "certified acts" coverage (based on the TRIA definition) and "non-certified acts" coverage (acts of terrorism that are not certified under TRIA because they do not meet one or several of the certification requirements). "Certified acts" are synonymous with foreign acts of terrorism due to the requirement that the act be "committed by an individual or individuals acting on behalf of any foreign person or foreign interest."

Under TRIA, an act committed by a "home-grown" terrorist could currently be certified as an act of terrorism and covered by TRIA so long as the terrorist was acting on behalf of any foreign person or foreign interest, and the other requirements are met. However, purely domestic terrorism, such as eco-terrorist attacks or an attack like Oklahoma City, would not be covered by TRIA. Such non-certified risks generally continue to be insured by the private market.

Recoupment

Unlike a private sector reinsurance company, the TRIA program does not require insurers to pay up-front premiums and does not build up surplus to pay future claims. Instead, the program is funded on a post-loss basis. TRIA provides authority for Treasury to recoup its federal payments through annual surcharges on commercial policyholders of up to three percent of a policy's premium. Certain recoupment is mandatory, while in other circumstances TRIA authorizes discretionary recoupment.

Mandatory recoupment is based on the concept of an "insurance marketplace aggregate retention" amount, which specifies the amount of losses the private sector as a whole must absorb in any given year. If the insured losses that the insurers collectively retain (individual company deductibles plus the co-pay portions paid above deductibles) are lower than the marketplace aggregate retention, Treasury must recoup the difference. In addition, Treasury has the discretion to seek recoupment of up to the full amount paid out based on consideration of specific factors described in TRIA. The "insurance marketplace aggregate retention" amounts have increased each year of the program, going from $10 billion in the first year to $27.5 billion in 2007.

Key Outcomes of the Extension Act

The TRIA program was originally designed as a three-year program set to expire on December 31, 2005. The temporary program structure allowed the federal government to re-evaluate the program in the context of current market conditions.

As the debate surrounding the extension of TRIA took place in 2005, the Administration focused on encouraging the private insurance market to develop innovative solutions and build capacity. This serves to reduce potential exposure to taxpayers. The core changes ultimately adopted as part of the Extension Act – increasing deductibles and co-share amounts, elevating program trigger levels, and eliminating coverage for certain lines of insurance – all focused on encouraging greater private market participation over time. The impact of these changes and an overall evaluation of the market for

terrorism risk insurance formed the basis for much of the President's Working Group on Financial Market's (PWG) 2006 report on terrorism risk insurance.

The Findings of the President's Working Group on Financial Markets

The Extension Act required the PWG to perform an analysis regarding the long-term availability and affordability of insurance for terrorism risk, including group life coverage; and coverage for chemical, nuclear, biological, and radiological events. In conducting this analysis, the PWG was assisted by staff of the member agencies who reviewed academic and industry studies on terrorism risk insurance, sought additional information and consultation through a Request for Comment published in the Federal Register, and also met with insurance regulators, policyholder groups, insurers, reinsurers, modelers, and other government agencies. The PWG submitted its report to Congress last September. Key findings of the report are summarized below.

Long-Term Overall Availability and Affordability of Terrorism Risk Insurance

One of the key findings of the PWG report was that overall the availability and affordability of terrorism risk insurance has improved since the terrorist attacks of September 11, 2001. The general trend observed in the market has been that as insurer retentions have increased under TRIA and policyholder surpluses have risen, prices for terrorism risk have fallen, and take-up rates have increased.

Much of the improvement in the terrorism risk insurance market is due to several important factors, including better risk measurement and management, improved modeling of terrorism risk, greater reinsurance capacity, and a recovery in the financial health of property and casualty insurers.

- Since September 11, insurers have made greater use of sophisticated models that allow them to identify and manage concentrations of risk in order to avoid accumulating too much risk in any given location. This improvement in risk accumulation management has allowed insurers to better diversify and control their terrorism risk exposures, which has enhanced their ability to underwrite terrorism risk. In addition, a significant effort has been made by the insurance industry in modeling the potential frequency and severity of terrorist attacks; however, given the uncertainty of terrorism in general and, in particular, the uncertainty associated with these modeling efforts, insurers appear to have limited confidence to date in these models for evaluating their risk exposures.

- In terms of market capacity, the PWG found that the quantity of terrorism risk reinsurance capacity has increased since the period following September 11. In addition, the financial health of insurers has recovered since September 11. As a result, insurers have more available capacity to allocate to terrorism risk as demonstrated by the increased provision of terrorism risk insurance coverage over the past few years.

Despite these overall improvements, the PWG report found that a significant number of policyholders are still not purchasing terrorism coverage – approximately 40 percent of all policyholders do not purchase coverage. Even in major cities, a high proportion of policyholders are not purchasing terrorism risk insurance. For example, in 2004, 46 percent of policyholders in New York City had not purchased terrorism insurance; in Los Angeles, 61 percent had not purchased terrorism insurance; in Chicago, 42 percent; and in Washington, D.C., 40 percent. Recently reported data for 2006 suggests this has improved for some cities; for example, approximately one-quarter of policyholders in the New York metropolitan area are uninsured, as compared to 46 percent in 2004. The PWG's report, Treasury's own 2005 study, and others have found that the primary reasons for non-purchase were price, perceptions of low risk, and perhaps to some degree an expectation that federal disaster aid might be available if a significant attack were to occur.

The PWG report concluded that further improvements in insurers' ability to model and manage terrorism risk will likely contribute to the long-term development of the terrorism risk insurance market. However, the high level of uncertainty currently associated with predicting the frequency of terrorist attacks, along with what appears to be a general unwillingness of some insurance policyholders to purchase insurance coverage, makes any prediction of the potential degree of long-term development of the terrorism risk insurance market somewhat difficult.

Group Life Insurance

As passed by Congress in 2002, TRIA did not include group life insurance in the program. Treasury was required to evaluate market conditions and determine whether to include it in the program if both insurance and reinsurance were not available, or not likely to be available in the future. In 2003, Treasury found that group life insurance coverage was readily available for consumers. Thus, group life was not added to the program. In 2005, when TRIA was extended by Congress, group life was not added to the program.

The PWG report found that group life insurance is still widely available in the private market even though it is not part of the TRIA program. In particular, the group life market is highly competitive and is very price sensitive. Group life insurers concede that competitive pressures have caused them to make coverage available, even in the absence of TRIA protection. In contrast to property and casualty insurers, group life insurers have decided to forgo purchasing reinsurance and to focus less on managing risk accumulations.

