Testimony of Kean Driscoll

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House Financial Services Subcommittee

on

Housing and Insurance

Hearing on

“The Future of Terrorism Insurance:

Fostering Private Market Innovation to Limit Taxpayer Exposure”

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My name is Kean Driscoll and I am the Chief Executive Officer of Validus Re. I am pleased to appear before you today to provide my company's perspective on possible changes to the Terrorism Risk Insurance Program ("TRIP" or the "Program") that would incent more private market involvement. I commend Chairman Neugebauer for holding this important hearing and welcome the opportunity to address the Subcommittee on Insurance, Housing, and Community Opportunity.

Validus Group ("Validus") is a leader in the global insurance and reinsurance markets, operating principally through Talbot Syndicate 1183 at Lloyd's of London, and Validus Re. Talbot has written direct and facultative terrorism business at Lloyd's for more than 12 years and it is now the largest writer of that business by income. Validus Re is one of the largest stand-alone property terrorism treaty coverage providers in the world, with an estimated 10% market share, and it evaluates business opportunities on approximately 90% of all direct and facultative terrorism business written throughout the world. Validus' guiding objective, through its operating subsidiaries, is to maximize its return on equity subject to prudent risk constraints on the amount of capital its exposes to any single loss event.

Background on Reinsurance

Reinsurance is commonly referred to as the insurance of insurance companies. The reinsurance market is global and plays an important role in maintaining the financial health of the insurance marketplace and ensuring the availability of property and casualty insurance in the United States. Reinsurance may be used by insurers for several reasons. One of the most common purposes is to transfer risk from the primary insurer for catastrophic events, including hurricanes, earthquakes, and conventional acts of terrorism. Reinsurers have responded financially to virtually every major U.S. catastrophe over the past century. By way of example, 60% of the losses related to the events of September 11th were absorbed by the global reinsurance industry, and in 2005, 61% of Hurricanes Katrina, Rita and Wilma losses were ultimately borne by reinsurers.

Background of the Terrorism Risk Insurance Program

TRIP was enacted in response to the September 11, 2001 terrorist attacks, which 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 in an unwavering manner, the events changed the way the industry views the terrorism risk.

TRIP was created to provide a federal backstop, which allowed the insurance industry to provide terrorism coverage to U.S. businesses. By limiting insurers' exposure to catastrophic terrorism losses, TRIP improved the private market for such coverage. The reinsurance industry strongly supported adoption of the Terrorism Risk Insurance Act in 2002, the 2005 Terrorism Risk Insurance Extension Act (TRIEA) and the 2007 Terrorism Risk Insurance Program Reauthorization Act (TRIPRA).

Reinsurers' Role Under TRIP

TRIP provides a large amount of reinsurance-like protection for commercial insurance exposures. Individual insurers retain a significant amount of terrorism risk losses through both a company deductible and a co-pay requirement for losses above the retention before TRIP funding is available. The insurance industry has significant financial risk and exposure to acts of terrorism because of the significant retentions under TRIP, the mandatory offer of coverage required under TRIP, state regulatory action related to rates and exclusions, and rating agency scrutiny.

Insurers may seek reinsurance from the private market to reduce the conventional terrorism exposure they face for potential losses between the deductible and loss-sharing provisions of TRIP. A reinsurer's ability to provide this coverage is limited by the amount of conventional terrorism risk it is willing and able to supply based on the amount of capital it allocates to terrorism coverage and its own specific risk evaluation. Because reinsurers are not covered by TRIP, reinsurers view TRIP in the context of the benefits provided to the broader industry as a whole.

