Testimony of

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"Protecting Americans from Catastrophic Terrorism Risk"

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Liberty Mutual appreciates the opportunity to submit this testimony in support of a continuing public-private partnership to protect Americans from catastrophic terrorism risk. The Terrorism Risk Insurance Act of 2002 (TRIA) and its successor, the Terrorism Risk Insurance Extension Act of 2005 (TRIEA), were short-term legislative responses to a long-term challenge facing our nation. Following the House vote to accept the Senate's slimmed-down version of the TRIA extension, Chairman Oxley aptly noted, "What we did is simply kick the can down the road." TRIEA leaves unresolved the questions of whether and how private insurance markets can offer terrorism risk insurance beyond 2007.

For several reasons outlined below, a significant public-private partnership is essential for ensuring the availability of terrorism risk insurance.

1) A MISUNDERSTANDING OF AVAILABLE CAPITAL IN INSURANCE

Some have suggested that since capital within the insurance industry exceeds $600 billion, the industry has sufficient capacity to assume the risk of terrorism. These estimates, however, include capital in the life insurance industry, which is not available for the terrorism risk addressed by TRIA—as well as capital that underpins other business line risks. For example, at Liberty Mutual we have in excess of $10B in surplus, which supports all our policyholders including our homeowners exposed to hurricane risk, our automobile owners exposed to accidents, workers exposed to lost time and medical expense from workplace accidents, and others; our surplus is not just set aside to cover exposure to terrorist events.

Many terrorism loss scenarios are modeled at costs exceeding $100 billion and some very plausible events at $700 billion or more. Yet, the entire property and casualty insurance industry has only an estimated $150 billion of capital backing all risks—including fire, wind, accident or other insured perils— covered by TRIEA-backstopped policies.

There is the very real potential that terrorism-related losses would overwhelm the industry's ability to pay its customers' losses.

There are limited sources of new capital.

Sources of new capital are few and limited. Organic growth (operating income and investment returns) is slow, subject to taxation, and inadequate to the terrorism risk. Stock and debt issuance are limited by prudent financial management, investors, regulators and rating agencies. Reinsurance is an option but global capacity is very limited for terrorism risk (estimated $6-8 billion) and almost none exists for NBCR (nuclear, biological, chemical, and radiological risk).

2) TERRORISM INSURANCE IS NOT A FREE MARKET

Many people suggest government should get out of terrorism insurance completely. They say let the free market handle terrorism. At Liberty Mutual, we fully believe—in an ideal world—free markets are better. Wherever we operate, we push hard for free markets. But terrorism insurance is not a free market. In a free market, providers of products and services compete to sell those products and services. If the terms, conditions, or prices are inadequate, or if the risk of loss is too large, the provider has the option to withdraw. We

cannot withdraw from terrorism insurance. In each and every state, as discussed further below, workers compensation must cover all loss from terrorism. If pricing is inadequate, or exposure too great, the only way to avoid the risk, is to completely withdraw from the workers compensation market.

Highly-Regulated Markets Present Distinct Challenges

Insurers operate in highly regulated environments. State insurance laws and regulations constrain capital and significantly limit the choices insurers can make to protect themselves from essentially unlimited terrorism exposure. Workers compensation is a particularly good example. Under state workers compensation laws, employers must purchase coverage to protect their employees. Insurers that provide this critically important insurance are required to do so without exclusions or limits of any kind. Thus the potential for large losses from terrorism, even for a single employer can be very great. For example, the value of survivor's benefits for a 42-year-old spouse with two children is about $4 million in Massachusetts. A terrorist attack resulting in 1,000 deaths at a Liberty Mutual insured workplace in Massachusetts would cost us $4 billion – or nearly half of our surplus. As we learned on September 11th, 1,000 deaths from a single terrorist attack is a very real risk.

Regulatory requirements on commercial property insurance further accentuate the challenge. Insurers face mandatory "fire following" coverage in standard fire policies in certain major market states including California, Illinois, and New York. Therefore, terrorism risk cannot be effectively excluded. Beyond commercial property, insurers are constrained by rate and form regulation in all lines of insurance. For example, Florida, Georgia, and New York do permit terrorism exclusions only with TRIEA and its mandatory "make available"

requirement. Absent TRIEA, the industry would have to provide the coverage in all cases or withdraw from the market.

Finally, insurers are required to participate in funding residual market coverage for those who cannot obtain insurance in the voluntary market. And, insurers must pay assessments so that guaranty funds in each state can pay the claims of customers of insolvent insurers. Thus, whether or not we reduce our exposure to terrorism risk, Liberty Mutual remains exposed to the losses and underwriting judgment of others.

These regulatory constraints restrict the industry's ability to manage its exposure to unpredictable and large-scale terrorism risk.

3) EVERY COMPANY HAS A FIDUCIARY OBLIGATION TO PROTECT ITS CAPITAL

There is a limited amount of capital any company could make available to underwrite terrorism risk. While each company has its own risk parameters, its own risk appetite, its own return objectives, its own view of the risk, and how to allocate capital to various risks—in the end, every company has a limited amount of capital to make available to underwrite terrorism; to expose more than that to the risk would be a breach of fiduciary responsibility.

