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February 27, 2002

Honorable Sue Kelly, Chair
Honorable Luis V. Gutierrez, Ranking Member
Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Representatives Kelly and Gutierrez:

In conjunction with the Oversight Subcommittee's February 27th hearing on terrorism insurance problems, the National Association of Insurance Commissioners (NAIC) is providing you with the attached update of actions taken by state insurance departments to address the availability and affordability of terrorism insurance in the United States. We ask that you include this letter and the attached report as part of the Subcommittee's hearing record.

Last year, beginning with our testimony before this Committee on September 26th, the NAIC and state regulators were vocal supporters of the need for a limited federal program that would bring certainty to commercial insurance markets, thereby encouraging insurers and reinsurers to offer terrorism insurance protection to their customers. When Congress failed to enact legislation before the general policy renewal deadline of January 1, 2002, state insurance departments were forced to take appropriate regulatory actions to preserve the solvency and stability of the Nation's insurance industry. However, we continue to believe a short-term federal assistance program could serve the public by making it possible for commercial insurers to accept terrorism risk. The terrorism exposure is potentially catastrophic to consumers and industry. Currently, there is no good way for private insurance underwriters to measure or control the likelihood and costs of terrorism losses.

State insurance regulators share the widespread belief in Congress that affordable terrorism coverage should be available to American businesses. Our primary legal responsibility is to preserve the financial health of the insurance industry so that all policyholders get their claims paid. As regulators, we cannot jeopardize the solvency of insurers covering homes, automobiles, and established business risks in order to require that they cover terrorism risks that nobody – not even the federal government – can presently quantify with reasonable precision. Accepting measurable risks and spreading them at a fair price is fundamental to the business of insurance, but forcibly assigning non-quantifiable terrorism risks to private insurers at this time would, in our opinion, unwisely put the entire American insurance system at risk.

State regulators have addressed the terrorism insurance issue in two basic ways. First, we are closely monitoring the financial condition of the insurance industry to assure that it remains strong. Second, most state insurance departments have approved limited commercial property and casualty policy exclusions that permit business insurers to control their terrorism risk exposure for an event that results in more than $25 million of insured losses in the aggregate. We have basically refused to permit blanket exclusions in personal coverage for home, auto, and other personal lines of insurance. Moreover, recognizing the policy exclusions approved for commercial insurers do not offer the same market certainty as federal legislation, they are set to expire 15 days after the President of the United States signs an appropriate federal assistance program, if that should happen.

As a result of state regulatory actions and market dynamics, individual policyholders and most small and medium-sized businesses today have insurance coverage for acts of terrorism. We are also beginning to see improvement in the availability of terrorism insurance coverage for large and extra-risky businesses, although the prices are high. State regulators and the NAIC will continue to monitor and re-evaluate market conditions to see if additional actions are needed to protect consumers.

State insurance departments have made some difficult decisions in trying to balance the solvency requirements of insurers with the public need for terrorism insurance coverage. We waited as long as possible to see if Congress would enact a federal assistance program. When that did not happen by January 1, 2002, state regulators in 47 jurisdictions acted to approve limited, but necessary solvency protections for the industry by January 15, 2002. Consequently, the insurance markets in America have kept working smoothly for individuals and most businesses.

State insurance departments acted effectively and promptly to address a huge national problem when federal government assistance was not available. The state regulatory response in the aftermath of September 11th – gathering information, monitoring claims, assessing solvency risks, and alerting Congress to potential displacements in the market place – illustrates that the American system of insurance supervision is second to none in moving quickly to protect the interests of the insurance buying public.

The NAIC and its members look forward to continuing our coordination and cooperation with Congress and federal agencies on insurance issues.

Sincerely,

Theresa M. Vaughan

Terri Vaughan
Commissioner of Insurance, Iowa
NAIC President

Cc: Honorable Michael G. Oxley, Chairman
Committee on Financial Services

Attachment

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Revised February 27, 2002

An Update of State Insurance Regulatory Actions Taken in Response to the Terrorist Attacks of September 11, 2001

Step 1 – Assessing the Immediate Financial Impact on America's Insurers

- Immediately following the terrorist attacks of September 11, 2001, the National Association of Insurance Commissioners (NAIC), through its Financial Analysis Working Group, began analyzing the impact on the financial position of affected insurers. Regulators focused particularly on those companies that were heavy writers of business in New York, New Jersey, and Connecticut. They identified and analyzed the financial resources of 20 primary insurance groups representing 150 property/casualty companies, 20 reinsurance groups representing about 50 U.S. and international reinsurance companies, and several Lloyd's of London syndicates. Together, these groups accounted for more than 90% of the estimated losses resulting from the terrorist attacks.

