Consumer Federation of America

WEANING THE INSURANCE INDUSTRYAND LARGE COMMERCIAL POLICYHOLDERS FROM TAXPAYER SUBSIDIES UNDER THE TERRORISM RISK INSURANCE ACT

TESTIMONY OF
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Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
of the
House Committee on Financial Services

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Mr. Chairman and members of the Subcommittee, thank you for your invitation to appear before you today to discuss the Terrorism Risk Insurance Act. I am J. Robert Hunter, Director of Insurance for the Consumer Federation of America. CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education. I am a former Federal Insurance Administrator under Presidents Ford and Carter and have also served as Texas Insurance Commissioner.

I. Introduction

As a result of the dreadful terrorist attacks of September 11, 2001, the property/casualty insurance industry suffered losses of almost $21 billion after taxes ($32 billion before taxes). Although a tax write-off of 35 percent is a significant financial benefit to insurers, Congress enacted the Terrorism Risk Insurance Act in 2002 to ensure that terrorism coverage was affordable and available in the aftermath of this unprecedented event. Congress also wanted to assure that a lack of affordable terrorism insurance did not set off a chain reaction that would prevent large construction projects from going forward, thus harming the overall economy.

TRIA established a program of federal reinsurance with no premium charged to the insurers. The law mandates that insurers write terrorism coverage, which is then backed by the federal reinsurance program. If and when a terrorism event occurs, the Secretary of the Treasury must certify that it qualifies as a reimbursable loss under TRIA, with at least $5 million in aggregate losses. Someone acting on behalf of a foreign interest must commit the attack. If an incident meets these criteria, taxpayers pay for insurance industry losses in accordance with a schedule that varies over time. The Act expires on December 31, 2005, unless renewed by Congress.

In 2003, insurers were responsible for losses below a deductible of 7 percent of their direct earned premium (DEP) for eligible commercial lines in the 2002 calendar year. In 2004, 10 percent of the 2003 DEP was the deductible. In 2005, 15 percent of the 2004 DEP is the deductible[1]. Above the deductible amount, the federal "backstop" is 90 percent of a company's insured terrorism losses, capped at an overall industry level of $100 billion. If an event triggers federal involvement, insurers are required to pay back a very small layer of taxpayer assistance, which could be passed on to insurance consumers in the form of a surcharge, but it is not a significant amount in major terrorism events.[2]

Not surprisingly, insurers and the real estate industry have encouraged lawmakers in both houses of Congress to extend TRIA in much the same form it is in now, and even expand it to cover group life insurance losses. These interests receive significant financial benefits from a program that provides expensive reinsurance coverage at no charge. If consumers received free, taxpayer funded auto insurance, there would likely be a clamor for Congress to extend that program as well.

[1]Under TRIA, the Secretary of the Treasury is authorized to extend the program through 2005, and in 2004, the Secretary elected to extend the program.

[2] TRIA does not require <u>any</u> payback if losses exceed $10 billion in the first year of the program, $12.5 billion in the second, and $15 billion in year three. Even when payback is required, it is miniscule: insurers only repay the <u>difference</u> between the total amount of retentions paid by individual insurers and the caps stated above.

However, the U. S. Department of the Treasury, which administers TRIA, has just issued a report determining that TRIA should not be extended in its current form.[3] The report found that TRIA had achieved its temporary objectives and that, given the robust economy, TRIA's expiration or extension would have little impact. The Treasury Department found that the program should be cut back to enable private sector terrorism insurance to develop and to reduce taxpayer exposure. The report therefore called for higher triggers for the availability of the backstop, higher deductibles and co-pays for the industry and the complete exclusion of smaller lines of insurance from the program.

In the wake of this important report, insurers are warning that, if TRIA is significantly pared back, there will be little terrorism insurance coverage available. As a result, the nation's economy will be seriously damaged as construction projects that cannot obtain terror coverage grind to a halt.

In this testimony, I will evaluate the current capacity of the property/casualty insurance industry to provide terrorism insurance if the TRIA program expires or is significantly scaled back and requires insurers to pay actuarially sound premiums and the degree to which commercial policyholders could afford increased terrorism insurance premiums. I will then review, briefly, the findings of the CBO and Treasury Department reports on extending TRIA. By reviewing what happened in most of 2002 when no TRIA was in effect, I will also addresses the claims of insurers and others that the elimination of TRIA will cause extreme dislocations in the nation's economy. I will then comment on what Congress should do as the termination of TRIA approaches.

II. Perfect Timing: Insurers and their Policyholders are in a Good Position for TRIA to Expire or be Sharply Scaled Back

A. The Insurance Industry is Flush with Profits and Retained Earnings

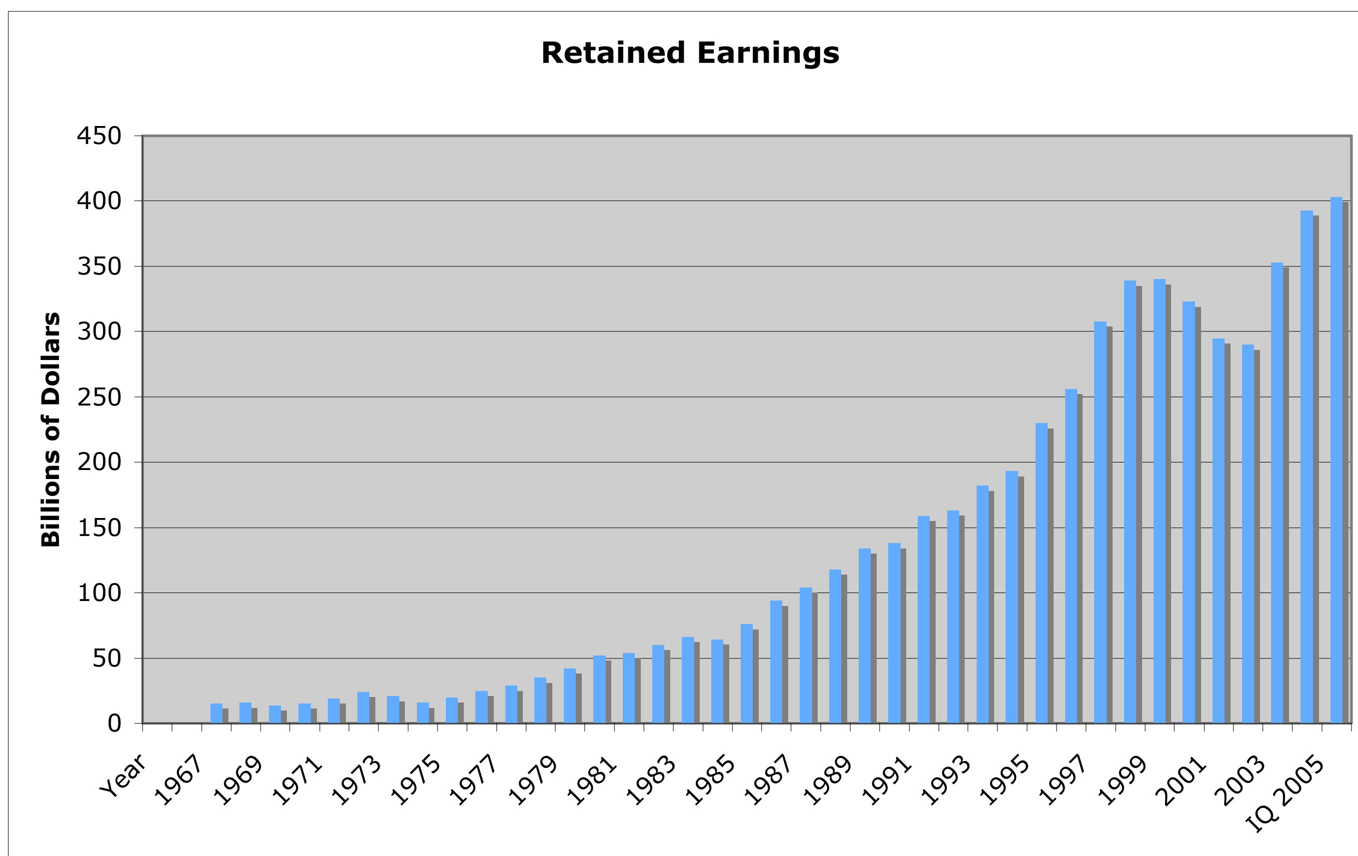
Since the attacks of September 11th, the property/casualty insurance industry has experienced a significant period of growth and raked in profits that are virtually unprecedented, and expected to increase further. In fact, the industry is clearly overcapitalized.

