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NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of

National Association of Mutual Insurance Companies

to the

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Committee on Financial Services

Hearing on

The Terrorism Risk Insurance Act of 2002

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## Introduction

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide testimony on the Terrorism Risk Insurance Act (TRIA) and its vital role in helping protect our country and our economy as we continue to consider how to best handle the ever-present threat of terrorism.

NAMIC is the largest and most diverse property/casualty trade association in the country, with 1,400 regional and local mutual insurance member companies on main streets across America joining many of the country's largest national insurers who also call NAMIC their home. Member companies serve more than 135 million auto, home and business policyholders, writing in excess of $196 billion in annual premiums that account for 50 percent of the automobile/ homeowners market and 31 percent of the business insurance market. More than 200,000 people are employed by NAMIC member companies.

Since the events of September 11, 2001, the federal government has developed a robust and sophisticated counter-terrorism apparatus that has thus far succeeded in preventing large-scale terrorist attacks on the U.S. homeland. That said, the threat of terrorism is continuing to evolve amid a changing, unstable and dangerous international environment. Attacks such as the Boston Marathon bombings were a stark and painful reminder that the United States must remain vigilant. However unfortunate, it will likely never simply be about prevention – response and recovery are also integral pieces of national security apparatus. It is vital that we protect the U.S. economy from financial devastation and help get it back on its feet after an attack.

It is our firm belief that in the absence of a risk-sharing mechanism between the private and public sectors, no self-sustaining private market for terrorism risk coverage is likely to develop. However, the demonstrated success of the program has created the certainty needed for the commercial insurance industry to effectively operate and more importantly policyholders can purchase coverage that would otherwise be unavailable. Now, all but the largest terrorist attacks are completely borne by the private sector.

Some have characterized the program as another example of corporate welfare. A close examination of the facts reveals this characterization is not only false, but belies the very nature of the program. Indeed, the existence of TRIA *allows* a viable private market to function – rather than providing government assistance to commercial insurers.

It is important to remember that the response of the federal government to a large-scale terrorist attack – particularly in the absence of the risk-sharing mechanism – will not be inaction. The current TRIA program allows the insurance industry to completely cover losses for the far more likely smaller-scale attacks. This results in fewer uninsured losses meaning less government compensation after an attack. Without the program there will be more – not less – exposure to the taxpayers as the government will be under extreme pressure to pay for all or most of the losses. And TRIA does all this at

no cost in the absence of an attack (except for negligible annual administrative costs) and with a built-in mechanism to recover every single penny the government pays out if there is a terrorist attack.

Therefore, we believe it is vitally important to our nation's finances, security, and economic strength that we maintain a long-term risk-sharing mechanism for terrorism insurance.

## The TRIA Program – History and Structure

Before the events of 9/11, the abstract possibility of a major terrorist attack on the U.S. was known, but largely dismissed by most people. At the time, terrorism was typically included in "all-risk" policies because the risk was deemed so small as to be incalculable. In one morning, the 9/11 attacks caused roughly $40 billion in insured losses.

Soon after the events, reinsurers and then insurers moved to exclude terrorism coverage from their new and renewing policies as this was a poorly understood risk that could potentially produce unimaginable losses. Consequently, the ability of commercial policyholders to purchase adequate coverage at affordable prices was severely constrained. As a result, many were forced to go without coverage or only partly insure their assets. In states which prohibited carriers from excluding coverage for terrorism and with reinsurance companies universally excluding terrorist acts in property/casualty treaties, most carriers' only alternative was to offer less coverage or not write the business at all.

The lack of adequate insurance capacity and significant increases in pricing of commercial multi-peril business resulted in the postponement of many construction projects. It was estimated at the time to have delayed or cancelled $15.5[1] billion in real estate transactions and cost 300,000 construction workers their jobs.[2] Given the economic uncertainty that was created and the insurance industry's serious concern about properly managing this risk, Congress passed and President George W. Bush signed into law the Terrorism Risk Insurance Act of 2002. It was quickly realized that without the program American businesses would be hard pressed to find or afford the coverage they needed and so TRIA was extended for two years in 2005 and again in 2007 for seven years.

Essentially, TRIA placed a ceiling on individual company terrorism losses, which permitted them to quantify their terrorism exposure and make the coverage available.. The program was purposefully designed to force insurers back into a market, with the benefit of knowing their exposure.

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[1] Real Estate Roundtable, "Survey Confirms Economic Toll of Terrorism Insurance Gap: Over $10 Billion of Real Estate Projects Affected Across U.S.," September 4, 2002.
[2] President George W. Bush, "President Reiterates Need for Terrorism Insurance Agreement," October 3, 2002.