Chemical, Nuclear, Biological, or Radiological (CNBR) Coverage under TRIA

CNBR is currently covered under TRIA. However, TRIA does not require insurers to make CNBR terrorism coverage available to policyholders if CNBR coverage for non-terrorism events is similarly not provided. Although not required by TRIA, if CNBR terrorism coverage is provided by the insurance policy, such as with workers' compensation insurance, TRIA covers insured losses from a certified terrorist event involving CNBR.

The PWG report found that historically CNBR risks (caused by a terrorist or by any other event) were typically not covered by insurance (except when mandated by state law, such as with workers' compensation). The factors determining the availability and affordability of CNBR coverage have more to do with the nature, scale, and uncertainty of the damage and losses from CNBR events – however caused – and less to do with terrorism specifically. In addition, policyholder expectations regarding their own potential terrorism risk exposure are probably lower and their expectations about the likelihood of post-disaster federal aid are probably higher for CNBR attacks than for relatively smaller-scale conventional terrorist attacks.

The Federal Government's Role in the Market for Terrorism Risk Insurance

As a basic principle, the federal government's role in any market, including the market for terrorism risk insurance, should be limited to those areas where private markets cannot function and hence broader costs are imposed on our Nation's overall economy. In playing such a role at a time when it was needed, TRIA appears to have been successful. TRIA provided time for insurers and others to adjust to the risks made clear by the September 11 terrorist attacks. Subsequently, there have been positive market responses by insurers and reinsurers to the reductions in the federal role over the five years that TRIA has been in place, most notably by assuming additional terrorism risk exposure in each year of the program. And as insurers have increased their terrorism risk exposure as TRIA was scaled back, prices for terrorism risk coverage have declined or remained stable. In some sense, we have conducted a market experiment under TRIA that has illustrated that the private sector is capable of taking on increasing amounts of terrorism risk as the federal government's role recedes. TRIA has generally been

effective in encouraging the greater provision of terrorism risk insurance, while at the same time encouraging and supporting private market development. However, by providing a terrorism risk reinsurance without any up-front premiums, it may also have displaced some private sector alternatives.

As has been clear from the outset, TRIA was designed as a temporary program. A permanent or long-term federal subsidy of free federal reinsurance was never intended. We firmly believe that temporary programs should be just that – temporary. Given the success achieved under TRIA to date, the obvious question is should the federal government maintain a limited role in the provision of terrorism risk insurance? It is clear that some challenges remain in the market for terrorism risk insurance almost five years after the passage of TRIA and nearly six years after September 11. Insurers have made great strides in modeling loss exposure and managing their concentration of risk; however, the ability of the insurance industry to model the frequency of terrorism attacks is uncertain, and market participants are skeptical of their current reliability. As a result, insurers are cautious in allocating more capacity to terrorism risk, although it appears that gradual increases have been occurring over time. If TRIA were to expire, our general view is that the market for terrorism risk insurance in much of the country would largely be unaffected, but that there could be some dislocations in certain markets and industries.

Based on where the market for terrorism risk insurance is today, our view is that TRIA should be phased out in order to increase private sector participation. The following three elements are critical if TRIA is to be reauthorized for a second time: the program remains temporary and short-term; private sector retentions are increased; and there is no expansion of the program. Unfortunately, H.R. 2761 does not meet these critical elements.

It is important that the program remain temporary and short-term. When the President signed TRIA in 2002 he said that it should be temporary, and the Administration maintains this position. Given the positive market developments during the last five years under a TRIA program where the federal role has been scaled-back further and further each year, we clearly do not believe the federal government's role in terrorism risk insurance should be made permanent. Similarly, if the program were extended for a long period of time there would be less urgency surrounding the development of private sector solutions, which would lead to market complacency. In considering the length of any extension we must maintain incentives for industry participants to continue to improve their systems (e.g., modeling) and develop private market capacity and innovative solutions. We believe the ten year extension in H.R. 2761 is not consistent with the critical element of keeping the program temporary and short-term.

It is also important to continue the trend of increasing the private sector's participation and reducing the role of the Federal Government. Private sector retentions provide financial incentives for insurers to encourage their policyholders to mitigate risk through such measures as improved physical security and evacuation and business continuation planning. Private sector retentions can be increased through deductibles, co-shares, or program triggers. Any extension of TRIA should not backtrack from current levels, but rather should reflect some real amount of increased private sector participation. As has been demonstrated by the increased willingness of insurance companies to take on terrorism risk exposure during the life of TRIA, there is ample opportunity to continue increasing private sector retentions. In addition, recent increases in the capacity of property and casualty insurers, as evidenced by growing surplus and profit levels as well as increased reinsurance availability, should allow for greater private sector retentions. Unfortunately, a number of provisions in H.R. 2761 move away from requiring increased private sector participation, such as leaving insurer deductibles and co-payment amounts flat and unchanged, lowering the program trigger level, and lowering retentions for subsequent events through a reset mechanism. Treasury would oppose these provisions as they are inconsistent with phasing out TRIA and encouraging private provision of terrorism risk insurance – which is the fundamental goal of TRIA.

The program should not be expanded to introduce new lines or types of coverage willingly provided by the private market. For example, we do not see any evidence of problems in the market for group life

insurance or in coverage for domestic terrorism. These markets continue to function despite not having access to the TRIA program. Expanding the TRIA program to include additional coverage for well functioning markets – as H.R. 2761 proposes – is inconsistent with the appropriate role of the federal government in the terrorism risk insurance market. Treasury would oppose any such efforts that move the program in the wrong direction.

Finally, there have been questions raised about the lack of coverage for CNBR terrorism risks. As noted previously, outside of workers' compensation insurance, coverage for CNBR risk has generally not been provided by insurers. However, TRIA does provide coverage for CNBR risk if insurers include such coverage in their policies. If policyholders were to demand CNBR coverage and were willing to pay appropriate prices, we would expect some additional capacity to emerge for CNBR risks. At this time the lack of CNBR coverage does not appear to be leading to any disruptions or imposing any broader costs on our Nation's overall economy. We do not support H.R. 2761's expansion of TRIA's "make available" provision that would require insurers to offer coverage for CNBR risks or its provisions that would lower insurer retentions. Nevertheless, outside the debate surrounding TRIA, we should continue to consider the potential economic implications associated with the limited amount of CNBR terrorism risk insurance coverage that is currently being provided.

Conclusion

We appreciate the efforts of the Chairman and Members of the Subcommittee in evaluating issues associated with terrorism risk insurance and TRIA. Unfortunately, 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 most efficient, lowest cost, and most innovative methods of providing terrorism risk insurance will come from the private sector. TRIA should be phased out in order to increase private sector participation.

