Statement of

Alice D. Schroeder
Senior US Nonlife Equity Insurance Analyst
Morgan Stanley

before the

Subcommittee on Oversight and Investigations of the House Financial Services Committee

Honorable Sue Kelly, Chairwoman

on

"How Much Are Americans at Risk Until Congress Passes Terrorism Insurance Protection"

February 27, 2002

Statement of Alice D. Schroeder
Senior US Equity Nonlife Insurance Analyst, Morgan Stanley

Good afternoon, Chairwoman Kelly, ranking member Gutierrez, and members of the Committee. My name is Alice Schroeder, and I am the senior US non-life insurance equity research analyst for Morgan Stanley. I appreciate the opportunity to appear before you today. As an equity analyst, my research serves the needs of investors who buy insurance stocks. Therefore, my perspective is that of an observer of the industry.

I would like to cover four main points today:
- The landscape of risk – how the financial values that are exposed to terrorism are concentrated, and the extent to which they are being insured.
- The likely extent of economic disruption as available insurance capacity is exhausted.
- Responses to terrorism risk from the capital markets, including rating agencies and securities analysts.
- The adequacy of insurance capital to handle terrorism risk, and why insurance prices are rising.

The Landscape of Risk

Distribution of economic value. We started by reviewing the landscape of risk – where economic values exposed to terrorism are concentrated. You can roughly describe the risk as falling into the categories of "people" and "property."

- The risk associated with human lives obviously extends far beyond economic value. However, as a simple example, a proxy for the economic cost of a single life in New York, might be $550,000, which is the typical combined minimal life insurance and workers' compensation insurance paid to the victim's survivors. So an event claiming 1,000 lives might result in $1.5 billion or more of such direct costs, in addition to indirect costs to the economy. This estimate also excludes disability, liability, and other potential costs, which could be even more significant.

- The risk to property is widespread, including buildings, airplanes, other vehicles, cargo, inventory, equipment, homes valuable articles and other properties. As one simple measure, the value of total commercial property appears to be around $7.1 trillion, distributed among commercial banks, savings institutions, insurers, pension funds, and commercial businesses, and investment companies. We also believe there may be significant property exposures that are not captured by our data – for example, houses of worship, monuments and public buildings.

We have performed detailed estimates of the aggregate economic cost of larger terrorism events. This easily could reach the hundreds of billions or even trillions of dollars, excluding indirect impacts to the economy. While the risk of the larger events may be lower than smaller events, no one knows exactly what that risk *is*. Further, we believe that dealing with a large loss after the fact is likely to result in inequitable outcomes.

Finally, we believe the current state of uncertainty indirectly harms the economy by making businesses and individuals less able to plan. While many are hoping that the government would protect them after an attack, our discussions with businesses indicate that the uncertainty of that outcome creates a chilling effect on the economy.

Economic Disruption from Terrorism Risk

Response to terrorism has been to distribute the risk. We believe the risk of terrorism, which was formerly born largely by insurers, is now being distributed more broadly throughout the economy.

- **Property and business owners** are seeking insurance coverage, but not necessarily finding it, except for workers' compensation and life coverages, where it is statutorily mandated. Some insureds are buying extra coverage from the limited number of markets offering it. However, their insurance renews year-round, so many still have coverage. Those who do not appear to have varying levels of concern about their lack of coverage. Some are extremely concerned, especially owners of large real estate properties. Others appear to be assuming the risk of loss is low, or that they would be bailed out by the government. Those who have coverage appear to take for granted that their claims would be paid, although our analysis of the impact of state-mandated coverages on insurer solvency suggests this is not necessarily a safe assumption.
- **Lenders** have two exposures: real estate loans and loans secured by collateral that could be damaged by terrorism. Lenders' main exposure would be default risk relative to their capital bases. Lenders also have shown varying degrees of concern about lack of coverage in their portfolios, which appears to relate to their business mix. We understand that some lenders are requiring insurance, whereas others have begun to ask borrowers to explicitly self-insure for this risk. Still others are not enforcing insurance covenants and appear to be living with the risk.
- **Primary insurers** have generally concluded that the risk exposes them to potential insolvency. They appear to be taking a variety of steps to reduce this exposure: 1) nonrenewing coverage for "skyline assets" and other obviously exposed properties; 2) attempting to reduce the risk of large workers' compensation exposures by nonrenewing some customers; 3) excluding the risk from coverage, to the extent permitted by regulators; 4) gathering data to better assess exposures; 5) developing models to measure exposures; 6) selling insurance on a "nonadmitted" basis, which may permit coverage exclusions where they are otherwise not permitted. One insurer is reportedly planning to sue the state of California for not allowing exclusions, and exposing it to insolvency. We cannot quantify the degree of nonrenewals. However, insurers tell us that they generally are not assuming significant terrorism risk from "target properties," such as large urban risks and power plants, unless required to do so by regulators.

