# TESTIMONY

# OF


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# OVERSIGHT OF THE TERRORISM RISK INSURANCE PROGRAM

**BEFORE**

**THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS**

**April 14, 2005**

GOOD MORNING CHAIRMAN SHELBY, RANKING MEMBER SARBANES, AND MEMBERS OF THE COMMITTEE.

My name is Frank Nutter and I am President of the Reinsurance Association of America. Incorporated in 1969, the RAA is a national trade association based here in Washington, D.C. We are the sole organization representing the U.S. property and casualty reinsurance industry. Our membership consists of U.S. domestic reinsurers and reinsurance brokers.

Reinsurance is commonly referred to as the insurance of insurance companies. Reinsurance plays a critical role in maintaining the financial health of the insurance marketplace and ensuring the availability of property and casualty insurance for U.S. citizens. Reinsurance can be used by insurers for several reasons. One of the most common purposes is to transfer losses from catastrophic events such as hurricanes, earthquakes, and in the case of September 11, acts of terrorism. To that end, reinsurers have financially responded to virtually every major U.S. catastrophe over the past century. For natural disasters typically one-fourth to one-third of the insured losses are passed on to reinsurers and in the events of September 11, 2001, two-thirds of the losses were absorbed by the reinsurance industry.

As the Committee has called this hearing to discuss “the Oversight of the Terrorism Risk Insurance Act (TRIA),” I am here to share with you the reinsurance industry’s perspective on TRIA. The RAA strongly supported the adoption of TRIA in 2002. We believe the program is working well to fill a vacuum in reinsurance capacity, keep premiums paid by consumers at affordable levels, provide insurance coverage to support economic activity, and to minimize disaster assistance should there be other terrorist acts in the U.S. We support the recent introduction of a TRIA extension bill by some Members of this Committee. The RAA believes that an extension is appropriate and will provide the industry and Congress a window of time to consider long-term solutions for managing catastrophic terrorism risk.

My comments are intended to provide the Committee with: (1) a better understanding of the significant challenges the reinsurance industry is facing in providing private terrorism reinsurance capacity, and (2) why the reinsurance industry strongly believes that a public/private partnership is necessary on a going forward basis to help stabilize the commercial insurance markets that underpin our free-market economy.

**Creation of TRIA**

As you are very well aware, TRIA was enacted in response to the tragic attacks of September 11, 2001. In the history of our nation, no hurricane, earthquake or other catastrophic event so fundamentally changed the American landscape and the insurance industry.

These attacks forced all Americans to confront the previously unforeseen realities associated with a catastrophic terrorist attack on U.S. soil. Although the insurance and reinsurance industry responded in an unwavering manner to the catastrophic losses associated with September 11, the events shook the financial foundation of the industry and forever changed the way it views this risk. The simple fact is that, on its own, the U.S. insurance and reinsurance industry does not have adequate capital to assume the potentially unlimited exposure to loss arising from insuring against catastrophic terrorist attacks. The industry cannot predict the number, the scale or the frequency of future terrorist attacks that we may face as our nation continues to execute the "war on terror."

TRIA was created to provide a federal backstop, which was essential to allow the primary insurance industry to provide terrorism coverage to our nations' businesses. The RAA believes that TRIA has principally fulfilled its purpose of allowing primary insurers to provide terrorism insurance coverage that is widely available and affordable to U.S. commercial policyholders in both urban and rural areas. By limiting insurers' exposure to catastrophic terrorism losses, TRIA has improved the market for such coverage and has had a stabilizing influence on the economy.

**Reinsurance Challenges to Underwriting Terrorism Risk**

Over the last several years, reinsurers have worked hard to develop a better understanding of terrorism risk. Reinsurance companies have created task forces, consulted military and intelligence experts, hired specialty risk modeling firms, invested in research and development, and developed new underwriting standards all with the intention of trying to determine if a private market could develop to absorb this risk. Despite these efforts, a key struggle in the development of a private market is that terrorism risk is not conventional. It has characteristics unlike any other peril or insured risk:

1. Terrorists plan to inflict maximum damage. These are not random or fortuitous acts.
2. Terrorists learn from their attacks and thus will attempt to defeat loss reduction methods used by policyholders, insurers and reinsurers.
3. The potential size of loss is enormous, with total destruction of multiple insured properties likely.
4. The potential size is compounded by the aggregation of losses arising from multiple clients and from multiple insurance products covering the occurrence. This is difficult to predict and thus difficult to measure.