Specifically, the program is a federal backstop for commercial property/casualty insurance that acts as reinsurance in the event of a certified terrorist event. A private insurance company pays for losses up to 20 percent of the prior year's direct earned premium on all lines of business covered in the TRIA program, which for the largest companies is several billion dollars, and then a 15 percent co-pay up to a program cap of $100 billion. After $100 billion, neither the government nor the company is required to pay for excess losses.

There are several other key elements to the program:

- **Program Trigger** – A terrorist event must hit a certain "trigger level" in order for there to be any Federal involvement. The trigger is currently set at $100 million.

- **Mandatory Offer** – The current program requires all insurers selling covered lines to offer terrorism coverage, compelling many insurers that had previously exited that market to return and dramatically reducing the amount of potentially uninsured losses in the event of an attack. Insurers are required to offer coverage for acts of terrorism on the same terms and conditions as other coverages, although this does not include coverage for nuclear, biological, chemical and radiological (NBCR) attacks. Currently policyholders are not required to purchase the offered coverage and in the last few years take-up rates have plateaued in the 60 percent to 65 percent ranges.

- **Recoupment** – Currently, *taxpayers are completely protected under TRIA* – the federal government has the ability to recoup any money that is spent through the program. By law the federal government *must* recoup the difference between insurers' total costs and the industry aggregate retention of $27.5 billion (assuming the total cost of the event with government payments is $27.5 billion or higher) over time through surcharges on every policy covered by TRIA. Since 2007, the government must actually recoup 133 percent of this mandatory recoupment. In the event the insurers' total costs exceed $27.5 billion then the government can still recoup whatever money it pays out, but this is at the discretion of the Treasury Secretary.

  In this way, the federal government can be thought of as a post-funded reinsurer for the catastrophic tail coverage of terrorism risks. This coverage is valuable, but not priced explicitly nor paid for upfront – it is paid for in the event it is used and in effect, pricing is determined after any event. It is common for risks that are more difficult to quantify and where there is great uncertainty as to the range of possible outcomes for benefits and policy limits to be determined up front and premiums after the policy period based on actual experience (nuclear power plant disasters are one example).

It is the structure of the current TRIA program that has created space for a private market to operate under the umbrella of federal participation. The private sector

involvement reduces the unaddressed needs of victims which in turn reduces the necessity of government intervention – thus taxpayer exposure – post attack. Importantly, what TRIA does is define the government's role in advance of a catastrophe rather than relying on ad-hoc authorizations after the fact, thus allowing all parties to efficiently plan.

## Why is the Program Necessary?

Managing terrorism risk defies the normal underwriting practices of insurers. Terrorism involves strategic human behavior and represents a dynamic threat that is intentional, responsive to countermeasures, and purposefully unpredictable. Immediately following 9/11, there was hope that, given time, more accurate modeling could be developed and utilized to help insurers manage the terror risk. And indeed, much has been done to develop tools to manage aggregate loss exposures that are based on a predetermined event of a certain magnitude in a given area.

That said, the underwriting challenges that remain are numerous and profound:

- **Identical to Acts of War** – Acts of war have always been considered uninsurable events with either an implicit or explicit expectation that financial responsibility resided with the governments involved. War-related damage has never been covered by insurers and no one has suggested that something must be done to maximize private sector capital to be used to provide such coverage. Simply because stateless, transnational groups are perpetrating these acts of terror does not categorically change them.

- **Absence of Meaningful Actuarial Data** – The data that insurers normally rely on when considering whether coverage can be offered and, if so, at what price, either does not exist or is not available. In the case of natural catastrophe risk, a company can rely on decades of relevant event data that can be plugged into mathematical models to quantify risk – there is no comparable historical record on which to draw for large-scale terrorist events. Further, much of the relevant data that might be used by an insurance company is appropriately kept secret by the federal government for national security reasons. Without access to this type of information insurers cannot meaningfully calculate the likelihood, nature, or extent of a potential event, making pricing and reserving virtually impossible. Although in theory access to classified information might paint a more accurate picture of the threat matrix facing targets in the U.S., insurers should not – and are not asking to – be given state secrets in order to write terrorism coverage.

- **Intentional Acts** – A related point is that terrorist acts are caused deliberately and do not occur randomly. Because of this, there is no way to determine the probability that a particular property or asset will experience a terrorism-related loss. Part of the difficulty in assessing terrorism risk stems from the

fact that, because of response measures taken in the wake of an attack, the next event is unlikely to follow a similar pattern. Unlike criminal acts such as robbery where the goals are predictably targeted, the goal of maximizing death and destruction can be accomplished in countless ways, anywhere, and at any time. Terrorism is not comparable to a random event – a hurricane cannot study wind-damage mitigation efforts and then think up new ways to get around them. The only truly effective mitigation tools – if there are any -- reside within the government's national security apparatus, and as noted above, these are understandably kept secret.

