Testimony of the
New York State Insurance Department

Before the
Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises
United States House of Representatives

Regarding:
Extension of a Terrorism Risk Insurance Program

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Introduction

Chairman Kanjorski, Ranking Member Bacchus, Members of the Committee, thank you for inviting me to testify today before this Committee. My name is Eric Dinallo. I am the acting Superintendent of Insurance for the state of New York. I'm here today to provide our views on the role of the federal government in a terrorism risk insurance program.

The question before us is what is the best way to deal with insurance protection from the threat of terrorist attack and specifically what role should the federal government play. I would like to make a couple of general points and then some specific recommendations about the proposed legislation.

Sadly, the threat of terrorist attack remains very real and there is no reason to believe that it will end any time soon. In dealing with the appropriate response to this threat, we must always remember that these are attacks aimed at our country as a whole. New York City and Washington were chosen as targets on 9/11 in order to have the maximum impact on the U.S. as a whole. New York City was chosen because it is the financial capital of the U.S. and the world. The terrorists hoped that by striking at the World Trade Center, they could with one blow disrupt the entire American economy.

It turned out that they could bring those two buildings down. But they did not destroy our economy or New York City or our financial markets. There is every reason to believe that New York continues to be a target for the same reason – hitting New York is a way to affect the whole country. That is the same reason that other major cities and ports remain prime targets.

My point is that terrorism insurance is an essential issue for New York. But it is not only a New York issue. This threat is not limited to our urban or economic centers and is not just a “big city” issue. Any attack, regardless of its location, is an attack on America. An attack on Wall Street, or the Port of San Francisco, or oil refineries in the gulf coast, or the Mall of America will not just have a local or regional impact, but will reverberate throughout the nation with significant ramifications on our national economy. As we increase security levels at locations that are obvious targets, there is the risk that terrorists will seek out softer targets in our suburban and rural areas. In other words, the terrorists’ choice of location to attack is simply a function of means and opportunity and our entire nation is at risk. Any response to this risk must also be national in scope.

The nation appropriately understood the attack on the World Trade Center was an attack on all of us and appropriately responded by spreading the costs of that attack on all Americans.

That brings us naturally to insurance. The role of insurance is to allow us to share or pool risk. We all buy home insurance so that if one of us has a fire, the loss does not wipe that one family out. The insurance industry has developed very sophisticated models to determine the risk for any given type of loss so that they can charge appropriately to provide a given type of coverage.

The problem with terrorism is that it is by its intention unpredictable. Insurers set prices or premiums by looking at past experience to predict future size and frequency of losses. But they lack such information about terrorist attacks. Some information is for very good reasons kept secret by government agencies.

We have been fortunate in that our experience with terrorism is limited, but the paucity of data on terrorism, as well as the potential magnitude of loss in the hundreds of billions of dollars, hinders the insurance industry’s ability to appropriately price and provide such coverage. But even if you could build a database of all past terrorist attacks, there is no reason to believe that such past information would be of significant help to accurately predict future attacks and their frequency. The goal of terrorists is to find new ways to attack that will cause the most possible damage and disruption

Let’s look at what that means concretely. One way to look at pricing for risks is by using a curve to represent all the possible losses. The bottom or horizontal line represents different possible losses – the farther out the line to the right, the larger the loss. The vertical line represents likelihood of each amount. Lower losses are relatively likelier because terrorist acts are rare. The curve lets you determine the mean or average loss and the industry will use that to set its premiums.

The problem is that terrorism adds a very long tail to the curve. Terrorism adds a small number of possible losses that are very, very large. For example, in March 2006 the American Academy of Actuaries provided a statement estimating that a large NBCR (nuclear, biological, chemical or radiological) event in downtown Manhattan could cause insured losses (property/casualty and group life insurance) of $778 billion dollars. Obviously, even a small number of huge possible losses of that size will substantially increase the mean, pushing premiums to unaffordable levels.

What the federal backstop does is eliminate the very, very large losses and thus cuts off the tail. That substantially reduces the mean and thus reduces premiums that insurers must charge and makes them more affordable.

Let’s look at the alternative which some advocate, a pure market solution to terrorism insurance. What that would mean is that insurers would have to charge to cover the largest potential risks. Prices would have to rise substantially. Effectively, only those who absolutely had to buy terrorism insurance would do so. This is known as adverse selection. For example, when this happens in health insurance, only the very sick buy health insurance and the cost gets higher and higher for those who most need the coverage.