5. The frequency of loss is unpredictable, with little historical track record to project future loss experience.
6. Risk of loss is inter-dependent. Individual policyholders can take all appropriate risk management actions, but still be rendered vulnerable by actions of others outside their control.
7. Unlike natural disaster risk, reinsurers achieve virtually no spread of risk with terrorism coverage. Hurricanes in Japan and Florida are not correlated. Premiums can be collected and risk assumed knowing that one loss will not lead to another. Writing terrorism coverage in Europe and North America may well lead to closely related loss events, thus minimizing any benefit of risk spreading around the world.
8. Terrorism events can lead to major disruptions in the financial markets. At a time when reinsurers will be liquidating assets to pay claims, the asset values themselves will be declining due to the likely downturn in the markets. This is not the case with natural disasters.
9. The U.S. government warns us that we are in a war on terrorism, which may increase the risk of loss.
10. Nuclear, biological, chemical and radiological weapons can create large losses of property and life. These extreme loss scenarios would cause losses that outstrip insurer financial resources and are uninsurable.

Reinsurance company underwriters must consider all of these factors and more when deciding whether to take on this risk. The result has been a development of a very limited private market for terrorism.

**Reinsurers' Role under TRIA**

TRIA provides a large amount of reinsurance-like protection for primary commercial insurance exposures. For 2005, 90 percent of the commercial terror loss for primary insurance companies is covered up to an industry total of $100 billion, subject to individual company retention of 15 percent of 2004 direct earned premium on commercial lines. These individual company retentions and the 10 percent co-pay for losses above the retention require commercial insurance companies to absorb significant losses before TRIA funding is available. The primary industry is under increasing financial risk and exposure to acts of terrorism because of: (1) the significant retentions under TRIA, (2) the mandatory offer of coverage required of insurers under the program, (3) state regulatory action or refusal to act on rates and exclusions, and (4) the scrutiny of independent rating agencies. In certain instances under TRIA, some insurance companies have to absorb losses greater than the losses they sustained during the World Trade Center attacks before the federal funding is provided. This is where the private reinsurance industry role fits under TRIA.

Primary insurers are actively seeking private reinsurance to help reduce the large un-reinsured gap in terror exposure they face from the retention and loss-sharing provisions under TRIA. Reinsurers are being asked to "buy down the primary company retentions."

Some have expressed the concern that TRIA has infringed on the private reinsurance market. This is absolutely not the case. In fact, the opposite is true. By establishing definitive loss parameters, TRIA has provided a defined layer for reinsurers to participate in sharing the retained risk of loss that primary companies face under the federal terrorism program.

**Reinsurance Terrorism Capacity**

Working with their client primary companies to manage their substantial retained exposure under TRIA, reinsurers have been willing to put limited capital at risk to manage terror-related losses. Reinsurers typically seek to manage the risk by offering terror coverage in a stand-alone contract rather than within a traditional all peril catastrophe treaty contract, especially for insurers writing a national portfolio. Some regional carriers, with exposures limited to rural or suburban areas far from target risk cities and business centers, have secured terrorism coverage within their standard reinsurance programs, usually with some limitations as to the nature of the subject risk or size of subject event.

With regard to workers' compensation, some insurers have been able to add the terrorism peril to their reinsurance programs, but this coverage typically excludes nuclear, biological, chemical, and radiological (NBCR) losses. It is important to point out that there is very little reinsurance appetite for NBCR risks. When it is available, pricing for coverage including NBCR is at a significant premium and coverage amounts are restricted. This presents a major problem for primary insurers since states do not allow them to exclude this peril.

