PROTECTING POLICYHOLDERS FROM TERRORISM: PRIVATE SECTOR SOLUTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

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ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PROTECTING POLICYHOLDERS FROM TERRORISM: PRIVATE SECTOR SOLUTIONS

WEDNESDAY, OCTOBER 24, 2001,

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 1:35 p.m., in room HC-8, The Capitol, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Ney, Shays, Cox, Bachus, Royce, Lucas of Oklahoma, Shadegg, Weldon, Fossella, Biggert, Miller, Ose, Toomey, Hart, Rogers, Kanjorski, Bentsen, J. Maloney of Connecticut, Hooley, S. Jones of Ohio, Capuano, Sherman, Inslee, Crowley, Israel, and Ross.

Also Present: Representatives Oxley, Roukema, LaFalce, and C. Maloney of New York.

Chairman BAKER. I offer a small apology for the environment in which we find ourselves holding this hearing on this most important matter. We, of course, appreciate all of the courtesies extended by all of those interested in the matter, and we certainly will try to facilitate providing information from the hearing to all of the parties, for those who can't simply get in the room. Ranking Member Kanjorski and I have adopted a no-jacket requirement for the proceedings. Feel free to comply at your leisure. I suspect as the day wears on, that will become a better and better idea.

Of course the hearing today is an extraordinarily important one, and I am very anxious that we as a subcommittee come to some recommendation for resolution of a problem of potentially significant systemic events to our economy. There is no doubt that we must act, and we must act in a timely way. But we should also act as best we can in the most professional and responsible manner time will permit. It may be very difficult to reach a long-term permanent solution if the remaining tenure of this session is indeed a matter of days. If, however, we have the luxury of time, then I am confident working together with regulators, the industry, stakeholders, consumers and members, we can reach an accord which will make economic sense and sense to the American taxpayer.

To that end, I merely want to point out one historic event that I think is constructive in these times. Going back to the days of the Reconstruction Finance Corporation under the Roosevelt presidency pursuant to the Great Depression in which in the course of the activities of that organization some $50 billion worth of financial resources were made available to a plethora of business organizations. What I found interesting about it is the manner in which the Texas businessman administered that program at the direction of the President. Fifty billion dollars in the 1930s is an extraordinary program, and at the end of the day, Jessie Jones, the administrator of the program, recouped every cent of taxpayer dollars.

Now, I know that the discussion of repayment of credit extensions is a very contentious matter, but as I said to some insurance company executives, they have their shareholders, and we have ours. They simply want our shareholders to give up our resources with no expectation at the moment of having their shareholders repay this courtesy.

I for one feel that is a very appropriate thing for us to explore and to discuss and not simply because of the urgency of this matter take action that leaves taxpayers with unlimited, incalculable liabilities. However, there is no doubt that the events of this year are extraordinary. Very difficult to reconcile, and we hope never to occur again, but we simply cannot rely on those events not reoccurring, perhaps unfortunately even in the near term. So the subcommittee must act.

I would refer Members to the Jessie Jones story of the 1930s with the recognition that the elements of that resolution were the basis for the Lockheed assistance in 1971 and the Chrysler Corporation workout in 1979, both of which resulted in taxpayers' resources being repaid and in one case the Government actually taking an equity position in one of the deals and showing a small profit. I think those are very helpful for the subcommittee to consider in the course of this difficult matter.

With that, I would like to call on the Ranking Member Kanjorski for an opening statement.

Mr. KANJORSKI. Thank you, Mr. Chairman. Mr. Chairman, I have prepared a full statement, but not to bore everybody in the room, I am going to try and truncate.

I just want to state my position, and it is very simply this. As a result of the occurrence of September 11th, I believe we must temporarily reinsure the marketplace to safeguard against the cascading financial crisis. In recent weeks, several alternatives to solve the problems were merged from one plan to establish a Government backstop for reinsurance designed to spread the risk across the industry. Another approach using quotas would distribute reinsurance costs for between industry and Government, and other solutions include allowing companies to build taxpayers reserves, limiting liabilities from damages as we presently do for accidents to nuclear reactors and facilitating the issuance of catastrophic bonds.

From my perspective, any legislation to assist the insurance industry and our economy in the short term should adhere to four principles. First, to the extent possible, the primary insurers must continue to bear the tangible share of the risk for future attacks through the use of deductibles, premiums or assessments. Equity owners must also carry some share of the risk in order to encourage them to implement appropriate safeguards.

Second, we must sunset the program. The reinsurance industry is dynamic, and we should not disrupt the development of new products.

Third, in order to protect taxpayers, we should consider placing caps on the Government's liability and implementing adequate oversight.

And fourth, everyone from the real estate mogul to the average homeowner should participate in the program.

As I have said in our last hearing, we must move cautiously and methodically in addressing this problem in order to prevent unintended consequences. Given our forthcoming adjournment, however, we must also move swiftly. Instead of convening additional hearings on this problem, we should quickly assemble a bipartisan, bicameral group to negotiate the solution with experts and industry leaders. Time is of the essence, and I stand ready to work with you, Mr. Chairman, and all other interested parties on these matters in the upcoming days.

[The prepared statement of Hon. Paul Kanjorski can be found on page 71 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman, and I will make the full statement part of the record. Without objection.

Chairman BAKER. Absolutely.

Mr. OXLEY. Welcome, Mr. Secretary. This is, as you can tell from the other opening statements, a very serious issue we are all aware of. We need to address this. This will be, along with our money laundering bill we passed last night in the House, probably the most important issue we are going to have to face and we need to do it in a timely manner, and I salute the Chairman of the subcommittee and the Ranking Member for their leadership on this issue. We all have to pull in the same direction.

I think we will find some differences of opinion on the proposal that you will be outlining, along with the industry people, but the purpose of this hearing, as I discussed with Chairman Baker, is to get all of our cards on the table, all of the ideas on the table and then start to whittle away until we create something that we can all live with and that will work.

Clearly this is not just an insurance issue. This is an issue that will affect our entire economy. A concern all of us have, I think, is that we will get a domino effect on the inability of companies to get insurance, the inability of lenders to lend to those companies, and it would have enormous negative consequences, and I notice you commented on that in your statement. So we are all in this together, and we will work with you and all your folks on this issue, and I yield back.

Chairman BAKER. Thank you.

Ranking Member LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman. I ask too, unanimous consent to put my full statement in the record.

Chairman BAKER. Without objection.

Mr. LAFALCE. Let me give you a couple of thoughts. First of all, I have been through so many situations over the years where we have been cutoff the credit or at least the credit crunch due to severe problems, lenders liability under CERCLA, for example, the banks wouldn't lend to the business if there was the remotest possibility of environmental difficulty for which they could, because of a $5,000 loan be liable for a $5 million cleanup, and I am most fearful of the economic impact to the United States, the damages to the economy, if we have the cessation of terrorism insurance.

Do I think the problem is real? Unfortunately, I do. I do think it is real, and therefore I think we have to do something.

Now, what do we do? I wish we had the luxury of careful deliberation. We don't. If we had the luxury of careful deliberation, I think we should come up with some scheme. It might be something similar to the scheme that England has, with a Federal charter and a Federal regulatory supervisory role commensurate with the Federal risk. I think that is going to be difficult to implement. We don't have that much expertise within the Federal Government right now to implement that immediately, and that is one of the reasons I think that representatives from the insurance industry have come up with a single State charter, but the State charter could be with an administerial role for the State, but still, because of the Federal assumption of risk a strong Federal regulatory supervisory role. I think that is a possibility. It is not my preference, but it is something. But even then, I don't know if we have the time to do it or the present expertise in the Federal Government to do it.

The third alternative is some stopgap, and I think that is where the Administration is, based upon my conversations with both Sheila and Peter Fisher. That is not my preferred option, but it may be the only viable option now. If that is true, it is either easier to coalesce around one Administration approach than it is one approach after 535 individuals have come to consensus, so I am willing to do it. But not willy nilly either. You know, there has got to be some principles that we follow, and at least we have to make sure that we are going to provide insurance for all Americans and businesses who need it, including a full range of property and casualty coverage. For me—and I don't know if the Administration is there yet—I think that means business interruption insurance, too.

I want you to address the issue, because I don't think we are adequately covered if we don't have that.

Second, if the Federal Government is going to put its toe into the water, we have got to make sure we have got all the desirable regulatory safeguards to protect the American taxpayer. We can't, you know, put a toe in without being protected. OK?

We have to require the industry to share the burden of any system that is ultimately adopted, and I think perhaps requiring even more of a first dollar contribution than presently contemplated by the Administration, that is negotiable, and have the price structure that provides compensation to the Federal Government while offering affordable prices to the ultimate consumer and facilitate the return of the private reinsurance market as soon as is possible if it is ever going to be possible. I look forward to working with you and Sheila.

Chairman BAKER. Thank you, Mr. LaFalce.

I would ask if possible for all of the Members' statements be made a part of the record so we could hear from our first witness. Without objection, so ordered.

It is a pleasure to welcome you here, Mr. Secretary. Chairman Oxley wanted me to make it very clear, he is not responsible for the meeting arrangements. He would have treated you with greater deference, I am sure, had we the luxury of time.

Mr. OXLEY. Mr. Ney.

Mr. NEY. Hey, this is the way our country was formed. Get with it.

Chairman BAKER. I hope we are as successful. With no further delay, Mr. Secretary, we are honored to have you here today on this most important matter. Thank you, sir.

STATEMENT OF HON. PAUL H. O'NEILL, SECRETARY, U.S. DEPARTMENT OF THE TREASURY; ACCOMPANIED BY SHEILA BAIR, ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS

Secretary O'NEILL. It is a pleasure to be with you and all the subcommittee Members. And Chairman Oxley, if I may pick up on a point you made——

Unidentified SPEAKER. Can you speak up a little bit for those of us that are sitting on the end here? Thank you.

Secretary O'NEILL. Let me say again, thank you very much for the speedy and I think very valuable action on money laundering. We are determined to do what the President said and wage a successful war on terrorist finance, and money laundering is a part of that issue and drug running and all the other things that we have talked about for a long time. With the added authority you have given and with the President's Executive Order, we are going to make this happen. We are going to shake down these people and their finances and do everything we can to take them out of business and we have had great cooperation around the world, and thank you all for that.

Now, to the issue of today, I don't know—did all of you—whether you had a chance to look at the prepared statement or not? And Chairman, how would you like for me to proceed? I have a short oral—actually, it is about 10 or 12 minutes—oral statement. If you would like me to begin with that, or I can simply put it in the record and go to questions, whichever you would like.

Chairman BAKER. Proceed as you wish. Maybe outline the highlights of the plan, and I think this opportunity for Members to engage with you would be terrific.

Secretary O'NEILL. Great. As I said, I appreciate the opportunity to comment on terrorism risk insurance. We believe that there is a real and present need for Congress to act on this issue now. Market mechanisms to provide terrorism risk insurance coverage have broken down in the wake of September the 11th. Such coverage is now being dropped from property and casualty reinsurance contracts as they come up for renewal, for policies renewing at year-end. If Congress fails to act, reinsurers have signaled their intention to exclude such coverage, meaning that primary insurers may have to drop this coverage or institute dramatic price increases.

As a result, after January 1st the vast majority of businesses in this country are at risk for either losing their terrorism risk insurance coverage or paying steep premiums for dramatically curtailed coverage. If businesses cannot obtain terrorism risk insurance, they may be unable to obtain financing or financing may be available only at much higher cost. This would have widespread effect to businesses of all types, which may, for instance, be unable to expand their facilities or build new facilities.

Our view is the problem is that insurance companies do not take a risk, and it is a misunderstanding of the insurance process to believe that insurance companies take risk. What they do do is knowingly accept and mutualize risk, which is another way of saying they do analysis of the possibility and probability of an undesirable event happening and then they assemble all the people in the society that they can who have the same kind of risk and charge enough premium so that in the event there is an occurrence of an adverse risk, they have the wherewithal to pay off the cost that they have contracted to pay, and at the end of the day what insurance companies do is that mutualizing of risk function, and in order to stay in business they must always have enough combination of premium income and earnings from the premiums that they collect in order to discharge all their obligations and make a market rate of return on the capital that they have employed.

So I want to say as affirmatively as I can that the Administration is not for "bailing out" the insurance industry. What we have proposed is not bail out anybody; it would instead provide for an ongoing mechanism to insure and to provide for the mutualization of risk.

Because insurance companies do not know upper bound of terrorism risk exposure, they will protect themselves by charging enormous premiums, dramatically curtailing coverage, or as we have already seen with terrorism risk exclusions, simply refuse to offer the coverage. Whatever avenue they choose, the result is the same: Increased premiums and/or increased risk exposure for businesses that will be passed on to the consumers in the form of higher product prices, transportation costs, energy costs and reduced production. Put another way, any of these choices have the potential to cause severe economic dislocations in the near term, either through higher insurance costs or higher financing costs.

Since September the 11th, the uncertainty surrounding terrorism risk has disrupted the ability of insurance companies to estimate price and insure risk. Now, as we worked on this subject, we said our objectives are, first, in grappling with this problem, first and foremost, we want to dampen the shock to the economy of dramatic cost increases for insurance or curtailed coverage. We also want to limit Federal intrusion into private economic activity as much as possible, while still achieving the first objective. And we want to rely on the existing State regulatory infrastructure as much as possible.

After reviewing an array of options—and I truly believe we have looked at the limits of the options that are available—we developed an approach that we believe best accomplishes these objectives. This approach reflects the current evolution of our thinking on this issue, and let me say as clearly as I can, we want to work with you to achieve the best possible solution. When terrorists target symbols of our Nation's political and military power, they are attacking the Nation as a whole. This argues for spreading the cost across all taxpayers. Yet there are also reasons to limit the Federal role. If property owners do not face any liability from potential attacks, they may underinvest in security measures and backup facilities. In addition, the insurance industry has sufficient experience and capacity to price some portion of the risk associated with terrorism and have the infrastructure necessary to assess and process claims. Under the approach we are suggesting, individuals, businesses and other entities would continue to obtain property and casualty insurance from insurance providers as they did before September the 11th. The terms of the terrorism risk coverage would be unchanged and would be the same as that for other risk.

Any loss claims resulting from a future terrorist act would be submitted by the policyholders to the insurance company. The insurance company would process the claims, and then submit an invoice to the Government for payment of its share. The Treasury would establish a general process by which insurance companies submit claims. The Treasury would also institute a process for reviewing and auditing claims and for ensuring that the private-public loss sharing arrangement is apportioned among all insurance companies in a consistent manner.

State insurance regulators also play an important role in monitoring the claims process and ensuring the overall integrity of the insurance system. Through the end of next year, 2002, the Government would absorb 80 percent of the first $20 billion of insured losses resulting from terrorism and 90 percent of insured losses, about $20 billion. Thus, the private sector would pay 20 percent of the first $20 billion in losses and 10 percent of losses above that amount.

Under this approach, the Federal Government is about absorbing a portion, but only a portion of the first dollar losses, which we believe is important to do in the first year of the program. The key problems faced by insurance companies right now is pricing for terrorism risk. We favor a first dollar loss sharing approach in the first year, because we are concerned about premium increases over the next 12 months. We see this as the best way to mitigate against premium increases, but it may not be the only approach, and, again, we are prepared and happy to work with you to shape an acceptable outcome.

The role of the Federal Government would recede over time, with the expectation that the private sector would further develop its capacity each year. 2003, we would have the private sector be responsible for 100 percent of the first $10 billion of insured losses, 50 percent of the insured losses between $10 and $20 billion, and 10 percent of the insured losses above $20 billion. The Government would be responsible for the remainder. In 2004, the private sector would be responsible for 100 percent of the first $20 billion of insured losses, 50 percent of insured losses between $20 and $40 billion, and 10 percent of insured losses above $40 billion, and the Government would be responsible for the remainder.

To preserve flexibility in an extraordinary attack, combined public-private liability for losses under the program would be capped at $100 billion. It would be left for the Congress to determine payments above $100 billion.

The Federal Government's involvement under our recommendation would sunset after 3 years. This approach would also provide certain legal procedures to manage and structure litigation arising out of mass tort terrorism incidents. This includes consolidation of claims into a single forum, a prohibition on punitive damages and provisions to ensure that the defendants pay only for noneconomic damages for which they are responsible. It is important to ensure that any liability arising from terrorist attacks results from behavior rather than overzealous litigation. These procedures are important in mitigating losses arising from future terrorist attacks on our Nation and are an absolutely essential component of the program that we have put together.

Now, Mr. Chairman, for the reasons I have set forth, the Administration believes that the economy is facing a temporary, but critical market problem in the provision of terrorism risk insurance. Leaving this problem unresolved threatens our economic stability.

We have limits for Government's direct involvement in all those elements of our private insurance system that continue to operate well, and we provide the transition period to allow the private sector to establish market mechanisms to deal with the risk that confronts our Nation.

In conclusion, I would say one more thing that I suggested this morning to the Senate committee. I honestly don't think we are going to know whether what we fashion together will work, in fact, until it is tested in the market. As well meaning as we may be and as brilliant as we may be, only the market will tell us whether we fashioned a solution that works. And so I suggested this morning to the Senate committee that you all may want to consider giving the Executive Branch some power to adjust the terms of trade in the frame of reference, because the policies that are at risk now are going to get canceled if we don't act at the end of December, and usually policy renewal takes place 45 days before the end of the contract period. So we don't have an awful lot of time to go through an endless process that works itself into next year, and so I think this is a time to think about some extraordinary ways we can make sure that what we do will work in fact, because we can't afford not to have a workable solution that takes care of this problem for the near term.

Mr. Chairman, I am happy to answer any questions.

[The prepared statement of Hon. Paul H. O'Neill can be found on page 73 in the appendix.]

Chairman BAKER. Thank you, Mr. Secretary.

Does somebody have a clock so we can keep our 5-minute rule here? OK. Give me a 30-second, you know, hand signal. And as best we can, you will advise me whatever the order for recognition is.

With that, Mr. Secretary, let me say I very much appreciate the description of the plan as outlined. Certainly I think in prior meetings with the Treasury officials that I have some concerns about elements of the plan, but I want to start with where we agree. I do believe we have to act. I do believe that if we cannot expect the occurrence of anything similar not to bring about significant economic consequences. And if we do not have an event and we approach January 1 and coverage is not made available, construction—the economy just stops. So we want to act very timely. To that end, I also agree we can't know how the market will react to whatever mechanism we do expect, and that for consideration only, perhaps the advisability of a short-term emergency response is to get us through the early months of the year, and I understand the industry reluctance to that. They can't price on something that is not real. But I would just observe that there is very little likelihood that this Congress will reconvene next year and will take this matter up as the highest priority and attempt to act in a very thorough and responsible manner, that even if that is not achievable, then I very much like the idea of discretionary authority and responsibility being given to the Administration to manage this event.

So if we don't get it right, there is the ability to act without the necessity of Congressional intervention to protect our economic viability. At the same time, one of the principal things I think that—as you would surmise from my opening statement, is some capacity at the appropriate window for expected repayment. If we go through the scenario of a $100 billion event, given the constraints of the programs now written, the United States taxpayer would ultimately pay for more than two-thirds of the claims paid. I hate to use this, because I overuse this so much, and Mr. Kanjorski doesn't like me using it so much either, but I will do it anyway. It is almost like a GSE chart. If you make money you get to keep it. There needs to be some balancing of equities in this, and with all due respect to the proposal, my initial first reaction to it is it certainly is better than the industry proposal we saw, because we do have some participation by the industry.

But I want to take you up on the statements that you repeatedly made that we want to work through this, and a mechanism whereby we can visit again, maybe not this week, certainly early next, and go through the essential elements that I think ought to be in any proposal. Administrative concerns, again side-stepping the policy for a moment, if we are going to have to direct providers of insurance laying claim to the United States Treasury for reimbursement of monies paid out as a result of an act of terrorism, the administrative process to do that with 2300 insurance companies each paying multiple claims, unfortunately for those concerned about bureaucracy, you have got to have some questions about how that is going to work. Then we are going to audit and make sure where the money went. I have suggested that our interface with the industry might be at a slightly different level. Wave fast and hard, so I can see. If we engage at the commercial reinsurance level, and it also speaks not only to minimizing the numbers of people with whom you would have to engage, but they are the folks really backstopping in the private market the risk of the direct provider. They also are the ones who set the underwriting stuff. So if you need that extra security, if you need an extra person at the door, if there is some other extraordinary circumstance which is identified in the market as being necessary, let the market dictate those requirements. I would be concerned that the more we become responsible, the more the pressure would be on the Congress to create more regulatory constraints and to begin to set those standards of what is acceptable conduct.

And then lastly, by leveling at the commercial reinsurance window, we narrow the scope of review of the eligible participants who have access to the funds. I don't want to have happen with the insurance industry what I would be so bold to say I think may have happened with the airline industry, where there were losses going into the September window that were rolled into the claims paid pursuant to the September event. We need to know who is getting in, that they are solvent, they have the capacity to meet the responsibilities as best any reasonable person could dictate, and if we do that only with the commercial reinsurers, we again are looking at corporations, generally international in scope, generally well priced by the market, and we have a clear view of what their operational condition might be, to limit again the Federal role and bureaucratic responsibility in what will be a very difficult time.

I can only imagine the explanation by the agent on the street to a claimant about why they hadn't gotten the payment, because the Federal Government hadn't acted in a timely manner.

Am I out? I am out. I am not even 30 seconds. I am out. But let me just leave it at this. I appreciate your willingness to come here today for this purpose. I appreciate the tone and comments that you have made, and I just as an individual in the room—and I am sure others will speak for themselves—really do want to engage the office to try to come with some resolution.

Thank you very much.

Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, thank you very much. I have a few questions. Of course, I could name certain principles I would like to go through in terms of when we put this policy together, but first and foremost, on the Administration's proposals, I don't see an incentive for the insurance industry to want to resolve the issue until the absolute down day of 2004. I think if the Government gets involved, and I think we should get involved, there has to be an incentive, either premiums collected or a penalty derived by the Government to encourage the private sector to take up the reinsurance issue. If not, it would seem to me all companies would stand to the bitter end, and I think one of the examples we have always had in flood insurance is there was never an incentive to get out and privatize it. It is going to stay with the Government as long as I guess the leaves turn to brown.

There is a couple of questions I have. One, I think we should insure actual loss, but not necessarily economic gain loss. You know, we have gone through a tremendous appreciation of assets over the last 7 or 8 years, and I think it would be foolhardy for the taxpayers to bail out investors 100 percent, or a mortgage holder 100 percent if there is reactivation going on in the system to take advantage of moving up the value of the asset to the highest degree or even above 100 percent. We have got to have some stopgap in there to protect it.

Second, I would like to ask you what portion of this business are we providing the Federal insurance for that is international? How many foreign companies?

Secretary O'NEILL. None.

Mr. KANJORSKI. We would not cover any foreign?

Secretary O'NEILL. Well, if they were a resident of the U.S., I think they would have all the right that any one of standing has in the U.S., but this is territorial. This is the U.S. .

Mr. KANJORSKI. Well, U.S. limited policy, but the——

Mr. KANJORSKI. Right, but we still have primary insurance for foreign companies, and this would apply to all companies across the board. Is that correct? Is there any way we can give a preference to the American insurers?

Secretary O'NEILL. I don't think you want to distinguish between sources of the capital where somebody's money is better than somebody else's.

Mr. KANJORSKI. So the RAC national insurance——

Secretary O'NEILL. There are people we don't let into the country for very good reasons.

Mr. KANJORSKI. I am just being facetious.

Mr. LAFALCE. If they are insurers, they have to be licensed in——

Secretary O'NEILL. Yes.

Mr. KANJORSKI. I would rather look at a portion, some graduation of liability. I like the fact that the first dollar the primary insurer has to stand some risk, but I think there should be maybe reverse graduation involved to where we get involved and then, finally, probably some sharing of the premiums. There has got to be something to the taxpayer that takes the risk, simply because I am trying to distinguish in my own mind—and I am not sure that I can anymore—of the occurrence of September 11th, whether that is a terrorist attack or an act of war. Clearly insurers and banks and other investors take the risk of actual war. They are not covered for that. So we could pretty close—I mean, using the President's word, we could make a very strong argument that we are in an undeclared war, and, therefore, we are picking up the next liability for the taxpayer.

I am willing to do that because I see the economic component, but I think that is justified. But I would just like to see that incentive for the private sector to get involved as early as possible. Some share—maybe the premium should be higher than the private sector so that the private reinsurance industry will see an opportunity to rush in and provide that insurance as soon as possible as opposed to delaying it. We may be interrupting the development of that market by being too generous, and thirdly, real losses as opposed to book losses, I think that is essential.

Secretary O'NEILL. May I comment?

Chairman BAKER. Please proceed.

Secretary O'NEILL. I think from some of the things I have read in the newspapers and some of the comments made, it may be useful to talk a little bit about the concept of insurance. I have tried to do that a little bit in my paper, but I think maybe it is worth emphasizing some points so that we are on the same ground together, and if—you know, simply because of the comments an insurer makes about repayment. Under our scheme, we are not giving—we, the people of the United States, are not giving the insurance companies anything. We are not giving them anything. Now, when you say repayment——

Mr. KANJORSKI. We are giving them coverage support.

Secretary O'NEILL. No, we are not at all. What we are doing is we are saying to the insurance companies that if you go out and write terrorism insurance, that after you reach a level of 20 percent of the $20 billion in the first year, that you don't have any remaining liabilities. Now, you know, maybe what we haven't made clear enough, and I guess we presume is clear, but it is obvious it is not, is that they are not going to write insurance for more than the size of their liability and the size of the premiums that they aggregate together. So they are not going to write us up for $100 billion. We are simply saying we would like for the private sector to play a role, and you are not going to do—we think they won't do it if they have unlimited liability and no reinsurance pool, that there is not going to be any insurance available.

OK. But if you understand how insurance companies work, what they do is they go out and find people with similar kinds of risk, and they do an assessment of what is the possibility of an untoward event, and then they collect enough premiums and invest the money so that they make income from the invested money, and when there is an untoward event, they pay off. OK? And this would work exactly the same way, but the liability, that is limited, and the reason we started with a fairly low number is because if you think about this now from the point of view of an individual insurance company and, you know, let's take the World Trade Center now and you be the proprietor of an individual insurance company. You would not today go in there and take a risk of having to pay off a $3.2 billion claim unless you are going to get paid something like $3.2 billion, because if it happens, it is a 100 percent event. OK?

Chairman BAKER. If I can, the gentleman's time has long since expired, and the Chairman is next. Chairman Oxley.

Mr. OXLEY. Mr. Secretary, let me take you through some of the criticisms of your proposal. The first one is that this is an obvious industry bailout. You have addressed that to some extent, but indeed we are asking insurers to collect 100 percent of the premiums and then the taxpayers in the first year at least would pick up the bulk of that cost at 80 percent.

Secretary O'NEILL. That is not really right. You know, it comes across as that portrayal, and I realize now we were not clear enough. The insurance company is not going to write $100 billion worth of face value coverage for $4 billion worth of premiums. What this basically says is we are creating a way for the insurance industry to create a pool that provides a first layer of mutualization of risk with an upper limit of $4 billion in the first year, and the taxpayers are going to, in effect, self-insure the rest. They are not getting paid premiums for $100 billion. They are going to get paid premiums because of the way the process works that gives them enough money to pay off the probable cost of insuring risk. And that is all they are going to get. They are not going to get any gifts, because as competition works, the interaction between the consumers, like where I was before, the head of a company, the interaction between companies, they are saying I want the lowest possible price, and the insurance company, you are saying I want to write the business. It is going to bring this price down to a level that provides at the end a $4 billion pool to pay off the probability of an untoward event, wiping out all of the agreed contractual coverage for the insurance companies. It doesn't do more than that.

Mr. OXLEY. And in your proposal it is a 3-year package, basically?

Secretary O'NEILL. Well, we have said we think as we go along that the insurance industry and the reinsurance industry will likely figure out how to deal with this issue as they were to deal with Hurricane Andrew kinds of issues. They never have before. And so we are saying let us look at a 3-year program with these kinds of characteristics.

But again I want to say to you what I said before, until we put this in the marketplace we are not going to know whether it really works, and that is why we need to be fast on our feet, because if this doesn't work, we need to figure out a scheme that will actually get the job done by the first of January.

Mr. OXLEY. Traditionally insurance has been based on obviously risk assessment. Is it fair, for example, let us say that the target is the Empire State Building, or obviously the World Trade Center for a terrorist attack presents a lot more attractive target, if you will, than, say, the Marathon Oil Building in Ohio. And indeed, currently the insurance rates are, for a lot of reasons, different in different parts of the country. Under your provision, and the way you explained it, would the market ultimately then seek that?

Secretary O'NEILL. Absolutely. If you think about—and I don't want to be quoted as "O'Neill identified," but you all think of places that you know about that are obvious symbolic targets in the United States. They are going to end up in what I would characterize as an assigned risk pool. You all know from your automobile insurance, you know, if you are over 25 and have three children and don't drink and smoke, then you get a preferred rate than if you are 15 years old and you wreck three cars and you get put in an assigned pool. We are going to see the insurance industry go through this probabilistic analysis and the premiums for high value symbolic targets are going to be a lot higher than they are for a suburban home in Maryland. The industry will work out what the appropriate premiums are and again they will do it in a competitive framework of, you know, State Farm says I will cover your house for this, and Hartford says I will give you a little bit less and throw in a blender, and that is how this process is going to work.

Because of the scale of what we are facing and the short amount of time that we have to deal with this, I think this is the only reason why we ought to be at the table, because it is right in front of us. There is a high degree of uncertainty, and we need to make sure that we don't go over the cliff January 1st and there is no insurance protection, because the thing that drives us, if you are borrowing money—or even if you are getting money from equity supporters and you don't have insurance to cover casualty loss to your property, you are not going to be able to get intelligent investors to give you money.

Right? Think about it as an individual investor. Would you give your money to someone who had the risk of losing 100 percent of all of their assets, including all of yours and no insurance coverage? You wouldn't do it.

Mr. KANJORSKI. Well, they do it all the time in war.

Secretary O'NEILL. Well, you know, I think you made an excellent point. If you go back and look at what we have done where we have declared wars, basically the American people have been the guarantor of casualty—of war-related events, and if we had a declared war, I think you could make an argument that we ought to move to that position. And I said earlier, one of the things that we did in working this subject, because, you know, for me—and I think for most of you—this is not an issue that lends itself in any way to partisanship. This is how we get it right, and so we looked at the question of maybe the American people should simply say define terrorism and determination of a terrorist act, we are going to use our system of collecting revenues and distributing benefits to people; that is to say, the general fiscal policy of the United States, to pay for acts, for the cost of acts that are determined to be terrorist acts and we will just take the insurance industry out of it.

Now, as I have said here, we didn't get there because we think the infrastructure of the insurance industry can bring real value to dealing with the possible future terrorist events that otherwise one would have to consider creating in the Federal Government. That we think would be a disaster, to create a new Federal freestanding agency that is in the insurance business with policy writers and claims adjusters and all the rest of that stuff.

Chairman BAKER. Now you are scaring me.

Secretary O'NEILL. We don't want to do that. And so we built in this idea that by creating in effect the controlled and limited risk and then ratcheting it up over time, that we can have the best of all possible worlds and learn as we go along. None of us have been here before.

Chairman BAKER. If I can, Mr. LaFalce.

Mr. LAFALCE. Yeah. Thanks very much. I will go quickly. We are ready to let you take the lead. When will you get us the legislative language by? I think there is a disposition to adjourn Congress by Thanksgiving, maybe by Veterans' Day. Some people will say Halloween.

Ms. BAIR. There is no Administration bill.

Mr. LAFALCE. Are you preparing it?

Ms. BAIR. We are prepared to work with the staff.

Mr. LAFALCE. Well, if you want to take the lead, you have to take the lead. That means you have to come up with the language quickly.

Second, what is the necessary effective date? It is one thing to pass it in November, but when must it be effective by?

Secretary O'NEILL. The sooner the better. As I said to you, most of the notices for renewal come out on the 15th of November, policies that expire on the 31st. So, you know, we need it quick.

Mr. LAFALCE. OK. Next, if you were to insure, Mr. Secretary, would you advise them to give business interruption insurance or not? I think the answer is yes, you would.

Secretary O'NEILL. The reason I am hesitating, I used to run a $30 billion company. I did make a decision in some cases to provide business interruption insurance, but out of my 26 businesses, I made different judgments about different parts of my business, depending what the customer relationships were and contractual relationships.

Mr. LAFALCE. My point is for an awful lot of businesses it is not their physical infrastructure. It is their business itself that is damaged. You know, they have no revenues coming in. They can't pay their bank back. They are going to go belly up with bankruptcy, and they need insurance against that.

Secretary O'NEILL. We have not included it. It is a debatable issue, and we ought to talk.

Mr. LAFALCE. You are not advancing it, but right now you are not saying you are opposed to it?

Secretary O'NEILL. No.

Mr. LAFALCE. All right. I think we have to act on it quickly. I am a little afraid that the insurance industry might be taking advantage of us, other people taking advantage of us. You have to be wary of that, too, the same way this economic stimulus bill, think the people are taking advantage of us. I think you would agree with me.

Secretary O'NEILL. On the latter I agree with you; on the former I don't.

Mr. LAFALCE. Well, good. In other words, you agree with me on the economic stimulus. It is an open question on insurance, or you don't. Fine.

Secretary O'NEILL. I think as long as we have competition.

Mr. LAFALCE. Then I understand you correctly, you agree with me on the economic stimulus bill that we are being taken advantage of.

Mr. KANJORSKI. You are going to be quoted on the floor.

Secretary O'NEILL. I don't want to get in trouble.

Mr. LAFALCE. You did say we were being taken advantage of.

Secretary O'NEILL. I didn't say by who.

Mr. LAFALCE. This money——

Chairman BAKER. Is the gentleman out of time?

Mr. LAFALCE. I have been interrupted. I want my time. We passed the money laundering bill today in the House. OK, fine. It is up to you to implement it strongly, aggressively. It is a great law. It can be meaningless unless you implement it strongly.

Secretary O'NEILL. Not to worry.

Mr. LAFALCE. OK, good. Now, I am a little concerned about your theological opposition to the concept of a Federal charter. You know, my God, we talk about the global economy and the need for harmonization of our banking laws, our bankruptcy laws, our money laundering laws, and so forth. But with respect to the insurance industry, which was one of the largest industries in the world, my God, we can't have the United States have a law on that. We have got to defer it to the States. This is the 21st century, Mr. Secretary, and let us not be afraid to step our toe into the 21st century with respect to insurance laws. Now, I am not saying we ought to do it with respect to terrorism insurance, because we only have a few weeks, and I don't know that we could get there, but don't be afraid to put your toe in. It is necessary.

Chairman BAKER. Thank you, Mr. LaFalce. By my list, I have Mr. Royce next. Is he here, Mr. Royce?

Mr. Bachus.

Mr. BACHUS. Thank you. Secretary O'Neill, I commend you for coming forward. I am as serious as you about what you are proposing. The first is that to me this is not a backstop. We have got the most recent proposal. Why is there not a layer of industry exposure any time there is a claim?

UNIDENTIFIED SPEAKER. Could you both speak a little louder, please?

Secretary O'NEILL. The reserves that are currently held by insurance companies are held because it is their best assessment, backed up by the securities laws about how much money they need to put away in order to be worthy, creditworthy by the judgment of the State insurance commissioner, that when they have events they can pay off their customers. And so the reserves——

Mr. BACHUS. Adequate reserves.

Secretary O'NEILL. I am saying they don't have extra reserves. They have reserves to take care of the business they have already written.

Mr. BACHUS. You are saying they don't have adequate reserves?

Secretary O'NEILL. No.

Mr. BACHUS. So, that is why you came—no. I am just—that is why——

Secretary O'NEILL. Well, you know, it begins with a very basic understanding of how business works.

Mr. BACHUS. Yeah. I know how insurance works.

Secretary O'NEILL. And how insurance companies work. They go out and they sell policies—.

Mr. BACHUS. Now, you are lecturing us about——

Secretary O'NEILL. I don't mean to be lecturing.

Mr. BACHUS. You have looked at a backstop proposal and you have rejected that. You think first dollar coverage is necessary, right?

Secretary O'NEILL. I think if we said to the insurance companies, for example, right now that we want you to write terrorist risk insurance and you all are responsible for the first $50 billion.

Mr. BACHUS. The second question is this, there is no catastrophic loss of over $100 million, which is what I think is the worst-case scenario, which I would think that you would address that. I think that is what the reinsurance people are concerned most about. There is absolutely nothing above $100 billion. Did you all consider that?

Secretary O'NEILL. Well, what we basically said is when you get to $100 billion, we the people of the United States will own it all.

Mr. BACHUS. You think so?

Secretary O'NEILL. Absolutely. Who else is going to put up the money? I don't know. There is no other mechanism in the world except the good faith and credit of the people of the United States that is going to be good for anything over $100 billion.

Mr. BACHUS. All right, let me think. Third, I don't think the insurance companies can prepare for phase-out of the Treasury program, because there is no tax incentive. There is no reserves against terrorist risk or other means. Why don't we start planning for the future? This 3-year plan basically acts as if the world is going to last another 3 years. What we ought to be doing is planning for the future and addressing this problem long term.

Secretary O'NEILL. A couple of points. I don't think we know enough to craft a plan that anybody can say this is the right thing and this is what we ought to do. You know, I haven't found anybody anywhere who thinks they completely understand how we can fashion a perfect solution to this problem and work.

Mr. BACHUS. Let me ask you this. As I see it, it fails to spread the risk of terrorist loss throughout the commercial insurance industries, does not provide the market stability necessary to encourage companies to cover terrorist risk. There is no requirement that they cover risk to participate. They could cherry pick. How do you respond?

Secretary O'NEILL. You know, let me revert to being a businessman. If I were where I was a year ago and I were faced with this situation—and fortunately I was with a company that was so good—but for most businesses they have got to pay a lot of attention to their bankers and to their equity holders and what their equity holders and bank holders will say to them—if there isn't something done like this by January 1st, we are taking our money away from you. And so what is going to happen is businesses are going to be driven to the insurance company to get terrorism coverage, and the price that is going to be charged is going to be related to the risk that an insurance company sees——

Mr. BACHUS. I understand all that. You know, the final thing, and let me just make this comment. You are not covering life insurance or health insurance?

Secretary O'NEILL. No.

Mr. BACHUS. This is basically commercial policyholders.

Secretary O'NEILL. Yes.

Mr. BACHUS. So when you say that you are underwriting the taxpayers, in effect you don't really mean the taxpayers; you mean those that are commercial?

Secretary O'NEILL. We are not underwriting them at all. They are going to be out there——

Mr. BACHUS. You said we were——

Secretary O'NEILL. They are either going to have to self-insure, be forced into the hands of the insurance companies who will write the risk insurance.

Mr. BACHUS. But, if those people were backing up, not exactly the taxpayers, but the policyholders as opposed to taxpayers——

Secretary O'NEILL. We are working a way to try to reduce the economic shock that is related to either no coverage or very, very high premiums as many companies wouldn't be able to afford, and some would therefore not have access to financial markets because nobody would give them any money.

Chairman BAKER. The gentleman's time has expired.

Mr. BACHUS. I am just concerned about people's life insurance policies.

Chairman BAKER. Mr. Inslee, are you here?

Mr. INSLEE. Thank you, Mr. Secretary, for coming. I am going to take issue with what I think I heard you say, that this is not a benefit to the industry as a whole. I think I heard you say that or something to that effect.

Secretary O'NEILL. That is exactly right.

Mr. INSLEE. And I have got to take issue with that, because it seems to me that if we do this, we are telling the industry that you can go out to prospective customers and tell them that if you buy my policy, you will also have in effect access to, you know, $90 billion plus of Federal money if things go south, and vis-a-vis other uses of that customer's money to protect themselves against risk, either by risk reduction work or other investments or the like. This, quote, distorts the market by helping the insurance industry *vis-a-vis* other expenditures that that investor could make.

Now, tell me where I am missing something in that analysis. This does benefit the city, because it makes their product more attractive *vis-a-vis*, say, risk loss investments.

Secretary O'NEILL. Well, think about the problem as a disaggregated problem. We here in Washington tend to talk about the insurance industry like it is one big monolithic thing. This is all going to be done one transaction at a time. So if you have a corner grocery store, you know, you are not thinking about, oh, the Government is going to provide $16 billion worth of additional coverage. Your issue with your insurance agent is how much the premium is to insure you against complete catastrophic loss in a terrorist incident. And when he tells you that the premium is more than the value of your business, you are going to say, I am going to get on the phone and start calling through the insurance list in the yellow pages and you are going to get people in there swarming around, nickling, diming, trying to figure out how they can reduce your premium so they can write your business. That is the way competition works. That is the way insurance works, and so, you know, all this lofty stuff about $20 billion and $80 billion, it is just an aggregation of millions of individual transactions.

So, you know, nobody is going to get done a favor here. Competition, given some time, is going to grind these rates down to an assessment of the probabilistic cost of a terrorist event.

Mr. INSLEE. Yeah, I agree with you as this is not going to benefit one insurance carrier vis-a-vis another insurance carrier. I accept your point in this regard, but it does benefit the whole industry, vis-a-vis other investment or other expenses by the insured. For instance, if I got a thousand dollars, whether I buy a bomb screening detection device to keep bombs out of my business or whether I put it in insurance premium, this lowers the price of the premium vis-a-vis that other investment.

Secretary O'NEILL. But the insurance company will help you make that decision.

Mr. INSLEE. I understand, but the investor, the customer makes that decision, and this is a clear benefit to the industry, because it makes their investment more valuable in relationship.