A significant shift in the insurance market since September 11th has also meant major benefits for insurance policyholders. The property/casualty insurance market has moved from the "hard" part of the cycle, when prices increased sharply and coverage cutbacks were widespread, to a soft market, where abundant capital has caused prices to drop precipitously.

In the first quarter of 2005 alone, the industry had a 92.3 percent combined ratio (the total of losses and all expenses divided by the premiums), one of the lowest such ratios in decades, signaling huge profits ahead. First quarter 2005 underwriting profit was $6.8 billion, investment return was $14 billion, offset by capital market losses of $4 billion, for a jump in retained earnings of $10 billion.[4] These extraordinary returns have spurred robust competition as insurers compete for greater market share.[5]

[3] "Assessment: The Terrorism Risk Insurance Act of 2002, U.S. Department of the Treasury, June 30, 2005.
[4] U.S. Property/Casualty Insurers Gain $6.8 billion in First QuarterBestWeek, July 8, 2005.
[5] US P/C Industry Loss Ratio Improves 2 Points in 2004, BestWire Service, July 11, 2005.

The industry has emerged from a classic cycle bottom with huge profits and is in one of the strongest periods in its history. The retained earnings (surplus) are exploding to record highs, as the chart below illustrates:



Source: 1967 to 2003, Aggregates and Averages, 2004 Edition, A. M. Best & Co. 2004 and 2005 calculated by CFA from Best reports of surplus growth.

Data for all segments of the property/casualty industry indicate that retained earnings were $323 billion at year-end 2000, before the terrorist attacks. As of the end of the first quarter of this year, retained earnings are $403 billion, fully $80 billion more than in 2000.

CFA estimates that the current property/casualty insurance premium writings-to-surplus-ratio is a remarkably safe one to one. By historical standards, this is a very wealthy and financially stable industry. The commercial lines segment of the industry was reported by Best's Aggregates and Averages to have a surplus of $155 billion at year-end 2003, which Best's estimates grew by 10.3 percent in 2004 to $171 billion.[6] At year-end 2000, the surplus was $122 billion. This growth in surplus of $49 billion alone would be enough to pay for losses for an attack more than two times the size of the World Trade Center attacks of September 11th.[7]

[6] Best's Aggregates and Averages, 2004 Edition, page 30 for 2003 data; 2004 growth in Best's Review/Preview, January 2005, page 20.
[7] An attack that resulted in losses of $49 billion after taxes would be $75 billion before taxes ($49/.65). This is 2.2 times the estimated $35 billion before taxes that the WTC event cost insurers and taxpayers.

The hugely profitable situation that exists today offers the perfect opportunity for Congress to end or sharply scale back TRIA. Excess insurer capacity is causing fierce competition for market share. This capital in search of risks to underwrite is a very promising sign for growth and development of a private terrorism market.

Moreover, this very wealthy industry has reaped significant financial benefits from the taxpayer subsidy provided by TRIA. So far, taxpayers have granted free reinsurance worth $2.8 billion.[8] Had insurers been required to pay premiums for this coverage, this $2.8 billion would now be available to the Treasury Department to pay for any attacks that might come in the future.

B. Policyholders are Enjoying Deep Premium Cuts in All Insurance Lines

As the following chart shows, price increases were severe as Congress was considering enactment of TRIA in 2001 and 2002. Year-to-year price increases approached 50 percent in some lines. That situation has changed dramatically over the course of the normal economic cycle:

	2001	2Q 2002	2Q 2003	**2Q 2005**
Small Comm. Accounts	21%	20%	7%	-5%
Mid-size Comm. Accounts	32%	27%	8%	-10%
Large Comm. Accounts	36%	34%	8%	-11%
Business Interruption	30%	21%	5%	-6%
Construction	46%	44%	17%	-3%
Commercial Cars	28%	27%	11%	-5%
Property	47%	42%	6%	-12%
General Liability	27%	24%	11%	-8%
Umbrella Liability	56%	52%	18%	-6%
Workers' Compensation	24%	26%	15%	-7%
D&O	NA	NA	21%	-3%
Employment Practices	NA	NA	17%	-4%
Medical Malpractice	NA	NA	48%	2%
Surety Bonds	NA	NA	13%	-6%
Terrorism	NA	NA	6%	-1%

Source: Council of Insurance Agents and Brokers.

As the Department of the Treasury report found, the average percentage of overall premium paid out by commercial policyholders for their terrorism coverage was 1.8 percent in 2004 (1.7 percent according to the policyholder survey).[9] Thus, if terrorism charges doubled as a result of TRIA's termination, the overall insurance premiums paid by all sizes of businesses

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[8] See calculations at page 5 of the Testimony of J. Robert Hunter before the Committee on Banking, Housing and Urban Affairs of the U.S. Senate, April 14, 2005.

[9] Department of the Treasury's Report, at page 4.

would still decline. At the current time, for large commercial accounts, terrorism prices could more than quintuple with no resulting premium increase overall.

C. Another Marketplace Improvement: the Risk of Terrorism Is Being Modeled and Insurance Companies Are Using These Models

The insurance industry argues that predicting terrorism risk for insurance purposes is impossible. The truth is, insurers are doing it already. Modeling terrorism risk is an imperfect science, but it is improving fast. A huge amount of research has been done in this area since TRIA was enacted, and several private companies have produced and are selling models to measure the actuarial and underwriting implications of the terrorism risk. The fact that insurers use these models is proof that they are of at least some value. Insurance companies pay significant dollars for the licenses to use these models. Businesses would not do that if they did not think the models were valuable. For instance, many insurers use the Insurance Services Office (ISO) model for setting terrorism rates. ISO's research shows that the terrorism insurance risk is limited to a fairly small number of cities and that for the vast majority of the nation, the risk is low and the cost can be fully borne privately.[10]

III. Reports by the Congressional Budget Office and Department of the Treasury Support Ending TRIA or Sharply Reducing Coverage in any TRIA Extension

A. The Congressional Budget Office Study

The well-balanced Congressional Budget Office report of January 2005 made these important points about how the market would be affected if TRIA expired:

- Terrorism premiums would likely rise for those buying insurance in high-risk situations.

- The number of businesses buying insurance would probably decrease. (Only about half of all businesses are currently purchasing terrorism coverage.) Such a decrease would mean more taxpayer involvement in a post-terrorism attack situation.

