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Testimony of

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Committee on Financial Services

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Introduction

Thank you Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee for the opportunity to testify today. My name is Sean McGovern. I have responsibility for Risk Management at Lloyd's and am also General Counsel. It is a privilege to share our views on the Terrorism Risk Insurance Act, which we believe has been an extremely successful program.

From its beginnings in Edward Lloyd's coffee house in the 1ate 17^{th} Century, Lloyd's has been at the forefront of insuring unusual and specialized risks.

Lloyd's has long been a large participant in the US insurance market, through both direct insurance and reinsurance. Our specialism is catastrophe coverage and we have been there to support the US economy in the face of many tragedies over hundreds of years, cementing our reputation with our response to the 1906 San Francisco earthquake and more recently in the very substantial claims arising from Katrina, Rita and Wilma in 2005. We know how to underwrite catastrophic risk and we have an appetite to take risk that others will not - it is our business.

I would like to begin by noting some of the experience on which our views on terrorism risk in general, and on TRIA in particular, are founded.

- Lloyd's paid more claims than any other insurer or reinsurer following the tragic events of September 11th – almost $8 billion.
- Lloyd's is a major provider of standalone terrorism coverage globally. We most recently incurred over $70 million of claims following the September 2013 Westgate Mall attack in Kenya.

- Lloyd's led the development of the standalone terrorism market in the US in the days following 9/11- a point acknowledged by Congresswoman Maloney at the full Committee hearing in September.[1]
- Lloyd's is generally wary of Government intervention and believes in free markets and private market solutions whenever possible.
- Lloyd's market has specialist providers of property and casualty insurance and reinsurance and also a growing standalone terrorism market.

Terrorism risk is different to other catastrophe risk

Notwithstanding all of the above, the nature of terrorism risk is simply different from other perils, even natural catastrophe perils. To name just a few of the differences:

- Risk assessment for terrorism is very difficult – frequency and severity are extremely hard to predict.
- Only the Government has access to intelligence information regarding terror threats and it cannot share that information with industry, nor should it.
- As the recent tragic events in Boston demonstrated, the likelihood and the mode of attack are highly variable – which adds to the uncertainty around the potential maximum size of an event.
- Although modeling exists, it has limitations – in particular, due to the infrequency of extreme terror events, there is much less historical data available to draw upon than exists for natural catastrophes.

None of this means that terrorism risk cannot ever be underwritten – we already do so after all. Nevertheless, all these factors act to substantially limit the appetite of the insurance and reinsurance industry to absorb this risk, particularly in major urban areas due to the density and accumulation of asset value.

TRIA is still necessary

Lloyd's supports the renewal of TRIA. The basic market conditions that necessitated TRIA still exist - commercial policyholders need insurance to protect the US economy against terrorism losses. But, as outlined above, the coverage of terrorism risk is different from other risks.

TRIA has been successful in giving the insurance industry the confidence to make terrorism coverage available. The availability and high take-up rates of terrorism risk insurance across all sectors of the economy are already well-documented in the record before the Committee. This availability has had a positive impact on pricing which has encouraged take-up and the result is that the Federal Government and ultimately the tax-payer are insulated from potential losses. Since TRIA, through the recoupment provisions, operates essentially as a post event cost-sharing mechanism, the high threshold for Federal involvement ensures that private capacity will absorb all but the most extreme losses.

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[1] From transcript of September 19 HCFS Hearing on TRIA: **"***the only place some companies could get insurance was Lloyd's of London. Why was Lloyd's of London able, in very limited ways, to provide insurance, yet no insurance company in America was providing insurance to anyone -- any business in New York"*

Without TRIA however, the aggregation of risk would quickly lead the industry to exclude coverage or withdraw capacity from key economic centres in the US.

There is much talk about the excess capital in the insurance industry and its ability to take on more terrorism risk. Nonetheless, it would be wrong to assume that more capital leads to a dramatic increase in the overall appetite to write US terrorism. Reinsurers need to manage risk aggregation and seek diversification. It is important also to bear in mind that there has so far been no TRIA certified terrorist attack since the program began, let alone one that reached the trigger for Government support. Should such an event occur, it is likely that capacity and risk appetite would be affected – just as with other catastrophe perils.