Secretary O'NEILL. No. If there is a thousand dollar value associated with a detection device, the insurance company will either charge you the thousand dollars you didn't invest or you will put the money into the detection device.

Mr. INSLEE. Well, I see we are at loggerheads on that issue. Let me try another one.

If you did accept the proposition, if you did, that this was of some benefit to the insurance industry and that the taxpayer ought to have some upside potential in this investment, how would you structure it? If you did want to do something like that, to, in effect, whether it is an equity or it is some benefit to the general fund, how would you structure the other experiences?

Secretary O'NEILL. Well, I know this is very difficult and I don't mean to sound like lecturing, but let me tell you with 25 years worth of experience running big companies and knowing a lot about this stuff, the way competition works, you know, you can find aberrations, but the insurance industry over time has to earn the cost of capital, and the competition is tough enough that it is very difficult to earn the cost of capital. There are a lot of companies out there, including in the insurance industry, are not even close to earning the cost of capital. So if you want the general taxpayer to get something out of what you think is a benefit, then you are going to have to give the insurance industry enough room so that they can make additional net profit so they can pay you—you, the Congress—something, because competition is going to grind them down to the necessary rate of return on the capital that they employ. They are not going to make economic rent out of this proposal. Competition doesn't create economic rent.

Mr. INSLEE. My time has expired. I remain unconvinced, but I appreciate the brilliance.

Chairman BAKER. Mrs. Biggert.

Mrs. BIGGERT. Mr. Secretary, as the market is sorting itself out, there are certain areas that are thought of as high risk. One of those would be, let us say, public schools or maybe municipalities or amusement parks. Does your proposal cover those?

Secretary O'NEILL. We are assuming as to the current practice, it would continue. The Federal Government, basically we are a self-insurer. We do not insure anything. We by habit, if not by explicit decision, have decided to use the future cash flow from our taxes to pay for these kind of events.

Local government has made different kinds of decisions. Some of them buy insurance. Some of them actually budget for a rainy day fund. We just basically assume that public bodies will continue to do whatever they are doing. We have not made a special provision or assumption about a change in policy direction.

Mrs. BIGGERT. I think a lot of those local governments are self-insured now. Whether they can afford that risk, if you take those high risks out of those, will we still have problems?

Secretary O'NEILL. I think so. I think we can find lots of examples like the World Trade Towers where catastrophic loss would be multi-billion dollars. Again, I don't want to tell you any names, but I see the threat list every day. A lot of those places are on the threat list.

Mrs. BIGGERT. If they are not self-insured, we are right back where we started.

Secretary O'NEILL. I am not talking about public, I am talking about private buildings like the World Trade Towers. There are a substantial number of places in this country that have multi-billion dollar replacement costs. I think Mr. Kanjorski made the point about historical value. We should have no conversations like that, because the difference between historical and replacement value in some places is significant, and I don't think you would like to be stuck with just the historical value protection.

Mrs. BIGGERT. So, if there is high risk and no coverage, is there a provision to require it, or is it just commercial insurance?

Secretary O'NEILL. We are working on the private sector side. I had a role in Pittsburgh in Allegheny County when I was there, and given what has happened, I probably would be advising the mayor that we have to take a look at whether we can buy some terrorism coverage for bridges.

Mrs. BIGGERT. Utilities?

Secretary O'NEILL. Public property. People must be rethinking those things on the State and local level, but we have not designed a new kind of Federal intervention or coverage.

Mrs. BIGGERT. Do you think that would be a possibility?

Secretary O'NEILL. I am not sure that we need to do that. I think the market will sort those pieces out without our intervention.

Mrs. BIGGERT. Thank you.

Chairman BAKER. Mr. Capuano.

Mr. CAPUANO. Mr. Chairman, thank you.

Mr. Secretary, this is a thoughtful approach toward a difficult issue. I love the fact that you said no one really knows how to deal with this. I appreciate that.

For the record, I would also like to get your answer relative to if this does not work, I assume you would have no objection to revisiting this next year or 2 or 3 years from now?

Secretary O'NEILL. As I said earlier, you all may want to consider writing a very unusual provision in whatever you may do, and give the Executive Branch the ability to modify terms and conditions on a very short turnaround basis, because if what you all write gets done, it will be the 10th or 15th of November. If it does not work, we need to make the changes right away.

Mr. CAPUANO. I am glad to hear that. One of my concerns is as you submit this, and I know it would be very difficult, but I would like to see some pricing estimates. The reason I ask this is because my concern is that terrorism is clearly a societal problem. Insurance is, in theory, in the greatest philosophical theory, all of us chipping in a few dollars so that nobody in particular takes a hit. In the private market system, that gets a little muddled. That is fine.

In this particular case when the Government gets out entirely in a couple of years, and let us assume that we do not change it between now and then, my concern is if there is a market impact of the cost of that insurance, that market impact will negatively impact downtown areas in general. That is a general statement.

The reason I say that is because, let us be serious, the best terrorist targets are downtown. In Boston, it would be the Hancock Tower, the Prudential Tower. That is not a secret. We all know that. It is unlikely that terrorists are going to target a one-story office complex along Route 128 in Massachusetts.

What kind of impact on the market of leasing, because most of our buildings in Boston are owned by real estate investment trusts? They are not owned by the Alcoas of the world. They are owned by real estate investment trusts that own the buildings.

They are the ones that have to buy the insurance, not the companies in the building. The companies in the building will be paying it through lease agreements. You pay a premium for being downtown, and you make a decision, and so forth, and so forth, how much more of an impact is that going to have.

That is very important, because it doubles the cost of downtown space. You are clearly having an impact on a different market that is unintentional. Again, I don't know enough about pricing insurance to know whether or not this is real or not, but I would like to see something on it.

Secretary O'NEILL. I think your question is an excellent one. It is useful to return to the principles of insurance. Over time the way premiums are determined is on the basis of experience. If you are an insurance company and you are covering 10 million automobiles and they have crashes at a certain rate, that determines what the premiums are in order to stay afloat and pay the claims and earn your cost of capital.

What we all ought to pray for is we never have another experience, and that means there will be no economic cost. There will be premiums for awhile, but the longer we can go without another experience, the lower the premiums can be because there is no cost. God forbid we have experience so we can begin to create premiums on the basis of terrible events happening on a regular basis.

So I think again, we do not know. There are so many things associated with these events that are just new thoughts that we never had to think about before. This is a broader question even than the question of insurance. If we are going to have to continue to, for example, have a separate facility to open mail because of the anthrax scare, it creates all cost and no value to our society.

Those kind of deadweights on our society are like the deadweight of having to have insurance coverage that hopefully we never really need to use. We do not know the answer to your question.

Mr. CAPUANO. I respect that. I think it needs to be thought about, not the least of which are the indirect items such as downtown parking facilities.

We just had a thousand pounds of fertilizer stolen in Massachusetts. We do not know what is going to happen to it, if it is going to be used by somebody that wants to do something horrendous, they are going to go to a downtown parking structure under a building. That means all the parking structures are gone, and that increases rents.

I am a little concerned about the free market having a completely terrible negative impact on the cost of rental property, particularly in downtown markets where people can least afford to have people move out of.

Chairman BAKER. The gentleman's time has expired.

Mr. Shays.

Mr. SHAYS. Mr. Secretary, I would have thought, unless I am not reading your proposal right, that you would want premiums to go up so you start to build a reserve, and that cost could be passed on, but you want a reasonable increase, something that is not outrageous. I was thinking that the cost of premiums would go up, and you would buildup a special reserve, and that over time this reserve would become so large that the liability disappears; that is, if there are no further terrorist activities. My reading is that you really do not buildup long-term reserves.

Secretary O'NEILL. I don't believe it is desirable for the Federal Government to create an insurance system. I think we have a way in our country of spreading the cost of things that impact society, and it is through a combination of our tax system and our spending system, and it ends up with a distribution effect on the general population.

I think for the part of the terrorism cost that we are going to accept, unless somebody has a better idea, the interaction of all those things that we do is perfectly fine with me, and we have a basis for spreading the cost for that part that we are going to put on the American people, for the insurance companies. What they will do, they will set premiums that they believe will give them the wherewithal to service terrorist events and earn a 12 or 15 percent return on their capital.

Mr. SHAYS. Are you saying they will build the reserve?

Secretary O'NEILL. They have reserves now against business that they have already written. If they add new business, they will add new reserves. Their premiums will include enough earnings to building up a reserve so if an untoward event happens, they have the money to pay it off.

Mr. SHAYS. My understanding is that you do the back end and not the front end. The Government says catastrophic, you are the first payer. Yet you are not doing it that way.

Secretary O'NEILL. I tell you why. It is a very important question of how much the traffic can bear under uncertain conditions and a lack of experience.

Think about this as an individual business person. You can afford to pay a certain level of insurance costs. Let us say you have been paying a certain level of insurance cost, and now this event comes along and your insurance company says in order to give you terrorist coverage which you need in order to get financing from your bank, I am going to raise your premiums on $1 million a year to $10 million a year. As a business person, if you are go to stay in business, you do not have a whole lot of choice.

The way we have crafted our proposal is in a way that we think will permit the premiums to be written on each of those business people and not put them out of business.

Mr. SHAYS. Do you believe premiums are going to go up significantly?

Secretary O'NEILL. Premiums will go up.

Mr. SHAYS. Even if we back them? Significantly?

Secretary O'NEILL. Yes. Premiums are going to go up, although it depends what you mean by "significant." if you want to make the insurance company just paper processors and guarantee them a 25 or 30 percent rate of return on their capital, they would be happy to take that.

This is an attempt to get the administrative structure and the value part of the insurance in front of us before the loss.

Mr. SHAYS. Thank you.

Chairman BAKER. Mr. Crowley.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Secretary, first of all, I concur with the Chairman. I think we would be better off, and I appreciate what you have done and what you have looked at. I don't completely agree with your proposal. None of us know what the perfect proposal is. I think we would be better off having a little shorter sunset, and I would also be a little reticent of extending too much flexibility to the Executive Branch, with all due respect, because at the end of the day, whether our name is on the bond or not, the Congress underwrites, if not fiduciary responsibility, the political responsibility for the taxpayer's liability.

I hope you all would take that into consideration, whether we try and do something that just gets us over the hump, and I realize that Congress is not always good about meeting its own deadlines, but we are going to have to focus on this.

Second of all, I am curious of how you determine your shared loss schedule? How did you decide the ratios that you set in 2002, 2003, and 2004?

Third, I am not convinced that you have made the case that from a cost-benefit standpoint to the taxpayers, that having a shared loss program with the first dollar coverage on the part of the taxpayers is all that much better on a dollar-per-dollar basis, or even on a market basis quite frankly, than a pooled model similar to deposit insurance.

I am curious whether or not the fear there, and it is not necessarily a cost-benefit analysis issue, it is a concern of the creation of another bureaucracy, and I am not sure that we can look at the deposit insurance and say that is such a bad system.

Finally, I would think the way your proposal is structured, and it might be true with pooled structure, is how we score it for budget purposes. I would think that under your proposal we might have to score it dollar for dollar and at some point we are going to have to keep an accounting of the money spent and back into what our long-term solution is.

Secretary O'NEILL. The last issue is that it would be scored like the money that is now spent for disaster assistance.

The pooling idea has some complications in terms of, if you are going to have a pool, yes, it suggests you are going to write policies. If you are going to write policies, somebody in the Federal Government is going to decide what the premium schedule is. And then we are going to charge premiums to people and money will come in, and what will we do with it. If we do with it what we do with almost all of the other money, we invest it in Government bonds where we do not really do anything. We have this paper game.

Mr. BENTSEN. And I grant you that, in your testimony you bring that up. But even in the shared loss, we are going to have to go through some underwriting analysis.

Secretary O'NEILL. We are going to write checks.

Mr. BENTSEN. My question, Mr. Secretary, from the taxpayers' standpoint, have you all determined where the taxpayer is really better off?

Secretary O'NEILL. I think the taxpayer is better off not having the fiction of a pool and all of the appearance of being in the insurance business when we really do not want to be in the insurance business.

If you think about setting up a pool, the implication of that is basically that we are going to withdraw capital from society on no particular basis and we are going to hold it aside. That is an added cost to society, that we take capital and in effect neutralize it.

Mr. BENTSEN. In fairness, Mr. Secretary, if we incur a liability, we are taking capital from society.

Secretary O'NEILL. But we take it when we need it and not in anticipation.

Mr. BENTSEN. If your staff can look at those issues. I agree that we could not do a pooled issue right away. I don't know that we can do any of this right away other than get us over the December hump. If you can get back to me on the question of how you determine your shared loss schedule, what the analysis was, I would appreciate that.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Ney.

Mr. NEY. Mr. Chairman, I want to focus on the issue on a broader, generic basis concerning McCarren-Ferguson and our current system and how we regulate insurance. Do you have any idea how the proposal would affect how we regulate insurance with respect to McCarren-Ferguson.

Secretary O'NEILL. Perhaps Ms. Bair could address that.

Ms. BAIR. We would want to rely on the current regulatory structure. I think there are a couple of scenarios and issues.

Mr. NEY. My second question, the plan hopefully addresses the underlying problem of the pricing and various taxes. In other words, if we had an attack 6 years from now, would we be right back to where we started? Is there any consideration about what the tax incentive side of this does for businesses?

Secretary O'NEILL. Is your question how you would entertain the needs of tax incentives, and who would they go to?

Mr. NEY. Without changing our tax laws on the insurance side reserves for terrorism, has that been discussed?

Secretary O'NEILL. Yes, we have discussed it. It has a certain amount of appeal, because it sounds like we are inducing insurance companies to do the right thing. We are lowering the cost of capital for insurance companies. I don't know why we would want to do that.

Mr. NEY. Assuming we want to phaseout the Government backstop, if that is an issue?

Secretary O'NEILL. We are assuming as there is more experience, the insurance companies will figure out a way to neutralize the risk of terrorist attacks in the way that they have done for hurricanes and tornadoes. There have been accusations that there is somehow an interest in bailing out the insurance companies or helping the insurance companies. A tax incentive would lower the cost of capital for insurance companies, which would be a prima facia case for a bailout for the insurance industry.

Mr. NEY. I just wondered when we talk about incentives, to eventually phaseout the Government's portion.

Secretary O'NEILL. We are saying that we will back out, and the industry will fill the hole.

Mr. NEY. I just wonder in 6 years, where are we at? I am not saying that I would have an idea to have a proposal that tax incentives are the way to go, I am just saying that the Government is going to be removing the backstop. Are there other incentives?

Secretary O'NEILL. I don't believe so.

Mr. NEY. Thank you.

Chairman BAKER. I am advised that the Secretary has a need to depart. If I could make this request of Ms. Bair in your absence to continue. We are most appreciative of your generous time. We do thank you, Mr. Secretary.

If I might suggest to the Members, we appreciate Ms. Bair's willingness to stay. We would ask that Mr. Hubbard come forward.

STATEMENT OF R. GLENN HUBBARD, CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS

Mr. HUBBARD. Thank you, Mr. Chairman.

I know that Secretary O'Neill has said a lot about the proposal, so I do not want to go into a great detail, but I want to spend a few minutes with your permission, Mr. Chairman, to talk a little bit about the economic rationale and why we proposed what we did, because I picked up a little of that in the discussion, the questions that you were asking the Secretary.

As an economist, the way that I think about the pure economic events of September 11, in addition to the terrible human tragedy, is that in one shot it gave a very powerful supply shock to the economy and a demand shock.

The supply shock is that it raised the cost of almost everything that we do. The first thing that we looked at with the Congress is commercial aviation. We are talking about insurance costs today, but the transacting cost of doing business went up a lot. That ultimately is going to show up in lower output and all the bad things we are worried about.

The second issue that does not concern us today is what is the effect on household and business confidence. I think it is important at the outset to reiterate something that Paul said, this is not about the insurance industry.

The purpose of your holding these hearings, which I think is very helpful, is to think about the property and casualty insurance market and the cost of insurance. There is no reason to suspect that this industry is not competitive, so that the issue here is about costs of insurance and not about the industry.

One way of thinking about the consequences of not acting or not acting in a timely way is to ask what we might lose. We have already been through the aviation issues and insurance. Here the problem is much more widespread. There are at least three ways of thinking about this. One, think about the new projects. I am trying to build a new skyscraper or general commercial real estate property. My ability to do that depends on the availability of insurance and its cost. Second, and more important, is existing assets. My ability to sell a building I own, a power plant, any facility, depends on the availability and cost of insurance. Those costs are capitalized into the value of that asset.

If one thinks about the size of potential costs here, the P&C premia are about 3 percent of domestic income, about $155 billion a year.

The Administration was concerned about some principles, and I want to go over those. I picked up the flavor of some of the questions to the Secretary.

In my own ordering, since I was not here for his remarks, I don't know if it is his ordering. One is intervention should encourage, not discourage, the private industry's ability to expand capacity. That is what this is all about. That is principle number one.

The second principle is that any intervention should be explicitly temporary. We are in the view in the Administration, and I gather many of you are from the questions that I heard, that the industry is capable of stepping up to the plate for a very large share of this and is capable of learning how to price. We have seen this in other areas. We will come back to that. We need to make sure that we have a receding Government intervention.

Third, we need to give the private sector incentives to limit losses should terrorist events occur, which means less than full cost takeover by the Federal Government.

A fourth that I will come to at the end is that we need to reduce one source of uncertainty that we really can deal with, which is uncertainty about liabilities that arise from litigation surrounding terrorist events.

Again, I would underscore that none of these principles has anything to do with a bailout of the insurance industry. In today's *Wall Street Journal* on the editorial page, an editorial that I otherwise liked, I did not like the beginning because there was an indication of "eating cabbage." There was an indication, coming to the table like we are today, that was "eating cabbage" in the editor of the *Wall Street Journal's* judgment. They talked again about bailing out the insurance industry, and that is not what we are talking about.

We want to work with you on the specifics. This is an outline of our ideas. We think that our approach is consistent with the principles from the economics of the problem.

First, we think that it encourages private sector capacity building and respects the industry's ability to price, market and service products. I am quite suspicious of alternatives that involve direct Government setting of premiums. I don't think that is something that Government officials, with all due respect to my Treasury colleagues, want to be doing.

Also in that respect I think there are plenty of people who say that the insurance industry cannot learn to do this. As somebody who in my academic life has worked in insurance a long time, I can remember 10 or 15 years ago naysayers saying we will never figure out how to really do disaster insurance. We will never figure out how to get beyond basic insurance and reinsurance, and experience has proven that wrong. I realize that this is a different set of risks, but I have every faith in the industry as being better able to figure out the way to go.

The second piece of what the Administration wants to do that I think is important is addressing the issue of capacity. I know that came up in some of the questions that the Secretary got. The big issue here is back end capacity. Several Members asked that question. I want to come back to that. That is the key insurance question that the Government ought to be at the table for.

The third is the fact that the industry is sharing in losses, and indeed in our proposal sharing a greater burden over time up to a cap, and provides, frankly speaking, a profit motive to learn the price. Somebody asked why we had this particular model, I believe it was Mr. Bentsen. The exact numbers one can quibble with. The idea was to give slivers of risk that the private sector would have an incentive to go out and learn. If we take 100 percent of that for some short period of time, we do not give that incentive. That was our economic rationale for doing that.

A final point I would make with regard to these principles is that the potential losses that we are looking at in this event, hopefully not in any future events, certainly in this event, depend not only on the security environment, which is something that we are coming to grips with and has a lot of uncertainty, but also in the legal setting.

The physical costs of Hurricane Andrew at the beginning of 1992 were pegged at $6 billion. They grew over time to more than $20 billion, not because the physical damage was any bigger that it was in 1992, but because of the cost in litigation.

In order for the private market to do what we want it to do, which is to take over the lion's share of this, we believe and put in the approach that I believe the Secretary outlined for you, a set of legal procedure issues that we felt would facilitate greater private market participation. Those were consolidating claims in a single Federal jurisdiction. That is the sign to promote consistency and avoid redundancy, limit some punitive damages other than obviously for actual perpetrators and abettors, and proportional liability for noneconomic harms.

This is not an attempt to marry tort reform agendas with insurance agendas. We want the private market to come in and work here. In addition to the uncertainty we are facing about terrorism itself, we have to be able to address uncertainty issues in the litigation area.

Let me say a little bit about roads not taken. Why not the monopoly pool? There I think a couple of reasons. One, we were very worried about monopoly power. To be frank, that just means higher premiums for businesses and ultimately consumers. We did not think that was wise. It also had the flavor of a very long-term Government presence, which is not something we wanted to suggest to you.

Somebody asked about charging premiums, why are we not charging premiums for taxpayers being on the hook. We decided on this sliding scale sharing mechanism as an alternative, because we did not want the Government in the business of setting arbitrary premiums. We will learn more about pricing only as the private sector figures this out, not us in Government.

Questions came up about health, life and business interruption. Let me take those up. The health issues are issues that should be discussed, but not in our view in the context of the P&C legislation. Likewise on life.

Business interruption is, just to be really frank with you as to why we did not put this in, is subject to very, in econspeak, moral hazard problems. For small businesses, the FEMA and the SBA emergency disaster programs do provide some stepping in on business insurance. We, of course, obviously are willing to work with you on what is in and out. In terms of exposure for the taxpayer, as an economist I would offer you advice: You do not want to put health, life and business interruptions in.

The other road not taken was full Government socialization. There again we felt the industry would not have any incentive to learn how to price, and the exit from that we viewed at least as being pretty dicey. That is a quick tour. I am sure that the Secretary told you all about our wonderful proposal.

[The prepared statement of R. Glenn Hubbard can be found on page 80 in the appendix.]

Chairman BAKER. Thank you.

We are going to pick up in the line of questioning from the Members who indicated an interest in asking questions of the Secretary. Next is Mrs. Hooley.

Mr. Israel.

Mr. Ross.

Mr. Maloney of Connecticut.

Mr. MALONEY. I have a couple of questions. The first one goes to the issue of experience and the idea that companies are going to learn how to price this risk. It strikes me that 3 years is a very short time to anticipate that to happen. I think it is a short time from a couple of different perspectives. The good news is what the Secretary was alluding to, perhaps there will not be another event; and if there is not, there is no experience from which to price.

Second, it is a very short timeframe from the perspective of the world we live in. I think it is clear from what I understand of the origins of these attacks, these are the results of historical processes which have been at work for 20-50 years. Bin Laden says 80. My first question is why 3 years? Isn't that far too short, even accepting the model, you say the road taken, even accepting the model for what you advocate, isn't 3 years much, much too short?

Mr. HUBBARD. This is a double-edged sword. What we wanted was a quickly receding Government presence. So we compromised with the 3-year number. We felt there was enough time for the industry to begin getting experience on pricing. Part of that would come from—since the industry is shouldering slivers of risk, they will try to lay off that risk on the capital markets, and modeling efforts will be used to fill in price, and the natural disaster area will come to bear as well.

So is 3 years a magic number? No. But that was our thinking. We wanted something longer than a very short run, but not so long as to intimate a long-term Government presence.

Mr. MALONEY. So there is no economic analysis behind the 3 years? It is a judgment call? It is sort of a best guess, is what we are being told?

Mr. HUBBARD. I can give you a fancy answer or a plain answer. The plain answer is this is new terrain. What we can learn by indirect example from the natural disaster area is relatively rapid learning, modeling capabilities to set up a securitization. We are in new terrain. I cannot tell you that period is exact here, but we were comfortable enough after talking with people in the industry and people expert in the disaster area that was a reasonable place to start. If you said 4 years, we would not scream.

Mr. MALONEY. Let me ask a similar question in regard to the cutoff point of the $100 billion. First of all, if I understand the proposal correctly, at the $100 billion there is no mechanism for payment, there is simply at that point the Treasury will sort of seek the advice of the Congress, and maybe the Congress will do something and maybe it will not. Maybe it will invest in some public improvements or maybe it will not. In terms of the market and the ability of the market to look at it, the $100 billion is the end of the line of any kind of insurance that can be then priced?

Mr. HUBBARD. I don't think so. I think on the back end, $100 billion was just a sign that we need to go back to the Congress. The obvious political answer is for a disaster that large, we probably are looking at Federal Government intervention. One model we might consider is a Price-Anderson type model.

Our view was $100 billion is a sufficiently big event.

Mr. MALONEY. The follow-on discussion is that that is what the insurance industry is concerned about? At some level the insurance industry, as I understand it, is not as concerned about a $5 billion event or a $10 billion event? There is a sense if that were the level of events, if that were the size and scope of the events, there might not be a need for any bill at all, and that their real concern is when you begin to get to the upper end? That is where the real concern is? The point is if you are asking the market to price something, you have built a cliff, and I am a lawyer and not an economist, but you have built a cliff in this bill that you have some coverage up to $100 billion, and then there is nothing?

Mr. HUBBARD. No, not that it is nothing.

Mr. MALONEY. What is it? As I read the bill, it basically says at $100 billion, go talk to the Congress?

Mr. HUBBARD. Our intent was to try to come up with alternative solutions. As you folks and the Treasury folks work on this, you may specify what that is. I think that from an economic perspective, you want the industry bearing some role, even if it is tiny. Our intent was not to walk away, you are exactly right.

Chairman BAKER. Mr. Weldon.

Dr. WELDON. I understand your criticisms of creating a pool which would put the Government in the business of pricing. It would take a lot of capital and just kind of lock it up. I am not sure that is the exact way to describe it, but the way you have laid this proposal out, at the end of 1 year, and the Secretary just testified if there is any first dollar exposure the insurance companies are not going to write it, but if you asked for first dollar exposure in the second year, do you really think in 1 year the insurance companies, and unless we have more experience, how are they going to be able to write premiums to effectively value that level of exposure in just 12 months?

Mr. HUBBARD. I don't know what the Secretary said, I was not here. But if you look at year 1 and year 2 in the proposal, our thinking was not just that insurance companies could not do anything in year 1. They can. It is a question of cost.

For example, if we did nothing, we do not believe that every project in America would go negative. I don't think that will happen at all. Part of our concern was trying to stabilize that supply shock so that there is a small cost to the business sector in the first year. Then the deductible starts in the second year.

If you decided to have a deductible in year 1, it does not mean that none of this works. It simply means a higher cost and makes it harder for us.

Dr. WELDON. I want to follow up on something that Mr. Ney asked about in trying to address this through the Tax Code.

One of the ways I think we can possibly do that if you had an officially declared disaster, the way that the insurance companies pay the tax system and collect on the premiums, they settle on the claims and what is left is taxed. If you had a provision in the law that allowed for, once a terrorist act was declared, that the costs of those claims would then be taken off the corporate tax responsibility, would that not be an easier way to encourage the industry to step up to the plate and start pricing?

Mr. HUBBARD. I don't think so. I agree with the Secretary's remarks that you do not want to start complicating the Tax Code. If there is a desire to revisit the taxation of insurance, that should be a general question that gets taken up by Congress. We felt that it was more transparent to do it the way we did. We think that the incentive for the industry to go out and build capacity is because of the risk that it is now having to bear.

Chairman BAKER. Mrs. Maloney.

Mrs. MALONEY. I want to thank as a New Yorker the Administration working swiftly on this.

Given your statement that we are in new terrain and the comments of many of my colleagues, why not a shorter period? Why not say for a year or just getting over the November crisis and then coming back and studying it more. Many of my colleagues are saying that we acted too swiftly on the airline proposals, that we should have thought it through a little better. Why not a shorter frame like a year or even shorter, just getting through November and giving us more time to look at it?

Second, the bill appears to be written in a way that would give a big incentive to interpret occurrences as terrorist occurences. Politics is everywhere. Earlier the Secretary was saying the Administration should have more leeway. There would be tremendous pressure if there is a crisis in one State to declare something a terrorist act because it would reflect a great deal of money. So how are we going to define it in a way that it does not become something that can be so flexible and that really has more taxpayer exposure?

Third, why 80 percent of the first $20 billion? Why not 50 percent? 50 percent for the taxpayers and 50 percent for the private industry? How did we get to the 80 percent?

Lastly, could you share with us some of your thoughts on what happened in England? Apparently they have had this pool insurance policy. Has it been a big liability on taxpayers? Has it worked? What has the experience in Britain been on insuring for terrorism?

Mr. HUBBARD. First, I am a fellow New Yorker.

Mrs. MALONEY. Great. So you are feeling our pain.

Mr. HUBBARD. I am feeling your pain.

First, on the question of why not just a year, I think our feeling was in order to give some certainty to the process in commercial lending and the construction of new projects, particularly of concern in Manhattan, that we believe some period longer than a year was necessary. We suggested three. This is not a religious position that it be three, but I think our position was that it be longer than a year.

On your issue of interpretation of occurrences of terrorism, it is important to have a rigorous definition of a terrorist act.

Second, a cabinet board or Presidentially directed board, probably consisting of the Attorney General, the Treasury Secretary, perhaps some others at the President's discretion, to make these——

Mrs. MALONEY. As a Member of the legislative body that has to produce the money, that would put us in a very difficult position, because the President can be put under political pressure to determine that this is a terrorist activity, and then we have to raise taxes to pay for it.

Mr. HUBBARD. That is why you want a tight definition of a terrorist act.

Mrs. MALONEY. I would want to have it shared with the legislative, not just be an Executive Branch decision.

Mr. HUBBARD. That is something to be worked out in the process. It is not obvious that the same political economy problem does not arise in Congress.

The third question was the 80/20 versus 50/50. This is not about industry, it is about cost. We picked a position which would have cushioned the cost for business insurance purchases in year 1. You could certainly do it 50/50. That would be a smaller cushion. That is why we made the decision.

The U.K. pool Re model is a different policy choice. It was a decision actually to have the Government more involved on a long-term basis.

Mrs. MALONEY. But has it worked? What has been the experience? Has it cost more for consumers? Has it been a successful experience?

Mr. HUBBARD. The British made a conscious decision to be long term.

Ms. BAIR. The capitalization at the end of 2000 was 1.3 billion pounds. It was set up to deal with car bombs. We are envisioning significantly greater events.

They do financial insolvency regulation. They have a monopoly pricing structure, so they have to have financial integrity regulation. It is quite an apparatus.

Chairman BAKER. I am sorry, Sheila Bair was never properly introduced. Sheila Bair is the Assistant Secretary for Financial Institutions.

Mr. Rogers.

Mr. Miller.

Mr. Lucas.

Mr. Toomey.

Ms. Hart.

Ms. HART. I just have a couple of questions. Is there anything that you see in here that would encourage private insurers to get back into the market, and I am not saying skyscrapers, say nuclear power plants?

Mr. HUBBARD. This proposal is related only for terrorism risk insurance, unless you wanted to rethink generally. The simple answer is nuclear power plants are covered under a separate provision of Government intervention.

The insurance companies see now an opportunity to deal with business, and the fact that the Government is on the back end of it, the hope is that they will.

Ms. HART. I didn't get a clear enough answer to Mrs. Maloney's question about the 80/20.

Mr. HUBBARD. The issue is what is the cost that is going to be borne in premiums. Our judgment is in the short run we wanted to err on the side of being cautious about premium increases for business. That is the 80/20. You could well decide to do 50/50 and stick within the same model. Indeed, you move toward that in later years in our proposal. If you do that, it would be higher cost increases in the short run. That is the tradeoff.

Ms. HART. Is it based on input from the industry?

Mr. HUBBARD. We talked with industry and mainly with commercial real estate holders and with large companies about the share of insurance premia in income. You could do 50/50. It would be a larger cost increase.

Ms. HART. My question is when you made the determination how much the Government would cover, was it based largely on what would make it affordable to the consumer as well as obviously what private insurers would cover?

Mr. HUBBARD. There were two parts. One, if you think about the outyears, the back end was primarily to focus on catastrophic issues; and in the short run, we deliberately erred on cost increases. That was our first and foremost issue.

Chairman BAKER. Mrs. Jones.

Mrs. JONES OF OHIO. Thank you, Mr. Chairman.

Mr. Hubbard, you keep saying it is not about the industry, it is about what?

Mr. HUBBARD. It is about people who buy insurance.

Mrs. JONES. But people who buy insurance create the industry?

Mr. HUBBARD. What I mean about it not being about the industry, there is a use, even in the *Wall Street Journal* editorial pages, which normally I praise, of saying this is a bailout of the industry. That is simply not true. This is a competitive marketplace. What you decide to do is being reflected in premiums that policyholders pay.

Mrs. JONES. But the basis of us doing this is saying that the people who use the industry will not be able to afford the industry.

Mr. HUBBARD. It is about the customers of this industry. Insurance companies are just a pass through, as the Secretary explained. They are just a financial intermediary. This is about risk sharing in the economy and the cost of that risk sharing.

Mrs. JONES. But there is some benefit of being a part of the industry and having an insurance company? That is why people invest in insurance companies because they are a good benefit?

Mr. HUBBARD. Absolutely.

Mrs. JONES. I am trying to make the point that it is about the industry, otherwise we would not be sitting at the table having this discussion about insurance.

My next question goes to you are saying this intervention should encourage private industry to increase capacity. Elaborate on that for me.

Mr. HUBBARD. In other words, by creating an incentive to price this; and after all the insurance companies are bearing part of this risk and you have to figure out how to price it, they will have to add capacity for those new lines of business. And they should, prudent business practice, try to lay off some of that risk, both through reinsurance and later to securitize it.

Mrs. JONES. How do we ensure that the buyers of this insurance, that they will not be priced out of the market when their dollars are undergirding this industry by doing what we do?

Mr. HUBBARD. Competition. If the taxpayers are on the hook for a fraction of this, that should float through to premiums. If Sheila's insurance company tries to charge too much, I will come in and undercut her. That process keeps insurance prices down.

Mr. KANJORSKI. If the gentlewoman would yield.

Mrs. JONES. Go ahead.

Mr. KANJORSKI. That all depends on the size of the policy. For a homeowner, there is not going to be competition. If Mrs. Jones' insurance company triples her insurance policy, All-State is not going to try to take that policy. That only happens in large industry?

Mr. HUBBARD. The process of competition works in mysterious ways, and if you think about something known as long distance telecommunications and aggressive competition on almost a customer-by-customer basis, where there are profit opportunities, people will come.

Mrs. JONES. I have got two more questions, so I am going to ask you to keep your answers short for me. Compare what you are talking about right now with floodplain insurance. Remember when we couldn't cover—people weren't covered for floods and we began to talk about a 100-year flood, and so forth, and so forth, and so forth, tell me—compare that, if you could.

Mr. HUBBARD. Well, the disaster insurance doesn't have the same kind of sharing mechanism that we are talking about. It is a subject for another day, would actually be the reform of natural disaster insurance generally.

Mrs. JONES. Well, forget that question. Tell me—compare what you are talking about—apply the concept you are talking about to what we did for the airline industry and no caps on victims, on the victims of September 11th.

Mr. HUBBARD. You mean the whole airline package?

Mrs. JONES. Yes.

Mr. HUBBARD. Basically I think what we are doing for aviation—and I say aviation, not airline industry, for the same reason I did before—was you were trying to——

Mrs. JONES. A semantical. Right?

Mr. HUBBARD. Not under competition, it is about customers and travelers. The reason for a Government intervention in aviation, we can always argue about the——

Mrs. JONES. Short.

Mr. HUBBARD. ——Is to help travelers, and today we think about another industry where business costs are very, very high. Well, part of your response earlier was something about private market participation and putting caps on people's ability to collect claims and so forth and so on. What are you factoring in for the people, the victims in this instance, if you are putting caps on their claims in the insurance industry? And I may not be able to get an answer. Maybe you can give me an answer later on. Am I out of time, or can I get the answer to my question?

Chairman BAKER. The time has expired, but if the gentleman wants to respond.

Mr. HUBBARD. This proposal, or this hopefully soon-to-be proposal, doesn't envision separate victims' funds. That is a separate thing. Is your question about the litigation involving victims or——

Mrs. JONES. No. In one of your answers, you said the reason we created this proposal was we took into consideration private market participation. We put in caps on people's abilities to make—and you listed six or seven other things that I wasn't——

Mr. HUBBARD. Yes. Punitive damages was important. To avoid certain litigation costs, you would want to cap non-economic damages and punitive damages.

Mrs. JONES. But we didn't do that in the airline industry.

Ms. BAIR. You eliminated——

Mrs. JONES. But there were no caps.

Ms. BAIR. We are talking about a $100 billion aggregate cap on payments that the Treasury Department and industry combined would make before we would have—there is the moral obligation, but before we would have to go to Congress. This is an aggregate cap on liability under this program. It is not a cap on tort liability. We believe to manage the litigation process in the event of a major event, there need to be some reforms along the lines of what was in the airline bill, which mainly were claims consolidation and elimination of punitive damages. So, two separate issues. And we were talking about aggregate capping on this.

Mrs. JONES. I didn't understand that to be what you were saying.

Mr. HUBBARD. Yes. The $100 billion is an aggregate cap.

Mrs. JONES. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Ose.

Mr. OSE. Ms. Bair, my question comes to you. I served for a number of years in Florida. The large property casualty issues—also borrow money to build things, and I understand the dilemma we are in. The thing we all struggled with before was providing certainty for the actuarial models. Does Treasury have a definition of a terrorist act that you would suggest we consider?

Ms. BAIR. We have been giving it a lot of thought and, yes, we are ready to sit down as soon as you would like and share our thoughts on that.

Mr. OSE. I think that would be very helpful to us. The other question I have is whether the proposal that we have talked about today, is this the President's proposal or is this the Treasury Department's proposal? Is this just an option to consider? What is it we are looking at here?

Mr. HUBBARD. This is from the President. This is not something the Treasury—that is why we are—this is a White House-adopted, signed off on—this is the Administration's approach.

Mr. OSE. I do want to compliment you. The biggest problem we always had was, first, the certainty; then the pricing; and then the processing of claims. And to the extent that this proposal would insulate the Federal Government from getting involved in the processing of claims, a remarkable step for clarity and for the purpose to bring something to the conclusion that goes beyond the understanding of people in this room.

I do want to encourage you to get us a definition of what the Terrorist Act is. That is the starting point, it would seem to me. What is the Terrorist Act?

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Ose. I have no further Democrat Members, I think, to be recognized. I would continue on our side. Mr. Fossella? Mr. Shays?

I just want to conclude by saying how much I appreciate your willingness to participate today.

Mr. BACHUS. We are going to continue to call him for questioning, yes?

Chairman BAKER. Well, we have another panel.

Mr. BACHUS. I haven't had an opportunity to question him.

Chairman BAKER. Oh, OK. Well, I went down the list and I didn't let the senior Members ask questions of this panel. One of the concerns that I had in reading an earlier version—and I don't know where the definition is now, not having read it of late. With regard to Mr. Ose's concerns and the definitive circumstance under which an act of terrorism would occur and then looking at the definition, the reading of it at the time was that it was very broad, and I hate the word "nebulous," but it wasn't necessarily very specific; and you could do careful reading of the provision, and I can see where there would be the question of $40, $50, $60 billion at stake, where there might be some legal perspective that would want to take that matter to court for some final determination. I rather suggested that since the nature of these events are extraordinary and unique and unfortunately will remain, I think, in that category no matter what our preparations; that the elements of each event are so unique that that should be a determination by somebody, not a statutory definition, for the principal reason of minimizing the potential for litigation.

Where we delegate—and the concern I think I heard expressed earlier today, if it were not the President, if it were a board, or we find some team on which this terrible decision would have to be placed. As opposed to a statutory definition, because I have not yet seen—and there may be an artful crafting yet to be done that would eliminate all probabilities—but my observation is that these events are each unique in themselves, and you are not ever going to have a definition of what has already occurred that would make absolute clarity possible.

Mr. HUBBARD. That is an excellent point. In the whole process of trying to write out a definition, multiple sets of bracketed language, we are struggling with it ourselves. I think the idea of the board is a good one and one that we are pursuing. I think we do want to have some designated board that would make this decision. How much guidance you give that board through the definitions is something that would be worked out.

Chairman BAKER. Certainly. Well, if the President or a President's representatives are required to make a declaration of the natural disaster for purposes of FEMA relief, it certainly seems like it should be appropriate in this regard.

Second, with regard to minimizing the bureaucracies, if the proposal still stands where the 2,300 insurance principles will make the claims for reinsurance reimbursement from the Federal Government—and the Secretary's characterization is we just write checks—even if that were the case, to process several thousand claims with 2,300 providers, merely looking at the forms is going to require I think an ample number of people that we don't now employ to do that work.

Second, to then audit, as he expressed, the efficacy of the claim and the fact that the person receiving it sustained the damages for which the claim was made is an enormous task. I can well imagine the Federal bureaucracy required to establish that role. Hence, my suggestion that the interface might more appropriately be the commercial reinsurance industry as opposed to the Federal Government's relationship directly to the insurance private delivery system; because the reinsurance market is where the underwriting criteria are established, where the security guards could be required, the doors be replaced, whatever it is that the markets determine are the most advisable to deter additional acts of terrorism, let the market work, and in that event we are not paying money out until after an actual claim has been paid.

We could then address some of the Members' concerns who have spoken earlier about first dollar coverage or haircuts on both end of the pipe, early and late, and at that juncture then consider the repayment process. And at the end of the day, under the current proposal, the Administration will share in the cost of those events, and we are going to do that by using taxpayer dollars.

Now, whether that is a subsidy or a bailout, that is not appropriate. What I am hoping is that we can come to an understanding we are using taxpayer money for a public purpose, but that the taxpayer should not bear the brunt of this for this reason: If we do the liquidity in the market so the economy remains stable and we do it for the economic system, but when they return to profitable and economic conditions are stable, I would hate to think there would be a year in which we would write a check for several million dollars for an industry that at year end reports several million dollars profit. We would not be looked on as very capable stewards of the taxpayers' resources, for this is to facilitate our economic system, not to enable the system to gain the books and make a profit. And I have great concerns about that, the way the structure of the current proposal is put together.