The Only Alternative to Additional Capital is to Reduce Exposure to Terrorism Risk

In the absence of TRIEA or a similar public-private partnership, insurers would be unable to add sufficient capacity from private sector sources; therefore, we would have to significantly

reduce exposure to terrorism risk. First, we could try to reduce exposure by using coverage exclusions or limits. But, as discussed, those tools are not available anywhere in workers compensation or for property insurance in certain standard fire policy states. Second, we could manage risk concentrations to ensure against over-exposure to terrorism risk in certain customer locations and geographic areas. To do so, we utilize geo-coding and other data on the number of policies, employees, and property values in specific locations. To keep concentrations low, we would shed risk by ceasing to write certain risks in certain areas or by not renewing existing coverages. These choices, while not made easily, would be necessary in the absence of TRIEA. These choices would also have a hugely negative effect on the economy as businesses would be unable to get insurance coverage.

4) TRIA PROTECTS AGAINST FINANCIAL RUIN, NOT AGAINST SIGNIFICANT FINANCIAL DAMAGE

Since company deductibles are so large, TRIEA would reimburse the industry only if a truly significant event occurred. At Liberty Mutual for example, our TRIEA deductible is approximately $1.5 billion. A backstop that protects us from a loss exceeding $1.5 Billion is hardly a handout —especially considering we're offering coverage we would otherwise not offer, or would offer on significantly different terms.

So the challenge moving forward is to create a mechanism that achieves two goals: First, to make certain needed insurance is available for economic growth by creating a structure in which insurance companies can write the coverages businesses need to manage their risk

without exposing themselves to financial ruin. And second, we need a vehicle that encourages the private market to develop financial responses to terrorism.

AMERICA NEEDS AN IMPROVED, LONG-TERM TERRORISM RISK INSURANCE PROGRAM

Liberty Mutual believes the industry needs a better terrorism risk insurance program to promote the stability of insurance and financial markets for the long-term; a program that will maximize private market capacity by facilitating new capital and encouraging government to do only what private markets cannot.

What we cannot do: NBCR Risk is Uninsurable and Requires Separate Treatment

Terrorist attacks using weapons of mass destruction – so-called NBCR (nuclear, biological, chemical, and radiological) risk – present unique and daunting challenges for our industry and our country. The potential human and economic consequences of an NBCR event are frightening. According to modeling by the American Academy of Actuaries, a single large-scale NBCR attack has the potential to cause insured losses of $700 billion or more depending on weapon type and location. A medium scale NBCR attack in a major U.S. city could result in insured losses in excess of $100 billion. Beyond the costs of compensation, NBCR attacks would disrupt the economy and shut off sources of insurance industry capital to pay current and future claims – both related to the terrorist event and the ongoing claims. Moreover, losses from NBCR attacks could take years to quantify. Unlike damages from

conventional attacks, NBCR damages will take much longer to determine given the latent nature of potential injuries. Also, the public's reaction to such an event can bring additional, yet unforeseen economic and emotional damages. Such extreme and long-term uncertainty means the insurance industry cannot assume the risk.

Given the unique properties of NBCR risk, insurers and reinsurers excluded such risk from their contracts long before September 11th. The major exceptions are workers compensation and, in some states, property insurance where exclusions by primary insurers are not permitted – although reinsurers routinely exclude all NBCR. NBCR risk remains outside the capability and capacity of the insurance industry. NBCR risk must receive separate treatment, distinct from the risk of conventional terrorism, in any legislative successor to TRIEA.

What we can do: In January 2006, the Property and Casualty CEO Roundtable (a non-advocacy group of more than a dozen large company CEOs currently chaired by Ted Kelly, Liberty Mutual CEO) initiated a process to design a program for long-term federal terrorism risk insurance. Through the process, the insurance industry has achieved significant consensus around a framework for long-term federal terrorism risk insurance. This framework will serve as a guide for the industry as further policy details are developed.

The framework envisions a two-part structure for financing both NBCR and non-NBCR (conventional) terrorism risk:

- NBCR
    - The federal government would assume NBCR risk on a reinsurance basis for losses covered by insurers (e.g., workers compensation).
    - The federal government would assume NBCR risk on a "follow-form" basis (subject to terms and conditions of the policy) for losses that would be covered but for NBCR exclusions (e.g., property insurance).
- Non-NBCR
    - A TRIEA-like structure would be maintained for non-NBCR losses. Insurer deductibles would gradually increase (e.g., one additional point per year for ten years) or adjust subject to Treasury determination of available capacity.
    - Legislation would facilitate creation of federally chartered entity to provide additional private insurance capacity and the sale of industry loss warranty (ILW) contracts to help fund the insurance residual exposure.

Covered lines – same as TRIEA

We believe this two-part program will effectively address the NBCR risk that is today uninsurable in the private sector. The program effectively backstops industry capacity for large non-NBCR terrorism events and encourages the development of new private sector financial mechanisms to manage the risk, so reducing the role of government over time. This approach forces the industry to work with its customers to better protect against terrorism risk. With such a plan in place, real estate can be developed, people can be employed, and buildings can be constructed; all, despite exposure to significant loss from terrorism. And,

since individual insurers continue to face the potential of major loss, we will all work with the capital markets to develop creative solutions.

Liberty Mutual and others in the insurance industry are working to flesh-out the details of this framework. We are committed to working with this Committee and others in our industry and in the policyholder community to establish a public/private partnership that makes terrorism insurance coverage available for the long-term.