



Consumer Federation of America

**WEANING THE INSURANCE INDUSTRY AND LARGE
COMMERCIAL POLICYHOLDERS FROM TAXPAYER
SUBSIDIES UNDER THE TERRORISM RISK
INSURANCE ACT**

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

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

I. Introduction

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

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

In 2003, insurers were responsible for losses below a deductible of 7 percent of their direct earned premium (DEP) for eligible commercial lines in the 2002 calendar year. In 2004, 10 percent of the 2003 DEP was the deductible. In 2005, 15 percent of the 2004 DEP is the deductible¹. Above the deductible amount, the federal “backstop” is 90 percent of a company’s insured terrorism losses, capped at an overall industry level of \$100 billion. If an event triggers federal involvement, insurers are required to pay back a very small layer of taxpayer assistance, which could be passed on to insurance consumers in the form of a surcharge, but it is not a significant amount in major terrorism events.²

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

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

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

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

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

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

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

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

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

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

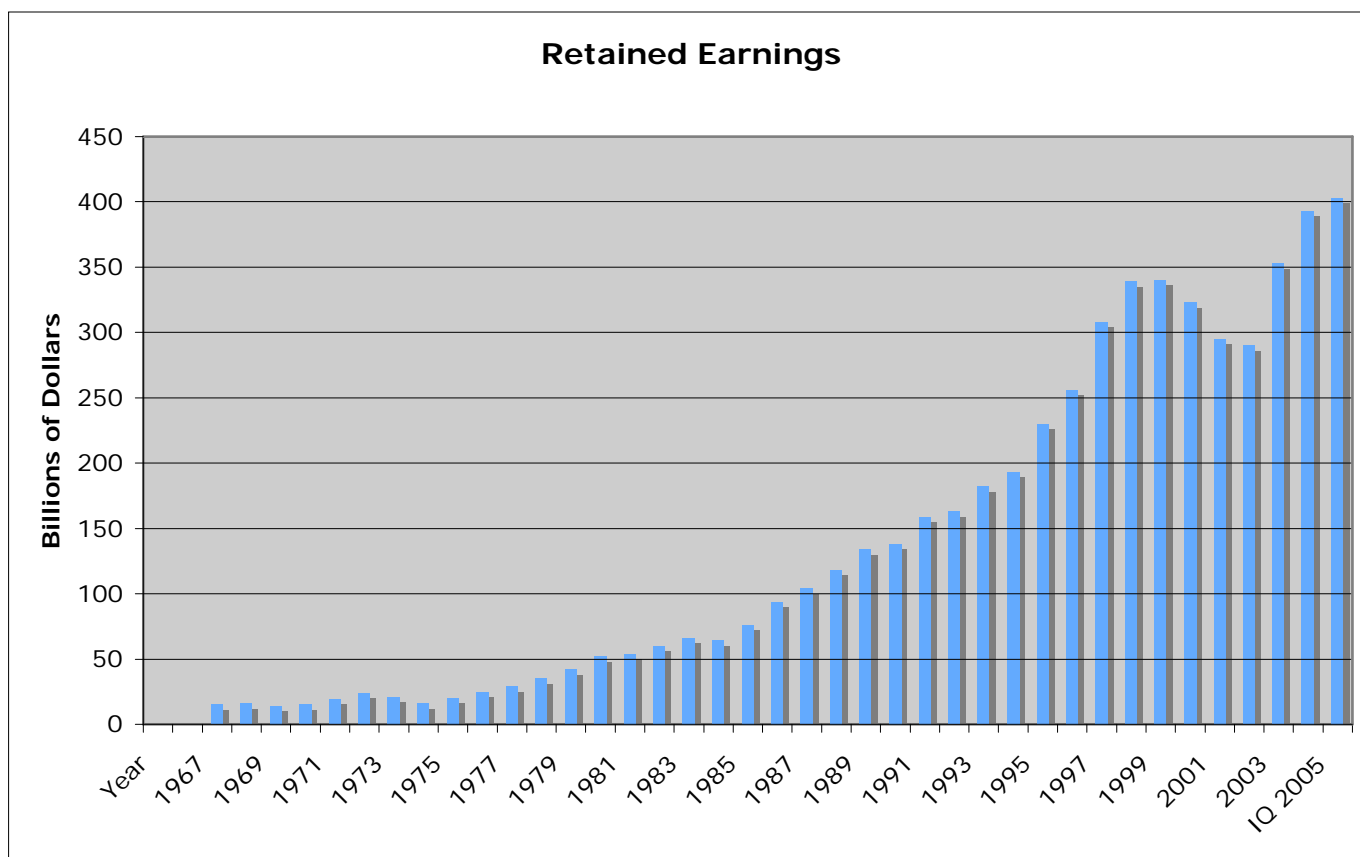
In the first quarter of 2005 alone, the industry had a 92.3 percent combined ratio (the total of losses and all expenses divided by the premiums), one of the lowest such ratios in decades, signaling huge profits ahead. First quarter 2005 underwriting profit was \$6.8 billion, investment return was \$14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