Mr. HUBBARD. Well, because the proposal is so short term, the Federal Government receives, and then if it has a presence at all, if the Congress wishes, it would be on the back end. And so I don't think you would be in that position. The question you raise would be more for the very short term.

Chairman BAKER. Well, I would never suggest this, but if I were in the insurance industry and had great PR people, then I would begin today after the passage of the act, begin building a public necessity for permit—engage in a rather significant communications program to say that unless the Congress continues this at even better levels, you are not going to get your coverage. We are going to have to face that one day or another, and I would rather not put into place a system which I think creates unlimited liability without an ability to recoup, in some manner or mechanism, even to the extent of just giving it to the Secretary of the Treasury and say when you think it is right, go get a check. And if it is not right and if it will cause economic turmoil, don't do it. But not give authority to write checks rather without limit, not fully understanding who the check is going to. And look at the interface with commercial reinsurers to minimize that bureaucratic structure. Now I am out of time.

Mr. KANJORSKI. They talked about the need for a fair impartial equity board, and by definition, that would rule out the Supreme Court.

Mr. HUBBARD. No comment.

Mr. KANJORSKI. No. I am a little bit disturbed in terms of—we seem to be talking about the events of September 11th in New York, and not talking about the recent anthrax problem. And if you look at it, I know I have one constituent in my district who runs a huge mail order house. They officially are out of business as a result of the threat through the mail and the potential closing down of the post office. And if that were to happen, we would have to make sure that we are not insuring all businesses across the country because they can't get their transactions. So we have to be fairly restrictive as to how we write this policy.

I know my friend from New York, Mr. LaFalce, mentioned business cessation, but there is no way that we could recover that kind of losses. A catastrophic event, even of a minimal nature, would rule that out.

I am disturbed that we are not thinking about other type events. This is not just something that is going to be concentrated in one area, but very easily could end up being a nuclear stockpile, a waste facility that probably in one event out of 104 nuclear plants, are likely to cause hundreds of billions of dollars of damage. I think that should be included, because, you know, we can't go to the limitations of policies on nuclear plants—I think is $7 billion—and then we have 102* an $300 billion dollars and a million people killed or radiated and we have no coverage.

But one of the things that really disturbed me about our failure to think this through to a large extent—and I don't want to push on you and then the Administration—is that the airline bill, the compensation act I think is atrocious. It is indefensible, because it wasn't thought out, it wasn't properly presented. We had 15 minutes, I believe, to read the bill beforehand. I almost had a heart attack as a former tort lawyer as to the potential liability. As I told Sheila, someday in the not too distant future, the Treasury is going to be writing out $1- and $2- and $3-billion checks to single estates in the United States Treasury. I don't think that was ever the intent of Congress, and yet the Administration hasn't come forward with a terrorist victims' compensation act. We have already had four or five deaths, and these people were in the service of this Government. They were the direct result of terrorist activity, and because they don't have contingent liability to have to go to banks, they are not going to get airline protection unless we do something about it.

And we have got a great time to do it right now. With this bill—I agree we are not bailing out the insurance company, but we sure as hell are encouraging business and providing a reduced cost of business. If we are going to do that, we ought to make sure that we compensate some of these people that are directly or indirectly affected in their life and person from the tragedies that are occurring and will occur in the future. I think it is absolutely incumbent upon the Administration to face that.

I also encourage the Administration to revisit the compensation act. I just believe we have to have limitations on this thing. To pay a bond trader that died in that building $3 billion when we are not compensating the people that died in Oklahoma City as a result of the terrorist act, that we won't be compensating these postal people that are dying all over the country, that is ludicrous and unacceptable, and we have to get out of a mind-set of just thinking about money for bricks and mortar. There are more people that could be hurt, and will be hurt, in terrorist activities in this country that deserve the total feeling of the taxpayers in the entire country to provide some compensation, not to make them wealthy, but to make them as near whole so that they can exist with their loss as possible. So I think we really have to study that. And in reality, we will be saving the taxpayers money when we do go back and find out how we can put a cap on this exposure.

Mr. OSE. Will the gentleman yield?

Mr. KANJORSKI. Yes.

Mr. OSE. When Paul talks about this, one of the questions that comes to my mind is with what happened on September 11th, one, two, or three terrorist acts, and I think that is right in the middle of your questioning, and we don't know what the answer to that is, and if it is 1, you know, the limitations on the policy are X; but if it is 2, it is twice a big as pi; or if it is 3, it is 3 times as big.

Chairman BAKER. 3.6 at risk if it is one event. 7.2 if it is two events.

Mr. KANJORSKI. Right now we are really trying to insure bricks and mortar and not people. After all, if the General Motors plant gets wiped out, it may be a $10-, $20-billion disaster. I would hate like hell to see a check for $20 billion going to General Motors when there are 2,000 families that lost their breath—and if we can send people in harm's way over to Afghanistan and only have a liability of $250,000 with them, we have to provide the soldiers on the homefront with some liability. And we shouldn't have unlimited liability or compensation for people that have to die in New York.

And I feel very sorry for them, but we are not to make them totally whole. That was never the intention, should never be the intention of the United States Government, because it is just incredibly—that liability, $30 to $70 billion, that is an awful lot of money. It should be used in other anticipatory events. And I guess with that I will——

Chairman BAKER. Your time has expired.

We are going to have to step out for a vote on the floor. I believe Mr. Bachus indicated to ask his question. On the conclusions of Mr. Bachus' questions, he will have to come up to the floor for the next vote. The bad news is for the next panel, I am told, that the votes that are now pending will keep us 20 minutes. And then we will reconvene for our final group. It has been suggested that we just delay the third panel and conclude that tomorrow, but I haven't had a chance to talk to Mr. Kanjorski about it. If you are here, I suspect many of you would like to go ahead. With that, I recognize Mr. Bachus in the chair, and we will return in a moment.

Mr. BACHUS. [Presiding.] Mr. Hubbard—and I think some of these questions have just been asked—there has been a significant blurring of the line between acts of terrorism and—between acts of terrorism and acts of war, and I don't know that anything in this will clear it up. Will a future attack by Usama bin Laden's network be covered by the Administration's proposal?

Mr. HUBBARD. Well, formally what we have been looking at is the war being mutually declared, more a formal declaration of war as opposed to a terrorist act. I agree with you, including the President's own rhetoric, maybe the impression of a blurred line between war and terrorism is certainly an open question.

Mr. BACHUS. Another attack by this network or another terrorist network. And if we don't clarify what this Government—I mean, if it doesn't cover acts of war, then——

Mr. HUBBARD. At least under the current definitions, another bin Laden attack and the present lack of a declared war would qualify as a terrorist act.

Mr. BACHUS. How about by the Taliban?

Ms. BAIR. No, we have decided that our current thinking is to have a bright line with a U.S.-declared war and——

Mr. BACHUS. The other thing, and I am not sure I disagree, but public policy questions have got to be what this Congress is going to do about health and life insurance coverage. If it is written to exclude terrorist acts, it is going to affect an awful lot of people, particularly when we are stepping in and procuring commercial law, not health law.

Mr. HUBBARD. We felt that at the moment, we wanted to focus narrowly on P&C laws, one of which is workmans' compensation, so there is some health related. What isn't is other health insurance. My impression of the HIA folks is that at least at the moment, to not exercise—they are——

Mr. BACHUS. That is something that we probably ought to at some point take up.

Ms. BAIR. There doesn't appear to be an obstruction of the market for life and health right now.

Mr. BACHUS. You are talking about the short term, and you want to get into the short term and do something, and the long term that the market ought to take care of. Let us assume that—should there be tax incentives for the private sector to build reserves against terrorist groups? That is not in here.

Mr. HUBBARD. No. That's right. We felt that we should just go more directly with the sharing scheme in the short run. I don't think it is a wise idea to distort the Tax Code. I think we can more explicitly——

Mr. BACHUS. Well, you know, what you do is a 3-year deal, but at the same time, when people finance property, they finance 10 years, 20 years, and 30 years.

Mr. HUBBARD. That is true, but nobody guarantees you insurance over 10, 20 or 30—all insurance has features or rate change features. I think the idea was to give the industry time.

Mr. BACHUS. If they are going to finance property and—will a 3-year plan actually cause them to bill that—to finance that property, when, you know, they are going to be financing it over 10 years or 15 years or 20 years? And what I am thinking, you know, have a 1-year plan, but come with some Government backstop is a better proposal than what you have here, and then you are not getting the Government as involved in the second and third—creating some backstop.

Mr. HUBBARD. Well, our hope is that 3 years would be enough time that the industry would have developed better pricing methodologies going forward. If you do just the year, our concern was that you are having an almost freezing in place for a year while people wonder what the Congress will do.

Mr. BACHUS. Another terrorist attack, another terrorist attack, this 3 years is going to turn into 6 years and it is going to continue to be pushed back. I am just saying that—backstop as part of a long-term solution.

Mr. HUBBARD. You should defensively do a backstop for a long-term solution. The question is the short term.

Mr. BACHUS. Should an insurance company's eligibility for the program be conditioned on providing terrorist risk insurance in all its P&C policies? You are not doing that in here.

Mr. HUBBARD. Well, it is an open question, actually, whether this is mandatory or not.

Mr. BACHUS. You mean legislation? We are not sure about looking at the legislation?

Mr. HUBBARD. No. I think it is an open question in this process whether you want to make it mandatory or not. One school of thought would be that——

Mr. BACHUS. Require P&C insurance to provide——

Mr. HUBBARD. Well, that would be a step that you could take.

Mr. BACHUS. Is the Administration open to that?

Mr. HUBBARD. We are looking at all these options.

Mr. BACHUS. You haven't rejected that option.

Mr. HUBBARD. No.

Mr. BACHUS. Particularly if the Government is going to be involved in a matter of public policy, if we are going to get involved in it, we want to make insurance affordable and available. And if we don't, and if we allow P&C companies to only select certain risk and—more high risk—to me it doesn't get—utilities, things of that nature.

Mr. HUBBARD. I agree. The tension was the Federal versus State aspects of the insurance industry in the U.S., but I agree with you in principle that that is a concern.

Mr. BACHUS. And I am just saying if the Government is going to get involved, the Government ought to say, you know, you offer it and you make it available.

Ms. BAIR. I would just say I think we thoroughly discussed that, and you might want to pose that question to them. I think there are a couple of questions. One is do you want to require that all

P&C insurers provide the coverage, or do you just want to say it has to be a standard part of the P&C policy?

Mr. BACHUS. Well, you could. So your eligibility to participate in this program——

Ms. BAIR. Well, you still have an adverse——

Mr. BACHUS. You don't have to provide that coverage, but if you don't provide that coverage, you don't participate in this program, because the program's design is to make that coverage available. And why allow someone who has no intention of providing that coverage to participate in the program; or has existing coverage, perhaps for the next year that is already written, but, you know, they have no intention of rewriting it?

Ms. BAIR. I think the 20/80 approach in the first year reduces the incentive for insurers to cherry-pick.

Mr. BACHUS. Well, a better incentive would be just a requirement that they participate in the program. And I would rather do that than constitutionally tell them they have to provide it. I think if they participate in the program, they have to.

Ms. BAIR. Yes.

Mr. BACHUS. You know, the British plan, their contribution—well, let me just say this. What about an ex-post subsidy? You know, for our cause, would you consider that?

Mr. HUBBARD. Priced how?

Mr. BACHUS. I don't know. Just give maybe the Secretary some discretionary authority to charge assessments based on some of the—to recoup any losses associated with administering the program.

Mr. HUBBARD. But then you are not encouraging the private industries' ability to price. I think our——

Mr. BACHUS. No, I agree.

Mr. HUBBARD. Our prejudice is the private industry could——

Mr. BACHUS. Yes. Thank you both for your testimony. I would now like to bring our third panel up.

We have a distinguished panel, and I always feel sorry for the third panel of any day, but particularly today, I know some of you came from out of town, in these wonderful quarters we are having for this hearing. But all that aside, we truly appreciate your being here, and I am subbing for Chairman Baker until he returns. But we wanted to give you folks an opportunity to testify and for the panel to ask questions.

Let me begin just to introduce the panel: Mr. David Mathis, Chairman and CEO of the Kemper Insurance Companies; Mr. Constantinos Iordanou—I always mess up this—Iordanou, Senior Executive Vice President of Group Operations and Business Development for the Zurich Financial Services Group; Scott Harrington, Professor of Insurance and Finance, Moore School of Business, University of South Carolina; Mr. J. David Cummins, Harry J. Loman Professor of Insurance and Risk Management at the Wharton School at the University of Pennsylvania; Mr. David Keating of the National Taxpayers Union; Mr. John T. Sinnott, Chairman and CEO of Marsh, Inc; Mr. Roy A. Williams, Director of Aviation from the Lewis Armstrong New Orleans International Airport; Mr. Richard J. Hillman, the Director of Financial Markets and Community Investment, U.S. General Accounting Office; and Ms. Marjorie S.

Nordlinger, Senior Attorney, Office of the General Counsel, Nuclear Regulatory Commission.

Thank you all for your patience under these very difficult circumstances.

We will begin with the gentleman from Chicago, Mr. Mathis.

STATEMENT OF DAVID B. MATHIS, CHAIRMAN AND CEO, KEMPER INSURANCE COMPANIES

Mr. MATHIS. Thank you. Thank you all for allowing us to attend. Having listened to some of the presentations today and having seen some of the other presentations earlier, I am going to cut short some of the comments that I would make in order to allow more time for questions and answers at the end. I do want to point out that Kemper is a large property and casualty insurance company, based in Chicago, with offices throughout the United States and in many foreign countries. Our largest line of business is workers' compensation coverage, but we also are a prominent writer of commercial coverages for a variety of businesses, from Main Street operations to mid-sized firms and to Fortune 500 companies.

I would point out also that as a structure, we are a mutual insurance company owned by our policyholders as opposed to being owned by the stockholders.

Skipping forward, I would mention that Kemper, like other property and casualty insurers, has been steadfastly committed to meeting our promises to policyholders as a result of the September 11 event. Our pretax losses are estimated at $360 million gross and $60 to $80 million net of reinsurance. I mentioned the two figures, because as we go forward I think it is interesting to keep in mind that absent reinsurance in this type of event, we would be looking at a $440 million loss as opposed to an $80 million loss. So the function of reinsurance has been important and continues to be important for the industry. While that is a significant sum, we will continue to meet our obligations to policyholders with no difficulties, and that includes the payment from our reinsurers as we go forward. For the industry as a whole, we are looking at losses from $30- to $60-billion, although the final number will not be known for some time.

Although no natural disaster or, for that matter, man-made catastrophe even comes close, for the sake of reference, I would note that Hurricane Andrew, which devastated south Florida, caused approximately $19 billion in insured losses, perhaps half compared to the September 11th losses. Put another way, the September 11 losses will exceed the entire property and casualty insurance net income for the past 3 years, 1999, 2000 and 2001. In just one day, industry profits for 3 years were wiped out, depleting investment income.

Recognizing that the American people and our economy will recover and move onward, we also are looking ahead. And although the property and casualty insurance industry can deal with the incredible loss of September 11th, we are very concerned about what will happen if additional large-scale terrorist acts in the future occur. It is critical that you as public policymakers share our recognition that terrorism currently presents four challenges to the insurance marketplace which we cannot meet. It is crucial that everyone recognize that we are dealing with a peril that is at this stage not quantifiable and therefore not insurable within the finite resources of the insurance industry. Quite simply, the financial capacity of the industry is limited, and unfortunately, the potential harm that terrorists may inflict is unpredictable in frequency and unlimited in severity. Given this mismatch, insurers and reinsurers cannot assess, measure or spread the risk of terrorism. As a result, terrorism has become uninsurable in the private market. This insurance market crisis, and, by its extension, pending economic crisis is why we are all here today.

As you probably are aware, more than two-thirds of the annual reinsurance agreements—and we have all talked about that—by which primary insurance companies purchase their own insurance to adequately spread risk are renewed as of January 1, and reinsurers have already notified primary carriers that the reinsurance contracts coming up for renewal will provide no coverage for terrorism. And although the primary insurance sector in the industry is adversely affected by such decisions, we recognize that this may well be the reinsurers' only way to protect against insolvency themselves.

Primary carriers, however, do not have the same flexibility as reinsurers with respect to their own products, because we are subject to tighter regulatory oversight. Any terrorism exclusion we might choose to introduce must be approved by individual State regulators. If approved, our customers could find them bearing 100 percent of the risk associated with terrorism, and certainly the repercussions of this are clear. However, if exclusions are not approved, primary insurers would be left to shoulder 100 percent of future terrorist losses, which we cannot do.

Allow me to give you an example of and to illustrate the higher retention of risk imposed on the industry. One of the Members of the subcommittee mentioned that we were not involved in dealing with lives here. We specialize in workers' compensation sector business, which significantly deals with lives. And let us say that an insurer provides workers' compensation coverage for a manufacturing facility with 6,000 employees. The plant in my example would not be located near an earthquake fault or any other place where a natural disaster caused a workforce loss of life. If, God forbid, that plant would be targeted by an extreme terrorist act which takes the lives of all the employees, the workers' compensation claim, depending on the State where the plant is located, could run between $2.5 billion to $3 billion and could fall on that individual insurer without reinsurance.

Chairman BAKER. I hate to interrupt you, but for the sake of the proceeding, on the panel I would ask that everybody try to prepare your remarks, revise them to, like, a 5-minute limit. We will incorporate the full statement into the record, and to give you a minute to collect your thoughts, if you could begin to summarize for us, because we will have other Members coming back, and it is going to be a lengthy evening for us if everybody wants to ask everybody questions.

Mr. MATHIS. I will do it without notes. Let me just say that a basic part of our discussion has been associated with trying to find a means where the industry would spread risk and could get a backup to replace the reinsurance mechanism. In our instance, I think the major issue that should be kept in mind really relates to four points. One is that the larger the amount of risk that the industry is forced to retain, without an adequate ability to spread that risk, will create a dislocation by individual companies. And that was the reason that the industry put forward a proposal to spread the risk and provide a Federal Government backstop.

Second, the industry needs to be in a position where it can pass rate increases on, in terms of any kind of charges for whatever net retention or, for that matter, whatever charge the Government may impose for its backup in terms of reinsurance. So any Federal legislation should provide some State regulatory preemption to allow that rate regulation to go through.

Third, the industry would need to be consistent in its wording for terrorism, not only with the Federal Government, but also with each insurance policy, and as a pass-through to the reinsurance industry as well. If you have a different definition of terrorism, which is excluded in the reinsurance industry, the industry would have no recourse but to underwrite against the biggest potential loss or net losses to the company.

And finally, the industry would need to have some measure of giving credit for any kind of reinsurance. So, bottom line, the industry needs to find a way to spread risk. We do not think that all of the proposals that are presented allow us to do that.

[The prepared statement of David B. Mathis can be found on page 87 in the appendix.]

Chairman BAKER. Thank you very much.

Please excuse me, is it Iordanou?

Mr. IORDANOU. Yes. It is a Greek name.

STATEMENT OF CONSTANTINOS IORDANOU, SENIOR EXECUTIVE VICE PRESIDENT, GROUP OPERATIONS AND BUSINESS DEVELOPMENT, ZURICH FINANCIAL SERVICES GROUP

Mr. IORDANOU. Chairman Baker, Chairman Oxley, it is a pleasure to be here. Zurich is a multinational insurer of significant size. We operate in 60 countries with $20 billion in equity capital. We have significant operations in the U.S.

The event of September 11th will cost consumers anywhere between $700 and $900 million in losses. This is net of reinsurance. If we would have counted our direct loss absent of any reinsurance protection, that would have been significantly higher, probably approaching $2 billion. Clearly, these are substantial amounts, but, however, Zurich in its strength with its global capital base can absorb these losses without any long-term financial implications for us, assuming there is no subsequent event of a size and assuming that we continue to have the ability to protect our balance sheet reinsurance purchases.

I will tell you today that we have notifications from all of our reinsurers that as of January 1, coverage for terrorist acts will be excluded from our reinsurance. So what does that mean? Unfortunately, for us it means that at a time when our customers need this coverage the most, not all the customers, but our largest and our smaller customers are being told by us that they cannot renew their insurance coverage absent some way of excluding terrorist risk. The larger ones have been told so because they represent very high-dollar risks to a single location and the smaller ones are being told so because the potential of risk in a particular territory creates the same issue.

This is a new economic reality, which is sad, but very real, and we need to deal with it. We now have such drastic steps——

Chairman BAKER. We are sorry. We are just trying to figure out strategy on the votes we have, just so we can dispel this. We are going to wait and run up to the—so we will go 5 minutes.

Mr. IORDANOU. Without the drastic steps that Zurich is taking to protect its balance sheet, but at the expense of our customers, we can't continue to assume these kinds of risks.

The private sector, in my view, is the way to respond to the situation and could potentially fill the void with some normal risk management tools. However, the cost to the Zurich for such tools will be prohibitive, and they will fail to provide sufficient capacity to address the multiexposures that the U.S. economy faces today.

Any Government solution should measure and should focus on bringing sufficient stability back to the insurance market so that companies like Zurich will feel comfortable including coverage for terrorist exposures to its risk portfolio.

I would remind the subcommittee that the essence of insurance is to efficiently apply capital to risk, so the standard way in which we determine whatever that goal has been met will be to whatever the degree and concentration of capital exposed to future terrorist acts is manageable. Too much exposure will force insurance to continue excluding terrorists from their coverages. However, we also appreciate that too much taxpayer exposure results are unacceptable. The solution, in our view, will need to balance the market's need for maximum stability with the Government's need for minimum exposure to these types of risk and involvement in the free marketplace.

I, for one, am confident that such a balance exists and would urge all participants to move this debate to focus on the common themes embedded in the options offered to date instead of the shared shortcomings we see in those options.

For example, the industry's original proposal utilized a pooling concept utilized a pooling structure, an approach that has long-standing use within the industry and has served other nations well in their quest to address the economic realities of terrorist risks. We understand while the concerns have been expressed, and that the debate has moved beyond this proposal, but the underlying concept of facilitating the spreading of this new type of risk is an important one that should not be abandoned. Ultimately the success or failure of this effort will be judged in the marketplace on a risk-by-risk basis, not by some broad industry aggregate, so there might be some component that serves as a proxy, even in the medium term, to the traditional reinsurance mechanism.

The White House has quoted a different approach that utilizes a pro rata risk sharing concept. It is a short-term stop-gap measure that increases the private sector retention in the second or third year, probably to the levels that are beyond the industry's capability to handle. Plus, there are a number of operational questions that would need to be answered before judging the effectiveness of this approach. However, the proposal effectively spreads both the risk and aggregate exposures that the industry is facing and signals a very important recognition on the part of the Administration that the Government does have a role to play in managing what are fundamentally political risks in our view.

Both proposals, then, reflect the underlying concept of shared private and public sector responsibility, and with modifications—some major, some minor—could serve as the basis of a meaningful resolution to this problem.

In closing, I would suggest that anyone who views a thorough backstop as a bailout may be underestimating the discipline of the private marketplace. The actions Zurich and other insurers have taken to minimize their exposure to terrorism are firmly in line with economic reality. Our capital is finite, but the risk is infinite. Thus, if there is any "bailing" out occurring, it is the natural tendency and expected flight of capital away from terrorism risk. This should not be surprising, since it is how markets operate in general, and it reflects an immediate manifestation of how the capital markets are responding to the "new normalcy" of post-September 11th American life.

Thank you for allowing me the time to present to you Zurich's perspective, and I would be happy to answer questions.

[The prepared statement of Constantinos Iordanou can be found on page 95 in the appendix.]

Chairman BAKER. Thank you very much.

What time do we have remaining? If we would, Mr. Harrington, we will recognize you, Professor of Insurance and Finance, University of South Carolina. Welcome.

STATEMENT OF SCOTT E. HARRINGTON, PROFESSOR OF INSURANCE AND FINANCE, MOORE SCHOOL OF BUSINESS, UNIVERSITY OF SOUTH CAROLINA

Mr. HARRINGTON. Chairman Baker, Mr. Oxley. I spent my career studying insurance, and I really appreciate the opportunity to be here to have this opportunity to testify.

We don't know how bad things are going to get this winter when these contracts are ultimately—we don't just know yet. Some Federal intervention may be very desirable to prevent a potential crisis. But we need to consider very carefully—insurance involves the fundamental tension between risk sharing and incentives—you have heard a little bit about this today. We widely appreciate the incentives of risk sharing. The moral hazard effects are likely less appreciated. It tends to dull incentives to manage risk. At this time, private markets do a tolerably good job of dealing with moral hazard.

Government insurance programs or Government-backed insurance mechanisms—they are also not likely to provide good incentives for efficient claims management. They are not going to provide the right incentives for risk management in the private sector.

Subsidized Federal reinsurance or direct Federal reimbursement of a large proportion of terrorist losses could make citizens more vulnerable to harm. And, again, it could make citizens more vulnerable to harm. If insurance against terrorist acts is made available at heavily-subsidized rates, some—perhaps many—businesses could take far fewer precautions to protect life and property. If you help too much, there is a good chance that more property will be destroyed and more people will, in fact, die.

The Administration's proposal has some advantages. It might keep the Federal Government out of pricing insurance; but then, it might not, because if you start thinking about mandating the offer of such coverage, I think you are going to pretty quickly have to think about limiting price. It could be awkward.

I think the Administration's proposal would provide some limited subsidy to the insurance industry. It would provide some significant subsidies to large commercial property owners. I think the major problem is the first dollar coverage at an 80 percent basis. Professor Hubbard said that they wanted to err on the side of caution. They erred on the side of too much precautionary risk spreading. That proposal would seriously undermine the integrity of risk assessment, claims adjustment, and management. And the proposal does relatively little to encourage capacity. In fact, I think it does very little to encourage capacity.

I encourage you to consider two things. One is some form of tax incentives for insurance companies to build the massive amounts of capital it takes to write this stuff. We are not talking about distorting the Tax Code. The Tax Code distorts these markets immensely. It is a punitive tax on the private sector. If we are going to try and help these markets accumulate capital, then we need to remove some of that punitive taxation.

I think you could encourage supply substantially with some form of temporary system of ex-post assessments. Let me just step through that very quickly. You might have a system where, with $5- or $10-billion in terrorist losses in a year, God forbid, that insurance companies, all property casualty insurance companies, will be assessed to finance a material proportion of the losses above that threshold. The insurance companies could limit their risk. We could allow them to borrow from the Treasury if the assessments in any given year exceeded some amount like 2 percent of the premiums. They could pay back the amount that they borrowed with future assessments under that type of proposal, if necessary, at a higher threshold. The Government could then become a direct sharer in the risk bearing.

In conclusion, I think the tax incentive approach and the possibility of ex-post assessment of the insurance industry would help mitigate the threat of a crisis and mitigate these inherent problems without substantial undermining of private sector risk assessment, claims settlement, and risk management, and I really think that the result could be less loss of property and less loss of life. Thank you.

[The prepared statement of Scott Harrington can be found on page 102 in the appendix.]

Chairman BAKER. Thank you very much.

I think we are going to call our next witness and proceed before we depart for the vote. So Mr. David Cummins, Professor of Insurance and Risk Management at the Wharton School.

STATEMENT OF J. DAVID CUMMINS, HARRY J. LOMAN PROFESSOR OF INSURANCE AND RISK MANAGEMENT, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Mr. CUMMINS. I would like to thank the Chairman and subcommittee Members for allowing me to be here today. I have outlined some principles that I think any Federal program should satisfy, and to say at the outset that they are more consistent with the Administration plan than they are with the private insurance industry plan. I am basically very much opposed to the private industry plan. I think the Administration plan has a number of features to recommend it, but there are a number of features or problems that would have to be fixed before it would be enacted and be really an effective program.

I think, first of all, the program should have the clearly stated objectives of helping the policyholders, insurers, and the economy to weather the current crisis by encouraging private insurers to return to the market as soon as possible.

Second, the Federal program should avoid the creation of any new institutions or new bureaucracies, such as the homeland security insurance company proposed by the industry.

Third, the Federal contracts have to be sold at a positive price. Providing free coverage would set off all the wrong incentives in terms of claims settlement and charging premiums in the direct market. So you have to come up with a price. I would recommend hiring an actuarial firm to apply the principles of actuarial science to come up with the best possible price under the uncertainties that we know are present in the program.

Fourth—and this is a commendable part of the Administration's proposal—that any Federal coverage should have a cost sharing provision, where the Government should never cover 100 percent of any layers. So it should at least be 20 percent covered by the industry, or maybe even more than that, except possibly at the very highest layers.

Fifth, Federal coverage should start after a reasonably large deductible. There should be no first dollar coverage, even during the first year. The industry could easily bear $5- to $10-billion. That is not the layer that they are really concerned about, and it sets the wrong incentives to provide Federal first dollar coverage.

Sixth, the Federal obligation should be capped. There is no magic number, but $100 billion is probably reasonable; perhaps something somewhat less than that would also be a possibility. And this basically gives the Congress the option to come back in at the $100 billion layer and either agree to continue or extend the program or decide to do something else. You don't want to put an unlimited program in place.

Seven, the program should be limited to property coverage——

Chairman BAKER. Just stop for a moment. We will put Mr. Bachus in the chair. We will be right back.

Mr. CUMMINS. The coverage should be limited to property coverage and other coverage to terrorism where the loss amounts are relatively easy to identify. For example, the program should not provide coverage for difficult-to-verify claims such as business interruption insurance. This is to prevent abuse of the Federal program and to provide incentives for policyholders to get back in business as quickly as possible following a loss. There may be the need for other policy remedies, especially for small businesses facing business interruption crises, but it shouldn't be a part of the insurance program.

Consideration should be given to incorporating "finite reinsurance" provisions in any Federal plan. Essentially finite reinsurance transfers less risk to the reinsurer than traditional indemnity reinsurance that is basically intended to smooth out the insurers' losses over time. The reinsurer essentially advances money to the insurance company when losses are high, with the obligation of the insurer to repay most of the money when losses are relatively low. This might be especially appropriate in a Federal plan at the lower layers of coverage.

And then finally, the Government should explore ways in which it could encourage the development of private markets for catastrophic risk without providing Federal backing, such as lowering regulatory barriers to securitize the insurance risk, and perhaps acting as a facilitator of securitization by providing data that could be used by private firms in developing better loss indices to enable the provision of securitized financial instruments which are much more efficient than insurance in insuring this type of risk.

So I guess just a couple comments on the Administration proposal. Several things I see wrong with it. First is providing first dollar coverage during the initial year is not a good idea. The industry should bear the first $10 billion of coverage.

Second, without going into each year and each layer, case by case, the proposal is generally too generous, and it is split between the Government share and the industry share.

Third, the finite reinsurance option should be seriously considered for lower layers of coverage, with the indemnity reinsurance going to the higher layers.

And then, fourth, the program should exclude certain types of difficult-to-verify claims, such as business interruption insurance.

And then also it is important to charge a premium for the coverage. Thank you.

[The prepared statement of J. David Cummins can be found on page 107 in the appendix.]

Mr. BACHUS. [Presiding.] And their proposal does exclude businesses. Right?

Mr. CUMMINS. It excludes punitive damages.

Mr. BACHUS. My understanding is the last draft took out that. Well, I think it is going to, if it hasn't, as a result of the testimony today.

Mr. Keating.

STATEMENT OF DAVID L. KEATING, SENIOR COUNSELOR, NATIONAL TAXPAYERS UNION

Mr. KEATING. Mr. Chairman, thank you for the invitation to speak before the subcommittee today. We represent 335,000 members, and we are strongly opposed to the insurance industry proposal and the Administration proposal, at least as it has been offered. I would like to associate our views with what I have heard both from Professor Harrington and Professor Cummins. All of the concerns that they have raised, all the points that they both made

I think were excellent, and the subcommittee should keep them foremost in your mind as you go to draft any legislation.

We wholeheartedly agree that both these proposals stand the risk not only pf putting taxpayers in danger of unnecessary losses of human life and property, and I didn't hear much—and much to my disappointment—from the Treasury Secretary or Mr. Hubbard about that, and I think that most people agree human life is the key thing that we should be watching here. And we need to have incentives for the people in the industry to watch their clients to see that they are putting forth the proper security measures, escape mechanisms and such, and if we just give away Federal reinsurance, we are not going to see that kind of activity taking place and clearly we need to have that kind of activity. People need to reassess how they are running their businesses.

It is essential that we limit the Government's total liabilities in any action or legislation, that you make firm limits or policy, clearly define terrorism, and limit the Government's exposure to certain types of losses. We are very concerned about business interruption coverage. Otherwise we could see the Government paying companies not to go back to work for years.

We see the same problems with unemployment insurance. I mean, people don't have the same incentive to go get a new job if the Government is underwriting their business revenues even though you are not in business. Things are very vague and can be stretched out. We can't go there.

We also have to make sure insurers pay enough of the claims out of their own pocket. Otherwise they are going to make their long-term clients happy with Federal Government taxpayer dollars. Easiest thing in the world to make someone happy with someone else's money.

Now, I also want to express my surprise and shock about the Treasury Secretary, of all people, and the Chairman of the Council of Economic Advisers, their understanding of tax laws regarding insurance. To me it is astonishing that they think that somehow allowing reserving on a tax-free basis for the expected losses from catastrophes is somehow a distortion of the tax laws. They have got it exactly backward. The tax laws are what are distorting sound insurance principles here. If we knew with precision what the future would bring, we could set aside the money now, the exact correct amount, so that when the disaster happens, the money would be there. If you guide it by years, you know it is the cost of doing business; yet the way the tax laws are written, that cost of doing business is counted as a profit and taxed. It is crazy.

So I think they have got it exactly backward, and Members that had asked about that, perhaps you are using the wrong language. Maybe they heard the question wrong. It is not so much we need a tax incentive. Should we stop the tax penalty for sound reserving catastrophes? That is the way I would ask the question and perhaps you would get a different answer next time.

Rather than discuss point by point what we have in front of us from the industry to the station, I would like to outline some principles for legislation. One.

One is, I think this is obvious, any Federal capacity should offer the maximum amount of economic benefit, not only to the Nation, but injured parties, at the lowest cost to the taxpayers.

Two, legislation must not erode incentives for wise underwriting and insurance company management of risk, proper security escape contingency plans I spoke of earlier. We cannot have a blank Federal reinsurance check and reduce incentives for increased security.

Three, if Federal reinsurance capacity is offered, then there should be payment for the use of capital and the assumption of risk, for many of the reasons I spoke of earlier.

Four, Federal coverage should certainly not insure against all industry terrorism losses. Coverage in the first dollar of losses is unnecessary and unwise, because it would erode incentives and increase security.

Fifth, Federal insurance capacity should be temporary to maximize the use of market mechanism, first for reentry of prior reinsurance at higher levels at the earliest possible date.

Six, legislation must contain strong incentives to pay only valid claims. We believe the Federal Government's copayment claims should never exceed 80 percent. As spoken of earlier, it is too easy to make other people happy with someone else's money, in this case the Federal Government's.

Seven, and this is a point I haven't heard yet today, maybe it is so obvious that no one has spoken of it, but I am not sure so I will say it. The Federal Government's exposure should be capped primarily to preserve America's national security options. Let us face it, we are in a war. We don't want to have a Federal Government entitlement program to underwrite every dollar of every damage that might happen. We are not facing the bombing of London like they did during World War II, but if something terrible should happen here, we can't have a Federal entitlement program to cover every dollar of loss for war or terrorist attacks.

So I am not even sure where the definition is, but the primary purpose of the Government is to defend our Nation. So we cannot have an unlimited liability, and that is one positive trait in this Administration proposal. We will have to balance off what we can do for our Nation's people, their property losses, the lives that are lost, but we also have to balance the key reason for Government, to defend the country. So that is the real reason why it needs to be capped.

Another principle that the Administration has talked about and we agree with, we need some sort of panel to quickly pay and settle claims to incur losses in a fair and inexpensive way. We don't want to spend taxpayer money paying the trial lawyer a lot of money, stretching out litigation years and years. If the private markets were to get back and cover this kind of loss, they need to know what the loss is. We can't stretch it out over the 5 or 10 years, figure out what the eventual losses are, and we don't need to waste money paying a lot of lawyers to do this.

So those I think are the key principles. I think by—listening to those principles and applying them to the proposals before you I think will help steer the subcommittee and the Congress in the proper direction, and we are willing to work with you, Mr. Chairman, other people in the industry, other interested parties to help work out a solution here. Thank you very much for the invitation.

[The prepared statement of David L. Keating can be found on page 113 in the appendix.]

Chairman BAKER. Thank you.

Mr. John Sinnott. You are Chairman and CEO of Marsh, Incorporated.

STATEMENT OF JOHN T. SINNOTT, CHAIRMAN AND CEO, MARSH, INC.

Mr. SINNOTT. Thank you, Mr. Chairman, for allowing me to be here. I should probably explain what Marsh, Inc., is, because we represent, perhaps a slightly different constituency than others. We are the world's largest risk adviser and insurance broker. We have about 35,000 employees around the world, and we are located in about a hundred countries. Our clients comprise all segments of the commercial world. Private clients also. And we also act as advisors and reinsurance brokers to insurance companies. So I think that we have a pretty good view of what is happening today in this marketplace and what we expect will happen for our clients if something doesn't happen here very quickly.

I should also point out that I represent not just Marsh, Inc., but I also represent the member firms of the Council of Insurance Agents and Brokers which is the national trade association. So I am speaking for both constituents. I will cut through some of the comments that I had planned to make. There are two problems here. One is the size of this event, which is more than twice the size of the next largest catastrophic event. If you add the other five largest events that took place in the last 10 years, you have only about aggregated what the estimated loss coming out of this particular event is.

The second problem is the uncertainty of the current environment. That is what is different since September 11th and why we are talking about this issue now. The nature of this risk has radically changed because of certainly a perception of what we have heard from Washington which is the probability that there will be another event. So trying to compare the way we approach this pre-September 11th and today you will never come up with the right answer.

What is the result of these two problems? Since September 11th, we have undertaken many renewals on behalf of our clients, and most reinsurance is still in place, although we are seeing terrorist exclusions on the policies more so than not. And the other thing that I can say, as we look forward to January 1st, our reinsurance unit cannot identify a reinsurance company that is not going to exclude terrorism come January 1. So the issue of this is not an issue of supporting the industry, but the fact that American business will not have protection for a catastrophic potential loss come January 1st.

I would disagree with the comments about business interruption. Business interruption is a normal sort of risk that business clients transfer to others. It will comprise a significant part of the September 11th event. And why one would exclude, when the commercial market is going to be picking up and adjusting these claims, and they have had to adjust these claims, if it is straight fire they will have to adjust it, if it is a fire caused by terrorism, they would have the same adjustment issue. The markets will not provide coverage for a terrorist event for business interruption if it is not covered for property damage in the first place. Markets almost never cover business interruption in isolation to property damage.

So I was not aware that there was a disconnect here on business interruption. But that just puts it back. There will be no coverage for this come January 1 with businesses if that is the case. Seems to me as far as the timing, it is fairly straightforward. If the current environment doesn't change, this risk is going to be 100 percent uninsurable in the commercial market.

What the Government is trying to do obviously is change that environment and cure this problem so we get back to some normalcy the way we were before September 11th. I am not saying it is going to be exactly the same, but at some point that has got to be our hope. I don't know whether that is in 2 years, 3 years or 6 years. I think it is something that one has to look at. And as soon as normalcy starts to come back, you will see the commercial market come back to this arena. That is why the Administration's plan does allow for that. And I think that will happen as long as we find some way to cure the environment.

I will just finish with one other comment. In 1993, we had the first terrorist attack on the World Trade Center. We had offices in that building at that time. Fortunately, we had no loss of life. That is most important. Second, the amount of the insurance claim that we had resulting from that loss was less than $5 million. So as a result of that particular incident, you didn't hear anything about the commercial insurance market saying it needed help that you are hearing now.

On September 11th, my firm lost almost 300 people in the World Trade Center. Obviously, that is the biggest loss that we have ever sustained. And it is something that my colleagues carry around in the halls and will for a long time. But secondarily, we will also have an insurance claim to present not of a few million, but in the hundreds of millions of dollars. And we just have an office occupancy.

Mr. BACHUS. Hundreds of millions?

Mr. SINNOTT. Hundreds of millions of dollars. That is the difference. That is what has happened. I don't see any way for us to get terrorism coverage—and we are starting on our renewals right now with our clients—if some mechanism isn't coming up for sharing the risk, even on a temporary basis between the Government and the private industry, we have got a train wreck coming January 1 in the property area.

Somebody mentioned the aspect of life insurance. I don't believe that withdrawal of coverage in the life insurance field is an issue, although I would defer maybe to Constantinos and Dave who are in that business.

[The prepared statement of John T. Sinnott can be found on page 123 in the appendix.]

Chairman BAKER. We are told it is not now. Or if you look at it from that perspective, the life industry pays 5,000 claims a day. So even this incident will not be significant for them. Because you take the U.S. population, 275 million people, if you say the average——

Mr. IORDANOU. 7,000. And most of them that have that understanding, so that industry covers it. It is not an unusual and extraordinary event for them. Yes, it is dramatic based on the way it happened, but not a big event for the life insurance business.

Chairman BAKER. Thank you, sir.

Mr. BACHUS. Just to clarify, again, we don't have the text of any legislation. It is in appropriations.

Chairman BAKER. All we have is a recommendation.

Mr. BACHUS. The approach says that business interruption is not a big deal.

Chairman BAKER. I would like to recognize Mr. Roy Williams, director of aviation, Louis Armstrong New Orleans International Airport, with which I am greatly familiar. Welcome.

