Testimony of the Property Casualty Insurers Association of America (PCI) Before the U.S. House Financial Services Subcommittee On Capital Markets, Insurance, and Government Sponsored Enterprises Policy Options for Extending the Terrorism Risk Insurance Act

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April 24, 2007

Chairman Kanjorski and members of the Subcommittee, thank you for this opportunity to testify before you today regarding the terrorism risk insurance program. My name is Vincent Donnelly and I am the President and CEO of The PMA Insurance Group (PMA) which is a member company of the Property Casualty Insurers Association of America (PCI). I am testifying today on behalf of PMA and the PCI.

The PMA Insurance Group is a group of property casualty insurance companies domiciled and headquartered in Pennsylvania that underwrites commercial lines business on a national basis, with workers compensation insurance producing about 84% of its written premium. Since its inception over 90 years ago, PMA has specialized in the writing of workers compensation insurance and has done so with a regional focus. Written premiums for PMA in 2006 were $430 million, placing it within the parameters of what the insurance industry considers to be small to medium-sized insurer. PMA markets its insurance products and services to a diverse cross section of our economy. Contractors, manufacturers, health care providers, nursing homes, retailers, schools and universities are representative of the type of accounts for which PMA has provided workers compensation insurance. PMA routinely competes in the same marketplace as many other small to medium-sized workers compensation insurers, as well as most of the larger commercial lines insurers.

The Property Casualty Insurers Association of America (PCI) is the nation's premier property/casualty trade association, representing more than 1,000 member companies. PCI member companies include large national insurance companies, mid-size regional writers, insurers doing business in a single state, and specialty companies that serve specific niche markets. PCI members write $173.6 billion in annual premium, nearly 40 percent of all the property/casualty insurance written in the United States. PCI members write 31.5 percent of the business insurance policies and 40.2 percent of the private workers compensation insurance market.

PMA and the PCI believe that small to mid-sized insurers and particularly those that are engaged in the underwriting of workers compensation have a meaningful, if not, somewhat unique perspective on terrorism insurance issues that we would like to share with you today.

Basic Principles

TRIA continues to be an essential part of our national security response to the threat of terrorism.

By protecting our businesses, our employees and making them more resilient against terrorist attacks, TRIA makes all of us more secure. PMA and PCI share the belief that participation in this effort is a fundamental obligation of the Federal government, especially when it is apparent that the threat of terrorism has not abated in the United States or elsewhere in the world.

TRIA has been critical to stabilizing the insurance market and the national economy by making it possible for insurers to provide affordable terrorism insurance to businesses.

According to Marsh, Inc., *MarketWatch: Terrorism Insurance, 2006,* terrorism insurance purchase rates have increased from 27 percent to nearly 60 percent in the last three years because of TRIA, and the cost of terrorism insurance has steadily declined, especially for smaller companies, providing a critical layer of stability and protection to America's businesses and their workers. This could not have taken place without TRIA.

The focus of TRIA has generally been one of concern for the insurance industry's ability to withstand future terrorism events, when it should be much broader than that. It is the entire national economy that could be disrupted if access to terrorism insurance is constrained or eliminated. The continuation of TRIA is about more than protecting the financial welfare of insurance companies; it is about protecting commercial policyholders and providing them with the ability to sustain risk and contribute to the maintenance of a healthy national economy. It is with that primary concern for all commercial policyholders in mind, regardless of their size, location or the type of product or service that they provide, that serious consideration needs to be given to the fact that payments that are made by insurers for terrorism losses are not limited by geography in their financial impact. When insurers respond to terrorism losses resulting from an event that occurs in Philadelphia or New York, the financial implications of this response are widespread and extend to policyholders throughout the nation who are depending on an insurer's surplus to be used to also respond to their losses.

Absent a Federal backstop the market for terrorism insurance would be virtually nonexistent.

Many experts from the insurance industry, academia and government agree that without a Federal backstop, the stand-alone market for terrorism insurance would be virtually nonexistent. Because of the insurance industry's limited ability to underwrite and rate terrorism risks, that are characterized as being essentially uninsurable due to the inability to predict when, where or how the next terrorist event will occur, it has become apparent that a stand alone, private sector solution is not a realistic possibility; this has become even more apparent with respect to nuclear, biological, chemical and radiological (NBCR) risks, for which coverage is generally non-existent. The potential magnitude of a terrorist event is likewise unpredictable, and it is difficult, if not impossible, for the industry to credibly estimate the amount or type of damages that could result from a future terrorist event.

A strong Federal role in terrorism insurance protection must continue, even as we work to reduce the Federal responsibility gradually over time.

