

Testimony of the
National Association of Insurance Commissioners

Before the
Committee on Commerce, Science, and Transportation
United States Senate

Regarding:
The Role of the Federal Government in Assuring that
Insurance for Terrorist Acts Remains Available to
American Consumers

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Introduction

My name is Diane Koken. I am the Commissioner of Insurance for the Commonwealth of Pennsylvania, and I also serve as chair of the National Association of Insurance Commissioners' (NAIC) Northeast Zone comprising 10 states and the District of Columbia. Speaking for myself and fellow members of the NAIC, we appreciate the opportunity to testify regarding the potential role of the federal government in making sure that insurance against acts of terrorism remains available to American consumers and businesses.

Today, I want to make three basic points:

- First, NAIC and its members believe there is presently a need for the federal government, working with the state regulatory system, to provide appropriate financial back-up to the private insurance market in order to assure that our nation's economy does not falter due to a lack of insurance coverage for terrorism. Although NAIC has not endorsed a specific proposal for federal assistance at this time, we have adopted a set of 19 guiding principles that we believe should form the basis of any successful federal program. A copy of the NAIC's guiding principles is attached at the end of my testimony.

- Second, we believe federal assistance should be a relatively short-term solution to stabilize the commercial marketplace while it regains the risk assessment and pricing equilibrium needed for private insurers to underwrite terrorism exposures. Thus, any federal terrorism insurance program should be limited in scope and duration.

- Third, a federal assistance program should maximize the use of market forces to add efficiency and reduce the risk of losses from terrorism and the potential costs to federal taxpayers.

The United States Insurance System Remains Fundamentally Sound

Let me start by saying that NAIC believes the insurance industry is well-capitalized and financially able to withstand the pressures created by the September 11th terrorist attacks, despite losses projected to exceed \$30 billion. The United States insurance industry is a \$1 trillion business with assets of more than \$3 trillion. Preliminary loss estimates of \$30 billion to \$40 billion represent just 3 to 4 percent of the premiums written in 2000.

America's insurance companies have time and again shown their ability to respond to huge disasters and successfully recover. Adjusted for inflation, Hurricane Andrew in 1992 caused \$19.7 billion in insured losses, and California's Northridge Earthquake in 1994 cost \$16.3 billion in insured losses. As with previous disasters, we believe insurers affected by the recent terrorist attacks will be able to pay their projected claims, as they themselves have said.

Insurance is the sale of a promise to pay claims when losses occur. As regulators, my colleagues and I will continue monitoring the process to make sure that insurance promises are kept. To do our job, we are backed by an impressive array of human and technical resources, including the NAIC and fifty-one state insurance departments that collectively employ more than 10,400 people and spend \$910 million annually on insurance supervision. In addition, at this time state insurance guaranty funds have the capacity to provide up to \$10 billion to compensate American consumers in the event of insurer insolvencies.

We would urge Congress to structure any federal assistance program to take full advantage of the existing state regulatory system. We have the mechanisms in place to monitor insurer solvency and handle claims payment issues.

Congress Should Not Disrupt the Power of Private Market Competition

The international commercial property/casualty insurance market is very powerful, dynamic, and competitive. As a free market, it responds to new information quickly, and sometimes with great volatility. Like the stock exchanges, insurance market participants often react in unison to reach the same conclusion at the same time with regard to what products are viable and profitable, meaning that the price and availability of specific products will rise and fall in conjunction with the industry's collective willingness to sell them. Substantially negative information, such as the September 11th terrorist attacks, can disrupt the entire market until new information becomes available that makes insuring terrorist risks acceptable.

Given sufficient time to adjust, however, the commercial insurance market has found ways in the past to assess and insure extremely large and difficult risks that were initially considered uninsurable. During the 1980's and 1990's, the insurance industry weathered enormous financial losses from asbestos, medical malpractice, and environmental pollution claims against corporate policyholders that were not foreseen by insurers. In those instances, insurers said they had not reasonably expected to be held responsible for such colossal claims, and therefore had not collected sufficient premiums or established sufficient loss reserves to cover them.