STATEMENT OF ROY A. WILLIAMS, DIRECTOR OF AVIATION, LEWIS ARMSTRONG NEW ORLEANS INTERNATIONAL AIRPORT

Mr. WILLIAMS. Thank you, Mr. Chairman. Mr. Bachus, Members of the subcommittee. And I am sure you are only familiar with it because you fly over it after you have left out of Baton Rouge Airport. But I am very happy to be here today, although I do feel I am a bit like a fish out of water with this panel that you have assembled here with you. Perhaps the airport experience that we are experiencing today gives some credence to the discussion of what may happen to other industries in the coming months.

Let me begin with a little background. Armstrong International has 16 passenger carriers and five air cargo carriers, and we just celebrated serving more than 10 million passengers in one 12-month period, an all-time record for the airport. That ranks us as 39th in the United States. There is nothing particularly unique in the airport in terms of insurance risks. It doesn't have any reservation centers, it is not a hub for a passenger cargo carrier. So I think we are sort of a normal example of an airport.

Prior to the events of September 11th, airports usually had substantial levels of war and terrorism risk included as part of their general airport liability coverage. In our case, $300 million and sometimes up to $1 billion at large hub airports. To date, since September 11th, only 2 insurers have come back into the market with a product that is very expensive and has a very limited and inadequate liability cap of $50 million. At least one of the available policies contains massive exclusions such as not covering screening, baggage and security functions. In addition, these policies include a 7-day cancellation clause.

So turning specifically to Armstrong International, for the 12 months which ended September 30th, 2001, our policies covered essentially all risks, including war and terrorism, up to $300 million. Our annual premium was $321,000.

We had already begun a search for a new policy before September 11th, and in fact, after September 20th we did have an offer of a policy. But the new policy excluded war and terrorism completely. It excluded certain officer and director coverage, and was at a price of $520,000 per year for the same $300 million coverage.

A short while later, we received an offer of $50 million in terrorism coverage for a $450,000 premium. Thankfully, we received a second offer for the same level of coverage, $50 million for a premium of just over $300,000. And we have bound those coverages. So right now we are now at about $900,000 in insurance costs for much less coverage than we had before at $321,000.

Now, just this week, we received an additional option to consider, and that is an offer of an additional $100 million in war and terrorism coverage which would increase our total protection to $150 million, half of what we had before. The premium on that additional coverage is $573,000 a year. So put simply, if we accept that coverage, we would have half of our prior war and terrorism coverage, essentially all of our other coverage as we had before for a total annual premium of nearly 5 times what the airport paid last year. About $1.4 million versus $321,000.

And the important point in this is who pays for this? In terms of our agreement with the airlines, we pass costs such as this directly to the air carriers in their rents and landing fees. That $1.1 million insurance premium increase that we are facing represents a 3 percent increase in the total air carrier costs to operate at Armstrong. This would raise our landing fee by about 15 cents per thousand pounds. Put another way, it is 22 cents per passenger. Again, this is simply not the same coverage we had before.

We really don't recommend that we sustain these risks of insuring ourselves against the risk of terrorism by simply assessing exorbitant costs. We instead recommend the subcommittee consider solutions to spread these risks as broadly as possible, taking into account the fact that the risks associated with an act of terrorism far exceed the economic capacity of any individual airport to sustain or pay.

For example, one solution might be to extend the current Federal War Risk Insurance Program exclusively to airports. The program now does cover airlines and covers their vendors and agents.

Looking forward, New Orleans is doing well. We are down only 14 percent from our regular scheduled flights. We appear to be operating at close to 75 percent of our normal traffic. We think these numbers will continue to improve. But we cannot fulfill our obligation to Louisiana unless national air volumes return to normal. We believe that what will get those passengers flying again is to restore confidence in the security of our planes and our airports and provide stability in the marketplace. The insecurity regarding the availability of insurance and the calculation of risks associated with actions of terror creates a background of instability, has wreaked havoc with the traveling public and the insurance industry. Restoring the insurance at reasonable rates should underpin any legislative effort to restore this confidence.

[The prepared statement of Roy A. Williams can be found on page 126 in the appendix.]

Chairman BAKER. Thank you, Mr. Williams.

Next, Ms. Marjorie Nordlinger, Senior Attorney, Office of General Counsel, Nuclear Regulatory Commission. Welcome.

STATEMENT OF MARJORIE S. NORDLINGER, SENIOR ATTORNEY, OFFICE OF THE GENERAL COUNSEL, U.S. NUCLEAR REGULATORY COMMISSION

Ms. NORDLINGER. I am pleased to be here today to provide information about the unique nontraditional Price-Anderson system referred to so many times today. It has evolved from Congress's initial 1957 enactment of the Price-Anderson Act. I will focus on the development of the functions of the indemnification of public liability compensation. The testimony, of course, relates to the nuclear power reactors regulated by the Nuclear Regulatory Commission. I am not speaking on behalf of DOE's parallel functions.

The Act addressed an unusual insurance situation which was blocking Congress's aim for the development of the peaceful uses of atomic energy. That situation was one where it was impossible to rule out the potential for an accident. There was little or no experience of the kind Secretary O'Neill described. And the possible costs of damages were uncertain. And thus neither industry nor private insurers could absorb the risk. Congress had two paramount goals in resolving this predicament. One was to make available adequate funds to satisfy public liability claims in a catastrophic nuclear accident, and the other was to permit private sector use of nuclear energy by removing the threat of potentially enormous liability in the event of such an accident.

The solution combined indemnification with the limit on liability. The solution applied to all reactors as a further condition of licensing. And the licensing process itself provided substantial assurance that each reactor would be designed, built and operated to satisfy high safety standards. Originally, Price-Anderson prescribed that each power reactor licensee had to procure available financial protection, which as a practical matter, meant the purchase of $60 million of commercial insurance, the maximum then available. I might add here that the commercial insurance was itself pooled coverage and that was the only way they could get some companies to stand behind the commitment for funding.

That first layer was then followed by indemnification by the United States itself to cover up to $500 million in liability over the amount covered by commercial insurance. And the United States never, on the commercial side, exceeded a $500 million indemnification role.

Aggregate liability for any single accident is, by statute, limited to the sum of the commercial insurance available and the Government indemnity. As you all perhaps know, the Government has never had to pay any indemnity for a nuclear accident on the commercial side, nuclear power plan. The aggregate liability included the liability of any one who was found liable for any reactor accident with the exception of an accident resulting from an act of war.

This broad coverage is known as omnibus coverage. The omnibus nature of the coverage was designed to serve many purposes. It was to ensure the availability of funds to compensate for personal injury or damage to property of members of the public, no matter who caused the accident. It was there to permit suppliers and professionals to participate in the industry without fear of liability far out of proportion to any profit they might expect to gain, and it was to make possible efficiencies in the process of presenting, settling and satisfying claims.

Mechanisms to accomplish these goals were incorporated in insurance contracts and in required agreements of indemnification between the licensee and the United States. The end result benefited the public by channeling all legal claims to the reactor licensee or operator.

While the Price-Anderson Act provided that liability was limited, the reports of both Houses on passage noted that if actual damages were to exceed the available funds in commercial insurance coverage and Government indemnity, "the way was left open for Federal contributions after further congressional consideration." This concept present at the outset was later expressly included in the Price-Anderson Act amendment, and is often referred to as a "third layer of protection."

Congress amends the Price-Anderson Act from time to time, always mindful of the delicate balance of obligations between operators at nuclear facilities and the United States Government as indemnitor and as representative of the people.

The most significant amendments to date were those that effectively remove the United States from its obligation to indemnify commercial power reactors and place the burden on the nuclear power industry. This was accomplished without any substantial alteration of the other elements that characterized the Price-Anderson theme, most particularly, without affecting omnibus coverage and liability limited to the availability of funding. And it was enacted with increased protection for the public.

The first step in this direction occurred in 1975 when Congress mandated that each commercial power reactor contribute $5 million to a retrospective payment premium pool. This retrospective premium was due if, and only if, there were to be damages for a nuclear accident that exceeded the maximum commercial insurance available. The limit of liability was then $560 million. Government indemnification was phased out in 1982 when the potential pool and available insurance reached that sum.

In 1988, Congress increased the potential obligation of each and every reactor in the event of a single accident at any reactor to $63 million. The liability insurance available to comprise the first layer is now $200 million. When that insurance is exhausted, each U.S. reactor licensee must pay into the pool up to $83.9 million as adjusted for inflation, if needed, to cover damages in excess of the sum covered by the commercial insurance. The $83.9 million is payable in annual installments not to exceed $10 million.

Today, the first layer of commercial insurance and the second layer from the reactor pool together would make available over $9 billion to cover any person or property harm to the public caused by an accident. An early amendment expanded the waivers so that in serious accidents, denominated extraordinary nuclear occurrences by the NRC, the defendants must also waive other defenses. The waivers in sum provide a result in the nature of strict liability where the harmed public need prove only that the accident caused their injury, proof of fault is eliminated.

The statute excludes coverage of property damage at the reactor site, and there are also provisions covering, among other things, settlements, establishment of a single Federal forum, case management, distribution of funds, criteria for allowing legal costs, and the preparation of reports to Congress in the event there is an expectation liabilities will exceed the available sums.

Thank you, Mr. Chairman. I welcome your comments and questions.

[The prepared statement of Marjorie S. Nordlinger can be found on page 130 in the appendix.]

Chairman BAKER. Thank you.

Our final panelist this afternoon, Mr. Richard Hillman, Director of Financial Markets and Community Investment with GAO. Welcome, sir.

STATEMENT OF RICHARD J. HILLMAN, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GENERAL ACCOUNTING OFFICE

Mr. HILLMAN. In the interest of time, I will be very brief. At your request, our testimony today outlined features of selected insurance programs covering terrorists and other catastrophic events ranking from programs completely controlled and managed by the Federal Government or other governments to programs with little or no explicit Government involvement. Sandwiched in between was a wide range of programs that the public and private sector shared risks together and in varying and different ways.

The second point of my testimony provided information on alternative mechanisms for funding insureds also including both pre- and post-funding mechanisms and the use of industry pools to share risk.

Finally, our last point provided some of our own thoughts about how the Congress ought to be approaching next steps. Most importantly we are hopeful that what we are seeing before us is a temporary market failure. And in that vein, we are hopeful that the program that would be designed would not displace the private market. Rather, it should create an environment in which the private market can displace the Government program.

In summary, we have provided a great deal of information on Federal and international programs to your staffs. And we stand ready to provide any additional information on these programs should you so desire.

[The prepared statement of Richard J. Hillman can be found on page 137 in the appendix.]

Chairman BAKER. Thank you very much. We appreciate your attendance and your brevity.

Let me suggest, Mr. Chairman, that since it is just the three of us and likely to be the only three of us that rather than just proceed with 5 minutes apiece, that we take advantage of a group discussion which would be a little more beneficial, I think and just dispense with the normal 5-minute rule and just jump in when you like.

We know that we have to do something. We are not sure what that something is. But providing liquidity to the markets at some point with some limit—because like the shareholders of insurance companies who don't and will not tolerate unlimited exposure, neither will our shareholders. So the meeting, I think, needs to be around perhaps a two-step approach, something immediate and short term that would buy us time to do the long-term resolution that might be more appropriate. Is that something—just that protocol from an industry perspective, say we are going to do X and then come back next spring and address the remaining issues, let's assume the short-term program is a 12- or 15-month short-term solution, is that enough comfort for the reinsurance markets to function, given that we are going to come back with a longer term resolution when we have the appropriate time to construct it? Is that acceptable?

Mr. MATHIS. Can I take the first crack at that? I think that several issues are associated with that. One, the reinsurance market isn't going to function. It is my hope and belief that they may function if there is a viable limit out there in the market. But there isn't any associated with that.

Mr. OXLEY. That wouldn't be right away.

Mr. MATHIS. No, it would be a matter of time associated with that. Second, that was the reason why there was an industry mechanism associated with a pool to try to spread the risk in that area, which could work in the retention area. The problem associated with big net retentions against the industry, and I understand that, in Government, is that it doesn't deal with the individual risk exposure. So therefore, individual companies still have to underwrite against the collective loss that they feel that they might have on an individual risk exposure. And I would predict that, even though a top level measurement on the top part of the Government would certainly bring some measure of comfort and stability back into the marketplace, it wouldn't solve it all unless there was some solution to that mechanism.

And third, if the Government comes up with something that is associated with a short term timeframe stopgap that isn't consistent over a period of time, you have to recognize that we write policies that have a 1-year policy limit. So if you have that, you have a net retention that is going to move next year to a much higher number, then you have to write the business understanding that that is what your net retention is.

Chairman BAKER. But that is a problem with even the 3-year program. Because there are projects that are going to take longer.

Mr. MATHIS. The industry or the current Administration proposal talks about a plan that is 80/20 to begin with and moves to 50/50 in the second year then to higher retention. I think that that is a problem for the industry to not have something that is consistent all the way across to look at and try to quantify and measure because, you know, one month after January 1st, you are writing into the next year.

Mr. SINNOTT. I think if you did it on a risk attachment basis, which is the normal way of doing things, since it will be the commercial insurance policy there that will adjust the claim, the Government will have to agree that the cause was terrorism, but if it is on a risk-attaching basis, it is during that policy year, it follows that policy. And if that acceptance happens to extend out over a period of years, it still goes back to that period. That is the way the insurance mechanism works. As long as it follows that, I don't see a problem.

Mr. IORDANOU. If there was no sunset provision. But you are postponing the issue, because at the end of the day you have to revisit it.

Chairman BAKER. We are understanding what we are doing is not final. We need more time to examine, study and understand. What I fear is we act precipitously in the next 3 weeks not fully understanding what we are doing, and find out that we have represented to the industry a 3- or 4- or 5-year program that is fatally flawed. That, to me, is a great disservice as opposed to a short term, publicly acknowledged, this is to get us by January 1, guys, and by March or April of next year, we will have an ample opportunity to thoroughly vet it. I wanted to know if there was a visceral no to that. But it may be with certain conditions.

Mr. IORDANOU. Let me jump in on a couple of our issues.

Mr. OXLEY. Let me back up. What is the biggest down argument against what Chairman Baker was talking about? What is the worst-case scenario if we were to do that? Is it that there is no longer the political will to fix the problem entirely?

Mr. SINNOTT. Really, the issue comes down to what is the sharing between the private industry and this mechanism. As long as that is basically agreed.

Chairman BAKER. For purposes of discussion, let's just take the President's first year of his plan and just say year one, here is the deal.

Mr. SINNOTT. If the industry and the insurers can live with that, and if the brokers and others, Dave, can go out now that it is only a 20 percent issue rather than 100 percent withdrawal from the market, I think there is an opportunity to start the market moving along to maybe provide some protection for that 20 percent.

Mr. OXLEY. The subcommittee will have some evidence by then as to what is happening in the marketplace?

Mr. SINNOTT. I think getting through January 1 is a big issue.

Mr. IORDANOU. You are talking——

Mr. OXLEY. The policy being renewed for another year?

Mr. SINNOTT. Yes.

Mr. IORDANOU. Or maybe more. On the risk attachment basis, if any of you own a 3-year policy for a project a construction project, that it will take 26 months or 27 months, if the risk attachment is there, then the coverage will follow throughout that period.

Mr. SINNOTT. It is the only logical way to do it. The 20 percent that the private industry has, that is the way the commercial market will look at the claim. It is on a risk attaching basis, even if it is a construction project that runs out. There is nothing unique about that. That is the way the mechanism works.

Mr. IORDANOU. There is another issue here that I think is grossly misunderstood about how the mechanisms in the industry work. Even I was surprised to hear the comments by my colleagues from academia that were opposed to the first dollar sharing of risk. I will agree that $5- or $10- or $15 billion in the aggregate is a size of risk that the industry can handle collectively. But the way contracts are issued, unless you create within that mechanism an invented sharing, it is not going to work in the marketplace; because at the end of the day, who does provide the insurance for the factory that has the 10,000 employees or assembly plant that might be the next attack?

Now, even though the industry loss might be $5 billion, not significant, it is only covered by one insurer, and that insurer is out of business. Because if it was Kemper or if it was Zurich in North America, with $4 billion committed to North America, we would be out of business. And that is the part that is being misunderstood in the debate today. That we have not only an issue with aggregation of small risk, but we have an issue in the way the mechanism works today in the private market by instructing the insurance component that allows spreading of risk to operate efficiently.

And focusing on $5-, $10-, $15-billion in the aggregate, it is significant, but not catastrophic, but it could be catastrophic to a single insurer.

Chairman BAKER. What has bothered me in the interface between the Government and the industry in the proposal is the direct providers of the policy to the insured property as opposed to the commercial reinsurance industry. Everybody that I have heard express concern about exposure goes to dense projects where you have high value, high numbers of people in small areas, not necessarily to cattle operations in Wyoming. And in order to not create more of a hazard, we need for insureds to take appropriate self-protecting actions.

Since the commercial reinsurance guys set the underwriting standards, doesn't it make some business sense for us to enter into our agreement for the backstop with the commercial reinsurers, and then have them set the new security measures or standards in a private market context, but ensure that they do provide coverage for terrorism?

Mr. BACHUS. I think actually what has been also discussed is the State-chartered reinsurance. They would then—in turn the Government would come in and——

Mr. MATHIS. The pool.

Mr. IORDANOU. Independent of how you do it, Chairman Baker, there is no opposition if it is insurance or reinsurance. The principle is the ability to share risk. But that is how you allow the free mechanism, you know, the freedom to go out and write these very large limit policies for the airport or for the water supply company or for the train station or for the stadium. Because at the end of the day, they know that if an event happens, you know that risk will be spread.

Chairman BAKER. The insurance company has to lay it off to the reinsurer. The reinsurer is going to lay it off to the Federal Government. All I am saying is from an operations standpoint, when your customer makes the claim and you have to fill out the form the Federal Government prescribes and send it to the Secretary of the Treasury for him to issue a check, I suspect for 2,300 companies and thousands of claims, you are going to have a long wait.

I would rather, as much as it is practicable, have you engage, turn it around as a business matter and ask a reinsurance company for their appropriate contribution and have the reinsurers dealing with the Department of the Treasury. It seems to me to be a more efficient mechanism.

Mr. SINNOTT. I hope no one is envisioning that we had a frequency problem. It is a severity issue. If you had a frequency problem, you are 100 percent right. But we are talking severity, which means very few; hopefully no events, but at the worst severity of events. They will be severe in nature. And that can be managed this way. That is the other reason why we advise our clients to take deductibles. Don't do first dollar. But in this case, with the few events—or hopefully none—but the few events that could occur, it is not really first dollar. The industry is going to be in there, because if you get an event, it is likely to be a major event. So the whole idea of first dollar doesn't ring with me on this. I don't view this as really first dollar, because we are talking catastrophic risk.

Mr. BACHUS. What about a special State-chartered reinsurance company?

Mr. CUMMINGS. I am really against setting up that. I think the market works more efficiently in terms of reinsurance contracts. I think that's what we see in commercial markets. It is fairly like financial.

Mr. BACHUS. You wouldn't have to. They could see——

Mr. MATHIS. The industry proposal. Not that it could pick and choose individual risk.

Mr. BACHUS. It is an option you can cede risk to. The reinsurance company, the Government would then participate.

Mr. HARRINGTON. Then you have the Government in pricing. You should avoid the Government in pricing. If you go down that route——

Mr. BACHUS. Don't you do that on other——

Mr. MATHIS. Supporting a funding of the first $10 billion of losses that has built up over a period of time.

Mr. BACHUS. You actually said that you thought there ought to be a first dollar.

Mr. IORDANOU. You oppose that.

Mr. HARRINGTON. I have assumed that given what I know about the sophistication of reinsurers, if there was a $5- or $10-billion attachment point, there are a lot of smart people in this business that would start thinking about how they could design property treaties so they could price it in recognition that there was a relatively low probability that there will be an amount greater than that amount. Maybe I have grossly overestimated sophistication in the reinsurance markets. But the latest contracts are set up, it has got to attach an 80/20 basis in the first dollar.

Mr. IORDANOU. There is no way to spread the risk on a catastrophic event. The concept of an industry aggregate of $5 or $10 billion and then something that attaches on the next system, it creates an environment that singular insurers will be exposing up to 100 percent of their capital to an acceptable risk. For that reason, you are defeating the purpose of trying to create liquidity.

Mr. HARRINGTON. I thought you could deal—you and your reinsurance friends could get together and negotiate this.

Mr. IORDANOU. It needs to be part of this proposal. If that happens and there is some encouragement either with tax, which I think is a great idea, the reason we are exploring more coverage to foreign markets today in the United States is because we have a bias against the mechanism of setting the reserves for events that we know that will happen once every 10 years, once every 25 years, once every 50 years. Today it is tax efficient for me as a buyer to send my dollars for reinsurance to Bermuda and get a deduction as a business expense, it is a cost of doing business, versus putting it in a tax-free pool.

Chairman BAKER. Let's go right to that point. We had the discussion earlier. If you were to create a tax-free pool for terrorism reserves only—and that is a reserve which does not exist—therefore I would argue has no budget implications, but that is a thin argument, what would that do for you in your perspective in enabling you to insure against terrorist risk?

Mr. IORDANOU. Over time—not immediately, over time as that builds up, it will create more and more capacity in an ability for companies——

Chairman BAKER. Are you talking 2 or 3 years?

Mr. IORDANOU. It depends on the size of how much would allow it to—because you got to have some—there is not going to be an open-ended ability to set terrorist reserves, you know, for risk. There has got to be some parameters; otherwise you will eliminate paying any taxes, continue putting up reserves and earmarking them.

Chairman BAKER. But from an industry perspective, that is a major element in the long-term private market resolution of this problem.

Mr. IORDANOU. I agree.

Chairman BAKER. Doesn't help us January 1.

Mr. KEATING. If we don't think about the long term, we are not going to get there. We will wind up having more of this.

Mr. SINNOTT. I think that is right. As I say, we do not have much time to figure out what we are going to do for January 1.

Chairman BAKER. Let's jump on that, if I may. If we take the President's first year proposal, what additions or modifications would this group suggest to make it a workable plan for, say, 15 months?

Mr. KEATING. Could I say something? I really don't think it makes sense that the Treasury do first dollar, because the assumption here is that anything that happens is going to be a catastrophic event. Just because they were so clever the first time around doesn't mean every event is going to be a huge event. I don't see the need for the Treasury to step in on everything that might be considered a terrorist act. So first dollar coverage to me makes absolutely no sense.

Mr. OXLEY. There ought to be a deductible.

Mr. SINNOTT. You are complicating it, because now you are trying to aggregate the industry together. You are getting into a very complex mechanism. If you keep it simple, it is a co-insurance, policy by policy by policy. Now, that is, you could view that as interim. But otherwise, you figure out an event occurs and you have many insurance companies; how do you allocate it? Who gets the benefit? It becomes more complicated.

Mr. IORDANOU. Worse than that, you get two insurance companies, both of them out of business.

Mr. SINNOTT. So you have to keep it simple starting out, although these points, looking at taxes, are clearly good; you know, the near-term/long-term things that can be done. The other thing that as I said before, I mean I don't know why the mechanism would not include business interruption. It will create another disconnect between the 0 percent that the commercial market is offering and the 80 percent, if that is the number that the Federal program provides. Because these are programs that are together. Most businesses buy property damage and business interruption.

Mr. IORDANOU. Let me give you the statistics. The business interruption component of loss arising out of covered perils is 50 percent of the loss. So for every dollar of indemnity we give to a customer, 50 cents goes to rebuild the factory and 50 cents goes to reimburse them for business interruption.

Mr. KEATING. But not everybody buys business interruption.

Mr. IORDANOU. There is no commercial enterprise that I know that has no business interruption coverage.

Mr. SINNOTT. Wait a second. Let me tell you. We have experience on this. We do the Fortune 500. I can tell you that there is only a handful, relatively speaking, of the very largest companies that don't buy business interruption. . You are talking about Fortune 500.

Mr. HARRINGTON. There are lots of things that are on business interruption.

Mr. IORDANOU. The business interruption provided by the insurance industry is business interruption arising out of covered perils, so you have to have an incident.

Mr. SINNOTT. Of your actual lost loss.

Mr. OXLEY. Mr. Hillman has been studying this at GAO. What is your cut on these different proposals?

Mr. HILLMAN. I find some of the remarks that these gentlemen are making to be very useful. One of the points that I think may be worth considering is rather than coming up with a $5 billion, a $10 billion, a $15 billion retention for the industry as a whole, because that provides a lot of complicating factors, one thing you may wish to consider is establishing a per-claim limit. And perhaps I will have Mr. Cluff provide that.

Mr. CLUFF. Either per claim or per insurer.

Chairman BAKER. For the record, give your name.

Mr. CLUFF. Lawrence Cluff with the U.S. General Accounting Office. But either way, you avoid the problem of trying to aggregate to some $5 billion, $10 billion, you avoid the pricing problem, and you also avoid the Treasury having to write a check for every little thing that happens. If you have a retention on a per-claim or a per-insurer basis, that solves a lot of those problems.

Chairman BAKER. Any reaction?

Mr. MATHIS. Well the 80/20 is a retention per claim.

Mr. SINNOTT. That does eliminate the problem that I was saying. It is specific.

Mr. KEATING. That is fine with me; but going on each claim, each first dollar doesn't make any sense.

Mr. CLUFF. I concur.

Mr. IORDANOU. There is no first dollar coverage to begin with in the business. First dollar coverage is for your homeowners. When you get into the commercial business, a lot of our clients will retain maybe $100,000, $500,000, $1 million, some of them $5 to $10 million over the first dollar coverage. They buy beyond that. So in those parameters, I think everything is workable. I don't think it is a bad idea. I think it needs to be on the table. As a company we will not be opposed to it.

Mr. SINNOTT. It just gets back to what the retention tolerance is of the industry. Fine. They take the first X amount, then they know that they are also going to have 80 percent. It is a matter of figuring out what the retention tolerance of the private industry is, and the willingness of the Government; and hopefully those two things on a temporary basis will match, so that we get beyond this particular real problem that we have and have more time.

And the brokers can help in this. There are already small bits of capacity that are being developed. The problem is it is just too big a gap that we are looking at, and we are looking at 100 percent withdrawal. If this was just 10 percent, it would be different, like when some markets decided to get out of the business when we went through this 16 years ago. We were able to deal with it without asking the Government to step in, and we were able to get policyholder investment, and we got it done, and the market returned to normal.

I think the same thing can happen here, though there is one difference. We didn't have an environmental issue 15 years ago that had to be changed, that we had to find a solution for. In our case, I can tell you that our midtown office, which is where our headquarters is, security is on the top of our list of priorities. I think the comments about this being a free ride for businesses is innacurate.

Mr. BACHUS. What about the comment, I thought you said, that would increase the risk when the Government steps in?

Mr. IORDANOU. We totally disagree.

Mr. SINNOTT. The insurance was there before. We are talking about the withdrawal of insurance. Let's continue to provide insurance which is a social instrument, continuing to provide it on a temporary basis, get the Government in there, get it out as quickly as possible and do it on a basis that allows competition, the particular competition that we like to see on behalf of our clients, which is each of the markets doing its own thing.

Chairman BAKER. Let me jump in.

Mr. HARRINGTON. Temporary, that is fine. But over the long term, it will be a good idea to have some relocation of certain businesses, to spread the risk out to reduce the risk of a big event in a particular place. In the long term, if we intervene we are going to discourage those type of responses.

Mr. SINNOTT. We are looking at it ourselves because we have 5,500 people in New York City in one big building. I mean, forget about whether or not we have insurance. We are looking at lives here, whether or not there is business disruption. Regardless of the insurance response, we had business disruption. If we have our risks better spread, we will have less business disruption and we lessen the risk to our colleagues. So all of those things are ongoing right now.

Chairman BAKER. Our position is not to——

Mr. BACHUS. Can we get into some of the finer points?

Chairman BAKER. Let me jump one more thing before you do that. As to the element of why there is the pushback on the structure either to the industry or the Administration proposal from some unidentified Members of Congress, you are going through this self-assessment of how do we protect our people, how do we ensure our business exists? But the resolution of that is to ask people with the checkbook or the money, without the people who are going to write that check knowing anything, with the industry, the solvency of the companies to whom we are extending the credit, the limit of our exposure if, God forbid, this thing does turn out to be frequent and large. What we are tying to say, we understand the importance of acting timely and responsibly, but we have to take risk aversion steps ourselves.

So that is what we are looking for here. If we can do that with something temporary and come back and not have industry claiming that Congress has not met its obligations because it has not met final resolution, and do that next year, we can have more of these and really get down to the fine points that Mr. Bachus and others would choose to pursue.

Only to that end in looking at the Administration proposal, pro and con, all the ideas possible are about how we tweak the first-year methodology to potentially be a short-term remedy to give us the long-term critical analysis. None of you gentlemen would invest large sums of money without relying on a great deal of examination by the best staff you could find to give you all the pros and cons. That is where at least I am speaking for myself. I don't feel I am competent to make this decision this afternoon. I may not be competent to make it next year, according to some people. But I think I want to give myself the best shot. So that is where I am.

Mr. BACHUS. Adverse risk selection. I ask this question: Should an insurance company eligibility for the program be conditioned on providing terrorist risk insurance in all its P and C policies?

Mr. MATHIS. To a large degree, it already is.

Mr. SINNOTT. The large commercial markets file and use, where you don't have to get State agreement.

Mr. BACHUS. But what I am saying, again, should one of the policies of this Congress be that we would require them to offer it?

Mr. MATHIS. Well, I have two questions which are associated with that. Are you going to agree that there is a rate preemption and that people can charge whatever rates they choose in the marketplace? The other is that you clearly wouldn't expect that every company would want to underwrite every risk.

Mr. IORDANOU. In order to eliminate the moral hazard, it has to put the pressure on the management of that company to deal with the kind of risk that would be criticized today in this area that maybe the industry is not paying much attention to.

And the second point is that, in our view, risk management for terrorism risk, the only authority who can do the best risk management is the U.S. military and the CIA and the FBI and the Federal Government. At the end of the day—that is why we have this event today. In 1993, in 1993 we knew we had a terrorist attack. In 1993 we knew it was the same set of buildings. In 1998 the industry suffered about a little over $1 billion in claims. And we were down in

Washington looking, because actual mechanisms of the industry dealt with it.

Today, just for the record on the perspective that we are talking about, the property casualty business has a revenue of $155 billion. When you look at the equity capital of the industry supporting the $155 billion, it is anywhere from $80 to $100 billion. In one event, almost 50 percent of that capital has appeared. So now you face executives that say they are providing that liquidity in the marketplace. They say if they have two such events in the next year, you will have no property casualty business. The entire business will vanish.

Chairman BAKER. That is only the case if we have a significant untoward event in the near term. If we are able to get a few years' grace, the industry can survive. And perhaps with tax incentives for reserves, whatever the necessary steps, we can get there. The short-term question is—I think the principal question we have got to resolve today, in the next few days, what do we do about January 1? What does it look like and what are the elements for the taxpayer to make marketplace sense?

Mr. BACHUS. Let me ask another. Should the Secretary be given discretion to preempt State regulation?

Mr. MATHIS. In certain areas. Not total.

Mr. BACHUS. It will have to happen.

Mr. SINNOTT. As he says, it will happen in certain cases once you get beyond a certain point where rates are not tariffed. You know, rates are freely negotiated, policy conditions are negotiated. There is not much issue there as far as scope of coverage.

Mr. MATHIS. Let us take workers' compensation.

Mr. SINNOTT. Well, that is statutory.

Mr. MATHIS. And it is State regulated in every State, and there is no ability to deal with——

Mr. SINNOTT. I was thinking workers' comp. Or what is a terrorist about? If we go to 50 States, we will be in litigation for the next 50 years.

Chairman BAKER. Some of the things I have read, we are going to be in litigation for the next 50 years.

Mr. BACHUS. That is something to give thought to.

Mr. MATHIS. I want to talk totally about a large—we write a lot of middle-America business. That is in urban areas.

Mr. BACHUS. OK. Now, this thing includes private passenger automobile coverage. We are talking about 7,000 people die every day. We insure every automobile every day. Should the Government program insure private passenger—isn't there going to be a lot of claims?

Mr. IORDANOU. Let me give you a scenario and you draw your own conclusion. Most personalized carriers write personal automobile and also write homeowners policies.

Mr. BACHUS. Homeowners?

Mr. IORDANOU. Well, if I am in your home and I drink contaminated water, I can have a claim against you, in essence, against your homeowner's, and I can paint a scenario that maybe a water company, their wells get contaminated, and now you have a significant number of homes that have contaminated water through an agent. And we have significant number of——

Mr. BACHUS. I am just concerned about the volume. If we cover private passenger automobile coverage, the Government proposed it, that is a big volume of claims.

Mr. IORDANOU. I can envision private passenger automobile to have a large number of claims.

Mr. BACHUS. It is in here. Right? What you don't want, you don't want a process in the automobile claim where there is some——

Mr. SINNOTT. Right.

Mr. MATHIS. I would say to you, we are in the commercial line. But I don't want to speak for——

Mr. BACHUS. It is in here right now.

Chairman BAKER. And I thought we had generally agreement that—because my comments earlier, I was reflecting on commercial reinsurance principally as an interface and commercial lines only being subject to——

Mr. BACHUS. Well, right now it is commercial property and commercial liability and commercial automobile, workers' compensation, private passenger automobile, homeowners. It does include business interruption, and that is my next question. You know, you are saying that that is——

Mr. SINNOTT. Sure it is.

Mr. BACHUS. It is possible to design a two-tier—what I did here is it is more subjective in figuring out——

Mr. SINNOTT. Yeah. It is a difficult business interruption adjustment.

Mr. BACHUS. We just have a different—you know, where we insure 90 percent, you know, and——

Mr. SINNOTT. We could, but——

Mr. BACHUS. Could we do 80, 75 percent——

Mr. SINNOTT. But the adjustment issue is not as straightforward, I grant you, but the World Trade Center claims are going to be adjusted eventually. There are going to be some disputes as respects property damage and also business interruption. There will be a sum total. So the fact that it is more difficult to adjust.

Mr. BACHUS. You mean to compute what the loss——

Mr. SINNOTT. Yeah. To calculate what the loss is. I don't see why that would make different treatment from the sharing.

Mr. BACHUS. It is——

Mr. IORDANOU. No. It is——

Mr. BACHUS. Certainly you are talking about a proposal by the Administration to take care of 50 percent of the profit.

Mr. SINNOTT. I wasn't aware of that. Was that a recent takeout?

Chairman BAKER. There are several memoranda characterizing the Administration's proposal. So we don't really have a——

Mr. SINNOTT. I heard the Secretary, and that was the first I had heard about it.

Mr. BACHUS. It is in here right now, and what I am saying, it certainly won't take care of the problems of increased premiums, which I agree is not an insurance problem. It is an economic problem. If we are going to have a recovery——

Mr. IORDANOU. You——

Mr. BACHUS. We are already in a recessionary situation.

Mr. SINNOTT. I can almost guarantee that the primary insurance carriers will not cover terrorism on their own for business interruption.

Mr. BACHUS. It may be what is done, is that it is an 80/20. Either way.

Mr. IORDANOU. So there have got to be those mechanisms. But I can tell you the liquidity of the market, working capital and capital for fixed assets will disappear. Why will a bank lend to a restaurant owner if he can't pay the mortgage back because of a business interruption versus a fire?

Chairman BAKER. Sure.

Mr. BACHUS. These are little things. You know, you get a package and——

Mr. KEATING. We have got to be very careful to have the things to protect——

Chairman BAKER. Well, let me suggest this as a starting point for us, because we have got to do something pretty quickly. Among the respective interests represented here, send us a couple pages apiece on the essential elements you think make short-term sense. Let us not try to fix the world long term. Let us try and get us past January 1, with the understanding that if we can reach an agreement, it would be our obligation to come back to stakeholders next year and do it the right way, but if you really—in my casual observation, where our potential risk is, there aren't many remaining elements that offer all the downside that occurred September 11th, and the likelihood of something of that magnitude occurring in the near term, no one knows.

But it would be very difficult, I think, given all the extraordinary measures that have been engaged in, and we certainly can expect, I think, more events, but, you know, hopefully no loss of lives and very little dollar. If we have that luxury and we can do this in a less difficult environment. February, March, I think we can craft a package, hearing everyone's perspective that makes some long-term economic sense, without only debating unnecessarily tax dollars beyond foreseeable vision. And to that end, unless you have got something further, Spencer, I just——

Mr. BACHUS. Well, we have had mail interruptions here. Does that—if you had a company that had mail interruptions because of an anthrax scare at a local post office, can they make a claim under business——

Mr. SINNOTT. There has got to be——

Mr. BACHUS. Or the business has to be shut?

Mr. SINNOTT. It has got to be damaged from a peril.

Mr. BACHUS. Mail interruption does——

Mr. SINNOTT. Sure.

Mr. IORDANOU. It was the same issue with the Y2K, that there was no business interruption, you know, and there was mitigation around that.

Mr. SINNOTT. Remember that we will have, I mentioned, our insured losses. We will have uninsured losses that will be very significant. So insurance——

Mr. IORDANOU. Professionals that you have——

Mr. SINNOTT. Insurance only covers generally a relatively small part of what the total loss is.

Mr. BACHUS. And Mr. Williams, there has been a proposal from this airline security to the airports, and you all write some of that. Be aware that in that bill, the proposal, the standby coverage, extended——

Mr. WILLIAMS. Yes.

Mr. BACHUS. We don't know. I am just telling you. They can start fighting and you can start fighting about that.

Chairman BAKER. Let me express my appreciation to all of you for your long-standing tolerance today. It was a difficult day and we made it and it was helpful to us in getting a better understanding. Thank you very much.

[Whereupon, at 5:55 p.m., the hearing was adjourned.]

A P P E N D I X

October 24, 2001

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON PROTECTING POLICYHOLDERS FROM TERRORISM

WEDNESDAY, OCTOBER 24, 2001

Mr. Chairman, I must commend you for your perseverance and determination in convening this important hearing to examine the impending availability crisis for terrorism reinsurance and to discuss potential alternatives for resolving this liquidity problem.

Prior to the assaults on the World Trade Center and the Pentagon, most Americans took their security for granted. The shock of the suicide attacks, however, has altered how we each assess risk. This adjustment has become especially apparent in the insurance industry. Prior to September 11, many insurance companies could not price for terrorism risk and offered it for free. Although such practices demonstrated poor economic judgment, many insurers have fortunately indicated that they have sufficient resources to absorb the catastrophic losses of the attacks.

Given the magnitude of the destruction in New York City, we should expect sharp hikes in business insurance premiums. But concerns have also arisen that any future terrorist incident of a similar or greater size could threaten the stability of the property and casualty industry. Further, many reinsurers have decided to curtail their coverage for future terrorism events because they cannot presently determine how to price the frequency, severity, or location of these acts. This problem appears especially acute in high-density areas with large-scale commercial activity.

Any scarcity in terrorism reinsurance will have deleterious effects on our already sluggish economy. Although this contraction in our reinsurance markets has not yet fully manifested itself, it soon will. According to the American Insurance Association, more than 70 percent of businesses renew their insurance contracts at the end of each year. This means that companies of all kinds could find themselves without protection against terrorism on the first day of 2002.

At that time, firms unable to obtain full insurance coverage might choose to cease some or all of their activities because of a determination that the risks from continuing business is too great. This outcome would likely result in worker layoffs and product shortages. Businesses that decide to self-insure against future attacks, could also experience difficulties in attracting new capital and -- in the event of another assault -- would have to cover their own losses. That outcome would surely bankrupt some companies and further destabilize our economy.

A lack of terrorism reinsurance will also cause substantial burdens for the real estate sector, which accounts for about a quarter of our gross domestic product. In order to obtain a loan, banks usually require businesses to insure any property they pledge as collateral. But in this uncertain environment, some developers and building owners may find it impossible to obtain the coverage that lenders demand. Furthermore, without terrorist insurance, it could become prohibitively expensive, if not impossible, to build and operate in high-risk areas.

<u>As a result, I believe that we must temporarily intervene in the reinsurance marketplace to safeguard against a cascading financial crisis</u>. In recent weeks, several alternatives to solve this problem have emerged. One plan would establish a government backstop for a reinsurance pool

designed to spread risk across the industry. Another approach using quotas would distribute reinsurance costs for terrorist acts between industry and the government. Other solutions include allowing insurance companies to build tax-free reserves, limiting liabilities for damages as we presently do for accidents at nuclear reactors, and facilitating the issuance of catastrophic bonds.

From my perspective, any legislation to assist the insurance industry and our economy in the short term should adhere to four principles:

- First, to the extent possible, the primary insurers must continue to bear a tangible share of the risk for future attacks through the use of deductibles, premiums, or assessments. Equity owners must also carry some share of the risk in order to encourage them to implement appropriate safety precautions.
- Second, we must sunset the program. The reinsurance industry is dynamic and we should not disrupt the development of new products.
- Third, in order to protect taxpayers we should consider placing caps on the government's liability and implementing adequate oversight.
- And fourth, everyone -- from the real estate mogul to the average homeowner -- should participate in the program.

As I said at our last hearing, we must move cautiously and methodically in addressing this problem in order to prevent unintended consequences. Given our forthcoming adjournment, however, we must also move forward expeditiously. Instead of convening additional hearings on this problem, we should quickly assemble a bipartisan and bicameral group to negotiate a solution with experts and industry leaders. Time is of the essence, and I stand ready to work with you, Mr. Chairman, and all other interested parties on these matters in the upcoming weeks.