³ "Assessment: The Terrorism Risk Insurance Act of 2002, U.S. Department of the Treasury, June 30, 2005.

⁴ U.S. Property/Casualty Insurers Gain \$6.8 billion in First Quarter BestWeek, July 8, 2005.

⁵ US P/C Industry Loss Ratio Improves 2 Points in 2004, BestWire Service, July 11, 2005.

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



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

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

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

⁶ Best's Aggregates and Averages, 2004 Edition, page 30 for 2003 data; 2004 growth in Best's Review/Preview, January 2005, page 20.

⁷ An attack that resulted in losses of \$49 billion after taxes would be \$75 billion before taxes (\$49/.65). This is 2.2 times the estimated \$35 billion before taxes that the WTC event cost insurers and taxpayers.

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

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

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

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

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

Source: Council of Insurance Agents and Brokers.

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

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

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

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

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

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

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

A. The Congressional Budget Office Study

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

- Terrorism premiums would likely rise for those buying insurance in high-risk situations.
- The number of businesses buying insurance would probably decrease. (Only about half of all businesses are currently purchasing terrorism coverage.) Such a decrease would mean more taxpayer involvement in a post-terrorism attack situation.
- Mitigation efforts would increase. Efforts to lower the risk of terrorism attacks or reduce their effects would be encouraged by the market charging actuarial rather than taxpayer-subsidized rates for terrorism insurance. Steps such as hiring guards and placing metal or explosives detectors at entrances to higher risk buildings would be encouraged by the expiration of TRIA.
- Private sector alternatives to TRIA would be encouraged by the expiration of TRIA, such as reinsurance to replace the free TRIA coverage or the development of securitized responses, such as bonds similar to catastrophe bonds.¹¹

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

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

- The economy might be affected somewhat, but not as much as the insurers contend. CBO indicates that the analysis presented to the public through press releases sent out by the insurance industry overstates the potential costs to the economy if TRIA expires.
- The cost of insuring against terrorism would not change much for the nation. TRIA does not change the anticipated terrorism costs except, CBO states, to the extent it increases national costs because it undermines the incentives of insurers to insist on mitigation measures and insured parties to implement these measures in order to get lower premium charges. Not extending TRIA would merely shift roughly the same costs from taxpayers to private firms and insurers.
- There could be insurance market disruption if another large terrorism event occurs. CFA believes that Congress knows how to handle this sort of situation, given the success it had in stabilizing the insurance market after September 11, 2001 and during the riots in the nation's cities in the 1960s, for example.

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

- Charging premiums would result in more mitigation by insurance purchasers because increased premiums would encourage the development of discount plans for safety precautions taken by insured businesses.
- Charging premiums would encourage the private sector to grow, since the private sector cannot compete with the free reinsurance provided by the taxpayers under TRIA.
- Charging premiums might result in less terrorism coverage being purchased. This would mean more taxpayer involvement in a post-terrorism attack situation.