In the short term, the insurance market responded to huge environmental exposures with policy cancellations, coverage limitations, exclusions, and increased prices, as is being threatened now with regard to terrorism risk coverage. In the longer term, coverage for these risks became available through a combination of aggressive risk management, self-insurance, captive insurance pools, other alternative risk-sharing mechanisms, and renewed interest by commercial insurers as they gained confidence in their abilities to adapt their policies and pricing to a level where they could underwrite the business profitably. Ultimately, the creativity and competitive discipline of the market overcame

its initial period of contraction and volatility to provide viable insurance solutions for enormous risks that were previously considered uninsurable.

The business of insurance is about measuring risks and selling promises to cover them at a reasonable profit. Insurance experts who perform these tasks are exceptionally talented. Over time, they have demonstrated a remarkable ability to adapt to unforeseen circumstances, while making available the insurance products that are essential to the growth and productivity of American business. As expected in a free competitive market, individual companies may stumble, falter, and even fail when substantial adversity strikes, but the United States insurance industry as a whole has a long and proud record of finding ways to overcome new obstacles while advancing its business goals and serving the interests of the insurance-buying public.

Thus, the NAIC believes Congress should begin its consideration of federal assistance to the insurance industry by recognizing the strength and adaptability of the private insurance markets. Federal actions that unduly disrupt or interfere with private market forces are likely to end up causing more harm than good for American consumers and federal taxpayers.

Appropriate Federal Government Action Can Help the Private Market Recover

State regulators know from their own experiences that government action can help the insurance market recover when it becomes overwhelmed by changing risk factors or catastrophic losses. When the psychology of the market results in industry reactions that harm the public, government has unique powers to alter the insurance marketplace for the benefit of consumers. We have found that successful government assistance involves tailoring actions to fix specific problems and keeping the program as narrow as possible.

Hurricane Andrew provides a useful example of limited government intervention that works. Following the tremendous losses from this hurricane in 1992, commercial reinsurers restricted their coverage for windstorms and raised prices. This caused a

corresponding reaction from primary insurers, who moved to raise prices, cancel coverage for coastal properties, and increase deductible amounts for consumers having significant hurricane exposure. Within a couple of years, normalcy returned to the reinsurance market, and then to the primary market. The Florida Insurance Department assisted with the recovery of the industry by introducing a moratorium on policy cancellations and beginning the discussion of the need for a state catastrophe pool. The Florida legislature later adopted a Hurricane Catastrophe Insurance Pool that provides a state-based backstop for catastrophic windstorms in Florida. These collective actions have resulted in a robust and competitive market for homeowners insurance in the State of Florida.

In the present situation, we believe the federal government can add certainty to the market for terrorism insurance using its unique powers. For example, Congress can establish a uniform national definition of “terrorism” so that everyone is very clear what will trigger insurance coverage for acts of terrorism. Providing a temporary financial back-stop for terrorism insurance coverage is another useful step, as long as it does not allow what some have called “cherry picking” by insurers seeking to have the government cover just the most risky policies.

State insurance regulators believe the current situation affecting the availability of insurance for acts of terrorism is similar in nature to other catastrophic events. Due to the magnitude and unpredictable nature of terrorism as it is currently perceived by insurers, a temporary level of federal assistance to spread risk appropriately should provide time for the marketplace to adjust its thinking about how insurance coverage for terrorist acts should be handled. If the federal government and business customers make quick progress in lessening exposure from acts of terrorism, the insurance industry may start providing the coverage American businesses and families demand. Enacting a temporary federal solution will provide the necessary time to craft a more thoughtful long-term solution.

Important Market Factors for Congress to Keep in Mind

As Congress considers what type of federal assistance may be appropriate to steady the commercial market while it adjusts to new demands, the NAIC recommends that you keep in mind three very important factors. These factors will greatly affect the costs of any federal program, as well as its lasting impact on America's consumers and private insurance markets.

