S. HRG. 107–805

# TERRORIST RISK INSURANCE

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

HOW THE INSURANCE INDUSTRY SHOULD RESPOND TO RISKS POSED BY POTENTIAL TERRORIST ATTACKS AND THE EXTENT TO WHICH THE GOVERNMENT SHOULD PLAY A ROLE ALONGSIDE THE INDUSTRY TO ADDRESS THESE RISKS, IN LIGHT OF SEPTEMBER 11, 2001, AND HOW THESE DECISIONS WILL EFFECT INSURANCE COVERAGE AND PREMIUMS ON PROPERTY AND CASUALTY REINSURANCE CONTRACTS AS THEY COME UP FOR RENEWAL

OCTOBER 24 AND 25, 2001

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

83–472 PDF WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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## WITNESSES



### Additional Material Supplied for the Record

# TERRORISM RISK INSURANCE

**WEDNESDAY, OCTOBER 24, 2001**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10:10 a.m., in room SC–5 of the Capitol Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

## OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. The Committee will come to order.

We have a number of important witnesses this morning and therefore, I am going to make a very brief opening statement. I would invite my colleagues to do the same.

[Laughter.]

It is just an invitation. It is a request, not a demand.

This is the first of 2 days of hearings that the Banking Committee intends to hold on the issue of terrorism insurance in light of the attacks of September 11. Since that day, the Congress has been moving in a number of directions to respond to the challenges that has been presented.

This Committee, I think, did a first-rate piece of work with respect to the money-laundering issue and we expect the House to pass that bill today as part of the antiterrorism package and it will be taken up in the Senate very shortly thereafter.

Today, we examine the future availability of terrorism insurance coverage for American business. There are a number of key questions that we obviously need to address—to what extent did the events of September 11 threaten the availability of terrorism coverage? If such coverage should be unavailable, what impact might that have on the functioning of our economy? Is Federal intervention necessary to prevent disruption of the economy? And if so, what form should that take?

I want to be clear at the outset that there seems to be no question of the industry's ability to pay the claims arising from the September 11 attack, and the industry has been clear in stating that.

Currently, the U.S. insurance industry appears to be in strong financial shape and able to weather those costs. The question there is what is the situation going to be in the future?

We have a number of witnesses with us this morning, and I am going to turn to them now. First, we are going to hear from our colleague, Bill Nelson, who spoke with me about the opportunity to come before the Committee.

Of course, Bill served for 6 years as the Insurance Commissioner of the State of Florida and oversaw State insurance regulation. Of course, insurance regulation has been at the State level traditionally in this country, not at the Federal level. Another issue that arises in the course of addressing this issue that is before us is what would that do to the regulatory scheme in terms of the Federal-State arrangements? And that is something I think we also need to keep in mind.

Bill Nelson led the rebuilding of Florida's insurance market in the wake of Hurricane Andrew, which was the most expensive natural disaster in American history.

He will be followed by Secretary of the Treasury, Paul O'Neill. Mr. Secretary, we are pleased that you are here with us. Then we will hear from R. Glenn Hubbard, Chairman of the Council of Economic Advisers.

We will conclude today's hearing with a panel of: Kathleen Sebelius, President of the National Association of Insurance Commissioners; Thomas McCool of the General Accounting Office; J. Robert Hunter, Director of Insurance for the Consumer Federation of America; and Professor Kenneth Froot of the Harvard University School of Business.

Tomorrow, we will hear from two panels, one from the insurance industry and another from business generally. It is our current intention that hearing will be in this room tomorrow as well, although that could be dependent on whether the Dirksen Senate Office Building, where the Committee rooms are located, reopens.

As we all know, the Russell Building reopened today. But the Hart and Dirksen buildings still remain closed while they complete the environmental examinations.

Senator Gramm.

**STATEMENT OF SENATOR PHIL GRAMM**

Senator GRAMM. Mr. Chairman, let me say that I do believe that we wrote a good money-laundering bill. I believe it is a prototype of bipartisanship and I want to congratulate you.

I cannot help but notice that the last time we were in this room together was the Financial Services Modernization Conference, and that all turned out well.

[Laughter.]

Chairman SARBANES. Much to the surprise of many.

[Laughter.]

Senator GRAMM. But not to the surprise of us.

[Laughter.]

Let me say on this issue, it is easy to frame the parameters, but making decisions on those parameters becomes more difficult. It is clear the Administration believes, and most observers believe that, ultimately, we are going to build the cost of terrorist insurance into the rate structure of the American insurance system.

I believe it is also believed that 2 or 3 years from now, we will have much better safeguards than we had on September 11. The basic question that is being debated so far as I am aware, there may be people with other ideas that we have yet to hear from, is how do we make this transition to building this new risk into the base? The question it seems to me boils down to what is going to happen on December 31, when current insurance policies expire?

Some question has been raised about the ability of insurance companies to bear risk, say, if I were the Hartford and I wanted to insure, or I was asked to insure the John Hancock Building. It seems to me that it is important for us to remember that there is a reinsurance market. It is one of the most active insurance markets in America. It is long-standing. It is common policy for insurance companies to lay off part of their risk.

Even before September 11, if a company was going to insure the John Hancock Building, they probably would have laid off part of that risk, either through a syndicate like a bank where you have a loan that is so big that the capital of the bank will not allow you to make the whole loan.

You can either do it through a syndication or you could actually have a lead bank go out and lay off part of the loan with other banks. I have no doubt that this would happen. The question is what would the price be, and how quick would the learning curve be in terms of this insurance?

The idea that somehow we have to have a Government-sanctioned, Government-monopoly insurance pool is totally alien to my thinking and I see that, from my personal view, as a nonstarter. The question is, how do we get into the system?

I have no doubt that the Administration's proposal would work. The question I have, however, and I think it is a real question, is if you start off with the Federal Government covering 80 cents out of the first dollar of exposure, so you do not have massive pressure to set up a terrorism reinsurance market in the first year, there is the possibility that the industry would never set it up, and would simply come back to Congress in 9 months or a year and say, we have to have this continued because we cannot make the reinsurance market work.

I personally believe that the best thing to do if we are going to do this is to have a threshold amount. I think it is debatable what it is, that the insurance industry would be 100 percent liable for, putting pressure on them to go ahead and establish this market and establish this mechanism if, in fact, we mean for the Federal assistance to be temporary. And I do not know of anybody who thinks the contrary.

These are the decisions we have to make. I do want to affirm that this is our jurisdiction in this Committee. This is about a loan and this is about guarantees. This is about insurance. All insurance issues are under the jurisdiction of this Committee.

I would argue that when we write the bill, that it would probably be an amendment to the Defense Production Act. I want to just reaffirm and I believe, Mr. Chairman, we are doing it by this hearing, that this is our jurisdiction. This bill should be written from this Committee. And I know that there are other committees who have ambitions to have this jurisdiction, but I think we are committed on a bipartisan basis to see that we protect our jurisdiction.

I am also confident that, given the experience of the Members of this Committee, that we could do a better job of writing this bill than any other committee in the Congress, and that it is very important that we do it.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much.

Senator Dodd, who has a very strong interest, as we know, in this issue, is unable to be with us for today's hearing. He is attending a funeral this morning. He has submitted a statement for the record and we will have it included in the record. Is there any other Member of the Committee who would like to insert a statement into the record.

Senator BUNNING. I just want to make sure that I can put my statement into the record.

Chairman SARBANES. Certainly. Well, we will turn to Senator Nelson.

Bill, as I said, we are very pleased you are here. We know you have had a lot of personal experience in dealing with the insurance market and you were regarded as probably the most effective State insurance commissioner in the country during your tenure.

We very much welcome your observations this morning.

## STATEMENT OF BILL NELSON
## A U.S. SENATOR FROM THE STATE OF FLORIDA

Senator NELSON. Mr. Chairman, let me say what a great privilege it is to serve with every one of you. It has been a humbling experience for me. And whatever I can bring to the table today, as we work through this very thorny problem, as we grapple with a new kind of problem.

And I would like to begin my testimony, Mr. Chairman, by saying that what we ought to approach this challenge with is the question, how are we going to protect America's insurance consumers by making sure that insurance is available and affordable to protect them against the despicable acts that we have seen? That is the thrust of where I am coming from.

Insurance we know is a crucial engine to our economy. Without it, the banks are not going to make loans. Businesses will not invest or expand. And millions of jobs would be lost as the impact rippled through the economy. And so, you are meeting today to make sure that this will not happen. But neither can we allow the insurance industry, Mr. Chairman to use the September attacks as an excuse to shirk its rightful role and responsibilities. Already, reinsurance and insurance companies are saying that they are no longer going to cover terrorist attacks after December 31, when about 70 percent of the commercial insurance contracts in the United States are scheduled to expire.

Now I do not doubt that the industry's problem is a genuine problem. In the immediate aftermath of September 11, it is virtually impossible for insurers to calculate their potential liability in the face of possible future terrorist attacks. We cannot allow ourselves to be held hostage by high-pressure tactics of any industry.

And I might just recall your attention to the fact of the mistake that I personally believe that we made in the airline bail-out bill where, on a Friday, we were faced with the fact of the following Monday, that the insurers were going to pull the ticket on both United and American Airlines, which was a real possibility.

We acted. We acted in haste and in the process, what happened was that we did not get the guarantees that all of, in addition to the limited liability and the victims compensation fund, we went beyond that and did the $5 billion of grants and the additional $10 billion of loans. But we did not get in return the fact that there was going to be commensurate saving for consumers.

I have been on flights where they have a monopoly. There were only five people on the plane and they kept the prices still jacked up. Nor did we get, for example, the guarantee that we were not going to only take care of the airline companies, but we were going to take care of the airline employees. And now, you see where we are. We cannot even get that up because of the filibuster.

What I am saying is, in the haste to solve this problem, let us not make a mistake on something that is so important to keep the engine of this economy running. From our experience in Florida, I know that the insurance industry is more willing to walk away from its biggest risk and turn them over to somebody else. And I can give you book, chapter, and verse, if you want it, because when companies paid out $16 billion in claims after Hurricane Andrew slammed across south Florida in 1992, which was the costliest natural disaster in insurance losses in the history of this country, then the major players in the industry spent the rest of the decade trying to slip through State legislation that would shift responsibility for hurricane coverage to Florida's government and its taxpayers.