- Mitigation efforts would increase. Efforts to lower the risk of terrorism attacks or reduce their effects would be encouraged by the market charging actuarial rather than taxpayer-subsidized rates for terrorism insurance. Steps such as hiring guards and placing metal or explosives detectors at entrances to higher risk buildings would be encouraged by the expiration of TRIA.

- Private sector alternatives to TRIA would be encouraged by the expiration of TRIA, such as reinsurance to replace the free TRIA coverage or the development of securitized responses, such as bonds similar to catastrophe bonds.[11]

[10] For a complete discussion of the implications of ISO's research, see CFA's report, "The Terrorism Risk Insurance Act: Should it be Renewed?" at http://www.consumerfed.org/terrorism_insurance_report.pdf. The report was presented to the Senate Banking Committee at its hearing of May 18, 2004.

[11] Indeed, there is evidence that just the potential of TRIA expiration is causing insurers to develop and risk managers to seek alternative ways to cover the terrorism risk.

- The economy might be affected somewhat, but not as much as the insurers contend. CBO indicates that the analysis presented to the public through press releases sent out by the insurance industry overstates the potential costs to the economy if TRIA expires.

- The cost of insuring against terrorism would not change much for the nation. TRIA does not change the anticipated terrorism costs except, CBO states, to the extent it increases national costs because it undermines the incentives of insurers to insist on mitigation measures and insured parties to implement these measures in order to get lower premium charges. Not extending TRIA would merely shift roughly the same costs from taxpayers to private firms and insurers.

- There could be insurance market disruption if another large terrorism event occurs. CFA believes that Congress knows how to handle this sort of situation, given the success it had in stabilizing the insurance market after September 11, 2001 and during the riots in the nation's cities in the 1960s, for example.

CBO also listed the pros and cons of altering TRIA by requiring that insurers be charged actuarial (or above actuarial) premiums for the coverage that is provided:

- Charging premiums would result in more mitigation by insurance purchasers because increased premiums would encourage the development of discount plans for safety precautions taken by insured businesses.

- Charging premiums would encourage the private sector to grow, since the private sector cannot compete with the free reinsurance provided by the taxpayers under TRIA.

- Charging premiums might result in less terrorism coverage being purchased. This would mean more taxpayer involvement in a post-terrorism attack situation.

CBO summarizes their conclusions as follows:

"In sum, as the Congress considers whether to extend TRIA (and in what form), it is useful to consider what has changed in the two years since the law was enacted. The most significant development seems to be a growing sense that the terrorism threat to the United States will continue for the foreseeable future. That development suggests that the economy, especially the stock of physical capital, needs to be responsive to the prospective losses from terrorist attacks. For example, new construction might be designed, located, and built to withstand such attacks. Existing structures might need to be retrofitted with safety features. *Those needs argue against extending the TRIA program in its current form, which subsidizes insurance and dampens incentives for mitigation activities.* (Emphasis added.)

"*The macroeconomic costs of scaling back the federal subsidy for terrorism insurance are likely to be small*. One reason is that the capacity of insurance companies to provide terrorism coverage has improved recently. Another reason is that TRIA does not lower the costs of terrorist attacks but rather partially shifts those costs from property owners to taxpayers. As noted above, total costs might be lower without TRIA. However, the gains

> in economic efficiency from allowing TRIA to expire could require a significant trade-off: without the TRIA program, an especially large loss from a terrorist attack would be likely to produce another episode of scarce coverage, rising prices, and uninsured assets." (Emphasis added.)

Thus, CBO concludes that immediately gaining more safety and lowering terrorism costs through mitigation – current real gains stemming from TRIA's expiration– have little possible future downside, except for the possible insurer reaction *after* a terrorist event. The benefits of improved mitigation efforts and increased private sector involvement in insuring against terrorist risk that would be encouraged if TRIA expires far outweigh the potential costs of insurer reaction after some future event, particularly since Congress has shown that it knows how to offset that potential cost through prompt action after such events.

B. The Department of the Treasury Report

On June 30, 2005, the Treasury Department issued their report, as required in TRIA. This is the most extensive review of TRIA by any party and represents an important contribution to the deliberations of Congress on what to do when the current TRIA expires. The report found that TRIA had served its purpose and should not be extended "as-is." If TRIA is extended at all, the Department recommended that it should be sharply cut back. In delivering the report, Secretary Snow stated:

> "While TRIA has been effective in achieving its temporary objectives, the economy is more robust today than when TRIA was enacted. GDP growth is up from 2.3 percent in 2002 to 3.9 percent in 2004 (fourth quarter over fourth quarter). Unemployment, which reached 6.0 percent in December 2002, is down to 5.1 percent in May 2005. Construction jobs, taking residential and nonresidential together, now stand at a record high 7.2 million. Extending TRIA would have little impact on the economy given its current strength.
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> "It is our view that 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.
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> "Any extension of the program should recognize several key principles, including the temporary nature of the program, the rapid expansion of private market development (particularly for insurers and reinsurers to grow capacity), and the need to significantly reduce taxpayer exposure. 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 co-payments, and eliminates from the program certain lines of insurance, such as Commercial Auto, General Liability, and other smaller lines, that are far less subject to aggregation risks and should be left to the private market."

The Treasury Department study offers Congress a reality check on the hype and misinformation about TRIA that has been offered by the insurance industry. Insurer claims that

terrorism insurance will not be available or affordable unless TRIA is extended "as is" and even broadened are debunked by the Department of the Treasury study. The study makes it very clear that the financially well-off insurance industry is receiving an overly generous and unnecessary subsidy from beleaguered taxpayers and consumers and that the law must be scaled back in order to foster the growth of the private market for terrorism insurance. The report also debunks the myth that the potential lack of terrorism coverage in 2001 and 2002 led to a slowdown in non-residential construction or that TRIA has been effective in increasing this construction since it took effect.[12]

The report is silent on whether insurers should be required to pay a premium for the reinsurance they receive in the future. CFA strongly believes that taxpayers should no longer be required to give away billions of dollars in free reinsurance to an industry that is financially flush. Even representatives of the insurance industry have agreed that it is hard to justify not requiring the payment of premiums for this coverage.

CFA does disagree with Treasury Secretary Snow's contention that the legal rights of Americans should be further rolled back in order to prevent TRIA from paying for illegitimate liability claims, a position not mentioned in the report itself. Current laws would certainly prevent payment for unjustified claims. Moreover, the Insurance Services Office estimates that <u>all</u> liability payments under TRIA would be very small, about ten percent of paid insurance losses. If the Treasury Department's proposal to remove federal back up from commercial auto and general liability lines of insurance is adopted by Congress, then this percentage will fall to a trivial level.

IV. Industry Claims of Economic Disaster if TRIA Expires Are Invalid

A. Current Industry Claims

Insurance companies and some large policyholders are making claims that, should Congress not extend TRIA in its current form -- or even expand the coverage to include group life -- there will be serious economic consequences. Some examples of these claims follow:

> "If the year ends without a federal program of any sort, then the economy is at risk."
> Jeffrey DeBoer, President
> Real Estate Roundtable[13]

> "It certainly creates enormous economic disruption. It threatens jobs. It threatens economic growth."
> Marolyn Davenport, Senior Vice President
> Real Estate Board of New York[14]

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[12] "From our current perspective it appears that neither the potential lack of terror risk insurance nor a general economic downturn were responsible for weakness in nonresidential building activity. In any case, nonresidential building is only 2.2 percent of GDP, and commercial office construction only 12.2 percent of the nonresidential building total. When the economy is fragile, concerns over weakness in even very small sectors of the economy (nonresidential construction) can loom large…such concerns recede as the economy strengthens. Given the small size of nonresidential and commercial office construction, stimulating this sector (whether through TRIA or otherwise) would be neither effective nor warranted." Treasury Department report at page 135.

