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United States Senate
On the Terrorism Risk Insurance Act of 2002

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Thank you, Chairman Shelby, Ranking Member Sarbanes, and members of the committee, for this opportunity to discuss the Treasury Department's report on the Terrorism Risk Insurance Act of 2002 (TRIA).

The Economic Climate in 2001 and 2002 was Uncertain

The terrorist attacks of September 11th, 2001, which devastated thousands of lives and wreaked billions of dollars in losses, also came at a time of considerable macroeconomic uncertainty. By that time, our economy had already slid into recession. Payroll employment peaked in March 2001 and declined through the remainder of 2001 and 2002. Industrial production stalled in the second half of 2000 and had already fallen by more than 5 percent by September 2001. At the time of the attacks, stock prices had been falling for a year and a half. The terrorist attacks heightened concerns about the near-term strength of a number of sectors of the economy, including aviation, travel and tourism, the financial industry, and nonresidential construction. Nearly one million jobs were lost in the first 90 days after September 11th.

As of late 2001, the prospect that terrorism risk insurance might be unavailable raised particular concerns. Prior to September 11th, insurers underwriting property and casualty policies generally treated terrorism as a negligible risk. The industry had not developed models of the likelihood or severity of potential terrorist events and consequently did not have the capacity to price those risks. Moreover, the large payouts associated with September 11th and low returns to insurers' portfolios reduced the financial capacity of the insurance industry. Some observers pointed out that, if terrorism risk insurance were unavailable or prohibitively expensive, the capitalized value of existing commercial structures might decline, possibly creating significant financial problems for lenders and building owners. The willingness of builders to undertake new commercial construction, or their ability to obtain financing for that construction, might also be reduced, putting construction jobs and economic growth in jeopardy. These concerns contributed to the prevailing climate of uncertainty about the economy in 2002.

In retrospect, survey results in the Treasury's report suggest that the market for terrorism risk insurance did not dry up in 2002, to the extent feared. The insurer survey indicates that more than 70 percent of insurers writing in commercial property and casualty (P&C) lines wrote terrorism risk insurance in 2002, and that 60 percent of commercial P&C policies written in 2002

carried terrorism cover. The policyholder survey offers a somewhat different picture, but likewise indicates that terrorism risk insurance was available in 2002. Nevertheless, given the considerable uncertainties of the time, it was prudent for Congress to enact TRIA and for the President to sign it into law in November 2002. TRIA provided a temporary Federal backstop in terrorism risk insurance and allowed the insurance industry a transition period to adjust to post-9/11 realities.

Insurers Have Increased Their Capacity to Deal with Terrorism Risk

The tragic events in London last week underscore the ongoing risks posed by terrorism. In the period immediately after September 11th, the ability of the insurance industry to handle terrorism risks was in considerable doubt. However, the evidence presented in the Treasury report suggests that, in the nearly four years since the attacks, private insurers have developed increased capacity to deal with such risks.

Insurer capital, known as policyholder surplus, has rebounded and now exceeds pre-September 11th levels. This surplus approached $341 billion in the third quarter of 2004, a 33 percent increase over the third quarter of 2001. The industry booked this increase of $85 billion over three years despite absorbing heavy hurricane losses last fall.

The industry has developed new analytical tools, including sophisticated models of loss exposure that allow insurers to limit and manage their accumulation risk from a terrorist attack. Better measurement of accumulation risk facilitates the spreading of the risk of loss from a terrorist attack across a broader set of insurers. The industry has also made progress in modeling the likelihood of terrorist attacks, although this is an area where considerable challenges remain.

The insurance industry's capacity to bear terrorism risk is not unlimited, of course. Some have raised concerns about the industry's ability to handle what might be termed a mega-event, resulting in insured losses of more than $100 billion. However, it is important to keep in mind that TRIA, as currently structured, provides reinsurance only up to $100 billion and does not specify how losses above $100 billion would be handled. TRIA states only that Congress would determine the source and procedure by which any payments in excess of $100 billion would be made. Likewise, should TRIA be allowed to expire and a mega-event were to occur, presumably Congress and the Administration would evaluate the overall situation and determine how to respond to such losses.