I am not slamming the industry. I am telling you that they provided the necessary support in crisis and they did it very well under very difficult circumstances. But I am telling you as an insurance commissioner, I had to battle how the insurance industry consistently wanted to shift the risk of hurricanes off onto Florida's government and to its taxpayers. Fortunately, we headed off almost all of those efforts. And we fought the industry's attempts since Andrew to force unconscionable and ever-increasing rates on Florida's homeowners.

Homeowner insurance rates are now stabilized in Florida and competition has returned. And that was one of the main things that we had to do. We had to have the Government step in temporarily, help nurture the private marketplace back to life, and then the competition started to stabilize the prices. It was a solution that backed up the industry if and when it had another mega-storm. And surely, there will be another mega-storm. But the emergency fund that was created in Florida, called the Florida Hurricane Catastrophe Fund, otherwise known as the Cap Fund, it was created by the State and it requires companies to pay for most of the hurricane loss and to shoulder their share of the cost of major storms. And then it spreads the risk by building up reserves with premium dollars, not taxpayer dollars.

Whatever solution that we come up with at the Federal level on terrorist coverage, I believe that the same principles of private enterprise must be applied. Government can play an important role in helping resolve the immediate crisis whose impact would be felt far beyond the insurance industry. For the most part, however, we should leave the business of insurance to the insurance business.

As you know, there are two basic plans so far, and you will hear about them in detail, the White House proposal and another plan that seems to have broad support from the insurance industry. And they are still being fleshed out. We do not have all the details to fully judge them. But based on the information that has emerged, I have some major concerns. For example, what safeguards would be provided to protect—correction—what safeguards would be provided to prohibit insurers from doing what the industry calls "cherry-picking." That is, "cherry-picking" the safest policies, or the flip side of that is, redlining the others out. In other words, once Federal help is provided, what is to stop the companies from covering only those properties or businesses that are relatively safe from terrorism and leaving the biggest risks to someone else? And what is to stop them from simply passing on any of the terrorism losses they might suffer in the form of sudden and steep surcharges against their customers? Or from finding ways, in the complex array of State regulations, of excluding acts of terrorism from the coverage consumers buy on their homes, their automobiles, and their lives? I say that anything we do here at the Federal level must assume and require that companies cover the peril of terrorism, a peril that looms so much larger since September 11.

Simply put, if the Federal Government's taxpayer resources are granted, then the terrorism peril cannot be dumped by the insurance industry. As I understand it, the Administration's plan would make the Federal Government responsible for paying 80 percent of the first $20 billion in claims and 90 percent of the next $80 billion resulting from any terrorist attacks next year in 2002. This proposal would increase the industry's liability from terrorist claims in the next 2 years, but still cap it at $23 billion in 2003 and $36 billion in 2004, with the Federal Government covering all the remaining claims. I have strong concerns about requiring the taxpayers to assume, even on a temporary basis, such a large percentage of the costs, especially at the front end. A more responsible approach, in my view, would be to require the companies to cover terrorist-related losses up to a certain level before any Federal help would kick in.

In other words, the primary insurer would cover it up to a certain dollar retention level and above that level, the risk could start to shift to the Federal Government. We should not support any proposal involving the use of taxpayer dollars unless we are convinced that the insurance companies have ample "skin in the game." And of course, the risk to the insurance companies could be spread by them purchasing reinsurance.

And then, under the separate industry-backed proposal, apparently, their proposal is that insurers would pool their premiums through the creation of a new Government-backed insurance company called the Homeland Security Mutual Reinsurance Company. And each participating company would retain 5 percent of terrorism and 5 percent of workers' compensation war risk, and leave the remaining 95 percent of each to the insurance pool.

Well, I hold true to the belief that private market solutions are more desirable than Federal intervention. But if I understand this plan correctly, the Federal Government would be responsible for covering 100 percent of any claims resulting from terrorism next year, while the new insurance pool starts to build up its capital. So look at it carefully, and as this debate progresses, we must constantly keep in mind that insurance companies are well equipped to handle most large-scale disasters.

It is true, this is a new kind of disaster. But nobody thought of the possibility a decade ago of a $50 billion hurricane. And had Andrew turned one degree to the north, instead of drawing a bead on downtown Homestead, a relatively sparsely populated area that produced a $16 billion storm loss, had it turned one degree to the north and drawn a bead on downtown Ft. Lauderdale, it would have been a $50 billion insurance storm that would have taken down into insolvency almost every company in the country that was doing business in the path of the storm.

The industry is recognized by many financial rating agencies, institutional investors, and economists as one of the strongest in the global economy. They have a lot of experience coming out of Andrew as a result of the near-death experience that they had there. Even one of the strongest companies, like State Farm, at the time had about $17 billion in surplus. Had that storm gone on one degree to the north, it would have just about wiped out State Farm's surplus at the time.

The fact is the companies have learned a lot from that experience and between them, the property and casualty and life and health insurance industry now counts nearly $3 trillion in invested assets. And the NAIC, whose president will testify here later today, has estimated that the capital cushion for the entire industry, including the life, is more than $550 billion of surplus to absorb unexpected downturns in the financial markets and adverse loss experience on its policies, including terrorist acts. In other words, the industry is flush right now with huge surpluses.

Whatever our solution in the Congress is to this aspect of the terrorist crisis, we must require insurers to pay their fair share. And as we consider the public policy implications of terrorism, reinsurance. I believe we must proceed in a deliberative fashion. And in my view, Mr. Chairman, this is just one suggestion from one Member of the Senate, that means reaching agreement in the coming weeks because of the shortness of time, on a short-term, what I would argue, no more than a 1 year or interim solution, to ensure that insurance protection against terrorist attacks remains available for the new year in 2002, and then to resume our work after January 1, to develop a more permanent plan.

That approach would also enable us to consider reform of the current system of insuring against natural catastrophe disasters. Despite our progress in Florida in dealing with the hurricane threat, the fact remains that no single State, no single industry, no single insurance company, could cope with the kind of mega-catastrophe of the big one of the hurricane or the earthquake located at exactly the right place because you are talking about in excess of $50 billion in insurance losses from the big one, either earthquake or hurricane.

In lieu of the perennial debate that we have over establishing a Federally backed insurance pool, I have been intrigued by other proposals of the way that you could approach it, by setting aside part of the profits for a rainy day. The idea is to let companies develop tax-deferred reserves and thereby, increase their capacity to respond to catastrophic loss. There needs to be a lot of deliberation on this and that is why, when I respectfully suggest that you may want to meet this immediate crisis that we are facing coming at the end of this year, with an interim solution, and then come back next year.

I know this Committee is clearly one of the ones that takes a keen interest in these problems, along with the Commerce Committee, and I look forward, Mr. Chairman, to working with you toward legislation, both short-term and long-term, that will keep our economic engines running, but also protect the consumers that we all serve.

Thank you for the opportunity. I am happy to take your questions or comments.

Chairman SARBANES. Thank you for a very helpful statement.

I might just observe that, while you are not on this Committee, you are a Member of the Senate, and every Member of the Senate will have an opportunity to deal with this legislation and to address this. We need to draw in as many opinions in terms of what ought to be done and how people react to the problems.

I have a couple of questions that I want to ask and they go back to your experience as an insurance commissioner. Did you have the authority to require insurance companies to offer coverage for terrorism events as insurance commissioner?

Senator NELSON. Mr. Chairman, I believe so. That question never came up because it was never a question of whether it was not to be covered. It was always assumed to be covered. And there was no exclusion.

Insurance companies are very specific about what are excluded in the coverage in a policy. And under most homeowners' policies in Florida, there was no specific exclusion for terrorism.

Chairman SARBANES. Well, suppose the companies were now to say, we are not going to cover terrorism. Could a State insurance commissioner say to the company, no, you are going to cover terrorism. If you are going to offer a policy, the policy must encompass terrorist coverage.

Senator NELSON. Were I still the insurance commissioner, I would try, Mr. Chairman, but I am not sure I would be successful.

Chairman SARBANES. Well, did they try to exclude hurricane coverage after the Florida experience?

Senator NELSON. No. That was required by law.

Chairman SARBANES. By Florida law?

Senator NELSON. Yes, as part of the homeowner's policy.

Chairman SARBANES. In other words, you could withdraw altogether from the business. But if you are going to offer a homeowner's policy, it had to encompass hurricane coverage.

Senator NELSON. That is correct.

Chairman SARBANES. And was that the law before Hurricane Andrew hit?

Senator NELSON. Yes, sir. It is called the Wind Risk.

Now there were times which, in the history of the development of coverage of Wind Risk, that there were attempts to, for example, in high wind risk areas, such as the Florida Keys, a consortium of 250 to 300 insurance companies came together to create a pool. And that was offered as an alternative of covering the wind risk in that high-risk area.

That was part of the problem when Hurricane Andrew hit, that they wanted to have that pool, that consortium of companies, cover all of the wind risk instead of an individual company, particularly in your high-density urban areas of south Florida.

And that is where we drew the line and said that we are not going to let you continue to expand and get rid of your wind or hurricane risk.

Chairman SARBANES. Did your authority as insurance commissioner also extend to the reinsurance business?

Senator NELSON. Reinsurance typically is not regulated by a State insurance commissioner or department of insurance. However, we would require certain data to be set forth so that we had some idea. But, typically, the reinsurance was not.

Chairman SARBANES. Anything else?

Senator GRAMM. Mr. Chairman, we have so many other witnesses—first of all, Bill, thank you for your testimony. I think it was very helpful to us. But out of respect for our other witnesses, I believe Bill has given us a far more comprehensive statement than we would have allowed anybody else to give, so I am not going to ask any questions.

Thank you, Bill.

Chairman SARBANES. Senator Schumer.

Senator NELSON. There is a similarity, Senator Gramm, on some of the things that you expressed and some of the things that I expressed.

Senator GRAMM. There are.

**STATEMENT OF SENATOR CHARLES E. SCHUMER**

Senator SCHUMER. Well, thank you, Mr. Chairman, and I have just a couple of questions for the witness.

First, I do want to thank you for having this hearing. From my State of New York, it is vital that we get something done. And having this hearing—this is a very interesting hearing because we are not bouncing a proposal off, nor is it a general exploratory hearing.

There is lots of division, Senator Nelson, as you ably brought out. And therefore, having this hearing will really help make up our minds on what to do and where to go to maybe seek a consensus. Let me just express a couple of thoughts to you and get your reaction to them.

