Statement of Gregory Case

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Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

and Subcommittee on Oversight and Investigations

"Protecting Americans from Catastrophic Terrorism Risk"

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Chairman Baker, Chairwoman Kelly, Ranking Members Kanjorski and Gutierrez, and members of the Subcommittees, thank you for the opportunity to testify before you today on protecting America from catastrophic terrorism risk. My name is Gregory Case. I am the President and Chief Executive Officer of Aon Corporation. My testimony today is on behalf of my firm, as well as the member firms of the Council of Insurance Agents and Brokers (The Council).

Aon Corporation (www.aon.com) is a leading provider of risk management services, insurance and reinsurance brokerage, human capital and management consulting, and specialty insurance underwriting. We have 47,000 employees working in Aon's 500 offices in more than 120 countries. Backed by broad resources, industry knowledge and technical expertise, Aon consultants, brokers, economists and actuaries help a wide range of clients develop effective risk management and workforce productivity solutions.

The Council represents the nation's largest, most productive and most profitable commercial property and casualty insurance agencies and brokerage firms. Council members specialize in a wide range of insurance products and risk management services for business, industry, government, and the public. Operating both nationally and internationally, Council members conduct business in more than

3,000 locations, employ more than 120,000 people, and annually place more than 80 percent – well over $90 billion – of all U.S. insurance products and services protecting business, industry, government and the public at-large, and they administer billions of dollars in employee benefits. Since 1913, The Council has worked in the best interests of its members, securing innovative solutions and creating new market opportunities at home and abroad.

Aon and the members of The Council share your belief that terrorism risk protection is an issue of utmost importance and a critical element in our Nation's efforts to confront and defeat the terrorist threat. Your subcommittees, as well as the full Committee, have been leaders in this effort and we commend you for all of your hard work, including the adoption of the Terrorism Risk Insurance Act (TRIA) in 2002 and the Terrorism Risk Insurance Extension Act (TRIEA) last year.

Introduction

We recently commemorated the fifth anniversary of the terrorist attacks of September 11, 2001. For many of us, it is difficult to believe it has been five years since thousands of our fellow Americans, our friends, colleagues and family members, were killed. For Aon, which lost 176 employees that terrible day, and for other Council members who suffered a similar catastrophe, the loss was personal.

One of the most important of the many steps that Congress and the President have taken to protect Americans from the effects of terror attacks was the enactment of TRIA in 2002, and its extension in 2005. Passage of TRIA was critical for individual businesses and for the economy as a whole. Although the spotlight was on the insurance industry's capacity to withstand further terror attacks and to cover terror risks going forward, the national risk was – and is – much broader. Because insurance provides individuals and businesses with the ability to take the risks that are essential to the functioning of our economy, constraining that ability would be economically devastating. TRIA has prevented that from happening. Indeed, not only have federal funds provided by the TRIA "backstop" never been tapped and not one taxpayer dollar spent, the program has proved to be an unqualified success in stabilizing the insurance markets, allowing insurers to provide much-needed terrorism coverage to consumers at prices they are able to afford. TRIA is not about protecting the balance sheets of insurers and brokers – it is about creating and sustaining a national economy that encourages investment and development.

When TRIA was originally adopted in 2002, the assumption was that the private sector would be able to create a market for terror insurance coverage and that the federal program would simply be a stop-gap measure to ensure stability while that market developed. Since that time, however, it has become clear that the private sector – insurance companies, capital markets and rating agencies - have a very limited ability to insure and rate terrorism risks that are only questionably quantifiable, totally unpredictable and, thus, essentially impossible to underwrite.

Given these realities, Aon and the members of The Council believe development of a long-term solution to the terrorism insurance crisis is essential and that the federal government will continue to have an important role to play in terrorism risk coverage for the foreseeable future. The insurance market needs some level of stability and predictability. The prospect of TRIA's demise – or the periodic renewal or extension of the program every few years – is not viable for the long-term. Failure to implement a permanent fix before TRIA expires next year will not only vastly decrease risk transfer options, it will expose the U.S. economy to potentially devastating uninsured economic loss in the event of another catastrophic terrorism attack. Thus, the issue before Congress is not whether the government will be the insurer of last resort in the event of such an attack, but rather whether the government will work with the insurance industry to thoughtfully and deliberately develop a plan to maximize private sector coverage of the massive damages that will result before an attack, rather than reacting in crisis mode after an attack occurs. Better TRIA than FEMA.

