Commercial Mortgage Securities Association (CMSA)

Statement of Leonard Cotton
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on behalf of

The Commercial Mortgage Securities Association (CMSA)

Before a Hearing of the House Financial Services Committee

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"Policy Considerations for Extending the Terrorism Risk Insurance Act"

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Chairman Kanjorski, Ranking Member Pryce, members of the Subcommittee, thank you for holding this important hearing and for the opportunity to testify before you today regarding the terrorism risk insurance program. My name is Lee Cotton. I am Vice Chairman of Centerline Capital Group (Centerline) and serve as president-elect of the Board of Governors of the Commercial Mortgage Securities Association (CMSA). My testimony today is on behalf of my firm, as well as the member firms of CMSA.

Centerline is one of the nation's leading real estate finance and investment companies. A subsidiary of Centerline Holding Company (NYSE:CHC), Centerline Capital Group matches the users of capital with the providers of capital, with a strong focus on the real estate industry.

The Commercial Mortgage Securities Association is the international trade organization for the commercial real estate capital market finance industry. The CMBS market is an important source of capital for the commercial real estate industry, and its liquidity provides reliable debt financing to commercial real estate borrowers. The organization's primary mission is to promote the ongoing strength, liquidity, and viability of commercial real estate capital market finance worldwide. Based in New York, and with a strong presence in Canada, Europe, and Japan, CMSA is the voice for the entire industry, representing a diverse global membership of over 400 financial services companies represented by more than 5,000 individuals who actively engage in commercial real estate finance activities. Unlike many trade associations that represent a single group of competitors, CMSA is the collective voice the entire commercial real estate capital finance marketplace. CMSA's membership includes the leaders from each sector of that marketplace:

- the lenders who make the initial loans;
- the investment banks that purchase the loans and package them into bonds and other securitized vehicles;
- the trustees that hold the loans which collateralize the bonds;
- the rating agencies that rate the bonds;
- the investors who buy the bonds; and
- the loan servicers who service the loans on behalf of the investors.

CMSA is a member of the Coalition to Insure Against Terrorism (CIAT). CIAT is a broad coalition of major trade and professional associations and businesses, representing the Nation's major consumers of commercial insurance lines.

Centerline and the members of CMSA share your belief that terrorism risk protection is an issue of utmost importance and a critical element in our nation's efforts to confront the threat of terrorism and its impact on our economic, as well as physical, welfare. Since 2001, the members of this Committee have been leaders in this effort with the adoption of the Terrorism Risk Insurance Act (TRIA) in 2002 and the Terrorism Risk Insurance Extension Act (TRIEA) in 2005. We commend you all for your hard and thoughtful work.

Introduction

It has been more than 5 ½ years since thousands of our fellow citizens, friends, colleagues and family members were killed in the September 11, 2001, terrorist attacks. Since that day, one of the most important of the many steps that Congress and the President have taken to protect Americans from the effects of terror attacks was the enactment of TRIA in 2002, and its extension in 2005. Passage of TRIA was critical for individual businesses and for the economy as a whole. Although the spotlight was on the insurance industry's capacity to withstand further terror attacks and to cover terror risks going forward, the national risk was – and is – much broader.

Because insurance provides individuals and businesses with the ability to take risks essential to the functioning of our economy, constraining that ability would be economically devastating. TRIA has prevented that from happening at virtually no cost to the federal government. Indeed, not only have federal funds provided by the TRIA "backstop" never been tapped, the program has proved to be an unqualified success in stabilizing the insurance markets, and ensuring that coverage is available and more affordable. TRIA is not about protecting the balance sheets of insurers – it is about protecting commercial policyholders, protecting the exposure of taxpayers, and creating and sustaining a national economy that encourages investment and development. That is what I am here to talk about today.