I worry that if we do not have some kind of legislative remedy, downtown New York will not be rebuilt, that given that we are at the epicenter of what happened, given that, while the insurance companies are clearly paying off all of the prior claims, that no one is going to insure in the future. And that may not just be for downtown Manhattan, although probably, we have the greatest liability or risk. But it might be for any new, large project anywhere, unless they can be assured of getting insurance.

And so, right now, as we sit probably in a recession, we do not want to have it decline much further. To risk not doing anything because we all cannot come together on an agreement, could really push us much further down the economic ladder. So I think it is important we do something.

I also think that we have to look at two issues—pricing, how do we, as you say, ensure the dense economic centers get coverage, a large project. This is in the future, and that is one thing that I guess I would like to make clear to everybody.

We are not looking at any bail-out of the past. The insurance industry is paying for everything that happened in downtown. There are going to be disputes here and there. I hear there is one, whether it is two incidents or one incident. But, overall, they are stepping up to the plate and paying.

The issue is the future. And unlike hurricanes, you had the most massive hurricane, but we had previous experience with hurricanes. And the day after the hurricane occurred, or a month or a week after, there were not warnings from our Nation's leaders—expect something else again, like the hurricane that occurred, the largest ever.

And so, I am not sure the analogy exactly applies. We have more pricing experience with hurricanes and we also had some experience with how regularly such a devastating hurricane over a populated area would occur. We have no experience here.

I think that we are playing with fire by saying, well, let us let the market see if it can solve this problem, and then maybe next year, we will come back. That is one issue. And the second issue is duration.

The solution that I think seems to be gathering a little steam is let the Government come in and pay an agreed-upon percentage for a year to help the industry renew contracts that we know are coming up December 31.

The problem is, will anyone build anything if they do not know what is going to happen a year later? Because these large projects are not of 1 year duration.

I do agree that perhaps in 2 or 3 years, we will have a little more experience and a little more market experience as to where to go. But we do not have it now.

I think the analogy with the Florida hurricane, while we certainly can learn from it, and your wisdom is going to be really needed by all of us because you have more experience with this than anybody else, but it is inexact. It is not precise.

Senator NELSON. May I respond?

Senator SCHUMER. Yes, I do want you to respond. So I would just like to know: Do you agree that the analysis is not precise? And what do you say, not only to my constituents in Manhattan, but to any large developer around the country?

The one other point that I would make is I think we have some divergence of interest between the insurance companies, which are very concerned, as they should be, with getting those policies renewed come January 1. That is for existing buildings.

But when I talk to real estate developers and entrepreneurs and everybody like that, they say that without a longer-term solution, they are not going to build a thing. That means rebuilding downtown Manhattan, but it might mean building a tall building in Detroit, Atlanta, Indianapolis, or Trenton. Banks will not give them the loan.

So that is the question I would like to ask you. Not so much to do this for the sake of the industry, but to do it for the sake of the economy of the country, which is hanging in the balance.

Senator NELSON. Senator Schumer, you, we, are under the gun. Insurance contracts that are to start 2½ months from now, less than 2½ months from now, they have to have notices sent out on cancellation, whatever the contract calls for. Typically, it is 45 to 60 days.

We are under the gun right here to get something done for the first of the year. And what my recommendation is to you, that you just cannot get the long-term permanent solution done. It needs more thought.

I have suggested to you that a potential solution is get insurance companies' "skin in the game." They have a retention level that you all set in law that up to that level that they pay, and above that, that the Federal Government either pays or participates in whatever form you may—you will hear a proposal later on about loans that would be paid back and loans that would be like guarantees that have a direct pass-through to the consumer. Bob Hunter of the Consumer Federation of America is going to make a proposal like that to you. It certainly entitles your consideration of that proposal.

I do not equate this to the hurricane risk. I am just telling you about the last big insurance catastrophe that we went through that I happened to be in the middle of the storm and had the responsibility as the regulator of pulling us out of, and want to share with you some of the things that I learned in the process and some of the nature of the insurance industry, which it will try to dump that risk if it can, when in fact, it is fairly robust in its health, and it is in the business of insuring risk. And again, we can all say that there is just never been a risk like this, and what is that unknown out there in the future?

That is why you have to act quickly. But I am not sure that you can act totally comprehensively in the next week and a half, is what we are talking about.

Senator SCHUMER. Would you agree, though, if we did no solution or a 1 year solution, that it would create a significant damper on economic growth next year?

Senator NELSON. Well, that is a consideration—we cannot do no solution. I do not think we can do that. So let us find the delicate balance.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SARBANES. Senator Bunning.

## COMMENT OF SENATOR JIM BUNNING

Senator BUNNING. No questions at this time. Thank you.

Chairman SARBANES. Senator Bayh.

## STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman. I have one question.

Senator I agree with so much of what you said. You gave an excellent statement. Your endorsement of market-based solutions, I think all of us would agree with that. I certainly do. And your concern with consumers and taxpayers being at the heart of our focus here I think is on target.

My question, you also mentioned at the very end about the unique nature of this risk and at the beginning of your statement, you mentioned about the impossibility of pricing this risk at this moment in time. Isn't that at the heart of the question here, which is, are we experiencing a market failure that puts the interests of consumers and taxpayers at peril?

That, it seems to me, is really the issue, and for particularly large risks, bet-the-company type risks. Won't the companies, if you go the consumer route, build in a risk premium, that if the Government acts to reduce some of that uncertainty, can be taken out, thereby reducing the aggregate cost to society as a whole?

Because the American people are going to pay for this one way or the other. You either pay for it through the consumer mechanism, which is spread through the economy in everything we buy, or you pay for it through the tax mechanism, in which case the taxpayers pay.

The difference between consumers and taxpayers to me seems to get blurred at the end of the day. So how do we reduce the aggregate amount of risk in an inherently unstable situation, it seems to me, seems to be the question. And if they really cannot price the risk, is not there a legitimate role for Government to step in a market failure and try and deal with that?

Senator NELSON. All very legitimate points, Senator. There is good news and bad news.

The good news is that the insurance industry is clearly capable of taking care of the losses that occurred on September 11. The bad news is, as you have raised the question, on a going-forward basis, how do you value that risk and how do you pay for it?

And nobody knows what that cost is going to be in the future. And that is why I am suggesting that you have to create a formula whereby, at the outset, the insurance companies have "skin in the game," so they will not walk away, and that they have to cover that initial loss up to a certain level, called the retention level, and then you can allow the Federal Government to participate either in direct grants or in loan guarantees. And you will hear two of those addressed by Mr. Hunter later on.

Senator BAYH. The final point I would make, Senator Nelson, and thank you for your contribution here today, is it seems to me we are trying to reduce as much as possible the inherent uncertainty in this unprecedented situation.

And the point Senator Schumer made I think is an excellent one. We have economic decisions that need to be made in the short run that are long-economic decisions, 6 to 7 year investments, bank commitments, that kind of thing. And if that uncertainty is not reduced, these decisions simply will be deferred or cancelled outright. Unfortunately, we are in the business, of having to make decisions now to protect the long-term interests of the economy. Some of this is unavoidable.

Senator NELSON. Well, said.

Chairman SARBANES. Senator Miller.

## COMMENT OF SENATOR ZELL MILLER

Senator MILLER. I have no questions.

Chairman SARBANES. Senator Stabenow.

## COMMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. No, thank you, Mr. Chairman.

Chairman SARBANES. Senator Corzine.

**COMMENT OF SENATOR JON S. CORZINE**

Senator CORZINE. Pass.

Chairman SARBANES. Senator Carper.

**STATEMENT OF SENATOR THOMAS R. CARPER**

Senator CARPER. There are two Senators in the U.S. Senate whose names are Nelson. And they are both former insurance commissioners. I do not know if that has been pointed out here today.

[Laughter.]

And I like to refer, when we have one of them on hand, as the half nelson. And when they are both present, as to what is referred to as the full nelson. But the half nelson is better than no nelson.

So thank you for being here.

[Laughter.]

One quick question. You have referred a couple of times to the financial health and strength, underlying the insurance industry. I just want to ask you to expand on that, if you could, please.

Senator NELSON. Yes. In the aftermath of Hurricane Andrew, the reinsurance markets of the world went haywire. It was hard to get reinsurance and when you got it, you had to pay through the nose to get it.

Over time, as the nurturing of the private marketplace came back, as the hurricanes did not hit that were devastating in their losses, that reinsurance market came back vigorously. And the insurance marketplace came back vigorously.

The surplus in the property and casualty lines is somewhere in the range of about $300 to $350 billion these days. The overall insurance industry surplus is in the range of about $550 billion. And that is in an industry that has about $3 trillion worth of assets.

The insurance industry is strong. And that is why I say you have to have some “skin in the game” as you devise what is going to be the mechanism by which we offset these risks.

Senator BAYH. Thank you.

Chairman SARBANES. Senator Allard.

**COMMENT OF SENATOR WANYE ALLARD**

Senator ALLARD. Mr. Chairman, I do not have any questions. Thank you.

Chairman SARBANES. Bill, thank you very much.

Senator NELSON. Thank you, Mr. Chairman.

Chairman SARBANES. It is very helpful.

Senator NELSON. Thank you.

Chairman SARBANES. Mr. Secretary, we would be happy to hear from you and your colleagues.

Let me say to the Members of the Committee, given the nature of the subject, its complexity, and the admission on the part of all of us that we are searching for a solution and a consensus, I am not going to rigorously hold witnesses to a highly limited time. I think it is very important that they get the opportunity to lay out their position because this is not only a situation in which the concept is important, but the details of the concept are in important and interrelate to the judgment about what should be done.

Mr. Secretary, that is not a carte blanche to go on forever——

[Laughter.]

——but it is a partial carte blanche to go ahead and lay out your position.

We very much appreciate your being here this morning. I might note that the Secretary was originally scheduled to come before this Committee. This had been arranged a long time back, to talk about the Treasury report on currency manipulation and international trade and that complex of issues.

Given where we are, we thought we should change the nature of the hearing. So we are pleased that you are here. We would be happy to hear from you, sir.

**STATEMENT OF PAUL H. O'NEILL**
**SECRETARY, U.S. DEPARTMENT OF THE TREASURY**

Secretary O'NEILL. Senator, thank you very much. And with regard to the other——

Chairman SARBANES. We will bring you back on the other issue.

Secretary O'NEILL. I was going to say, with regard to that, I know that we must deal with this issue today. But I look forward very much to coming back and sharing with you the action the Administration is taking and thank you all very much for what you are doing in strengthening our hand to deal with money laundering and associated issues that we believe will permit us to achieve the present objective of shutting down the financial means the terrorists have to support their activities.

