Testimony of the
National Association of Insurance Commissioners

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

Regarding:
Federal Assistance in Assuring that Insurance for Terrorist Acts Remains Available to American Consumers

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Testimony of Howard Mills
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Introduction

My name is Howard Mills. I am the Acting Superintendent of Insurance for the State of New York, and this year I am serving as chair of the Terrorism Insurance Implementation Working Group of the National Association of Insurance Commissioners (NAIC). We appreciate the opportunity to testify regarding the role of the federal government in ensuring that insurance to protect against losses from acts of terrorism remains available to Americans.

Today, I want to make three basic points:

- First, there is still a need for the federal government to provide appropriate financial back-up to the private insurance market in order to assure that segments of our nation's economy do not falter due to a lack of insurance coverage for terrorism. The insurance marketplace is not yet ready to take on the risk of providing coverage for acts of terrorism on its own.

- Second, Congress should act this year to extend coverage under the Terrorism Risk Insurance Program (TRIP), or enact a comparable federal backstop for acts of terrorism, at least through 2007, because the commercial insurance markets lack the capacity and means to underwrite sufficient terrorism coverage without a federal backstop.

- Third, The CBO January 2005 Paper—*Federal Terrorism Reinsurance: An Update*—contains some opinions on how markets will react to the Terrorism Risk Insurance Act of 2002 (TRIA) that are not borne out by observations of how businesses and insurers have reacted to TRIA.

TRIA Has Been A Success, But Challenges Remain

Following enactment of TRIA, the NAIC established a Terrorism Insurance Implementation Working Group of state regulators that has worked closely with the Treasury Department to successfully implement TRIA's provisions, as well as to monitor the impact it has had on the insurance marketplace. There are many who believe the United States economy remains vulnerable to terrorist attack. This is evidenced by an increased take-up rate for terrorism coverage observed in recent surveys. Indeed, those who need coverage the most are able to obtain it because of the existence of TRIA.

We believe the presence of the federal backstop has provided a an appropriate mechanism for the insurance industry to make vital terrorism coverage widely available to American businesses.. By requiring insurers through the "make available" mechanism to offer coverage for acts of terrorism they otherwise might not have offered in the wake of the tragic events of September 11th, TRIA brought certainty to the insurance marketplace.

The NAIC's Terrorism Insurance Implementation Working Group believes that TRIA has been successful in stabilizing the insurance market. In particular, TRIA's "make available" requirement has contributed to the overall effectiveness of the program during its first three years. American businesses -- both large and small -- have been offered choices they might not otherwise have had. Through the "make available" provision, TRIA has given them the opportunity to make an informed choice regarding the purchase of coverage for acts of terrorism.

During the first week of May 2004, insurance regulators began receiving contingency filings from Insurance Services Office, Inc. (ISO), the nation's largest insurance advisory organization. In the event Congress does not extend the TRIA program this year, these policy form filings would reinstate terrorism coverage limitations that were in effect prior to TRIA's enactment for any policies that extend coverage into 2006. In addition to protecting insurers from additional terrorism liability, these filings demonstrate that the insurance industry is not yet willing to assume the full risk of terrorism losses at this time. If triggered by the expiration of TRIA, these limitations will greatly reduce terrorism coverage in the states that have approved the endorsements. In those states that have rejected these coverage limitations, insurers will have to make the difficult choice of writing the coverage and accepting the potentially catastrophic terrorism exposure or not writing it at all. This could lead to availability and affordability problems down the road.

Industry Capacity Limitations

One of the elements that Congress should consider is the capacity of the insurance industry to accept the risk of losses from acts of terrorism. Insurance capacity is generally measured by determining the amount of capital and surplus available to insurers to support their policy writings. Using that measure, NAIC data shows that 2003 was a profitable year for property and casualty insurers, with aggregated policyholder surplus increasing approximately 26% to $375 billion. It should be noted however, that policyholder surplus declined each year from 1999 to 2002, and the $375 billion figure is only 4.3% higher than the $360 billion in policyholder surplus held in 1999. Less than half of those funds are used to support commercial products in all lines of insurance, including terrorism coverage. Moreover, the substantial losses incurred by insurers in responding to claims from four major hurricanes during 2004 will erode some of the recent surplus gains.

As part of considering whether the insurance industry has sufficient capacity to underwrite the risk of terrorism losses, Congress should consider whether the industry is willing to put its capital at risk. At present, we believe the answer is no.

In addition, insurers and the marketplace-at-large are finding it very difficult to accurately price coverage for acts of terrorism. Unknown frequency, coupled with the potential for severe losses, make insurers reluctant to provide coverage for acts of terrorism. Until insurers and their reinsurers become more comfortable that government efforts are adequate to protect citizens from terrorist acts, or at least become more predictable than they are today, they will be reluctant to accept complete risk transfers from American businesses for this exposure. In particular, businesses viewed by insurers as having a greater risk of terrorism losses, such as those located in America's financial and commercial centers, will have trouble finding terrorism insurance.