TRIA's Effect on Pricing and Availability: Evidence from the Treasury Study

We cannot observe the counterfactual of what would have happened to the pricing and availability of terrorism risk insurance had TRIA not been enacted. But the Treasury study's survey results allow a comparison of pricing and availability immediately before and after TRIA's enactment, as well as changes to pricing and availability in the second year of TRIA's operation, as higher deductibles were phased in and the Federal provision of reinsurance was scaled back.

The survey results indicate that, after the passage of TRIA, the proportion of P&C policies

carrying terrorism cover at a non-zero premium increased. This pattern tended to raise average premiums for terrorism risk insurance after the introduction of TRIA. On the other hand, policies that had non-zero premiums in 2002 exhibited a pattern of declining cost share for terrorism risk insurance (as a proportion of total P&C premiums) between 2002 and 2003. The net effect was a slight *increase* in the cost share of terrorism risk insurance across all policies after the introduction of TRIA, contrary to some expectations.

Between 2003 and 2004, TRIA's insurer deductible for Federal reinsurance increased from 7 to 10 percent of direct earned P&C premiums, shifting some exposure to terrorism losses from the Federal government back to insurers. Yet, despite this increased exposure, the cost share of terrorism risk insurance across all policies rose only slightly, from 1.6 percent of P&C premiums in 2003 to 1.7 percent in 2004. It would be inappropriate to read too much into these results about the likely effects of allowing TRIA to expire. However, at least for the period during which TRIA has been in force, the surveys do not support the view that the cost share of terrorism risk insurance is highly sensitive to changes in the industry's risk exposure.

Regarding the availability of insurance, the insurer survey indicates that the proportion of commercial P&C policies carrying terrorism risk insurance grew by 7 percentage points between 2002 and 2003, and the policyholder survey found that takeup rates for P&C policyholders rose during that period as well. These results suggest that TRIA improved the availability of insurance during 2003. However, the proportion of commercial P&C policies carrying terrorism risk insurance remained stable through 2004, while takeup rates increased, despite the fact that TRIA's increasing deductible raised insurers' exposure to terrorism risks. Again, it is important not to extrapolate these results too far. However, at least after 2003, availability of insurance does not appear to have been closely linked to the industry's overall exposure to terrorism risk.

These insurer and policyholder survey results are consistent with the view that TRIA succeeded in providing a transition period for insurers. The data also appear consistent with the view that insurers have been able to cope with increased exposure to terrorism risks as the Federal provision of reinsurance has diminished.

The Economy Has Strengthened

The economy is more robust now than when TRIA was enacted. GDP growth has increased from 2.3 percent in 2002 to 3.9 percent in 2004 (fourth quarter over fourth quarter). The unemployment rate, which was 6.0 percent in December 2002, has fallen to 5.0 percent as of June 2005. Overall construction jobs (residential and nonresidential) are at a record high 7.2 million. Financial markets are also functioning well now, with more credit available at lower long-term rates. The economic uncertainties that partly motivated TRIA's adoption have receded and the economy is fundamentally stronger and more robust.

Conclusions

TRIA has succeeded in its limited role of providing a transition period for the insurance industry to adjust to the new realities after September 11th, through a temporary Federal backstop. Continuation of the program in its current form is likely to hinder the further development of the

insurance market by crowding out innovation and capacity building.

Consistent with its original purpose as a temporary program scheduled to end on December 31, 2005, and the need to encourage further development of the private market, the Administration opposes extension of TRIA in its current form.

Any extension of the program should recognize several key principles: the temporary nature of the program, the need to rapidly expand the development of private markets and capacity, as well as the need to substantially reduce taxpayer exposure. The last point bears emphasizing: TRIA does not eliminate terrorism risk but merely shifts the burden to taxpayers. It should be noted that, should a large terrorism event occur, the Treasury would face many competing priorities, and the responsibility to provide large insurance payments under TRIA could put a heavy strain on the government's finances.

If TRIA is to be retained, it should be reformed in such a way as to increase the role of private insurers and significantly diminish the public responsibility for terrorism risks. The Administration would accept an extension only if it includes a significant increase to $500 million of the event size that triggers coverage, increases the dollar deductibles and percentage copayments, and eliminates certain lines of insurance from the program, such as commercial auto, general liability, and other lines that are much less subject to accumulation risks. The Administration also supports reasonable reforms to ensure that injured plaintiffs can recover against negligent defendants, but that also guarantee that no person is able to exploit the litigation system, exposing the American taxpayer to excessive and inappropriate costs. We look forward to discussing this very important issue further with Congress.