The three critical elements that we have set forth surrounding an acceptable extension of TRIA – (1) the program remain temporary and short-term; (2) private sector retentions are increased; and (3) there is no expansion of the program – reflect the positive experience under TRIA to date, and are grounded in the basic principle of limited government involvement in private markets. Without these critical elements, we would not be supportive of extending TRIA as, in our view, the program would be moving in the wrong direction. H.R. 2761 does not meet our objectives. In Treasury's view, from both a market and economic perspective, it would be better to have no TRIA than a bad TRIA. We are willing to continue to work with Congress toward finding an appropriately balanced solution and to establish the appropriate increases in private sector participation.

We look forward to continuing to work with Congress on this important issue. Thank you. I look forward to answering your questions.

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American Bankers Association
American Bankers Insurance Association
American Gas Association
American Hotel and Lodging Association
American Public Power Association
American Resort Development Association Resort Owners' Coalition
American Society of Association Executives
America's Community Bankers
Associated Builders and Contractors
Associated General Contractors of America
Association of American Railroads
Association of Art Museum Directors
The Bond Market Association
Building Owners and Managers Association International
Boston Properties
CCIM Institute
Chemical Producers and Distributors Association
Commercial Mortgage Securities Association
Edison Electric Institute
Electric Power Supply Association
The Food Marketing Institute
General Aviation Manufacturers Association
Helicopter Association International
Hilton Hotels Corporation
Host Marriott
Independent Electrical Contractors
Institute of Real Estate Management
International Council of Shopping Centers
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National Football League
National Hockey League
National Multi Housing Council
National Petrochemical & Refiners Association
National Restaurant Association
National Retail Federation
National Roofing Contractors Association
National Rural Electric Cooperative Association
The New England Council
New York City Partnership
Office of the Commissioner of Baseball
Public Utilities Risk Management Association
The Real Estate Board of New York
The Real Estate Roundtable
Six Continents Hotels
Society of American Florists
Starwood Hotels and Resorts
Taxicab, Limousine & Paratransit Association
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PRESIDENT,
CHIEF EXECUTIVE OFFICER AND DIRECTOR,
HOST HOTELS & RESORTS, INC. AND
CHAIRMAN,
THE REAL ESTATE ROUNDTABLE

ON BEHALF OF
THE COALITION TO INSURE AGAINST TERRORISM

BEFORE A HEARING OF

THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES

ENTITLED

EXAMINING A LEGISLATIVE SOLUTION TO EXTEND AND REVISE THE TERRORISM RISK INSURANCE ACT

JUNE 21, 2007

♦ ♦ ♦
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Good morning Chairman Kanjorski, Ranking Member Pryce, and members of the Subcommittee. Thank you for holding this important hearing on the Terrorism Risk Insurance Act (TRIA) and allowing me to testify today. My name is Christopher Nassetta, and I am the CEO of Host Hotels and Resorts, Inc. Host owns or has interests in 128 luxury and upscale hotel properties in eight countries, 28 States and the District of Columbia and is one of the largest owners of hotels in the world. I also serve as Chairman of The Real Estate Roundtable (RER) and the Second Vice Chairman of the National Association of Real Estate Investment Trusts (NAREIT). Today, I am testifying on behalf of the Coalition to Insure Against Terrorism (CIAT).

Executive Summary

CIAT commends the sponsors of the Terrorism Risk Insurance Revision and Extension Act of 2007 (H.R. 2761) for developing a proposal which is responsive to the major issues identified by CIAT and other stakeholders. Although we continue to urge making TRIA permanent, we appreciate the sponsors' willingness to extend the TRIA Program for at least ten years in recognition of the importance of the continuity of such insurance coverage to business planning and construction financing. We also applaud the proposed elimination of the largely artificial distinction between so-called "foreign" and "domestic" acts of terrorism, and we note and appreciate the bill's set of provisions which are designed to encourage greater availability of insurance against NBCR terrorism. As the legislation is considered, we look forward to working with the Committee, Congress as a whole, and other stakeholders, in determining whether the mix of an immediately effective mandate to "make available," lowered deductibles, sliding quota share retentions, and the "hardened" cap on insurers' aggregate liability is the optimum mix to expand market capacity of adequate and affordable insurance protection for the nation's

business sector. Above all, we urge Congress to complete TRIA renewal before the current Program expires at year-end.

Who We Are

CIAT is a broad coalition of commercial insurance consumers formed immediately after 9/11 to ensure that American businesses could obtain comprehensive and affordable terrorism insurance. CIAT joined Congress and the Administration in recognizing that only the Federal government could provide the framework to make this coverage available to all those who required it. The diverse CIAT membership represents virtually every sector of the U.S. economy: hotels, banking, energy, construction, entertainment, real estate, stadium owners, manufacturing, transportation, as well as public sector buyers of insurance. In addition to NAREIT and the RER, CIAT members include the U.S. Chamber of Commerce, the National Association of Manufacturers, and the National Retail Federation. CIAT's membership embraces, to name a few sectors, transportation interests (e.g., the Association of American Railroads, the General Aviation Manufacturers Association, and the Taxicab, Limousine and Paratransit Association), utilities (e.g., American Gas Association, American Public Power Association, Edison Electric Institute, and National Rural Electric Cooperative Association), finance (e.g., American Bankers Association, America's Community Bankers, Mortgage Bankers Association of America, Commercial Mortgage-Backed Securities Association), real estate (American Resort Development Association, National Association of Realtors, Building Owners and Manufacturers International, International Council of Shopping Centers, and National Association of Industrial and Office Properties) and sports (e.g., Major League Baseball, NFL, NBA, NHL, and the NCAA). Collectively, the member companies of the 79 trade associations and organizations that form our coalition are the nation's principal consumers of commercial property and casualty insurance in the United States. Simply put, CIAT is the true consumer voice with respect to the subject of terrorism insurance.

The Availability and Affordability of Terrorism Risk Insurance is Vital to National Economic Security

Sometimes the subject of today's hearing is characterized as an insurance industry issue. I respectfully suggest that it is not. Instead, it is an issue of national economic security. It ultimately is an issue of jobs. And, it is an issue of protecting the investments of pensioners, shareholders, bondholders and individuals from across the nation.

Since 9/11, this Subcommittee and the full House Financial Services Committee have worked hard to find solutions to the economic risks associated with terrorism. I should point out that my company owned the World Trade Center Marriott which was destroyed by the collapses of the World Trade Center towers; we lost not only property, but also valued personnel. The terrorism insurance law that you originally enacted following 9/11 certainly has been welcomed and very much appreciated.

In the 14-month period between 9/11 and the enactment of TRIA, over $15 billion in real estate related transactions were stalled or even cancelled because of a lack of terrorism insurance, according to a RER study. Furthermore, the White House Council of Economic Advisors indicated that approximately 300,000 jobs were lost over that period. Congress and the President worked together to enact TRIA, which required insurers to make terrorism coverage available in commercial lines, and in return provided a Federal backstop that allows the economy to recover quickly from a terrorist attack. Without it, not only was the economy slowed and at risk, but economic recovery following any further attack would have been weakened. The same is still true today.