- State insurance regulators prepared and implemented financial impact surveys during the fourth quarter of 2001. These surveys asked a number of questions about the projected losses, assumptions in estimating losses, reinsurance arrangements, liquidity issues, market risk, and so forth. Based on the responses, the regulators concluded the losses were large, but manageable. No specific solvency concerns were identified during the initial evaluation; however, insurance regulators have continued to actively monitor the situation.

- State insurance regulators have also been looking carefully at insurer investments. The NAIC's financial database contains detailed information on insurer investment holdings, updated quarterly. This has enabled regulators to gauge the industry's asset exposure in sectors that were directly affected by the events of Sept. 11th. Scenario testing was performed to evaluate market risks in the airline and transportation sectors, travel and insurance sectors, high-yield bond markets, and stock markets in general. Much of the market risk of the insurance industry is held by the life insurance sector. While regulators found some insurers to have heavy exposures in these holdings, overall the industry appears to be well diversified. Less than 100 of more than 4,800 companies included in the analysis had significant capital and surplus decreases under these scenarios.

Step 2 – Assuring the Future Ability of Insurers to Pay Claims

- Following September 11th, the NAIC and its members commenced an ongoing dialog regarding possible language for commercial lines insurance policies that would exclude coverage for acts of terrorism. State insurance regulators agreed they would need to allow insurers to adopt terrorism exclusions for commercial lines if Congress failed to provide a federal financial backstop that limited insurer losses from future acts. Absent state action, the financial health and resources needed by the insurance industry to pay all types of claims could be imperiled by potential losses from terrorism that could cause insolvencies, yet could not be reasonably measured or predicted in advance.

- On December 21, 2001, the NAIC concluded that if Congress adjourned without enacting a federal backstop, the states should approve narrow commercial insurance policy exclusions for acts of terrorism. The specific recommendation was that this exclusion would apply if the aggregate insured losses exceeded $25 million for interrelated events within a 72-hour period. In addition, coverage for nuclear events caused by acts of terrorism would be excluded from the first dollar. Overt acts of biological or chemical terrorism would also be excluded from the first dollar. "Overt acts" mean acts of terrorism that actually involve or are carried out by disbursing biological agents or chemicals, or attacking a property with an intentional release of biological or chemical agents, as opposed to an incidental release of hazardous materials. In the case of liability insurance coverage, the exclusion would apply if 50 or more individuals were killed or severely injured during the event.

- The NAIC also recommended that state approval of commercial policy terrorism exclusions be "conditional." That is, the exclusions would be subject to withdrawal 15 working days after the President signs federal legislation, if permitted by state law. Thus, if the President were to sign into law a federal insurance backstop program covering acts of terrorism, 15 working days later insurers would no longer be permitted to use these exclusions. The 15-day period provides insurance regulators with an opportunity to assess any federal assistance legislation, and reconsider what actions, if any, might be appropriate regarding the use of terrorism exclusions.

- Shortly after the NAIC reached its recommendations, Congress adjourned without enacting a federal terrorism assistance program. The NAIC immediately kicked into high gear. A model bulletin was drafted that included an expedited approval process. The Insurance Services Office, Inc. (ISO), an organization representing more than 800 insurers, re-filed its proposed commercial policy exclusions according to the language agreed to by the NAIC membership. At the end of the first week in January 2002, 35 regulatory jurisdictions had approved the ISO filing. By January 17th, 47 jurisdictions had approved the ISO filing, including the District of Columbia and Puerto Rico. At the time of this update report, the ISO filing on terrorism exclusions is still under consideration in California, Georgia, Florida, New York, and Texas.

- State laws do not permit exclusions of coverage for acts of terrorism for workers' compensation insurance. Under a workers' compensation policy, the insurer agrees to pay what state law requires it to pay on behalf of an employer. Workers' compensation policies typically refer back to state statutes under a simple insuring agreement, and insurers pay the benefits that are required by such statutes. State laws do not provide for an insurer to assume only part of a workers' compensation exposure. Thus, insurers are required to cover all risks, and there is a continuing exposure to catastrophic loss for acts of terrorism in the workers' compensation line.

- In addition, 29 states have long standing laws based on the old New York 165 line fire policy. The result of this fire policy codification is that policies must continue to cover any ensuing fire that follows a terrorist act. Consequently, while an insurer can exclude the terrorist act itself from a policy, any ensuing fire must be covered in at least 29 states. At the World Trade Center, ensuing fire claims were a significant part of total losses.

- State insurance regulators have recently received policy filings from insurers asking to exclude coverage in personal lines for acts of terrorism. On January 29, 2002, the NAIC adopted a motion that effectively precludes the use of policy exclusions for personal lines. The motion reads: "It is the sense of the NAIC membership that terrorism exclusions are generally not necessary in personal lines property and casualty products to maintain a competitive market, and they may violate state law. However, we recognize that state laws vary in their authority and discretion. Further, there may be unique company circumstances that need to be considered in individual cases. We expect these cases to be limited."