- In their role as risk aggregators, nearly all **reinsurers** appear to have chosen to exclude the risk, so that they can separately underwrite an amount of terrorism coverage that is reasonable relative to their capital bases.
- **State regulators** in key states (New York, Florida, California and potentially, Illinois) are mandating that insurers provide coverage. In the majority of industrial states, state laws require that fire following an act of terrorism must be covered. State laws also require that workers compensation and life insurance coverages include terrorism risk. Accordingly, customers by law are receiving some insurance protection, although the amount varies. To avoid assuming the risk, some insurers are using nonstandard policy forms which may not be subject to these laws.

Redistribution does not reduce risk. Mathematically, the efforts of customers and insurers collectively will not protect the economy against terrorism. The risk has only been redistributed among the various affected parties. In the process, we believe that some implicit assumptions might be made by some about what would happen if another terrorist attack occurred. These include the assumptions that 1) the federal government would provide essentially unlimited post-event funding; 2) such funding would be in proportion to economic losses incurred, regardless of insurance coverage; 3) any capital destroyed by the event, as well as debt such as insurance claims would be paid by the government; 4) the attack would be considered an act of war; and 5) terrorism exclusions imposed in "nonadmitted" policies would be upheld, if challenged in court. We do not believe these assumptions can necessarily be taken for granted.

Extent of economic disruption. We can identify at least four reasons why there has not been more evidence of economic disruption. First, insurance policies renew throughout the year, and many customers have not experienced 2002 renewals yet. Second, some exposed parties appear to be assessing their individual odds of being attacked as low, hoping for the best. Third, some exposed parties appear to be counting on Congress to pass a bill or provide post-event funding. Finally, insurers have shown more restraint than we expected in nonrenewing customers. We attribute this to fear of competition, fear of being downgraded by rating agencies, and a desire not to create friction with customers.

We believe it is important to separate economic disruption from panic behavior. Because exposed parties are using various coping strategies to minimize panic behavior, there has been a perception in some quarters that no economic disruption is occurring. **On the contrary, we believe that transfer of a significant risk from insurers to customers by definition is a meaningful economic disruption.**

Even if every exposed party assesses its own odds of loss as low, collectively, the risk remains in the economy. We commend the Congress for its efforts to address this issue, and encourage you to work toward closure.

Economic disruption may worsen. We believe the complaints about economic disruption may worsen. Many insurance policies have not yet renewed, and thus continue to cover terrorism, but that is temporary. Some limited insurance capacity also is available for terrorism. However, it appears this capacity is being used by customers whose policies renew early in the year. Although more capacity will likely be developed, we do not believe it will meet demand. Accordingly, customers whose renewals occur later are likely to find that capacity is exhausted.

Terrorism risk not underwritable yet. In general, we believe that insurers may be, in the aggregate, under-estimating risks from locations other than so-called "target" properties. While the individual odds of an attack on other properties may be low, in total, those odds may be much higher. To date, terrorists have not behaved predictably, and no study we have seen suggests that they will do so. We do not believe insurers have a reasonable basis for underwriting the risk at this time. At best, they can limit the amount of capital they expose to the risk. Although insurers are beginning to gather data, as indicated by former CIA Director Robert Gates in a recent speech, it may be at least five years before risk falls and experience rises to the level at which insurers can adequately underwrite terrorism.

Responses to Terrorism Risk in the Capital Markets

Rating agencies expressed concern, but have not downgraded: Rating agencies expressed concern about terrorism risk in the fall of 2001. In general, rating agencies commented on the potential rating threat, in the absence of legislation, to corporates, other bond issuers, and insurers. However, since the legislation failed to pass, rating agencies have not downgraded bond or debt issuers or insurers.