In closing, I am looking forward to hearing from each of our witnesses today and especially from Professor David Cummins. Professor Cummins with the Wharton School of Business in Pennsylvania is an expert on insurance and risk management issues, and in recent weeks I have found his advice informative and insightful.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

EMBARGOED UNTIL 10:00 A.M.
October 24, 2001

TERRORISM RISK INSURANCE

Testimony of the Honorable Paul H. O'Neill
Secretary of the Treasury

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

Mr. Chairman, Congressman Kanjorski, and Members of the Committee, I appreciate the opportunity to comment on terrorism risk insurance. These hearings are extremely important. We believe that there is a real and pressing need for Congress to act on this issue now. As I will discuss in more detail, market mechanisms to provide terrorism risk insurance coverage have broken down in the wake of September 11. Such coverage is now being dropped from property and casualty reinsurance contracts as they come up for renewal, with most policies renewing at year-end. If Congress fails to act, reinsurers have signaled their intention to exclude such coverage meaning that primary insurers may have to drop this coverage or institute dramatic price increases. As a result, after January 1 the vast majority of businesses in this country are at risk for either losing their terrorism risk insurance coverage or paying steep premiums for dramatically curtailed coverage. This dynamic can in turn be expected to cause dislocations throughout our economy, particularly in the real estate, transportation, and energy sectors.

1. The Problem

The terrorist attacks of September 11 created widespread uncertainty about the risk and potential costs of future terrorist acts. Since September 11, we have endured this uncertainty every day as a country. It has permeated every sector of our economy.

A key part of the government's response to the events of September 11 is to ensure that our economic stability is not undermined by terrorist acts. Continued economic activity is dependent on well functioning financial markets – where the lifeblood of capital is provided to business enterprises. Financial markets allocate capital based on the potential success of a business. In doing so, financial markets rely on the insurance sector to mitigate certain types of risk that are not directly related to the plans or operations of a business.

Insurance companies manage risk in economic activity and facilitate the efficient deployment of capital in our economy by estimating probabilities of possible adverse outcomes, and pooling risk across a large group. Since September 11 the uncertainty surrounding terrorism risk has disrupted the ability of insurance companies to estimate, price, and insure the risk.

We learned on September 11 that, while perhaps highly improbable, terrorists are capable of enormous destruction. Could such an event be repeated? As a country and a government, we are doing everything in our power to prevent a repetition of anything like the events of September 11. But how does an insurance company assess this uncertainty? How does an insurance company price for it? At the moment, there are no models, no meaningful experience, no reasonable upper bound on what an individual company's risk exposure may be.

Insurance companies do not "take" risks. They knowingly accept and mutualize risks. They are private, for-profit enterprises. If they do not believe they can make money by underwriting a particular risk, they will not cover it. Because insurance companies do not know the upper bound of terrorism risk exposure, they will protect themselves by charging enormous premiums, dramatically curtailing coverage, or – as we have already seen with terrorism risk exclusions – simply refusing to offer the coverage. Whatever avenue they choose, the result is the same: increased premiums and/or increased risk exposure for businesses that will be passed on to consumers in the form of higher product prices, transportation costs, energy costs and reduced production.

The consequences of uncertainties surrounding terrorism risk are already evident in the airline sector. The Department of Transportation's initial projection is that, as a result of the September 11 attacks, airlines will pay nearly $1 billion in premium increases for terrorism risk insurance in the next year despite a congressionally imposed cap on third-party liability. Within the next few months, similar increases can be expected for other forms of economic activity deemed "high risk" – if coverage is available at all. Higher premiums will divert capital away from other forms of business investment.

The need for action is urgent. From our conversations with insurance company representatives, state insurance regulators, policyholders, banks and other entities which provide financing for property transactions, the next two months are critical. The insurance industry relies on a complicated structure of risk sharing. Risk is shared among primary insurers, reinsurers, and retrocessionairs (i.e., providing reinsurance to the reinsurers). This structure has worked well in the past and greatly contributed to widely spreading losses associated with the events of September 11 across the insurance industry.

However, in light of the uncertainty created by September 11, reinsurers have told us that they will no longer cover acts of terrorism in their reinsurance contracts with primary insurers. And as I have said, most property and casualty insurance contracts are up for renewal at year-end. This will create the following choices for insurers: assume all of the risk of terrorism coverage and raise prices to cover all of the associated, unshared costs; reduce coverage levels; or cancel coverage. Any of these choices has the potential to cause severe economic dislocations in the near-term either through higher insurance costs or higher financing costs.

2. Objectives

In grappling with this problem, we have had several objectives.

First and foremost, we want to dampen the shock to the economy of dramatic cost increases for insurance or curtailed coverage. We also want to limit federal intrusion into private economic activity as much as possible while still achieving the first objective. And we want to rely on the existing state regulatory infrastructure as much as practicable.

Note that none of these objectives are directed at providing government assistance to the insurance industry. The industry is absorbing the financial losses it contracted for as a result of the September 11 attacks, and is fully capable of making good on those losses. The industry is also capable of continuing to provide insurance for non-terrorist hazards. The problem, as I have said, is one of uncertainty about future terrorist risk. At the moment, there is no basis upon which to price terrorism risk and no sense of the upper bound on the risk exposure.

3. Options

Over the past few weeks, a variety of proposals have emerged to deal with the problem I have outlined. Before turning to the approach we have developed, I will briefly discuss a few of the alternatives we considered and some of the shortcomings we identified with each.

A case could be made to treat terrorism risk insurance like war risk insurance. During World War II, the federal government provided property owners with insurance protection against loss from enemy attack. Similarly, the Israeli government provides insurance for terrorism risk. This approach would recognize the terrorist threat as one made against all Americans and would establish the broadest possible risk pool for insuring against this risk. At the same time, such an approach implies a permanent federal intrusion in the market so long as any terrorism risk remains.

A second approach, one suggested in various forms by insurance industry representatives, involves the creation of a reinsurance company to pool terrorism risk. This model follows an approach developed in the United Kingdom in response to IRA terrorist activities. This approach has some appeal, especially in providing a vehicle for pooling the industry's risk while providing an upper bound on industry losses through a government backstop. With more time, or in different circumstances, this approach may have been desirable.

In our judgement, however, it has several significant shortcomings. First, the approach ultimately leads to the federal government setting premium rates by establishing the rate charged to the pool for the government's backstop. If the basic problem is that the insurance industry – whose business it is to measure and price risk – cannot currently price terrorism risk without distorting markets, why would we think the government can do a better job?

Establishing a pool would also take time, and time is very limited since most policies expire at year-end. It is unclear how long it would take industry to capitalize the pool. In the interim, the government's exposure could be substantial, insofar as it would be liable for 100 percent of losses that exceeded the pool's capitalization. In addition, we question whether the government could move quickly enough on its end to establish the contracts, the pricing structure, and the regulatory structure needed to make the proposal work.

Finally, the pool approach creates a federal insurance regulatory apparatus with some presumption of permanence, and a potentially enormous pool of captive capital that we may never need to use. We believe that there will be less uncertainty about terrorism risk a few years from now and that uncertainty will be more manageable by the private sector than is the case today. Given that, why undertake the effort to create a monopoly reinsurer and give a new federal regulator the power to both set prices and regulate insurance companies and their activities?

A third option would be to simply set a large industry deductible and let the federal government cover all losses from acts of terrorism past that point. For instance, the federal government could require the insurance industry to cover all losses up to, say, $40 billion in a given year and the federal government would pay all losses above that amount.

This approach has two substantial drawbacks. First, it does not address the fundamental problem: the industry has no basis for knowing – and hence pricing – terrorism risk. A large deductible would require them to assess premiums large enough to cover a large potential loss. In the absence of better information, we might well expect companies to price insurance as if they fully expected losses up to the deductible amount. Second, this approach makes it difficult to control losses above the deductible as insurance companies would have no incentive to limit costs once their deductible has been paid.

4. A Shared Loss Compensation Program

After reviewing these and other options, and discussing these issues with congressional and industry leadership and the state insurance regulatory community, we developed an approach that we believe best accomplishes the objectives I set forth. Let me say at the outset that this approach reflects the current evolution of our thinking on this issue. We want to work with Congress to achieve the best possible solution. As I have said, the insurance industry can easily protect itself by eliminating coverage or charging very high premiums. What we are trying to do is craft a plan that will prevent the economic dislocations that will otherwise take place if private insurers follow the course they are now on. It is imperative that we find a solution that works in the marketplace. We must get it right, and we must get it right now.

When terrorists target symbols of our nation's economic, political and military power, they are attacking the nation as a whole, not the symbol. This argues for spreading the cost across all taxpayers. Yet there are also reasons to limit the federal role. If property owners do not face any liability from potential attacks, they may under-invest in security measures and backup facilities. In addition, the insurance industry has sufficient experience and capacity to price some portion of the risk associated with terrorism and has the infrastructure necessary to assess and process claims.

Under the approach we are suggesting, individuals, businesses, and other entities would continue to obtain property and casualty insurance from insurance providers as they did before September 11. The terms of the terrorism risk coverage would be unchanged and would be the same as that for other risks.

Any loss claims resulting from a future terrorist act would be submitted by the policyholder to the insurance company. The insurance company would process the claims, and then submit an invoice to the government for payment of its share.

The Treasury would establish a general process by which insurance companies submit claims. The Treasury would also institute a process for reviewing and auditing claims and for ensuring that the private/public loss sharing arrangement is apportioned among all insurance companies in a consistent manner. State insurance regulators would also play an important role in monitoring the claims process and ensuring the overall integrity of the insurance system.

Through the end of 2002, the government would absorb 80 percent of the first $20 billion of insured losses resulting from terrorism and 90 percent of insured losses above $20 billion. Thus, the private sector would pay 20 percent of the first $20 billion in losses and 10 percent of losses above that amount.

Under this approach the federal government is absorbing a portion -- but only a portion -- of the first dollar of losses, which we believe is important to do in the first year of the program. The key problem faced by insurance companies right now is pricing for terrorism risk. While this type of loss sharing approach does not completely alleviate that problem, it does provide insurance companies with the ability to evaluate potential losses on a policy by policy basis, with clearly defined maximum exposures. For example, on a $100 million commercial policy the insurance company's maximum exposure would be $20 million. If industry losses were greater than $20 billion that exposure would be reduced even further.

More importantly, price increases to policyholders should be lower under this approach than under an approach that requires companies to absorb 100 percent of losses up to a large, aggregate industry loss deductible. Under this approach, if an insurance company's maximum exposure was defined at $20 million on a $100 million policy, the insurance company could then price that $20 million exposure on the probability of a complete loss event occurring.

Suppose instead that the insurance industry had to absorb $20 billion in losses before any government loss sharing began. Then, in our example, the insurance company's maximum loss exposure would be $100 million on that policy, not $20 million. Pricing to this maximum loss would create the economic dislocation we are trying to avoid.

The role of the federal government would recede over time, with the expectation that the private sector would further develop its capacity each year. As private sector capacity increases, the nature of the government's loss sharing agreement would also change. Given more time and experience, we believe that the insurance industry could reestablish robust risk-sharing arrangements such as reinsurance that would enable the private sector to insure losses from terrorism before the government loss sharing commenced.

Thus, in 2003, we would have the private sector be responsible for 100 percent of the first $10 billion of insured losses, 50 percent of the insured losses between $10 and $20 billion, and 10 percent of the insured losses above $20 billion. The government would be responsible for the remainder.

In 2004, the private sector would be responsible for 100 percent of the first $20 billion of insured losses, 50 percent of the insured losses between $20 and $40 billion, and 10 percent of the insured losses above $40 billion. The government would be responsible for the remainder.

To preserve flexibility in an extraordinary attack, combined private/public liability for losses under the program would be capped at $100 billion in any year. It would be left to Congress to determine payments above $100 billion.

The federal government's involvement would sunset after three years. It is our hope, indeed our expectation, that the market problem we face today will have been corrected by then so that the private sector will be able to effectively price and manage terrorism risk insurance going forward. Of course, should that prove not to be the case, Congress and the President can reevaluate the program in place and decide at that time on an extension of the program or establishment of some other approach.

This approach would also provide certain legal procedures to manage and structure litigation arising out of mass tort terrorism incidents. This includes consolidation of claims into a single forum, a prohibition on punitive damages, and provisions to ensure that defendants pay only for non-economic damages for which they are responsible. It is important to ensure that any liability arising from terrorist attacks results from culpable behavior rather than overzealous litigation. These procedures are important to mitigating losses arising from any future terrorist attack on our nation, and are an absolutely essential component of the program I have outlined.

Finally, this approach requires a clear definition of an "act of terrorism." We suggest that the Secretary of the Treasury, with the concurrence of the Attorney General, and in consultation with other members of the Cabinet, be given authority to certify that a terrorist act had taken place for purposes of activating the shared loss compensation arrangement.

We believe that this approach dampens any adverse economic impact from a sudden increase in the cost from terrorism risk insurance over the next 12 months. The imposition of a deductible in the second year, and an increase in the deductible in the third year, permits the federal government to gradually withdraw from the market as the private sector adapts to measuring and pricing terrorism risk.

5. Conclusion

Mr. Chairman, for the reasons I have set forth, the Administration believes that the economy is facing a temporary, but critical, market problem in the provision of terrorism risk insurance. Keeping our economy moving must be our overriding concern. Leaving this problem unresolved threatens our economic stability. The approach I have outlined limits the government's direct involvement, retains all those elements of our private insurance system that continue to operate well, and provides a transition period to allow the private sector to establish market mechanisms to deal with this insidious new risk that confronts our nation.

There are no perfect solutions to this problem. We have developed what we believe is a sound approach. As I explained earlier, we do not believe that creation of a reinsurance pool can be accomplished under the time constraints we face, but we would be glad to explore modifications to our approach with the Committee.

I would be pleased to answer any questions the Committee may have.

Testimony
of
R. Glenn Hubbard
Chairman
Council of Economic Advisers
Before the
Committee on Financial Services
U.S. House of Representatives

October 24, 2001
1:30 P.M.

Mr. Chairman, Congressman LaFalce, and members of the Committee, I appreciate the opportunity to appear before you today to discuss the situation facing insurance markets in the context of the current terrorist threat. In a very real sense, the timing of these hearings is significant; it is important that Congress act on the issue of terrorism risk insurance before the end of the year.

The terrible tragedy associated with the terrorist attacks on New York and Washington exacted an economic toll on the United States as well as a human toll, and the Administration is working with Congress to address both losses. Among the direct repercussions of these attacks has been an increased appreciation of the need to focus public policy on security, including efforts toward defending American economic activity against terrorist intrusions. The need for security in economic activity – whether in such visible forms as Federal Air Marshals or more mundane needs like additional backup computer systems – raises the overall cost of transacting business. In this sense, the attacks acted as a shock to the costs of supplying goods and services in the economy. It is in our economic interest to contain these transactions costs as much as possible.

The attacks also raised the degree of uncertainty in the economic environment – from the state of aggregate demand, to the demand for particular goods and services (air travel, for example), to a myriad of other areas.

Commercial insurance lies at the intersection of these two forces. Property and casualty insurance is one mechanism by which economies respond efficiently to risks in the environment. Risks are spread, converting for each business a potential cost of unknowable size and timing into a set of smaller, known premium payments. The events of September 11 induced a dramatic revision in perceived risks. In normal circumstances, increased risks are translated into higher premiums. This serves the useful economic function of pricing risk, leading the private sector toward those activities where the risk is "worth it" -- there might be losses now and then, but on average society will benefit – and away from foolhardy gambles.

At the moment, however, the entire nation is unsure of the genuine likelihood of additional terrorist events. For insurance markets, unfortunately, the distinction between risk – not knowing when an event will happen, but having solid knowledge of the odds of an occurrence – and genuine uncertainty about the frequency of an insured event is the key to being able to price efficiently. Experience with our new security environment will mitigate this difficulty over time. In the near term, however, it would not be terribly surprising to experience disruption of the property and casualty market. In the extreme, customers may not be able to renew policies until the market resolves pricing difficulties. That is, reinsurers may no longer cover acts of terrorism in their reinsurance contracts with primary insurers.

An interruption of coverage is a particular, and extreme, version of an increase in transactions costs as a result of terrorist-associated risks. Still, there is the possibility that existing lines of coverage will be renewed only with quite substantial increases in premiums. I believe we are all now familiar with the difficulties facing aviation; disproportionate rises in insurance coverage or, in the extreme, withdrawal of insurance coverage, would hinder transition to a new operating environment. This phenomenon is more widespread, however. Lenders usually require businesses to insure any property they use to secure loans. The terms of terrorism coverage could diminish bank lending for new construction projects. It could as well act as a sharp impediment to transactions that permit existing commercial properties – skyscrapers, pipelines, power plants, and so forth – to change hands. It is important to point out that this "changing hands" is an important economic function. The relative efficiency with which our economy reallocates capital from less productive to more productive uses sets it apart from many other nations.

In short, a well-functioning insurance market is part of the financial infrastructure that underpins our economy. The Administration and Congress worked together to restore the institutional underpinnings of the financial markets in the week after September 11. In the same way, the Administration looks forward to working with the Congress to bolster the capacity of private insurance markets to provide the risk-sharing services that benefit commerce and consumers.

Principles for Government Involvement

To this end, the Administration believes that any federal intervention in the insurance market should adhere to four key principles:

1. Intervention should encourage, not discourage, private market incentives to expand the industry's capacity to absorb and diversify risk.
2. Intervention should be temporary, permitting us to review in the future the ability of the insurance industry to price these risks and absorb losses.

3. Private market actors should face appropriate price incentives to encourage efforts to minimize the probability of a terrorist event and to limit losses should such an event occur.
4. Private sector uncertainty about liabilities that arise from litigation should be reduced.

Importantly, these principles do not imply an objective of providing government assistance to the property and casualty insurance industry; rather, the principles address implementation of the objective of mitigating short-run cost increases for insurance.
The Administration's approach to Terrorism Risk Insurance adheres to each of these four principles. In order to see this, please allow me to first explain the basic outlines of how this approach would work.

The Administration Approach

After reviewing several options and discussing terrorism risk insurance with industry lenders, insurance regulators, and academics, the Administration developed an approach, one with which we look forward to working with Congress. Upon enactment of this legislation, if the United States were the victim of a terrorist attack before the end of 2002, the federal government would pay for 80 percent of the first $20 billion of insured losses, and 90 percent of insured losses in excess of this amount. The private insurance industry would pay for the remaining insured losses.

In the year 2003, the industry would be responsible for the first $10 billion in insured losses, and 50 percent of insured losses between $10 billion and $20 billion. Above $20 billion, the federal government would continue to pay 90 percent of all losses.

In the year 2004, the third and final year of this program, the industry would be responsible for 100 percent of the first $20 billion in losses, and 50 percent of insured losses between $20 billion and $40 billion. Above $40 billion, the federal government would continue to pay 90 percent of all losses.

In the event that total insured losses exceed $100 billion in any calendar year, Congress would determine the procedures for and source of any such payments.

In addition to this insurance component, the Administration approach would also consolidate all claims arising from a terrorist incident in a single federal forum. In addition, it would prohibit claims for punitive damages (other than those directed at the perpetrators), and require that non-economic damages be proportional to a defendant's responsibility (for economic losses, ordinary rules of joint and several liability would apply).

This approach is designed to mitigate economic consequences from sudden increases in the cost of terrorism insurance over the next year. The imposition of a deductible (in the second year) and a subsequent increase in the deductible (in the third year) permits the federal government to recede gradually from the market as the insurance industry adapts to measuring and pricing terrorism risk.

Consistency of Approach with Prinicples

The approach I outlined is consistent with the Administration principles outlined above.

This proposal encourages private sector capacity building in several ways. First, it is forward-looking. It respects the insurance industry's proven ability to develop the capacity to price, market, and service products for new types of risks. In the past, naysayers deemed reinsurance against the risks of natural catastrophes such as hurricanes as beyond the reach of private insurance markets. Experience has proven them wrong. By providing a temporary bridge of three years, a steadily receding Federal presence, and an explicit sunset, we will permit the industry to grow into this new market.

Second, the Administration's proposal recognizes that a limitation facing the insurance and reinsurance industry is its total capacity to absorb risk. For this reason, we provide the economic function of limiting its maximum exposure in order to provide a backstop against catastrophic losses, which could generate large increases in transactions costs for businesses and, ultimately, for consumers.

Third, because the industry shares in the losses – up to a maximum loss – and the share it shoulders rises over time, there will be a profit motive for insurance companies – and actuaries and economists – to begin now to refine pricing models. As I noted earlier, there are economic benefits to the efficient pricing of risks. While no covered individual company can control whether terrorists strike, efficient pricing can lead every covered company to take actions lessen the damage that results from terrorist incidents. After the approach sunsets, the industry will have made progress toward efficient pricing of risks. At that time, issues of pricing and the industry's capacity to absorb losses can be revisited.

In addition, having the industry participate will control costs after any event. If the government agrees to pick up 100 percent of all claims, the insurance industry has no incentive to do careful claims adjustments.

The potential losses facing insurers depend not only upon the security and economic environment, but on the legal setting as well. That is why the Administration approach would also include certain legal procedures designed to manage mass tort cases arising out of terrorism incidents. These procedures will bring damage claims closer to their economic foundation and reduce the uncertainty about the magnitude of potential claims. The consolidation of claims in a single federal forum, for example, helps to ensure that the claims will be treated in a consistent manner and eliminates the redundancy costs of litigating similar claims in multiple courts. In addition, consolidation tends to expedite the claims process, reducing the uncertainty about the length of the litigation. Limitations on punitive damages (other than those directed at perpetrators or abettors) and proportional liability for non-economic harms (except those caused by perpetrators or abettors) reduces the potential for open-ended claims that would exhaust the defendants' resources in mass tort cases. Such reforms are essential for economically enhancing the efficiency of the insurance market by increasing the ability of the insurance industry to price and absorb the risks associated with terrorism.

Conclusion

To conclude, the U. S. economy is very resilient, and, through the combined efforts of the Administration and Congress it is possible to provide transitional public policy to support the needs of purchasers of property and casualty insurance. Thank you again, Mr. Chairman, for the opportunity to appear before you today. I am happy to answer your questions.

Testimony of
David B. Mathis,
Chairman of the Board and Chief Executive Officer
Kemper Insurance Companies
Before the House Subcommitee on Capital Markets, Insurance and Governmental Sponsored Enterprises
October 24, 2001

Chairman Baker, Congressman Kanjorski and other members of the Subcommittee, I'm Dave Mathis, chairman of the board and chief executive officer of the Kemper Insurance Companies. I appreciate the opportunity to testify before the Subcommittee today, representing not only Kemper but also the American Insurance Association.

Let me tell you a little bit about our company. Kemper is a mutual insurance company based in Long Grove, Ill., outside of Chicago, and has offices located throughout the United States and in many foreign markets. Our largest line of business is workers' compensation, but we also are a prominent writer of commercial coverages for a variety of businesses, from Main Street operations and mid-sized firms to Fortune 500 corporations.

The tragic events of September 11, 2001, forever changed our collective understanding of, and concern about, terrorism on our own shores. The scope and nature of those attacks were unprecedented in world history. None of us – neither private nor public sector interests – had made accommodations for this type of occurrence, because such things were simply beyond our conception. Unfortunately, we are now presented with a new view of the very real risks and potentially infinite costs associated with terrorist acts. The new, post-September 11 world in which we find ourselves is fundamentally different than that which existed before, for Americans in general, and very specifically for property/casualty insurers and our customers.

Today, I would like to address two topics. First, I would like to briefly describe how our industry has responded to the tragic events of September 11. Then, I would like to share our thoughts on how we can make sure that insurers are able to continue meeting the expectations and future needs of our policyholders with respect to terrorism and the wide range of other risks which we insure.

I'd like to be very clear about our response to the attack on the World Trade Center. But before I do that, let me say how grateful I am that all of Kemper's 225 employees who were based in Tower One of the World Trade Center are safe.

Kemper like other property/casualty insurers, has been publicly and steadfastly committed to meeting our promises to policyholders affected by the events of September 11. We have not attempted to invoke our war exclusions, despite the militaristic nature of the attacks.

Our pre-tax losses are estimated at $360 million gross and $60 million to $80 million, net of reinsurance. While that is a significant sum, Kemper will meet its obligations to its policyholders with no difficulties. We are paying our claims quickly and fully. For the industry as a whole, current estimates of total insured losses resulting from the September 11 attacks stand at between $30 billion and $60 billion, although the final number will not be known for some time, and could end up being much higher. This makes the September 11 attacks, by far, the most costly insured event in history.

Although no natural disaster or man-made catastrophe even comes close, for the sake of some reference, I would note that Hurricane Andrew, which devastated south Florida in 1992, caused approximately $19 billion in insured losses, perhaps half to one third of the September 11 losses. Put another way, the September 11 losses will exceed the entire property/casualty industry's net income for the past three years (1999, 2000, and 2001). On this one day, three years of industry profits, including investment income, were wiped out.

Recognizing that the American people and our economy will recover and move onward, we also are looking ahead. Although the property/casualty insurance industry can deal with the incredible losses from September 11, we are very concerned about what will happen if there are additional, large-scale terrorist attacks in the future. It is critical that you as public policymakers share our recognition that terrorism currently presents core challenges to the insurance market that we cannot meet.

It is crucial that everyone recognize that we are dealing with a peril this is not quantifiable and therefore not insurable within the finite resources of the private insurance industry. Quite simply, the financial capacity of our industry is limited. Unfortunately, the potential harm that terrorists can inflict is unpredictable in frequency and unlimited in severity. Given this mismatch, insurers (including reinsurers), cannot assess, measure, or spread the risk of terrorism. As a result, terrorism has become uninsurable in the private marketplace. This insurance market crisis, and by extension, pending economic crisis, is unprecedented.

As you probably are aware, more than two-thirds of annual reinsurance contracts – agreements by which primary insurance companies purchase their own insurance to adequately spread the risk of large-scale losses – are renewed each January 1. Reinsurers already have notified primary carriers that they intend to exclude or dramatically scale back terrorism coverage in the reinsurance contracts coming up for renewal. Although the primary insurance sector of the industry is adversely affected by such decisions, we recognize that this may well be the reinsurers' only way to protect their solvency.

Primary carriers, however, do not have the same flexibility as reinsurers with respect to our own products because we are subject to tighter regulatory oversight. Any terrorism exclusions we might choose to introduce must be approved by individual state insurance departments. If approved, our customers could find themselves bearing 100 percent of the risks associated with terrorism. Certainly, the repercussions of this are clear. However, if exclusions were not approved, primary insurers would be left to shoulder 100 percent of future terrorist losses, which we cannot do.

Allow me to give you an example to illustrate the effect of a high retention of risk imposed on the industry. Let's say that an insurer provides workers' compensation coverage for a manufacturing facility with 6,000 employees. The plant in my example would not be located on an earthquake fault or elsewhere where it would be likely that there would be significant loss of life for the workforce due to natural disasters. If, God forbid, that plant is targeted by an extreme terrorist act which take the lives of all the employees, the workers' compensation claims, depending on the state where the plant is located, could run between \$2.5 billion and \$3 billion. This would deplete the surplus of some companies, and would cause severe damage even to the largest, most well capitalized insurers. Companies would not have been able to purchase reinsurance through the marketplace because reinsurers are already telling us that they won't provide it. Under that scenario, if they weren't able to receive government assistance, many companies would be out of business. Of course, in the face of that kind of exposure, prudent companies would respond by managing their risk through careful underwriting, including reduced writings, which mean that some business customers would no longer be able to get the insurance they need to protect them from risk.

So we face a very difficult challenge: how can we do the most prudent thing to protect our own solvency, and still serve the needs of our customers for financial protection against terrorism. I am proud to say that insurers are working hard with you and your colleagues in the House, with Senators and with the Bush Administration, to come up with a public policy solution that will allow us to continue providing this much-needed coverage to our policyholders.

We believe that the best course of action is immediate enactment of legislation to create a federal financial backstop for losses that result from future terrorist attacks. This backstop could be temporary, existing for as long as it is needed, but for as short a period of time as possible, perhaps two to three years. Also, the legislation must be enacted before Congress recesses for the year, because so many reinsurance contracts which cover this risk will expire on January 1.

The legislation we are seeking is not, repeat not, a "bailout" for the insurance industry. In fact, the primary beneficiaries of such legislation would be our customers, and the U.S. economy. Ultimately, the costs of risk must be borne by the policyholders who seek protection through insurance. Given the unprecedented nature of the terrorism threat, the best way for this to be done is through a public/private partnership that allows us to service the coverage needs of our policyholders while remaining financially strong.

The goal of this legislation is not to provide a windfall to insurers, but rather to ensure that adequate insurance coverage remains available to American businesses. Federal Reserve Chairman Alan Greenspan recognized this when he testified before Congress last week, coming to what he termed the "very unusual conclusion that the viability of free markets may, on occasion, when you are dealing with a degree of violence, require that the costs of insurance are basically reinsured by the taxpayer, as indeed they are, for example, in Great Britain and in Israel and in other countries which have run into problems quite similar to ours."

There are a number of ways in which this could be done. One is the British-style reinsurance pool concept, and another is the quota share approach recently suggested by the Administration. We are not wedded to the details of any particular proposal; not even our own. Whatever approach you choose to take in order to successfully avert the looming economic crisis, the legislation must achieve the following three goals: it must improve predictability, immediately stabilize the market, and it must preserve insurer solvency.

No proposal can make the risk of terrorism go away, nor can it make the cost of insurance against terrorism risk go away. However, the right legislation can provide a way for the public and private sectors to co-manage this risk – a risk whose dimensions changed fundamentally and exponentially on September 11. To ensure this result, the probable maximum loss for individual companies and the industry must be limited in a way that allows us to service the coverage needs of our policyholders while remaining financially strong. Legislation that does not strike this balance will not achieve the public policy objective we all share.

The bottom line is that the higher percentage of risk insurers are forced to retain, the less stability there will be in the marketplace.

What must be in the legislation from our perspective to make it workable? First, rather than 51 possible separate definitions of "terrorist act," there must be a uniform national definition that will constitute the terrorism coverage provided by insurance policies all across America. A broad national definition of terrorism is essential to avoid non-concurrence of coverages among primary insurers, reinsurers and the federal backstop. Such uniformity cannot be achieved if states retain the authority to approve or disapprove policy forms in this narrow area.

Second, insurers must be able to quickly include the price for terrorism coverage in their insurance policies, rather than be required to go to every state insurance regulator and seek that regulator's approval for the terrorism rate in every property/casualty line. Even with a federal terrorism reinsurance program that provides a partial backstop, individual insurers' retention for terrorism risk will be expensive, given the huge uncertainties and potentially large losses we collectively face as a nation. States cannot take the attitude that "terrorism can't happen in our particular backyard," and therefore suppress rates. Mindful of the general prerogatives of state insurance regulators in the rate-setting arena, there must be language in place that, on the one hand, allows for rate review by the appropriate state regulator, but, on the other hand, does not subject the rates to any review or approval prior to or in connection with the introduction of those rates into the marketplace.

Third, we recognize that any federal terrorism reinsurance program will include a number of important details with respect to the mechanics of reimbursement and other issues. These details must be drafted and implemented in a way that is workable for insurance companies and our regulators.

We understand that, in all likelihood, any new risk sharing mechanism for terrorism coverage will include some significant retention of future losses by private insurers. On that point, I would like to note that the more risk insurers are forced to retain, the less stability there will be in the marketplace.

Terrorism has become uninsurable in the private marketplace as currently structured. Period. Appreciating that an immediate, stopgap solution may be somewhat imperfect, we expect that dislocations will still occur as insurers cautiously re-enter the marketplace. It is our hope that, with time and experience, we will be able to craft longer-term, more complete solutions that avoid such disruptions.

In the absence of federal legislation to prevent the complete collapse of the insurance market, entire sectors of the U.S. economy could be left wholly exposed and unable to continue the normal course of business. I urge you to act quickly and decisively to ensure that all businesses are able to obtain much-needed protection against future losses.

I thank you for your attention and look forward to responding to your questions.

ZURICH

Testimony of Constantinos ("Dinos") Iordanou
Senior Executive Vice President, Group Operations and Business Development
Zurich Financial Services Group

Before the
House Financial Services
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises

October 24, 2001

Chairman Baker, Ranking member Kanjorski, members of the subcommittee, my name is Dinos Iordanou, and I oversee all business development and operational activities of the Zurich Financial Services Group. Zurich, one of the world's largest insurance companies, operates in nearly 60 nations globally, with the U.S. serving as its single largest market. In America, we employ over 35,000 workers and write more property casualty premiums than all but two of our competitors. Prior to assuming my current position in July, I served as CEO of Zurich North America, our flagship commercial lines carrier, and before that in a number of different positions with Zurich, AIG, and Berkshire Hathaway.

Since the September 11 attacks, the senior management team at Zurich has been confronted with a number of difficult issues. First and foremost, we had to cope with the fact that six of our employees were murdered simply for going to work that day. Secondly, we had to relocate 650 employees to assure continuity of our business operations. And thirdly, as a major insurer and reinsurer of commercial risks in New York and across the country, we needed to decide how to address the marketplace implications of this new and vicious form of risk.

This last decision – which is evolving constantly – also faces you, as policymakers for the federal government, and I commend you for holding this hearing today amidst the very real challenges facing you and your staff.

In the few minutes I have here this morning, I would like to outline for you the steps Zurich is taking to address what Vice President Cheney has referred to as the "new normalcy," and to describe how an insurance executive is likely to judge any government action taken to return stability to this marketplace.

In 2000, Zurich Financial Services Group wrote a total of $25.5 billion of net premiums, making it one of the 10 largest insurers in the world. In the U.S., Zurich North America's 2000 net premium volume was $3.5 billion, which was supported by a capital base of $2.161 billion. This asset base is significantly enhanced by the use of top-tier reinsurers around the world, and together these sources of capital allowed Zurich to provide innovative risk management products to corporate customers in all 50 states, ranging from the Fortune 100 to the smallest of businesses. It is important to note that even prior to September 11, though, market forces were creating significant upward pricing pressures, which were being felt in most commercial insurance lines. Thus, with premiums increasing and a strong balance sheet, Zurich managed its capital-to-risk ratios in such a way that maximized its appetite for risk while ensuring long-term financial stability for our client base.

The terrorist attacks, besides costing our company six valued employees and millions of dollars in relocation costs, cost the entire Zurich family between $700 and $900 million in losses, net of reinsurance. Clearly, this is a substantial amount, and will impact our revenue figures at year's end, a fact that analysts are watching very closely. However, one of Zurich's strengths is its global capital base, and the company will absorb these losses without long-term financial implications.

The decision facing us today, though, is how -- or whether -- we assimilate this new risk of terrorism into our risk portfolio, with the resulting exposures reflected in our now fully exposed capital allocations, since reinsurance for terrorism coverage is now unavailable in the private markets. At its core, the insurance function is an application of capital to risk; so the fundamental question facing Zurich today is how much, if any, of our capital base do we feel reasonably assured we can expose to terrorism risk while still providing the financial security and long-term stability required of our customers.

Today, the answer is very little, and then only for customer profiles that represent relatively remote targets of this new ambiguous risk. The primary reason for this is that absent reinsurance, our traditional risk-spreading mechanism, we can not adequately manage the concentration of risk that certain policyholders or groups of policyholders represent. In short, the new risk of terrorism simply overwhelms the traditional insurance mechanism.

What does that decision mean? Unfortunately, it means that at the time when they need it most, our largest and our smaller customers are being told that we can not renew their insurance coverages absent some way to exclude terrorism risks. The larger ones are being told so because they represent such high-dollar risks on their own, while the smaller ones are being told so because of potential aggregation problems that the industry is just now starting to appreciate. For example, prior to September 11, an insurer could comfortably write a building or a factory that represented a $1 billion risk because the carrier knew it could obtain per risk reinsurance coverage that allowed it to share that risk with others. Similarly, an insurer could also write a number of smaller risks in an office park or close proximity that totaled $1 billion because it could obtain catastrophe coverages from reinsurers that spread the risk beyond its own capital base. Today, that ability to share both per risk and aggregate risks is gone, rendering primary insurers financially incapable of assuming those risks. This new economic reality is a sad but very real indication of just how deeply the September 11 attacks altered our way of life.

As a trained engineer who has built his career on managing complex risks, it is personally very painful to acknowledge that a risk exists in our economy that I can not manage. However, absent any basis by which to actuarially price terrorism coverage, my duties to my customers and my shareholders force me to minimize the exposure of my capital base to this insidious new risk.

Without such drastic steps, though, we would be jeopardizing our ability to provide coverage for the multitude of other economic risks covered by our products – risks ranging from workplace injuries and product liability suits to e-commerce security lapses and employment practices. These are the risks that face businesses every day, and Zurich is committed to helping entrepreneurs and corporate leaders manage those risks in ways that allow American businesses do what they do best – produce the best goods and services available anywhere in the world.

Simply minimizing the impact of terrorism risk on Zurich's portfolio doesn't solve the problem, though; it simply transfers the risk back onto corporate America, and their financial partners. This means that lenders, shareholders and other creditors assume the risk instead of the insurance markets, a result that will likely lead to an immediate constriction in capital available to American businesses. Effectively, this scenario leaves the risk unmanaged, and poses a major financial threat to the U.S. economy. Chairman Baker, members of the subcommittee, I applaud you for recognizing the gravity of this situation, and for committing to address it through some federal role.

The private sector, left to its own to respond to this situation, would partially fill this void with some novel risk-management tools. However, the cost to the consumer for such tools would be prohibitive, and they would fail to provide sufficient capacity to address the multitude of exposed risks in the U.S. economy.

Any government solution, though, should be measured, and should focus on bringing sufficient stability back to the insurance markets so that companies like Zurich will feel comfortable including a degree of terrorism exposure in its risk portfolio. Remember, the essence of insurance is to efficiently apply capital to risk. So, the standard by which we will determine whether that goal has been met will be whether the degree and concentration of capital exposure presented by the prospect of future terrorist attacks is manageable. Too much exposure will force insurers to continue excluding terrorism risks from their coverages. However, we also recognize that if there's too little exposure to the insurance industry, U.S. taxpayers will shoulder the bulk of this new risk, and the political reality is that this is unacceptable. We accept and respect that reality.

The solution, then, will need to balance the industry's need for maximum stability, with the government's need for minimum exposure to the risk and involvement in the marketplace. I, for one, am confident that such a balance exists, and would urge all participants in this debate to focus on the common themes embedded in the options offered to date, instead of their shared shortcomings.

For example, the insurance industry's original proposal utilized a pooling structure to spread risks across the industry and accumulate private sector capital committed to covering terrorism risks. This is an approach that has long-standing use within the industry, and it's one that has served other nations well in their quest to address the economic realities of terrorism risk. We understand that the potential for large government exposure and the extent of interaction between the pool and the government caused concerns among many, but the underlying concept of facilitating the spreading of a this new form of risk is an important one that should not be abandoned. Ultimately, the success or failure of this effort will be judged on a risk-by-risk assessment, not by some broad industry aggregate, so there must be some component that serves as a proxy – even in the short-term – to the traditional reinsurance mechanism.

The White House has floated a different approach that utilizes a pro-rata risk sharing concept akin to the quota share arrangements prevalent in the private sector. It's a short-term stop-gap measure that increases the private sector retention in the second and third years, probably to levels that are beyond the industry's capacity to handle. Furthermore, there are a number of operational questions that would need to be answered before judging the effectiveness of this approach, such as how the government would contract with companies for the indemnification, and how the necessary terms and conditions would be made consistent throughout the risk chain. However, the proposal adopts an approach that addresses both per risk and aggregate exposures, and signals a very important recognition on the part of the Administration that the government does have a role to play in managing what are fundamentally political risks.

Both proposals, then, reflect an underlying concept of shared private and public sector responsibility, and with modifications – some major, some minor – could serve as the basis for a meaningful resolution to this problem.

In closing, I would suggest that anyone who views government involvement to address this market crisis as "bailout" may be underestimating the discipline of the private markets. The actions Zurich and other insurers are taking to minimize their exposure to terrorism risks are firmly in line with economic reality: our capital is finite, but the risk is infinite. Thus, if there is any "bailing" out occurring, then, it is the natural and expected flight of capital away from terrorism risk. This should not be surprising, since it is how markets operate, and it reflects an immediate manifestation of how the capital markets are responding to the "new normalcy" of post-September 11 American life.

Thank you for allowing me the time to present you with Zurich's perspective of this important issue, and I look forward to answering any questions you might have.

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Testimony Before the Committee on Financial Services
U.S. House of Representatives
October 18, 2001

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The risk of loss from repeated, large-scale terrorist attacks does not presently appear great enough to make terrorism largely uninsurable. Although some federal action may be desirable to guard against a potential crisis in property/casualty insurance markets if the risk of loss escalates, appropriate action should encourage private sector risk spreading and consider the costs of subsidies, including their adverse effects on private incentives to control losses and settle claims efficiently.

Insurance involves a fundamental tension between risk sharing and incentives. The benefits of risk sharing are widely appreciated. Moral hazard – the dulling of incentives to reduce risky activity and take precautions to control loss that often accompanies insurance – is less visible. Private insurance premiums reflect each policyholder's risk of loss, thus reducing moral hazard. Insurers that fail to price policies accurately in relation to the buyer's risk of loss suffer adverse selection: they attract a disproportionate number of buyers at inadequate rates. Those insurers lose money and either learn or disappear. Private insurers also have strong incentives to settle claims efficiently.

Government insurance invariably results in subsidized rates that are crudely related to the risk of loss, thus aggravating moral hazard and adverse selection.

Incentives for efficient claim settlement are relatively weak compared with private insurance. Mandating the purchase of coverage can mitigate adverse selection (it has kept social security from unraveling), but mandates are unpopular. In federal crop and flood insurance, a disproportionate number of high-risk entities are insured at inadequate rates, thus requiring large taxpayer subsidies. Private insurers that market federal crop insurance have vigorously expanded supply with government encouragement. Federal insurance programs tend to lose money and expand, crowding out viable private sector coverage. Risky activity and the amount of losses tend to increase as parties adapt to the terms of subsidized coverage.