So I look forward very much to coming back for that engagement.

Mr. Chairman, I do have what I would characterize as a long statement for me. But I have an oral statement that is quite a bit shorter that I think carries the essential points.

Normally, as you know, I would submit my statement for the record. But this is a sufficiently complicated subject, that, if you do not mind, I am going to work my way through what I think will take maybe 10 minutes to lay down the terms.

Chairman SARBANES. Very good.

Secretary O'NEILL. It is a pleasure to be with you, Senator Gramm, Members of the Committee. I appreciate the opportunity to comment on terrorism risk insurance. We believe that there is a real and pressing need for Congress to act on this issue now. Market mechanisms to provide terrorism risk insurance coverage have broken down in the wake of September 11. Such coverage is now being dropped from property and casualty reinsurance contracts as they come up for renewal, with most policies renewing at year-end. If we in Congress fail to Act, reinsurers have signaled their intention to exclude such coverage, meaning that primary insurers may have to drop this coverage or institute dramatic price increases. As a result, after January 1 the vast majority of businesses in this country are at risk for either losing their terrorism risk insurance coverage or paying steep premiums for dramatically curtailed coverage. If businesses cannot obtain terrorism risk insurance, they may be unable to obtain financing or financing may be available only at a much higher cost. This would have widespread effects as businesses of all types may, for instance, be unable to expand their facilities or build new facilities.

Let me state what I believe the problem to be. First, insurance companies do not take risk. They knowingly accept and mutualize risk. Because insurance companies do not know the upper bound of terrorism risk exposure, they will protect themselves by charging enormous premiums, dramatically curtailing coverage or, as we have already seen with terrorism risk exclusions, simply refuse to offer the coverage. Whatever avenue they choose, the result is the same—increased premiums and/or increased risk exposure for businesses that will be passed on to consumers in the form of higher product prices, transportation costs, energy costs, and reduced production.

Another way, any of the choices has the potential to cause severe economic dislocations in the near-term, either through higher insurance costs or higher financing costs. Since September 11, the uncertainty surrounding terrorism risk has disrupted the ability of insurance companies to estimate price and insure risk.

Now to the question of what I believe our objectives should be. In grappling with this problem, we have several objectives. First and foremost, we want to dampen the shock to the economy of dramatic cost increases for insurance or curtailed coverage. We also want to limit Federal intrusion into private economic activity as much as possible, while still achieving the first objective, and we want to rely on the existing State regulatory infrastructure as much as it is practicable to do so.

I would like to talk briefly about a shared loss compensation program, which is what we are recommending that you consider. After reviewing an array of options, we have developed an approach that we believe best accomplishes these objectives. This approach reflects the current evolution of our thinking on this issue. But I also want to say that we want to work with you and with the Congress to achieve the best possible solution. This is such a new and novel problem, that we think we need to evolve in our thinking. I must say to you that the real test will not come in what we produce. We will only know if we have succeeded if life goes on in insuring a risk in the private market and businesses have the ability to achieve financing, so that our economy can return to a much higher rate of real growth than we are now experiencing. There is no other test that makes any difference. The real test is does what we do allow our economy to go forward in a good way?

When terrorists target symbols of our Nation's political and military power, they are attacking the Nation as a whole, not the symbol. This argues for spreading the cost across all taxpayers. Yet, there are also reasons to limit the Federal role. If property owners do not face any liability from potential attacks, they may underinvest in security measures and backup facilities. In addition, the insurance industry has sufficient experience and capacity to price some portion of the risk associated with terrorism and has the infrastructure necessary to assess and process claims.

Under the approach we are suggesting, individual's businesses and other entities would continue to obtain property and casualty insurance from insurance providers as they did before September 11. The terms of the terrorism risk coverage would be unchanged and would be the same as that for other risks.

Any loss claims resulting from a future terrorist act would be submitted by a policyholder to the insurance company. The insurance company would process the claims and then submit an invoice to the Government for the payment of its share. In other words, we would use the existing insurance claims process infrastructure to deal with potential claims experience.

The Treasury would establish a general process by which insurance companies would submit their claims. The Treasury would also institute a process for reviewing and auditing claims and for insuring that the private/public loss-sharing arrangement is apportioned among all insurance companies in a consistent manner. State insurance regulators would also play an important role in monitoring the claims process and insuring the overall integrity of the system.

Through the end of 2002, the Government would absorb 80 percent of the first $20 billion of insured losses resulting from terrorism, and 90 percent of insured losses above $20 billion. Thus, the private sector would pay 20 percent of the first $20 billion in losses and 10 percent of losses above that amount.

Let me say parenthetically here, when I say the private sector, I mean the customers of insurance companies, not the insurance companies, because if you understand how business works, then you know there are no insurance companies who can survive if they do not collect the loss values that they must pay out from the people that they service in the form of premiums. I think it is a very bad mistake of logic and understanding of how economics works to believe in fact that insurance companies actually pay for the losses that they cover. They are simply the transmission belt that mutualizes risk among people with similar exposures.

Under this approach, the Federal Government is absorbing a portion, but only a portion, of the first dollar of losses, which we believe is important to do in the first year of the program. The key problem faced by insurance companies right now is pricing the terrorism risk. We favor a first-dollar loss-sharing approach in the first year because we are concerned about premium increases over the next 12 months. We see this as the best way to mitigate against premium increases, but it may not be the only approach. And again, we want to work with you in finding an approach that will work in the marketplace.

The role of the Federal Government would recede over time under our proposal, with the expectation that the private sector would further develop its capacity each year. In 2003, we would have the private sector be responsible for 100 percent of the first $10 billion of insured losses, 50 percent of the insured losses between $10 and $20 billion, and 10 percent of the insured losses above $20 billion. The Government would be responsible for the remainder.

In 2004, the private sector would be responsible for 100 percent of the first $20 billion of insured losses, 50 percent of the insured losses between $20 and $40 billion, and 10 percent of the insured losses above $40 billion. The Government would be responsible for the remainder.

To preserve flexibility in an extraordinary attack, combined public/private liability for losses under the program would be capped at $100 billion in any year and it would be left to the Congress to determine payments above $100 billion.

The Federal Government's involvement would sunset after 3 years. This approach would also provide certain legal procedures to manage and structure litigation arising out of mass tort terrorism incidents. This includes consolidation of claims into a single forum, a prohibition on punitive damages, and provisions to insure that defendants pay only for noneconomic damages for which they are responsible. It is important to insure that any liability arising from terrorist attacks results from culpable behavior rather than overzealous litigation. These procedures are important to mitigating losses arising from any future terrorist attack on our Nation and are an essential component of the program I have outlined.

In conclusion, Mr. Chairman, for the reasons I have set forth, the Administration believes that the economy is facing a temporary but critical market problem in the provision of terrorism risk insurance. Leaving this problem unresolved threatens our economic stability. The approach I have outlined limits the Government's direct involvement and retains all of those elements of our private insurance system that continue to operate well and provides a transition period to allow the private sector to establish market mechanisms to deal with this insidious new risk that confronts our Nation.

Mr. Chairman, I would be pleased to respond to questions that you and the Members may have.

Chairman SARBANES. Well, thank you very much, Mr. Secretary.

Did you all examine the riot reinsurance program that was put in place after the 1968 riots?

Secretary O'NEILL. Yes, I think we looked at what we consider to be analogous kinds of situations and the staff looked at the riot reinsurance. I think we did not find it to be a very compelling equivalent to what we are facing with the terrorism risk that we are now facing.

Chairman SARBANES. Why not?

Secretary O'NEILL. Sheila, come up here, would you?

You know Sheila Bair.

Chairman SARBANES. Certainly. Sheila's nomination was approved by this Committee in record time.

[Laughter.]

That is how well we know her.

Secretary O'NEILL. And I must say that I greatly appreciated it.

[Laughter.]

Ms. BAIR. I must confess, that was one of the early suggestions that we got. We looked at it. I think we thought it involved too much of an infrastructure.

As I understand that program, the funds are set up on a State-by-State basis. It looked like a more dramatic permanent fix to a problem that we thought was very temporary. It has been several weeks since we looked at it, but I would be happy to talk to your staff later about more of our analysis.

Chairman SARBANES. I think it is probably worth looking at.

Mr. Secretary, how would you assure, if the Government is going to take a significant part of the cost of some of this risk, if the premiums charged by the companies for the balance of the risk will not be excessive, so that, in effect, the taxpayer is on the hook to pay the responsibility that the Government is assuming, and then the taxpayer as consumer is in effect overpaying on the premium side for the risk that is retained by the company?

Secretary O'NEILL. In a way, I think your question goes to the center of the problem.

If you walk around the problem from the point of view of the different participants, let us say, first of all, that you are a business owner and you need to have terrorism risk insurance.

Why do you have to have it? Because your bank will not continue to support you. They will not give you money, either for continuation for rollover loans or for a future investment, if you can prove to them that you have protected them and have the ability to pay back the money that they have loaned you in the event that you suffer the loss associated with a terrorist catastrophe. And so, as a business person, you are forced into a position where you must find some coverage.

And under the proposal that we have made, if you saw this as an economy with one insurance company and one business person and you, the insurance company, now were at risk for $4 billion. And let us say for purposes of illustration, that my business had a $4 billion catastrophic loss potential. Then, as an intelligent business person, you would probably seek to charge me something close to the value of me being the target of a terrorist event that costs me $4 billion.

How do we keep that being the experience in the situation that we are talking about through the competitive process of insurance companies seeking to provide coverage, which is how they make their money, after all, by charging premiums with an expectation that, through the combination of premiums and investment, a flow of funds, that they are going to be able to make a market rate of return? That is what insurance companies do. Like all other business, they are out there trying to make a market rate of return. And through the competitive process, multiple millions of business owners will be approaching insurance companies and hundreds of insurance companies will be trying to make sales, if you will. And through that process, there will be a determination of what the premium is that is required on an insurable basis.

And that is part of the reason that we have suggested that we take a 3 year approach to this. We are facing a cliff on the first of January. And since we have not really priced terrorist acts before, we are going to go through a learning process.

I guess I would say, in a succinct way, the response to your answer is the competitive process will not permit rapacious pricing by the insurance companies because the competitive process will get this down to a level that the general judgment says, at this premium rate and with reinvestment of funds, we are protected against a $4 billion loss.