Proposals that would suddenly and severely curtail the Federal government's participation in the terrorism re-insurance market in the immediate future would likely result in a drastic reduction in the availability of affordable terrorism insurance and seriously harm the economy. The federal government participation is even more important to workers compensation, where terrorism coverage is statutorily mandated and workers compensation insurers do not have the same opportunity as other commercial lines insurers to avoid or mitigate this exposure. Insurance coverage for work related injuries that arise out and in the course of employment cannot be excluded, which differentiates it from the other types of insurance coverages that are typically purchased by business owners. Without a federal "backstop," workers compensation insurers, who find themselves with limited realistic options for responding to their exposure to terrorism risk, may seriously consider their position in the insurance marketplace and conclude that a continued presence in certain segments of the marketplace is not in their best interests.

Ensure that all potential victims of terrorist attacks, regardless of geographic location or the source of an attack, have access to terrorism insurance protection.

Just as all Americans mourned the losses of the terrorist attacks of September 11, 2001, we should share in the responsibility of securing the nation's economy in the event of another attack. Terrorism is not a problem only for America's urban centers and access to insurers who are willing and able to provide terrorism coverage is critical for businesses regardless of their size or location. TRIA has been instrumental in providing market support to ordinary employers, not just owners of potential target buildings located in major metropolitan areas. Steps which limit the protection provided by this program would reduce the nation's economic preparedness and limit the ability of our businesses to purchase terrorism insurance as an important component of a comprehensive risk management program.

Of even more significance in the area of workers compensation insurance is the fact that, given the mandatory nature of the coverage, insurers that do provide the coverage may find themselves so economically constrained without a federal backstop that they become limited in their ability to compete, a problem that is an especially intense one for small and medium-sized insurers.

Ensure that all acts of terrorism are covered.

Proposals that would limit a government role to only "foreign-inspired" terrorist attack or to a few types of attacks (i.e., NBCR) would curtail the essential protection afforded to American businesses and their workers, and ignore the significant threat from other forms of terrorism on American soil. The inability of workers compensation insurers to exclude coverage for any type of terrorist acts makes it even more critical that any federally supported program be "all inclusive" as to the type of terrorism risks it responds to.

Ensure that robust competition in the marketplace for terrorism insurance continues without disruption.

America's small, medium, and large insurance companies provide terrorism insurance to our nation's businesses and their workers every day. TRIA policy should maintain full and relatively equivalent access to the program to ensure that insurance consumers have available to them a competitive range of options for coverage and prices. Without a TRIA program, many entities may be forced to self-insure due to a lack of available or affordable coverage, leaving their balance sheets and their workers exposed to a catastrophic event that could bankrupt the company.

Moreover, without the involvement of the federal government in providing reinsurance capacity, there is a strong likelihood that insurers will no longer be able to obtain private reinsurance protection, a situation which occurred during the period following 9/11 until the enactment of TRIA. Indeed, even with the current TRIA backstop, reinsurers cannot meet the capacity demand of primary insurers for reinsurance coverage of their TRIA deductible and coinsurance obligations. Without the TRIA "backstop," private reinsurers will want to limit their exposure to terrorism risk, particularly NBCR, as much as possible.

As a result of this type of private reinsurance constriction, insurers may decide to withdraw from the terrorism insurance market entirely or make the coverage available only on a very limited basis at significantly higher prices. As for workers compensation insurers who will be required to offer the terrorism coverage, the loss of reinsurance protection from the private market and the federal government will be even more economically devastating; requiring them to redeploy capital in way that could potentially threaten their financial solvency.

Impact of TRIA on small and medium-sized insurers

The design of the terrorism risk protection program going forward has implications for smaller and medium-sized providers of commercial (or, more precisely, TRIA-covered) property/casualty insurance coverage. In order to fully appreciate the significance of these implications it is important to recognize the marketplace contributions of smaller and medium-sized insurers which include the following:

- Ninety-four percent (94%) of companies writing TRIA lines of insurance are small or medium-sized. These 964 small and medium-sized insurers write almost one-quarter (22%) of the TRIA-covered lines of business in the nation (approximately $38 billion).* Given the number of small and medium-sized insurers, if these companies' profitability and survival means no longer writing TRIA-covered lines, the detrimental result for policyholders and consumers is a more limited availability of certain product offerings and at potentially higher cost.