Lloyd's is likewise skeptical of suggestions that the ILS market could provide sufficient capacity to meet demand for terrorism cover absent TRIA. With 9/11 as the precedent, terrorism correlates more closely with adverse market events than even severe natural catastrophes[2], which would limit appetite from ILS investors who are typically looking for risks that do not correlate with financial market risk. ILS investors also typically seek very tightly modeled risks. Modeling techniques have been developed for terrorism risks, but they are limited by the relative paucity of historical data available regarding extreme terrorism losses. While we do not doubt that there will be some appetite from the ILS market, it is no cure-all.

Further factors that need to be considered include the appetite of the cedents to write the original risks without TRIA's backstop and "make available" requirement. Moreover, total reinsurance capacity does not cater only for terrorism risk – and increasing demand outside the United States offers reinsurers opportunity for portfolio diversification.

More broadly, the United States is by no means the only country confronted with the challenge of ensuring the national economy is protected in the event of a failure of counter-terrorism measures. The UK has lived with the threat of domestic terrorism for many years. Whilst the structure of the co-operation between Government and industry to make terrorism cover available in the UK is different from TRIA, the program ("Pool Re") is covered by an unlimited Government backstop. Similar arrangements exist in the major European economies (see **Appendix A**), as well as many other industrialised nations – despite none having experienced a terrorist event of the magnitude of 9/11.

Looking Ahead to Future of TRIA

Lloyd's believes the current TRIA structure is the right framework within which to encourage greater private market innovation in meeting the demand for terrorism cover. It ensures private sector involvement from the first dollar. It allows the expertise and innovation that have been developed in the context of the TRIA backdrop to evolve, rather than be discarded.

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[2] The Dow had lost nearly 1400 points from its pre-September 11th close in the first week of trading after the markets reopened. By contrast, the Dow was generally stable following Hurricane Katrina; even gaining in the first week after the storm.

While current modeling methodologies do give some ability to individual insurers to manage their own exposure to terrorism risk, they do not offer any assurance that sufficient cover will be available to meet overall demand. In that scenario, the consequences can be dramatic – as demonstrated by the economic paralysis we saw in late 2001 and 2002.

We accept the need to assess whether or not TRIA should change – and it may well be that the balance between Government and private market involvement could tilt more towards the private market. But any changes to TRIA to facilitate greater private insurance and reinsurance capacity should not sacrifice the stability TRIA has already achieved.

How changes are made can be just as important as what changes are made. For example, sudden or drastic increases in the retentions or co-shares could prompt some insurers to concentrate their capacity elsewhere.

While Lloyd's recognises and supports the goal of reducing the Government's overall exposure to terrorism risk, the best way to increase private participation and benefit from the expertise that TRIA has enabled the industry to develop, would be through incremental changes over the course of a long-term extension of the program.

Hanging the sword of Damocles over the entire edifice every few years creates instability and damaging uncertainty – for industry (the insurance industry and other impacted industries, such as commercial real estate), policyholders and taxpayers alike. By contrast, well-defined incremental changes over the course of a long-term extension of the program may provide a transparent process of reductions in the risk borne by the taxpayer. This would also be consistent with supporting gradually increasing industry appetite and capacity to underwrite terrorism risk.

Making those step-changes contingent on regular, independent assessments of availability and capacity may give a means to safeguard the steady development of a stable private market for terrorism cover.

However it is important to note that Lloyd's does not envisage the end-point of such a transition being the complete removal of TRIA. For the reasons we have outlined, we believe that TRIA will continue to be needed in some form for the foreseeable future. This is not because of any particular failure of either industry or of government, but as a consequence of sociological and political changes both within and without the United States.

Increasing urbanization combined with growing geo-political tensions has created 'tinderbox' conditions both for the emergence of new terrorist threats and also their capacity to inflict concentrated destruction. While it may be possible to increase private participation in covering terrorism risk, we struggle with the notion that there could be no federal backstop.

Nevertheless, some improvements could also be made to the administrative aspects of TRIA. The Boston Marathon attack revealed a need to clarify the operation of the certification process, due to market effects even where federal compensation is not at issue.

