Testimony
of
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Mr. Chairman, Congressman LaFalce, and members of the Committee, I appreciate the opportunity to appear before you today to discuss the situation facing insurance markets in the context of the current terrorist threat. In a very real sense, the timing of these hearings is significant; it is important that Congress act on the issue of terrorism risk insurance before the end of the year.

The terrible tragedy associated with the terrorist attacks on New York and Washington exacted an economic toll on the United States as well as a human toll, and the Administration is working with Congress to address both losses. Among the direct repercussions of these attacks has been an increased appreciation of the need to focus public policy on security, including efforts toward defending American economic activity against terrorist intrusions. The need for security in economic activity – whether in such visible forms as Federal Air Marshals or more mundane needs like additional backup computer systems – raises the overall cost of transacting business. In this sense, the attacks acted as a shock to the costs of supplying goods and services in the economy. It is in our economic interest to contain these transactions costs as much as possible.

The attacks also raised the degree of uncertainty in the economic environment – from the state of aggregate demand, to the demand for particular goods and services (air travel, for example), to a myriad of other areas.

Commercial insurance lies at the intersection of these two forces. Property and casualty insurance is one mechanism by which economies respond efficiently to risks in the environment. Risks are spread, converting for each business a potential cost of unknowable size and timing into a set of smaller, known premium payments. The events of September 11 induced a dramatic revision in perceived risks. In normal circumstances, increased risks are translated into higher premiums. This serves the useful economic function of pricing risk, leading the private sector toward those activities where the risk is "worth it" -- there might be losses now and then, but on average society will benefit – and away from foolhardy gambles.

At the moment, however, the entire nation is unsure of the genuine likelihood of additional terrorist events. For insurance markets, unfortunately, the distinction between risk – not knowing when an event will happen, but having solid knowledge of the odds of an occurrence – and genuine uncertainty about the frequency of an insured event is the key to being able to price efficiently. Experience with our new security environment will mitigate this difficulty over time. In the near term, however, it would not be terribly surprising to experience disruption of the property and casualty market. In the extreme, customers may not be able to renew policies until the market resolves pricing difficulties. That is, reinsurers may no longer cover acts of terrorism in their reinsurance contracts with primary insurers.

An interruption of coverage is a particular, and extreme, version of an increase in transactions costs as a result of terrorist-associated risks. Still, there is the possibility that existing lines of coverage will be renewed only with quite substantial increases in premiums. I believe we are all now familiar with the difficulties facing aviation; disproportionate rises in insurance coverage or, in the extreme, withdrawal of insurance coverage, would hinder transition to a new operating environment. This phenomenon is more widespread, however. Lenders usually require businesses to insure any property they use to secure loans. The terms of terrorism coverage could diminish bank lending for new construction projects. It could as well act as a sharp impediment to transactions that permit existing commercial properties – skyscrapers, pipelines, power plants, and so forth – to change hands. It is important to point out that this "changing hands" is an important economic function. The relative efficiency with which our economy reallocates capital from less productive to more productive uses sets it apart from many other nations.

In short, a well-functioning insurance market is part of the financial infrastructure that underpins our economy. The Administration and Congress worked together to restore the institutional underpinnings of the financial markets in the week after September 11. In the same way, the Administration looks forward to working with the Congress to bolster the capacity of private insurance markets to provide the risk-sharing services that benefit commerce and consumers.

Principles for Government Involvement

To this end, the Administration believes that any federal intervention in the insurance market should adhere to four key principles:

1. Intervention should encourage, not discourage, private market incentives to expand the industry's capacity to absorb and diversify risk.
2. Intervention should be temporary, permitting us to review in the future the ability of the insurance industry to price these risks and absorb losses.

3. Private market actors should face appropriate price incentives to encourage efforts to minimize the probability of a terrorist event and to limit losses should such an event occur.

4. Private sector uncertainty about liabilities that arise from litigation should be reduced.

Importantly, these principles do not imply an objective of providing government assistance to the property and casualty insurance industry; rather, the principles address implementation of the objective of mitigating short-run cost increases for insurance.

The Administration's approach to Terrorism Risk Insurance adheres to each of these four principles. In order to see this, please allow me to first explain the basic outlines of how this approach would work.