The RAA surveyed both reinsurance brokers and reinsurance underwriters to estimate how much terrorism reinsurance capacity the private reinsurance marketplace is providing. The survey suggests terrorism capacity for a reinsurance program may range from $300 million up to $600 million on an occurrence basis for property and workers' compensation. This coverage includes TRIA "covered acts" as well as domestic terrorism and personal lines exposure. Overall, our estimates are that the global reinsurance capacity available in the United States for 2005 is about $4-6 billion for stand-alone and treaty reinsurance. Some experts predict that given favorable loss experience this supply could increase to $6-8 billion in private reinsurance coverage within several years. This projected growth is still very modest and will not fill the capacity needs of the primary industry, with or without TRIA.

We understand some in Congress are disappointed that the private reinsurance market has not provided more capacity. Most market participants believe, as we do, that reinsurers may never be able to provide enough capacity to replace TRIA coverage.

Although much progress has been made trying to model terrorism loss scenarios, forecasts of the frequency and the magnitude of terrorism losses are extremely problematic. Reinsurers are only able to provide limited capacity for terrorism because the potential losses would otherwise place these companies at risk of insolvency. To that end, it is important to point out that the global reinsurance industry does not have the capital necessary to absorb losses of up to $100 billion which are contemplated by TRIA. Reinsurers' capital is necessary to support all outstanding underwriting commitments reinsurers face, including natural disasters, terrorism, workers' compensation and other casualty coverages.

**Capital Markets Limited Impact Under TRIA**

Some Members of Congress and the Congressional Budget Office have suggested the possibility of the capital markets assuming terrorism risk. Catastrophe bonds are a known mechanism for using financial markets to absorb and spread natural hazards risk. Indeed, reinsurance companies are one of the most frequent users and facilitators of catastrophe bonds. Yet, hurricane and other natural disaster "cat" bonds are currently in limited use. According to a Marsh McLennan Corporation (MMC) Securities Corp. 2005 report, total cat bond issuance in 2004 was only $1.14 billion, a decline from 2003. The report notes that since 1997, when cat bonds first were issued, the total number of transactions has only been 59 with total issuance limits of $8.66 billion of which only

$4.04 billion is outstanding. This is a very small amount in comparison to the industry's catastrophe exposure. Although many in the industry had hoped the cat bond market would provide significant additional capacity for natural disasters, it simply has not. Factors such as cost, complexity, regulatory and accounting issues, high risks, lack of analytical capacity and liquidity concerns are often cited as reasons the catastrophe bond market has not developed further.

Acts of terrorism present much greater underwriting and pricing challenges to the insurance and reinsurance industry and of course to those issuing and investing in catastrophe bonds. There is no reason to believe terrorism bonds are likely to be a significant provider of terrorism coverage in the foreseeable future. The capital markets face the same problems as insurers: inability to assess frequency of attack, a lack of predictive experience, correlation of loss to other exposures such as a stock market decline, and potentially devastating financial loss.

Likewise, some have suggested allowing tax-free catastrophe reserves might be a solution to increase the industry capacity for terrorism risk, but, as GAO reported, this proposal is controversial. The GAO notes that Treasury officials are concerned that not only would such a proposal lower federal tax receipts, but there would be no assurance that the increase in capital would result in the allocation of more capacity toward terrorism risk or other catastrophe risk. GAO also notes that it would be difficult to determine the appropriate size for such reserve because the modeling used to determine terrorism risk is not sufficiently reliable. Furthermore, both proponents and opponents of catastrophe reserves alike agree that insurers might substitute the reserves for other types of capacity such as reinsurance. So in effect there would not be an increase in capacity.

**Private/Public Partnership Necessary to Address Terrorism Risk**

Mr. Chairman, even without a federal backstop, the reinsurance industry remains committed to working with primary insurers to cover terrorism exposure. Our companies will continue to explore private market solutions to terrorism risk. Due to the nature of this peril, however, we believe that private market mechanisms are insufficient at this time to spread the risk of catastrophic terrorism loss in a meaningful way. Without a federal backstop we would expect less coverage available at the policyholder level, rising prices for terrorism cover and more limited private reinsurance capacity.

The RAA continues to work with task forces from both our reinsurance companies and the primary industry national trade associations to determine what the most effective and less intrusive federal role would entail beyond TRIA. Key to these ongoing discussions is the participation and consensus from the policyholder community. No single solution has emerged but we welcome the opportunity to work with the Congress and all private sector stakeholders to craft a public/private partnership to address this most important national issue.