First, risk management precautions that reduce the likelihood of losses from terrorist attacks will have a large impact on the willingness of private insurers to offer terrorism insurance coverage to customers. Risk management – meaning the implementation of safety and security measures to prevent harm – is a standard part of insuring commercial and government facilities that are most susceptible to terrorist attacks. Large firms have professional risk management departments whose mission is to reduce a company's exposure to potential accidents and intentional harm, thereby improving the company's chances to get insurance at the lowest rates possible.

Following the September 11th attacks, government and commercial facilities across America have added security measures to prevent acts of terrorism and limit potential damages. As commercial risk managers review these new precautions, it seems likely they will become more inclined to offer terrorism insurance because the possibility and extent of potential insured losses occurring will be greatly reduced. At that point, we expect market forces will start working to fill the gap by making terrorism insurance available through private industry.

The NAIC recommends that Congress build-in strong incentives for insurers or companies receiving federal assistance to implement and maintain effective risk management measures to prevent acts of terrorism from occurring. In that way, the federal government will be building upon standard risk-reducing steps that are well-accepted in the private marketplace for insurance products.

Second, the private market instills policyholder discipline to avoid insurance claims through the concept of co-insurance. Co-insurance means that policyholders are liable to pay part of any losses covered by insurance before expecting a recovery from an insurer. Obviously, the higher the dollar amount covered by the policyholder himself, the greater will be his incentive to take steps to avoid losses. This concept is commonly understood by everyone owning a car or a home who agrees to bear the cost of a “deductible” before receiving payment from an insurance company.

Co-insurance should be considered by Congress as an important market discipline tool that works equally well with government programs.

Third, the scope and duration of any federal assistance program will itself become a factor in the private insurance market. Even though Congress is considering special government assistance intended to operate as a supplement to normal business channels, the very fact that government will pay certain costs of a commercial business becomes a factor to be taken into account when private market decisions on terrorism insurance are made.

The NAIC urges you to keep in mind that federal government policy regarding terrorism insurance assistance will not occur in a vacuum. It will become a private market consideration affecting prices and availability of insurance, and it may impact insurance products having nothing to do with terrorism. The extent of the federal influence on private market insurance products can be expected to be directly commensurate with the size, details, and length of the federal assistance program.

State Actions Are Not Driving the Market Demand for Terrorism Insurance

The NAIC and its members have recently been asked to explain how requirements of state law impact the market demand for terrorism insurance. Many people in Congress apparently think that states require private businesses to carry insurance against terrorism, and that failure of the private insurance market to offer terrorism coverage will result in

violating state laws and regulations. We believe there is a misunderstanding of what state laws require and what state insurance regulators do.

Let me say clearly that states do not drive the private market for terrorism insurance. To our knowledge, no state currently requires that business entities maintain insurance against acts of terrorism. In fact, the NAIC recently performed an electronic search of state laws and regulation for references to “terrorism”. We found nothing.

Furthermore, it is important to understand that state insurance regulators do not normally get involved in the details of property/casualty insurance policies for large business operations. These are considered to be the product of free market negotiations among sophisticated insurance underwriters, brokers, and professional corporate risk managers who rely upon the traditional powers of buyers and sellers to bargain for the best deal they can get. The state regulatory interest in such large transactions is mainly that they not impair the overall financial health of an insurer, since monitoring insurer solvency is a major responsibility of regulators.

Banks and investors typically use their private market influence to require that large business and government entities maintain adequate property/casualty insurance coverage against foreseeable harm. As a result of September 11th, foreseeable harm may now start to include possible terrorist acts in addition to normal hazards. However, terrorism coverage would usually be just one part of a comprehensive insurance package that insurers want to sell. Their desire to avoid terrorist risk exposures may be offset by their need to include it in order to sell a package of insurance coverage judged to be profitable overall.

State Actions Having a Limited and Indirect Impact on Terrorism Insurance

What, then, is the impact of state laws on terrorism insurance? Primarily, it falls into three areas – workers’ compensation requirements, policy form regulations, and rate regulations. We believe these areas have a limited and indirect effect upon the price and

availability of terrorism coverage in commercial property/casualty policies for large business projects that significantly affect the American economy.