The Need for a Federal Solution to the Economic Threat of Terrorism Continues

Holding this hearing here today demonstrates that you know that the essential facts that caused the Congress to enact TRIA in 2002 have not changed. First, and most unfortunately, the threat of terrorism remains. Terrorists continue to attempt acts against our governmental policies and our way of life. Terrorism continues to be an unpredictable, man-made threat with potentially mammoth losses. Not surprisingly, therefore, insurers and reinsurers have an extremely difficult time assessing and pricing terrorism risk insurance. Insurers continue to say terrorism risk is uninsurable. This will, unfortunately, continue to be the case until we see clear evidence that the overall threat to our society has subsided.

Second, it is a simple, indisputable fact that markets like certainty. Unfortunately, there is almost nothing that can be considered "certain" about terrorism risks. This is why rating agencies such as Moody's and Fitch conclude that there will be numerous market repercussions if the Federal backstop expires. Nowhere is this more evident than the commercial real estate market. For example, commercial mortgage backed security (CMBS) borrowers face the threat of default and potential bond downgrades in the absence of terrorism insurance coverage. In fact, based on its review of the coverage in place and the ongoing loan requirements for coverage, Fitch has declined to rate certain transactions.

What is certain is that our economy continues to need terrorism insurance availability in order to function in the face of the terrorist threat. American businesses must have adequate insurance coverage in order to effectively manage economic risks and protect the economic value of their underlying assets. Without terrorism risk insurance coverage, America's economic infrastructure would be totally exposed, and

America's businesses, lenders, shareholders, pensioners, and bondholders would be forced to bear the brunt of terrorism risk.

Third, the reinsurance market currently only provides a fraction of the capacity needed to protect the U.S. economy from catastrophic terrorism losses. I support market solutions to problems, but the fact is that a meaningful private market for terrorism risk reinsurance has never existed and is not likely to ever develop. Even with the TRIA backstop, reinsurers are not meeting the capacity demand of primary insurers for their deductible and coinsurance layers. This suggests that private reinsurers simply want very little exposure to terrorism risk, and refutes the notion that the Federal backstop is crowding out the private market.

Fourth, primary insurers remain largely averse to exposing themselves to potentially catastrophic terrorism losses – especially from nuclear, biological, chemical and radiological (NBCR) terrorism – without adequate reinsurance availability or a federal backstop. As the original sunset of TRIA approached in 2005, many policies were issued with "pop-up" or springing exclusions that would have voided terrorism coverage after the termination of the Federal backstop. According to a Moody's report, 50-75% of all policies written prior to TRIEA's enactment included such exclusions. Congress acted again in 2005 by extending the backstop under the Terrorism Risk Insurance Extension Act (TRIEA). However, the current law, as you know, is set to expire at the end of this year – just six months from now. As the program approaches sunset once again, we anticipate again seeing the same types of exclusions that emerged in 2005.

Fifth, even though TRIA, as amended, covers NBCR perils, there is still a big gap in coverage against NCBR terrorism-related risk. Reports by the Government

Accountability Office (GAO) and the President's Working Group on Capital Markets (PWG) confirm that, other than workers' compensation insurance mandated by state law, no meaningful amount of insurance against NBCR perils is available on the market today.

We thank you for recognizing that ensuring the continued availability of terrorism risk insurance is a national problem of economic security that requires a Federal solution.

Revision and Extension of the Terrorism Risk Insurance Act is the Right Solution

We commend you for your work in crafting H.R. 2761. I am pleased to announce today that the Coalition to Insure Against Terrorism supports this legislation. This bill includes key provisions proposed by CIAT over these past months. We believe you have made a sincere effort to address the shortcomings which have been identified in the original TRIA program

First, the program term would be extended for ten years, giving policyholders more of the continuity needed for long-term projects and economic activity to move forward. We applaud you for recognizing that long-term extension will enhance the stability of our financial markets.

However, we urge you to consider making the program permanent. As we have previously testified, the threat of terrorism has become a part of our daily lives and there are no signs that this threat is going away. At a minimum, we encourage you to keep the program in place until Congress declares that terrorism is no longer a risk.

Second, the bill ensures that policyholders will continue to have access to terrorism insurance through the "make available" provision. For conventional terrorism losses, the bill would leave in place the existing TRIA backstop, with the insurer deductibles and co-pays unchanged from their 2007 levels for conventional terrorism

risks, and the bill would encourage more participation by medium and small insurers by returning the program trigger to its 2006 level of $50 million.

Taxpayers continue to be protected from all but the most catastrophic events because of the post-event surcharges which CIAT member policyholders will pay.

Third, and very importantly, the bill would eliminate the distinction between foreign and domestic acts of terrorism. Retaining this distinction would have forced the Treasury Secretary to make determinations that may not serve our national security needs. Furthermore, the distinction serves no sound policy goal. As the London bombings and the foiled Kennedy Airport plot demonstrate, we must be prepared for "home-grown" terrorism as well as threats from abroad. The distinction makes no difference to the human victims or to a post-terrorist attack economy.

Fourth, the bill features a two-part structure to address NBCR risks in addition to conventional terrorism risks. The bill would give businesses the option to purchase insurance for the most catastrophic conventional terrorism risks - the types of risks our government warns us about repeatedly - while encouraging meaningful insurance coverage against losses resulting from weapons of mass destruction through a mandatory "make available" requirement for NBCR risks. Such coverage would be made available under "same terms and conditions" as "conventional" risks. CIAT believes that this new feature will work best only if the legislation requires the optional NBCR terrorism coverage to be separately priced from conventional terrorism coverage.

The bill would incentivize insurers to write the NBCR coverage by (i) setting the insurer deductible at 7.5% and (ii) giving insurers greater assurance that their ultimate losses will be capped at a manageable level for NBCR events. We look forward to

hearing from the insurance industry regarding the projected impact of these and other incentives on the development of meaningful NBCR insurance capacity.

Finally, the bill addresses continuing problems of availability and affordability particularly in perceived high-risk urban areas and the need to enhance the economy's ability to recover quickly and efficiently after some future terrorist attack. Specifically, the bill establishes a "reset" mechanism that would address areas impacted by significant terrorist attacks. We do not know where the next terrorist attack will be – it could be in a location that has already been hit (e.g., lower Manhattan, central Pennsylvania), or it could be a new target in the Midwest or in the Sunbelt. What we know from experience is that insurers can be slow to provide adequate new coverage in those areas that have been hit; the reset mechanism would provide targeted incentives -- lower insurer deductibles and program trigger -- for such areas following a significant attack.