Chairman SARBANES. Well, I have other questions, but I will defer to my colleagues.

Senator Gramm.

Senator GRAMM. Well, thank you, Mr. Chairman. Let me say, Mr. Secretary, that I have sat in many hearings on this Committee and others. I have never heard a better statement on the subject than you gave today and I want to thank you for it.

Secretary O'NEILL. Thank you.

Senator GRAMM. Let me go through three principles and see if you agree with them and then I want to just talk about your proposal and my own thinking on it. First of all, the question was raised earlier about eliminating risk, other than through law enforcement, private security, restructuring physically potential targets, and the use of American military.

When we have used all of those vehicles, whatever risk remains, I would say as a first principle, is that risk cannot be eliminated. No bill that we could pass, no law that we could write could eliminate that risk, that all we can do is redistribute it, and ultimately, redistribute it from the person paying insurance premiums to the taxpayer. Do you agree with that principle?

Secretary O'NEILL. I think, generally, with this one caveat.

If you think about insurance, what it does is it mutualizes the risk against people in like situations. If you think about the insurance industry taking this $4 billion worth of exposure in our first-year proposal, there is an assumption basically that there are enough people out there who are willing to pay premiums to have their terrorist coverage, that we have effectively mutualized the cost of the risk that is associated with their exposure to the people who choose to buy or who, for financial reasons, are forced to buy policies, and that population is a smaller subset than the general population. But at the end of the day, you either have that subset of the population that mutualizes and shares the cost and the risk, or the taxpayers do, yes.

Senator GRAMM. The second principle would be that private insurance as the basic structure is the cheapest way to lay off this risk and manage risk. And I do not know of any evidence that Government has ever been more efficient than private insurance.

Secretary O'NEILL. I would agree with you completely.

Senator GRAMM. The third is not a principle, but an objective. I am sure you share my objective that nothing we do here would in any way permanently get the Federal Government in the insurance business.

Secretary O'NEILL. That is the last thing we should do.

Senator GRAMM. As I look at your proposal, let me first say that I think your proposal is a good proposal. And I think if we adopted your proposal, that it would be a dramatic improvement over the *status quo.* Can anything be improved? I guess you can always debate that.

It seems to me that, as I look at it, the various proposals that are being made—first of all, the proposal by the insurance industry, for us to sanction a monopoly reinsurance pool, is an absolute nonstarter with me. I assume it is with you.

Secretary O'NEILL. You are right.

Senator GRAMM. It seems to me that the real question is, based on our experience with reinsurance, could we, to use Bill Nelson's words, get the insurance—I do not want to use his words.

[Laughter.]

But the point is, it seems to me that if we are talking about a relatively small amount of risk given the size of the industry, $10 billion, for example, that if the Federal Government were backing up a program where the first $10 billion was the liability of the insurance industry—in other words, moving your proposal really 1 year forward—the disadvantage of that is you have a very compressed process whereby reinsurance would be marketed.

My guess is that in this interim, you would have a lot of insurance companies that would become the primary insurer and they would line up partners individually, and then the reinsurance market would come in and say, well, we can really do that more efficiently if you will just simply contract with us. My guess is that that is how it would happen.

That is the cost of skipping a year in your program. I think the advantage of skipping a year in your program is you would put pressure for the reinsurance market to develop. And one of my concerns is that the comforting effect of having the Federal Government there with the first dollar coverage, 80 cents on the dollar, would be such that if I were in the insurance business, I might want to come to Congress in 9 months and say, well, look, we have not developed this reinsurance market and therefore, we want you to extend this program. One of the advantages of skipping a year would be to force the development of this market sooner.

I think also, from a political point of view, which is a relevant factor here, is that Members would feel more comfortable if the first exposure were private and the Federal Government were a backup, part of the backup process, rather than the Federal Government being on the hook for the first dollar. Let me just get your reaction to those alternatives and the trade-offs. It is not a question of right and wrong.

Secretary O'NEILL. No, I understand, Senator.

I believe we have what you are saying as a suggestion for the second year of our program. Let me tell you why we did not end up with it as the first year of our program. We do not have much time, and I do not want to name them because I do not want television reporting that O'Neill said these are high-visibility targets. But you all have in your own mind, there are places in our country that are high-visibility targets that have a billion dollars' worth of value. If I own one of those places—let me be the owner first—and I have to have insurance because my financing is going to walk away with me if I do not have terrorist insurance.

So with the $10 billion, in effect, deductible that is out there for the industry to absorb, I am one insurance company. So if I am going to write insurance for one of these high-visibility, multibillion dollar places, then I have to get a very big premium because the Government does not do anything until I have had a $10 billion loss. And it could be all my loss as an individual company unless there is a reinsurance pool possibility for a mutualization of the risk among insurance companies somehow. It is really that question of whether the market can develop quickly enough.

I have no doubt that there will be a reinsurance market developed for this kind of risk-in-kind. But there is uncertainty and in the early days, my guess would be, because these are not fools who put their money into reinsurance or into insurance companies, they will insist in the early days on a higher risk premium than they will likely need going forward. There is a counterpoint, which is this, and it is directly related to what Senator Nelson said.

What the insurance companies had to do after they had huge catastrophic losses because of hurricanes is they had to raise the premiums going forward to put themselves on a sound financial basis.

Again, we are reminding ourselves, insurance companies do not accept risk. They mutualize it. And they pay their losses out of premiums and earnings on premiums that have come in. And it is that that provides the basis for our economy to operate in the way that it does to absorb risk.

I do not have any trouble with your idea if we could quickly test it. And if I may offer this. One thing is we have talked about this. I do not think we are going to know whether the terms that you all adopt in your legislative proposal are going to work until we have had a real market test. And therefore, it may be useful for you all to think about the possibility of giving the Executive the ability to adjust these terms.

If, in the first instance, after you have drawn a line and it does not work, and we find that we are in trouble because we do not have a whole lot of time to go through an elaborate reconsideration of the legislation.

So just a thought for you. Believe me, not a reach for power. We could do without this. But we need a mechanism that is going to be able to adjust the market conditions and work in the real world, and we need it quickly.

Senator GRAMM. And my time is expired. But the problem is, the fact that you have that power affects behavior.

Secretary O'NEILL. You are right. You are absolutely right.

Senator GRAMM. That is the problem.

Chairman SARBANES. I say to my colleagues, we are going to hand everyone—because we do not have the lights here—after 5 minutes, we will hand you a piece of paper. We do not want to cut anyone off in midstream. But then we would like you to start winding it up.

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman.

I want to thank you, Mr. Secretary. You have been out front on this issue early, and that is really important, I think even in terms of assuring the markets now that we are looking at a solution. Just a quick question. There are some in the Congress who say we do not need any solution at all next year. Do you strongly disagree with that?

Secretary O'NEILL. I just do not think that we are in a workable position because with the reinsurance companies pulling out, we are going to face real-life situations out there where people will not be able to get financing.

Senator SCHUMER. My two other questions relate to the specifics of your proposal. I am worried about two things and I wish you could address both.

One is what Bill Nelson referred to as "cherry-picking" or "fail-safe" or whatever. Even if you do not do what Senator Gramm suggested, and do this very generous proposal in the first year, how do we know that some very important existing entities, buildings or just large physical entities, which is what is at the most risk, a lot of value, economic value concentrated in a small space, I guess, how do we know that they will get any insurance, that the insurance companies will say, look, I will write with this 80 percent, I will write for this, this, this, this, and this, but I will not write for 5 percent of the economy. And that would really create unusual havoc.

Secretary O'NEILL. I think there is no doubt in my mind that the market will eventually provide risk insurance or terrorism risk insurance for everyone.

But if we think about this problem in a way that we are all more familiar with. If you are buying automobile insurance, it is experience rated, which means if you are over 25 and you have three children and you do not drink and smoke and do other things, that insurance companies will like you and you will get the preferred premiums. If you are 15 years old and you have never been to driving school, your premiums are unbelievable.

Senator SCHUMER. And there are some people who no one will insure.

Secretary O'NEILL. That is right.

Senator SCHUMER. The State government steps in and does it.

Secretary O'NEILL. All right. And what the insurance companies do, though, effectively, and your example is the top-off case, what they do is they create an experienced rate of premiums and assigned risk pools and that is going to happen in this case.

It is obvious that some of the high symbolic value things have a higher risk associated with them than a suburban home in a tract development.

Senator SCHUMER. Correct.

Secretary O'NEILL. And the insurance industry will work through its market process with bid and ask on the part of buyers and sellers, and the premium rates will be established.

Senator SCHUMER. But how do we know—and I am going to ask my second question now so you can answer both. But how do we know that there are going to be some part of the economy, a valuable part, albeit, a small part, for which there will either be no insurance or the rate will be so high that, in effect, there will be no insurance? And if you could answer that. And then let me ask my second one.

Chairman SARBANES. You cannot do that.

Senator SCHUMER. Yes, I understand.

Chairman SARBANES. We have been through that before. I can say, I have three questions.

[Laughter.]

Senator SCHUMER. I just want to hurry him up, so I get in my second before you start singing, Mr. Chairman.

[Laughter.]

Secretary O'NEILL. I think we need to work this issue really hard. I think there are arguments that can be made on your side that we need to anticipate uninsurable companies or situations. We do not have a magic bullet answer that I am going to throw my body on the fire for. We should work with the Committee on this.

Senator SCHUMER. I would like to work with you on that.

My second question relates to my dialogue with Senator Nelson. I have heard from numerous banks, that they will not insure long-term projects if they are only given 1 year or 2 years, or even 3 years, of some certainty that insurance will exist.

We are talking about prospective rather than retroactive. We are talking about new projects rather than existing, although it might apply to refinancing as well. And that worries me.

Now, the alternative proposal, the pool proposal, deals with that issue better, although, admittedly, it deals with some issues worse. Could you please address your view about how much dampening will be placed on the economy unless we have some longer-term solution, a 1 to 3 year solution. I fear it is moving back away from 3 years to 1, that if we do not have such a thing in place, we are going to prevent lots of lending and projects from being built. Even if the entrepreneur wants to go ahead, the banks are cautious fellows and they do not lend unless they are assured of insurance for the term of the project.

Secretary O'NEILL. Let me draw on my experience as an industrialist who had properties that were worth in excess of a billion dollars' apiece. And recall in that incarnation, what I found is that the insurance policies that I had that were full catastrophic coverage, including explosions, but not as a self-initiated intentional act, but as a catastrophic failure of a boiler or something, that all of my policies had cancellation provisions in them and/or, and usually and/or, provision for resetting the premium on an experience basis.