So, only businesses in New York City, Washington, Chicago, Houston and other large cities seen as targets would buy terrorism insurance. Thus, instead of the risk being shared or pooled, it would be concentrated. That would increase the cost of doing business in our largest cities and hurt their ability to compete with cities in other countries, especially those which do provide a government backstop for terrorism insurance.

That assumes that the private market would even be willing to offer terrorism insurance. Given the huge risks and the lack of information, many insurers would simply not offer coverage or price it so high that it would amount to the same thing.

People have a healthy skepticism about any kind of subsidy. Critics fear that the government’s assistance will encourage risky behavior. In other words, people will take risks they would not otherwise take because they don’t have to consider the true cost. Economic theory calls that moral hazard. In insurance, that is called morale hazard. It is to reduce morale hazard that, for example, people who smoke cigarettes pay more for life insurance and auto insurance policies have deductibles to discourage reckless driving by insured motorists.

But the people of New York didn’t make a bad decision by choosing to make our city the world financial capital. The fact that New York is the financial capital of the world is not a risk factor that can or should be mitigated. In fact, having the world financial capital in New York and not in another country is a very major asset for all Americans.

New Yorkers take rational steps to reduce the risk of terrorism. New York State and its business community spend billions of dollars to prevent future terrorism related risk, despite the presence of TRIA.

But there is no way to completely avoid the risk. It is not a realistic to spread the financial services industry throughout the country, so there is no one financial capital vulnerable to attack. There are still many strong benefits to concentration. That’s why the competition for New York comes from other financial centers, such as London, Tokyo and Hong Kong. And if New York is no longer the world financial capital, the alternative is not going to be another city in America, it’s likely to be one of those foreign cities that are already competing for that title.

I don’t believe in letting the insurance industry completely off the hook. Quite the opposite, it is essential that we continue to take measures to increase the private markets ability to take on as much terrorism risk as possible. The current legislation does give the industry a substantial role. That’s appropriate and we should continue to work to increase it. For example, I would like to see the reinsurance industry get involved. That’s more difficult because reinsurance is largely unregulated. I think it would be a mistake to hold up this legislation until we find a solution to that problem. But I am eager to work with others on solutions.

So now let me turn to the specific issues surrounding the proposed legislation. Given the vital role that the Terrorism Risk Insurance Act (TRIA) and the Terrorism Risk Insurance Extension Act (TRIEA) have played in ensuring the affordability and availability of terrorism insurance in the market, and by extension the overall US economy, we cannot and should not lower our economic preparedness by allowing TRIEA to expire without an appropriate federal backstop being in place on January 1, 2008.

The Economy Depends on Terrorism Insurance

Today, TRIEA is quickly approaching its expiration date. Our commitment to the need for a federal backstop as an essential underpinning of our national economy has not changed. My fellow State commissioners and I continue to believe the United States economy remains vulnerable to terrorist attack and requires insurance to help manage exposure to that very real, very unpredictable, and very volatile risk. If some federal backstop is not in place by January 1, 2008, we may revisit some of the same market disruptions and economic uncertainties we faced in the aftermath of September 11 - especially since the private market still does not have the means and the capacity to appropriately address this exposure and its magnitude. Without a federal backstop, property insurance, especially in our urban cities, will become unavailable or unaffordable. Trophy properties across the nation, including hospitals, stadiums, and government buildings, will be significantly impacted and real estate and construction projects could come to a standstill. The uncertainty surrounding the expiration of TRIEA also affects our competitive position internationally. Other nations with serious terrorism problems have permanent programs in place to ensure terrorism insurance is available. A long-term American solution to the terrorism exposure is long overdue.

TRIA and TRIEA have worked exactly as intended by making terrorism coverage available to those who need it. More businesses are insured for terrorism now than ever before, as evidenced by an increased take-up rate (that is, the rate at which companies have purchased terrorism insurance coverage) for terrorism coverage since the passage of TRIA. As mentioned in the President's Working Group on Financial Markets (PWG) report on terrorism insurance, the "take-up" rate has increased from 27 percent in 2003 to nearly 60 percent in 2005, while the cost for that coverage represents about 3 to 5 percent of the total cost of property coverage. Indeed, in areas of perceived high risk -- the commercial real estate, construction, and financing markets among others -- depend on the availability of terrorism insurance coverage that likely would not exist without a federal backstop.