Conclusion

We thank the Subcommittee for developing a proposed long-term solution which focuses the government role on what the private markets have been unwilling or unable to do: enabling policyholders to purchase insurance for the most catastrophic conventional terrorism risks; addressing NBCR risks; and ensuring adequate capacity in high risk, urban areas. By maintaining a terrorism reinsurance program which preserves the public-private partnership, you have recognized that it is appropriate, necessary and vital that the Federal Government continue to play a role in maintaining the stability of our nation's economy. We stand ready to assist this Subcommittee and the Congress in finalizing and enacting this legislation.

REINSURANCE
ASSOCIATION
OF AMERICA

STATEMENT

TESTIMONY

OF

FRANKLIN W. NUTTER
PRESIDENT
REINSURANCE ASSOCIATION OF AMERICA

EXAMINING A LEGISLATIVE SOLUTION TO
EXTEND AND REVISE THE TERRORISM
RISK INSURANCE ACT

BEFORE

FINANCIAL SERVICES SUBCOMMITTEE
ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES

JUNE 21, 2007

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My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). It is an honor to appear before you on behalf of the RAA. The RAA is a national trade association representing property and casualty companies that specialize in assuming reinsurance. Together, RAA members write nearly two-thirds of the reinsurance coverage provided by U.S. property and casualty reinsurers and affiliates.

Before I begin my testimony, I want to applaud Chairman Kanjorski and Ranking Member Pryce, and the members of this Committee, for their leadership demonstrated on the terrorism insurance issue. Your leadership has been instrumental in the continuation of the successful, and very necessary, TRIEA program. The reinsurance industry commends you for the hard work and tremendous support you have provided on this most important issue.

Reinsurance is commonly referred to as insurance for insurance companies. Reinsurance plays a critical role in maintaining the financial health of the insurance marketplace and ensuring the availability of property and casualty insurance for U.S. citizens. Reinsurance can be used by insurers for several reasons. One of the most important purposes is to protect insurers from catastrophic losses resulting from various perils, including hurricanes, earthquakes, fire and floods. To that end, reinsurers have assisted in the recovery after virtually every major U.S. catastrophe over the past century. For natural disasters typically one-third of the insured losses are passed on to reinsurers and in the events of September 11, two-thirds of the losses were absorbed by the reinsurance industry. Fifty percent of 2005 losses associated with hurricanes Katrina, Rita and Wilma were ultimately borne by reinsurers.

The RAA strongly supported the adoption of the Terrorism Risk Insurance Act (TRIA) in 2002 and the Extension Act (TRIEA) in 2005. We believe the program is necessary and working well to: 1) fill a vacuum in reinsurance capacity for acts of terrorism; 2) keep premiums paid by

policyholders at affordable levels; 3) provide insurance coverage to support economic activity; and 4) minimize the need for public disaster assistance should there be future terrorist acts in the U.S. Today, my comments are intended to provide the Committee with: 1) the RAA's perspective on key provisions on the Terrorism Risk Insurance Revision and Extension Act of 2007 (H.R. 2761); 2) a better understanding of the status of the current private reinsurance market for terrorism risk; and 3) an explanation as to why the reinsurance industry strongly believes that continuation of a public-private partnership is necessary to help stabilize the commercial insurance markets that fortify our free-market economy.

RAA's Perspective on Key Provisions in H.R. 2761

The RAA applauds Chairman Frank, Congressman Capuano and all co-sponsors of H.R 2761 for the introduction of this most important legislation. We understand there is a commitment by the Committee to continue to work in a bipartisan manner as this legislation moves toward a Committee mark up. The RAA supports the legislation as an important first step toward the continuation of a federal program by the end of this year. We look forward to working with this Committee and the House of Representatives in moving the bill forward.

Since reinsurance is not covered under the TRAIE program, the RAA does not independently advocate specific changes or solutions for a federal program. The RAA has a close working relationship with the direct insurance community and will continue to support their efforts for a long-term solution. However, we understand the Committee is interested in understanding the impact certain provisions may have on the growth of a private reinsurance market under the program and thus we offer the following observations on some of the key provisions.

- **Program Duration:** The RAA applauds the bill sponsors for acknowledging that a two-year extension is commercially very difficult. RAA believes an extended program will provide an opportunity for insurers to continue to build capacity. There is no reason to believe at this point that the private reinsurance market will significantly develop over the next ten years thus a continued private/public program for an extended period of time is appropriate.

- **Co-pay and Deductibles:** The RAA supports maintaining the 20% direct earned premium deductible and the 15% co-pay. We believe these retentions provide plenty of room for the private marketplace to operate under the program. A discussion of the role the private marketplace plays under the program is discussed below.

- **Event Size:** The RAA supports lowering the event size to provide small companies with meaningful protection.

- **Group life:** The RAA supports the addition of this as a covered line and the "amount at risk" deductible. Given the potential solvency threat that a major act of terrorism could present to group life insurers, we believe it is necessary to include group life coverage in a federal backstop.

- **Nuclear, Biological, Chemical, Radiological (NBCR) Mandatory Offer:** Since reinsurers are not covered under the legislation, the RAA does not have a position on

the addition of this particular provision. As discussed below, however, there is even less private reinsurance for NBCR risks than for conventional terrorism risk. RAA believes it will be very difficult for direct companies to purchase private reinsurance to help them manage their 7.5% NBCR retention, which could threaten the solvency of some companies.

- **Blue Ribbon Commission:** The RAA supports the creation of a Blue Ribbon Commission to study long- term solutions. We appreciate and support the Commission's inclusion of a reinsurance representative.

- **Market Reforms:** RAA urges the Committee to consider including a key market reform that addresses the challenges the state regulatory system poses for direct companies in managing this risk. The RAA believes that the state regulation of terrorism risk insurance rates and forms can undermine the program's basic objectives and should be preempted.

The Need for H.R. 2761

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

These attacks forced all Americans to confront the previously unforeseen realities associated with a catastrophic terrorist attack on U.S. soil. Although the insurance and

reinsurance industry responded unwaveringly to the catastrophic losses of September 11, the events shook the financial foundation of the industry and forever changed the way it views this risk. The simple fact is that the U.S. insurance and reinsurance industry cannot underwrite or model the scale, size or frequency of future terrorist attacks in our nation. The insurance and reinsurance industry cannot adequately provide significant terrorism coverage, especially nuclear, biological, chemical and radiological (NBCR) risks, without TRIEA's public-private partnership.