CBO summarizes their conclusions as follows:

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

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

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

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

B. The Department of the Treasury Report

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

“While TRIA has been effective in achieving its temporary objectives, the economy is more robust today than when TRIA was enacted. GDP growth is up from 2.3 percent in 2002 to 3.9 percent in 2004 (fourth quarter over fourth quarter). Unemployment, which reached 6.0 percent in December 2002, is down to 5.1 percent in May 2005. Construction jobs, taking residential and nonresidential together, now stand at a record high 7.2 million. Extending TRIA would have little impact on the economy given its current strength.

“It is our view that continuation of the program in its current form is likely to hinder the further development of the insurance market by crowding out innovation and capacity building. Consistent with its original purpose as a temporary program scheduled to end on December 31, 2005, and the need to encourage further development of the private market, the Administration opposes extension of TRIA in its current form.

“Any extension of the program should recognize several key principles, including the temporary nature of the program, the rapid expansion of private market development (particularly for insurers and reinsurers to grow capacity), and the need to significantly reduce taxpayer exposure. The Administration would accept an extension only if it includes a significant increase to \$500 million of the event size that triggers coverage, increases the dollar deductibles and percentage co-payments, and eliminates from the program certain lines of insurance, such as Commercial Auto, General Liability, and other smaller lines, that are far less subject to aggregation risks and should be left to the private market.”

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

insurers, meanwhile, are actually proposing an expansion. There is no meaningful evidence that justifies expanding TRIA to cover group life insurance. The Treasury Department has already rejected the request to expand the current TRIA to include group life. That was the right decision. Even the National Association of Insurance Commissioners, a group well known to be very industry-friendly and particularly concerned about solvency and any possibility of undue risk, has refused to allow group life exclusions. It is likely that a major reason that both the Treasury Department and NAIC have rejected the appeals of life insurers for relief is that these insurers have not attempted all meaningful measures to spread their risk privately. CFA has not received a single complaint from a consumer or business indicating that there is a problem in the life insurance market. Since there are no exclusions allowed by the NAIC, we would likely be hearing about rising costs if they were rising, but we are hearing no complaints at all. To test this hypothesis, CFA did research using the NAIC complaint database.²³ The top ten group life insurance writers had 294 complaints under “group life” in 2001 and 361 in 2003. The increase in complaints (67) was virtually all related to Metropolitan Life Insurance Company, which had a growth in complaints of 65. Looking in detail at Metropolitan’s complaints, we found zero complaints related to “terrorism” in either 2001 or 2003.²⁴

- ❑ **Beware of insurer attempts to use TRIA renewal as a pretext to deregulate insurance.** Insurers appear to be opportunistically seeking to cripple key aspects of insurance oversight under the guise of creating a uniform, national market for terrorism insurance. There is simply no connection between TRIA renewal and regulatory issues. There is no evidence that over-regulation has in any way hampered the ability of insurers to innovate and come up with viable private alternatives to TRIA. Indeed, some insurers are creating terrorism insurance alternatives today, such as stand-alone policies and automatic coverage in some instances. Several insurers are prepared to offer stand-alone terrorism coverage should TRIA expire. Given the soft market, market sources say that some insurers stand ready to “give away” terrorism coverage to attract business.²⁵ Insurers are poorly regulated in most states regarding necessary consumer protections. Congress should not interfere with state insurance regulation unless a balanced, thorough study of such action is undertaken separate and apart from TRIA issues.
- ❑ **Spur non-governmental alternatives to TRIA.** Private markets can handle most, if not all, of the terrorism risk. Stand-alone policies are ready to be used should TRIA expire. Except in the largest cities, terrorism coverage should be available at little or no increase in price should TRIA expire. As we indicate above, even a five-fold increase in terrorism insurance premiums would not result in an overall increase for large and medium sized businesses as their insurance premiums are sharply dropping due to the soft market conditions caused by excessive capital in the property/casualty insurance business. TRIA itself has hampered the development of private alternatives such as normal reinsurance and securitization alternatives, such as catastrophe bonds. Expiry of TRIA will very likely result in the development of such mechanisms to cover terrorism risk.

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

²⁴ “Terrorism” is itemized as a complaint area in the NAIC complaint database.

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

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

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

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

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

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

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

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

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