The Importance of Terrorism Insurance to the CMBS Industry

Commercial mortgage-backed securities (CMBS) are bonds collateralized by a pool of commercial mortgage loans. All the principal and interest paid on the underlying mortgages flows to investors, the purchasers of the bonds. To create these investment vehicles, mortgage loans of varying dollar amounts, property types, and locations — and containing a myriad of individualized terms and conditions — are pooled and transferred to a trust. Bonds are then issued, backed by the pool of assets held in the trust. Those bonds vary in yield (the amount of return on the bonds), duration (the length of time before the bond is expected to be paid off), and payment priority (the order in which investors are paid a return on their investment).

The CMBS industry plays a vital role in the functioning of the commercial real estate market. The liquidity provided by CMBS enables mortgage borrowers to have access both to larger pools of capital than would otherwise be available in traditional lending markets and to lower interest rates. Mortgage lenders benefit from CMBS as well, because securitization enables them to access the capital markets with their loan products and to obtain new capital to make new loans. Investors also benefit from the creation of potentially attractive and credit-worthy investment vehicles that may cater to an investor's desired risk profile, investment term, and yield.

The importance of the CMBS industry to the U.S. economy cannot be overstated. The $770 billion U.S. CMBS market is the second largest source of commercial real estate credit in the U.S. and accounts for 26 percent of the $2.95 trillion U.S. commercial real estate debt market. In 2006 alone, CMBS provided more than $207 billion in debt capital to the U.S. commercial real estate industry, including 40% of all new commercial loans. In addition, as much as 80% of commercial mortgages are believed to be securitization eligible.

The functioning of the CMBS market, in turn, is dependent upon the availability of insurance coverage, including terrorism insurance which is critical to this ever-growing market. In fact, since 2000, 2002 is the only year in which the CMBS business experienced negative growth when new CMBS issuance dropped almost 25% from 2001. This decline is largely attributed to the lack of reliable terrorism insurance coverage between 9/11 (actually, the point in time when the reinsurers withdrew from the market) and the passage of TRIA 14 months later.

It has been our experience that the ability of insurers to provide terror coverage will be limited without TRIA. Consequently, commercial real estate mortgage borrowers will be in technical default under their loan agreements without the appropriate insurance coverage, rendering their loans unacceptable for pooling in CMBS. This has a tremendous impact on both new loans and the more than $770 billion in outstanding loans, as well, bringing unwelcome price volatility to the bonds backed by those loans. Virtually every single Congressional district includes commercial projects financed through the liquidity provided by CMBS. Therefore, the impact of a potential market disruption would be felt nationwide.

Specifically, investors presume a certain stability of income and ratings. When ratings become volatile reserves must be adjusted to reflect the rating changes. This volatility can cause bonds backed by existing loans to lose their attractiveness as an investment, and bonds already held by investors to lose value. The resulting decline in investors and increase in capital reserve requirements would limit cash flow for everything from capital for new commercial real estate developments to funds for pension benefits whose portfolios are heavily invested in commercial mortgage-backed securities. This oversimplifies the matter, of course, but the threat is real. The loss of terrorism coverage resulting from the demise of TRIA would damage not only the real estate market and related industries, including CMBS, but it will cause a huge economic hit that will ripple across the Nation's economy.

The Success of TRIA and TRIEA

When TRIA was originally adopted in 2002, the assumption of many was that the private sector would be able to create a market for terror insurance coverage and the federal program would be a stop-gap measure to ensure stability while that market developed. Since that time, however, it has become clear that the private sector – insurance companies, the capital markets and rating agencies – have a very limited ability to insure and rate terrorism risks that are only questionably quantifiable, totally unpredictable and, essentially, impossible to underwrite. This is further exacerbated with respect to coverage for nuclear, biological, chemical and radiological risks (NBCR), the most catastrophic types of attacks for which coverage is essentially nonexistent even with TRIA in place.