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

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

Private Reinsurers Still Face Significant Hurdles in Underwriting Terrorism Risk

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

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

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

Frequency

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

Severity

1. Terrorist acts are willful and intended to inflict maximum damage. They are not random or fortuitous acts.
2. The potential size of loss is enormous, with total destruction of multiple insured properties likely. The introduction of nuclear, biological, chemical and radiological weapons can greatly magnify losses to property and life. As an example, the American Academy of Actuaries has modeled potential insured losses totaling $778 billion stemming from an NBCR event in New York City. These extreme loss

scenarios would cause losses that far outstrip insurer financial resources and therefore are uninsurable.

Correlation

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

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

Private Reinsurers' Function under the TRIEA Program

In the event of a certified terrorist attack, TRIEA will provide reinsurance-like protection for primary commercial insurance exposures. For 2007, 90 percent of the commercial terror loss for primary insurance companies is covered up to an industry total of $100 billion. This

coverage is subject to an individual company retention of 20 percent of 2006 direct earned premium (DEP) on commercial lines. These individual company retentions, and the 10 percent co-pay for losses above the retention, require commercial insurance companies to absorb significant losses before TRIEA funding is available. H.R. 2761 would also require direct companies to offer NBCR coverage with a 7.5% DEP deductible. Direct companies will no doubt seek to purchase private reinsurance to help them manage this new exposure. The primary industry is under increasing financial risk and exposure to acts of terrorism because of: (1) the significant and rising retentions under TRIEA; (2) the mandatory offer of coverage required of insurers under the program; (3) state regulatory action or refusal to act on rates and exclusions; and (4) the scrutiny of independent rating agencies. In certain instances under TRIEA, some insurance companies will have to absorb losses greater than those losses sustained during the terrorist attacks of 2001 before federal funding is provided.

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

Market Observations on Reinsurance Terrorism Capacity

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

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

Regarding losses from NBCR generally, there is very little reinsurance appetite for this risk. NBCR capacity is believed to be 15-20 percent of non-NBCR capacity for terrorism risk. And when it is available, pricing for coverage that includes NBCR is reported to be at a significant premium and coverage amounts are restricted. The limited market for NBCR reinsurance will put a strain on direct companies who would have to manage their 7.5% retention under H.R. 2761. With regard to workers' compensation, some insurers have been able to add

the terrorism peril to their reinsurance programs, but this coverage typically excludes NBCR events.

The RAA believes that for the foreseeable future, there will continue to be a shortage of reinsurance capacity for TRIEA coverage. Although progress has been made in modeling terrorism loss scenarios, forecasts of the frequency and severity of terrorism losses remain extremely problematic. Reinsurers can provide only limited capacity for terrorism because the magnitude of these potential losses would otherwise put their solvency at risk. Reinsurers' capital is necessary to support their many other outstanding underwriting commitments, including natural disasters, workers' compensation and other casualty coverages.

Limited Impact of Capital Markets on Terrorism Risk Capacity

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

few new companies have expressed an interest in providing terrorism insurance, their capacity is limited and market presence untested.

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

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

Due to the nature of the terrorism peril, the RAA believes that private market mechanisms alone are insufficient to spread the risk of catastrophic terrorism loss in a meaningful way. The RAA believes H.R. 2761 goes a long way toward establishing an effective long-term solution. We look forward to working with this Committee to move the bill through the legislative process. Without a significant federal role, we would expect less coverage available at the policyholder level, rising prices for terrorism cover, and even more limited private reinsurance capacity.

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES –

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND

GOVERNMENT SPONSORED ENTERPRISES

JUNE 21, 2007

"EXAMINING A LEGISLATIVE SOLUTION TO EXTEND AND REVISE THE TERRORISM RISK INSURANCE ACT"

GOVERNOR MARC RACICOT, PRESIDENT

AMERICAN INSURANCE ASSOCIATION

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GOVERNOR MARC RACICOT, PRESIDENT
AMERICAN INSURANCE ASSOCIATION

Good morning. My name is Marc Racicot. I am president of the American Insurance Association (AIA). AIA represents approximately 350 major property-casualty insurance companies that underwrite about one-third of the U.S. commercial insurance market covered by TRIA and its successor, TRIEA; our membership includes half of the top ten commercial lines writers in the U.S. Terrorism insurance is among the highest priority public policy and marketplace issues for our members, and is a key part of the economic war against terrorism.

I am grateful for the opportunity to testify this morning and would like to express AIA's appreciation for this Committee's steadfast commitment to addressing the vital continuing role that the terrorism insurance program plays in our Nation's economic security, as well as your recognition of the unique catastrophic risk posed by terrorists with access to, and the willingness to use, unconventional weapons against U.S. citizens and businesses. The recently-introduced Terrorism Risk Insurance Revision and Extension Act of 2007 (HR 2761) reflects this Committee's resolve on this important issue. AIA strongly supports the Committee's efforts, and we pledge to continue to work with you, our colleagues in the insurance industry, and our policyholders to maintain the strong public-private partnership that TRIA and its successor have provided over the past 5 years.

I would like to use my time today to discuss three important aspects of the terrorism insurance debate, in the context of HR 2761:

1. The importance of a workable TRIA financial structure in addressing the market availability of terrorism insurance, and creating opportunities for additional capacity.

2. The critical recognition of the catastrophic risk posed by nuclear, biological, chemical, and radiological (NBCR) terrorism and the need to address that risk in a straightforward manner.

3. Introduction of free market competition among insurers as one way of promoting terrorism insurance availability and affordability, and providing policyholders with a fuller range of choices.

The Importance of TRIA

Since its enactment in 2002, TRIA has advanced its goals of making terrorism risk insurance widely available to U.S. businesses – even for urban areas, high-risk industries, and iconic properties – and of stabilizing the private marketplace for a risk that has many features that make it difficult, if not impossible, to insure. Unfortunately, despite the government's success since 9/11 in interdicting several terrorist plots and preventing another major strike in the U.S., most experts agree that it is not a matter of if, but when, another catastrophic attack will occur on U.S. soil. A continued, vibrant federal terrorism risk insurance program therefore remains vital to the national security and economic well-being of our nation for the foreseeable future.

The current program is scheduled to expire on December 31, 2007. The positive comments by Chairmen Frank and Kanjorski have helped to preserve stability in the marketplace, but they do not have the same effect as actual legislation. We therefore urge you to act as quickly as possible to advance HR 2761 so that the new program is in place as insurers and their policyholders go through the upcoming renewal season.

