TESTIMONY

OF

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CATASTROPHIC TERRORISM RISK

BEFORE

CAPITAL MARKETS
INSURANCE AND GOVERNMENT SPONSORED
ENTERPRISES SUBCOMMITTEE
AND
OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE
OF
FINANCIAL SERVICES COMMITTEE
US HOUSE OF REPRESENTATIVES

SEPTEMBER 27, 2006

My name is Jacques E. Dubois and I am President and CEO of Swiss Re America Holding Corp. I am also here on behalf of the Reinsurance Association of America (RAA). First, a few words about Swiss Re. Founded in Zurich, Switzerland in 1863, Swiss Re has operated in the US since 1880. Swiss Re is the largest reinsurer in North America and the world. Our company insures risks globally, operating from 70 offices in 30 countries. We incurred over $19 billion in claims for all lines of business on a worldwide basis in 2005. Swiss Re has three businesses: Property & Casualty reinsurance, Life & Health reinsurance and Financial Services. Swiss Re is also a member of the American Council of Life Insurers.

The RAA is a national trade association based in Washington, DC and incorporated in 1969. It is the sole organization representing the U.S. property and casualty reinsurance industry. RAA's membership consists of U.S. domestic reinsurers and reinsurance brokers.

Before I begin my testimony, I want to thank Chairmen Oxley, Baker, Kelly, Ranking Member Kanjorski, and many members of this Committee for the leadership you all have shown on the terrorism insurance issue. Your leadership has been critical to the adoption and continuation of the successful TRIEA program. The reinsurance industry commends you all for the hard work and tremendous support you have provided on this most important issue. When one considers the potential damage terrorism events could do to this country, both in human suffering and general economic consequences, the importance of a TRIEA renewal is a case that must be made.

Reinsurance is commonly referred to as insurance for insurance companies. Reinsurance plays a critical role in maintaining the financial health of the insurance marketplace and ensuring the availability of property and casualty insurance for U.S. citizens. Reinsurance can be used by insurers for several reasons. One of the most important purposes is to protect insurers from catastrophic losses from various perils including hurricanes, earthquakes, fire and floods. To that end, reinsurers, Swiss Re among them, have financially responded to every major U.S. catastrophe for more than a century. It is important to note that two-thirds of the insured losses from the September 11 terrorism attack were absorbed by the reinsurance industry.

Swiss Re and the RAA strongly supported the adoption of the Terrorism Risk Insurance Act (TRIA) in 2002 and the extension in 2005. The program has worked very well to fill a vacuum in reinsurance capacity and has brought stability to the market place and the economy. TRIEA has enabled insurers to provide insurance coverage to support economic activity, and it should reduce disaster assistance should another terrorist act occur in the U.S. It is worth noting that this program has proven to be an effective and efficient program. In providing its backstop to the insurance industry, TRIEA has preformed as designed and has cost little to administer (albeit in the absence of a significant payout).

My comments are intended to provide the Committee with: (1) a better understanding of the significant challenges the reinsurance industry is facing in providing private terrorism reinsurance capacity, and (2) why the reinsurance industry strongly believes that a public/private partnership is necessary to help stabilize the commercial insurance markets that underpin our free-market economy.

Creation of TRIA/TRIEA

As you are very well aware, TRIA was enacted in response to the tragic attacks of September 11, 2001. In the history of our nation, no hurricane, earthquake or other catastrophic event so fundamentally changed the American landscape and the insurance and reinsurance industries.

These attacks forced all Americans to confront the previously unforeseen realities associated with a catastrophic terrorist attack on U.S. soil. Although the insurance and reinsurance industry responded unwaveringly to the catastrophic losses of September 11, the events shook the financial foundation of the industry and forever changed the way it views this risk. The simple fact is that the U.S. insurance and reinsurance industry cannot underwrite and model the number, the scale or frequency of future terrorist attacks that we may face in our nation. The insurance and reinsurance industry cannot provide significant terrorism coverage for this country, especially NRBC risks, without TRIEA's public/private partnership. Will this change in the future? If terrorism risk lessens in the world, the need for a public-private backstop should also ameliorate. But absent these world improvements, Swiss Re does not see a time in the foreseeable future when frequency or severity of terrorism risk can be successfully modeled and underwritten.