Insurance Brokers' Interest in Terrorism Insurance

The role of insurance agents and brokers (producers) in general, and Aon and Council members in particular, is to help our clients manage risks and secure the insurance coverage they need to protect them from the risk of loss. As the insurance experts closest to insurance consumers and the insurance marketplace, we understand our clients' needs and the needs and appetite of the market, and thus bring a unique perspective to the discussion of terrorism insurance coverage. Commercial insureds need terrorism coverage not just for piece of mind, but for their businesses. Indeed, in many cases, purchase of terrorism coverage is mandatory – it is required to obtain a mortgage or financing for new construction, the expansion of a business or a new entrepreneurial venture, sometimes by state laws and regulations and often by contract. The most important issue for the broker community, therefore, is maintaining consumer access to coverage at a price at which businesses can afford. In order to get this access, we need insurers who are able and willing to provide the coverage.

Aon's business is not dependent on any Federal backstop. We will continue to help our clients mitigate their risks by the best means available. But insurance is an important component in a comprehensive risk management program, and the availability and affordability of terror coverage is a critical issue for our clients and the US economy. We supported TRIA in 2002, 2005 and today because of our clients' need for terror coverage, the lack of capacity in the private market, and the high cost of the small amount of coverage that was available absent TRIA. For the same reasons, and because TRIA successfully brought stability to the private market for terrorism risk insurance, Aon and the Council believe the creation of a permanent solution to the terrorism insurance affordability and availability crisis is essential. There is no more important policy issue for Council members.

The Success of TRIA

Since its inception in 2002, TRIA has been incredibly successful in providing the commercial property and casualty market, and insurance buyers, with increased terrorism capacity and significantly decreased pricing without costing taxpayers one dollar. In addition to providing readily available and affordable terrorism capacity for U.S. based risks, the program has also allowed the private markets to progressively increase its role in terms of retained terrorism exposures under TRIA.

Coverage that is both available and affordable is directly due to the existence of the federal backstop. Since TRIA's enactment, as the availability of terrorism coverage has grown and premium prices have dropped, take-up rates for terrorism coverage have steadily increased. A brief history of the terrorism insurance marketplace since 9/11 illustrates TRIA's success:

- Prior to September 11, 2001, coverage for terrorism was generally included at no additional cost in most property and casualty policies; it was not treated as a separate risk.
- Between 9/11 and the enactment of TRIA, terrorism insurance became almost entirely unavailable, and the small amount that was available was extremely expensive. The consequences of this lack of coverage rippled far beyond the insurance industry. For example, innumerable construction projects and real estate financing arrangements were derailed or delayed due to a lack of adequate terrorism insurance protection.
- In the months after enactment of TRIA, the initial pricing was high and the take-up was low.
- Since that time, however, the purchase of terrorism insurance has been steadily increasing. Aon's commercial property benchmarking shows a nearly 100% increase in take-up rates among

our clients between 2002 and year-to-date in 2006. For example, in 2003, the first full year of the program, less than 40% of large- and mid-sized U.S. businesses obtained insurance to cover property terrorism risks; in 2004, that number increased to nearly 50%; in 2005, the take-up rate grew towards 60 percent; and this year the take up rate is in excess of 60%.

The increase in take-up rates reflects the increasing demand by America's business community for terrorism coverage at commercially viable prices. Statistics show that the average rates for terrorism coverage dropped 25% between 2004 and 2005, providing more stability to the market. This has enabled business transactions that were previously stalled due to lack of insurance coverage to go forward without threatening the solvency of the parties involved or their insurers. Policyholders – the businesses of our economy - have not had to deal with dramatically volatile terrorism insurance costs and have been able to budget for their existing and expanding business plans.