We also wish to underscore the importance of a program that provides a workable financial and operational structure for both insurers and policyholders. This includes TRIA per company retentions and co-shares that are set at levels that do not subject insurers to such a high level of risk that the backstop becomes meaningless or, at best, a solvency tool. HR 2761 maintains the current retentions and co-share levels for insured losses from so-called "conventional" terrorism. While the resulting exposure from conventional terrorism poses a significant operational and risk management challenge for many insurers, the market as a whole has adapted. We urge you to hold firm against any further increases that might be advanced in the name of reducing the federal role. We believe that such a rationale for rising insurer retentions and co-shares is based on economic theories about capacity that ignore practical market reality. NBCR terrorism requires a much greater level of federal participation, as discussed in more detail below.

I also would like to commend the sponsors of the legislation for incorporating domestic terrorism acts into the program. Experience has shown that the distinction between foreign and domestic terrorism is artificial. Post-TRIA events such as the London Underground bombing and the thwarted attack on John F. Kennedy Airport have reinforced the practical difficulty of making this distinction and have underscored that it is meaningless from an economic perspective, and impractical from an insurance perspective. Equally important, terrorists are intent on causing widespread physical, psychological, and economic harm to the United States, regardless of the source of their motivation.

Finally, extending the statute for ten years, while maintaining a stable program structure, will bring much needed certainty to all of the participants in the market, as well

as regulators, rating agencies, and financial analysts. This is critical for long-term investment, economic development, and growth.

NBCR Risk

NBCR terrorism is the 21st century equivalent of war, in terms of the potential for broad physical and psychological damage to individuals and businesses throughout the United States----for example, a 1-kiloton bomb (about one tenth of the size of the Hiroshima explosion) that is transported in a truck, a container ship, or even a backpack, could devastate any U.S. city.

The unique risk characteristics associated with these unconventional attacks require that the framework established by TRIA be altered to address the distinctive challenges that this risk poses to the insurance system and our economy at large. We believe that HR 2761 provides an excellent first step in redefining the federal program to meet these challenges, but we also believe that the current provisions could be further improved to meet the needs of U.S. commercial policyholders while dealing with the operational difficulties faced by insurers.

Last fall's President's Working Group on Financial Markets (PWG) and Government Accountability Office (GAO) reports confirmed that no private market for NBCR terrorism risk insurance existed prior to September 11, none exists today, and none is likely to exist in the foreseeable future. This is due to the staggering loss scenarios associated with NBCR events, the extreme inadequacy of computer models for measuring exposures, and the long-term nature of the damage. Unless mandated by state law, coverage for NBCR risk has not been generally available, and reinsurance and "cat bond" capacity for NBCR terrorism has been virtually non-existent.

Yet, despite the almost complete lack of private sector capacity, policyholders want protection, through insurance, against the devastating economic losses that are associated with a NBCR attack. Testifying before this Committee, they have supported expansion of TRIA's current "mandatory availability" requirement to cover NBCR risks that currently fall within general coverage exclusions. At the same time, they recognize that legislation that simply forces insurers to make more NBCR terrorism coverage available to policyholders without addressing insurers' exposure needs cannot artificially generate more private market capacity, and may actually result in insurers scrutinizing their current accumulations of terrorism risk (and commercial risk generally) and reallocating their existing capacity. The other alternative is that policyholders will decide to forego purchasing any terrorism coverage at all. This conclusion is reinforced by a recent RAND report that found that creating a new NBCR terrorism program with "make available" mandates, without simultaneously providing other meaningful program changes, could cause the take-up rate for insurance against conventional attacks to plummet, thus further exposing our economy in the event of an attack.

HR 2761 addresses these concerns by reducing and creating certainty around insurer financial exposure for NBCR terrorism. First, the bill establishes a 7.5 percent individual insurer deductible for NBCR terrorism events (rather than the current 20 percent

deductible that remains applicable to conventional attacks), in part to account for the inability of insurers to spread NBCR risk to any private market entity.

The bill also calibrates the insurer co-share for NBCR terrorism losses that exceed the 7.5 percent deductible, depending on the size of the loss. Because of the potential for huge losses from NBCR terrorism, it is critical that the co-share obligation does not impose a financial burden that makes insurers more reluctant to allocate capacity to this risk. The bill takes a positive step in this regard through the gradually declining co-share, but we urge that you reconsider the need for <u>any</u> co-share above the 7.5 percent deductible in the event of an NBCR attack. If, like TRIA and its successor, creating private capacity and availability and promoting market stability remain goals for the federal program, capping individual insurer financial exposure at the deductible level set in the bill serves those goals.

The bill also recognizes that NBCR attacks may well exceed the current TRIA program cap of $100 billion. It therefore provides additional legal certainty to insurers by clarifying that the limits of an insurer's financial exposure for all losses, including workers' compensation and other state-mandated coverages, are limited to its applicable deductible and co-share payments. Treasury would provide notice if losses are expected to exceed $100 billion, so that insurers could unwind and halt the claims process. Further, the bill includes provisions to reimburse insurers for (1) payments exceeding the cap that are made before the aforementioned Treasury notice is received, and (2) payments exceeding the cap ordered by a court or other governmental authority, provided that insurers make a good-faith effort to enforce the cap. All of these provisions recognize that TRIA is not an unrestricted backstop, but a program that "provides finite liability limits for terrorism insurance losses for insurers and the government" (HR 2761, §101(b)(3).

We also support the Committee's efforts to put some emphasis on the need for Treasury to issue pro-rata allocation regulations in the near term, in order to avoid a post-event crisis should a mega-catastrophic event exceeding $100 billion occur. Coupling legal certainty to insurers with advance notice of how claims will be paid for cap-breaching events benefits everyone by providing clear parameters with respect to the public-private financial responsibility for terrorism and how the claims process will work under difficult conditions.

It is indeed unfortunate that we need to grapple with scenarios where horrific terrorist attacks could result in losses that exceed the $100 billion level. Frankly, we would have preferred to make sure that federal payments would be fully available to policyholders in such a situation. Nonetheless, we believe that HR 2761 deals with this situation in a fiscally responsible, sensible manner and we commend the Committee for the effort.

<u>Reducing Regulatory Barriers</u>

As we have discussed at prior hearings on this issue, the current state regulatory system poses significant challenges to insurers that are trying to manage terrorism risk within the context of TRIA. TRIA recognizes that terrorism is a national problem that does not respect state boundaries or distinctions among economic sectors or lines of

insurance. State insurance regulation, however, is often parochial, leading to artificial rate suppression or policy language that is at odds with what policyholders really want.