TRIA was created to provide a federal backstop, which was essential to allow the primary insurance industry to provide terrorism coverage to our nation's businesses. A client survey by Marsh & McLennan, the global insurance broker, finds that the take-up rate for terrorism coverage has risen steadily from 23% in 2003Q2 to 64% in 2005Q4.[1] TRIA has bolstered take-up rates in two ways. First, its requirement that insurers make coverage for "certified acts" of terrorism available to policyholders on terms and conditions not materially different from the policy's other property and casualty coverages has increased the supply of coverage. Second, the TRIA backstop has reduced the cost of property terrorism coverage by more than 25 percent from 2004 to 2005.[2]

Swiss Re and the RAA believe that TRIA/TRIEA has fulfilled its purpose of enabling primary insurers to provide terrorism insurance coverage to commercial policyholders in both

[1,2] Marsh & McLennan, *Marketwatch: Terrorism insurance 2006*

urban and rural areas. By limiting insurers' exposure to catastrophic terrorism losses, TRIEA has improved the market for such coverage and has had, therefore, a stabilizing influence on the economy.

Reinsurance Challenges to Underwriting Terrorism Risk

Over the last several years, insurers and reinsurers have worked hard to develop a better understanding of terrorism risk. Reinsurance companies have consulted military and intelligence experts, hired specialty risk modeling firms, invested in new research and development, and developed new underwriting standards.

Despite these considerable efforts, the basic facts have not changed: terrorism risk poses great challenges as an insurable risk. As noted in Swiss Re's *sigma* publication No. 4/2005, "Innovating to insure the uninsurable", insurable risks are measurable; have independent loss occurrences; contain manageable and predictable average and maximum losses; premium rates acceptable to both insurer and insured and adequate industry capacity. Terrorism risk fails to meet these criteria.

A key struggle in the development of a private market is that terrorism risk is not conventional. The Federal government, in fact, is telling us that we are at war on terrorism. War, by nature, is not insurable. Terrorism risk also has characteristics regarding frequency, severity and correlation that make it unlike any other insured peril or risk. These characteristics include the following:

Frequency

1. The frequency of loss is unpredictable, with little historical track record to project future loss experience. In addition, the insurance industry does not have access to all existing information about terrorism, targets and potential attacks due to national security interests.
2. Terrorists learn from their attacks and thus will attempt to defeat loss prevention and mitigation methods used by policyholders, insurers and reinsurers. This also suggests that history will never be a reliable predictor of future terrorism losses.

Severity

1. Terrorist acts are willful and intended to inflict maximum damage. These are not random or fortuitous acts.

2. The potential size of loss is enormous, with total destruction of multiple insured properties likely. The introduction of nuclear, biological, chemical and radiological weapons can greatly magnify losses to property and life. As an example, the American Academy of Actuaries has modeled insured losses totaling $778 billion stemming from a NRBC event in New York City. These extreme loss scenarios would cause losses that outstrip insurer financial resources and are uninsurable.

Correlation

1. The potential size of loss is compounded by the aggregation of losses arising from multiple clients and from multiple insurance products implicated in the occurrence.
2. Unlike natural disaster risk, reinsurers achieve virtually no spread of risk with terrorism coverage. Hurricanes in Japan and Florida are not correlated. Premiums

can be collected from each risk knowing that one loss will not lead to another. Terrorism risk in Europe and North America, however, may be highly correlated and thus minimize any benefit of risk spreading geographically.

3. At the same time, terrorism events can lead to major disruptions in the financial markets. In the event of a large loss, reinsurers may be liquidating assets to pay claims. The asset values themselves may be under market pressure due to investors' concerns over the terrorist attack.

Terrorism risk has many qualities that make it challenging to write. In a free market insurers limit or avoid exposures that lack insurability characteristics. Terrorism risk poses such significant challenges that market failure can result and actuarially fair pricing on a broad scale may not be economically feasible.

Reinsurers' Role Under TRIEA

TRIEA provides reinsurance-like protection for primary commercial insurance exposures. For 2006, 90 percent of the commercial terror loss for primary insurance companies is covered up to an industry total of $100 billion. This coverage is subject to individual company retention of 17.5 percent of 2005 direct earned premium on commercial lines or approximately $35 billion. (It's important to note that property and business interruption losses from September 11 totaled about $20 billion. This amount is within the current retention required by TRIEA and, as such, the losses would not have been covered by the TRIEA program if it had been in existence.) These individual company retentions and the 10 percent co-pay for losses above the retention require commercial insurance companies to absorb significant losses before TRIEA funding is available.