Given these realities, Centerline and the members of CMSA believe a sustainable solution to the terrorism insurance crisis is essential and that the federal government must play an important role in terrorism risk coverage for the foreseeable future. In order to function properly, the insurance market needs some level of stability and predictability. The prospect of TRIA's demise – or the uncertainty that would come with periodic renewal or extension of the program every few years – is not viable for the long term. Failure to implement a long term or, ideally, a permanent fix before TRIA expires at the end of the year will not only vastly decrease risk transfer options, it will expose the U.S. economy to potentially devastating uninsured economic loss in the event of another catastrophic terrorism attack. Of course, the impact on CMBS is critical to us, but the potential ramifications for all sectors of the economy are even more significant.

In our view, the issue before Congress, then, is not whether the government will be the insurer of last resort in the event of such an attack, but how to develop a plan before an attack to maximize private sector coverage of the massive damages that will result from a terror strike, rather than reacting in crisis mode after an attack occurs. CMSA believes that such a plan must also protect policyholders and taxpayers from NBCR risks that today are almost completely uninsured.

We do not have to look far to see what can happen in the aftermath of a catastrophe in the absence of proper financial preparation. New Orleans has not recovered nearly two years after Katrina struck despite billions of dollars in assistance from the federal government. In addition, serious questions have been raised about the efficiency and effectiveness of the post-disaster funding. If history serves us, it would seem that the federal government would step in to provide assistance after a terrorist attack, particularly if there is insufficient private sector relief. But without TRIA or some sort of federal involvement enabling the private insurance market to be involved in providing terror coverage, you lose all that the insurance industry has to offer: direct contribution through upfront premium payments, relief delivery through established claims processes, and a repayment mechanism through policyholder surcharges after the event. So it is not a question of whether the federal government will pay, but rather whether the federal government will work with the insurance industry to ensure that the preparation and response to a terrorist attack is handled in the most efficient way possible. Put simply, better TRIA than FEMA.

Since its inception in 2002, TRIA has been successful in providing the commercial property and casualty market, and insurance buyers, with increased terrorism capacity and in decreased prices at virtually no cost to the federal government. In addition to providing readily available and more affordable terrorism capacity for U.S. based risks, the program has also allowed the private market to progressively increase its role in coverage terrorism risks through retained terrorism exposures under TRIA.

Coverage that is both available and more affordable is directly due to the existence of the federal backstop. Since TRIA's enactment, as the availability of terrorism coverage has grown and premium prices have dropped, take-up rates for terrorism coverage have steadily increased. A brief history of the terrorism insurance marketplace since 9/11 illustrates TRIA's success:

- Prior to September 11, 2001, terrorism risk was considered minimal and coverage for terrorism was generally included at no additional cost in most property and casualty policies.

- After September 11 and prior to the enactment of TRIA, terrorism insurance became almost entirely unavailable, and the small amount that was available was prohibitively expensive. The lack of coverage for terrorism risk at a time when the perceived risk was enormous resulted in uncertainties whose effects rippled far beyond the insurance industry.

- In the months after enactment of TRIA, the initial pricing for terror coverage was high and the take-up was low.

- Since that time, the purchase of terrorism insurance has been steadily increasing, according to the major insurance brokerages.

- The increase in take-up rates reflects the increasing demand by America's business community for terrorism coverage at commercially viable prices. Affordable terrorism coverage has allowed numerous business transactions that would otherwise have been stalled to go forward, without threatening the solvency of the parties involved or their insurers. Policyholders – the businesses of our economy – have not had to deal with extremely high — and volatile — terrorism insurance costs and have been able to budget for their business plans.

- Purchase of terrorism risk coverage has not been limited to urban, coastal areas and is not limited to particular industries. Insurance industry reports indicate that the take-up rates are high across the country and across industries, and policyholders are generally willing to purchase terrorism coverage when it is available at an affordable price. For companies with a higher perceived risk, whether due to size, location, industry or other factors, the take-up rates are even higher. Within specific industrial sectors, the largest percentage of insureds buying terrorism insurance were in real estate, financial services, health care, media, hospitality, transportation and education. These take-up rates illustrate not only the demand for coverage, but that we are making progress toward the public policy goal of encouraging coverage in affected areas and industries. By comparison, take-up rates for terrorism insurance show a higher percentage of commercial buyers across the country purchasing such coverage than the percentage of eligible purchasers in most of the other areas where the federal or state governments have provided capacity – areas such as earthquake, flood, crop and wind.