HR 2761 takes limited steps to curtail state prior approval regulation of terrorism risk insurance rates and forms that might undermine the program's basic objectives, by reinstituting TRIA's "year 1" limited terrorism rate/form preemption, but only for NBCR terrorism risk. In the original TRIA statute, this provision preempted for one year state rate and form laws to the extent that those laws allowed state regulators to require government approval of filed terrorism insurance rates or policy forms prior to introduction into the market. However, it preserved state authority to disapprove terrorism policy forms after market introduction and the ability of states to disapprove rates that were considered to be inadequate, excessive, or unfairly discriminatory. Insurers' experience during the TRIA's "year 1" demonstrates that the preemption was easily disregarded in some states and narrowly interpreted in others, and did little to provide insurers with the flexibility they needed to better serve their policyholders. We believe that a stronger preemption going beyond a single year would be of great value as insurers comply with their new obligations under an NBCR "make available" requirement. Specifically, we suggest that the preemption apply more broadly to all state rate and form regulation for terrorism all insurance, and that it continue for the duration of the TRIA program.

We look forward to working with you to advance the strongest possible version of HR 2761 in the shortest possible time. Thank you again for inviting me to testify today, and for your unfaltering dedication to a strong national economy through a robust TRIA program.

Testimony of Mr. Dennis Smith
President, Missouri Employers Mutual Insurance
Incoming President, The American Association of State Compensation Insurance Funds

HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

June 21, 2007

Chairman Kanjorski, Ranking Member Pryce, and Members of the Committee, it is my distinct honor to be here today on behalf of Missouri Employers Mutual Insurance Company, which was established by the State of Missouri in 1993. I am also the First Vice President of the American Association of State Compensation Insurance Funds, the association of twenty six (26) workers' compensation funds established by their State legislatures. As you know, Mr. Chairman, a state workers' compensation insurance fund has been established by the Commonwealth of Pennsylvania, and Members of this Committee who hail from the States of Ohio, New York, Arizona, Texas, California, Colorado, Oklahoma, Louisiana, and New Mexico also have similar funds operating in their States. State funds support the extension of TRIA, and the length of the extension you have proposed should bring stability to the marketplace. However, for the reasons I will set out in my testimony, further changes to the trigger level, co-pays, and deductibles, are crucial to the ability of State funds to survive financially a catastrophic terrorist event.

The 26 State funds operating in the United States write only workers' compensation. The funds are typically organized as non-stock mutual companies, although depending on the State law, some funds have quasi-governmental attributes. Five of the funds are their States' exclusive provider of workers' compensation insurance. The rest, like Missouri Employers Mutual, compete in their State marketplace both with small regional companies similar in size to us, and very large national and multinational companies. The 26 State funds insure over 1 Million employers, most of them small

businesses, who in turn employ an estimated 10 Million workers. The market share of these companies ranges from 15% in my State of Missouri and a similar number in Pennsylvania, to 60% in Arizona.

For many reasons, Mr. Chairman, workers' compensation is a unique line of insurance, and State funds are a unique subset of that line. State funds, alone among those who write workers' compensation, provide an assured market for employers to secure coverage, that is, we are always in the market and either by law or State policy we insure all who apply. Workers' compensation provides statutory benefits, including lifetime medical benefits, rehabilitation services, wage replacement payments, and extensive survivors' benefits to spouses and dependent children. These "long tail" benefits can run for years or decades. Medical benefits are unlimited and can total in the millions of dollars for a single catastrophic injury. Coverage for injuries resulting from acts of terrorism cannot be excluded, including the terrible injuries that would occur from a nuclear, biological, chemical, or radiological attack, or NBCR attack. State funds also provide a number of other important functions for employers and their employees. These services include important loss prevention services for our policy holders such as safety audits and training, insuring that injured workers receive appropriate medical care including rehabilitation, and working for the continued improvement of the workers' compensation system.

These unique aspects of workers' compensation insurance, especially as they apply to State funds in a terrorism context, places our funds in a particularly vulnerable position in the event of a catastrophic terrorist attack. Because we must always be in the market and operate as a market of last resort, we cannot control our concentration of risk as others can. Our competitors can choose to decline coverage in a particular zip code, for example, or use geocoding to avoid concentrations

of coverage in a potential high threat area. State funds cannot manage their risk in this way. Should a catastrophic event occur, especially where a State fund has risk concentration, the solvency of the fund would likely immediately be threatened. Not only would the benefits of those injured in the attack be in jeopardy, but the benefits of workers around the State who may later be injured in the normal course of work would also be at risk.

Mr. Chairman, a trio of TRIA provisions holds especially negative consequences for State funds in the event of terrorism losses: high program trigger; high deductibles, and high co-pays. The current trigger of $100M would consume the entire surplus of Missouri Employers Mutual and all or a substantial percentage of the surpluses of other State funds. The proposed trigger of $50M would therefore be an improvement. Nevertheless, even this reduced trigger would consume such a large percentage of our policy holder surplus that it could threaten our solvency and rating. Similar consequences would occur with current deductible and co-pay levels. Leaving the deductibles and co-pays unchanged has the effect of substantially negating any potential relief offered by a lower trigger. Therefore, I urge the Committee to seek a further trigger reduction as the legislative process moves forward.

Because of the unique nature of State fund company operation and coverage which limits our ability to manage risk, combined with substantial benefits payable over many years, it can be said that in a terrorism context, we have a finite amount of capital supporting infinite risk. Modeling by internationally recognized re-insurance brokerage Guy Carpenter & Company LLC has shown that in many terrorist scenarios, workers' compensation is easily the largest loss component. Even a two-ton conventional attack at one of our concentrated risk locations would produce losses far exceeding our policy holder surplus. These losses would be magnified in the case of NBCR attacks, which

must be covered in any workers' compensation policy. Therefore, we are pleased that the proposed legislation provides a specific backstop for NBCR losses. Without such a backstop, the solvency of my company would be in instant jeopardy in the event of an NBCR attack. Furthermore, the State of Missouri would face substantial political, legal, and moral pressure to take over not only the payment obligations of Missouri Employers Mutual to those injured in a terrorist attack, but also those workers injured in normal workplace events unrelated to terrorist events. Other States and state fund companies would face similar circumstances and pressures in the event of a terrorist attack; an attack that all agree would be an attack against the United States, not any particular State.

Mr. Chairman, workers' compensation insurance provides important security to employers, employees, and their families. In your consideration of extending the Federal terrorism insurance program, it is crucial to recognize the impact that high program triggers, co-pays, and deductibles will have on smaller insurers and on State fund insurers. We do not have the discretion to withdraw from our market if high triggers, co-pays, and deductibles create unreasonable financial risk for the size of our policyholders' surplus. Terrorism exposure under the current terms clearly puts the safety and soundness of my company, and other State fund companies, at risk in the event of a catastrophic terrorist attack. I urge the Committee to adopt lower triggers along with lower co-pays and deductibles for both conventional terrorism and NBCR coverage. Such action will provide the meaningful backstop necessary to preserve the viability of this important coverage when it is most urgently needed.

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