- Small and medium-sized insurers that write TRIA-covered lines of insurance are significant employers, estimated to employ some 220,000 people nationwide, with a payroll exceeding $11.6 billion (PCI estimate). The "downstream" annual economic impact of the payroll provided by these insurers is estimated to be over $17.5 billion (PCI estimate). Almost one-quarter (24%) of the property/casualty industry's federal income taxes are paid by small and medium-sized TRIA insurers.*

*Source: PCI using NAIC 2005 Annual Statement Database via National Underwriter Insurance Data Services/Highline Data

- Eighty-one (81) small and medium-sized TRIA insurers, writing almost $5 billion in TRIA lines of business, are located in the 11 most at-risk cities for terrorism, as identified by A.M. Best Company. These cities are New York; Chicago; San Francisco; Washington, D.C.; Boston; Seattle; Los Angeles; Houston; Philadelphia; Las Vegas; and Miami. A loss of insurers in these markets would make it that much more difficult for consumers to shop their business amongst competitors.

*Source: PCI using NAIC 2005 Annual Statement Database via National Underwriter Insurance Data Services/Highline Data

- Small and medium-sized insurers are more regional in nature, servicing tightly defined markets and consumer market segments. They are often highly specialized, possessing unique knowledge of their market niches. Given their size and the scale disadvantages they sometimes face in the market, most are highly focused on consumer service and risk knowledge, providing significant benefits to their policyholders. Their absence from these markets would be a loss of consumer choice and consumer products and services, a situation which is easily illustrated in PMA's case, where we have been one of the predominant providers of Pennsylvania workers compensation insurance products and services, with a marketplace presence that would appreciably impact Pennsylvania employers were it to cease to exist.

- Some niche businesses may experience a serious limitation upon their ability to operate effectively without the insurance provided by the niche carriers. Just a few examples of the niches filled by smaller insurers include providing insurance to jewelers; religious institutions; specialized workers compensation risks; ocean marine offshore energy, transport, cargo and fishing vessels; the mining industry; entertainment parks; small artisan contractors; and contractors in the Gulf coast states.

Aspects of TRIA program that negatively impact competitive position of small and medium-sized insurers

Three aspects of TRIA that adversely impact the competitive position of small and medium-sized insurers are a high program trigger, a high deductible and a high coinsurance percentage, all of which should be given serious consideration in designing a continuation of the TRIA program.

<u>Program Trigger</u>

- The level of the trigger, which has significantly increased since the inception of TRIA, determines when the program will be activated; that is, whether any of the loss will be paid by the program. A high program trigger is a greater solvency threat to small and medium-sized insurers, as 75% of insurers writing TRIA lines of business have less than $100 million dollars in policyholder surplus.* The current $100 million trigger means that no insurer will be reimbursed unless the total industry TRIA losses from a terrorist event exceed $100 million.

*Source: PCI using NAIC 2005 Annual Statement Database via National Underwriter Insurance Data Services/Highline Data

- A high trigger undermines small and medium-sized companies because it puts too high a fraction of a smaller company's capital at risk. To avoid this risk, small and medium-sized companies could decide to exit TRIA lines of insurance, which in turn limits the potential for consumers to enjoy the benefits of more choices, lower prices, and product innovation.

- A high program trigger increases the number of insurers whose capital is less than the trigger- that is, it increases the number of insurers who could face a loss that does not trigger the program but which exceeds their total capital. No insurer can endure the risk of any single loss that can wipe out its entire capital base.

- A terrorist attack on a business resulting in 100 employee death claims in the state of Pennsylvania, for example, could result in $75 million in workers compensation benefits. This size terrorist attack would be devastating to a small or medium-sized insurer, since the $75 million loss falls below the current $100 million trigger, and therefore would have to be borne entirely by the insurer.

Deductible

- A high TRIA deductible means a greater proportion of the terrorism loss is paid out of a company's surplus, putting more of its capital at risk. At the current high 20 percent deductible, a company must first absorb losses equal to 20 percent of its prior year's TRIA lines earned premium before receiving any reimbursement from the federal program.

- Because of their smaller capital base, small and medium-sized insurers have less financial ability to sustain catastrophic losses or in some cases, even large losses. For example, a company with $5 billion in surplus is better able to withstand a loss of $50 million than a company with $100 million in surplus. A high deductible threatens solvency for small and medium-sized insurers to a greater degree, resulting in potential financial rating downgrades, fewer insurers being active in the terrorism insurance market and insurer failures; this in turn results in less competition and the likelihood of higher prices for consumers.

- A high program deductible is a greater solvency threat to small and medium-sized insurers. Larger companies can better survive a greater "hit" to surplus than can small and medium-sized companies; large companies are generally considered to be stronger credit risks, have more established connections to capital markets and therefore can more readily access the necessary capital than can small and medium-sized companies.

- A 10% or greater "hit" to the surplus of a small or medium-sized company could result in a company-closing event; a 10% loss of surplus could lead to a rating downgrade(s) by A.M. Best, followed by the potential loss of major accounts (i.e., those with 'A' rated paper requirements) and the premium dollars associated with such accounts, that could eventually fatally impair the financial viability of the company, a circumstance that would not be entirely unlikely for an insurer such as PMA.