[13] "Congress Urged to Extend Help After Attacks," New York Times, July 11, 2005.

"That is potentially the start of a serious storm for our economy."
Rolf Lundberg, Senior Vice President
U. S. Chamber of Commerce[15]

"If TRIA is not extended…this will…have a severe negative effect on the national economy, including job loss, stalled commercial transactions and delayed construction projects."
Brian Duperreault, Chairman
ACE Limited[16]

"CIAT is unanimous in its belief that the Federal government must continue to provide a reinsurance backstop beyond 2005 if we are to avoid major disruptions to the economy."
Robert J. Lowe, Chairman and CEO
Lowe Enterprises
Speaking on behalf of the Coalition to Insure Against Terrorism, the Real Estate Roundtable and the United States Chamber of Commerce.[17]

B. The Terrorism Market in 2001 and 2002

These claims are identical to those made by insurers and the real estate industry in 2001 as Congress was considering what to do about terrorism insurance after the September 11th attacks. In late 2001, insurers and some policyholders warned that a national crisis would ensue in early 2002 if no terrorism back up was put in place by Congress. Insurers claimed that the crisis would hit suddenly in 2002, since most reinsurance contracts would expire January 1, 2002.

The Consumer Federation of America initially supported legislation to provide a federal terror insurance back up, as long as insurers were required to pay back the taxpayer-supported reinsurance that was provided. However, Congress adjourned in late December 2001 without enacting terror insurance legislation. CFA took this position of support in part because the insurers were making a strong argument that if no program was in place by January 1, 2002, there would be significant problems in the insurance market leading to unavailability of insurance, banks calling loans, damage to the nation's economy and other dire consequences. Congress failed to act in 2001.

C. CFA Study of January 2002

Fearing that a crisis would develop immediately after reinsurance contracts expired on December 31, 2001 and new contracts took effect on January 1, 2002 without terrorism reinsurance back up for primary insurers, CFA undertook a major study of market conditions in late January 2002. To our surprise, CFA found that, contrary to the grim scenarios feared by many and predicted by the insurance industry, the failure of Congress to enact a terrorism

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14 Ibid.
15 Ibid.
16 Testimony Before Senate Banking Committee, April 14, 2005.
17 Testimony Before Senate Banking Committee, April 14, 2005.

insurance back up program had not caused major gaps in coverage or economic disruption in the nation. As a result, CFA changed its position and called upon Congress to enact narrower, targeted measures to provide terror back up only to the "target risks" and parts of the country (like New York City) that were still having trouble procuring terrorism insurance.[18]

The study CFA released in late January 2002 had five major conclusions:

1. The insurance industry was wealthy and overcapitalized.
2. High rates were a problem for mid-sized and larger firms.
3. The rate problem was caused by the classic turn in the economic cycle of the industry, sped up--but not caused by--terrorist attacks.
4. Banks were freely loaning money to the vast majority of businesses--if not all of them---regardless of the terrorism insurance situation in the nation.
5. There were no widespread economic problems related to the terrorism insurance situation.

D. CFA Study of August 2002

Insurers responded to CFA's report by saying that it would soon be apparent that the lack of terrorism reinsurance was having negative consequences as policy renewals took place through the year. This was a change from their earlier prediction so we waited to study the situation until well after at least half of the policies in the nation had been renewed (i.e., after July 1, 2002). By August, at least 80 percent of the policies in the nation had been renewed without terrorism reinsurance coverage. CFA's August report on the terrorism insurance marketplace had three significant findings. We report these finding here in great detail since insurers are now making identical claims of dire consequences if TRIA is not renewed.[19]

1. No General Terrorism Insurance Crisis Existed in 2002.

CFA found that a broad-based terrorism insurance crisis did not exist as of August 2002. There were reports of problems in some areas of the nation (New York City and Chicago were mentioned as problem spots by some reinsurers) but most of the nation had not had significant difficulty finding coverage. Moreover, the price had dropped for stand-alone terrorism insurance, although it was still expensive.

Below is a sampling of contemporaneous news stories that demonstrate that coverage was often available and prices were coming down:

> Terrorism coverage, which was unobtainable immediately after the September attacks, is becoming more widely available and in larger amounts. Premiums are falling as more insurers enter the market. So what of the dire predictions?
>
> New York Times, February 27, 2002

[18] "How the Lack of Federal Back Up for Terrorism Insurance Has Affected Insurers and Consumers: An Analysis of Market Conditions and Policy Implications," Consumer Federation of America, January 23, 2002.
[19] "How the Lack of Federal Back Up for Terrorism Insurance Has Affected Insurers and Consumers: An Update," Consumer Federation of America, August 22, 2002

A growing number of insurers are beginning to offer terrorism insurance to U.S. businesses, a development that has begun to lower the cost of such coverage while at the same time casting doubts on the need for a government-sponsored terrorism-insurance solution…

Wall Street Journal, April 15, 2002

Terrorism insurance isn't only available, the price of it has fallen in the last six months, according to an executive with American International Group's new Lloyd's syndicate.

BestWire, April 16, 2002

Last fall, insurers were offering dire predictions that unless Congress stepped in quickly, the construction industry would all but come to a halt because builders and owners wouldn't have insurance against terrorist attacks. For thousands of companies, protection against terrorism was going to expire on January 1, and the industry wasn't rushing to renew. Well, it's May. The sky hasn't fallen.

Chicago Tribune, May 1, 2002

In the seven months following Sept. 11, the market has stabilized, more capacity has become available, and prices have dropped, sources agree. "The market has settled down and is obviously more comfortable with the type of risk that it's seeing, the cover that's being offered, and the pricing," said Simon Low, divisional underwriter for the war and political risk department at Wellington Underwriting, a Lloyd's managing agency.

National Underwriter, May 6, 2002

The world's largest commercial lines insurer, AIG, asked the federal government not to offer airlines war and terrorism insurance any more since, as the CEO Mr. Greenburg put it, "We, as taxpayers, don't want to compete with our own government for business that the commercial sector can underwrite."

New York Times, February 26, 2002

Hard markets are extremely rare. But the moment that terrorism brought down the World Trade Center towers, it was obvious that insurance prices would jump. Capitalists react at such moments…At first, after Sept. 11, it looked as if both primary insurers and their reinsurers would, to the extent possible, flee from covering any losses terrorism might cause in the future. But that hasn't happened. Said Donald Kramer, a vice chairman of ACE, in late April: "Is terrorism insurable? Everybody's said no. Yet everybody's coming out with terrorism products." …It's uncommon for insurers to spell out the details of their terrorism coverage. But in the 2001 Berkshire Hathaway annual report, Warren Buffett gave some facts about four contracts exposing Berkshire to terrorism risks. One new property catastrophe policy that Berkshire has taken on, for example, leaves it providing "significant coverage" on Chicago's Sears Tower once losses there pass a threshold of $500 million. In another instance of terrorism tolerance, Bermuda's RenaissanceRe, a master at using sophisticated simulation models to write natural-disaster catastrophe reinsurance, has put the models to use in filling, at prices that have soared, today's demand for workers' comp catastrophe reinsurance. When they can get terrorism out of their minds, P&C insurers are loving the market they're in right now.