Terrorism Insurance Depends on Private Market Partnership with the Federal Government

As I indicated before, insurance depends on an estimation of future loss costs which in turn depends on an understanding of frequency and severity for a particular event. While insurers, reinsurers, risk modelers and others have made strides in improving their tools for deriving this information, it is still impossible to accurately apply insurance principles to the risk of catastrophic terrorism. The notion of frequency, in particular, is very difficult to estimate because a terrorist attack is not a random event. The events of September 11, orchestrated by a mere 19 terrorists, illustrate the severity of terrorism events. It was the third costliest insurance event in modern times resulting in nearly $21 billion in losses.. When considering these events in the context of a nuclear, biological, chemical, or radiological (NBCR) event, the severity becomes even more troubling. The NAIC held a public hearing on terrorism insurance matters in March 2006 at which the

American Academy of Actuaries provided a statement estimating that a large NBCR event in downtown Manhattan could cause insured losses (property/casualty and group life insurance) of $778 billion dollars.

As Congress considers the ramifications of what a $778 billion dollar event would do to the insurance industry, it is important to have an understanding of the capacity of the market. As the PWG report also noted, the capacity of the market has increased since 2001. Insurance capacity is generally measured by determining the amount of capital available to insurers to support their policy writings. Using that measure, NAIC data shows that in 2005 aggregate capital for property and casualty insurers was $427 billion. It should be noted however, that that number is the total capacity for the market, for all property/casualty lines. Less than half of that capital is used to support the insuring of commercial enterprises, and the capacity of any one company is far less. Unknown frequency, coupled with the potential for severe losses, make it virtually impossible for insurers to provide coverage for acts of terrorism.

We believe the presence of the federal backstop has provided an appropriate mechanism for the insurance industry to make vital terrorism coverage widely available to American businesses. By requiring insurers through the “make available” mechanism to offer coverage for acts of terrorism they otherwise might not have offered, the federal backstop has been successful in bringing certainty to the insurance marketplace.

As was the case when the initial program was set to expire in 2005, insurance companies and insurance contracts are already affected by the possible expiration of the current program. Terrorism insurance coverage as insurers offer it today is typically contingent on a federal backstop, and insurers will again place limitations on commercial policies to exclude terrorism coverage if a federal backstop no longer exists. These limitations will greatly reduce terrorism coverage in the states that have approved them. In those states that have rejected these coverage limitations, insurers will have to make the difficult choice of writing the coverage and accepting the potentially catastrophic terrorism exposure or not writing it at all. This could lead to availability and affordability problems down the road.

Congress Should Continue A Terrorism Risk Insurance Program

TRIA and TRIEA are examples of a partnership between the private and public sectors to solve a problem that neither can handle alone. Given our economic dependence on terrorism insurance, and in the absence of a private market solution to make managing this risk practical, I urge immediate action by Congress on a federal measure to ensure continued marketplace stability when TRIEA expires at the end of 2007. Because some terrorism risks are largely uninsurable without a financial backstop, state regulators are very concerned that significant market disruptions will develop before the program's expiration, due in part to timing of the business cycle for insurance renewals.

The commercial insurance business cycle operates in such a way that insurers and their policyholders are required to make decisions now that extend well into 2008. These decisions must reflect the possibility that a federal backstop may cease to exist. For this reason, state insurance regulators have observed widespread insistence by insurers that conditional policy exclusions for terrorism coverage be included in renewal policies. This is the same situation we encountered in the aftermath of September 11, which prompted enactment of TRIA. While this particular dynamic is not present in the New York marketplace, the few states that have not allowed insurers to file coverage limitations fear that without a federal backstop, insurers will be unwilling to underwrite many businesses that want appropriate and reasonably priced terrorism insurance coverage. In my own state, New York, since conditional policy exclusions for terrorism are not permitted, as we draw closer to the December 31 sunsetting of TRIEA, some insurers may review individual underwriting decisions on annual policies that renew throughout 2007, since the possibility of termination of the federal backstop may result in unlimited exposure in 2008.