- The current 20% TRIA deductible is greater than 10% of company surplus for 47 percent of all TRIA writers. That is, 478 companies (47%) are vulnerable to A.M. Best downgrades and precarious company stability due to the negative impact to their surplus at a 20% TRIA deductible. Small and medium-sized insurers are most at risk since they make up 447 of the 478 total companies (94%); a lower deductible would put them in a stronger position to continue writing and assist in market stabilization.*

*Source: PCI using NAIC 2005 Annual Statement Database via National Underwriter Insurance Data Services/Highline Data

Coinsurance

- The deductible is not the only stress to a company's surplus in the wake of a terrorist event. The impact on surplus is intensified by an insurer's TRIA retention (coinsurance share) of an additional 15% of losses (up from the 2006 coinsurance requirement of 10%) above its deductible.

- A high coinsurance amount is a greater solvency threat to small and medium-sized insurers. Because smaller companies have less capital to draw on than other writers, coinsurance places a more crushing financial burden on the small and medium-sized companies.

- A terrorist attack on a business resulting in 500 employee death claims in the state of Pennsylvania, for example, could result in the payment of $375 million in workers compensation benefits. A terrorist attack of this proportion would trigger coverage under TRIA, but under the current program, a company with premium writings similar to PMA would retain a deductible of $75 million plus be subject to the application of a $45 million coinsurance requirement.

Small and medium-sized insurers provide essential competition

Given that several TRIA program features have a disproportionate impact on small and medium-sized insurers, how important is this to insurance markets and consumers? Indeed, some have argued that public policy should not be concerned with the effects of a terrorist attack on any particular segment of the insurance industry, but only with the impact of an attack on the insurance market itself. This argument seems to suggest that concerns about the impact on small and medium-sized insurers is misplaced - that the only concern of policymakers should be whether a "market" exists; this argument is misguided.

Competition

The best public policy is one that balances the economic interests of all market participants and has as much concern for the continued viability of all of the companies that actually populate the market and keep it competitive, as it does for the existence of a "market". Second, it is one thing for unregulated markets to develop overtime in a way that makes some business models obsolete and allows others to thrive. That happens normally in a market economy and is one of the primary reasons for the success of market systems.

However, terrorism is fundamentally different from other risks that arise in a market economy and requires changes in business models. First, for all of the reasons insurers have argued that terrorism is different and uninsurable, allowing the structure of a government policy response to itself to make small and medium-sized insurers less competitive is inappropriate public policy. The issue at hand is the design of a government program. It is no more fair to establish program triggers and deductibles in a way that disadvantages small and medium-sized insurers than it would be to structure the program in a way that disadvantages the largest insurers. The program itself should be as neutral as possible to the competitive playing field.

Finally, government policy itself has a strong influence on the nature of the risks insurers' must respond to in regards to terrorism. Insurers have no control over the way in which the government chooses to respond to terrorism and, thus, are placed in the position of bearing a risk that they cannot effectively mitigate or manage.

Conclusion

The enactment of a federal terrorism reinsurance program with a term substantially long enough to maintain marketplace stability and the continued growth of our national economy is an issue of utmost importance. It is a critical component of our national agenda to strengthen each company's economic security and its ability to protect itself against the threat of a terroristic attack. It is imperative that we recognize that the terrorist threats that challenge our country remain significant and unpredictable, that the private reinsurance market still lacks sufficient capacity to respond to terrorism risks, and that there are primary insurers that continue to be unable or unwilling to expose themselves to the perceived enormity of terrorism risks. Characteristics that have made terrorism a unique and even more importantly, an uninsurable risk are as present today as they were after the events of September 11.

In designing a future program, a key principle should be that it not interfere with or disrupt the competitive playing field that otherwise exists in the market. In this instance, the provisions of an extended terrorism reinsurance program should not create barriers to the ability of smaller and medium-sized insurers to continue serving markets and consumers. It should also be sensitive to the unique characteristics of the small and medium-sized insurers when considering deductibles, triggers and co-pays. Insurance consumers will have more choices, prices will be lower, and product innovation will be greater when the greatest possible number of strong, viable competitors is able to actively serve the insurance market place. The design of the federal terrorism reinsurance program must not disrupt that competitive landscape.

On behalf of PMA and PCI, I would like to thank the Chairman and the members of the Subcommittee for giving me this opportunity to share our perspective and to work together in developing a long-term, market responsive solution to the availability and affordability of terrorism insurance coverage for U.S. businesses. I also sincerely appreciate your interest in and leadership on this important issue and welcome any questions that you may have for me.

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