Subsidized federal reinsurance, or direct federal reimbursement of terrorism losses, could make citizens more vulnerable to harm by discouraging rational responses to increased risk following September's attacks. Consider the question: Will businesses take the same precautions to protect life and property if insurance against terrorist attacks is made available at substantially lower cost due to federally subsidized reinsurance or direct federal reimbursement of loss?

While the Administration's proposal would avoid creating a complex, new entity that would displace private insurer risk assessment, it would require substantial subsidies to insurers and large, commercial property owners. Federal reimbursement of terrorist losses on essentially a first dollar basis is not needed and would be counter-productive. It would seriously undermine the integrity or risk management, risk assessment, and claims adjustment. While the suggested thresholds and percentages for federal reimbursement increase materially after the first year, the proposal would do nothing to encourage private insurers to increase capital and their underlying ability to bear risk.

A two-pronged approach would significantly mitigate funding problems and therefore promote greater private market risk spreading – without requiring large subsidies and displacing private market pricing and risk assessment. First, allow insurers and reinsurers to accumulate some amount of capital (reserves) on a tax-deferred basis. Corporate income taxes on insurers' investment income significantly increase the premium rates needed to cover the costs of holding the large amounts of capital necessary to insure potentially large losses, whether natural or man-made. Tax deferral has previously been proposed for insurance against large losses from natural catastrophes. It is permitted for existing state government catastrophe reinsurance mechanisms. Reducing the tax on insurers' capital would expand private sector capacity to insure potentially large losses from terrorism. Tax deferral would make terrorism coverage cheaper and more abundant.

Second, consider authorizing a temporary system of ex post assessments to help private insurers spread the risk of loss from terrorist attacks. If annual losses from terrorism exceeded an initial threshold, such as $10 billion, all property/casualty insurers could be assessed a percentage of their premiums to finance a material proportion of excess losses. Carriers that wrote the underlying policies would pay the remainder. If annual assessments reached a specified limit, such as 2 percent of premiums, insurers could be allowed to borrow from the Treasury to finance additional assessments. Any loans could be repaid with future assessments. Establishment of a second and much higher threshold also might be considered, above which the federal government would share directly in additional losses.

With this approach, insurers and reinsurers would negotiate contracts that reflect broader risk spreading and the probabilities of being assessed. The risk to taxpayers would be low. The risk of assessments would be manageable by insurers and would influence competitively determined premium rates. If necessary to address concerns that price regulation in some states might prevent that result, direct assessments of policyholders could be authorized.

The tax incentive / ex post assessment approach would significantly mitigate the inherent problems of funding potentially large losses from terrorism. Compared to creation of a federally backed reinsurer or direct federal reimbursement of losses from terrorism, insurers could achieve additional risk spreading without large subsidies and without materially undermining the integrity of private sector risk assessment, claims settlement, and risk management. The results could include less loss of life and property.

Supplemental Statement
Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
U.S. House of Representatives
October 26, 2001

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At the close of the Subcommittee's October 24th hearing on terrorism insurance and reinsurance, Chairman Baker requested that witnesses provide a short written summary of any additional observations on how to address potential near-term problems with the price and availability of insurance for loss from terrorist attacks. I wish to emphasize 3 points in response to that request:

1. Any federal intervention in property/casualty insurance markets should encourage private sector risk spreading and consider the costs of subsidies, including their adverse effects on private sector risk assessment, risk management, and claims adjustment.

2. Intervention should avoid having the government set or approve premium rates for terrorist insurance or reinsurance. It should also avoid mandating the offer of such coverage. Mandates would likely lead to intervention in pricing decisions.

3. Intervention on a first dollar basis is undesirable. Some witnesses have argued that, because of an "aggregation" problem, it would be infeasible to have federal reimbursement of losses from terrorism begin only once insurers have reached a significant threshold of aggregate loss. That aggregation problem would not arise with a suitably designed program (for example, if federal dollars to reimburse loss above the threshold were divided among insurers and reinsurers in proportion to each company's net losses incurred).

On a longer-term basis, allowing insurers and reinsurers to accumulate some amount of capital (reserves) on a tax-deferred basis would make terrorism coverage cheaper and more abundant. It would make future problems less likely. Rather than distorting the tax code, it would help alleviate the chilling effects of the code on insurers' ability to amass the large amounts of capital needed bear catastrophic risk. If a longer-term mechanism for achieving additional risk spreading is ultimately deemed necessary, ex post assessments on property/casualty insurers should be considered as an alternative to using taxpayer funds to reimburse losses.

PROTECTING POLICYHOLDERS FROM TERRORISM: PRIVATE SECTOR SOLUTIONS

Testimony

By

J. David Cummins
Harry J. Loman Professor of Insurance and Risk Management
The Wharton School
University of Pennsylvania[1]

Before

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
United States House of Representatives

October 24, 2001

Introduction

I would like to begin by thanking Subcommittee Chairman Baker, Ranking Member Kanjorski, and the other members of the Subcommittee for inviting me to testify on this important issue.

The events of September 11 have led participants in insurance and reinsurance markets to drastically reevaluate their estimates of potential insured property losses from terrorist attacks. To put the matter in perspective, current estimates are that insured property losses from the World Trade Center (WTC) attack will be at least two times as large as the largest previous insured event, Hurricane Andrew, which caused about $19 billion in insured property losses. Hurricane Andrew resulted in the insolvency of several insurance companies and led to higher prices and reduced availability in international reinsurance markets. Over the post-Andrew years, private markets responded by supplying significant amounts of new capital to the reinsurance industry, eventually leading to reinsurance price declines and increased supply.

In my testimony, I first will briefly discuss terrorism risk in the context of risks normally handled through insurance and reinsurance markets. I will then discuss the appropriateness of a Federal role in resolving insurance and reinsurance supply problems related to terrorism. I will discuss some general principles that any Federal terrorism program should adhere to and provide a critique of the

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current U.S. Treasury proposal for Federal involvement in this market.

Is Terrorism Risk Different From Other Insured Risks?

In some respects, terrorism risk is not materially different from other risks that are handled by insurance and reinsurance markets. Although the WTC attack is expected to cost at least twice as much as Hurricane Andrew, firms that model hurricane and earthquake losses have projected that losses of up to $100 billion could result from a major Florida hurricane or California earthquake.

Questions have been raised about the feasibility of financing such a large event through insurance and reinsurance markets. A study I recently conducted indicates that the insurance industry could survive an event of that magnitude but that markets would be disrupted by numerous insurer insolvencies as well as market price and availability problems. Nevertheless, insurance industry capitalization has increased significantly since Andrew, indicating that the private market does respond to the need for coverage of large events. Moreover, events of this nature may be more efficiently handled through capital markets via financial instruments such as catastrophic risk (CAT) bonds. Securitized CAT instruments are likely to be the most efficient way to cover catastrophic events, including terrorism. *One risk of Federal involvement in the terrorism insurance market is that it would potentially discourage the development of these private market alternatives.*

Another feature of terrorism coverage that initially seems different from other catastrophic risks is its uncertainty. We have thankfully had very little experience with such events, making it difficult for insurers to estimate the probability and severity of loss. Even though we have not observed the projected $100 billion hurricane or earthquake, we do have statistical data on hurricanes and earthquakes and scientific models exist that also can be used in gauging the expected costs of such events. Nevertheless, the insurance industry has provided coverage for other uncertain events which lacked statistical reliability such as political risk insurance and satellite launches. It is likely that the private market can eventually develop pricing for terrorism coverage as it has for other uncertain and unique risks. *Therefore, any Federal involvement should be done in such a way as to not discourage private industry from returning to this market.*

Appropriateness of a Federal Role

Terrorism insurance and reinsurance have become generally unavailable following September 11. The unavailability of insurance causes severe economic problems for policyholders, including difficulties in financing construction and investments in other new projects, potentially having a damaging effect on the economy. Given that most reinsurance contracts will be up for renewal over the next few weeks, a Federal role may be appropriate in getting the industry and the economy through the current crisis. However, any Federal involvement should be done in such a way as to encourage private market "crowding out" of Federal insurance or reinsurance. Federal insurance or reinsurance should be priced in such as way as to eventually make it attractive for private firms to return to the market and undercut government pricing. There should be a clear "sunset" date when the program would have to be renewed or allowed to expire.

General Principles of a Federal Program

A. The objective of the Federal program should be clearly stated as: (1) Helping policyholders and insurers to weather the current crisis, and (2) encouraging private insurers to return to the market and eventually replace government coverage.

B. The Federal program should avoid the creation of new private or public institutions and any new bureaucracies, which are likely to be difficult to eliminate. Rather the program should be run through existing Federal agencies such as the Department of the Treasury. One appropriate design would be the periodic sale or auction of Federally backed excess of loss (XOL) reinsurance contracts.

C. Federal XOL contracts should be sold at a price no less than the best available estimate of the expected losses and expenses likely to arise under the contacts, with a risk loading of some multiple of the expected loss such as 100 or 200 percent. Loadings of this magnitude are common in the reinsurance market for high level XOL contracts, and such loadings would be considerably less than the median loading in the CAT bond market. An actuarial firm should be retained to price the contracts with the objective of trying to determine a price that is in the range that would likely be charged by private insurers or reinsurers. The objective of pricing the contracts in this way would be to provide appropriate incentives for policyholders, insurers, and reinsurers not to misuse the contracts and to encourage private firms to reenter the market to compete with the government contracts. The possibility of securitizing a proportion of the coverage should be explored to facilitate price discovery.

D. Any Federal XOL coverage should have a cost sharing provision, i.e., the government should not cover 100 percent of any layer of coverage. An appropriate co-payment provision could be established whereby the government would be responsible for, say, 70 percent of the loss and the private insurers and reinsurers responsible for 30 percent. The purpose of this provision would be to provide the incentive for insurers and reinsurers to settle claims conservatively and appropriately in the government layer of coverage and to obviate the need for a Federal bureaucracy to oversee claims settlement. Failure to deal adequately with potential claims settlement incentive problems could expose the government and taxpayers to substantial liabilities that would do little to benefit the overall health of the economy.

E. Federal coverage should start after a reasonably large deductible, i.e., the government should not provide first dollar coverage. This is based on the principle that all parties to a contract should share in the risks at every layer of coverage. This approach also parallels private XOL reinsurance markets, where first dollar coverage is unavailable. The deductible should be adjusted upward over time to reflect private market capacity.

F. The Federal obligation should be capped. For example, government coverage should stop at some reasonable limit such as $60 billion, $75 billion, or $100 billion. This is to protect taxpayers from an open-ended commitment. A cap provides Congress with a valuable option – either to reinstate coverage for losses above the cap or to terminate government involvement at the cap.

G. The program should be limited to property coverage, where loss amounts are relatively easy to determine. The Federal program should not provide coverage for difficult to verify claims such as business interruption. This is to prevent abuse of the Federal program and to provide incentives for policyholders to get back in business as quickly as possible following a loss. Avoiding coverage for business interruption also provides incentives for businesses to adopt strategies that would minimize and mitigate losses to revenues following a terrorist attack. The program should not cover liability insurance, for similar reasons, including punitive damage awards.

H. Consideration should be given to incorporating "Finite Reinsurance" provisions into any Federal plan. Finite reinsurance transfers less risk to the reinsurer than traditional indemnity reinsurance. It is primarily intended to smooth out an insurer's losses over time, with the insurer ultimately bearing most of its own losses. Essentially, the finite reinsurer advances the insurer money when losses are high with the contractual obligation for the insurer to pay back most of the money when losses are relatively low. Although some indemnity-only features may be appropriate in higher layers of Federal terrorism insurance, the plan might be more appropriately written as finite reinsurance, especially for relatively low layers of coverage.

I. The government should explore ways in which it could encourage the development of private markets for catastrophic risk without providing Federal financial backing. For example, it should investigate the possibility of lowering regulatory barriers that may exist to securitizing insurance risk and taking control of this aspect of insurance regulation to simplify the regulatory system. The government should also explore serving as a facilitator of securitization by providing data that could be used by private firms in developing better loss indices to serve as the basis for the trading and settlement of CAT risk securities, on both natural and man-made (e.g., terrorism) catastrophes.

The Treasury Proposal

The proposal I am discussing is the "Background Briefing by Senior Administration Officials on Terrorism Insurance," Office of the Press Secretary, The White House, October 15, 2001.

The proposal calls for Federal terrorism coverage with loss sharing between the Federal government and the private insurance industry. It states as follows:

> Individuals, businesses, and other entities . . . would continue to obtain their coverage from private insurers. . . . If there is a future terrorist act, losses . . . from that terrorist act would be filed with the insurance company. The insurance company would pay their portion of the loss . . . Then they would file their balance of the claim with . . . the Department of Treasury . . . and then the Secretary of Treasury would pay the balance of the policy coverage.

The proposed sharing ratios, which vary by the year of the program, are as follows:

First year: First dollar coverage is provided with the government paying 80% and the insurers 20% up to a limit of $20 billion. For losses above $20 billion, the government would pay 90% and the industry 10%.

Second year: For the first $10 billion, the private insurance industry would bear 100%. Losses above $10 billion would be split 50% for the government, 50% for private insurers. If losses exceed $20 billion, the ratio would go to 90% for the government and 10% for private industry.

Third year: Private sector would be responsible for 100% of the first $20 billion. From $20 to $40 billion, the loss sharing would be 50:50, and for losses above 40 billion, the government would pay 90% and private industry 10%.

There would be a proposed overall cap of $100 billion. If total losses paid by industry and the government reached $100 billion, the Secretary of Treasury would request guidance from Congress as to how any larger losses should be paid.

The plan would sunset after three years. There would be some loss mitigation provisions and a prohibition on punitive damages coverage.

Comments on the Proposal

The proposal incorporates several sensible provisions such as cost sharing (for most layers of coverage) and an overall cap on the government's obligations. The loss mitigation proposals are a good idea in general but no specifics are given. The sunset provision is strong point of the proposal.

Problems with the proposal:

1. It may be neither necessary nor advisable to provide first dollar coverage during the first year. The private industry should sustain the first layer of coverage. This provides appropriate incentives for loss mitigation and claims settlement conservatism and gives private insurers a stronger stake in loss outcomes. The industry should be able to sustain a loss of $10 billion, and probably more, without government involvement. The industry's involvement in covering the first layer would be an act of good faith and a signal of commitment to the economy.

2. Without considering each year and layer case by case, the proposal generally is too generous in its split between the government share and the industry share. The industry should probably bear more of the cost, especially in the lower layers.

3. The reinsurance in the lower layers of coverage should be written as "finite reinsurance" rather than pure indemnity reinsurance as in the present plan.

4. The plan apparently covers all risks, with the exception of punitive damages. There are many types of risks that should not be covered by Federal insurance/reinsurance, such as business interruption and liability insurance, as discussed above.

5. There is no provision for charging private industry a premium for the coverage. This is a very serious defect which creates adverse incentives and discourages private insurers from reentering the market. It is difficult to compete with a product that is given away for free. Even though any premium estimate would be inevitably somewhat inaccurate, this is also the case with many other unique and uncertain risks covered y insurance.

Statement of

David L. Keating
Senior Counselor
National Taxpayers Union

on

Proposals for Terror Reinsurance
before the

Committee on Financial Services
U.S. House of Representatives

October 24, 2001

Mr. Chairman, and members of the Committee, thank you for the opportunity to present our views on proposals for terror reinsurance. The 335,000-member National Taxpayers Union strongly opposes the proposals offered by the insurance industry and the Administration, both of which would violate key principles of sound insurance policymaking. These flaws would put lives and property in danger and expose taxpayers to unnecessary losses.

Congress should move cautiously as precedents may be created for congressional responses to other large losses and major insurance industry difficulties.

Unless insurance companies have to pay--and pay a lot--for Federal reinsurance, they will compete by giving the coverage away to clients. This creates moral and security hazards. Second--and this is very important--they will have no incentive to underwrite individual risks with any caution, to avoid concentration risks or to help their clients reduce their risks. They will assume more risk for the government than they ever would have if their own money were at risk.

It is essential to limit the government's total liabilities, set firm limits per policy, clearly define terrorism and limit the government's exposure to certain types of loss (e.g., business interruption). Otherwise, we could be paying companies not to be going back to work for years. Of course, the insurers should have to pay enough of the claims, a minimum of 20 percent in the first year, to carefully monitor claims administration.

Too often legislation is passed as a quick response to a problem without addressing fundamental flaws in public policy. During our work over the last six years studying proposed legislation and public policy regarding natural disasters, we have found that a number of Federal and state laws and regulations greatly hamper the ability of the private sector to provide insurance for catastrophes.

Perhaps the most important impediment to affordable insurance against man-made or natural catastrophes is the Federal tax law, which contains a huge implicit tax penalty on businesses and homeowners who attempt to purchase such insurance. These same laws prevent insurance companies from deducting an amount equal to the risk of catastrophic natural disasters or terror attacks; amounts that we consider legitimate business expenses. We hope this problem will be corrected and urge the Committee to use the Policyholder Disaster Protection Act (HR 785), by Representatives Foley and Matsui, as a starting point.

It is not clear to us whether a Federal terror reinsurance program is needed at this time. Certainly it is completely unacceptable to enact a program that would increase risks to lives, property and federal finances.

Insurers are not claiming they are in trouble, only that the market may fail to respond to higher pricing with more capacity. That's dubious at best and there's a good case to be made that we ought to wait and see what happens in the market. Even if terrorism is excluded from some policies, life and business will certainly go on.

The Fidelity Select Insurance Fund is up about 3 percent since September 10. Insurance stocks' performance shows a great deal about market experts' view of the industry's future claims-paying ability, future risk, and the opportunities associated with expected higher pricing. It also shows--along with the new company announcements--that the capital markets have in no way restricted the industry's ability to raise capital and take on additional risk.

If Congress enacts such a reinsurance program, we strongly urge you to be guided by the following principles.

1. Any Federal capacity should offer the maximum amount of economic benefit to the nation as well as injured parties at the lowest possible cost to the taxpayer.

2. Legislation must not erode strong incentives for wise underwriting and insurance company management of risks (e.g., proper security and escape contingency plans). If no reinsurance is available, then the insurance industry will continue to cover claims until their current policies expire or a time the current policy allows for modification of the coverage. Until then, the insurance companies have an extremely high incentive to help their clients take sensible steps to reduce their risk of terrorism loss. Likewise, if a business finds it cannot insure for terror risks when its policy expires, it too will take much more vigilant steps to secure its property, customers and employees. A blank federal reinsurance check would eliminate a very important incentive to increase security.

3. If Federal reinsurance capacity is offered, then there should be payment for the use of that capital and assumption of risk. Any plan that fails to collect premiums is a giveaway that will increase losses from any future attacks since it would undermine insurer incentives to boost security and create effective disaster control and reaction plans. It would be irresponsible to discourage effective safeguards that can reduce the

number of lives and amount of property that could be lost from a terror attack. While no one knows how to price this risk since the market is not offering it now, the government should use very conservative assumptions in pricing for that risk so that the private sector can retake this market as soon as possible.

4. Federal coverage should certainly not insure against all industry terror losses. Coverage of the first dollar of losses is both unnecessary and unwise because this too will erode incentives to increase security. Lower levels of financial risk should remain in the private sector, which will attempt to price the insurance for the limited risk. Those price signals will provide important pricing information to the government for the use of its capacity. If the government provides coverage, we strongly recommend restricting coverage to property loss and workers' compensation only. If insureds also want business interruption coverage, they can go to the private sector for supplemental coverage.

5. Federal reinsurance capacity should be temporary, maximize the use of market mechanisms and encourage the reentry of private reinsurance at higher levels at the earliest possible date. We must rigorously avoid any establishment of a permanent entity. Insurance is available for many other large and highly uncertain risks and terror insurance will be more efficiently administered and priced by the private sector in the long run. It is too easy to make a mistake in haste, which could prove impossible politically to fix later.

6. Legislation must contain strong incentives to pay only valid claims. The Federal government's co-payment of claims should never exceed 80 percent. It is easy for insurance companies to keep customers happy if they have little or no financial incentive to monitor claims for fraud and overpayments.

7. The federal government's exposure must be capped to preserve America's national security options. The Federal government must not insure against unlimited terror or war risks. In the event of a war or a terror attack with weapons of mass destruction, the losses would be far more serious than experienced in the September 11th attacks. The government needs to limit its liability so that it can preserve the fiscal flexibility needed to fight a war.

8. Incentives should be created to get the federal government out of this business and reduce its role to covering a higher layer of loss as early as possible.

9. A mediation panel is needed to quickly pay and settle claims for terror losses in a fair and inexpensive way. However undesirable it may be to spend taxpayer monies on terrorism losses of property, it will be completely unacceptable to pay large amounts to the trial bar in the aftermath of an event, and further slow the process of getting funds into the hands of rightful recipients. Any non-productive activity such as litigation, which slows the process of pricing the event, will lead to more uncertainty in repricing insurance for future events and will add to the ultimate cost of such events. Such a variation was included in the airline industry bailout. If people do not wish to waive their rights to sue, then they should purchase their own terrorism coverage, unsubsidized by the government.

10. Legislation should contain a clear definition of what is a terror loss, and all other losses should be excluded from coverage. The formulation of coverage will need to be quite specific or there will be lots of opportunities for financial mischief at taxpayers' expense. This definition would then need to be met on any private industry claim payment, prior to allowing either the customer or the insurance company to present the balance of the claim to the government. If this definition is not clear or not rigorously applied, there will be endless disputes.
11. Federal law should override any state terror insurance regulations until the Federal capacity has disappeared.

The Insurance Industry Proposal

We are strongly opposed to the industry bill as presented in its most recent draft, which is riddled with both short and long-term flaws. It is completely contrary to at least principles 1-10 listed above.

The proposal appears to create an unlimited liability for the Federal government for terror risks. The legislation also covers an unclear amount of war risks. As noted above, the Federal government must have complete flexibility during war because the most important function of our government is to defend the country. We cannot and must not create an entitlement program to insure against all terror or war risks, which may cripple the financial capacity of the government to win the war.

This proposal initially offers no payment to the Federal government for its reinsurance capacity, and it is quite possible that no payment would ever be forthcoming. We are strongly opposed to any such giveaway. Just because it is difficult to properly charge for the risk doesn't mean that nothing should be charged.

The pool concept is fundamentally flawed, and there are better alternatives. It allows companies to be looser in their underwriting and increases moral hazard problems compared to alternatives. Companies could shift risk in an undetectable manner to the pool.

Another key concern is that the proposal would set up a permanent bureaucracy that would greatly expand its mission over time, concentrating risk and displacing a healthy reinsurance market.

This facility would have enormous advantages that no other firm could match, including tax-free reserving, explicit access to Federal credit and a location in one of the least-regulated states in the country. At the end of its "life" there is to be a report on the state of capacity in the industry, not just for terror, but for other large risks currently handled by the private sector such as natural disasters.

We understand that the proposal has a sunset clause, but are not reassured. Once federal programs start, they rarely disappear, and this entity will have powerful allies who will likely seek to dump their other least attractive risks on the taxpayer. Important sectors of the industry have been trying for years to push legislation through the Congress to set up a natural disaster insurance corporation, and this entity could well take on that role as it is about to supposedly expire.

The inherent advantages of the proposed "Homeland" insurance entity would make it almost impossible for the private sector to move back into the business of insuring against terror risks as it could not compete against Homeland's awesome advantages in amassing tax-free reserves and accessing Federal credit.

Attached to my statement are additional section-by-section comments on the proposed legislation.

The Administration Proposal

The proposal is a public-private sector program. In 2002, the government would absorb 80 percent of the first $20 billion of insured losses resulting from terrorism, and 90 percent of insured losses above $20 billion.

In 2003, the private sector would handle the first $10 billion of loss. Losses between $10 billion and $20 billion would be shared, with the government paying 50 percent and the private sector paying 50 percent. After losses exceed $20 billion, the government would cover 90 percent of losses, and the private sector would cover 10 percent.

In 2004, the private sector would cover the first $20 billion in losses. Between $20 billion and $40 billion of losses, the government and private sector would each cover 50 percent of the losses. At above $40 billion in losses, the government would pay 90 percent of losses.

Overall liability would be capped at $100 billion.

The Administration plan has fewer flaws than the industry plan, but these flaws are also huge. It violates at least principles 1, 3, 6, 9 and 10 above and principles 2 and 4 in its first year of operation.

It too fails to collect any premium for the risk taken by the Federal government. A failure to collect premiums is a giveaway that might increase terrorism losses since it would undermine incentives to boost security and create effective disaster response preparations. It must collect a premium for the exposure.

In its first year of operation the Administration proposal covers the first dollar of losses, which is unnecessary and unwise. To minimize the danger to lives and property, insurance companies must have a financial stake in mitigating claims, which they will help enforce on their clients.

Coverage of the first dollar of losses for all insurance companies would also lead to an unnecessary increase in Federal bureaucracy, costs, and insurance waste. It is hard to find any consumer or business insurance policies that do not have some form of a deductible, and Federal terror reinsurance shouldn't eliminate this sound principle of insurance.

If the Federal government must participate in every loss, no matter how small, clearly there will be far less incentive for claims to be processed by the insurance companies in a way that is fair to the taxpayer. Any such proposal should leave some level of losses to be paid first by the insurance companies. After that level, the co-payment by the insurance companies must be substantial in order to guard against excessive payments.

Claims handling will be a key element of the coverage. Someone will need to provide people to perform this function or at least audit it, and it wouldn't seem that the small percentages of loss coming from the industry would be effective in getting them to police themselves and their customers effectively.

As you can imagine, these companies are currently buried under an avalanche of claims arising from September 11, many of which either are fraudulent or contain elements of fraud. They will police these as best they can, but we would want, if anything, even more diligence in the future when less of their own money is involved, as would be the case with the Administration proposal.

From an insurer's standpoint, it is a lot easier to make your long-term customers happier when you are paying out dollars to them that cost you as little as 10 cents, the standard under the Administration proposal.

We should note that the "industry" doesn't insure anything; individual companies do, and these companies vary considerably in their capabilities and capacity. It isn't apparent how the Administration's plan would distribute the losses around the industry. Individual companies write individual risks that will incur discreet losses (some of which might be covered, some not under normal policy conditions), then claim payments are made as negotiated with each individual client. Risks and losses are not distributed proportionately around the market, as will be seen when the cost of September 11 is tallied.

This week *The New York Times* reported that Berkshire Hathaway chief executive Warren Buffett said, "I think there is nothing wrong with having the industry lose a lot of money if something like [a terror attack] happens. We just have to keep it within the ability of the industry to pay. The industry can pay for a $10 billion loss. It can't price for a $500 billion loss."

Lower levels of exposure should remain in the private sector, which will price the insurance for the limited exposures. Those price signals will provide important pricing information to the government for its reinsurance capacity.

Compared to the industry proposal, the Administration approach creates less bureaucracy and clearly has a much better chance of being temporary, which is a plus.

The Administration proposal does cap the exposure, though the exposure level is very high.

Improving the Administration Proposal

The Administration proposal can be greatly improved with a few key modifications. Clearly, the Federal government must charge for its reinsurance capacity and the coverage should kick in at higher levels.

While it may seem like a good idea for the Federal government to stay out of pricing, we must not lose sight of the fact that the Federal government is offering $88 billion in reserves against terror losses. It should certainly charge some reasonable amount for that risk.

If the insurance companies are covering only 12 percent of losses, then they should be receiving, on average, 12 percent of the associated premium. Since there is no traditional way to estimate or annualize losses, there probably should be a nominal "load" established to be added to every dollar of non-terrorism premium.

Perhaps the Treasury could simply assume that such losses could occur every ten or twenty years, and price the reinsurance or capacity according to that time horizon.

We strongly recommend that the first year of the program also require that the private sector cover at least the first $10 billion of losses. Between $10 billion and $20 billion the government would cover 50 percent of additional losses. Between $20 billion and $100 billion, the government would cover 80 percent of additional losses.

In 2003, the private sector should cover the first $15 billion of losses. Between $15 billion and $25 billion, the private sector should cover 50 percent of losses, and between $25 billion and $100 billion, the government would cover 70 percent of additional losses.

In 2004, the private sector should cover the first $25 billion of losses. Between $25 billion and $100 billion, the private sector should cover 50 percent of losses.

Conclusion

Proposals for Federal insurance for terror and war risks are both politically and economically risky and should be subjected to extensive examination and comment before being enacted into law. We strongly urge the Committee to remember that even the best-intentioned programs can have budget-busting consequences. In this case, a poorly designed program would also place more lives at risk and conceivably harm the financial ability of the government to defend the country. Congress must move carefully in this highly complex area to ensure that it does not create a fiscal disaster, unwisely interfere with private markets or violate sound insurance principles.

Attachment

Section by section discussion of the Insurance Stabilization and Availability Act of 2001

Sec 2. The findings could recognize that there are sufficient uncertainties surrounding the commercial market at the present time to consider establishing a facility. If it is advisable to create a facility at the Federal level, the purposes should clearly state that the facility should interfere with the market function as little as possible and should, to the maximum extent possible facilitate the re-entry into the market of commercial entities.

Sec 101. Why not a federally regulated and chartered entity? Why subject to state laws at all? If the Federal government funds it, then the Federal government must regulate it.

It is unclear how much financial exposure would be created by the war risks covered by the proposal. Parts of the bill seem to limit such exposure to workers' compensation, while other portions seem to permit broader coverage. Even workers' compensation may set up unacceptably large financial risks for the Federal government during a war.

Sec 103 a. This provision should instead say something to the effect that "The Secretary shall establish an entity for the sole purpose of applying Federal resources to the issue of risk transfer from private enterprise and individuals, through the mechanism of the private insurance industry."

Sec 103 b 1. Why "irrespective of Homeland's available funds" during the first year? Why isn't Homeland always required, first and foremost to pay out, down to some reasonable base amount, before other resources are tapped?

Sec 103 b 3. Should instead state that "The Secretary shall determine the charges to be paid by Homeland, and Homeland shall determine the charges to be made for such coverages." The requirement that Federal reinsurance be made available at no charge is both unwise and unacceptable.

If this approach is taken, there is merit in the view that Homeland should always be the sole provider of terrorism coverages in the United States. This is essential or Homeland and the Treasury will be the target of adverse selection and predatory pricing which will attempt to "cherry pick" the more desirable risks against Homeland.

Clearly there will be a commercial market available in many areas. The insurance industry just can't figure out how to deal with the bigger, tougher risks, not all risks. As the Administration noted in its briefing last week, "The attacks that took place on September 11th were against the physical structure of the World Trade Center, but they were really against the nation as a whole. So there's some logic and rationale that . . . other symbols . . . do not have to pay exceptionally high rates."

Moreover, it should be a stated objective of Homeland and the Secretary to re-establish a viable commercial market as quickly as possible. A piecemeal approach will not hasten that result because it will pass the most difficult and complex risks out of the commercial market.

Sec 104 b. This provision should provide added flexibility to allow Homeland and the Secretary to purchase retrocessional capacity elsewhere as they see fit. In particular, it may be possible to securitize this risk through the equivalent of CAT bonds or some other instrument such as excess-of-loss contracts as suggested by Christopher M. Lewis in his studies on providing additional insurance capacity for natural disasters.

Sec 105. We don't agree that Homeland should be organized in this way. Perhaps this section should require that "All companies licensed to conduct business (or conducting business) in the US shall be required to cede these defined risks to Homeland." There is no need to make the companies members. This shouldn't be a "club," and the members shouldn't own it unless they fund it.

Sec 106. As noted above, it is completely unacceptable that a State would have control over an entity whose risks are almost completely underwritten by the Federal government.

Again, if this approach is taken, Homeland needs an oversight board and a clear charter to minimize Federal involvement and increase private sector capacity. To achieve anything logical, Homeland may need some sort of participation, however finite, by the commercial industry to succeed. Full faith and credit doesn't necessarily equate to no commercial involvement. It may be that the terrorism problem is so protracted and so massive that it might become nearly impossible to substitute commercial money for tax money at some level, but the problem may also turn out be much more manageable and localized than is now perceived. Homeland's management should be rewarded for finding ways to slice, dice and parcel out the problem with minimum public money at risk.

Sec 107. These provisions will need much more definition by Homeland to adequately price and underwrite coverages correctly.

Sec 107 b. These definitions are very loose and unclear and could be read to cover many other acts, including gang vandalism or abortion clinic bombings. Do these need to be "known" or could they be "unknown" parties? How tight does the proof need to be to get a settlement in 45 days? What if evidence emerges later that the attack was supported by another nation?

Sec 107 b 2. If coverage is retroactive, then the premium should be retroactive too.

Sec 108 c. It is unclear as to why there is a need for separate divisions.

Sec 109 d. See comments on Sec. 101. No one state should have the right to regulate this entity. Insurance regulation is not the appropriate model in any case. Our current insurance regulatory scheme is notoriously balkanized and antiquated. While it may not be possible to repair this system at this point, it would not be desirable or wise to subject this entity to these weaknesses.

Sec 110. It would be unwise to allow only Homeland to reserve funds for terror risks without payment of taxes, when other domestic insurers and reinsurers are burdened with rules that improperly tax such prudent actions as setting aside reserves for future losses whose timing and magnitude are impossible to determine. All insurers should be allowed to set up tax-free reserves.

Sec 113 a. The legislation should also allow for an earlier expiration date, such as "at such time prior to that as the Secretary determines that a valid commercial market exists for the coverages provided by Homeland."

Statement of John T. Sinnott, Chairman and CEO, Marsh, Inc.
Before the House Financial Services Committee

"Protecting Policyholders from Terrorism: Private Sector Solutions"
October 25, 2001

Mr. Chairman and members of the Subcommittee, I am John T. Sinnott, Chairman and CEO of Marsh, Inc, headquartered in New York City. Marsh is the world's largest risk management and insurance brokerage firm. We have 35,000 employees and serve clients in over 100 countries around the world. We also serve virtually all of the major insurance firms with reinsurance broking and related services through our Guy Carpenter unit. My testimony is on behalf of my firm as well as the member firms of the Council of Insurance Agents and Brokers.

I'd like to thank you, Mr. Chairman, for giving me this opportunity to testify today on the topic of private sector solutions to the burgeoning terror insurance availability crisis in the wake of the September 11 attacks. While it has been said many times before, I think it bears repeating that the events of that day have changed the United States, and that life and business as we once knew it will never be the same. The events of that day were singularly devastating on one industry - the financial services industry - not only in business terms, but also in human terms.

The World Trade Center housed several companies from the banking, securities and insurance industries that must now deal not only with the new business challenges facing them as a result of the attacks but also with the loss of colleagues and employees. Within the insurance industry, the brokerage community was hit particularly hard. Marsh maintained offices in both of the World Trade Center towers and the space that we occupied in the north tower comprised the floors directly struck by the first aircraft. No one in those offices at the time escaped. In fact, of the 1900 members of the Marsh & McLennan Companies working in both towers (or who were visiting that day) 294 were lost. Another colleague was a passenger aboard one of the aircraft.

The world's second largest brokerage firm, Aon, also had a large presence in Tower 2. They lost 200 of their colleagues.

While our first response was to focus on our people and the families of those lost, we also realized that we had to begin the job of our affected clients in resuming their usual business operations.

The events of September 11 have changed the landscape of commercial insurance in a way that I have not seen in my 36 years in the business. To be sure, there have been trying times in the past - the liability crisis in the mid-1980s, the property catastrophe coverage problems in the early 1990s following Hurricane Andrew, to name a couple. Marsh rose to the occasion during both those crises to help our clients secure the coverage that they needed to adequately protect their businesses. This is a function that is quite common in the brokerage community - not merely selling insurance products, but identifying client needs and developing new and innovative products or programs to address coverage shortfalls and to make our clients more successful.

In response to the mid-1980s liability crisis, Marsh played a leading role in the creation of the insurance and reinsurance companies ACE Limited in 1985 and XL Capital in 1986. These companies were formed to provide excess liability and directors' and officers' liability coverages at a time when the market could not provide the necessary capacity. These companies were very successful in providing much-needed market capacity and eventually were spun off from Marsh. They exist as major insurers today. Similarly, Marsh played a role in the creation of Mid Ocean Limited during the property catastrophe reinsurance crisis following Hurricane Andrew in 1992. This company has also done very well in meeting the needs voiced by our clients.

It was in this same spirit of responding to customer needs that MMC Capital, our sister company, recently announced the formation of AXIS Specialty Limited, a new insurance and reinsurance company formed to provide capacity needed in the wake of the September 11 attacks. AXIS has an initial capitalization in excess of $1 billion, and will begin underwriting later on this quarter.

Thus I think that it is fitting that the Subcommittee is exploring private-sector solutions to this unique situation. Our firm is proud to be able to continue our tradition of responding to supply and demand imbalances in the insurance and reinsurance markets. But I must tell you in all candor that what your committee heard has been hearing over the past three weeks is true - there is an immediate crisis that demands your attention. In the current unique, and hopefully short-term, environment of uncertainty, the private sector alone will not be able to provide the insurance capacity America's businesses need to conduct their operations. Government involvement is needed until the environment becomes secure and returns to a state of more normalcy.

The problem with what happened on September 11 is that it presented a risk that no one had could conceive would happen. When the buildings were built, loss scenarios did contemplate the impact of one Boeing 707 (the largest commercial aircraft at the time) however the idea of two, fully fueled 767's hitting both towers was unimaginable. Thus, we arrive at the problem presented by terrorism: the magnitude and severity of potential future events.

There has been considerable discussion about the scale of the World Trade Center and associated losses of September 11. While it will be some time before the total costs of the tragedies are computed, we all know that they represent the largest-ever losses in the insurance industry, by far. The previous largest insured loss was Hurricane Andrew at nearly $20 billion - or less than half of the losses of September 11. Some further context - The five most recent catastrophic losses for the insurance industry - including Hurricane's Andrew and Hugo, the Northridge and Kobe earthquakes and the Lothar and Martin windstorms in Europe - totaled $53 billion in losses. Chances are that the losses stemming from the attacks at the World Trade Center will exceed that number - perhaps significantly.

The true cost of these events will not be know for years, because some types of insurance, such as business interruption and workers compensation, do not constitute one-time payments but are rather ongoing for longer periods of time. While the industry has stated it can cover the severity of losses from this event, it is very unclear that the industry will be able to meet any frequency of future losses that may occur. We are told by federal authorities to expect retaliatory strikes against America and that it is virtually impossible to completely shield ourselves from the assaults of those who disregard their own lives.

We have already seen massive and virtually unanimous signs of the unwillingness to take on such risks that are unquantifiable. As our commercial clients' policies have come up for renewals, we have seen a majority of insurers add terrorism exclusions to their policies. Of the top 25 property insurers with whom we trade, 17 have stated that terrorism exclusions will apply effective immediately and most of the others can also be expected to apply an exclusion.

While most insurers will be unwilling to underwrite terrorism risks going forward, there may be a few companies who will be willing to take on those risks. However, even if they are willing to provide the coverage, it is not clear that they will do so at prices which are affordable by most businesses. And clearly, such efforts will involve adverse selection, in that many businesses that are considered most vulnerable probably will not be able to secure coverage at any price from any insurer, absent federal intervention.

Similarly, there is now a new definition of what a maximum insured loss may be. There are not many people who would have ever believed that the twin towers of the World Trade Center could or would be completely destroyed, turned into a pile of dust and rubble, with nothing of value left, and with thousands of deaths and injuries. We know now that it is possible, and that the concept of a maximum insured loss post September 11 does not in any way resemble the concept we had before that date. Threats can come from anywhere in the world, not just from one's business partners or from Mother Nature. The scope of risks we must plan for has changed as well.

This change in the perception of risk will have great repercussions in the pricing of policies going forward. Before September 11, the insurance industry was already experiencing what is known as a "hard market," meaning that premium rates were rising. That trend has now accelerated significantly. We are now seeing average rate increases in the area of 65% to 75% coupled with dramatically increased deductibles, and a contraction of available limits and coverages. Some price increases exceed 100%.

It is for this reason that I would urge the Congress to address the market contraction that we are facing before it adjourns for this year. We are facing a deadline of the end of the year for reinsurance contract renewals that will begin to exclude terrorism coverage. If insurers cannot cede this risk to a reinsurer, they will be unwilling to take it on themselves and will refuse to offer the coverage.

That is why I am delighted that proposals to address the insurance problems we face are being advanced.

We all are familiar with the two major proposals – the 80/20 plan and the pooling arrangement. There are others as well.

Until there is a cure for the current environment of uncertainty created by the prospect of terrorism, the insurance coverage our clients need cannot be obtained from the private sector solely. In this somewhat unique – and hopefully short-term-environment, it is critical that the public and private sectors collaborate.

Then, once the environment has stabilized, and we achieve a state of greater normalcy in the environment, it should be practical for government involvement to decline and ultimately be withdrawn.

May I close by saying that my firm has been severely affected by the events of September 11. The first aircraft directly struck our offices in the World Trade Center and we lost 295 members of our corporate family. That was the real tragedy and is still with us in our offices and hallways.

We also incurred huge losses of property and equipment. So I speak here today from painful personal experience - and perhaps with a deeper understanding of what our clients face as they look to an uncertain future.

Mr. Chairman, let me restate that we are on the brink of an availability/affordability crisis insurance caused by the terrorist events. I commend you for holding this hearing, for your efforts to create a solution that restores and strengthens the private marketplace, and I urge you to work with your colleagues in Congress and the Administration and within our industry to find workable answers.