Most commercial insurance policies in the U.S. market cover or exclude terrorism peril by reference to a certified “act of terrorism” under TRIA. The lack of guidance to date on whether the Boston attack constitutes an “act of terrorism” therefore continues to create significant uncertainty for claims adjusters, particularly in relation to various claims-handling obligations (and time lines) that insurers face under State laws.

Where exclusions in property policies turn on certification of an event, the decision of whether or not to certify an event must be made by an independent body not a political one, and either of the insurer or the insured should be able to request a determination.

Some aspects of the program, however, should not change. For example, the design of the program as a retrospective assessment is preferable to pre-event pooling, which is always complex for an extremely low-frequency, but potentially catastrophic loss risk.

Likewise the recoupment mechanism protects taxpayers and essentially means that federal support provides bridge liquidity for those insurers hardest hit by an event.

Conclusion

Whatever the future of TRIA, Lloyd’s will remain committed to providing the fullest cover it can to its American customers – just as we did immediately after 9/11, before TRIA was enacted.

But our ability to do that will be limited by our need to manage our risk aggregation. The same issue will apply across the industry and we have no confidence that the private sector alone is capable of providing the entirety of the coverage that would be needed should TRIA not be renewed.

TRIA has been and continues to be an effective plan for stabilizing the economy in the wake of uncertain terrorism risk, while also ensuring a smooth economic recovery following a future attack. We believe that it should be renewed.

Avenues for increasing private involvement may exist, but must be explored in such a way that the market is protected should additional private market capacity fail to materialize. We look forward to working with the Subcommittee on finding ways to do this.

Thank you, and I am happy answer any questions.

Appendix A – European Government Terrorism Pools

Source: Willis European Terrorism Exposure Bulletin February 2011

COUNTRY	GOVERNMENT POOL	COMPULSORY/ OPTIONAL	LIMITATIONS
Austria	Österreichischer Versicherungspool zur Deckung von Terrorisiken	Optional	Limit €5 million per location
Belgium	No government pool is in place	Compulsory	Since May 2008 it has been mandatory for terrorism insurance to be provided by all Belgian insurers
Denmark	No government pool, however a fund established in June 2008 takes effect when insurers reserves have been exhausted	Optional	Most insurers now exclude terrorism cover from policies so cover has to be purchased separately if required
Finland	No government pool is in place	Optional	Two local insurers provide terrorism buy-back within their standard property policy
France	GAREAT	Compulsory	Terrorism exclusions apply for large risks above a stated limit, being €20 million or 20% of the sum insured, whichever is greater. Cover is 'bought back' via GAREAT
Germany	Extremus	Optional	Cover available via Extremus for risks exceeding €25 million. Terrorism buy-back for sums insured below this value is generally available via the primary Insurer
Italy	No government pool is in place	Optional	The majority of policies exclude terrorism cover where the sum insured exceeds €50 million
Netherlands	Nederlandse Herverzekeringsmaatschappijvoor Terrorismeschaden (NHT)	Optional	Government pool provides cover for risks up to €75 million per location per annum
Norway	No government pool is in place	Optional	Terrorism cover is generally excluded from commercial risks with a limited writeback. Cover is not readily available in the open market
Portugal	No government pool is in place	Optional	Cover is usually excluded from personal and commercial risks
Spain	Consorcio	Compulsory	Consorcio provides terrorism buy-back cover, subject to an appropriate premium
Sweden	No government pool is in place	Optional	Terrorism normally excluded from Property policies and is not readily available through the local market. Where required this has to be secured through the global insurance market
Switzerland	No government pool is in place	Optional	All primary property policies with a sum insured exceeding CHF 10 million exclude terrorism cover. Commercial and industrial risks also contain a terrorism exclusion for risks below CHF 10 million
United Kingdom	Pool Re	Not compulsory, however if cover is required it must be purchased for all properties of the Insured and the Insured may elect to purchase cover for property and business interruption or property only	Cover is subject to the same limits as the UK property damage/business interruption policy. The Pool Re programme provides for terrorism on an 'all risks' basis, but excludes acts of war