Where We Stand Now

Unfortunately, despite the success of TRIA and TRIEA in stabilizing the terrorism insurance market, the basic facts that prompted the enactment of TRIA and TRIEA in the first place – including the threat and nature of terrorist attacks – have not changed and still call for federal involvement in providing terrorism insurance after the expiration of TRIEA. Although the particular ways of federal involvement are open to discussion, some sort of federal involvement must be preserved in order to avoid the potentially devastating effects caused by the expiration of TRIEA. CMSA comes to this conclusion after considering the following facts:

First, the threat of terrorism remains unabated and unpredictable. More than five years after September 11th, we have been fortunate to not have had another terrorism attack on the American soil. Nonetheless, terrorism attacks elsewhere in the world since September 11 — including the bombings in Madrid and London — remind us that terrorists could strike any time, at any place. The continuing conflicts in Iraq and Afghanistan make the security situation even more fragile. Given this continued threat, the underwriting process is inhibited by the ability to predict the location, timing and scope of any terrorist attacks.

Second, without the federal involvement, reinsurers would be unable to quantify the risk and would have to effectively withdraw from the terrorism reinsurance market. This conclusion was true when TRIA and TRIEA were first enacted, and remains true today. The private reinsurance industry paid about two-thirds of the roughly $33 billion insured losses related to 9/11 claims. After September 11th and prior to TRIA, the reinsurance industry withdrew from the terrorism reinsurance market due to the huge and unpredictable terrorism risk. Today, despite the success of TRIA and TRIEA over the past several years, the reinsurance industry estimates that there is only about $6 billion to $8 billion in global terrorism reinsurance capacity available, and only $1 billion to $2 billion in capacity available for nuclear, biological, chemical and radiological (NBCR) coverage. This current capacity is nowhere near the level needed to adequately insure our economy against terrorism risk without the TRIA backstop. It is estimated that terrorism losses could reach $100 billion and that losses from a large NBCR attack in New York City alone could reach $778 billion. Without the TRIA backstop, private reinsurers would want as little exposure to terrorism risk as possible. Indeed, even with TRIA backstop now, reinsurers are not meeting the capacity demand of primary insurers for their deductible and coinsurance layers.

Finally, without TRIA backstop or adequate reinsurance coverage from reinsurers, primary insurers are reluctant to expose themselves to potentially unlimited terrorism risks. We saw this quite clearly the last time when Congress was debating whether to enact TRIEA and extend TRIA, in 2005. Back then, primary insurers were including exclusions that would have voided terrorism coverage beginning January 1, 2006, had TRIEA not been enacted. A Moody's report indicates that 50-75% of all policies written prior to TRIEA's enactment included such exclusions. Now, with the possible expiration of TRIEA at the end of 2007, primary insurers may once again ask policyholders in the market shopping for policies that run past the end of 2007 to accept those exclusions in their insurance policies. It is obvious that if TRIA were allowed to expire after 2007, a large percentage of those policyholders would have no choice but to accept those exclusions, and therefore would see their terrorism risks uninsured—and their business plans disrupted or even halted as a result.

Going Forward

From our perspective, the goal of the federal government should be to create a mechanism that would result in a stable insurance market in which terrorism coverage is available and more affordable. The specific approach taken is most relevant to the insurance industry and the federal government, provided it meets the market demands that our industry and other policyholders face. We want to emphasize that the path forward should be carefully chosen based on considerations of economic realities, and whatever we choose to do should be done with input from all relevant players, such as the commercial real estate capital market finance industry – which includes lenders, issuers, servicers, rating agencies, and investors, among other marker participants represented by CMSA.

