

March 5, 2007

Testimony of

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on

“The Need To Extend the Terrorism Risk Insurance Act”

before

**The Committee on Financial Services
Subcommittee on**

Capital Markets, Insurance, and Government Sponsored Enterprises

U.S. House of Representatives

I would like to thank Chairmen Kanjorski and Frank for holding this hearing on the need to extend the Terrorism Risk Insurance Extension Act, an important and very successful public-private partnership. My name is Roger W. Ferguson. I am chairman of Swiss Re American Holding Corporation, a member of the Executive Committee and Head of Swiss Re Financial Services. Swiss Re, the largest reinsurer in North America and the world, is a member of the American Council of Life Insurers and the Reinsurance Association of America.

TRIEA may be analyzed from many different perspectives. As an economist, I'd like to share a few thoughts about why this public-private partnership is critical to an important segment of the US economy. My argument has three parts. First, terrorism does not have the usual characteristics of an insurable risk. Second, industry capacity is insufficient to handle the losses that would arise from a major terrorist event. And third, the government has created an implicit backstop already. From those three points, I conclude it is better public policy to have an explicit Federal backstop for the terrorism insurance market.

Competitive private markets generally lead to the most productive allocation of resources. Nonetheless, markets sometimes fail to function efficiently, creating a waste of resources and the loss of economic value. Terrorism insurance and reinsurance are businesses prone to market failure because terrorism risk is largely uninsurable for the following reasons:

- First, terrorism risk cannot be measured satisfactorily because terrorist events are willful acts undertaken by parties who wish to confound those who study them. The historical data on these events is scarce and of little relevance in predicting future events. There is no reliable model that measures terrorism risk.
- Second, terrorists' coordinated large-scale attacks can cause loss occurrences to be correlated over time and across business lines. This makes the risk difficult to diversify. The vast loss potential of terrorist events further undermines the private insurance industry's ability to diversify its terrorism risk exposures.
- Finally, due to adverse selection, terrorism insurance may become unaffordable in the major urban areas, where the need for coverage is greatest.

After 9/11 highlighted these dimensions of terrorism risk — its unpredictability, high correlation of loss occurrences and large scale of potential losses — insurers withdrew from the market. In a clear case of market failure, real estate projects, particularly those in target areas such as New

York, were delayed or canceled because insurance could not be secured. This economic domino effect ultimately resulted in the loss of jobs.

Aside from the fact that a terrorist event does not have the usual characteristics of insurability, the potential scale of the risk makes it difficult for the private sector to manage on its own. Although the US property/casualty sector has an aggregate surplus of more than \$400 billion and writes nearly \$500 billion in annual premiums, it lacks the resources to cover large-scale terror events. Only a small fraction of industry premiums and surplus is available to cover terrorism losses because this money must also be available to repay policyholders for losses due to other insured risks such as workers' compensation, product liability, fires and earthquakes.

We cannot look to Insurance-linked securities (ILS) to provide substantial terrorism risk coverage, at least for the foreseeable future. ILS investors have many of the same concerns about terrorism risk as insurers and reinsurers. Consequently, no pure terrorism bond has yet been issued. The most mature ILS segment, catastrophe bonds and sidecars (a variant on cat bonds), had \$10 billion of issuance in 2006, an amount dwarfed by the potential size of insured losses from a large terrorism event.

Many observers believe that the government would be forced to provide aid to individuals, insurers and other businesses who suffer devastating losses from a terrorist event, even if they have not purchased insurance. There is ample precedent to support this belief. Thus, even without an explicit terrorism risk backstop, the government provides an implicit backstop. The absence of an explicit program distorts incentives and increases the likelihood of misspending funds. Confusion about whether the government would step in is clearly not constructive.

An explicit government terrorism risk backstop offers numerous advantages. First, it reduces ambiguity both pre- and post-event and enhances transparency by making it clear who will pay how much for what, should an event occur. This clarity makes it easier for insurers to price risks more fairly and strengthens the incentives to mitigate risks and to purchase terrorism insurance. Second, a broader societal sharing of terrorism risk makes lower premium rates possible. Third, by reducing uncertainty, a backstop reduces the risk of financial market disruption in the wake of an attack.

Finally, I'd like to make a somewhat academic but important point. Please consider for a moment whether an explicit backstop might reduce the "gains to terrorism". A goal of terrorists is to undermine a society through confusion and fear. A major terrorist attack will likely have negative externalities, or spillover effects, on the economy. A government backstop mitigates these losses by: keeping insurers solvent; assuring that insured victims of attacks receive policy benefits promptly; and by preventing a run on insurers and their forced sale of securities. A backstop that provides contingent resources reduces the cost of disruptions and the gains to terrorist acts. Gradually, it may become apparent that terrorist events are less disruptive than attackers had hoped. The prospect of a smaller "payoff" for their activities may conceivably reduce the incentive for terrorists to act.

A viable terrorism insurance market with adequate capacity reduces the level of uncertainty before and after a terrorist attack occurs. Certainty, security, stability and respect for property rights are public services critical to society. This is why governments provide law enforcement and national defense.

In closing, insurers, Swiss Re among them, generally agree that TRIEA has done a good job of stabilizing the terrorism insurance market. There are, however, several elements that undercut the law's benefits.

- First is the distinction between certified acts of terrorism, which TRIEA covers, and non certified acts, which it does not. This distinction creates areas of ambiguity that makes the law's protections less certain and therefore less effective.

- Second is the law's impermanence. Uncertainty regarding whether the backstop will be renewed every two years taxes the energies of lawmakers and insurers, which can better be spent on finding permanent solutions to the challenges that terrorism poses.
- A final point of note is the exclusion of group life from TRIEA's covered lines. Group life business, like worker's compensation, contains a significant concentration of risk. Moreover, group life insurers are not free to manage their risk through terrorism exclusions. Most state regulators do not allow it. A very large scale attack can cause a massive number of mortality claims that threatens the stability of even the leading group life insurers. In view of this, group life should be part of an effective Federal backstop. Group life insurers have asked that a separate recoupment mechanisms be created for group life insurers. This seems logical and reasonable.

The US is not alone in providing a government backstop. Many other countries have government-backed terrorism insurance programs. To help meet the threat that terrorism poses in a proactive, economically efficient manner, we ask this Subcommittee to craft a permanent public-private response that builds on the strengths of the insurance industry and of the government.

Thank you for the opportunity to express our views on this very important matter.