The Administration Approach

After reviewing several options and discussing terrorism risk insurance with industry lenders, insurance regulators, and academics, the Administration developed an approach, one with which we look forward to working with Congress. Upon enactment of this legislation, if the United States were the victim of a terrorist attack before the end of 2002, the federal government would pay for 80 percent of the first $20 billion of insured losses, and 90 percent of insured losses in excess of this amount. The private insurance industry would pay for the remaining insured losses.

In the year 2003, the industry would be responsible for the first $10 billion in insured losses, and 50 percent of insured losses between $10 billion and $20 billion. Above $20 billion, the federal government would continue to pay 90 percent of all losses.

In the year 2004, the third and final year of this program, the industry would be responsible for 100 percent of the first $20 billion in losses, and 50 percent of insured losses between $20 billion and $40 billion. Above $40 billion, the federal government would continue to pay 90 percent of all losses.

In the event that total insured losses exceed $100 billion in any calendar year, Congress would determine the procedures for and source of any such payments.

In addition to this insurance component, the Administration approach would also consolidate all claims arising from a terrorist incident in a single federal forum. In addition, it would prohibit claims for punitive damages (other than those directed at the perpetrators), and require that non-economic damages be proportional to a defendant's responsibility (for economic losses, ordinary rules of joint and several liability would apply).

This approach is designed to mitigate economic consequences from sudden increases in the cost of terrorism insurance over the next year. The imposition of a deductible (in the second year) and a subsequent increase in the deductible (in the third year) permits the federal government to recede gradually from the market as the insurance industry adapts to measuring and pricing terrorism risk.

Consistency of Approach with Prinicples

The approach I outlined is consistent with the Administration principles outlined above.

This proposal encourages private sector capacity building in several ways. First, it is forward-looking. It respects the insurance industry's proven ability to develop the capacity to price, market, and service products for new types of risks. In the past, naysayers deemed reinsurance against the risks of natural catastrophes such as hurricanes as beyond the reach of private insurance markets. Experience has proven them wrong. By providing a temporary bridge of three years, a steadily receding Federal presence, and an explicit sunset, we will permit the industry to grow into this new market.

Second, the Administration's proposal recognizes that a limitation facing the insurance and reinsurance industry is its total capacity to absorb risk. For this reason, we provide the economic function of limiting its maximum exposure in order to provide a backstop against catastrophic losses, which could generate large increases in transactions costs for businesses and, ultimately, for consumers.

Third, because the industry shares in the losses – up to a maximum loss – and the share it shoulders rises over time, there will be a profit motive for insurance companies – and actuaries and economists – to begin now to refine pricing models. As I noted earlier, there are economic benefits to the efficient pricing of risks. While no covered individual company can control whether terrorists strike, efficient pricing can lead every covered company to take actions lessen the damage that results from terrorist incidents. After the approach sunsets, the industry will have made progress toward efficient pricing of risks. At that time, issues of pricing and the industry's capacity to absorb losses can be revisited.

In addition, having the industry participate will control costs after any event. If the government agrees to pick up 100 percent of all claims, the insurance industry has no incentive to do careful claims adjustments.

The potential losses facing insurers depend not only upon the security and economic environment, but on the legal setting as well. That is why the Administration approach would also include certain legal procedures designed to manage mass tort cases arising out of terrorism incidents. These procedures will bring damage claims closer to their economic foundation and reduce the uncertainty about the magnitude of potential claims. The consolidation of claims in a single federal forum, for example, helps to ensure that the claims will be treated in a consistent manner and eliminates the redundancy costs of litigating similar claims in multiple courts. In addition, consolidation tends to expedite the claims process, reducing the uncertainty about the length of the litigation. Limitations on punitive damages (other than those directed at perpetrators or abettors) and proportional liability for non-economic harms (except those caused by perpetrators or abettors) reduces the potential for open-ended claims that would exhaust the defendants' resources in mass tort cases. Such reforms are essential for economically enhancing the efficiency of the insurance market by increasing the ability of the insurance industry to price and absorb the risks associated with terrorism.

Conclusion

To conclude, the U. S. economy is very resilient, and, through the combined efforts of the Administration and Congress it is possible to provide transitional public policy to support the needs of purchasers of property and casualty insurance. Thank you again, Mr. Chairman, for the opportunity to appear before you today. I am happy to answer your questions.