Statement of Roy A. Williams
Director of Aviation, Louis Armstrong New Orleans International Airport
Before the
Subcommittee on Capital Markets, Insurance,
And Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
October 24, 2001

Good Afternoon. My name is Roy A. Williams and I am Director of Aviation for the Louis Armstrong New Orleans International Airport located in Kenner, Louisiana. I am here to testify regarding the financial impact of the events of September 11, 2001 on our airport and our ability to continue functioning as an economically competitive provider of airport services to our community. In particular, I have been asked to offer testimony regarding the availability of insurance for operations at the airport and the increased costs involved where we have found insurance.

General Information about Louis Armstrong New Orleans International Airport

Louis Armstrong New Orleans International Airport serves Southeastern Louisiana and the Gulf South with extensive domestic and international service. Sixteen passenger carriers and air cargo carriers operate scheduled service to and from the airport, along with numerous charter, corporate, and general aviation flights. In the twelve months ending August 2001, we served move than 10 million passengers, an all-time record. Louis Armstrong ranks 39th in the United States for total passenger traffic.

The airport is located entirely in Jefferson and St. Charles Parishes. The New Orleans Aviation Board, appointed by the Mayor of the City of New Orleans, manages the airport. The nine member board includes representatives from New Orleans, Jefferson, and St. Charles Parishes.

The Jefferson Parish and St. Charles Parish Sheriff offices provide primary law enforcement, with additional support from the Kenner and New Orleans Police Departments. Numerous Federal agencies have a presence at the Airport, including the Federal Aviation Administration, Federal Bureau Investigation, United States Customs Service, Immigration Naturalization Service, and the Department of Agriculture. We also benefit from the presence of the Louisiana National Guard.

Passenger security screening is provided by ITS and Wackenhut. They are private firms working directly for the airlines serving New Orleans. The airport does not have a number of activities, found at many airports, which could pose additional security issues. For example, we do not have a major aircraft maintenance facility, a passenger or cargo connecting hub, or an airline reservation center.

Overview of Airport Insurance Availability Since September 11, 2001

As a consequence of the September 11th events, the worldwide aviation insurance market has been in a state of crisis. Initially, the underwriting community's emphasis was directed at the airline portfolio; then their attention quickly shifted to other lines of aviation risk coverage, including airport liability, with negative implications.

Immediately after the attacks on the World Trade Center and the Pentagon, the underwriters issued notices of cancellation of "War, Hi-Jacking and Other Perils" risk liability, which includes acts of terrorism, to all airlines. To permit continuing airline service, Congress passed the Air Transportation Safety and System Stabilization Act, which included a mechanism for the federal government to indemnify air carriers for all war and terrorism risk above $100 million.

In late September, airports were put on notice that their war insurance would be cancelled as of October 1, 2001. Although underwriters are beginning to offer war risk insurance, again, there has been no commitment whatsoever from the insurance industry that reasonable reinstatement terms will be offered to airports. That is why airports are continuing to petition the market, Congress and Department of Transportation for this essential coverage. In essence, airports are uninsured or "naked" with respect to this risk coverage and are exposed to substantial third party liability risk going forward. Currently, airports are solely dependent on state sovereign immunity laws to back them up. The problem is that these laws vary in inclusiveness across the states, they may not fully cover proprietary responsibility, and they do not cover all airport operating entities such as BAA USA, which operates the Indianapolis International Airport, the JFK/IAT International Air Terminal Group which operates Terminal 4 at John F. Kennedy International Airport, or the company that operates Stewart Airport. Also, where state sovereign immunity law applies, 3rd party claims would go unsatisfied, a moral/ethical issue that concerns most governmental entities operating airports.

Prior to the September 11th events, airports usually had substantial levels of war and terrorism risk included as part of their general airport liability coverage, generally $300 million at airports such as Louis Armstrong Airport to $1 billion for large hub airports. To date, three insurers have come back into the market with a product that is expensive and has a very limited and inadequate liability cap of $50 million. At least one of the available policies contains massive exclusions such as screening, baggage and security functions. In addition, all policies still include the 7-day cancellation clause, which would allow insurers to cancel their policy on short notice.

Impact of September 11 at Louis Armstrong Airport

Prior to September 11th, the airport was able to acquire adequate insurance at reasonable premiums. For the 12 months ending September 30, 2001, our policies covered essentially all risks, including War and Terrorism, up to $300 million. Our annual premium was $321,000 and our provider was Westchester.

We began searching for a replacement policy after the events of September 11th. By September 20 we had an insurance proposal for the coming year, but it is quite different from the insurance we previously had. The new policy excludes war and terrorism, completely, it excludes coverage for officers and directors, and it costs significantly more - $520,350 for $300 million of coverage.

The airport continued to seek additional coverage and was later offered an amended proposal that included $50 million of war and terrorism coverage, at an added cost of $450,000. A second provider was able to offer $50 million of this coverage for a premium of $303,000. We were also able to obtain officers and directors coverage for $8,000.

The board sought additional coverage, hoping to bring the airport to the pre-September level, but none was available. We accepted and "bound" the offers we had. As of this time, we have similar general liability coverage to what we had before September 11, but far less for war and terrorism coverage. And, the airport's annual premiums have nearly tripled.

Just this week, we have received one additional insurance option that we are considering. For a $572,950 annual premium, we can obtain $100 million in additional war and terrorism coverage, increasing our total protection for this coverage to $150 million. If we accept this option we will have half of our prior war and terrorism coverage for a total annual premium of five times what the airport paid last year: $1.4 million versus $321,000 in the year 2000.

We will have no choice but to charge this cost to the air carriers through increases in their rents and landing fees. The $1.1 million insurance premium increase I have described represents a 3 percent increase in total air carrier costs. Put another way, this increase could raise landing fee by 15 cents per 1,000 lbs. of aircraft weight or approximately 22 cents per passenger.

The board remains committed to maintaining adequate insurance to protect the airport. The board is equally committed to minimizing air carrier costs and would therefore welcome your help in providing airports with war and terrorism coverage at a cost we can all afford.

Recommendations

Congress quickly stepped into the marketplace to ensure that airlines would not be faced with financial ruin as a result of the September 11th tragedy. Our airport and airports across the country will benefit by the fast action of the Congress in this regard. However, as many people in this hearing are aware, our nations airports are a primary driver of the economies of our nations' cities. It is at our airports where jobs and value added services provide a tax base and economic opportunity. In order to sustain those jobs, our airport and airports like it must remain competitive and efficient.

The Louis Armstrong International Airport cannot sustain the risks of insuring itself against perceived risks of terrorism across the world by passing on the exorbitant costs of higher premiums through higher landing fees. There is simply no mechanism for an individual airport to recover these costs in an efficient and economic manner given the magnitude of the risk compared with the limited resources available at any single airport. Therefore, we recommend that the committee consider solutions that spread the risk to individual companies and airports in as broad of a way as possible, taking into account that the risks associated with an act of terror far exceed the economic capacity of an individual airport to sustain. One of these solutions would be to extend the federal war risk insurance program explicitly to airports (the program now covers airlines and their vendors, agents and subcontractors).

We are cautiously optimistic that the Louis Armstrong International Airport has recovered from the downturn of air travel nationwide. For the first half of October, the airport has handled an average of 157 flights, down 14% from a daily average of 180 flights reported in all of October 2000. The airport is at about 90% of air passenger volume reported in August and 85% of volume as compared with October 2000. We hope these numbers for New Orleans will improve, but we cannot fulfill our obligation to our community unless national volumes return to normal.

What will get those passengers flying again? The single best means of getting back to business in air travel is to restore confidence in the security of our planes and airports and to provide stability in the marketplace. The uncertainty regarding the availability of insurance and the calculation of risk associated with acts of terror creates a background of instability that has wreaked havoc with the traveling public and the insurance industry. Restoring the certainty of insurance at reasonable rates should underpin any legislative effort to restore this confidence.

STATEMENT SUBMITTED

BY THE

UNITED STATES NUCLEAR REGULATORY COMMISSION

TO THE

SUBCOMMITTEE ON

CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

OF THE COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING

PRICE-ANDERSON ACT

SUBMITTED BY
MARJORIE S. NORDLINGER, SENIOR ATTORNEY
OFFICE OF THE GENERAL COUNSEL

OCTOBER 24, 2001

Mr. Chairman, I am pleased to appear before you today as a representative of the United States Nuclear Regulatory Commission (NRC) to provide you information on a unique, nontraditional system that has evolved from Congress's initial enactment in 1957 of the "Price-Anderson Act". We hope that this information will assist the Committee in its consideration of the important insurance issues that are before you today. This testimony relates, of course, to the application of the Price-Anderson Act to the nuclear power reactors regulated by the NRC.

The Price-Anderson Act addressed an unusual insurance situation which needed to be resolved for Congress to succeed in its aim to have private sector development of peaceful uses of atomic energy. That situation can be simply described as one where (1) it was impossible to rule out the potential for an accident, which if it occurred could have catastrophic liability; (2) there was little or no experience and the possible costs of damages were uncertain; and (3) thus, neither industry nor private insurers were able substantially to absorb the risk.

Two paramount goals governed Congress's consideration of a solution to this predicament: that the solution would ensure the availability of adequate funds for the public to satisfy liability claims in a catastrophic nuclear accident and further, that it would permit private sector participation in nuclear energy by removing the threat of potentially enormous liability in the event of such an accident.

The original solution, as enacted in 1957, was characterized by its creation of a governmental role in providing indemnification and limiting liability and its application to all reactors as a further condition of licensing them. The licensing process itself provided substantial assurance that each reactor would be designed, built and operated to satisfy the government's high safety standards.

The original Price-Anderson Act approach included as a first layer a requirement that each power reactor licensee had to procure available financial protection (a requirement which as a practical matter meant the purchase of commercial insurance, the maximum then available being $60 million). That layer was then followed by indemnification by the United States itself to cover up to $500 million in liability over the amount covered by required commercial insurance. Aggregate liability for any single accident was by statute limited to the sum of the commercial insurance available and the governmental indemnity .

The aggregate liability included the liability of anyone who was found liable for any reactor accident, with the notable exception of an accident resulting from an act of war. This broad coverage is known as omnibus coverage. The statute also required a licensee to waive any immunities under state or federal law. The omnibus nature of coverage was designed to serve many purposes: to assure the availability of funds to compensate for personal injury or damage to property of members of the public no matter who caused the accident; to permit suppliers and professionals to participate in the industry without fear of liability far out of proportion to any profit they might expect to gain; and to make possible efficiencies in the process of presenting, settling and satisfying claims. The mechanism for accomplishing these goals was incorporated in insurance contracts purchased by each reactor licensee and in required agreements of indemnification between the reactor licensee and the United States government.

While the Price-Anderson Act provided that liability was limited, the Report at the time of original passage noted that if actual damages were to exceed the available funds, i.e., the sum of commercial insurance coverage and government indemnity, "the way was left open for Federal contributions after further congressional consideration." S. Rep. No. 296, 85th Cong., 1st Sess. 2, (1957). This concept, present at the outset, was later expressly included in Price-Anderson Act legislation and is often referred to as a "third layer" of funding.

While Congress has amended the Price-Anderson Act from time to time, it has done so cautiously so as to avoid upsetting the delicate balance of obligations between operators of nuclear facilities and the United States government as representative of the people. Before proceeding to discuss what are likely the most interesting and significant changes, I would note that Congress eliminated the requirement that non-commercial small educational and test reactors purchase insurance, but nonetheless, continued to have the United States indemnify each for $500 million once the small reactor licensee had paid out $250,000 in liability damages.

The most significant amendments to date were those that effectively removed the United States government from its obligation to indemnify any reactor up to a half billion dollars and, for commercial power reactors, placed the burden on the nuclear power industry. This was accomplished without any substantial alteration of the other elements that characterized the Price-Anderson scheme-- most particularly omnibus coverage and liability limited to the availability of funding-- and with increased protections for the public.

The first step in this direction occurred in the 1975 amendments, when Congress mandated that each large reactor, essentially each reactor providing power commercially, contribute $5 million to a retrospective premium pool. This retrospective "premium" was due if and only if there were to be damages from a nuclear incident that exceeded the maximum commercial insurance available. The limit of liability was then $560 million. Government indemnification was phased out in 1982 when the potential pool and available insurance reached that sum.

In 1988, Congress increased the potential obligation of each reactor in the event of a single accident at any reactor to $63 million to be adjusted for inflation. The liability insurance available to comprise the first layer is now $200 million. When that insurance is exhausted each U.S. reactor licensee must pay into the pool up to $83.9 million, as adjusted for inflation, if needed to cover damages in excess of the sum covered by the first layer of insurance. The $83.9 million is payable in annual installments not to exceed $10 million. Today the first layer of commercial insurance and the second layer from the reactor pool together would make available well over $9 billion to cover any personal or property harm to the public caused by an accident.

Other features of the system as it exists today are worthy of attention without tracing their history. As I noted, from the outset the system provided that indemnified licensees waive immunities. An early amendment expanded the waivers so that in serious accidents, denominated "extraordinary nuclear occurrences" by the NRC, the defendants must also waive other defenses, including any more stringent statute of limitations for filing claims. The waivers in sum provide a result in the nature of strict liability where the claimants need prove only that the accident caused their injury; proof of fault is eliminated.

Under the limited experience to date, claimants have settled with insurance companies or filed suits in state or federal court. Those sued under the Price Anderson Act are entitled to have the lawsuit removed to the United States District Court where the accident occurred.

Punitive damages may not be awarded to any person on behalf of whom the United States is obligated to make payments under an agreement of indemnification that covers the accident at issue.

Price-Anderson Act coverage pertains to what is known as "third-party liability". It does not cover property damage at the site of the reactor where the accident occurred. Nor does it cover those covered by workmen's compensation. Reactor licensees obtain commercially available insurance to cover on-site property damage.

There are also statutory provisions covering case management, distribution of funds, allowance for legal costs and the preparation of reports to Congress in the event there is an expectation that liabilities will exceed the available sums. Congress expressly provided that proposed compensation plans should provide for full and prompt compensation (a third layer) and contain recommendations of possible sources of those funds.

The Price-Anderson system from its origins has contained specific, separate provisions to define coverage for Department of Energy (DOE) facilities and contractors. While the DOE coverage does not include a retrospective premium plan, the United States currently indemnifies DOE facilities and contractors up to the same sum available from power reactor retrospective payments and commercial insurance–now set at $9. 5 billion.

Several bills to reauthorize the Price-Anderson Act are now before Congress. Without reauthorization, new reactors licensed after August 1, 2002 would not be covered by the Price-Anderson Act.

We hope that this brief overview of an intricate and complicated statutory program will assist you in achieving your purposes. Further exposition of the process and of model agreements for insurance and indemnification are available in the NRC regulations published at 10 CFR Part 140. We stand ready to answer any questions that you might have about the Price-Anderson Act.

Thank you Mr. Chairman. I welcome your comments and questions.

United States General Accounting Office

GAO

Testimony

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

For Release on Delivery
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TERRORISM INSURANCE

Alternative Programs for Protecting Insurance Consumers

Statement of Richard J. Hillman
Director, Financial Markets and
Community Investment

GAO Accountability * Integrity * Reliability

Statement
Terrorism Insurance: Alternative Proposals for Protecting Insurance Consumers

Mr. Chairman and Members of the Subcommittee:

The tragic events of September 11, 2001, bring to light numerous areas of concern within the financial services sector, especially as threats of future terrorist attacks continue. One area of concern voiced by various industry groups and the Congress is how the insurance industry should respond to risks posed by potential terrorist attacks and the extent to which the government should play a role alongside the industry to address these risks. We appreciate the opportunity to discuss this issue.

Prior to September 11th, insurance coverage for losses from terrorism was included as a normal feature of insurance contracts. According to industry analysts, this was because insurers' experience suggested that domestic exposure to terrorism, both in the number of occurrences and the magnitude of losses, was limited. The September 11th attacks have changed insurers' perception of their potential risk exposure. Insurance companies have indicated that they will pay their share of the losses from these tragic events. However, both insurers and the reinsurers who share the industry's risks, have indicated that they don't know how much to charge for this coverage going forward because they cannot predict future losses. As a result, it has been reported that industry leaders may exclude insurance for terrorism from future insurance contracts unless the federal government provides some form of assistance to the industry.

A financially strong insurance industry is essential to the smooth functioning of the economy. Industry officials have indicated that insurance coverage for catastrophic events such as a major terrorist act is necessary for investors and other financial decision-makers to be willing to provide capital to promote continued economic growth and stability. If the federal government chooses to provide financial backing to this industry, the primary driving force should be to safeguard the economy's access to necessary insurance protection. At the same time, care needs to be taken to ensure that the interests of both the federal government and American taxpayers are safeguarded, and that the industry is assuming its fair share of risks.

Any mechanism established by the federal government to support the ability of individuals and businesses to get insurance for terrorist acts should address several significant concerns. Most importantly, the program should not displace the private market. Rather, it should create an environment in which the private market can displace the government program. Second, it should be temporary, at least initially. Finally, any program should be designed to ensure that private market incentives for prudent and efficient behavior are not replaced by an attitude that says, "Don't worry about it, the government is paying."

Features of Selected Insurance Programs Covering Catastrophic or Terrorist Events

In the aftermath of the September 11th terrorist attacks, the Congress is considering whether and how to provide financial backing to the insurance industry so that insurance is available for losses due to terrorist acts. As requested, we will present (1) features of several existing insurance programs, both domestic and international; (2) alternative mechanisms for funding insured losses; and (3) some broad principles or guidance that the Congress may wish to bear in mind as it considers possible ways to support the insurance industry in case of future catastrophic losses due to terrorist acts. My observations are based on publicly available information on a variety of insurance programs within the United States and other countries and from prior GAO work.

Today, a number of insurance programs exist in the United States and other countries to help ensure that insurance will be available to cover risks that the private sector has been unable or unwilling to cover by itself, including losses from catastrophic events and terrorism. Certain insurance programs are completely controlled and managed by the government, while others have little or no explicit government involvement. Likewise, in many programs the public and private sectors share risks, though in several different ways.

For this testimony, we are highlighting features from selected insurance programs, including some established by the federal government as well as some from other countries, the states, and others. For example, the federal government insures individuals and firms against natural disasters under the flood and crop insurance programs and bank and employer bankruptcies under the deposit and pension insurance programs. Some federal programs cover political risk insurance for overseas investment activities, third-party claims for nuclear accidents, and protection against war-related risks. Other countries and organizations have also developed insurance programs covering catastrophic or terrorist events. These programs can provide useful insights in developing an appropriate insurance mechanism to cover losses from terrorist acts.

For government insurance programs, the question of long-term cost and program funding needs to be addressed before the program is established. Some federal insurance programs have the statutory intent to provide subsidized coverage, while others are intended to be self-funding. As noted in some of GAO's previous work, whatever merits the federal government has as an insurer, the same characteristics that inhibit private insurance firms from covering certain events could also make a federally-sponsored insurance program a costly undertaking.[1]

In some cases, the federal government subsidizes insurance programs in order to achieve a public policy objective. For instance, catastrophic coverage under the crop insurance program is subsidized in an attempt to reduce reliance on ad hoc disaster assistance. In other cases, the federal government may set up premium and fee structures intended to cover the full cost of providing insurance. However, regardless of statutory intent, if federal insurance is underpriced relative to its long-run costs and the federal government pays the difference, a government subsidy results. For example, under the Flood Insurance Program, program operating losses have been financed through borrowings from the U.S. Treasury or covered by appropriated funds.

Selected Insurance Programs Established by Federal Statute

The federal government's size and sovereign power provide it with the unique ability to offer insurance when the private market is unable or unwilling to do so. Currently, the federal government has a variety of mechanisms, including insurance programs, to cover risks that the private sector has traditionally been unable or unwilling to cover. Appendix I, table 1, highlights key features of several selected programs. We will describe some of them further today.

Insurance for Catastrophic Nuclear Accidents

Features:

- *Mandatory participation*
- *Liability of the private sector is limited*
- *Implicit government backing*

A system that limits liability and provides indemnification for operators of nuclear reactors was established through the passage of the Price-Anderson Act of 1957. Specifically, the act limits the total liability of individual reactor operators for any accident. First, the operators must obtain insurance up to the maximum amount of private insurance available to the operator, which is currently about $200 million per reactor per accident. In addition, in the event of an accident at any single reactor that results in losses exceeding $200 million, all operators of the 106 commercial nuclear power reactors in the United States would be required to provide additional protection by paying into a secondary insurance fund. Depending on the amount of the claims, these contributions could be as high as $88.1 million per reactor per accident. Following an incident, the operators of commercial power reactors would be required to pay as much as $10 million annually for 9 years to complete the secondary insurance fund. For the 106 reactors in the United States, the nuclear industry's current exposure to third-party liability claims would be approximately $9.5 billion before the Congress intervenes.

[1] Budget Issues: Budgeting for Federal Insurance Programs, (**GAO/AIMD-97-16**), September 1977.

In the event of an accident that involves damages that exceed the amount in the secondary insurance fund, the government is not explicitly required to fund the balance. Rather, Price-Anderson commits the Congress to investigate the accident and to take whatever action it deems necessary. This action could include, among other things, appropriating funds or requiring the nuclear industry to provide additional funding to satisfy remaining claims. No nuclear accidents have occurred since Price-Anderson was enacted that cost more than was provided by the available private insurance. As a result, the industry has never had to pay into the secondary insurance fund, nor has the Congress been required to take action on excessive losses.

Insurance Against Overseas Political Risk

Features:

Voluntary participation

Federal government is the insurer and risk bearer

The Overseas Private Investment Corporation (OPIC), which began operations in 1971, was established to facilitate private investment by U.S. investors in developing countries and countries with emerging markets. OPIC insurance programs reduce the risk to U.S. investors in these countries by offering protection against several political risks. In general, the coverage offered by OPIC is more comprehensive both in scope and duration than the coverage currently available from private sector insurers. OPIC operates as a self-financing government agency. A significant portion of its income is derived from premiums and fees, but the program is also backed by $100 million in borrowing authority from the U.S. Treasury. Premium rates are based on a standard pricing table for different business sectors, with adjustments for project-specific risks. The risk assessment methods OPIC uses to establish insurance reserves and set premium rates rely heavily on expert judgment and are not highly quantitative. According to OPIC officials, no standard actuarial model exists for quantifying political risks. Over the life of OPIC, the government has made money on the insurance provided.

Insurance Against Urban Riots and Civil Disorder

Features:

Voluntary participation

Encouraged states and the private sector to provide insurance in urban areas

Offered federal reinsurance for insured property in urban areas

The National Insurance Development Program was established by the Housing and Urban Development Act of 1968 (P.L. 90-448). The program sought to ensure the availability and affordability of fire, crime, and other property insurance to residential and commercial owners located in high-risk urban areas. The act created a Federal Insurance Administrator within the Department of Housing and Urban Development to administer the reinsurance program, but responsibility was later transferred to the Federal Emergency Management Agency. The program was a response to the urban riots and civil disorders of the 1960s, when many of America's cities suffered major property losses.

As a result of these losses, insurers became reluctant to underwrite property insurance in communities considered to be at risk for such events. The program had two purposes. First, the program encouraged state insurance regulators and the industry to develop and carry out programs to make property coverage more readily available. Second, it provided a voluntary federal program of reinsurance for urban property owner relief against abnormally high property insurance rates in private markets. Under this program, federal reinsurance was made available to property insurance companies operating in states that voluntarily adopted Fair Access to Insurance Requirements Plans. Insurers were required to retain a small portion of the liability,[1] which had to be paid first in the event of a claim. Insurers could transfer most of the remaining risk by making a premium payment to the federal government, which then assumed the remaining liability. This liability ranged from 90 to 98 percent of the remaining insured amount, and coverage increased as losses grew. The program was backed by $250 million in borrowing authority from the U.S. Treasury.

The program also included a requirement that states share in program losses with the federal government.[2] According to a former program official, state sharing of program losses was a feature designed in part to keep states from setting property insurance premiums too low. At the program's inception, federal reinsurance was to last less than 5 years. However, former officials reported that the program made money because claims never reached the anticipated levels and, beginning in the early 1970s, the program premiums were used to subsidize a crime insurance program. Reinsurance was discontinued in 1984 because of the small number of insurers participating.

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[1] A "net retention amount" of not more than 2.5 percent of the premiums paid by owners, calculated on a state-by-state basis, depending on the line of insurance offered. Insurers purchasing reinsurance could also be assessed an amount in the event of losses in excess of all reinsurance premiums paid nationwide.
[2] If federal reinsurance payments exceed premiums from the property-casualty companies in a state, the state must pay an amount up to 5 per cent of the aggregate property insurance premiums earned in that state during the preceding year of those lines of insurance reinsured by the federal government.

Insurance Against Floods

Features:

Voluntary participation

Federal government is the insurer for flood risk

Subsidized rates offered to encourage mitigation

The National Flood Insurance Program, which was established by the National Flood Insurance Act of 1968, makes federal flood insurance available to property owners living in communities that join the program. Some of the key factors that led to the program's establishment were private insurers' reluctance to sell flood coverage, increasing losses from floods because of floodplain encroachment, and high federal expenditures for relief and flood control. This program, which is financed primarily through premiums, fees, and interest income, aims to reduce federal spending on disaster assistance. By design, this program is not actuarially sound, because it does not collect sufficient income from premiums to build reserves to meet long-term expenditures on flood losses. Though the Federal Insurance Administrator is authorized to subsidize a significant portion of the total policies in force, its annual appropriations do not cover these subsidies. As a result, the Congress has appropriated funds for the program from time to time. In addition, the Federal Insurance Administration has periodically borrowed from the U.S. Treasury to finance operating losses.[1] The program is backed by $1 billion in borrowing authority from the U.S. Treasury.

Selected Insurance Programs of Other Countries

Many other countries have government-sponsored insurance programs that cover catastrophes, terrorist events, or both. Some of these programs are essentially run by the government, while others have little or no government backing. Appendix I, table 2, highlights key features of such programs in Israel, Japan, Switzerland, and the United Kingdom. We will briefly discuss these programs.

Japan's Insurance Against Earthquakes

[1]FLOOD INSURANCE: INFORMATION ON FINANCIAL ASPECTS OF THE NATIONA

Japan's earthquake insurance program, originally conceived in 1966, arose out of a major earthquake in that country in 1964. The insurance is purchased as a supplement to residential fire insurance and covers homes and household goods. Private insurers and the government share in any losses that result from a disaster according to a three-tiered payment system. Under the first tier of coverage, private insurers are responsible for the first \$625 million[1] of damages before government assistance is triggered. This initial amount effectively acts as a deductible. Losses above this amount trigger a second tier of coverage, for damages up to \$6.821 billion. The Japanese government pays 50 percent of the losses in this second tier. The third tier of coverage involves losses of between \$6.821 billion and \$34.166 billion, with the government paying 95 percent of losses exceeding \$6.821 billion. The Japanese government receives reinsurance premiums from primary insurers, but its total liability is not necessarily limited to the total amount of premiums received.

Features:

Mandated insurer participation

Private/public risk sharing

Government share increases as losses increase

Japan's program has several distinguishing features. First, the private sector is responsible for the initial portion of losses. This feature helps to ensure the development of a private market for earthquake insurance that is unencumbered by a monopoly. Additionally, industry pool arrangements are mandated under the program. The government takes on an increasing share of losses as they rise, up to a maximum cap on the total amount of exposure, but the private sector still bears some cost even at higher levels. This feature helps to ensure that risk of disaster is spread throughout the entire country and economy. Finally, the Japanese program was not established to provide coverage for all potential losses, but rather as a first step toward providing some level of coverage, with the government and private sector working together.

United Kingdom's Insurance Against Terrorist Events

[1] Dollar figures presented are based on the conversion of yen to dollars from documents on the program provided by Japan's Board of Audit.

Features:

Voluntary participation

Created because of withdrawal of private reinsurance

Insurers pay 110 percent of premium received before government pays

The United Kingdom's Pool Reinsurance (Pool Re) program was established in 1993 to provide insurance against losses and damages caused by terrorists attacks on industrial, commercial, and residential properties located within the British mainland. There are several distinct layers of coverage. All policyholders who buy basic property coverage from insurers have the option of buying additional coverage from the same insurers to protect against terrorism. Insurers are responsible for the first 100,000 pounds of coverage per coverage type, with no reimbursement from the government. Claims exceeding 100,000 pounds are paid from premiums accumulated within a pool made up of insurance companies and Lloyd's syndicates. (The British government and the insurance trade group established a mutual company from these companies and syndicates to provide terrorism reinsurance.) If the pool of funds is exhausted, all participating insurers face a call of up to 10 percent of the premiums they have collected during the year. Beyond the 10 percent call, the pool investment income is tapped, and the government meets any claims in excess of this. According to United Kingdom officials familiar with the program, the government has not yet had to bail out the pool as the reinsurer of last resort.

Israel's Insurance Against Terrorist Attacks

Features:

Mandatory participation

Government bears all risk

Funded by tax revenues

Israel has two programs for covering losses resulting from a terrorist attack. The first is the Property Tax and Compensation Fund, which covers property and casualty insurance. The second is the Law for the Victims of Enemy Action, which covers life and health insurance. The Israeli government funds and administers both programs. Under the Property Tax and Compensation Fund, the Israeli Income and Property Tax Commission levies a national property tax predominantly on Israeli businesses. The commission pays claims on property damages that are the direct result of a hostile terrorist attack (including losses of business inventory), on the basis of the market value of a property immediately before the attack. All indirect damages, including those for business-interruptions, must be covered through private insurance. Private supplemental coverage or additional state coverage can be purchased to cover the difference between a property's current market value and the cost of rebuilding (known as the replacement value). State coverage is capped by implementing regulations.

The second program, the Law for the Compensation of Victims of Enemy Action, is a state-run program administered by the National Insurance Institute (NII) and is also funded by the government. The NII is similar to the U.S. Social Security Administration. Coverage is provided for medical care, lost wages, extended payments to the families of attack victims, and personal injury. Coverage also extends to visitors and tourists who are in Israel. Coverage amounts for this program are again determined by implementing regulations.

Switzerland's Insurance Against Selected Catastrophic Events

Features:

Mandatory participation

No government risk exposure

Switzerland's Catastrophe Insurance program was established to insure against natural disasters, including storms, hail, floods, landslides, and avalanches. Earthquakes are not covered under this program. This program does not set up a separate catastrophic insurance fund, but instead obliges insurers to include coverage for specified catastrophes in fire insurance policies for buildings and their contents at a statutorily fixed rate. These compulsory premiums are the sole means of financing the catastrophe insurance program. Although this scheme does not set up a separate catastrophe insurance fund, Swiss insurers have created a reinsurance pool where these additional premiums are deposited. Membership in this pool is optional for insurers, but currently 85 percent of claims are ceded to it. Should claims exceed the funds in the pool, the difference would be payable from the insurers' capital and assets. There is no government involvement or exposure associated with the operation of the program, since the Swiss government does not provide any guarantee. For this reason, the private sector has an incentive to reduce risks. Insurers that participate in the pool are also subject to a cash-call in proportion to their participation in the pool to cover claims that exceed pool capacity.

Insurance Programs Sponsored by States or Other Entities

Other insurance programs that may provide useful insights in developing insurance coverage for terrorist acts include those established by state governments and private sector entities. Appendix I, table 3, highlights the features of several state and private sector insurance programs, and I will describe these programs here.

State Insurance/Guarantees Against Insolvent Insurers

Features:

Mandatory participation

Funded by post event assessments

Operated by industry

No explicit subsidy

Every state has guaranty funds to protect policyholders when an insurance company fails. These funds exist for property-casualty as well as life-health insurers. While there are differences between the funds for the two insurance sectors, in general they operate similarly. Insurance guaranty funds are not really funds. In nearly all states, the money used by guaranty funds to pay policyholders of failed insurers is collected through post-failure assessments. After an insurance company is found to be insolvent by a state regulator, the regulator and the guaranty funds in each state where policies were sold determine by how much the failed company's policyholder claims exceed the value of the company's assets. The guaranty funds then provide sufficient funds to ensure that all claims are paid (up to each state's statutory limits). Guaranty funds are not operated by state governments, nor are they funded by public money (i.e., there is no explicit subsidy).

However, the funds were created by statute and operate as part of the insurance regulatory system. Even though no appropriated funds are used to fund the guaranty funds, insurers do not bear the entire cost of guaranty fund assessments. While tax treatment varies among states, many states allow the insurers to offset their premium taxes for assessments paid to guaranty funds. Where this tax credit is permitted, insurers can usually reduce their premium tax bill by 20 percent each year for 5 years. Other states allow insurers to recoup assessments by increasing or adding a surcharge to policyholder premiums.

California's Insurance Against Earthquakes

Features:

Participation based on statutory requirements

Funded by assessments on insurance companies

No public funding

The California Earthquake Authority was established to insure California residents against losses caused by earthquakes. The Earthquake Authority was set up by state statute. The state of California, however, does not contribute any funding to the authority. After the Northridge, CA earthquake in 1994, insurance companies determined that the premiums they had been charging for earthquake coverage were inadequate. Furthermore, the companies did not know how to set an actuarially sound price. Insurance companies attempted to stop selling insurance against earthquake damage, but were opposed by the state. After negotiations, insurers were permitted to exclude earthquake coverage from their property-casualty policies if insurance companies representing at least 70 percent of the market agreed to participate in the Earthquake Authority.

Participation meant agreeing to pay an initial assessment totaling \$717 million plus two additional assessments of \$2.15 billion and \$1.434 billion after certain levels of earthquake-related losses occurred. Thus, potential Earthquake Authority losses are to be funded by a multilayered financing arrangement involving insurer contributions, premiums, conventional reinsurance, and pre-established debt financing. In early 2000, these layers totaled about $7 billion. In the event that all authority funds were expended, claims payments would be prorated. The Earthquake Authority currently provides virtually all of the earthquake insurance available in the state of California.

The International Group of Protection and Indemnity Clubs (Group) includes the 14 protection and indemnity associations or "clubs" that insure about 90 percent of the world's seagoing tonnage. The individual clubs are nonprofit-making mutual insurance organizations that cover third-party risks of shipowning members. The American Steamship Owners Mutual Protection and Indemnity Association, Inc., known as the American Club, was established in New York State in 1917 and is the only U.S. domiciled member.[1] The American Club has no government subsidy. The Group arranges collective insurance and reinsurance that covers risks such as those arising from oil spills and other polluting substances. The program uses primarily a prefunded approach to pool funds through advance calls of premium. The advance premiums paid by shipowners are 80 percent of estimated claims for the policy year. Premiums are invested by the Group. Should loss experience prove higher than anticipated, the program also encompasses other reinsurance and a post assessment call feature.

The pooling arrangement is a four-layered system. Claims of less than $5 million are essentially risk of loss retained by the club member shipowners. The program then enables the pooling of claims from $5 million to $30 million between clubs based on a formula incorporating tonnage size, premium income, and claims record. The next layer, called "excess of loss reinsurance," is reinsurance purchased by the Group for third-party claims incurred in a single incident in excess of $30 million—up to $1 billion in the case of oil pollution liabilities and up to $2 billion for all other liabilities. Finally, the program encompasses an "over spill" layer to cover claims in the $2 billion to $4 billion range. This layer is funded through a post assessment of club members.

Alternative Mechanisms for Funding Insured Losses

Features:

Voluntary participation

Risks are pooled and funded by pre and post assessments

No government involvement

In order to pay claims when an insured event occurs, a mechanism must exist to ensure that the funds will be available when they are needed. Currently, there are two possible models for such a mechanism. First, insurers can prefund for expected losses by estimating potential liabilities (establishing a reserve liability) and collecting assets (premiums) to pay claims when an insured event occurs. Alternatively, under certain circumstances, after an

[1] The American Club became a signatory to the Pooling Agreement in February 1998. Prior to that, the American Club was reinsured with the Group via the London Club. Protection and Indemnity is the traditional name for insurance to cover ship owners and ship chartering firms against their legal liabilities to third parties.

insured event when losses are known with certainty, assessments can be levied to provide the necessary funds. Both models, and in many cases a combination of the two, are widely used in the insurance industry.

Prefunding Versus Post Assessment

The deposit insurance provided by the Federal Deposit Insurance Corporation (FDIC) is an example of a prefunded system. Banks pay premiums into a fund. When a bank fails, the deposit insurance fund is used to make up the difference between the bank's remaining assets and customer deposits, up to a legal limit. Of course, if the deposit insurance fund falls below a certain level because of large payouts, banks must pay additional amounts into the fund to ensure that sufficient funds are available for future failures. In contrast, most of the state insurance guaranty funds described earlier are examples of post assessment plans. After an insurance insolvency, the remaining insurance companies in each state where the company operated are assessed the difference between the failed insurer's legal obligations to its policyholders and its assets. Some of the programs described earlier in this statement include a combination of both prefunded and post assessment mechanisms, including the British Pool Re and the California Earthquake Authority.

For ordinary, noncatastrophic events, insurance companies set up reserves (liabilities) that measure their expected losses[1] and set aside assets to offset those liabilities. For catastrophic events, when both the timing and magnitude of losses are difficult or impossible to predict, insurance companies generally do not set up reserves.[2] These losses are generally paid out of the company's ongoing premium stream, the company's capital, or both. If income from premiums is too low or losses are too high, an insurer's capital can be depleted, and the insurer may become insolvent. In the long run, if an insurer does not become insolvent, it can recoup catastrophic losses by adjusting the premium rates charged to policyholders. Thus, even insurance companies postfund some of their insured losses. Both prefunding and post assessment are reasonable ways to fund the exposure to losses from large catastrophic events, including terrorism. Both mechanisms have advantages and disadvantages. Used together, they could

[1] For a reserve to be established by an insurance company, the losses must have already occurred (either reported but unpaid, or incurred but not reported), or be "probable" and "estimable."
[2] Accounting standards and tax law discourage the establishment of "contingency reserves." That is, insurers must usually build such contingency reserves from after-tax income (retained earnings). As a result, it is unusual for insurers to establish contingency reserves for events like hurricanes, since it is impossible to measure either the probability of such occurrences or the expected loss that is likely to occur during the current accounting period, irrespective of the long-term predictability of the event.

provide a multilayer mechanism for funding levels of risk exposure that otherwise could limit the availability of needed insurance.

Reinsurance: A Further Means of Protection

Insurance companies that insure catastrophes can also reduce the potential for insolvency by purchasing reinsurance. The insurer remains liable for any claims when they are presented, but is later reimbursed by the reinsurer for the portion of the liability that was reinsured. The problem for the insurer then becomes one of liquidity rather than solvency. Of course, over time both the insurer's and the reinsurer's solvency depend on a reasonable correspondence between premium income (plus investment income) and losses.

Reinsurers remain in business if the direct insurer can charge premiums that provide sufficient income to pay claims and related expenses and to record a profit. If a reinsurer does not believe an insurer is capable setting a price commensurate with the risk, or of generating enough premium income to pay those risks, it will not reinsure that business. According to the insurance industry, it is now facing that situation in the aftermath of the September attacks. One possible solution would be for a group of insurers to establish a pool to take the place of the unwilling reinsurers. In this case, losses from any terrorist event that affect only one or a few members can be spread across the entire pool, reducing the likelihood that individual members will become insolvent. However, while the pool may take the place of the reinsurers, the pool faces the same difficulties in establishing catastrophic (contingency) reserves as the individual insurers. It would also be holding the same risks that the reinsurers were unwilling to accept. Hence, the desire to add the government to the equation.

How the Federal Government Can Support Insurers Facing Catastrophic Losses

The federal government could help the insurers in a number of ways. It could allow the pool to build tax-free, multiyear reserves for potential losses that do not have a measurable probability or estimable value. Such a pool arrangement has been used in Britain for the purposes of increasing pool assets for catastrophic losses. This tax-free status would increase the pool's ability to pay for future terrorist events. However, if the insured event occurs before the pool builds up substantial reserves, or if the prices insurers are charging for coverage turn out to be too low, the pool's reserves would still be depleted. If so, the member insurers would still risk insolvency, since they would be obligated to pay all legitimate claims whether they could recover the funds from the pool or not. To alleviate this possibility, the government could also stand behind the pool as a risk-bearer. In this case, if the pool's assets were depleted, the government would assume the contingent liability, using its resources to pay additional losses and reducing the risk of insolvency for the insurance companies.

The government could also fund its contingent liability to the pool in a variety of ways. It could charge the pool a premium for the reinsurance-like protection it provides, accumulating a fund it could use to pay for losses. Of course, any premiums charged to the pool would reduce the pool's assets and accelerate both the time when the government would have to begin covering losses and its total exposure. Alternatively, the government could fund its losses out of tax revenues, either with or without repayment requirements.

Given that the problem currently facing the insurance industry is an inability to correctly price the risk of a terrorist act, prefunding may not generate sufficient funds to fully pay potential insured losses from major terrorist events. A postfunding (post assessment) mechanism could be used either to substitute for or to augment a prefunded reserving mechanism. Post event assessments could be a feature of the pool, of the government mechanism, or both. Pool Re, the British plan for public/private sharing of terrorism risk, includes a call on each member-insurer after the private pool is exhausted, in an additional amount equal to 10 percent of the total premium that insurers collected for terrorism coverage. Alternatively, the government could pay that portion of the losses that exceed the pool's resources and then assess the member companies over time in order to recoup part or all of its expenditures. In this variant, the government would be lending the insurance companies part or all of the cash needed to meet liquidity demands resulting from the terrorist event, but not bailing the industry out.

Principles to Consider When Providing Financial Assistance

At this point, we would like to discuss some broad principles that we have drawn from lessons learned over several decades of supporting congressional efforts to assist industries and firms in moments of crisis, including the savings and loan industry and, most recently, the aviation industry.[1] These principles may provide guidance as you consider whether the government should take actions to ensure the continued availability of insurance and reinsurance for terrorist-related acts. We believe that the following three principles are key to such efforts:

- Clearly define the problem to be solved.
- Ensure that the program protects the government and taxpayers from excessive and unnecessary losses.
- Avoid a self-perpetuating program, that is, the government's involvement should be temporary.