We believe there are essentially three options going forward: (1) take no further action and let TRIEA expire; (2) modify and extend the current TRIEA program; or (3) take a new approach aimed at creating a permanent private market solution that allows TRIEA to sunset.

Because the insurance industry clearly cannot to handle terrorism risk on its own, we believe that the first option is not feasible for the reasons mentioned earlier. Simply letting TRIA expire would return our economy back to the post – September 11th and pre-TRIA era, and would undo the progress we have made in the past five years under TRIA and TRIEA.

The second option, or the first "real" option, is to modify and extend the current TRIEA program. Extending the life of TRIEA, improving the program to better encompass NBCR exposures and readjusting its terms to address the changed parameters will keep terrorism coverage available and the market and economy stable, continuing the positive trends mentioned earlier.

A third option is to create an alternative permanent private market solution. We are aware of a number of proposals circulating that envision a private sector pooling arrangement. Such a mechanism could allow the insurance industry to essentially "backstop" itself, by growing the capacity to handle a catastrophic terrorism attack like those of September 11th. The existence of a terrorism insurance pool and backstop may provide insurers with a reinsurance vehicle that will allow them to further expand capacity. Growth in capacity could stabilize prices and decrease the need for the federal backstop over time as the government's potential liability phased out. CMSA is open to considering proposals designed to create shielded pools of dedicated capital that can be applied to these exposures.

Finally, there are several issues that we wish to raise and hope that Congress will consider in order to better protect policyholders and taxpayers.

The first issue relates to the length of any extension or any federal mechanism for terrorism insurance. While CMSA would like to see a permanent solution, we support a sustainable solution to ensure that coverage is available and more affordable. We believe that any program should last for a minimum of 10 years. If the program is going to be for such a limited time, we think that it should provide for some transition period and that mechanisms should to be built to address long term coverage needs (such as pooling or dedicated tax credits).

Second, CMSA asks Congress to consider addressing the distinction between "domestic" and "foreign" acts of terrorism in the current program. The market does not distinguish between "domestic" and "foreign" acts of terrorism, and such a change may be needed primarily to address confusion issues and to eliminate an unnecessary and potentially unworkable distinction. Any act designed to destabilize the government and our economy should be encompassed by the program. Under the current structure, the Secretary of the Treasury Department ultimately will determine what is and is not covered by the Act. In the meantime, it is important that policyholders have access to complete coverage without gaps or carve-outs in coverage.

Third, CMSA, along with CIAT of which we are a member, has been concerned about the lack of availability for NBCR coverage where it is not statutorily mandated. We believe that it is important to consider any provisions that will encourage an expansion of private sector coverage for NBCR. Mechanisms to help achieve that could include lowering deductibles for NBCR exposures and lowering insurer co-payments for such exposures. CMSA would also support a "mandatory offer" regime that permitted different policyholder attachment points for NBCR coverage than primary coverage. We believe that mechanisms like those discussed above could help lead to greater take-up rates that protect policyholders and taxpayers, while also spreading risk and building capacity.

Conclusion

We have come a long way since TRIA was first enacted. With the help of TRIA and TRIEA, the terrorism insurance market has been largely stabilized, coverage has been steadily expanding, and the price of coverage has become more affordable. TRIA and TRIEA have provided relief that is essential to the smooth functioning of our economy, all without paying a penny in claims.

Accordingly, TRIA and TRIEA have clearly made a difference for the insurance industry, policyholders and the Nation's economy as a whole. However, federal government involvement is still necessary to ensure a stable terrorism insurance market because: terrorism threats facing our country remain significant and unpredictable; our reinsurance industry still lacks sufficient capacity to address terrorism risks on its own; and primary insurers remain unwilling to expose themselves to enormous terrorism risks without charging prohibitively high prices. Allowing TRIEA to expire at this time would have devastating affects across the economy, and would particularly disrupt the commercial real estate capital market finance industry.

CMSA urges Congress to enact a sustainable solution to ensure that terrorism insurance continues to be available and more affordable. We also ask Congress to consider strengthening the program with regard to "domestic" acts of terrorism and NBCR coverage in order to protect policyholders and taxpayers.