Fortune, June 10, 2002

Discussing the state of reinsurance markets at the annual conference of the Inland Marine Underwriters Assn. earlier this month in Oak Brook, Ill., Vincent D. Liotta, managing director at Guy Carpenter & Co. Inc., said prices are "dramatically dropping" for

terrorism reinsurance. Mr. Liotta, who is head of the marine and aviation department at the New York-based reinsurance brokerage, said capacity is readily available for terrorism reinsurance, with coverage available on an excess-of-loss and pro rata basis, as well as on an annual aggregate-of-liability basis. The principal markets for terrorism reinsurance are Bermuda and London, Mr. Liotta said, and available coverage includes reinsurance for biological and chemical attacks.

Business Insurance, June 17, 2002

2. The Capacity to Write Insurance in the Wake of the Terrorist Attacks Had Increased.

One of the concerns expressed when the terrorist attacks occurred was that the drain on capital in the insurance industry might adversely impact insurers.

CFA found that the insurance industry continued to be overcapitalized. Year-end 2001 data indicates that Net Premium Written in 2001 was $324.0 billion and Surplus at year-end was $289.6 billion.[20] This is an ultra-safe premium to surplus ratio of 1.1 to 1.[21] We predicted that: "This continues to be a rich industry which, given the massive cyclical price jump they have enjoyed since late 2000, will be getting even richer."

The below excerpts from various news articles from that time period illustrate this positive trend:

Bermuda is once again the hub of renewed insurance activity as a second wave of new insurers and reinsurers landed on its shores following the Sept. 11 terrorism, according to the cover story, "Bermuda Bound," in the March issue of Best's Review. Within weeks of Sept. 11, March & McLennan formed Axis Specialty, through its private equity subsidiary MMC Capital, and Bermuda-based RenaissanceRe Holdings Ltd. started DaVinci Reinsurance to address the industry's capacity shortage. In all, nine new insurers have moved into Bermuda since the terrorist attacks. The other seven are Allied World Assurance, Endurance Specialty Insurance, Arch Reinsurance, Montpelier Reinsurance, Goshawk Reinsurance, Olympus Reinsurance and Queens Island Reinsurance.

Best Wire, March 1, 2002

"My observation would be that, in seven months post 9/11 the insurance market has done pretty well" with regards to providing capacity, said Stephen Ashwell, war, terrorism and political violence underwriter at Syndicate 33, which is managed by Hiscox plc, a Lloyd's managing agency. For a fairly innocuous risk, a buyer could get between $500 million and $1 billion of standalone terrorism coverage placed in the global insurance marketplace, he said, although he emphasized there are clearly aggregation issues. "The worldwide capacity probably now is approaching $1 billion [for one risk]," said Tom Bartleet, executive director in global property-casualty for Willis Ltd. in London. "It's theoretically possible," to put together a program with $1 billion of coverage, although the ability to do so "relies on the industry, the location, the accumulations around it and the price you're prepared to pay." In the seven months following Sept. 11, the market has stabilized, more capacity has become available, and prices have dropped, sources agree.

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[20] Industry Financial Results, Insurance Services Office, June 28, 2002.

[21] The proper target leverage ratio is 2 to 1, according to the National Association of Insurance Commissioners (NAIC.) A 3 to 1 ratio is considered to be a sign of instability for an insurer.

> "The market has settled down and is obviously more comfortable with the type of risk that it's seeing, the cover that's being offered, and the pricing," said Simon Low, divisional underwriter for the war and political risk department at Wellington Underwriting, a Lloyd's managing agency.
>
> National Underwriter, May 6, 2002

> Chances for passage of a federal terrorism reinsurance program are hard to judge, but failure to pass it would not have an adverse effect on his brokerage firm, the head of Marsh [Marsh and McLennan, the world's largest insurance broker] said today during an insurance conference in New York…he said failure to pass such a plan would not have great implication for his company. Terrorism coverage is available on a limited basis. Mr. Sinnott said the firm can write coverage of up to $300-to-$400 million. But for clients who are considered targets of terrorism, such as high-rise buildings, it can "price itself out of most client's view," Mr. Sinnott observed.
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> National Underwriter, June 5, 2002

> Fortunately for buyers, the immediate post-Sept. 11 situation for terrorism coverage appears to be easing somewhat as new players enter the field.
>
> Business Insurance, July 8, 2002

> Terrorism coverage, a huge concern for ceding insurers since its exclusion from most contracts last year, is now reappearing in limited forms, but with continuing exclusion of nuclear, chemical and biological terror risks, reinsurers and brokers say. On the plus side, the post-Sept. 11 chaos that characterized the Jan. 1 renewal market has ended and renewals are being completed smoothly. In most cases, capacity is available to complete programs where reinsurers are satisfied with pricing, observers report.
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> Business Insurance, July 8, 2002

3. Terrorism Coverage Was Available in Most Cases. Even Hard to Place Policies Were Being Written.

The key problem CFA found at the time was limited to very large properties (in excess of the available $500 million to $1 billion stand alone coverage), particularly in very large cities (New York, Washington and Chicago). This problem seemed to be restricted to the areas with the heaviest concentration of risk and therefore the most reluctance by underwriters to fully cover all risks that applied.

But even very hard-to-place risks were finding coverage, as these contemporaneous articles indicated:

> Construction contractors for years have turned to the surplus lines market for liability coverage…. Now, even very large commercial construction project accounts are seeking coverage through wholesalers, noted Swett and Crawford's Mr. Hartoch. "We are doing some huge ones," he said.
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> Business Insurance, August 19, 2002

> The ground zero cleanup and construction project at the World Trade Center site is covered in a "wrap up" policy issued by Liberty Mutual.
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> BestWire, January 24, 2002

Captive insurance companies are forming to cover terrorism, for instance for construction trades.

National Underwriter, January 31, 2002

U.S. airlines are planning to set up their own insurance company as a way of covering their big-ticket liability exposures in the wake of Sept. 11, sources said Monday.

Reuters, February 11, 2002

Simon Property Group, Inc. announced today that it has purchased two stand-alone policies of terrorism insurance, each with $100,000,000 aggregate limits. The first policy will insure Mall of America in Bloomington, Minnesota against damage incurred from acts of terrorism. The second policy will insure the remainder of Simon's shopping center portfolio against similar perils. The policies were purchased from Lexington Insurance Company, a subsidiary of American International Group…"We are pleased that we were able to successfully negotiate an acceptable premium for terrorism insurance with Lexington Insurance Company," said David Simon, the company's chief executive officer.

First Call Newswire, March 27, 2002

"Even with insurance expenses increasing on average 30%, it still, in most cases, represents only about 1% to 3% of a property's expenses. This addition to overall expenses, by itself, will not in most cases make a dramatic difference in debt-service coverage," said Roy Chun, a managing director in Standard & Poor's surveillance group. "Standard & Poor's has not yet had to downgrade a transaction due to rising property and casualty insurance premiums," he said. "Rated REITs have also reported material increases in property and casualty insurance costs," added Lisa Sarajian, managing director of Standard & Poor's REIT group. "But these costs have risen during a time when other operating costs have fallen, which has helped to cushion the impact," said Ms. Sarajian. Thus, there has not yet been any significant impact to the operating cash flow of REITs due to rising insurance premiums.