[1] Commercial Aviation: A Framework for Considering Federal Financial Assistance (**GAO-01-1163T**, Sept. 20, 2001).

Defining the Problem the Industry Faces

The industry and federal government need to work together to clearly define the specific nature of the problems confronting the industry, separating short-term needs from long-term challenges and wants from genuine needs. It seems clear, given insurers increased recognition of their exposures in the aftermath of the unprecedented events on September 11, 2001, that coverage for terrorist acts is not now amenable to normal insurance underwriting, risk management, and actuarial techniques. As a result, insurers and reinsurers are concerned about their ability to set an appropriate price for insurance coverage for terrorist acts. Given this uncertainty if this kind of insurance were to be offered at all, it is likely that either the prices insurers set would be prohibitively high or so low as to invite insolvency. However, even if we conclude that insurers cannot price and, therefore, cannot sell this kind of insurance, defining the nature of the problem facing both the economy and the insurance industry is a critical first step. Many important questions need to be addressed. Among them are:

- What is the appropriate definition of a terrorist act?
- How would the lack of insurance coverage for terrorist events affect other sectors of the economy?
- What are the public policy objectives to be achieved by an assistance program?

Protecting the Government From Excessive Losses

Whatever program or mechanism is put in place, protecting the government—and, therefore, taxpayers—from inefficiency and excessive costs needs to be a primary objective. When the government becomes involved in providing insurance, it is usually because the private insurance market is having difficulty underwriting and pricing certain risks. For instance, some risks are difficult to predict and can be catastrophic in size. Additionally, some risks may not be independent—that is, the losses may strike a large number of insured individuals or entities at the same time. Furthermore, spreading the risk to a large and diverse population may be difficult. This difficulty sometimes results from adverse selection, which occurs when those with the highest probability of loss tend to purchase insurance, while those with the least risk opt out.

While these factors may provide a basis for government intervention in the market, they also complicate efforts to measure the government's exposure to loss. Nevertheless, the government can take steps to control and limit losses. For example, any program should have keep market incentives where they belong—with private firms. As long as private firms have their own money at risk, the private market is a better choice than the government for handling traditional insurance functions such as setting prices, underwriting policies, and handling and adjusting claims. If the government is bearing all or most of the risk, private firms will not have the same incentives to maximize efficiency.

Thus, any government program must be structured to ensure that private insurers have the same incentives they would have if the government were not involved. For example, firms should have an incentive to set the best prices they can (even in an environment of insufficient information), to require risk mitigation on the part of their customers in exchange for a reduced premium, and to carefully investigate losses to ensure that claims payments are appropriate. Creating a mechanism that places part of each company's capital at risk—as well as premium income—could serve to maintain the correct incentive structure. If insurance companies believe that their own exposure to losses is insignificant, they are not likely to behave the same way they would if their own money was at stake.

Reevaluating Future Government Involvement

Finally, in the current crisis environment any government solution should be temporary and needs to be revisited periodically. Congress may decide that ensuring the continued ability of the insurance industry to serve all its customers is in the national interest. However, given the lack of information about the scope and nature of the long-term problem, it does not seem prudent to establish such assistance in a program that may become permanent. However, government programs that are not carefully designed tend to become self-perpetuating. We can find examples of such programs in our own government experience and in some of the foreign programs we have described today. Fortunately, several strategies are available to minimize the possibility that a program will perpetuate itself. First, government bureaucracy should be kept to a minimum. An established bureaucracy tends to find reasons for its own continued existence. Second, any program should have an exit strategy from the beginning. An exit plan will provide the insurance industry and program administrators with congressional guidance on how the industry should emerge from the assistance program. Finally, a primary goal of any federal insurance program must be to create an environment in which the private market can and will be reestablished.

Conclusions

The government may have an important role to play in helping the insurance industry establish insurance coverage for losses from terrorist acts. GAO believes that should any assistance program be established it would be most successful if based on the principles we have described today. Following these principles will help ensure that assistance addresses market problems, protects taxpayers from excessive and unnecessary losses, and does not displace the private market for providing such insurance coverage.

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or other members of the Subcommittee may have.

Contacts and Acknowledgments

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Appendix I: Summary of Alternative Programs

Table 1: Summary of Insurance Programs Sponsored by the Federal Government[1]

Program	Description	Government subsidy	Sources of financing
Castrophic Nuclear Accidents	Insures operators of commercial power nuclear reactors from large liability claims from a major nuclear accident regardless of cause such as terrorism, negligence, and natural disasters.	Unclear	Operators of commercial power nuclear reactors obtain maximum amount of private insurance available. After an accident occurs, they pay into a secondary insurance fund.
Overseas Private Investment Corporation (OPIC) Political Risk Insurance	Insures the investments of U.S. companies in developing countries against several political risks, including expropriation, currency inconvertibility, and political violence.	No. Self-financing but guaranteed by the full faith and credit of the U.S. government.	Premiums, insurance claim recoveries, and interest earnings.
National Insurance Development Program (Riot Re)	Insures against property losses due to riot and civil disorder. Provides owners with affordable insurance in high-risk urban areas.	Provided federal reinsurance mechanism. Capped Treasury borrowing authority at $250 million.	Deposited insurer premiums into a Treasury account. Required states to provide funds for program losses.
National Flood Insurance	Insures buildings and contents against losses due to flooding in communities nationwide that enact and enforce appropriate flood plain management measures.	Yes	Premiums, interest earnings, and appropriated funds.
Bank Insurance Fund	Insures deposits up to a specified amount.	Deposits up to a specified amount, backed by the full faith and credit of the U.S. government.	Premiums, recovery of assets acquired in receivership, deposit assumption transactions, and interest earnings.
Aviation War-Risk Insurance	Insures against losses resulting from war, terrorism, and other hostile acts when commercial insurance is unavailable on reasonable terms and conditions and continued air service is in the interest of U.S. policy.	No. Self-financing from premiums for assumption of anticipated risks.	Premiums, interest earnings, and one-time registration fees for nonpremium insurance.
Federal Crop Insurance	Insures against crop damage from unavoidable risks associated with adverse weather, plant diseases, and insect infestations.	Yes	Premiums and appropriations.[2]

[1] Sources of information for these program summaries included (GAO/AIMD-97-16) and various publicly available documents describing the programs.

Program	Description	Government subsidy	Sources of financing
Maritime War-Risk Insurance	Insures losses resulting from war, terrorism, and other hostile acts when commercial insurance is unavailable on reasonable terms and conditions and continued service is in the interest of U.S. policy.	No. Self-financing from premiums for assumption of anticipated risks.	Premiums, interest earnings, binder fees, and claim reimbursements.
National Credit Union Share Insurance	Insures member shares (deposits) up to a specified amount.	Deposits backed by the full faith and credit of the U.S. government up to a specified amount.	Premiums, interest earnings, and 1-percent deposit from insured credit unions.
Pension Benefit Guaranty Corporation Insurance	Insures retirement benefits of workers and beneficiaries covered by private sector-defined benefit pension plans.	No. Self-financing from premiums paid by employers on behalf of their employees.	Premiums, assets from terminated plans, and investment income.
Savings Association Insurance Fund	Insures deposits up to a specified amount.	Deposits backed by the full faith and credit of the U.S. government.	Premiums, recovery of assets acquired in receivership, deposit assumption transactions, and interest earnings.
Service-Disabled Veterans Insurance	Provides life insurance to veterans with service-connected disabilities.	Yes	Premiums, interest on policy loans, policy loan repayments, and appropriations.
National Vaccine Injury Compensation	Provides compensation for vaccine-related injury and death.	No	Excise tax on manufacturers and interest earnings.

[2] The Federal Crop Insurance Corporation is authorized under the Federal Crop Insurance Act, as amended, to use the funds from issuance of capital stock, which provides working capital for the Corporation.

Table 2: Summary of Insurance Programs Sponsored by Other Countries[3]

Program	Description	Government subsidy	Sources of financing
Japan's Earthquake Insurance	Provides a public/private, three-tiered payment system for damages resulting from an earthquake.	Not presently known	Participating insurer and reinsurer premiums; some government tax revenue.
United Kingdom's Pool Re	Insures against losses resulting from terrorism.	Self-financing from premiums, pool members, and the government as last source of funds.	Premiums, collections from pool members, investment income, and government contributions.
Israel's Insurance for Victims of Enemy Action	Provides government-funded property/casualty and health/life insurance for victims of a terrorist attack.	Yes	Government property taxation, and premiums for additional state coverage. Although not explicitly stated, general tax revenues stand behind the primary funding sources.
Switzerland's Catastrophic Insurance	Insures against losses from natural disasters (excluding earthquakes).	No. Intent was that it would be self-financing from premiums for assumption of anticipated risks. If claims exceed premium payments, the difference would be payable from the insurer's capital and reserves.	Premiums on buildings and their contents.

[3] Information on these program summaries was collected from a United Nations document and various publicly available sources describing the programs.

Table 3: Summary of Insurance Programs Sponsored by States or Other Entities[4]

Program	Description	Government subsidy	Sources of financing
State Insurance Guaranty Funds	Protects policyholders when an insurance company fails.	No. However, in some states companies can deduct assessments from state taxes or recoup by increasing insurance premiums.	In all states but New York, insurers are only assessed after a failure occurs. In New York, insurers pay a premium into a state guaranty fund, similar to the way federal deposit insurance is funded.
California Earthquake Authority	Insures California residents and businesses against losses associated with earthquakes.	No subsidy.	Funding is provided by a multilevel mechanism, including insurance premiums, insurance company assessments, and debt financing.
The International Group of Protection and Indemnity Clubs	Insures shipowners against third-party claims for oil spills and other risks	No subsidy.	Member contributions via pre- and post-funding mechanisms.
Workers Compensation Residual Market Reinsurance Pool	National Council on Compensation Insurance (NCCI) is operating mechanism for paying claims from a pool fund.	No subsidy.	Premiums and additional contributions from member carriers in the state when pool funds cannot pay claims.

[4] Information on these program summaries was collected from various publicly available documents describing the programs.

Statement of the American Council of Life Insurers

before the

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

of the

House Committee on Financial Services

on the

Effects of Terrorism on Insurance Markets

October 24, 2001

The ACLI is the principal trade association for the life insurance industry, representing 426 companies, which account for 80% of the life insurance premiums and 81% of annuity considerations in the United States among legal reserve life insurance companies. ACLI member company assets account for 80% the total assets of legal reserve life insurance companies. We appreciate the opportunity to present this statement to the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises on the topic of insurance coverage for terrorist acts.

As the collateral effects of the attacks of September 11 continue to unfold, much attention has been focused on the financial condition of the insurance industry. In this regard, the property/casualty insurance business will ultimately incur losses estimated at between $30 to 50 billion, while the life insurance industry losses will be in the $4 to 6 billion range.

Both segments of the insurance industry have repeatedly sought to assure the public and Members of Congress that they have adequate resources to cover these losses. However, the threat of additional and perhaps more widespread terrorist attacks, with even more devastating losses, dictate that Congress examine the capacity of the insurance system to respond to such previously unthinkable scenarios. We commend the Committee on Financial Services for timely examination of this critical issue.

Thus far, the property/casualty industry has been the focus of efforts to develop a private sector/government partnership to underwrite the risks associated with expanded terrorist losses. This is appropriate as the property/casualty industry has obviously had to absorb a much greater impact on its available capital reserves as well as a more immediate response from its reinsurers that terrorist coverage would be severely limited or unavailable in the future.

Because the life insurance industry has more than $3.2 trillion in assets and processes, on the average, about 10,000 death claims each day, the losses of life resulting from the September 11 attacks, while tragic, do not pose a threat to the solvency of the life insurance industry. However, the potential for continued acts of terrorism to result in substantially more significant adverse effects on mortality, and by that we mean the potential for mass death and disability on a much larger scale than we have previously experienced or imagined, gives rise to questions that we believe must be considered by Congress as well as the life insurance business. Will there continue to be a viable private sector market for life insurance products that cover risks of terrorism? Put differently, will life reinsurers continue to enter into reinsurance treaties covering catastrophic risks that include acts of terrorism? Additionally, if there are realistic prospects of an act of terrorism of sufficient magnitude to adversely affect the overall solvency of the life insurance business, is there a justifiable need for some mechanism to address that situation, and, if so, what form might such a mechanism take?

The uncertainty surrounding these questions suggests a need for the Committee to evaluate the potential needs of the life insurance industry, including its customers, as part of its current inquiry.

At this time, we are not seeking the establishment of a mechanism similar to those under consideration for property/casualty insurers. Indeed, it is not clear at this point that such a mechanism would be necessary or useful for life insurers. Nor is there any agreement within our industry as to what such a mechanism should look like were it deemed to be necessary. We think it is prudent, however, to start the process of asking "what if?" and to begin doing it now, before events necessitate a last-minute, crisis-driven reaction that might not be entirely in the best interests of the life insurance industry or its customers.

In that regard, the ACLI has developed a proposal to create a study commission comprised of government and private sector representatives to assess the potential effects on the life insurance industry of further terrorist activities. The proposal is designed to be included in whatever legislation the Congress develops to address property/casualty insurance issues. This is not a request for government assistance. It is instead our industry laying down a marker to reflect the need to examine this issue thoughtfully, hopefully without the risk of being overtaken by events.

Briefly, the proposal would work as follows. A nine member study commission would be appointed to assess: (1) possible steps that could be taken to encourage and sustain the private market for life insurance products covering death or disability resulting from acts of terrorism and the threat of such acts; and (2) possible steps or mechanisms to sustain or supplement the ability of life insurers to cover losses due to death or disability resulting from acts of terrorism that significantly affect mortality experience or jeopardize the solvency of the industry as a whole.

This study commission would be comprised of five representatives from government (two from Treasury, one from Commerce, one from the Office of Homeland Security, and one from the ranks of state insurance regulators) and four from the private sector (two representing life insurers, and two representing life reinsurers). Any affirmative recommendations by the study commission would have to have the concurrence of at least two-thirds of the commission members to assure that such recommendations have at least some support from the life insurance business.

The study commission would have 30 days to organize itself and another 90 days to complete its work. The report of the commission would be submitted to the President pro tempore of the Senate and the Speaker of the House, with a copy to the White House. The legislation would direct Congress to give "prompt and deliberate consideration" to any recommendations for federal legislative action contained in the report. The study commission would be disbanded within 60 days after submission of the report.

To reiterate, by advancing this study commission, the ACLI is simply suggesting that the question of how acts of terrorism, or even the threat of such acts, will affect the life insurance business is a critical matter warranting prompt and thoughtful consideration by both the private sector and government. The events of September 11 have unquestionably introduced great uncertainty into the life insurance business. This uncertainty involves concerns over the way in which the risk of terrorism will be covered in insurance policies, how that risk will be quantified, how attendant pricing decisions will be made, and whether future events that even a few months ago were unimaginable carry with them the potential to overwhelm the solvency of our business. Given this uncertainty and the gravity of the issues at stake, we believe a study as outlined in the attached draft language is an appropriate response at this juncture.

ACLI Concept Draft:
Study & Report on Potential Effects of Terrorism on the U.S. Life Insurance Business

Draft of October 24, 2001

Section ___. Study and report on potential effects of terrorism on U.S. life insurance industry

(a) Establishment.--Not later than 30 days after the date of enactment of this Act, the President shall establish a Commission (in this section referred to as the "Commission") to study and report on the potential effects of an act or acts of terrorism on the U.S. life insurance industry and the markets it serves.

(b) Membership.--

(1) Appointment.--The Commission shall consist of 9 members, as follows:

(A) The Secretary of the Treasury, or the Secretary's designee;

(B) The Deputy Secretary of the Treasury, or a designee appointed by the Secretary of the Treasury;

(C) The Secretary of Commerce, or the Secretary's designee;

(D) The Director of the Office of Homeland Security, or the Director's designee;

(E) Five members of the public appointed by the President, two of whom shall be representatives of direct underwriters of life insurance within the United States; two of whom shall be representatives of reinsurers of life insurance within the United States; and one of whom shall be an officer of the National Association of Insurance Commissioners.

(2) Vacancy.--A vacancy on the Commission shall be filled in the same manner in which the original appointment was made under subsection (b)(1).

(3) Chair.--The President shall designate one of the members of the Commission, who is also an officer or employee of the United States, as the chair.

(c) Operations in general.--

(1) Staff.--The chair of the Commission may appoint and fix the compensation of a staff of such persons as may be necessary to discharge the responsibilities of the Commission, subject to the applicable provisions of the Federal Advisory Committee Act (5 U.S.C. App.2) and title 5 of the United States Code.

(2) Coordination with General Services Administration.--To the extent permitted by law, and requested by the chair of the Commission, the Administrator of General Services shall provide the Commission with necessary administrative services, facilities, and support on a reimbursable basis.

(3) Support from represented departments.--The Secretary of the Treasury, the Secretary of Commerce, and the Director of the Office of Homeland Security, shall, to the extent permitted by law and subject to the availability of funds, provide the Commission with such facilities, support, funds and services, including staff, as may be necessary for the effective performance of the functions of the Commission.

(4) Agency cooperation.--The Commission may request any Executive agency to furnish such information, advice, or assistance as it determines necessary to carry out its functions. Each such agency is directed, to the extent permitted by law, to furnish such information, advice or assistance upon request of the chair of the Commission.

(5) Compensation.--All members of the Commission who are not officers or employees of the United States shall serve without compensation for work on the Commission. All members of the Commission who are officers or employees of the United States shall serve without compensation in addition to that received for their services as officers or employees of the United States.

(6) Expenses.--While away from their homes or regular places of business in the performance of duties of the Commission, members of the

Commission shall be allowed travel expenses, including per diem in lieu of subsistence, as authorized by law for persons intermittently in the Government service under section 5703 of title 5 of the United States Code.

(d) Study.--The Commission shall conduct a study of the U.S. life insurance industry to identify:

(1) Possible steps to encourage, facilitate and sustain provision by the U.S. life insurance industry of coverage for losses due to death or disability resulting from an act or acts of terrorism, including in the face of threats of such acts; and

(2) Possible steps or mechanisms to sustain or supplement the ability of the U.S. life insurance industry to cover losses due to death or disability resulting from an act or acts of terrorism--

(A) In the event that such act or acts of terrorism significantly affect mortality experience of [for] the U.S. population over any period of time;

(B) In the event that such losses jeopardize the capital and surplus of the U.S. life insurance industry as a whole; or

(C) In the event of other consequences from such act or acts of terrorism that the Commission determines may significantly affect the ability of the U.S. life insurance industry to cover independently such losses.

(e) Recommendations.--Based on the results of the study conducted under subsection (d), the Commission shall develop such recommendations as may be appropriate for changes in statutes, regulations and policies to--

(1) Encourage, facilitate and sustain provision by the U.S. life insurance industry of coverage for losses due to death or disability resulting from an act or acts of terrorism, including in the face of threats of such acts; and

(2) Sustain or supplement the ability of the U.S. life insurance industry to cover losses due to death or disability resulting from an act or acts of terrorism in the case of any event described in subparagraph (A), (B) or (C) of subsection (d)(2).

Recommendations developed under this subsection shall require the concurrence of at least two-thirds of the Commission's members.

(f) Report and Action.--Not later than 120 days after the date of enactment of this Act, the Commission shall submit to the President pro tempore of the Senate, and the Speaker of the House of Representatives a report describing the results of the study conducted under subsection (d) and recommendations developed under subsection (e). A copy of such report shall be submitted to the President of the United States. Upon receipt of such report by the President pro tempore of the Senate, and the Speaker of the of the House of Representatives, the Senate and House of Representatives shall give prompt and deliberate consideration to any recommendations for federal legislative action contained in the report.

(g) Termination.--The Commission shall terminate 60 days after submission of the report as provided for in subsection (f).

STATEMENT OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA

UNITED STATES HOUSE FINANCIAL SERVICES COMMITTEE
OCTOBER 24, 2001

This testimony is submitted on behalf of the Independent Insurance Agents of America (IIAA). IIAA is a non-profit trade association that represents over 300,000 independent insurance agents and brokers and their employees nationwide. IIAA's membership is composed of large and small businesses that offer consumers a wide array of products in every state, city, and town in the country. The independent insurance agent and broker industry sells 75 percent of all commercial lines policies in the country. In essence, independent agents and brokers write coverage for America's businesses, and through this unique prism of expertise and for the reasons outlined below, we strongly urge the passage of legislation to ensure the availability and affordability of essential business insurance products in the aftermath of the horrific acts of September 11.

The terrorist acts of September 11 have had a profound impact upon all of us, with the insurance industry being hit particularly hard, both physically and financially. IIAA has over 20 agency members in Lower Manhattan, including one that was previously located in the South Tower of the World Trade Center, and many more had valued customers who were located in the complex. In the days and weeks that have followed the attacks, countless victims and survivors have begun putting their lives back in order, and the insurance industry has played a pivotal role in this recovery-and-rebuilding process. We are proud and pleased by the manner in which our industry responded to the events of September 11, and the best news was that things worked as they were intended. The insurance industry has honored its commitment to thousands of Americans in their greatest time of need—and the industry is proving that it has the resources needed to quickly and fully pay claims.

Although the insurance industry has responded efficiently and effectively to these attacks, we must now work to ensure that the industry is in a position to respond in similar ways to future terrorist attacks. In order to address these new challenges, we will need the leadership and assistance of the United States Congress and the Bush Administration to ensure that appropriate insurance coverage remains available. The issue of terrorism reinsurance is so vital to the future of American businesses—large and small alike—and to the health of the nation's economy that it needs Washington's immediate attention The time for action is now. Congress and the Administration need to address this important national policy issue as soon as possible.

The possibility of further terrorist attacks elucidates the need for mechanisms to assure the continuing availability of coverage for these risks. Although the insurance industry is prudently managed and well capitalized, it cannot and should not be expected to provide coverage for an uncertain number of attacks in the future (that cannot be scientifically modeled) without the establishment of a government mechanism that can provide a backstop for losses caused by terrorism. While most insurance policies today exclude damage from war, they typically do not include terrorism exclusions.

The problem now is that many understandably skittish domestic and foreign reinsurers stated that they would not cover terrorist acts when contracts come up for renewal on January 1. Primary insurers warn they cannot support repeated terror claims, especially if reinsurers exclude such losses from coverage. Without reinsurance, insurers will leave markets, exclude terrorism coverage or charge premiums that in essence will make insurance coverage unaffordable and largely unavailable. The specter of any of these options has dire ramifications for commercial consumers of insurance products that need the financial protection offered by insurance to stay in business and on commercial lines insurers, agents and brokers that serve them. Failure to address this potential coverage gap will thus not be felt only within the insurance industry but on the national economy as a whole.

Development of a terrorism reinsurance pool to cover commercial policies is critically important not just to insurance companies, agents and brokers, but also to the future viability of literally hundreds of thousands of small and large U.S. businesses. Without some kind of mechanism to cover terrorism losses, insurance protection would be difficult—if not impossible—to find, financiers would be reluctant to lend, and businesses would be hesitant to invest. The end result is an economic shockwave to the U.S. economy. No one wants to return to an insurance market like the mid-to-late '80s when the lack of available or affordable insurance altered the business and personal activities of Americans. Therefore, the issue of terrorism reinsurance is critical.

For this reason, IIAA supports the creation of a federal backstop to ensure that the industry will be able to continue offering coverage for damages caused by terrorism. In establishing such a backstop, we will be able to restore coverage for the millions of businesses that will otherwise be unable to renew their current insurance policies and we will be able to restore the confidence customers rely upon in securing their needs through all insurance policies.

When insurance industry representatives testified before the United States House of Representatives Financial Services Committee on September 26, the panelists' concerns focused more on the future than the present, and all seemed to agree that the U.S. government must play a role in addressing the need for terrorism reinsurance. IIAA believes that congressional action is necessary, and we believe the creation of a federal backstop is a necessary element of any proposal that attempts to address these issues. The establishment of a federal backstop would help ensure the continued solvency of the insurance industry,stabilize premiums, allow reinsurance companies to have renewed confidence to underwrite primary insurers, and make terrorism coverage available to the buyers who urgently need it. Regardless of whether it is the stability expected from the proposed establishment of a U.S. Treasury federal backstop that the insurance industry agrees upon, a division of future terrorist claims between the insurance industry and the federal government suggested by the Administration, or a hybrid proposal, the core objective must be to insure that mechanism are instituted to enable small and large businesses to purchase insurance policies that might otherwise be unavailable or unaffordable in the wake of the September 11th attacks. IIAA pledges to continue working with the Administration, members of this committee, consumers, our industry colleagues, and any others to ensure that an appropriate solution is attained.

The issue of terrorism reinsurance is so vital to the future of American businesses and to the health of the nation's economy that it needs the immediate attention of Congress. Without a backstop for acts of terrorism, most insurance companies have two options – stop writing many types of commercial insurance or charge significantly higher premiums. The specter of either option has dire ramifications for many business owners and agents and brokers. The impact on independent agents and brokers and their business clients is such a major concern that IIAA believes prompt congressional action is absolutely necessary. We are very pragmatic when it comes to drafting and moving legislation to address this national issue. While interested parties may have differing opinions on how such a mechanism should work, we believe it is far more important to expeditiously work through differences to achieve the timely enactment of a proposal that can meet the immediate and long-term needs of the customers of independent agents and brokers, We stand ready to work with you on this important national issue.

STATEMENT BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE

October 24, 2001

PROTECTING POLICYHOLDERS FROM TERRORISM:
PRIVATE SECTOR SOLUTIONS

On Behalf of the Following Associations and their Members:

American Council for Capital Formation
Associated General Contractors of America
American Resort Development Association
Building Owners and Managers Association International
International Council of Shopping Centers
Mortgage Bankers Association of America
National Apartment Association
National Association of Industrial and Office Properties
National Association of Real Estate Investment Trusts
National Association of Realtors
National Multi Housing Council
Pension Real Estate Association
The Real Estate Board of New York
The Real Estate Roundtable

Mr. Chairman, we commend you and the Committee for the much-needed attention that you are bringing to this important issue by holding a hearing today. You clearly recognize the importance of this issue and its potential effect on the U.S. economy. We thank you for your leadership in addressing insurance-related problems as a result of the events of September 11, and we also appreciate the White House efforts to remedy a potential insurance coverage crisis. The real estate and construction industries, which account for over a quarter of the nation's gross domestic product, could face severe economic dislocation in the coming months if the federal government does not immediately address insurance-related issues tied to terrorism.

To continue to operate in the normal course of business, these industries need to continue to have insurance for risks that have traditionally been insurable, including damage associated with terrorism. The insurance industry recently testified before the full Committee that without Federal support, it will not be able to provide terrorism coverage in the future. Further, as the nation expands its mission against terrorism, the line between terrorism and war will likely become increasingly blurred from an insurance standpoint.

The Problem

On September 26, the CEOs of several major insurance companies testified before your committee that the insurance industry expects to be able to pay claims associated with the September 11 terrorist attacks. However, they also said that insurers would not be able to provide terrorism coverage for future terrorist acts. The reason is that reinsurance for terrorist risks is generally unavailable in the current marketplace.

We take the insurance industry's warnings seriously and the Congress must as well. The lack of adequate reinsurance in the current market means that coverages our members need could very soon become unavailable to large segments of the U.S. economy. A significant percentage of owners of commercial properties open to the public, including shopping centers, offices, apartments and hotels, renew their insurance coverage on January 1 of each year. Many construction projects, including a number of new power plants, are slated to begin early and throughout next year. Many of the owners and developers already have been advised that their policies may not be renewed or that their new policies will exclude terror/war risks. Further, some owners have been advised that their current coverage may be terminated before their policies were set to expire, after the insurers provide the required advance notice (usually 90 days).

On October 15, a senior Bush Administration official said: "Without coverage against terrorist acts, banks will not lend to new construction; it will be difficult to sell major projects such as new pipelines, new power plants, skyscrapers. So we do think there is a problem that needs to be addressed." We could not agree more.

Mr. Chairman, the property owners among our members (including many pension funds that provide retirement security for their workers and families) cannot buy, sell, or finance the acquisition or construction of a commercial building unless it is covered by adequate insurance. Before September 11, adequate insurance was readily available. Neither property nor general liability policies in the U.S. excluded losses stemming from terrorist attacks. They excluded only acts of war. It now appears that terrorism coverage will not be available and that war risk coverage, which did not previously seem imperative, is now necessary to the extent any future attacks could be viewed as war-related.

The real estate and construction industries are leading pillars of the U.S. economy. Without adequate insurance, it will be difficult, if not impossible to operate or acquire properties, to construct new properties, to refinance loans, or sell commercial mortgage-backed securities (of which $350 billion is currently outstanding). Disappearance of coverage for terrorist acts could severely disrupt the U.S. economy.

The effects on our members of losing their insurance coverage are potentially severe. First, building owners and operators will be fully exposed to property damage losses from terrorist attacks and will be powerless to do anything about it. Worse, some state insurance regulators may not permit insurers to exclude terrorism coverage, raising the possibility that insurers will withdraw completely from such states and leave our members without any coverage at all.

Second, our members will also be exposed to third-party liability claims for terrorism and war risks. Without adequate insurance, they will be forced to choose between incurring these risks or closing their buildings to avoid them.

Third, virtually all of our members have clauses in their financing agreements requiring that minimum levels of insurance coverage on the property be in place. Without the required coverage, lenders would be free to foreclose because the loan would be in default without required insurance. Even more importantly, without adequate insurance coverage, lenders would not approve new loans to finance new construction or property sales, or refinance existing debt. This lack of liquidity could lead to the same severe problems the real estate and construction industries confronted after the savings and loans crisis when property values fell more than 30% largely because sources of capital dried up. Any similar liquidity crunch could have severe consequences on employment and state and local property and sales tax collections.

Further, portfolio lenders would be confronted with the possibility of limiting operations. The ability to finance commercial real estate transactions by institutional investors such as pension funds and life insurance companies would be at risk. These mortgage lenders have a fiduciary duty of prudence in investing money, and investing funds without adequate insurance would breach this duty. A lender refusing to make a loan without adequate insurance is not being arbitrary, it is acting in the best interest of the investor, whose money the lender is investing.

Fourth, the property owners among our members are likely to find that they cannot complete their construction projects, or begin new projects, until terrorism coverage can be restored. Lenders are unlikely to approve construction loans until our members can obtain builders risk insurance that is broad enough to cover acts of terrorism. This will affect not only our members, but also the U.S. economy as a whole. As you know, the construction industry is enormous and our economy was already struggling at the time of the terrorist attacks. The volume of construction that our members were putting into place had already begun to decline. Without government action to resolve this insurance problem, many construction workers are at risk of layoffs.

Fifth, apartment residents would see higher housing costs as real estate operating costs would increase significantly in the absence of continuing coverage of acts of terrorism. Even before September 11, multifamily owners and operators were facing year-over-year increases of 25-100% in their property and casualty insurance costs. Typically, these significant operating cost increases are reflected in higher market rents, especially in major urban markets with strong renter demand. In the absence of federal government involvement to provide for continuing coverage of terrorist acts, apartment renters, many of them low- and moderate-income families, will be forced to absorb a disproportionate share of heightened insurance costs and more-limited coverage. Federal government risk-sharing and the continued provision of coverage for acts of terrorism are needed to help moderate the impact on housing costs that renters will face as a result of the events of September 11.

Sixth, loss of coverage may lead to an increase in the cost of mortgage financing, especially in the commercial mortgage-backed securities (CMBS) market, as the result of an additional, difficult-to-quantify catastrophic risk to the real estate assets serving as security for the CMBS offerings. CMBS offerings are usually priced in the same manner as bonds and other fixed-income securities, heavily dependent on credit ratings issued by the major securities-ratings agencies. The rating agencies, and the fixed-income investment community in general, are very sensitive to any possible circumstances that could impair the cash flow available for payment of the securities in question. Of course, uninsured damage caused by terrorism could, as we have all seen, terminate, interrupt, or otherwise materially impair cash flow; that risk would loom particularly large to the extent that it is difficult to quantify.

An increase in the cost of mortgage financing could, in turn, cause otherwise viable projects not to be undertaken, and reduce income throughout the industry, leading to further lessening of demand and economic activity.

The war exclusions that have been included in our members' insurance policies for years mean that our members have always been exposed to losses resulting from acts of war. They cannot purchase war risk coverage separately in the market. This has not previously been a major concern because it was thought that the likelihood of losses related to acts of war on U.S. soil were quite remote. However, the events of September 11 and subsequent U.S. military activities in Afghanistan will cause the property owners among our members, and possibly their lenders, to reconsider whether it is acceptable to be exposed to such risks. The line between acts of war and acts of terrorism is in danger of blurring and our members cannot afford to be exposed to either risk. Henceforth, they must have adequate insurance protection for both risks. As of now they do not.

With many real estate businesses facing insurance policy cancellations and modifications on or before January 1, and both power plants and other construction projects ready to begin, the government must act now. Without government action, our industries will likely face the prospect of breaking promises to lenders, partners and others, of operating without necessary insurance coverage, and of watching the construction of new facilities slow down. Since operating a business without adequate insurance in many cases is not feasible, and is certainly unwise, real estate businesses will confront the possibility of ceasing or limiting operations until insurance once again becomes available. Without Federal action, the ability to finance, construct, buy or sell properties across the nation may be at risk.

Proposed Solution

We understand that the Subcommittee will wish to ensure that the Federal government does not take action that will ultimately interfere with or displace the private insurance markets. We share that concern. However, it is not clear when, or if, the private insurance markets will be able to meet our members' needs for terrorist insurance coverage.

The Federal Government must play a role in ensuring that commercial property owners can continue to obtain coverage for damage for acts of terrorism. This is especially true in the near-term while we wait to see whether and how the private markets will adjust to the new post-September 11 realities and risks. Further, given the increasing possibility that a court could conclude that future damages caused by a terrorist actions is excludable as damages resulting from a state of war, the Government must also play a role, at least in a standby capacity, in ensuring the availability of coverage for damages arising from the actions undertaken by terrorists such as al Qaeda or their allies.

There is ample precedent for the Federal Government filling the insurance or reinsurance gap: (1) crime and riot insurance programs were created for urban business owners following the social unrest of the late 1960s and early 1970s; (2) flood and crop failures are insured under Federally sponsored programs; (3) standby war risk coverage already exists for certain aviation and maritime operations (including a post-September 11 expansion of the aviation war risk program); and (4) during World War II, the Government authorized a program, administered by private insurers, which insured property against "enemy attack."

The insurance industry has put forward a proposal to establish a special, state-chartered reinsurance company that would accept terrorist risks from companies wishing to cede risks to it. That company would then reinsure 95% of these terrorism risks to the federal government. That proposal builds upon a model in the United Kingdom where a special reinsurance pool for terrorist risks was created in the early 1990s in the wake of IRA bombings in the City of London. The U.K. Government provides a backstop to that pool, but has not been called upon to pay any losses to date.

The Bush Administration has outlined a proposal to deal with the current problem that would involve a three-year program under which the Federal Government and the insurance industry would share, in declining proportions each year, the risks of terrorist acts. While the details of this proposal must be made clear, including the scope of acts covered within the definition of terrorism, we believe it represents a positive step towards addressing this issue.

We commend both proposals to your careful consideration. In the end, however, we emphasize that the problem must be addressed in a satisfactory and timely manner. A critical criterion in measuring the effectiveness of any solution is whether the financial community will continue to provide capital necessary to buy, sell, construct or refinance properties. Since real estate is a long-lived asset, real estate financing tends to be long-term. Accordingly, the finite duration of federal involvement must not prevent lenders from making these long-term commitments. Further, the insurance industry's primary coverage should not be rendered immaterial by unrealistic retention amounts (*i.e.*, deductibles) imposed on insureds.

The Congress must not fail to act. The real estate and construction industries welcome the opportunity to work with the Administration and Congress to achieve a workable solution to this immediate problem this year. To discuss these issues in greater detail, please contact Tony Edwards at NAREIT at (202) 739-9400 or tedwards@nareit.com or Chip Rodgers at The Real Estate Roundtable at (202) 639-8400 or crodgers@rer.org.

AMERICAN ACADEMY *of* ACTUARIES

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Committee on Financial Services U. S. House of Representatives Hearing on Protecting Policyholders from Terrorism: Private Sector Solutions

Statement of Steve Lehmann, FCAS, MAAA
Vice President, Property/Casualty
American Academy of Actuaries

October 24, 2001

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

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Introduction

The American Academy of Actuaries appreciates the opportunity to provide comments on private sector solutions to protect insureds from the threat of future terrorist acts. The Academy hopes that these comments will be helpful as the Subcommittee considers related proposals.

The Academy is the non-partisan public policy organization for the actuarial profession and assists policymakers through presentation of clear actuarial analysis. For more than thirty years, membership in the Academy has been a hallmark of professional quality for U.S. actuaries. Academy members are bound by rigorous professional standards for conduct, practice and qualification, and discipline.

The actuarial profession is uniquely qualified to examine issues relating to insurance and reinsurance of catastrophes. Academy members who practice in the insurance field typically have a broad understanding of insurance risk and company financial management, and they are well equipped to evaluate reinsurance arrangements. Many Academy members also have extensive practical experience in evaluating the financial risk associated with natural disasters and other catastrophic events and in pricing related coverages for the private marketplace.

Given this expertise, the actuarial perspective is particularly valuable in examining the fundamental aspects of insurance and in describing policy considerations associated with proposals to address the impact of terrorism on the insurance industry.

Defining the Problem

In the aftermath of September 11, insurers and insureds face a significant problem with respect to future coverage of terrorism risk, due to both the nature of insurance and the nature of the threat involved.

Insurance is at the foundation of a free market system, because it gives entrepreneurs and businesses the freedom to focus their resources on the conduct of their business without concern over the magnitude and volatility of potential fortuitous losses. Insurers accept that risk as long as it is quantifiable and can be appropriately priced. Where that is not possible, insurers become reluctant to accept the risk.

A dramatic change occurred on September 11, when a new risk of terrorism emerged from an event that had never even been imagined by insurers or insureds. The risk of terrorism involves prospective losses of unknown but potentially very high severity and unknown frequency. This makes risk quantification very difficult. Furthermore, it reaches beyond first-party property coverage to involve other coverages (such as workers compensation, liability, and business interruption) that are also difficult to quantify.

Even building a new risk model to define the scope of potential losses from acts of terrorism will be extremely difficult. This difficulty is aggravated by the inapplicability of existing models and the total absence of any historical data.

As a result of the September 11 events, there is enormous strain on the entire insurance system. Insurance mechanisms have to bear previously existing risks as well as the unknown and unpriced risk associated with terrorism. Additionally, though the industry may have retained significant surplus following the September 11 attacks, such surplus is needed to support all of the risk assumed by insurers for all of the lines of business they have written.

Given these difficulties, in the short-term at least, insurers are being driven to avoid losses that could occur from acts of terrorism in order to preserve their own financial security. From a public policy perspective, however, lack of coverage for such losses is not an acceptable outcome.

Private-Sector Solutions

Because insurance coverage plays such a vital role in our economic system, various proposals have emerged to provide some limitation on the aggregate risk from terrorism to be borne by the private sector. The immediate actuarial problem of pricing this new risk can be diminished by limiting the losses that would have to be paid by the private insurance market.

In considering solutions to the problem, considerable discussion has focused on the concept of a terrorism reinsurance mechanism, which in turn raises a number of important concerns. For example:

- How would such a mechanism be funded? Would it be funded prospectively by premiums charged to the participant insurers, retrospectively by assessments to the participant insurers, or through some combination of these approaches?
- How would liquidity be assured so that funds would be immediately available to pay claims when they occur?
- How would the terrorism trigger be defined so as to preclude coverage disputes between participating?
- Would this mechanism be voluntary or mandatory? Would it be available to non-insurer, risk-assuming entities such as self-insured municipality pools?
- Will governmental protection be available as a backstop above a finite limit of loss?

Answers to each of these questions and perhaps others will be necessary before a pricing model can be developed.

Broad-based participation by insurers is critical to spreading terrorism risk if a private-sector mechanism is adopted. If the mechanism is voluntary, there must be adequate incentives to entice insurers to participate. Voluntary participation in any mechanism also brings up issues of potential adverse selection (i.e., only high-risk insurers and businesses participate).

It has been suggested that it would be appropriate for government to provide coverage for terrorism losses above a certain limit. In view of the magnitude of potential losses, it is difficult to conceive of any effective mechanism that would not have to involve the federal government, at least in the short-term.

However, any short-term solution will undoubtedly require future modification to reflect an increased understanding of the risk involved as well as subsequent experience gained in addressing it. All of the proposals currently being considered sunset in less than 10 years.

A sunset period is necessary to provide time for the insurance industry to develop adequate risk assessment techniques while providing protection for insurers and insureds in the interim. A new mechanism may also be needed to address terrorism risk over the long-term.

Conclusion

Some mechanism is needed now to ensure stability of insurance coverage. Some level of government intervention appears to be necessary and appropriate in the short-term. Over time, the insurance industry should be able to develop tools and techniques to help them quantify and assess the risk of terrorist attacks more effectively.

Public policy-makers evaluating any proposal designed to assist insurers in achieving that objective and to protect insureds from the threat of terrorism should carefully weigh the following considerations:

- Incentives for participation in voluntary mechanisms;
- Potential for adverse selection;
- Funding source and liquidity of mechanism; and
- Level of government involvement in the short-term and long-term.

The American Academy of Actuaries is available as a resource to the Subcommittee as it seeks to address this important concern.