Terrorism risk is not limited to urban, coastal areas. Policyholders across the country – and across industries – are rightly concerned about the risks they face and will purchase coverage when it is available at an affordable price. According to industry reports, take-up rates are higher for companies with a higher perceived risk, whether due to size, location, industry or other factors. One of the most interesting and important industry findings is that the take-up rates are high across the country and across industries. According to industry reports, take-up rates were highest in the Northeast and Midwest, followed by the South and West. Take-up rates in major cities in the Midwest, South and East were over 50%, and were only slightly lower in Los Angeles and San Francisco. Within specific industrial sectors, the largest percentage of insureds buying terrorism insurance were in real estate, financial services, health care, media, hospitality, transportation and education. Even companies in the sectors with comparatively low take-up rates – energy and manufacturing, for example – each had take-up rates exceeding 33 percent in 2004. These relatively high rates show not only demand, but that we are making progress toward the public policy goal of encouraging coverage in affected areas and industries. By comparison, in California – where the likelihood of a major earthquake can be better modeled, understood and underwritten – price and complexity have capped take up rates of earthquake insurance at only 11%.

The Development of a Long-Term Solution to Terrorism Risk Coverage

TRIA has stabilized the insurance market and allowed insurers to become more comfortable offering terrorism coverage *within the TRIA framework*. Nonetheless, capacity in the terrorism insurance market clearly remains limited. And the capital markets have no appetite for hedging terrorism risk absent a Federal backstop.

We don't have to guess what the post TRIA market will look like if the TRIA program is allowed to lapse unrenewed at the end of 2007. Renewal activity in the latter half of 2005 – before TRIA was extended – as well as pre-2002 TRIA provides a clear roadmap. According to industry reports, during late 2005, the availability of coverage and the pricing of coverage varied greatly according to the exposure. For medium and large insureds with little or no exposure – i.e., businesses in low risk industries located away from high risk areas – property coverage for terrorism was generally available at reasonable prices. In contrast, insureds in areas with high concentrations of risk (generally urban areas), in high-risk industries, or properties perceived as "targets," capacity was low and prices were high. This is also true of large insureds seeking large amounts of terror coverage. Thus, without TRIA, reasonably priced coverage will not be available for the major ports, oil refineries, sporting venues, hospitals, universities, airports, train stations and others that need it most.

It is also not realistic to rely on the private reinsurance market to fill the terrorism reinsurance capacity hole that TRIA's expiration will create. If there is no permanent solution when the program ends at the end of next year, we will see an increased demand for private market reinsurance. The increase in demand and the limited reinsurance capacity will cause rates to rise dramatically.

In addition, the entire global surplus capacity for P&C companies of $425B for all perils – national catastrophe, workers, compensation, normal course – is committed. We need only look to the Gulf post-Katrina to see how the commercial P&C market will react when faced with increased rating pressure, liquidity impairment loss scenarios and very highly priced and scarce private market reinsurance capacity: an overwhelming portion of the P&C market will look to either exclude or severely sublimit terrorism exposures. This will create an immediate imbalance in terms of available supply for terrorism capacity versus demand at the primary insurance level. Market exit creates availability constraints, which drives up pricing, which decreases the take up rate which – ultimately – transfers the risk back onto the government. The economy will need capital to recover from any event and if that capital does not come from the private market via a vehicle like TRIA, it will come from the public one.

We recognize that a long-term solution to this issue could take any of a number of forms, although at this point, the form of the solution is less important than the content: increased affordability, increased availability, and increased certainty in the terrorism insurance marketplace. Because of the unique characteristics of terrorism risk – unpredictability, the political dynamic, the catastrophic nature of the losses – any workable solution must involve the federal government. Indeed, with respect to nuclear, biological, chemical and radiological (NBCR) risks, we agree with Ramani Ayer, CEO of the Hartford and a co-panelist at today's hearing, that the insurance industry is not capable of insuring against such an act of war and the Federal government should provide first dollar coverage for such losses. Even with respect to non-NBCR risks, we see a necessary role for the federal government, most efficiently by providing a backstop that provides the implicit reinsurance that the capital and reinsurance markets will not provide. As is referenced in the Aon proposal below, in exchange for the Federal participation, there should be a mechanism that increases the payback of any government funds used to cover insured terrorism losses.