National Underwriter, May 16, 2002

Even in New York, the picture has improved sharply from the immediate aftermath of Sept. 11, when insurers simply refused to provide coverage for terrorist attacks. "It is available, for the most part, at a price," said Walter L. Harris, the president of Tanenbaum-Harber, a brokerage firm providing coverage for big New York City buildings."

New York Times, June 11, 2002

Fitch Ratings has affirmed and removed from Rating Watch Negative GS Mortgage Securities Corp II, series 2001-LIB, classes A-1 ($58.4 million) and A-2 ($186.9 million) and X (interest only), rated 'AAA'. Fitch also affirms and removes from Rating Watch Negative the class B certificates ($50.8 million), rated 'A'. The four classes were placed on Rating Watch Negative on June 3, 2002 in connection with 12 other CMBS deals. Fitch has been in contact with ORIX Real Estate Capital Markets, LLC, the master and special servicer of this transaction, and the sponsor of the loan, Brookfield Properties, with regard to the terrorism insurance policies specific to One Liberty Plaza and other properties covered under Brookfield's terrorism insurance policies…After this review, Fitch believes the current insurance policies provide sufficient coverage for these certificates.

Businesswire, June 12, 2002

> Fitch Ratings has affirmed and removed from Rating Watch Negative 1345 Avenue of the Americas Trust, classes A-1 ($40.8 million), A-2 ($233.3 million), and X (interest only), all currently rated 'AAA'…The three classes were placed on Rating Watch Negative alert on June 3, 2002 in connection with 12 other CMBS deals. Fitch has been in contact with Wells Fargo Bank, N.A., the master and special servicer for this transaction, with regard to the terrorism insurance policies specific to 1345 Avenue of the Americas and other properties covered under the borrower's terrorism insurance policies…After this review, Fitch believes the current insurance policies provide sufficient coverage for these certificates.
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> Businesswire, June 13, 2002

E. Claims that Ending TRIA or Cutting it Back Sharply to Protect Taxpayers Will Result in Economic Chaos Are Not Justified

If the terrorism reinsurance "gap" in 2002 taught us anything, it was that the nation quickly adjusted to the terrorism insurance shortage and the private market found ways to provide most of the needed coverage. In 2002, the insurance industry was in the early stages of steep price increases and general insurance shortages, which are typical of the hard market phase of the insurance cycle that had begun in early 2001 and was exacerbated by the September 11th attacks. In 2005, the industry is in a much better financial position. It has record reserves, as well as extremely high levels of profits and retained earnings. If this industry could adjust to a lack of terrorism reinsurance in 2002, it certainly can do so in 2006. If terrorism insurance premium charges increase in the wake of TRIA's expiration or limitation, policyholders are in a good position to handle these increases because overall insurance rates are generally falling as the market enters its "soft' phase.

V. Recommendations to Congress

A. The Best Short-Term Solution: Allow TRIA to Expire

Based on the findings of recent studies by CBO and the Department of the Treasury, improvements in terrorism risk modeling, low terrorism rates in much of the country, as well as strong industry profitability and financial soundness and the growing capacity of insurers to offer terrorism coverage, CFA finds no compelling reason to extend TRIA beyond the end of 2005. In fact, as stated above, insurers and large commercial policyholders are in a very good financial position right now to deal with the expiration of TRIA.

B. The Next Best Short-Term Solution: The Treasury Department's Recommendations

If TRIA is extended, it should be dramatically scaled back along the lines recommended by the Department of the Treasury:

- **Increase the retentions that insurers must pay for losses**. The industry is flush with profits and higher retained earnings. CFA believes that any new TRIA that extends beyond December 31, 2005 should be based upon the Treasury Department's minimum of a $500 million event trigger, but should also include an industry retention of at least $75 billion pre-tax (which translates to $50 billion post-tax). This would guarantee that,

even in the worst case of terrorism, the industry would be in at least as strong a position as they were just before the attacks of September 11th.

- **Ensure that taxpayers pay no costs for backing up terrorism losses**. Overall, commercial insurance rates are dropping fast. There could be no better time to allow private alternatives to develop. The Treasury Department should require that insurers pay premiums for the coverage that taxpayers are providing that are actuarially sound, if a not a little higher. Requiring insurers to pay rates that are slightly higher than estimated will, as CBO noted, encourage private insurance mechanisms to quickly compete by offering lower rates and will encourage mitigation efforts.[22] This process would not necessitate the development of a large government bureaucracy. A handful of staff handled premium payments by insurers under the Riot Reinsurance Act.

- **Remove TRIA back up for commercial auto, general liability and other minor lines of insurance**. It makes perfect sense to limit the TRIA backstop to important lines of insurance that the industry might have trouble covering, as the Department of Treasury proposed.

- **Make it clear that this extension is a one-time, temporary extension that will not be renewed absent remarkable events.** The industry and large commercial policyholders must be told clearly that taxpayer assistance completely ends on a date certain.

- **Do not get into a tort reform fight as part of this debate**. The proposal by the Department of the Treasury to eliminate coverage for general liability lines is at odds with Treasury Secretary Snow's accompanying letter to Congress recommending that tort reform be a part of the TRIA extension process. Liability only amounts to 10 percent of the terrorism risk according to the ISO model and will be almost completely eliminated from federal coverage if the lines of insurance recommended by the Treasury Department are not covered by TRIA. Secretary Snow's proposal is not only harmful to consumers, it is unnecessary. The proposal also adds an extremely divisive element to the debate about renewing TRIA that could endanger renewal of the program in any form.

- **Increase the share of losses that insurers must pay above the deductible amount** from 10 percent to 15 percent, increasing by 5 percent a year.

- **Provide taxpayer back-up only for truly exceptional terrorist events**, such as attacks with weapons of mass destruction.

- **Do not add group life coverage to TRIA.** The Treasury Department's report proposes to reduce the number of lines of insurance that are covered by TRIA by excluding coverage for auto insurance losses and commercial general liability coverage. Group life

[22] When the author of this report, an actuary, was Federal Insurance Administrator under Presidents Ford and Carter, he had the job of calculating actuarially sound rates for the Riot Reinsurance Program. This program was very similar to TRIA, covering violent man-made attacks on property. These riot reinsurance rates were determined by only one employee, in consultation with the insurance industry and actuarial organizations. It is feasible to make actuarial rates for terrorism insurance, starting with extant models (such as the Insurance Services Office model used by most insurers) and building on that effort. This effort would not require a large bureaucracy.

insurers, meanwhile, are actually proposing an expansion. There is no meaningful evidence that justifies expanding TRIA to cover group life insurance. The Treasury Department has already rejected the request to expand the current TRIA to include group life. Than was the right decision. Even the National Association of Insurance Commissioners, a group well known to be very industry-friendly and particularly concerned about solvency and any possibility of undue risk, has refused to allow group life exclusions. It is likely that a major reason that both the Treasury Department and NAIC have rejected the appeals of life insurers for relief is that these insurers have not attempted all meaningful measures to spread their risk privately. CFA has not received a single complaint from a consumer or business indicating that there is a problem in the life insurance market. Since there are no exclusions allowed by the NAIC, we would likely be hearing about rising costs if they were rising, but we are hearing no complaints at all. To test this hypothesis, CFA did research using the NAIC complaint database.[23] The top ten group life insurance writers had 294 complaints under "group life" in 2001 and 361 in 2003. The increase in complaints (67) was virtually all related to Metropolitan Life Insurance Company, which had a growth in complaints of 65. Looking in detail at Metropolitan's complaints, we found zero complaints related to "terrorism" in either 2001 or 2003.[24]

- **Beware of insurer attempts to use TRIA renewal as a pretext to deregulate insurance.** Insurers appear to be opportunistically seeking to cripple key aspects of insurance oversight under the guise of creating a uniform, national market for terrorism insurance. There is simply no connection between TRIA renewal and regulatory issues. There is no evidence that over-regulation has in any way hampered the ability of insurers to innovate and come up with viable private alternatives to TRIA. Indeed, some insurers are creating terrorism insurance alternatives today, such as stand-alone policies and automatic coverage in some instances. Several insurers are prepared to offer stand-alone terrorism coverage should TRIA expire. Given the soft market, market sources say that some insurers stand ready to "give away" terrorism coverage to attract business.[25] Insurers are poorly regulated in most states regarding necessary consumer protections. Congress should not interfere with state insurance regulation unless a balanced, thorough study of such action is undertaken separate and apart from TRIA issues.