It is important to recognize that states do not initiate market requirements in these areas, but only react to market forces that threaten to deny consumers fair insurance coverage. In normal practice, for example, an insurer would ask a state regulator for permission to exclude a specific type of coverage, such as terrorism, when the insurer issues a policy to customers. The regulator may have general authority under state law to deny the insurer's request for the coverage exclusion as a matter of public policy, and thus force the insurer to include terrorism coverage when it sells an insurance policy. However, the insurer makes the ultimate decision as to whether it will offer an insurance policy at all, and can refuse to offer insurance policies in the state if terrorism coverage is not excluded. If enough insurers threaten to withdraw from a state's insurance market, state regulators will be under tremendous pressure to grant an exclusion for terrorism in order to keep insurers in the market providing other types of insurance.

Workers' Compensation Requirements

State workers' compensation laws were developed early in the 20th Century. In the late 1800's and early 1900's, the number of occupational injuries and illnesses occurring in the American workplace was hindering the Industrial Revolution. Businesses were asking how they could assure that working men and women who are injured on the job get the care they need, while protecting industry and commerce from the financially crippling and demoralizing prospect of employees suing their bosses for every work-related injury. The question was answered with the state workers' compensation system, which covers employees' medical expenses and lost wages for work-related injuries and disease, regardless of who was at fault. In return, employees are limited to the benefits provided by the workers' compensation system as their exclusive remedy.

State workers' compensation laws require a set of benefits that are guaranteed by employers to their employees who are injured on the job. Insurers play a key role in the delivery of the benefits promised by employers. Typically, insurers assume by contract the obligation to provide the employer's share of medical benefits, rehabilitation benefits, and survivor's benefits in exchange for premiums the employer pays the insurer. Since state law obligates the employer – and therefore the insurer that has assumed the employer's obligations – to provide the benefits specified in a state's Workers' Compensation Act, the insurer cannot introduce either an exclusion for war or an exclusion for terrorist acts.

As a no-fault safety net for workers' injuries on the job, state workers' compensation laws do not permit coverage exclusions as a matter of public policy. Workers' compensation insurance is one part of the commercial coverage maintained by significant employers.

State Policy Form Regulations

Many states have statutory authority over insurance contract language through general policy form regulations. These requirements typically prohibit contract language that is misleading, illusory, inconsistent, ambiguous, deceptive, or contrary to public policy. Since no currently enacted state laws specifically prohibit an insurer's request to exclude coverage for terrorist acts, states would have to rely upon the general provisions above if they seek to deny an insurer's request to exclude terrorism coverage. Under state law, an adverse regulatory decision can be challenged by an insurer through the state insurance department's administrative process, with the right of appeal to state courts.

State insurance regulators are also charged with solvency oversight of insurers. Thus, an action to deny an exclusion of terrorist activities under general policy form provisions could cause financial difficulties for insurance companies. However, it is ultimately the insurer's choice whether to provide coverage for a

specific business event or peril. Primary insurers may be hesitant to exclude coverage for terrorist acts because they know their business and individual customers will want assurances that the coverage is provided. Reinsurers do not directly deal with businesses and families, and therefore do not face the same pressures to provide terrorism coverage.

State Rate Regulations

State rate regulations are primarily focused on protecting small businesses and individual policyholders. For commercial lines insurance products, only 13 states still require that the insurance department exercise prior approval requirement for most rate changes. The remaining 38 jurisdictions have some form of competitive rating mechanism that allows insurers to file and use rates, or use them even before they are filed with insurance regulators. Moreover, in recent years insurers have been successful in convincing state legislatures to create rate regulation exemptions for large commercial policyholders. The NAIC does not believe that state rate regulations are preventing insurers from charging adequate rates for terrorism insurance.

Conclusion

The NAIC and state regulators believe the insurance industry remains strong, and that it retains tremendous strength to recover from the September 11th attacks and adjust its business practices to new conditions in the marketplace. State insurance regulators are working together to help assure that any glitches which occur do not disrupt the process of getting people's lives back in order and America's businesses back to work. The NAIC and its members plan to work closely with Congress and fellow regulators, as set forth in the Gramm-Leach-Bliley Act, so that the needs of individual Americans and our Nation's economy are met in a timely way.