- **Risk Concentration** – Terrorism risk is highly concentrated and incredibly difficult to effectively pool across geographical locations and policyholder type, particularly in an age of mass-casualty terror. Acts of terrorism on the scale of 9/11 are what are known as a "clash events" meaning they cause significant losses across multiple lines of insurance. These types of events directly threaten the solvency of both insurers and reinsurers and are not typically covered risks. In a fully free market, it would likely be the case that highly concentrated urban areas in particular would find it difficult to find or afford coverage for terrorism.

- **Interdependencies** – At the very highest level, the nation's foreign policy decisions and the effectiveness of its homeland defense have a direct impact on the likelihood and success of an attack. At the policyholder level, the vulnerability of one organization is not simply dependent on its own security decisions, but also on the decisions of other organizations and agents beyond its control.

In the end, it is more accurate to think of the TRIA program's purpose not as providing reinsurance for losses resulting from "acts of terrorism," but as protection against from losses that result from a failure in the government's systems for detecting and preventing acts of terrorism. With respect to natural catastrophe risk, it would be absurd to assign to a government agency the task of preventing hurricanes, tornadoes, and earthquakes. But it makes perfect sense for citizens to expect their government to prevent attacks by America's enemies, and that is precisely what Americans have come to expect from their government in the aftermath of 9/11. It is now widely recognized that one of the federal government's fundamental duties is to prevent terrorist attacks through the use of effective counter-terrorism measures. Only if the government does not fulfill its responsibility to protect Americans from terrorist attacks will Americans incur terrorism losses. "Terrorism risk" in 2013 and beyond is better understood as the risk of government counter-terrorism failure.

Accordingly, while the private insurance industry is willing to assume a substantial portion of this risk within the limits of its capability, the ultimate responsibility for managing the risk of government counter-terrorism failure does and should rest with the federal government itself.

## What Would Happen if TRIA Expired or Was Materially Changed?

Termination of the program threatens the space in which a viable private market for terrorism insurance has grown. In considering what is likely to happen if the Terrorism Risk Insurance Program is terminated on December 31, 2014, the immediate aftermath of 9/11 in commercial property/casualty markets for terrorism coverage as described above is instructive.

Most insurers would likely not offer terrorism coverage in the absence of a federal risk-sharing mechanism like TRIA. To offer coverage for a risk that could result in a 9/11-size loss is a "bet the company" risk for insurers and they understandably withdrew from this segment of the market following 9/11. It was only with a program in place that put some structure around an ill-defined catastrophic risk that allowed insurers to participate. By providing more definitive loss parameters, TRIA has facilitated the participation of the private sector at current levels. We cannot hastily conclude that because the private sector can handle a portion of the risk, it could figure out a way to handle all of it.

Assuming that allowing the program to expire or drastically changing the federal government's role will simply result in private market innovation that has heretofore failed to materialize is unwise. State insurance regulators indicate that they have not seen evidence suggesting that the insurance marketplace is capable or willing to voluntarily take on a substantial portion of the risk of providing coverage for acts of terrorism in the absence of the program.

If TRIA is allowed to expire, it would create a particular disruption to worker's compensation system. Without a federal backstop, workers' compensation insurers will bear the entire financial burden of losses due to a terrorist attack. Reinsurers have shown an unwillingness to accept this potentially devastating risk or to offer affordable limits to protect the solvency of the workers' compensation insurers.

The workers' compensation benefit delivery system operates very differently from other property casualty insurance and should be given special attention in the debate to extend the program. Workers' compensation insurers are not allowed to exclude losses due to terrorism. The expiration of TRIA could result in disaster for workers' compensation insurers, and the businesses they serve, should a catastrophic terrorist event, occur. A migration of business currently being offered by private workers' compensation carriers to public state funds, residual markets and guaranty funds for large segments of metropolitan areas would be expected. These public options for workers' compensation are not designed to handle a catastrophic terrorist event. Injured workers and their families would face potential disruption in benefits. If the workers' compensation system fails, taxpayers could still be responsible for compensating victims – the very scenario that some policymakers want to avoid by letting TRIA expire. There would be delays in payment and hardship for those injured because of the lack of

an efficient compensation system. These disruptions can be averted. Extending TRIA is more than a federal backstop for insurers -- it is a social and economic imperative.