Congress Should Extend the Terrorism Risk Insurance Program

The NAIC urges immediate action by Congress on a federal solution to ensure continued marketplace stability when TRIA expires at the end of 2005. Because some terrorism risks are largely uninsurable without a financial backstop, state regulators are very concerned that significant market disruptions will develop before TRIA's expiration. This is due in large part to the deadlines contained in TRIA, which do not match the business cycle for insurance renewals.

The commercial insurance business cycle operates in such a way that insurers and their policyholders were required to make decisions as early as September 2004 regarding coverage that extends well into 2006. At present, annual policy renewals with effective dates of January 2, 2005 or later must contemplate there will be no federal backstop for any losses occurring in 2006. For this reason, state insurance regulators have observed widespread insistence by insurers that conditional policy exclusions for terrorism coverage be included in renewal policies. This is the same situation we encountered in the aftermath of September 11th, which prompted enactment of TRIA. While this particular dynamic is not present in the New York marketplace, the few states that have not allowed insurers to file coverage limitations fear that without TRIA, insurers will be unwilling to underwrite many businesses that want appropriate and reasonably priced terrorism insurance coverage.

To address this situation, Congress should promptly act to extend TRIA for two years. Time is needed for Congress to receive and review the report from the Treasury on June 30, 2005, and then have roughly fifteen months to digest and debate the future federal role related to acts of terrorism before reaching another milestone for insurers and American businesses.

The NAIC stands ready to assist Congress in developing an appropriate method for continuing the federal terrorism reinsurance backstop. The NAIC has begun to discuss a concept that would involve the federal government only for mega-catastrophes. It would encourage the use of the private sector to insure more moderate catastrophe risks using traditional methods such as reinsurance, access to financial market products, and risk diversification, along with changes in U.S. law that would allow insurers to build tax-deferred catastrophe reserves.

Workers' Compensation and Group Life Insurance

There are two major types of insurance that cause insurers special concern about whether they can continue to underwrite them without some form of assistance from the federal government. The first is workers' compensation, which is a property-casualty product that provides coverage for work-related injuries, illness, and death. It covers lost wages, provides unlimited medical benefits and, in most states, provides rehabilitation benefits to get injured workers back on the job. In the event of death on the job, worker's compensation provides monetary death benefits to the surviving spouse and children. It also provides employers with liability coverage if an employee pursues legal action against an employer in court. Workers' compensation is currently included under TRIA.

State laws do not allow an insurer to exclude or limit worker's compensation coverage, except as permitted by state law. As a result, an insurer underwriting this risk without adequate reinsurance is subject to a large potential loss if there are a significant number of employees at a single location. The American Academy of Actuaries estimates that "a modest-sized insured with 200 employees could easily generate a terrorism related event of $50 million. This presumes death of all employees and typical death benefit of $250,000 per employee.[1]"

The second type of coverage causing insurers special concern is group life insurance, which is not currently included in TRIA. Like workers' compensation, this insurance coverage is vulnerable to risk concentration problems. For example, if a business has 1,000 employees at a given location, the pricing employed by life insurers for group products probably assumes that three or four employees might die in a given year. If instead, a location with 1,000 employees is hit by a terror attack and all of them die, the insurer has an enormous financial exposure from a single occurrence.

Unlike worker's compensation, there is no statutory requirement for group life that prohibits an insurer from limiting available coverage for acts of terrorism in some fashion. However, the employer, the insurer, the insurance industry in general and the American economy would suffer if an insurer is only able to pay a fraction of the policy face amount in a mass casualty situation.

Insurance regulators are not inclined to approve exclusionary or limiting language in those states that have approval authority over the wording in group life insurance contracts. Although there is some level of private reinsurance available for group life coverage, it is not sufficient to cover catastrophic terrorism losses. While the NAIC has not taken a formal position on whether group life should be included in TRIA or another form of federal backstop, regulators have heard these concerns expressed by group life insurance underwriters.

The CBO Report

In January 2005, the Congressional Budget Office ("CBO") issued a paper entitled "Federal Terrorism Reinsurance. An Update" that concluded, in part, that TRIA's "zero premium" coverage could serve to dampen incentives for owner's of assets to engage in

[1] American Academy of Actuaries, P/C Extreme Events Committee May 4, 2004 Report, P/C Terrorism

loss control. The report stated that if the "government continued to subsidize terrorism insurance it would probably contribute to deferring the private-sector's long-term adjustment to the increase in risk", and this in turn would result in greater future losses than could otherwise be avoided. I wish to inform you that in New York State, and indeed, throughout the country, we see little evidence to support the conclusion that TRIA has resulted in owners failing to take appropriate steps to protect their assets from terrorist attacks. To the contrary, the evidence demonstrates that owners have invested heavily in strengthening disaster preparedness and response efforts in the wake of the 9/11 terrorist attacks notwithstanding the existence of TRIA.