To address this situation Congress should act to ensure the existence of a federal backstop program. As the private market continues to improve its tools and resources to manage terrorism risk, there may be an opportunity for the private market to assume more risk. And let me be clear, I am not satisfied that private insurers are doing all they can or should do in this area. But even if they were doing everything they should, given the potential for such enormous losses, a federal backstop at the extreme catastrophic level would still be necessary. An individual terrorist attack on American soil may only directly or physically affect a finite area or group of people, but the American public and the federal government have made it clear that we will interpret and respond to any such attack as an attack on our nation as a whole. Knowing that this is and will continue to be the case, a federal role in partnering with the private market to insure acts of terror is an inevitable and therefore ongoing obligation.

The NAIC Continues to Work on Terrorism Insurance Solutions

Following enactment of the Terrorism Risk Insurance Act (TRIA), the National Association of Insurance Commissioners (NAIC) established a Terrorism Insurance Implementation Working Group, chaired by New York, that has worked closely with the Treasury Department and insurance companies to successfully implement TRIA's provisions, as well as to monitor the impact it has had on the insurance marketplace. The Working Group continued that involvement in 2005 when the program was set to expire and supported its extension through the Terrorism Risk Insurance Extension Act (TRIEA).

My fellow commissioners and I, once again, stand ready to assist Congress in developing an appropriate method for continuing a federal terrorism reinsurance backstop. The NAIC continues to discuss the challenges of terrorism insurance at its national meetings and in public hearings, and we are committed to maximizing the participation of the private market in this obligation. As Congress contemplates the expiration of the current program, there are a few issues and concepts that should be considered in addition to, or in conjunction with, a federal reinsurance backstop:

Length of Program

The duration of any successor program to TRIEA should be long enough to provide sustained stability that reflects the commercial insurance cycle as well as sufficient time and means for the private sector to build the appropriate capacity.

Domestic Terrorism

Any successor program to TRIEA should not make a distinction between domestic and foreign acts of terrorism. Both types should be covered. The effects of a terrorist act will be equally devastating regardless of whether such act was perpetrated by an American citizen or foreign national. I urge you to give this matter serious consideration in light of the fact that many perpetrators of the London train bombings last year were born and raised in the U.K and are British citizens.

Tax-Deferred Catastrophe Reserves

One concept that could potentially allow for more private market terrorism insurance capacity, and therefore a lessening of the government's role, is the development of tax-deferred catastrophe reserves. Currently, terrorism premiums collected by an insurer, in the absence of any terrorism losses, become part of the insurers profit and can be paid out in dividends. There are no current requirements for insurers to set aside such premiums in reserves and in fact, federal taxation rules provide insurers with no incentives to create such reserves. By establishing tax-deferred reserves that could be used only for catastrophic losses of a certain magnitude, companies could be encouraged or required to hold a portion of that money and let it grow over time. In essence, private insurers could create their own backstop funds that would be available for catastrophic events. Tax-deferred reserves would put more of the responsibility on policyholder dollars, which are correlated with risk, rather than taxpayer dollars, which are not correlated with risk.

Although challenges exist in how these reserves are structured and monitored, they are common throughout the world for various catastrophic policies.

Workers' Compensation and Group Life Insurance

There are two major types of insurance that cause insurers special concern about whether they can continue to underwrite them without some form of partnership with the federal government. Workers' Compensation and Group Life Insurance are vulnerable to geographically centralized events and this problem can not be addressed solely by the private market. Workers' compensation is a property-casualty product that provides coverage for work-related injuries, illness, and death. It covers lost wages, provides unlimited medical benefits and, in most states, provides rehabilitation benefits to get injured workers back on the job. In the event of death on the job, worker's compensation provides monetary death benefits to the surviving spouse and children. It also provides employers with liability coverage if an employee pursues legal action against an employer in court. Workers' compensation is currently included under the federal backstop.

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

[1] American Academy of Actuaries, P/C Extreme Events Committee May 4, 2004 Report, P/C Terrorism Coverage: Where Do We Go Post-Terrorism Risk Insurance Act?, Page 14.

Like workers' compensation, Group Life Insurance coverage is vulnerable to geographic risk concentration problems. For example, if a business has 1,000 employees at a given location, the pricing employed by life insurers for group products probably assumes that three or four employees might die in a given year. If instead, a location with 1,000 employees is hit by a terror attack and all of them die, the insurer has an enormous financial exposure from a single occurrence.