Again, thank you for holding this important hearing today and for the opportunity to present the views of the members of CMSA.

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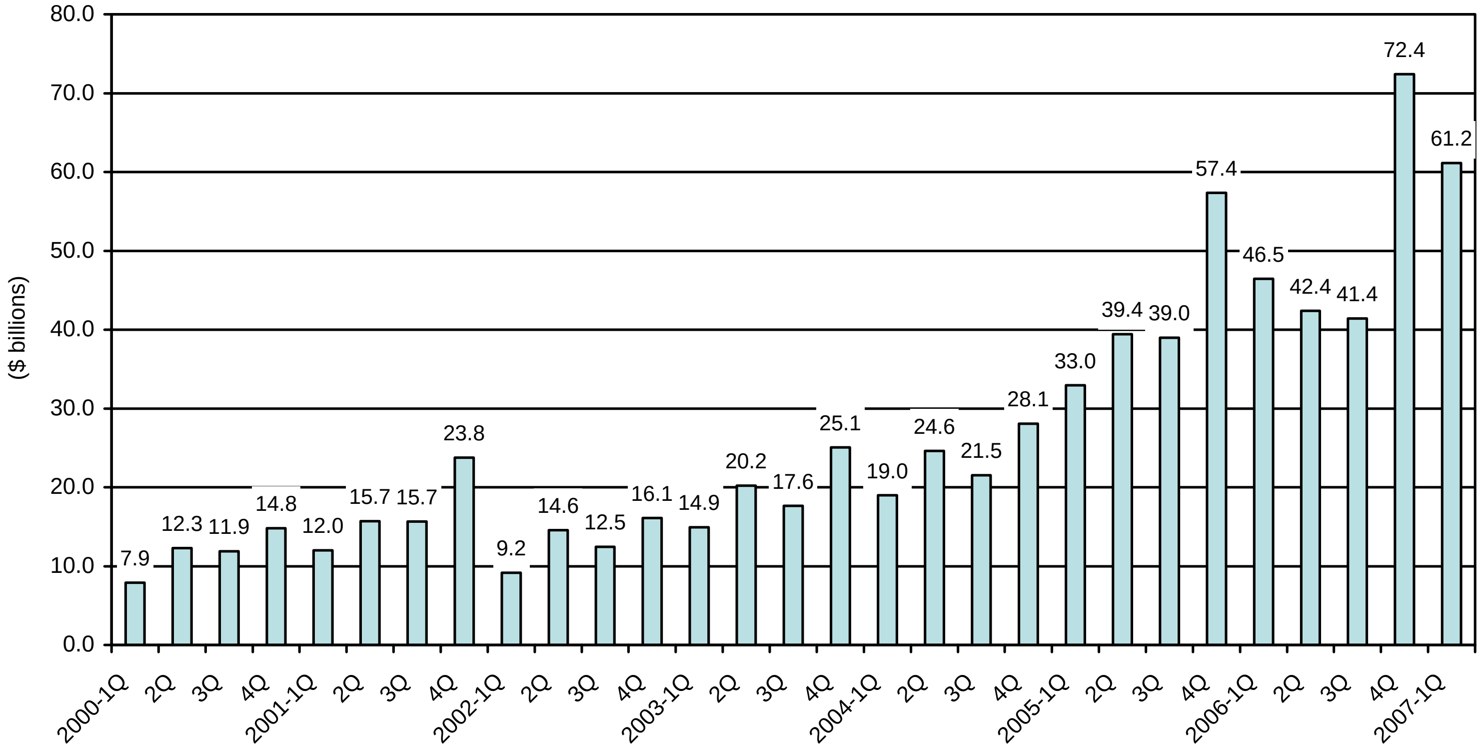
Quarterly U.S.CMBS Issuance
2000-2007 Q1



Source: Commercial Mortgage Alert, CMSA.