- At the time of this report, the NAIC is still reviewing the possibility of implementing group life insurance exclusions. It is possible that a motion similar to that adopted for personal lines may be considered for group life insurance products.

Step 3 – Monitoring the Availability and Affordability of Commercial Terrorism Insurance

- The NAIC's Reinsurance Task Force held a public hearing in Washington, D.C. on January 17, 2002 to explore the facts behind widespread anecdotal reports of significant rate increases and availability issues – not just related to acts of terrorism, but across the board. The hearing included representatives from primary insurance companies, both property/casualty and life, as well as reinsurers, insurance brokers, reinsurance intermediaries, and financial analysts who spoke about what is occurring in the marketplace.

- Regulators knew some upward adjustments in pricing were already taking place prior to September 11th. The insurance industry has experienced underwriting losses in many lines of business during recent years, and it was clear there needed to be some price increases. State insurance departments were receiving rate increase filings in the range of 10% to 20%. That process appears to have accelerated since September 11th, particularly in November and December of 2001. While acts of terrorism play a role in these increases, it is likely that some rate changes would have taken place regardless of the tragedy.

- A confluence of several factors appears to be driving current insurance market conditions. First, there is a general increase in rates and tightened underwriting to correct for prior underpricing in some markets. Second, investment income results last year were poor and cannot be relied upon to offset poor underwriting results. Third, reinsurance costs have risen, sometimes substantially, and reinsurance coverage restrictions have been introduced. Finally, the loss of capital from the events of September 11 and the continuing terrorism threat have likely exacerbated underlying market conditions. It is difficult to separate the impact of the September 11th terrorism events from the other underlying conditions that are driving market change.

- During the January 17, 2002 hearing, state insurance regulators heard that different markets are being affected differently. In the markets for small commercial and homeowners insurance, coverage for acts of terrorism is still available; it appears, unless there is a serious terrorism exposure for a specific risk. Rate increases tend to be in the 10% to 30% range. In the middle market, there are larger increases in some areas for lines or classes of business that have experienced significant losses. Exclusions for acts of terrorism are more common in the middle market, but are by no means universal. In the large market – the Fortune 1000 companies –capacity problems have developed. These problems are driving even larger price increases, and policy exclusions for acts of terrorism in that market are essentially universal. A separate terrorism insurance market has developed where companies can get some amount of coverage up to approximately $300 million, but the rates are fairly substantial.

- Reinsurance rates are going up significantly, particularly in property catastrophe and workers' compensation insurance. Insurers are much more concerned about the concentration of risk that exists in workers' compensation in light of the fact that they cannot exclude terrorism from workers' compensation policies. For example, insurers are looking at how many employees are located at one site, as well as the site's proximity to a potential terrorist target location. Risk concentration has become a significant concern in the underwriting process.

- Since September 11th, the market has experienced some reduction in available capital, although there have been several significant capital commitments, particularly in the reinsurance industry. Primary insurers now have limited exclusions available to them for acts of terrorism, although the exclusions do not eliminate the terrorism exposure in workers compensation or, in many states, for fire ensuing. This is not an ideal solution as many American businesses are exposed to significant potential losses for acts of terrorism for which they cannot obtain insurance protection. Small or weakly-capitalized insurers are also at risk. A single terrorism event causing $25 million in aggregate loss primarily to their policyholders could put the survival of the entire entity at stake. Thus, the present situation, which can more accurately be described as a Band-Aid rather than a viable solution, remains a significant cause for concern.

- The threat of terrorism hovers like a cloud over the insurance industry. It has caused insurers to be much more careful in how they underwrite and accept risk. They are being very careful in their underwriting process, and the results are appearing sometimes as rate increases and other times as a coverage availability issue. The terrorism threat arising from the events of September 11th is exacerbating some underlying market dynamics that would have existed in any event. The good news is that capital is coming into the industry in a rapid pace, particularly into the reinsurance sector. This should help ease the capacity problem and some of the market disruptions that are occurring.

- Today's changing market conditions should be viewed as an evolution rather than a revolution. All insurance contracts did not change on January 1, 2002. While many reinsurance policies have a common January 1st effective date, most primary insurance policies do not. For an individual policyholder, the problem of terrorism exclusions will not arise until it is time to renew their policy. Thus, this is a problem that will continue to emerge over time. Further, many businesses may not be cognizant of this insurance coverage issue, unless there is a major terrorist event causing insured losses that exceed $25 million. If that threshold is not pierced, it may seem as if things are proceeding as if it were business as usual. Another major event, however, may cause severe economic disruptions, due to the probability that some businesses will have terrorism coverage while others will not.