Unlike worker's compensation, there is no statutory requirement for group life that prohibits an insurer from limiting available coverage for acts of terrorism in some fashion. However, insurance regulators are not inclined to approve exclusionary or limiting language in those states that have approval authority over the wording in traditional group life insurance contracts. Further, employers are reluctant to purchase coverage that contains such exclusionary language and employees would not be able to rely on such coverage in their financial and estate planning. Although there is some level of private reinsurance available for group life coverage, it is not sufficient to cover catastrophic terrorism losses. Given the potential solvency threat that a major act of terrorism would present to group life insurers, the NAIC adopted a resolution in June 2005 urging Congress to include group life coverage in any federal backstop program.

Insuring Nuclear, Biological, Chemical, and Radiological (NBCR) Events

In Japan in 1995, domestic terrorists orchestrated a sarin nerve gas attack in the Tokyo subway system that killed twelve people, injured nearly one thousand, and caused massive disruptions to the city. This was the work of just ten men with only a few liters of sarin gas. Our country has thankfully avoided a massive NBCR terrorism event, but we would be naïve to assume that such an event is beyond the realm of possibility. Indeed, the Congress knows all too well the reality of chemical or biological attacks. Just weeks after the events of September 11, two Senate offices and several media outlets were contaminated by anthrax-laced letters that resulted in five fatalities and seventeen persons becoming ill. These events were relatively small in scale and complexity, and as noted previously in this testimony, a large-scale NBCR event in a densely-populated urban area like Manhattan could result in insured losses of $778 billion.

In September 2006, the Government Accountability Office (GAO) released a report concluding that the NBCR risk does not match the principles of insurability. There is little appetite in the private market to insure it even with the presence of a federal backstop, and even in a non-terrorism context. Private insurers currently structure their policies to exclude NBCR events, except where coverage is expressly required under state law, such as with workers' compensation coverage. However, the potential catastrophic nature of the NBCR risk poses a serious threat to policyholders and our national economy. I encourage you to consider inclusion of terrorist related NBCR losses in any backstop that becomes effective next year. Inclusion of the NBCR risk should be structured so as to leverage the private market's ability to issue policies and settle claims while recognizing the private market's difficulty in overcoming the challenge of insurability. The threshold of retention for NBCR risks should be much lower than for other risks but set at a level to ensure private market participation and responsibility.

Responsibility of Policyholders and Insurers

Some have argued that federal involvement in terrorism insurance has stymied the development of private market solutions and personal responsibility on the part of commercial policyholders. As my predecessor, Howard Mills, stated to this Committee in 2005, in New York State and indeed throughout the country we see little evidence to support this conclusion. To the contrary, the evidence demonstrates that owners have invested heavily in strengthening disaster preparedness and response efforts in the wake of the 9/11 terrorist attacks notwithstanding the existence of a federal backstop.