The effects of a termination of the TRIA program extend beyond the property/casualty insurance industry. As we saw, commercial development can grind to a halt in the absence of terrorism coverage if the financial institutions financing projects require the coverage as a condition of their loans. In fact, many outstanding loans that require developers to maintain coverage would be thrown into technical default if the program were terminated and insurers had made arrangements to exclude or limit coverage in the absence of TRIA. The impact on the broader economy was one of the key reasons that the program was first put into place and why it has continued to be reauthorized and nothing has fundamentally altered this dynamic.

A more pedestrian point involves the fact that private insurance companies, including mutual companies, are return-seeking operations. Therefore, if they believe there is an opportunity to earn an economic return and it is possible to do so in accordance with an overall successful business model, then they will. In other words, if there was money to be made in insuring against terrorism risk, coverage would be offered without government intervention. To that point, the companies would be arguing for less—not more—government intervention to increase that earning potential. The fact that they are uniformly not doing so and in fact suggesting that without the TRIA program private coverage would not expand and instead retract, is telling.

In seeking to accomplish the goal of increasing private sector participation in the terrorism insurance market, it is important to recognize that the entire marketplace as it stands today has grown up in the presence of the TRIA program. Insurance industry capital remains insufficient to absorb the cost of a large-scale terrorist attack on its own – simply put, the insurance industry's capacity is dwarfed for most modeled long-tail, high severity, catastrophic terrorism events. That capacity cannot be exposed beyond a reasonable level without failing in its primary purpose - supporting the economy by protecting against non-terrorism related losses and events. In the event of a major attack, substantially depleted reserves and surpluses, and insolvencies could mean that policyholders of non-covered lines could go unprotected. A company that engages in business that endangers the ability to pay on existing or future policies is violating its duties to existing policyholders.

Moreover, even if the overall industry capacity was significantly greater, serious concern about terrorism risk would remain for individual insurance companies. For a catastrophic event, the losses are not likely to be spread evenly among a large number of insurers. Thus terrorism risk is a situation in which no firm will be the "average" company. Insurance companies may either suffer no losses or else they could suffer losses sufficient to threaten their very existence. This dynamic lends itself to very strict underwriting and would severely constrain the private market in the absence of TRIA.

NAMIC would also caution policymakers not to assume that they can increase private sector participation by fiat. Increasing the nominal amount of private sector involvement

in the current TRIA structure does not immediately translate into an increase in private sector capital in the marketplace. In fact, altering trigger levels or individual company retentions may cause market participants – particularly small and medium-sized companies – to exit, thereby reducing total private capital. An effective public-private partnership also depends on participation by insurers of all sizes and structures.

It is not at all clear that eliminating or scaling-back the TRIA program would lead to more involvement in the market by private insurers. In fact the opposite is likely true.

## Improving the Program

The current TRIA program has worked very well. In large part this is because it has provided some certainty and predictability to a difficult risk. That said, NAMIC has suggestions to help improve the operation of TRIA in the event of an attack.

- **Streamlining Functionality of Program** – The TRIA program is capped at $100 billion dollars, a level above which neither the insurance companies nor the federal government is responsible for further payment. What is not clear is how proration would work for either the insurers or the policyholders. Which companies get to stop paying when, and which policyholders have to take how many cents on the dollar remains unclear. Providing clear guidance on how an event of this magnitude would work would provide more certainty for market participants.

- **Certification of Terrorist Event** – Although the Boston Marathon bombing did not come close to losses that would have hit the $100 million trigger, the debate surrounding certifying the event as a terrorist attack, which ultimately led to no certification, has led to significant concern in the industry. Insurance contracts are written and priced with specific terms and exclusions in mind and to the extent that a Treasury certification can become an uncertain political process that impacts a company's claims, it sets a bad precedent. To continue to encourage insurers to write covered TRIA lines – or to write any lines in markets perceived to have a higher terrorism risk – strengthening the predictability of the certification process, including imposing a deadline for certification, should be a part of the reauthorization process.

## Conclusion

Since the passage of TRIA in 2002, the U.S. has been fortunate not to have suffered another event like 9/11. Therefore the program has not demonstrated its ability to help the nation recover in the aftermath of such a disaster. What we can and have seen is the market that has formed in the space created by the program, almost certainly drawing in more private capital than had the program been structured differently. TRIA was able to accomplish this without paying out a dime to the private sector and without

creating a new fund or revenue stream or bureaucratic structure, all while creating a system that will reduce taxpayer exposure in the event of a massive terrorist attack.

In the end, the purpose of the program is not to protect insurers, but to make sure that the economy can recover in as orderly a fashion as possible from a terrorist event. In order to encourage private sector involvement in the terrorism insurance marketplace – and thereby protect and promote our nation's finances, security, and economic strength – we must maintain a long-term private/public partnership for terrorism risk insurance.