- **Spur non-governmental alternatives to TRIA**. Private markets can handle most, if not all, of the terrorism risk. Stand-alone policies are ready to be used should TRIA expire. Except in the largest cities, terrorism coverage should be available at little or no increase in price should TRIA expire. As we indicate above, even a five-fold increase in terrorism insurance premiums would not result in an overall increase for large and medium sized businesses as their insurance premiums are sharply dropping due to the soft market conditions caused by excessive capital in the property/casualty insurance business. TRIA itself has hampered the development of private alternatives such as normal reinsurance and securitization alternatives, such as catastrophe bonds. Expiry of TRIA will very likely result in the development of such mechanisms to cover terrorism risk.

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[23] The database can be accessed from the NAIC web page, www.naic.org at the Consumer Information Source (CIS).

[24] "Terrorism" is itemized as a complaint area in the NAIC complaint database.

[25] Liability and Insurance Week, March 21, 2005, page 2.

Creating private pools of like risks, similar to the pooling done in several other countries, is another method for covering terrorism risk that requires no federal role. There has been no need to create such private pools given the availability of free, taxpayer-subsidized TRIA reinsurance. TRIA also does not cover terrorist attacks involving most weapons of mass destruction (WMD), including attacks using biological, chemical or nuclear methods. This is one area where a federal role might be needed to create such coverage in the future. If a federal backstop for WMD is created, it should require actuarial rates for the reinsurance so that taxpayers are not subsidizing insurers that don't need the help. Finally, the federal government could assist in the development of private alternatives by allowing catastrophe reserves to build up tax-free on funds earmarked for the sole purpose of paying terrorism losses and nothing else, (perhaps by placing such funds into fiduciary accounts not available except for the purpose of funding payments after terrorism losses are incurred).

C. Longer Term Solutions

We understand that this Subcommittee is considering a longer-term solution to the terrorism insurance problem -- perhaps modeled after the risk pool that Florida has established to cover losses due to windstorm damage.

CFA believes that such a longer-term solution would be exceedingly complex. It is unlikely that Congress could reach a consensus on such a solution by January 1, 2005. Further, we are concerned that such a solution would significantly increase the risk of a permanent federal presence in the terrorism insurance market and, thus, unnecessarily increases taxpayer exposure. We are also concerned that such a solution would raise many complex federal/state issues that deserve a separate discussion, perhaps in the context of this committee's discussion about "SMART" legislation.

1. How Florida's Extremely Complex Risk Pool Works

The Florida risk pool, known as Citizens Property Insurance Association, was created by the Florida legislature to provide windstorm coverage in high-risk areas of Florida. It sells personal lines of insurance directly to consumers (outside the designated high-risk areas), commercial lines of insurance directly to consumers (outside the designated high-risk areas) and high-risk coverage directly to consumers (within the designated high-risk areas). The Association and participating insurers may, by law, enter into a quota share reinsurance arrangement for wind coverage only, which means that the Association and insurers share each risk on a percentage basis as determined in the reinsurance contract. The percentage share must be in the range of 50 percent to 90 percent with the Association sharing the majority of each risk. Insurers can opt out of the reinsurance program. If they opt in, however, they pay a premium at the percentage of the quota share applied to the total written premium paid by the policyholder.

Insurers are required to pay an assessment for each account and can lower their assessments by covering higher risks voluntarily or covering risks currently receiving insurance from the pool. If deficits occur in the pool, insurers are assessed. This assessment is limited to 10 percent of the premiums written for these lines of insurance. If the deficit exceeds 10 percent, the Association then collects this amount over time from insurers and can obtain loans to cover the deficits, by issuing bonds pledging the assessments as collateral.

Rates are required to be actuarially sound so as not to interfere with private sector competition with the corporation. The corporation is free from federal taxation, enabling it to accumulate reserves more quickly. Every aspect of the corporation is subject to regulation by the Florida Insurance Department, including policy forms, rates, the reinsurance arrangement, the plan of operation for the corporation and other matters. This highly complex review requires the services of attorneys, underwriters, actuaries and other experts.

2. Federal Pool Concept

We understand that the federal long-term proposal differs from Florida's pool in that it would authorize an industry reinsurance facility designed to provide a middle layer of coverage between what primary insurers supply and any federal reinsurance offered above and beyond that covered by the pool. Insurers that pay into the pool would build capital, tax-free, to be used as a buffer to cover terrorism losses below the level of federal reinsurance. It is unclear if this would be quota share reinsurance that the pool provides to the primary insurers, or excess of loss reinsurance. If it is excess of loss coverage, the rates for the reinsurance will have to be separately determined. We understand that the federal reinsurance over that covered by the pool would be excess of loss reinsurance above the retentions paid by primary insurers. This provision would be structured in a manner similar to TRIA, but at increased retention levels and with an "event trigger" similar to that proposed by the Department of the Treasury of around $500 million. We further understand that the coverage would be limited to commercial businesses but would include all property/casualty lines, as well as group life.

Insurers would be required to pay premiums for the reinsurance coverage. Insurers could opt not to take federal reinsurance. Provisions to prevent adverse selection are being considered, including charging reinsurance rates to each insurer based on the risk of the coverage the insurer is offering, and/or requiring all members of an insurance group of companies to either accept federal reinsurance or not. We understand that the Committee is looking for a reaction to this general idea in the absence of a specific, drafted plan.

3. Principals for Ensuring the Proper Implementation of a Risk Pool

CFA believes that a pool could be established by insurers with no federal involvement if TRIA expires. In fact, we think it is likely that, over time, at least some states with higher risks would do so via interstate compact, such as New York, Illinois, California, D.C. and Texas. The simplest solution would be for Congress to authorize this approach and step away. If Congress considers a long-term solution, such as a federally authorized risk pool with federal reinsurance, we offer several principles for your consideration.

a. Beware of insurer cherry picking against the pool. Several pool plans we have seen over the years would allow insurers to "cherry pick" against the pool, by sending the highest risk policyholders into the pool and keeping the lowest risks for the insurer's own accounts. This can be done if an insurer is allowed to send individual risks to the pool or it can be done if a group of insurance companies is allowed to place the high risks into one company that is part of the group and only reinsure that company (as opposed to all companies that are part of the group). An insurer group must, if it has any choice, be completely in or out of the pool.