I think the idea that we have to provide 30 years' worth of iron-clad insurance protection to people is just wrong-headed. It seems like a plausible thing. But I have not found that to be my experience that my financial backers insisted I had to have 30 years' worth of iron-clad insurance coverage for a property that was at risk.

It was at risk for cancellation and it was at risk for premium adjustment. But I never found a bank or that my equity investors said we cannot invest in you or we are going to discount your value because you do not have 30 years' worth of protection.

Senator SCHUMER. But in this new world we are in, wouldn't the fact that we do not know what is going to happen create a real dampening effect on the economy if we have a short-term plan?

Secretary O'NEILL. I think if we can do something and set the terms down for a year, then we will have an experience base and say to the American people, which I think we can all do in good faith, if this does not work quite right, we are going to revisit it and we will adjust the terms and conditions because we are all determined that we are not going to be set back by these people and we will figure out a way to do it. I think we will be fine. As long as we make a good-faith commitment to the American financial community and the individual investors, we will be fine.

Senator SCHUMER. Thank you, Mr. Secretary. Thank you, Chairman Sarbanes.

Chairman SARBANES. Senator Bunning.

Senator BUNNING. Mr. Secretary, I have real problems with the Federal Government guaranteeing profits for insurance and reinsurance companies.

Secretary O'NEILL. I would not ever suggest that we do that in any way, shape, or form.

Senator BUNNING. Well, your proposal does—I mean, you are guaranteeing whatever premium they charge, whatever risk and investment they make, they cannot lose over a certain amount.

Secretary O'NEILL. And I am assuming that the competitive marketplace will bring them into a position where they will be able to make a market rate of return on the risk that they are taking and no more.

Senator BUNNING. That is a debatable question in your proposal.

Secretary O'NEILL. I agree with what Senator Nelson said about insurance companies being flush and all the rest of that. I do not know about the rest of you, but I know a lot about investment. I do not know anybody who is rushing out because they think insurance companies are such a preferred investment vehicle, that they prefer insurance companies over all the other investments.

My experience is that the markets grind very finely. And is anybody making a whole lot more than the market rate of return, either competition or the process of competition and price competition grinds people down so that it is very hard on a sustainable basis to make more than the market rate of return. I am assuming, with the event of terrorism, we did not lose our ability to run a capitalist society that produces that result.

Senator BUNNING. I am worried about the fact that if you have first-dollar coverage on a terrorism act, why should I as a reinsurer try to adjust to the market when the following year, you are going to take a certain percentage also? And only at the end of 3 years, I might want to change the way I approach my reinsurance company or my insurance company.

Somebody brought the economy up and I think that is really interesting, that this act, this hideous act that happened on September 11, is a disaster for the economy.

The economy was a disaster before September 11. This is just adding to it. We had an even growth in the second quarter, a negative growth in the third, and a negative growth in the fourth. And heaven help us, we had better not start out 2002 with a negative growth in the first quarter then. Or else, these things will not mean a thing, what you are trying to accomplish by your proposal. We do have State insurance commissioners. They are capable of dealing with this problem.

As Senator Nelson said, he had to deal with premiums and requiring premiums in law that required insurance companies to write catastrophic insurance for hurricanes. Or else they could not practice insurance or they could not do business in Florida. Well, there is the same capability in New York, Illinois, or wherever that we are capable of assuming there is major risk.

I believe insurance companies intend to make money. And I believe reinsurance companies intend to make money, or they ought not be in business. What I am trying to say is, I like part of your solution, but I do not like the first dollar coverage of that. I think it is necessary we act quickly so that we insure and reinsure as quickly as possible so there is no more negative effect on the economy. But the Federal Government does things so poorly, and writing insurance policies would just be another one of those things that we do poorly.

Secretary O'NEILL. We do not want to write a single insurance policy.

Senator BUNNING. You want to have what we call an assigned risk pool——

Secretary O'NEILL. No.

Senator BUNNING. That is almost exactly what it is.

Secretary O'NEILL. No, no, no. We do not want to have an assigned risk pool at all. We do not want any pool. We do not want any Federal insurance policywriting or rating.

Senator BUNNING. What is 80 percent of $20 billion, then? That is your proposal for the first year.

Secretary O'NEILL. It is basically saying that is the part of a series of terrorist incident costs that we believe ought to be mutualized to the general taxpayer.

Senator BUNNING. In other words——

Secretary O'NEILL. In the first year.

Senator BUNNING. ——in the process of the insurance companies doing that, and the reinsurance companies doing that, you do not think that is possible?

Secretary O'NEILL. We think that there is a substantial risk if we do not do something like what we have recommended, we will have a significant dislocation in the economy on the first of January. And I can understand your view that maybe this is not right and maybe it is the wish——

Senator BUNNING. I like the other part.

Secretary O'NEILL. Maybe it is the wish of the Congress to take that risk. That certainly is a decision that you could make. And we would find out. This is different from lots of things we do here in Washington. This is going to either work or it is not going to work.

Senator BUNNING. I intend to work with the whole Committee to see to it that we come up with a reasonable solution. I hope you can work with us.

Secretary O'NEILL. Absolutely.

Chairman SARBANES. I am going to interject a question because it flows from what Senator Bunning has said. Did you consider the Government assuming the responsibility for all terrorist claims?

Secretary O'NEILL. Yes.

Chairman SARBANES. In effect, saying, it is the Government's responsibility to protect the society against terrorism. And if we fall short of that, the Government will pay these premiums. Therefore, to the insurance business, you do not have to factor it in. You do not have to take up the premiums. You do not have to have a record on which to establish it. And we will assume it.

If there are no terrorist attacks, the Government does not pay anything. If there are terrorist attacks, the Government has to certify the claims and then pay them. Did you consider that?

Secretary O'NEILL. I think, Senator, it is fair to say that, within the economic team, and eventually, in a process of consultation with the President, we looked at every conceivable way of thinking about this problem, including 100 percent Federal role for costs directly associated with terrorism.

On balance, we came down with what we have recommended to you, that we do this 3 year pilot process with the first year, 80/20. And the reason we got to 80/20 is because we think there is a high probability that it will be possible for the private industry to write policies and be in the process for claims processing and working with companies, for companies to take investment actions and the management actions to reduce risks that otherwise might not be tended to.

So, yes, we have worked this issue very hard, including everything that we thought was a logical possibility. And on balance, we have come down with what I have said to you today.

Chairman SARBANES. Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman.

Thank you, Mr. Secretary. I was interested in your answer to Senator Schumer's question. I would like to ask you, given the state of the economy right now, the macroeconomic situation, it seems to me this is a particularly inopportune time to have a significant amount of additional risk put into the marketplace.

We are trying to rebuild confidence on the part of consumers and on the part of people who make investments and all that thing. Now we are faced with a large, very difficult-to-quantify risk.

So it seems to me that something other than just a stop-gap measure was in order. We needed something to allow the industry to be able to quantify this risk and then we get out of any intervention and let them, assuming they have enough experience to do what they do better than the Government possibly can.

But I took your response to Senator Schumer to be more of, not along those lines. You mentioned the cancellation provisions and the ability to increase premiums in light of experience and that thing. Given that, why would we do anything? So I am having trouble reconciling my own sense that this is a particularly inopportune time for this amount of additional risk, that we ought to do something, something more than just 6 months or 12 months. But I took your comments to be to the contrary. Maybe I did not understand you correctly.

Secretary O'NEILL. Well, what I said is I think we should put in place, by our thought process, we should put in place a 3 year commitment from the Federal Government. But I am going to say to you again, the real test of what we do here is whether it works in the marketplace. And if someone has 100 percent certainty about what is going to work in the marketplace, I have not yet found one. I believe we have to proceed with a sense of flexibility and caution and an expectation that we may have to make some adjustments.

Senator BAYH. I guess that gets to the heart of my question, Mr. Secretary. At this moment, with the economy being in the shape that it is, perhaps it is better to err on the side of caution rather than additional risk-taking. Is that a fair way to characterize it?

Secretary O'NEILL. I am not sure how that translates into what conclusion you would draw.

Senator BAYH. That is why you have a 3 year——

Secretary O'NEILL. On the side of caution, yes.

Senator BAYH. ——proposal rather than a 6 month proposal.

Secretary O'NEILL. Six months, I would say, would not work. People need to be able to rely on at least a year's worth of understanding of what they are going to face and make a contract.

Let me be a business person. And if you told me I have to face this music every 3 months with great uncertainty, I would say you are torturing me. Why are you doing this? It does not make any sense. I need to get this out of my life after I have made a decision for the next year and I will deal with it again maybe next year, which I have to do anyway under conventional and catastrophic provisions. You get revisited every year.

And believe me, if you think risk adjustment is not real, I can tell you, if you have a boiler explosion, you know what the premium increase is going to be next year. It is going to be big enough so that, in an expected value time of 3 years or so, the insurance company got back the money it needed to pay off your claim.

Senator BAYH. Anybody who has reported an accident with their automobile has gone through that, too.

Secretary O'NEILL. You know that.

Senator BAYH. Just two other points. Something that Senator Gramm said and I think Senator Bunning touched upon it, too. The risk is what the risk is. We take steps to reduce it as much as possible. But at the end of the day, it has to be dealt with and distributed throughout society. But what we are dealing with here is a temporary market imperfection where the ability to quantify that risk is in doubt because we do not have enough experience.

It seems to me that is what we are dealing with here. And we are trying to get us through this period until the market is able to perform the function it does much better than the Government possibly could. It is just a temporary market imperfection that we are attempting to address.

My final question, Mr. Secretary, what about the British experience? They have had to deal with acts of terror for some time. How does your proposal differ from what they have instituted over there? And what has their experience been?

Secretary O'NEILL. Basically, we think the UK decided to put their national government into the insurance business. And we have elected not to take that route. I think it is true both for the UK and for Israel. They have both basically put the government into the insurance business.

We just think it is a step way too far—in thinking about the logical possibilities, we did look at that possibility. But I think we would have to have some huge additional, horrendous, ongoing experiences to get to the point where we said, this is a sensible thing for us to do.

Senator BAYH. Let us all hope it does not come to that. Thank you very much, Mr. Secretary.

Chairman SARBANES. Senator Allard.