Regarding the approach to issuers, we believe the rating agencies are approaching this issue similarly to the way risk-bearing enterprises are viewing it. That is, they are assessing the risk for each issuer based on probabilities. Putting aside the lack of frequency data or other means to assess probabilities, the large number of potential targets of terrorism by itself ensures that, mathematically, the risk to most individual issuers can be described as low by rating agency standards. Accordingly, there appears to be an ironic outcome.

- Although there have been a number of instances since September 11 in which the federal government has declared a "high alert" for terrorism based on specific evidence of planned attacks, the collective impact on ratings of terrorism risk has been nil.

- Based on rating agency comments in the fall of 2001, we would have expected that at least some businesses that lack terrorism insurance would have been deemed high enough risk by rating agencies to warrant downgrades or negative outlooks. Likewise, we would have expected some action on insurer ratings.

- It may be that the rating agencies are waiting for Congress to act, or are continuing to analyze the situation. However, nearly 60 days into 2002, we are somewhat surprised to see no rating consequences from terrorism.

It would be disappointing if rating agencies analyzed terrorism risk as if it had no solvency consequences to any issuers. We believe that claims-paying and credit ratings are heavily relied on by investors and insurance buyers as an important signal of financial health. We believe there is the possibility of insolvencies due to terrorism; and rating agencies have acknowledged this risk.

Rating agencies have come under criticism recently for their role in certain business failures, especially the failure to act as an early warning system in the case of Enron. It is not our intention to add to this criticism. However, we believe it would be unfortunate if terrorism-related impairments occurred of entities without insurance against terrorism, or of insurers overexposed to terrorism, with no warning that those entities had exposure. This would be especially regrettable after the rating agencies made such a good start last fall analyzing terrorism risk.

Institutional investor concerns can be addressed through disclosure: Similar to the rating agencies, we have not seen a dramatic response by the capital markets to this risk. However, our conversations with institutional investors suggest that they generally are not pleased about the degree to which their capital is being used to assume large amounts of terrorism risk. We question whether companies would have the same risk tolerance if their managements were putting their own personal net worth at risk of terrorism.

The SEC is considering the extent to which lack of terrorism insurance should be disclosed by risk-bearing enterprises. We understand the difficult tradeoffs this entails. However, we believe that investors, as the company's owners, generally have a right to know this information.

We have reflected terrorism risk in our own stock ratings. We downgraded the whole sector in November in part due to this risk. We also generally are not recommending the stocks of commercial insurance companies that appear to have material terrorism exposures relative to their market capitalization. Some stocks that we are recommending do have exposure, but we have carefully selected our recommendations to try and protect investors as much as possible. To reduce this exposure further, we also are recommending that investors avoid concentrating in terrorism-exposed insurers beyond their own risk tolerance, since individual insurer exposure, loss frequency and loss severity are impossible for an analyst or investor to assess.

Insurance Capital Adequate to Handle Terrorism?

Some observers have suggested that insurers are overcapitalized. We have even seen terms such as "wealthy" used to describe the industry. Rather than relying on emotionally loaded rhetoric, we believe Congress should consider the facts.

- Since its peak in 1999, the capital of the US nonlife industry has declined by $58 billion, or 17%. This decline has come largely from the commercial lines companies.

- As a group, the commercial lines industry is producing more than $2 of premiums for every $1 of economic capital, a level at which there generally is considered to be **no** excess capital under regulatory and rating agency standards.

- Reflecting this level of capitalization, rating agencies have downgraded numerous insurers in the past two years, and at an accelerating pace. In addition, a number of insurers have failed or decided they cannot afford to continue in business, and others are fighting for survival. A few examples:

  - Major insurance failures include Reliance, HIH, Independence, Frontier, Taisei, and Superior National.

  - Several companies have decided to radically downsize or discontinue their principal businesses, including Highlands, Gainsco, and Industrial Risk Insurers, which was formerly the largest insurer of large engineered properties in the US.

  - A number of reinsurers, including Overseas Partners, Copenhagen Re, Scandinavian Re, and Fortress Re, have discontinued operations. Many others, such as CNA, Hartford, St. Paul, and W.R. Berkley, are downsizing their reinsurance operations significantly.

  - Rating agency actions continue to affect insurers. Legion, a major commercial insurer, was just downgraded to the single "B" level. The California State Compensation Fund, which is the largest workers' compensation insurer in the US with more than a 10% national market share, recently had its rating withdrawn by Standard & Poor's because it had fallen to such a low level. Other ratings remain on watch and subject to further action.