Any legislation authorizing a pool must recognize that such an arrangement subjects the government to potential adverse selection as insurers with less catastrophe risk are less likely to voluntarily purchase coverage, while those with greater risk are more likely to purchase coverage. If legislation were to create a government reinsurance program, the program should encourage the inclusion of both low-risk and high-risk policyholders to promote greater risk spreading in a way that does not subject the government to adverse selection.

b. Beware of insurer attempts to deregulate insurance oversight as part of a pool proposal. A pool established by the federal government is a legally authorized cartel that requires regulatory oversight. When terrorism insurance was first being considered in 2001 and 2002, insurers proposed adopting the Illinois regulatory system for the national pool. This provoked a strong negative reaction from consumer organizations, which view Illinois as the worst system in the country because it has very few consumer protections. If Congress is seeking uniformity as part of this process, it should raise standards, not lower them, by picking a state such as California with high regulatory standards.

c. The reinsurance offered by the federal government should not cover lines with minor terrorism exposure. As Department of the Treasury proposed, the lines covered by any federal reinsurance plan should be scaled back from the current TRIA coverage. General liability and commercial auto and other such lines should not be part of the federal backstop plan in effect after December 31, 2005. Group life insurance should not be added, as study after study by the Treasury Department and the regulators has found that to be unnecessary.

d. Beware of attempts to override state and federal anti-trust laws. When Congress last considered such a pool, insurers sought an override of federal and state anti-trust laws. This is not needed and is dangerous if there is little or no regulation of the pool. After all, the association would be a cartel and, unless regulation is effective, there would be potential for price gouging by the pool.

e. Make sure insurers pay the federal government full actuarial rates. Taxpayers should no longer be required to subsidize the extremely flush insurance industry, especially in light of the size of current budget deficits. Insurers must be required to pay the full cost of any coverage they receive. Excess of loss reinsurance prices can be established, but such a process will take time.

f. The pool should be supervised by a board representing policyholders, not just insurers, regulators and the federal government. Different private and public interests must be represented on the board of directors of any pool that is established, so that all parties are adequately represented.

g. All records of the pool must be public. All records must be fully available for federal and state audit and, to the extent possible, available online to the public.

h. Assure that the cost of terrorism coverage charged by reinsured insurance companies to the consumer is actuarially based and correlated in price with the reinsurance offered by the government, especially if a quota share arrangement is adopted. This will ensure that policyholders are not overcharged.

i. The legislation must clearly define "terrorism" and exclude any coverage beyond that definition. The Secretary of the Treasury should determine if a specific event falls into the definition. Consideration should be given to including losses incurred through Weapons of Mass Destruction (nuclear, chemical and biological attacks) as part of the coverage for terrorism, as this is an area where the private sector will require help if coverage for these events is to be provided.

j. Promote or encourage coverage that is available to any property that meets reasonable standards of insurability. Federal security requirements should be met within reasonable time periods by insured risks and policed by inspection by reinsured insurers. A requirement to sell insurance to businesses meeting such standards should be imposed as part of any long-term federal reinsurance backstop plan.

k. State residual market mechanisms and other pooling mechanisms for insurance should be allowed to participate in the entity established by legislation to provide terrorism insurance, in such a way as to not create incentives for business to be placed in the residual market. To the extent that a risk meets the minimum-security requirements, it should be able to get terrorism coverage through some source, and a residual market if necessary.

l. Jurisdiction over claim settlement practices should remain with the states. There are many sorts of abusive claims practices that harm policyholders and consumers. These are defined by state unfair claim settlement practices acts in all states. States regulate to assure that claims are not unnecessarily delayed or denied. These important consumer protections must be maintained.

m. State and federal tax laws should be amended or overridden to avoid penalties on and encourage the accumulation of reserves for terrorism losses.

n. Encourage loss reduction and hazard mitigation efforts through enhanced security.

VI. Conclusion

Unlike the period when TRIA was adopted by Congress and signed by the President, the property/casualty insurance industry is earning record profits and has set aside record retained earnings (surplus) in their accounts. The industry is overcapitalized at near historic low leverage ratios. As a result, competition to offer insurance coverage is intense and is sharply driving down current premiums for policyholders. Large and medium sized commercial risks are seeing premiums drop by double digits in 2005. Smaller commercial risks are witnessing a five percent drop.

Now is the perfect time to wean the affluent insurance industry and its largest policyholders from the current free reinsurance provided to them by taxpayers who face mounting federal deficits. The recent CBO and Treasury Department reports make clear that there is no need to extend TRIA in anything like its current form. CFA agrees.

In the wake of these reports the property/casualty industry and some of the insurance industry's largest and most affluent policyholders have warned of disastrous consequences to the economy should TRIA expire or be sharply cut back. We find these predictions of impending

doom to be easily disproven by events during the year following the terrorist attacks of September 11th, when there was no TRIA in place. In fact, insurers warned of exactly the same repercussions if TRIA was not enacted before January 1, 2002. These did not materialize when the insurance industry faced declining surpluses and skyrocketing premium charges to the policyholders. If it did not happen in 2002, it will not happen in 2006, when the industry is in a far stronger financial position.

CFA believes that TRIA should simply expire (this is our first choice). But if TRIA is extended, CFA largely supports the Department of the Treasury's recommendations to significantly pare back the program. This would include the elimination from the program of lines of insurance such as general liability and commercial auto with small terrorism risk. Group life insurance should definitely not be added to TRIA since life insurers have not provided meaningful evidence that it is necessary. CFA also agrees with the Treasury Department's recommendation that the "trigger" for reinsurance coverage should be raised to $500 million in losses and that the retention (deductible) should be raised (we believe the deductible should be raised to $75 billion [$50 billion after tax considerations]). Co-payments should also rise, by five percent per year.

Beyond the Treasury Department recommendations, CFA recommends charging a premium for whatever coverage is available to insurers. CBO appears to favor such a premium charge. Even insurers have agreed that there is no legitimate argument against such a charge. Developing and administering a premium payment system is very easy and would require only a handful of staff.

Any extension of TRIA must be clearly temporary and enacted only for the purpose of giving the private sector a short time to prepare to handle all terrorism coverage itself.

CFA does not support Secretary Snow's call for tort reforms to be enacted in conjunction with TRIA, which would likely harm consumers with legitimate claims. Such changes are also not justified given the small size of projected liability losses from terrorism, which will all but disappear if general liability and auto is removed from TRIA coverage, as the Department has recommended.

By ending TRIA or sharply cutting it back and charging actuarially sound premiums for the coverage provided, Congress will enable the private sector to grow and manage this coverage. The charging of accurate, risk-related prices will also enhance mitigation efforts as policyholders seek ways to achieve discounts from insurers.

The third and least effective choice is the establishment of a longer-term terrorism risk pool backed by the federal government. Such a pool could be set up by insurers with no federal involvement if TRIA expires (and we think it is likely that, over time, at least the key risk states, such as New York, Illinois, California, D.C. and Texas would do so via interstate compact.) So a simple solution would be for Congress to authorize that approach and step away.

It is unlikely that Congress can put together a complex risk-pooling bill by January 1, 2006, much less institute such a program. Further, we are concerned that it significantly increases the risk of a permanent federal presence in the terrorism insurance market and, thus,

unnecessarily increases taxpayer exposure. We also worry that it may raise many complex federal/state issues that deserve a separate discussion.

If Congress attempts to create such a pool, there are many requirements that must be included, such as blocking insurer cherry picking, creating federal regulation to replace any preempted regulatory requirements, and assuring full actuarial rates are part of the plan.