Senator ALLARD. Mr. Secretary, I agree with you on the limited role of Government. And I also agree with Senator Phil Gramm that we need to be very careful, again, about how involved Government is in this whole process. I am searching for ways to see just where that proper role might be. I would hope that, with time, we can completely phase the Government out of this. Terrorist acts are not anything new that happened with the attack on September 11. There were terrorist acts before.

There is one question that comes to mind. Did you look at how the industry had factored in that risk, because some of those terrorist acts, even prior to that, showed the possibility—for example, in the bombing of the World Trade Center—of being huge in nature and catastrophic in nature. It seems like up to that point, the private sector had been willing to respond, or did you find that at that point in time, the private sector had not been willing to respond to that potential type of accident?

Secretary O'NEILL. You have the experts here from the insurance industry and I think your best qualified answer will come from them. Let me tell you my view of it, and this is from talking with high-level insurance executives around the country.

I think there had been the terrorist act provisions and insurance policies and it was possible to have them as long as we did not have terrorist acts. And what we are seeing now is the realization that terrorist acts are not some unimaginable impossibility. They are a reality in our society, hopefully, not again and again. And therefore, the insurance companies are now having to think about the possibility of having to deliver on their promises to pay in the event of terrorist acts. And that means they have to address the real issue of pricing for these things, instead of it being a freebie that you would give some people comfort that they were covered for terrorist acts, when you had no intention of ever actually having to pay for a terrorist act.

Senator ALLARD. Subtly, you implied, but there is a lot in the definition of a terrorist act.

Secretary O'NEILL. Yes.

Senator ALLARD. In your comments. Are you thinking about leaving it up to each individual policyholder to define this, or is this going to be something that you are going to suggest? To me, that is a real bucket of worms.

Secretary O'NEILL. I agree with you. But I think we need as tight a definition as we can fashion of what a terrorist act is. If we are going to put the Federal Government on the line, then we need to know what it is that we are putting ourselves on the line for.

Senator ALLARD. The other question I have is on foreign assets.

In your proposal, I was not clear on how you would treat property owned by Americans. Are you putting them into that risk pool, or are you holding them out separately from that? And how do you do that?

Secretary O'NEILL. Well, what we fashioned is United States.

But, again, as a business person who has operations in 36 countries, now having seen this kind of issue up front and very clear, businesses are going to face this issue and different countries will sort the problem out in different ways. And equity-holders will pay attention to whether or not our risk has been covered.

You know, I guess I can do this. There are lots of terrorist acts in some other countries that we are very good friends with and they have now incorporated these risks into their premiums in some of these other countries. It is not as though we are alone in the world. But businesses are going to have a much more complicated set of issues to deal with now. In fact, there is a different premium structure. If you are an American company and you have assets in places that are subject to lots of terrorist activity, you can tell the difference in your insurance cost.

Senator ALLARD. I thought that was an important thing to think about, the foreign coverage, because, like the Chairman said, the question came to my mind, which government are you talking about, foreign investments?

Secretary O'NEILL. Right.

Senator ALLARD. Some do a better job than others. And I would hope that we will improve and do a better job in this country as far as trying to keep terrorist acts to a minimum. I do not think it is a practical goal to completely eliminate all terrorist acts. I think we can take up organized terrorist acts perhaps that are international in nature.

Secretary O'NEILL. Again, Senator, as a business person, how you factor this in is important. Again, I do not want to name countries, but the financial premium of the intelligent business person requires in places that have more fragile governments and less robust protections against terrorist acts than the rest, then the discount rate that you can earn on your money is 18 or 24 percent instead of the 11 or 12 percent that is considered a reasonable rate of return in our economy before September 11.

So there already is a risk adjustment mechanism in the capitalist system to take into account exactly what you are talking about. And it shows up in the premium that business people require in order to deploy capital in other societies.

Senator ALLARD. Is my time up, Mr. Chairman?

Chairman SARBANES. Yes.

Senator ALLARD. Okay. Thank you.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman. Secretary O'Neill, I appreciate the thoughtfulness of your presentation, even though I might not totally agree on all aspects.

Let me just make a point that has been made and reinforced. This is a real economic issue for the moment and, in my view, the intermediate and long run. I might dispute a little bit about how much these risks get adjusted. People who write bond issues for 7 years, 10 years, and we have already seen a very significant erosion of yield spreads, virtual shutdown of the high-yield market.

I saw where one of the great motor companies is paying almost 300 over Treasuries in intermediate and long-range, which is relatively unprecedented.

I think some of this risk is already there and I think it will be an underminer of economic strength. So I think we need something, certainly in the short run, to address these issues. But I want to go to a statement you made, and you are talking about insurance companies.

If we do not believe they can make money by underwriting a particular risk, they will not cover it. There will not be availability. And there is an assumption in this testimony and from a number of my colleagues that, somehow or another, we are going to be able to quantify terrorist risk next year. We are going to get enough experience that we will be able to understand that risk and therefore, people are going to want to accept that.

And in its particulars comes the "cherry-picking." But there is no reason to believe in my mind the reinsurers are going to say that this is a great deal and we ought to step into it. As a matter of fact, most business people do not put companies at risk on things that they do not know.

We need a long-term solution that is not just completely dependent on the marketplace making a decision. I am actually troubled that there is not an understanding that our national defense somehow slips into what we are talking about here with regard to the insurance activity.

There are examples and we do not need to debate the merits and the pool, but I have some sympathy for that. And we have actually practiced that in some ways, in ways that we would not otherwise have been able to have insurance and think about nuclear power plants as a perfect example. And while it is not perfect, it is better than if we did not have it.

So I hope that we are not so firm in believing that we understand how this risk is going to work its way through the system. Are we going to be able to put a probability assessment on terrorist risk in 4 years any better than we are today, strikes me as a huge leap of intellectual view to be able to do that.

At least one business person who would like to make money, I would not bet the ranch on something that I did not understand. That leads me to believe that there may be a reason to think more broadly about what the long-term solutions are. And since the President has talked about this as a long-term situation, this is not a 1 year or other type program.

That said, I am sympathetic with what Senator Nelson said—haste makes waste too often and there is a lot of reason to think that we ought to analyze this in great detail before we come to a long-term solution. And then I get to your suggestions, which are some good ideas, and I actually like Year Two or Year Three better because I do believe that the industry ought to be responsible for managing a substantial amount of this risk. It is the catastrophic risk that I am more concerned about.

It just strikes me that this first dollar exposure is very high. I have heard your arguments about it. I would love to hear if there is any greater element on that. And then I have one other question.

Do you have a feel for how much impact on the economy failure to act would have? Do you have estimates, macroeconomic views, about how much we would undermine the economy?

So, really, two questions. Do you think we could expand and protect the economy by having a much larger first-dollar exposure of insurance companies?

And have you all done a lot of market testing on that? And what do you think the impact of failing to do anything would have with regard to the economy?

Secretary O'NEILL. R. Glenn Hubbard, Chairman of the CEA, is here and I am going to let him answer the broader—and Glenn, you can correct me.

[Laughter.]

Senator CORZINE. What would be the long-term impact?

Secretary O'NEILL. Absolutely. Again, Senator, if you think about this, and I like working problems in a way that I can understand them and think about them that reflects some experience.

If I received a notice where I was before, that my terrorism risk coverage was cancelled next year, it would not have any immediate effect on a company of the size of Alcoa with $36 billion worth of market cap. But the S&P and Moody's would probably take a new look at my credit rating and because we were so terrific, they probably would not knock us down. But other companies that were not so terrific would probably get an adjustment in their rating and that would cause them in their next roll-over financing to pay more money and, in effect, the risk value would be imposed through the financial system indirectly instead of through a premium for insurance. And we do not really know what that is.

To return to your question to the broader issue of what happens in the general economy, where you would expect to see the effect is in new project proposals. That kind of wash-through effect that I have described would happen for things that are already there.

Where you would see impact is in people not being able to get financing at all because they were not able to get terrorism insurance even during the construction period. How does that translate? I do not know. I will let Glenn give you a number for that.

[Laughter.]

Mr. HUBBARD. I could do it now if you want.

Secretary O'NEILL. I am going to say one more thing first, Glenn.

With regard to the proposal with the 80/20, I would argue that the companies, the reinsurance companies, will arbitrage between their aggregate exposure and the premiums that they are able to collect. And the more coverage that is written, the more the premiums will come down.

The companies will make sure that whatever premiums they collect, their complete exposure is covered. Otherwise, they are not running a business. They are running a lottery. And that is why I would start with what you would say is first-dollar coverage, I would say is still a considerable exposure for an individual company in the aggregate.

I expect that this competitive process will arbitrage between the maximum exposure and they would collect all of the maximum exposure in premiums. It is a reason to start with a fairly small number and develop some experience instead of making the exposure big upfront because, at least I cannot imagine that the industry is going to collect less in premiums than what we say is their first-line exposure.

Chairman SARBANES. Well, the Secretary I know has to leave at 12:15 p.m. We still have some Members and, Chairman Hubbard, you will have a chance to go at some length.

Senator Bennett.

## STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

Mr. Secretary, I appreciate you being here and I agree with Senator Gramm that your opening statement was unusually clear. We do not often get that. We appreciate the work that went into it.

Let me just see if I understand what we are saying here, because this is not an area where I have a great deal of expertise or previous experience. I just paid the premiums and went on running the business.

[Laughter.]

There is an assumption that in the uncertainty of what we face, the initial premiums of the industry will be very high. Is that a correct assumption?

Secretary O'NEILL. First of all, there is an assumption that if there is no reinsurance pool, that individual insurance companies will have to collect premiums that are large enough to cover all of their potential exposure.

Senator BENNETT. I understand that. But even with the reinsurance pool, as the green eyeshade folks sit down and figure out what the risk is going to be, they are going to err on the high side.

Secretary O'NEILL. That is right.

Senator BENNETT. Simply because they have no experience.

Secretary O'NEILL. That is right.

Senator BENNETT. And presumably, by the end of 3 years, you will have had a track record of experience so that someone in reinsurance Company X, can say, we can come in under the market with this kind of a premium because we now have enough experience to know that the exposure is not going to be as high as we originally thought it would be and therefore, the competitive forces will bring the premiums down. Is that a fair assumption?

Secretary O'NEILL. I believe so, although I want to go back to the comment that Senator Corzine made about the difficulty of pricing the risk of terrorism. I personally, and I am sure you all join me, in not wanting to have enough actuarial experience that we can price terrorism.

But if you know how insurance works, it is based on a set of actuarial judgments and experience base that gives one a basis for making some judgment about what the premiums should be when there is an event.