One of the common themes of several proposals is a pooling mechanism. A pooling mechanism would allow the insurance industry to essentially "backstop" itself by growing the capacity to handle a catastrophic attack like those of September 11. The growing premium base of a terrorism insurance pool and backstop could bring reinsurers back into the market, further expanding capacity. Growth in capacity will bring prices down and decrease the need for the federal backstop over time or increase the dollar amount at which such a backstop would kick-in.

In general, a terrorism insurance pool would be financed by participating insurers which would each deposit some percentage of their written premium covered by the program into the pool. In order to avoid adverse selection, contributions to the pool would be based on each individual company's entire premium for lines of insurance covered by the pool, not select lines or policies. In the unfortunate circumstance that a qualifying loss from a terrorist incident occurs, participating insurers would first pay down a pre-established deductible (all or part of which could be covered by the premium deposits); once deductibles are fully paid, funds from the pool would be tapped; when the pool is drained, the federal backstop would kick in, up to a pre-set limit. The federal backstop is more likely to be tapped in early years, before the pool has a chance to fully develop, and the government's potential short-term liability will decrease as the pool grows. All federal backstop payments would be repaid through policyholder surcharges or other means.

Along those lines, Aon has developed a solution that would engage the private market while maintaining the Federal backstop. The Aon proposal would:

- Create an industry funded insurance pool capable of covering two consecutive $40 billion events. (Aon considers $40 billion to be a 1 in 100 year occurrence, similar in scale to the attacks on 9/11).

- Industry would be required to contribute annual premiums of $2 billion per year. The fund would build up over 20 years to $40 billion. The Federal Government would cover excess losses up to $100 billion.

- Should a calamitous event occur prior to the pool reaching $40 billion, the pool will be funded through the issuance of post-event bonds to be repaid through assessments on all policies from covered lines for the life of the bonds.

- Bond repayments would not cripple the industry. To cover two $40 billion events in a four year period, premiums by covered lines would rise by only 1.4% through the life of the post-event bonds.

We also believe participation in the pool should be on an individual company basis, rather than a "family of companies," holding-company-wide basis. The holding company approach penalizes the largest insurers because the size of their deductibles renders the program somewhat superfluous for them. It also punishes them for exploring areas of business that are new for them, including areas in which terrorism coverage may be a component. Allowing individual insurers in a holding company family to participate in the pool separately would allow the maximum amount of flexibility and entrepreneurship as those companies explore the various ways through which to address terrorism coverage concerns. The insurance industry is renowned for its ability to come up with new ways to solve problems old and new, and providing this type of flexibility should maximize the extent of that entrepreneurship that is needed so desperately here. This approach also would allow many families of insurers to experiment with the pooling concept – to dip their toes in, so to speak, before deciding whether or not to dive. In the long run, we believe that allowing individual companies to participate in such a pool will maximize the availability of terrorism coverage in the private marketplace and thereby help to reduce the government's on-going role in providing the terrorism backstop.

Conclusion

In closing, thank you once again for your diligent work on this issue, which is critical to the insurance industry, policyholders, and the Nation. We are deeply appreciative of the bipartisan consensus that has existed on the Financial Services Committee – and these Subcommittees – with respect to this issue since 2001, thus enabling the TRIA program to do its job. TRIA has stabilized the terrorism insurance marketplace and provided the structure around which the private market can play an effective role and facilitate a long-term private sector solution. The work is not done, however, and there remains an essential role for the federal government to provide stability and certainty to facilitate a long-term solution for terrorism risk protection. We offer our assistance in any way as the industry, policyholders and policymakers work next year to develop lasting public-private solutions that minimize risk to the Treasury while allowing policyholders to secure coverage to protect them against the financial risks of terror.

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