Testimony of
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Chairman Baker, Congressman Kanjorski and other members of the Subcommittee, I'm Dave Mathis, chairman of the board and chief executive officer of the Kemper Insurance Companies. I appreciate the opportunity to testify before the Subcommittee today, representing not only Kemper but also the American Insurance Association.

Let me tell you a little bit about our company. Kemper is a mutual insurance company based in Long Grove, Ill., outside of Chicago, and has offices located throughout the United States and in many foreign markets. Our largest line of business is workers' compensation, but we also are a prominent writer of commercial coverages for a variety of businesses, from Main Street operations and mid-sized firms to Fortune 500 corporations.

The tragic events of September 11, 2001, forever changed our collective understanding of, and concern about, terrorism on our own shores. The scope and nature of those attacks were unprecedented in world history. None of us – neither private nor public sector interests – had made accommodations for this type of occurrence, because such things were simply beyond our conception. Unfortunately, we are now presented with a new view of the very real risks and potentially infinite costs associated with terrorist acts. The new, post-September 11 world in which we find ourselves is fundamentally different than that which existed before, for Americans in general, and very specifically for property/casualty insurers and our customers.

Today, I would like to address two topics. First, I would like to briefly describe how our industry has responded to the tragic events of September 11. Then, I would like to share our thoughts on how we can make sure that insurers are able to continue meeting the expectations and future needs of our policyholders with respect to terrorism and the wide range of other risks which we insure.

I'd like to be very clear about our response to the attack on the World Trade Center. But before I do that, let me say how grateful I am that all of Kemper's 225 employees who were based in Tower One of the World Trade Center are safe.

Kemper like other property/casualty insurers, has been publicly and steadfastly committed to meeting our promises to policyholders affected by the events of September 11. We have not attempted to invoke our war exclusions, despite the militaristic nature of the attacks.

Our pre-tax losses are estimated at $360 million gross and $60 million to $80 million, net of reinsurance. While that is a significant sum, Kemper will meet its obligations to its policyholders with no difficulties. We are paying our claims quickly and fully. For the industry as a whole, current estimates of total insured losses resulting from the September 11 attacks stand at between $30 billion and $60 billion, although the final number will not be known for some time, and could end up being much higher. This makes the September 11 attacks, by far, the most costly insured event in history.

Although no natural disaster or man-made catastrophe even comes close, for the sake of some reference, I would note that Hurricane Andrew, which devastated south Florida in 1992, caused approximately $19 billion in insured losses, perhaps half to one third of the September 11 losses. Put another way, the September 11 losses will exceed the entire property/casualty industry's net income for the past three years (1999, 2000, and 2001). On this one day, three years of industry profits, including investment income, were wiped out.

Recognizing that the American people and our economy will recover and move onward, we also are looking ahead. Although the property/casualty insurance industry can deal with the incredible losses from September 11, we are very concerned about what will happen if there are additional, large-scale terrorist attacks in the future. It is critical that you as public policymakers share our recognition that terrorism currently presents core challenges to the insurance market that we cannot meet.

It is crucial that everyone recognize that we are dealing with a peril this is not quantifiable and therefore not insurable within the finite resources of the private insurance industry. Quite simply, the financial capacity of our industry is limited. Unfortunately, the potential harm that terrorists can inflict is unpredictable in frequency and unlimited in severity. Given this mismatch, insurers (including reinsurers), cannot assess, measure, or spread the risk of terrorism. As a result, terrorism has become uninsurable in the private marketplace. This insurance market crisis, and by extension, pending economic crisis, is unprecedented.

As you probably are aware, more than two-thirds of annual reinsurance contracts – agreements by which primary insurance companies purchase their own insurance to adequately spread the risk of large-scale losses – are renewed each January 1. Reinsurers already have notified primary carriers that they intend to exclude or dramatically scale back terrorism coverage in the reinsurance contracts coming up for renewal. Although the primary insurance sector of the industry is adversely affected by such decisions, we recognize that this may well be the reinsurers' only way to protect their solvency.

Primary carriers, however, do not have the same flexibility as reinsurers with respect to our own products because we are subject to tighter regulatory oversight. Any terrorism exclusions we might choose to introduce must be approved by individual state insurance departments. If approved, our customers could find themselves bearing 100 percent of the risks associated with terrorism. Certainly, the repercussions of this are clear. However, if exclusions were not approved, primary insurers would be left to shoulder 100 percent of future terrorist losses, which we cannot do.

Allow me to give you an example to illustrate the effect of a high retention of risk imposed on the industry. Let's say that an insurer provides workers' compensation coverage for a manufacturing facility with 6,000 employees. The plant in my example would not be located on an earthquake fault or elsewhere where it would be likely that there would be significant loss of life for the workforce due to natural disasters. If, God forbid, that plant is targeted by an extreme terrorist act which take the lives of all the employees, the workers' compensation claims, depending on the state where the plant is located, could run between $2.5 billion and $3 billion. This would deplete the surplus of some companies, and would cause severe damage even to the largest, most well capitalized insurers. Companies would not have been able to purchase reinsurance through the marketplace because reinsurers are already telling us that they won't provide it. Under that scenario, if they weren't able to receive government assistance, many companies would be out of business. Of course, in the face of that kind of exposure, prudent companies would respond by managing their risk through careful underwriting, including reduced writings, which mean that some business customers would no longer be able to get the insurance they need to protect them from risk.

