American Insurance Association

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"

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

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.