  - In our view, the majority of the capital raised in 2001 by insurers was in order to maintain ratings, because these companies had become undercapitalized.

In considering the insurance industry's capital to withstand terrorism risk, only the capital of the US *commercial lines* industry should be considered, which we estimate at approximately $125 billion. This compares to estimated terrorism exposure of $100 billion or more from a single event.

Why Insurance Prices are Rising

Finally, we address the reasons for insurance price increases.

Insurers produce poor returns. To an insurance investor, accusations of price-gouging and excess profits seem topsy-turvy. Nonlife insurers rarely earn their cost of capital. Insurance buyers typically receive very good value for their premiums, in our view, and periods of price adequacy are relatively rare. Over the past 10 years, US insurers have averaged an 8.5% return on surplus, falling to 7.4% from 1998-2000 and a loss in 2001. This is 7.6% - 10.2% worse than the average S&P 500 company, and equivalent to a corporate bond yield. Yet insurance equity investors take on considerably more risk than bond investors.

In addition, from our perspective, even these relatively low returns were provided by two factors largely outside of the industry's control. These were the unusually strong investment returns of the 1990s, and cost deflation experienced by insurers during this period. These factors enabled insurers to lower prices continually on virtually all products. Without these factors, insurers would have lost money during the entire decade of the 1990s.

Importantly, however, both of these trends have reversed. Investment returns have declined to more normal levels, and the industry is now grappling with significant cost inflation. The combined impact of low investment returns and high inflation is the most important reason for current insurance price increases, in our view.

Prices rising for many reasons. Insurance prices had been rising for approximately 18 months before September 11. While terrorism losses, terrorism risk and rising insurance prices have become linked in the public's mind, we believe this is misleading. Insurers seem to be pricing terrorism consistent with the way they generally price a new hazard that is extremely difficult to quantify and which could destroy large amounts of capital. The price has to be high enough to cover the insurers' almost complete lack of knowledge about the risk of loss.

In general, there are three basic factors that drive insurance pricing. These are the supply of capital willing to assume risk, the demand to transfer risk via insurance products, and the profitability of the business.

Insurance capital to assume terrorism risk. Insurance capital was diminishing before September 11. We estimate that roughly an additional $50 billion was destroyed by the terrorist attack. We estimate that more than $35 billion of losses have already been recognized by the industry. Part of this has not been reported in financial statements due to accounting devices such as finite reinsurance, which appear to have been extensively used, especially by non-US companies, to avoid reporting September 11 claims. In addition, insured losses from large catastrophes are virtually always underestimated in the initial months, and continue to increase over time. Accordingly, we do not believe that credible data supports a claim that the loss is lower than expected. We also believe it is unlikely that the loss could be only $35 billion, considering that known loss estimates including finite appears to already exceed this amount, and is likely to go higher.

It has been argued that new insurance capital raised since September 11 should protect the economy against terrorism. In addition to several start-up reinsurers, undercapitalized insurers have raised money to maintain their ratings, totaling more than $20 billion. However, this capital is not being used to take terrorism risk. Even if it were, $20 billion would not cover a fraction of the potential losses from terrorism.

Demand for protection against risk increasing. The second factor is the demand for risk transfer products. September 11 revealed that the risk was greater than previously assumed. Customers and insurers also recognized that financial exposures to terrorism needed to be measured differently. Customer exposures to terrorism in the hundreds of billions of dollars – or higher – may exist, most of which was previously covered by insurance. Finally, other loss events not related to terrorism, such as Enron claims, have indicated that both insurers and customers were assuming more risk than they contemplated. This has increased the demand for and price of coverage by causing both insurers and customers to become more risk-averse.

Insurers must raise prices to prevent more insolvencies. Finally, insurers have achieved unusually poor returns over the past four years due to underpricing. The industry reported estimated underwriting losses of $130 billion in total from 1998 to 2001. We expect these losses to grow over time as insurers recognize the impact of inflation, which does not appear to have been adequately understood at the time these numbers were reported. These losses have financially impaired a number of sizeable insurers. **Customers have gotten a bargain over the last few years, and some insurers have even been bankrupted in the process.** Now, prices have to rise to allow the remaining companies to cover their costs.

We appreciate the opportunity to provide you with information that we hope was useful. We would be pleased to answer any questions you may have.