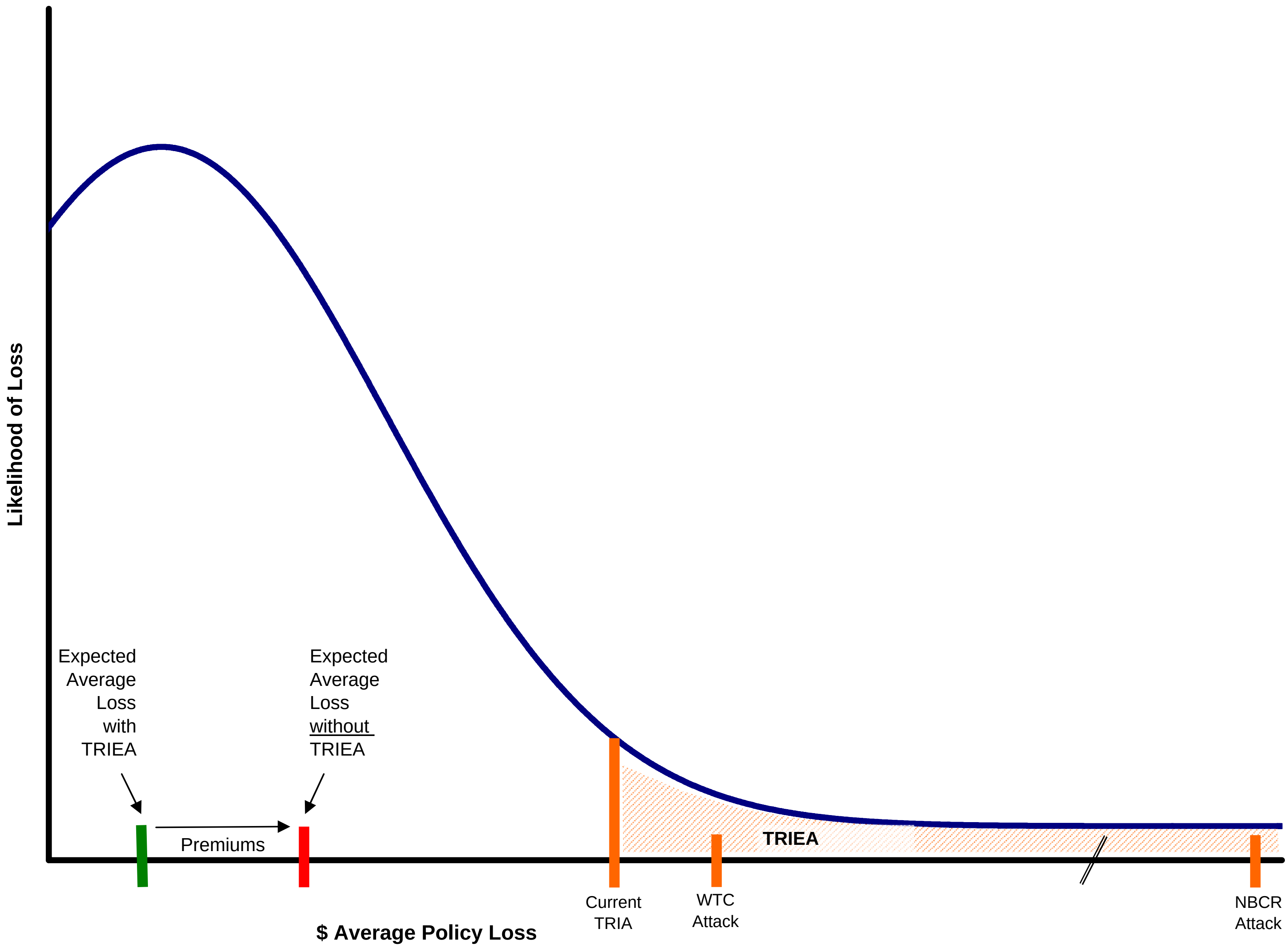
For example, since 9/11, most large commercial and many multi-family residential buildings in New York and elsewhere regularly subject entrants to security checks before permitting entry. Sensitive locations may even require visitors to submit to background checks prior to entry. Structural design has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

The country has taken steps to improve airport and aircraft security and to harden many of our commercial enterprises and government facilities, but we still remain vulnerable to another terrorist attack with a potential magnitude that dwarfs the insurance industry's capacity to respond. The steps taken to mitigate losses may also result in countermeasures by terrorist that could lead to attacks on buildings or infrastructure that we might not have previously considered targets. This inescapable reality demonstrates the need for a federal backstop to help in dealing with potential losses of this magnitude. Clearly, loss control must be a part of any long-term solution in the private sector to manage terrorism exposures, but such mitigation techniques do not address the issue of financing the catastrophic losses should they occur. No amount of mitigation can result in foolproof guarantees that losses will not occur. Terrorism coverage in today's world is an integral part of any business's risk management efforts. Without a federal backstop we could face market disruptions, and terrorism insurance will likely become less affordable or even unavailable to consumers.

Conclusion

I strongly urge Congressional action to ensure a sustained and stable marketplace for terrorism insurance by providing a federal backstop program. Such a program should cover foreign and domestic events, expand coverage to group life insurance, and provide a mechanism to leverage the private market strengths in covering NBCR risks. Terrorism insurance is crucial to the healthy functioning of the American economy, and in the absence of private market capacity, federal involvement is essential.

My Office stands ready to assist Congress in developing an appropriate federal terrorism insurance program. Thank you for inviting me to testify and for considering the views of state insurance regulators as you move forward on this crucial issue.


Likelihood of Loss
Expected Average Loss with TRIEA
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