For example, since 9/11, most large commercial and many multi-family residential buildings in New York and elsewhere regularly subject entrants to security checks before permitting entry. Sensitive locations may even require visitors to submit to background checks prior to entry. Structural design has also changed substantially in response to the terrorist threat not the least of which is the ubiquitous use of barriers to thwart vehicle-borne explosive devices.

While risk mitigation and loss control efforts are important tools to reduce exposure, the sad fact is that such measures can do little to avoid the catastrophic consequences of a successful large-scale terrorist attack. The country has taken such steps to improve airport and aircraft security and to harden many of our commercial enterprises and government facilities, but we still remain vulnerable to terrorist attack. The steps taken to mitigate losses, however, may result in countermeasures by terrorist that could lead to attacks on buildings or infrastructure that we might not have previously considered targets. This inescapable reality demonstrates the need for a federal backstop to help in dealing with potential losses of this magnitude. Of course, loss control must be a part of any long-term solution in the private sector to manage terrorism exposures. Mitigation techniques do not, however, address the issue of financing the catastrophic losses should such losses occur. No amount of mitigation can result in foolproof guarantees that losses will not occur. Terrorism coverage in today's world is an integral part of any businesses'

Coverage: Where Do We Go Post-Terrorism Risk Insurance Act?, Page 14.

risk management efforts. Without a federal backstop we could face market disruptions, and terrorism insurance will likely become less affordable or even unavailable to consumers. The insurance industry has not yet built the capacity to respond adequately to the terrorism exposure and extending TRIA for an additional period will allow the industry the time to appropriately accept increasing levels of this risk.

Conclusion

We strongly urge Congressional action to extend TRIA or enact an alternative form of federal terrorism backstop this year in order to avoid market disruptions likely to occur in the absence of a federal backstop program. Immediate action by Congress will help ensure the insurance market's continued role in supporting economic development. In addition, it will allow Congress adequate time to fully evaluate the Treasury Department's June 2005 report and recommendations.

The NAIC stands ready to assist Congress in developing an appropriate method for continuing the federal terrorism reinsurance backstop. The extension of TRIA will provide American businesses with the essential insurance coverage needed to successfully operate in today's uncertain global environment.

NAIC Resolution to Extend TRIA

June 12, 2004

RESOLUTION

Whereas, the Terrorism Risk Insurance Act of 2002 (TRIA) was adopted by Congress to provide a temporary federal shared loss program for incurred losses resulting from certain acts of terrorism to protect American businesses by minimizing market disruptions and ensuring the widespread availability and affordability of property and casualty insurance for terrorism risks;

Whereas, the TRIA was adopted by Congress to allow a transitional period for private markets to stabilize, resume pricing of terrorism insurance, and build capacity to absorb any future losses, while preserving the benefits of state regulation and consumer protections;

Whereas, the presence of the federal backstop has provided a measure of security to the insurance industry and has enabled them to extend offers of coverage for acts of terrorism in the wake of the tragic events of September 11th;

Whereas, insurance regulators do not believe the insurance marketplace is ready to take on the entire risk of providing coverage for acts of terrorism;

Whereas, insurance regulators have received contingent filings from advisory organizations and insurers that would reinstate the coverage limitations that were in effect prior to TRIA's enactment, in the event Congress does not act this year to extend TRIA;

Whereas, there are many who believe that the U.S. economy remains vulnerable to terrorist attack;

Whereas, the take up rate for terrorism risk insurance has increased in recent months;

Whereas, unknown frequency, coupled with the potential for substantial severity of a loss makes coverage for acts of terrorism one that insurers might choose to avoid if given the opportunity; and

Whereas, insurers and their reinsurers remain uncertain that the efforts of the U.S. Government are sufficient to protect citizens from terrorist acts, or at least have become more predictable than they are today, and as a result they will be reluctant to accept complete risk transfers from American businesses, particularly those businesses that they view as having a greater risk of loss from acts of terrorism.

Now, Therefore, Be It Resolved, That:

State insurance regulators urge Members of Congress to adopt a short-term extension of TRIA to avoid market uncertainty this fall. The short-term extension would provide sufficient time for the next Congress to consider longer-term solutions to the terrorism insurance risk and the nation's economic security. An extension of two years would provide Congress with the time it needs to evaluate the study and report required of Treasury on the effectiveness of TRIA and the insurance industry's capacity to provide terrorism insurance. It will also provide sufficient time to review and evaluate information provided by others.

Be It Further Resolved, That:

The NAIC urges Members of Congress to encourage the Secretary of the Treasury to extend the "make available" requirement into Year 3. This will avoid any market disruptions that would occur in the absence of the mandated coverage offer. Such action will ensure the insurance market's continued role supporting economic development.

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