Primary insurers seek private reinsurance to help reduce the large gap in terror exposure they face between the individual company's normal retention and loss-sharing/retention provisions under TRIEA. Some have expressed the concern that TRIEA preempted the private reinsurance market. This is absolutely not the case. In fact, the opposite is true. By establishing definitive loss parameters, TRIEA has provided a defined layer for reinsurers to participate in sharing the retained risk of loss that primary companies face under the federal terrorism program.

Reinsurance Terrorism Capacity

Working with client companies to manage their substantial retained exposure under TRIEA, reinsurers have been willing to put limited capital at risk to manage terror-related losses. Swiss Re is active in this limited market. Reinsurers like Swiss Re typically seek to offer terror coverage in a stand-alone contract rather than within a traditional all perils catastrophe contract, especially for insurer clients writing a national portfolio. Some regional carriers, with exposures limited to rural or suburban areas, have secured terrorism coverage within their standard reinsurance programs, usually with some limitations as to the nature of the subject risk or size of subject event.

The RAA surveyed both reinsurance brokers and reinsurance underwriters to estimate how much terrorism reinsurance capacity the private reinsurance marketplace is providing. This coverage generally includes TRIEA "covered acts" as well as domestic terrorism and personal lines exposure where requested. Overall, the RAA estimates the global reinsurance capacity available in the United States for 2006 at about $6 to 8 billion for TRIEA certified, stand-alone and treaty reinsurance. Favorable loss experience and surplus growth may increase the supply of private terrorism reinsurance but availability would still be very modest and will not fill the capacity needs of the primary industry, with or without TRIEA. The survey suggests terrorism capacity for an individual company's reinsurance program may range up to $600 million on an annual aggregate basis for property and workers' compensation. According to RAA, some market observers also believe that hedge funds may have some interest in providing capacity although estimates are for no more than $3 to 4 billion – if at all.

With regard to workers' compensation, some insurers have been able to add the terrorism peril to their reinsurance programs, but this coverage typically excludes nuclear, radiological biological, and chemical, (NRBC) losses.

Regarding NRBC generally, there is very little reinsurance appetite for this risk. According to the RAA, knowledgeable market participants believe NRBC capacity to be 15 to 20 percent of non-NRBC capacity for terrorism risk. And, when it is available, pricing for coverage including NRBC is at a significant premium and coverage amounts are restricted.

Swiss Re and the RAA believe that in the foreseeable future reinsurers will be unable to provide enough capacity to replace TRIEA coverage. Although progress has been made in modeling terrorism loss scenarios, forecasts of the frequency and the severity of terrorism losses are extremely problematic. Reinsurers can provide only limited capacity for terrorism because the potential losses would otherwise place these companies at risk of insolvency. Reinsurers' capital is necessary to support many other outstanding underwriting commitments reinsurers face, including natural disasters, workers' compensation and other casualty coverages. As a reinsurer, our business is to provide risk protection to our client companies on a sustainable basis. After all, the only way we make money is if we actually provide coverage. If the terrorism risk market were sustainable, Swiss Re and our competitors would be writing significantly more protection.

Capital Markets Limited Impact On Terrorism Risk Capacity

Some have suggested the possibility that the capital markets could assume terrorism risk. Catastrophe bonds, the most mature segment of the Insurance Linked Securities (ILS) market, were first issued in 1994. Of the over $3 billion in cat bonds issued so far in 2006, over $2 billion was underwritten by Swiss Re Capital Markets and/or sponsored by Swiss Re. In 2006, issuance of cat bonds and other capital market vehicles will likely exceed $6 billion. Swiss Re experts estimate cat bond issuance to grow to $10 billion by 2010.

This amount, however, is dwarfed by the total value of privately-owned commercial structures in the US. According to Bureau of Economic Analysis, these structures had an estimated value of $8.8 trillion at yearend 2005, of which commercial and office buildings accounted for $3 trillion; power and communication $1.4 trillion; manufacturing plants $1.1 trillion and medical facilities $0.6 trillion. Thus, even if all $10 billion of projected future cat bond issuance covered terrorism risk, it would amount to a mere fraction of a percent of the cover needed.