The Current Reinsurance Market

Since 2001, insurers and reinsurers have worked hard to develop a better understanding of conventional terrorism risk. Reinsurers have created task forces, consulted military and intelligence experts, hired specialty risk modeling firms, invested in research and development, and implemented new underwriting standards all with the intention of offering private market solutions for the transfer of conventional terrorism risk. Conventional terrorism can be modeled, priced, and managed on a portfolio basis. The probability or frequency of an event can be estimated, albeit with less certainty than risk classes with a more robust historical record; however, the insurance and reinsurance industries have pioneered risk transfer solutions for many other classes of business that suffer the same shortcomings. To supplement the lack of a rich data set on frequency, we use open source intelligence that helps us estimate both the intent and capability of terror threat agents. This information is consolidated into an event set that helps us estimate the probability of various attack types at different targets.

Once we have established a perspective on frequency, we use well established modeling techniques to quantify hazard severity, vulnerability and financial loss. There is very good data on damageability from various blast sizes with secondary effects.

The question is not whether conventional terrorism risk can be priced, but rather, the precision of the parameters in a pricing model. We can and do currently price conventional terrorism risk, and estimate that approximately $7-8 billion of reinsurance coverage is purchased annually on a stand-alone basis for conventional U.S. terrorism. This excludes coverage that is included as part of general property/casualty, worker's compensation and other specialty lines coverages. We believe presently there is adequate reinsurance capacity to cover the insurance industry's current $27.5 billion retention under TRIP, and if the industry retention for conventional terrorism exposure grew over time, so to would the capacity of the reinsurance industry for conventional terrorism risk.

<u>TRIP Renewal</u>

TRIP is valuable to the insurance industry in underwriting conventional terrorism risk but it takes a "one size fits all" approach that could be modified to encourage more private market insurance and reinsurance participation. If the Committee is inclined to make changes to the Program, Validus encourages you to tailor the Program in accordance with the following comments.

1. The Program should continue to cover catastrophic terrorism loss scenarios related to nuclear, biological, chemical and radiological ("NBCR") attacks. The broader industry cannot effectively address these perils as the breadth of potential events is either unknowable or could potentially bankrupt the industry.

2. Cyber terrorism, a peril distinct from cyber liability, should be clearly covered by the Program. The scope, duration, potential damage and economic losses from this risk are also unknowable, and therefore, uninsurable.

3. The Program should clarify the process for certifying a terrorism event, including a defined time for making the certification

4. Validus has the ability and willingness to assume more conventional terrorism risk exposure, and I believe the reinsurance industry also has the ability and willingness to meaningfully expand its capacity for conventional terrorism risk. To reflect the fact that the industry's appetite for writing conventional terrorism risk has grown since the last extension, the Program could be modified through a variety of ways, including:

    a. Gradually increasing the insurance industry retention and the size of a qualifying terrorism loss under the Program. This reduces the likelihood of having to fund a loss through taxpayer funds and it avoids short-term price and capacity dislocation in the broader industry.

    b. An expansion of the co-participation which would better align the insurance industry with the Program.

5. The insurance industry is a critical facilitator of effective risk management in virtually every industry, and every facet of life. Risky behavior, or highly exposed assets typically result in a higher premium charge. Policyholders can reduce higher premiums through effective risk mitigation techniques. Currently, the Program impedes the ability of the insurance industry to properly price its products, by shifting the risk of a conventional terror attack from the policyholder to the taxpayer. The improper allocation of a risk premium facilitates unintended outcomes. We see this phenomenon playing out in the flood market, as the heavily subsidized National Flood Insurance Program ("NFIP") has produced significant deficits. Congress should encourage a greater private sector risk bearing role and appropriate risk pricing. Insureds and insurers will then have an incentive to mitigate risk and price it

appropriately, and Congress can focus on genuinely becoming a "reinsurer" of last resort for conventional terrorism risk.

6. Finally, special consideration should be made for smaller insurers, as well as for the insurance industry generally with respect to workers compensation exposure accumulations in metropolitan areas, which could be disproportionately impacted in the near term by any of the changes to the Program.

Thank you for the opportunity to testify. We look forward to continuing this dialogue as the renewal process moves forward.