Guiding Principles for Federal Legislation Related to Property and Casualty Insurance Coverage for Losses Caused by Terrorism

The insurance industry has repeatedly encountered new, unexpected, and severe risks in the past and has always, given reasonable time and experience, been able to develop creative ways to price its products. However, certain events may exceed the capacity and willingness of the property and casualty insurance industry to provide future coverage for terrorism exposures. State insurance regulators recognize that federal legislation is urgently needed to provide a federal backstop to buttress the ability of the property and casualty insurance industry to protect Americans from financial losses associated with terrorism, while at the same time safeguarding insurer solvency so that insurance companies can continue to meet all of their other claims obligations. Outlined below are the governing principles and essential elements of any federal disaster insurance legislation that state insurance regulators support. The National Association of Insurance Commissioners (NAIC) urges Congress to take immediate action to enact legislation consistent with these principles.

For purposes of this document, the use of the word “terrorism” includes the war risk for workers’ compensation that insurers are required to provide coverage for as a result of statutory provisions contained in state workers’ compensation laws.

A. The Role of a Federal Government Program

1. Federal legislation in this area should “sunset” at a date certain of limited duration after enactment in order to allow a reevaluation of the need for and design of the program.
2. To take advantage of the substantial experience of state-based insurance regulation, the expertise of the NAIC should be made available to any federal program in this area and consideration should be given to including representatives of the NAIC as members of the governing body of such a program.

B. The Content of a Federal Program

3. Federal legislation should supplement but not replace other private and public insurance mechanisms where those mechanisms can provide coverage more efficiently.
4. Federal legislation should include clear and non-ambiguous definitions of terrorism to be applied to all policies nationwide.

5. Rates should consider all reasonable factors that can be feasibly measured and supported by theoretical and empirical analysis, including relative risk.
6. Federal legislation should encourage loss reduction and hazard mitigation efforts.
7. State residual market mechanisms and other pooling mechanisms providing coverage should be allowed to participate in any program established by federal legislation but in such a way as to not create incentives for business to be placed in those residual markets.
8. Federal legislation should recognize that terrorism exposures subject insurers to potential “adverse selection,” *i.e.*, entities with lower risk are less likely to voluntarily purchase coverage, while those with greater risk are more likely to purchase coverage. If possible, the federal program should encourage the inclusion of both low-risk and high-risk entities to promote greater risk spreading in a way that does not subject risk-bearing entities, including the federal government, to adverse selection.
9. Federal legislation should address coverage and cost for all risks exposed to terrorism, regardless of geographic, demographic or other classification, such as “more-at-risk” or “less-at-risk.”
10. There should be a safety net protection, within reasonable limits, for any private program created by federal legislation in the event of the insolvency of the program or its participants.
11. Tax law changes should be encouraged to avoid penalties on and encourage the accumulation of reserves for the portion of terrorism losses insurable in the private marketplace.
12. Federal legislation should not unnecessarily preempt state authority.

C. Participation in the Program

13. Federal legislation should encourage individuals and businesses to maintain private coverage for terrorism exposure.
14. Federal legislation should promote or encourage awareness that coverage is available for any property and/or casualty risk that meets reasonable standards of insurability.

15. Federal legislation should encourage or mandate that eligible entities participate in the program or run the risk of losing access to federal disaster assistance.

D. Administration of the Program

16. There should be an appropriate balance of the different private and public interests in the governance of regulatory oversight over the program.
17. Federal legislation should recognize the expertise of the states in insurance regulation with respect to such areas as licensing insurers, solvency surveillance, oversight of rates and forms in most jurisdictions, licensing producers, assisting policyholders and consumers during the claim settlement process and performing market conduct examinations.
18. To more efficiently achieve the objectives of any federal terrorism program, there should be coordination of state and federal regulatory responsibilities.
19. Jurisdiction over insurer claim settlement practices should remain with the states.