Since Hurricane Katrina, an additional $4 to 6 billion in capital has been dedicated to cat bonds and other capital market vehicles. An additional $7.8 billion in capital has been raised for Bermuda reinsurance start-ups, and $12.1 billion has been raised by existing insurance/reinsurance companies. The total amount of capital raised since Katrina is $25 billion. None of this money, however, has been dedicated to terrorism risk. It is quite telling that even after the most expensive hurricane season in 2005, on the heals of the costly 2004 season, the capital markets have responded by investing in hurricane risk. At the same time, there has been no appetite from the capital markets to dedicate much, if any, capital to terrorism risk.

Acts of terrorism present much greater underwriting and pricing challenges than natural catastrophe risk to the insurance and reinsurance industry and, of course, to those issuing and investing in catastrophe bonds. There is no reason to believe terrorism bonds are likely to be a significant provider of terrorism coverage in the foreseeable future. The capital markets face the same problems as insurers: inability to assess frequency of attack, a lack of predictive experience, correlation of loss to other exposures such as a stock market decline, and potentially devastating financial loss. Rating agencies have to date been unwilling to rate terrorism-only bonds.

Some have suggested allowing insurers to set up tax-free catastrophe reserves to increase the industry capacity for terrorism risk. Unless this was accomplished through a pooling mechanism, there would be no assurance that this would result in the allocation of more capacity toward terrorism risk. On an individual company basis, it would be difficult to determine the appropriate size for such a tax-free reserve because the modeling used to determine terrorism risk is not yet sufficiently reliable.

An Explicit Backstop Expedites Recovery Post Attack

One important point that is often lost in the TRIEA debate is that, absent TRIEA; the Federal government would lack an explicit backstop for major terrorist attacks. Many observers believe that the government would nonetheless be forced to provide aid, whether to insurers, other businesses or individuals who suffer devastating losses due to a terrorist event. There is ample reason for this belief. To cite just one example, twelve days after the 9/11 event, the September 11th Victim Compensation Fund of 2001 (P.L. 107-42) became law. The $6 billion program compensated individuals (or the personal representative of deceased individuals) who were physically injured or killed as a result of the attack.

The confusion – about whether the government would step in post terrorism attack– is clearly not constructive. The belief in an implicit government backstop undercuts demand for terrorism insurance, as many see no reason to insure against events that government would cover anyway. It likewise reduces incentives for businesses and individuals to buy insurance coverage or to take risk mitigation efforts such as hiring extra security or relocating.

If some expect a government bailout while others do not, there is a free rider problem. Those who purchase insurance are punished for their prudence, relative to those who failed to insure. And hastily-arranged aid packages may be more costly and less effective than carefully planned aid.

An explicit government terrorism risk backstop offers numerous advantages. It reduces ambiguity both pre- and post-event. It also enhances transparency by making it clear who will pay how much for what, should an event occur. This clarity helps facilitate actuarial pricing of risks and strengthens the incentives to purchase terrorism insurance and to mitigate risks. By reducing uncertainty, a backstop also reduces the risk of financial market disruption in the wake of an attack.

A final but important point to make about TRIEA is this is by no means a bailout for the insurance industry. TRIEA expressly provides that the Federal government can be compensated for payouts through premium charges to policyholders.

A Public/Private Partnership Is Necessary to Address Terrorism Risk

Certain group life writers have petitioned for inclusion of group life insurance in TRIA. Swiss Re is the largest reinsurer of group life writers in the US and we support their petition. Adding group life to TRIA will provide group life insurers the protection they need to insure the lives of people in the workplace. Group life insurers are not free to manage their risk through terrorism exclusions. Most state regulators will not allow it. As a public policy matter, state regulators have decided that this basic insurance covering 167 million Americans is vital. We urge you to add group life insurance to a permanent backstop.

Swiss Re and the RAA continue to work with industry task forces to determine the most effective federal program. Key to these ongoing discussions is the participation and consensus from the policyholder community. Several solutions have emerged. Swiss Re will continue to work with our clients on the most effective and efficient program design. We welcome the opportunity to work with this Committee, the Congress at large, the Administration and all private sector stakeholders to craft a public/private partnership to address this most important national issue.

In conclusion, due to the nature of the terrorism peril, we believe that private market mechanisms are insufficient at this time to spread the risk of catastrophic terrorism loss. Without some form of a federal backstop we would expect less coverage available at the policyholder level, increased prices for terrorism cover and limited private reinsurance capacity.

Thank you for the opportunity to provide testimony on this important issue.