So we face a very difficult challenge: how can we do the most prudent thing to protect our own solvency, and still serve the needs of our customers for financial protection against terrorism. I am proud to say that insurers are working hard with you and your colleagues in the House, with Senators and with the Bush Administration, to come up with a public policy solution that will allow us to continue providing this much-needed coverage to our policyholders.

We believe that the best course of action is immediate enactment of legislation to create a federal financial backstop for losses that result from future terrorist attacks. This backstop could be temporary, existing for as long as it is needed, but for as short a period of time as possible, perhaps two to three years. Also, the legislation must be enacted before Congress recesses for the year, because so many reinsurance contracts which cover this risk will expire on January 1.

The legislation we are seeking is not, repeat <u>not</u>, a "bailout" for the insurance industry. In fact, the primary beneficiaries of such legislation would be our customers, and the U.S. economy. Ultimately, the costs of risk must be borne by the policyholders who seek protection through insurance. Given the unprecedented nature of the terrorism threat, the best way for this to be done is through a public/private partnership that allows us to service the coverage needs of our policyholders while remaining financially strong.

The goal of this legislation is not to provide a windfall to insurers, but rather to ensure that adequate insurance coverage remains available to American businesses. Federal Reserve Chairman Alan Greenspan recognized this when he testified before Congress last week, coming to what he termed the "very unusual conclusion that the viability of free markets may, on occasion, when you are dealing with a degree of violence, require that the costs of insurance are basically reinsured by the taxpayer, as indeed they are, for example, in Great Britain and in Israel and in other countries which have run into problems quite similar to ours."

There are a number of ways in which this could be done. One is the British-style reinsurance pool concept, and another is the quota share approach recently suggested by the Administration. We are not wedded to the details of any particular proposal; not even our own. Whatever approach you choose to take in order to successfully avert the looming economic crisis, the legislation must achieve the following three goals: it must improve predictability, immediately stabilize the market, and it must preserve insurer solvency.

No proposal can make the risk of terrorism go away, nor can it make the cost of insurance against terrorism risk go away. However, the right legislation can provide a way for the public and private sectors to co-manage this risk – a risk whose dimensions changed fundamentally and exponentially on September 11. To ensure this result, the probable maximum loss for individual companies and the industry must be limited in a way that allows us to service the coverage needs of our policyholders while remaining financially strong. Legislation that does not strike this balance will not achieve the public policy objective we all share.

The bottom line is that the higher percentage of risk insurers are forced to retain, the less stability there will be in the marketplace.

What must be in the legislation from our perspective to make it workable? First, rather than 51 possible separate definitions of "terrorist act," there must be a uniform national definition that will constitute the terrorism coverage provided by insurance policies all across America. A broad national definition of terrorism is essential to avoid non-concurrence of coverages among primary insurers, reinsurers and the federal backstop. Such uniformity cannot be achieved if states retain the authority to approve or disapprove policy forms in this narrow area.

Second, insurers must be able to quickly include the price for terrorism coverage in their insurance policies, rather than be required to go to every state insurance regulator and seek that regulator's approval for the terrorism rate in every property/casualty line. Even with a federal terrorism reinsurance program that provides a partial backstop, individual insurers' retention for terrorism risk will be expensive, given the huge uncertainties and potentially large losses we collectively face as a nation. States cannot take the attitude that "terrorism can't happen in our particular backyard," and therefore suppress rates. Mindful of the general prerogatives of state insurance regulators in the rate-setting arena, there must be language in place that, on the one hand, allows for rate review by the appropriate state regulator, but, on the other hand, does not subject the rates to any review or approval prior to or in connection with the introduction of those rates into the marketplace.

Third, we recognize that any federal terrorism reinsurance program will include a number of important details with respect to the mechanics of reimbursement and other issues. These details must be drafted and implemented in a way that is workable for insurance companies and our regulators.

We understand that, in all likelihood, any new risk sharing mechanism for terrorism coverage will include some significant retention of future losses by private insurers. On that point, I would like to note that the more risk insurers are forced to retain, the less stability there will be in the marketplace.

Terrorism has become uninsurable in the private marketplace as currently structured. Period. Appreciating that an immediate, stopgap solution may be somewhat imperfect, we expect that dislocations will still occur as insurers cautiously re-enter the marketplace. It is our hope that, with time and experience, we will be able to craft longer-term, more complete solutions that avoid such disruptions.

In the absence of federal legislation to prevent the complete collapse of the insurance market, entire sectors of the U.S. economy could be left wholly exposed and unable to continue the normal course of business. I urge you to act quickly and decisively to ensure that all businesses are able to obtain much-needed protection against future losses.

I thank you for your attention and look forward to responding to your questions.