And even for hurricanes and tornadoes, we have enough weather experience that it is now possible to do that. I hope we never have enough experience to figure out what the costs should be, and that should be our ultimate objective.

But I think part of the reason we have suggested this graded approach is because we think we need some learning. We need to evolve our thinking. We have never really had to face this kind of issue, and we honestly do not know if it is possible to proceed in the way we have suggested and beyond to basically turn this over to a private function and let it forever be a private function.

I am saying we can, if we do not have more terrorist experience. If we have lots of additional terrorist experience, I do not know what we do next.

Senator BENNETT. Well, you are going the same direction I am. At the end of the 3 year period, we need to revisit this and see exactly what we are because, put in a slightly different context, we are dependent upon the success of the Administration in conducting the war. And if the war goes badly, at the end of 3 years we are going to be faced with an entirely different problem than if the war goes well.

Now you talk about the British. Their principal source of terrorism has been the IRA. And that has been going on for long enough that they do, unfortunately, as you say, have a base of experience on which to deal with it.

We are in a world where we do not know whether the attack on the World Trade Center and the Pentagon was the ultimate gasp of this group and the absolute most they could possibly do, or if they have in the pipeline a whole series of attacks that could replicate that over the next 3 years.

So I think you have had a thoughtful approach here, but as I try to get my arms around it, that is what I keep coming up against. I do not really know what I can endorse because I do not know what the risk is going to be, and presumably, nobody else does. Maybe Secretary Rumsfeld does, but he is not telling us.

Senator GRAMM. Because we would leak it to the media.

[Laughter.]

Senator BENNETT. Not I.

[Laughter.]

Isn't that what is driving your decision as to the first-year activity?

Secretary O'NEILL. Yes, it is, Senator. You said it very well.

Senator BENNETT. As I read the criticisms and listen to the criticisms, we say let's wait for the second and third year. Aren't you telling us we cannot wait because we have a January 1 deadline with many of these policies and we do not know? And given the fact that the insurance company does not know, that means we hit January 1 with no insurance at all.

Secretary O'NEILL. Exactly right.

Senator BENNETT. Is that——

Secretary O'NEILL. Yes, sir. You said it extremely well.

Senator BENNETT. Well, I am not trying to say it extremely well. I am trying to get it in my own head so that I understand it when we come along.

Thank you.

Secretary O'NEILL. Thank you.

Chairman SARBANES. Thank you, Senator Bennett.

Senator Carper.

Senator CARPER. Thanks, Mr. Chairman. And to the Secretary we welcome you here. Thanks for joining us today.

You brought your written testimony and it has been entered into the record. Everybody keeps saying how good your oral testimony was. Who wrote your oral testimony?

Secretary O'NEILL. You know, I am really delighted you asked me because it gives me an opportunity to say, I believe we have assembled the finest team of people that have ever been at one time at the Treasury. Sheila Bair, who you probably know, Peter Fisher, and David Ockhauser. I could go on naming fabulous people at the Treasury. I am proud to represent them and I am proud to say that Sheila wrote the oral testimony.

Senator CARPER. I know because while you were speaking, her lips were moving.

[Laughter.]

We are grateful for you and your team, for your presentation today.

I want to go back to a question that I asked of Senator Nelson. The question dealt with the underlying financial strength of the industry itself.

As I read the Administration's proposal, and I add up the industry's share of the potential cost, it looks like the industry's share in the first year could be as much as $12 billion. In the second year, maybe $24 billion. And the third year, as I recall it, it was $36 billion. That is a lot of money. But compare that, if you will, to the reserves of the industry itself and whether or not those are fair and reasonable numbers.

Secretary O'NEILL. I think the reserves are irrelevant. The reason I think they are irrelevant is this. Again, if you are a business person and you understand how business works, then you know that the reserves that they have there are there for a good reason. And if they are excessive, then competition will grind them down over time.

But the reserves are there because they are required to be there so that the company can operate in the jurisdictions where it sells policies in the event that there is a loss, the company can pay off the claims that it has contractually agreed to pay off. And so, the fact that companies have huge values in reserves has no relevance whatsoever to the taking on of new risk.

Senator CARPER. The second question I want to ask is this.

There are others who are going to testify after you, some have liked what you suggested and some will not. You have heard from critics within the Administration, Executive Branch, Legislative Branch, and the industry itself, and others. What are some of the most valid criticisms that you have heard of the Administration proposals? How would you rebut those criticisms?

Secretary O'NEILL. Well, since we are near perfect, I do not know how to answer that question.

[Laughter.]

What do I think are valid criticisms? Senator Sarbanes asked me earlier, did we look at the possibility of simply waving a wand and saying, the American people are ultimately responsible for the cost of terrorist acts?

I think that is a legitimate question. But there is a legitimate question beside it which says, or a legitimate thought process beside it which says, we have demonstrated that insurance companies are very good at assessing a risk and handling the claims process and working with clients to assure that clients take reasonable and necessary steps to reduce the risk that they have because they do not have proper security, say for this instance, or they do not have the structural integrity that is required to deal with terrorist risks, and the rest of that.

Using the insurance companies as an intermediary to make sure that the Nation presses harder on building in reasonable protections against terrorist acts seems to me to be an intelligent argument and a reason to keep the insurance companies out there interfacing the rest of the world so that we do not have to create a huge Federal bureaucracy to run a parallel insurance system.

But what this has the effect of doing by using the private industry sector to cover part of this risk is a way of spreading the cost to people who have assets at risk instead of to the general taxpayer.

And there is an argument one can have about whether it is reasonable to spread the cost through our tax and redistribution system as compared to using an insurance vehicle to accomplish it. It is an age-old argument. We will never be done with it. But I think at the moment, one thing that is really clear to me, that we need to take some action and we need to do it very soon, or we are going to regret the implication that no action has for our economy.

Senator CARPER. Thank you very much.

Secretary O'NEILL. My pleasure.

Chairman SARBANES. Mr. Secretary, I just have a couple of thoughts I want to leave with you. I know you have to get away.

First, presumably, whatever we do here becomes a precedent for health and life insurance issues as well. Is that a fair concern?

Secretary O'NEILL. We would like for it not to be. We would like to keep that off the table. But I can understand why you would think that. For sure, I think we should talk with the Committee about the reasons why we think it is not a good idea to include those. But we can do that.

Second, the complexity of this issue is reflected in an article in today's *Wall Street Journal*. I do not know if you have seen it—"Insurers Have Easy Time Raising Money."

> For a business faced with pay-outs of $40 billion or more in the wake of September 11 terrorist attacks, the property casualty insurance industry is having a remarkably easy time raising money from investors.

Then it goes on and tells about what is at work in the market.

> Behind the enthusiasm for the sector is the fact that property and liability insurers, after a decade of competing for business by lowering prices and thus squeezing profit margins, now are in a position to increase the premiums they charge.

And an analyst says, "The pattern with catastrophic losses is that the price increases are greater than the losses."

And then they do a track in the market. They say, sudden premium. And they show that the index for U.S. property and casualty insurer stocks, which was trailing behind the S&P prior to September 11, has now jumped substantially above the S&P. I do not quite know what to make of that, except that I believe that it is pertinent to get that observation out on the table.

The final point, when we did the Chrysler guarantee, which was done by this Committee, those of us who were Members of the Committee then, we wrote in provisions of fee charges and compensation to the Government for the guarantee for Chrysler, which, over time—actually, the Government came out more than whole in the situation.

Now the airlines, we moved so quickly, we did not do that, although I think there is some discretionary authority in the panel of which you were a member and which is chaired by Chairman Greenspan who can place constraints of that sort on.

Now in this instance, I gather that there is no compensation to the Government, is there, for taking on this risk that you are talking about in your plan?

Secretary O'NEILL. No.

Chairman SARBANES. I have no further questions.

Senator GRAMM. Mr. Chairman, let me just make the following comment.

I think, first of all, I am not the least bit surprised that capital is available to go into insurance and reinsurance. This is obviously going to be a growth industry. We have had a cataclysmic event. And clearly, this is going to be a new market for a new product that, in essence, has not existed. People, at least, did not know they were covering it. And that, clearly, this market is going to come into existence.

I see this, what you read there, I am not surprised and I view it as very good news because I think it is an indicator of two things.

One, if I had to bet my life on whether or not the market would not solve this problem if we did nothing, I would not be willing to bet my life on it. My guess is they will solve it. My guess is if we did absolutely zero, that this thing would sort itself out. I think we are taking a risk that I am not willing to take by doing that. But I am not convinced that the market would not solve the problem.

But what this says is that we can get the extra protection for the taxpayer by having a threshold or retention, as they call it in the insurance industry, of, say, $10 million. We can make that work.

And I think this cursory data indicates we could. And I think, second, that this is something that at the end of 2 years or 3 years, the market will be able to deal with.

I think it is good news. I think it encourages us that if we just did nothing, that we might survive it. And if we do a bridge program, we probably will not have to do a permanent program. Also I think it says to me, do as little as we can do to hedge the risk for the economy, but do not do any more.

What I am fearful of, and I would just tell you, I would rather have the Government come in and pay for every penny of terrorist losses for the next 2 years, than to get the Federal Government in the insurance business. That is the greatest fear I have, is that we are going to step into this thing now and 20 years from now, we are going to still be in the insurance business. That just scares the hell out of me, much more than what is going to happen if we do not take the first step.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Gramm.

I also note that *The Wall Street Journal*, which you probably saw——

Secretary O'NEILL. The cabbage article there.

Chairman SARBANES. They are eating cabbage now up at *The Wall Street Journal*.

[Laughter.]

It says, "We loathe cabbage, so understand the sacrifice involved when we say that we would rather eat cabbage for the next 20 years than have to suggest that the insurance industry needs some government help."

And then they conclude, it needs some help, although they are not very clear on exactly what that ought to be.

[Laughter.]

They do end up with this paragraph, "We will also admit to some nagging doubts about whether or not the industry is bluffing about shutting down on December 31. But we would rather eat cabbage than find out."

[Laughter.]

Mr. Secretary, thank you very much. You have been very helpful. We look forward to working closely with your people as we continue to address this issue.

Secretary O'NEILL. Thank you.

Chairman SARBANES. Chairman Hubbard, if you can come on up to the table, we look forward to hearing from you.

If I could have the attention of the next panel for a moment, presumably, Ms. Sebelius, Mr. McCool, Mr. Hunter, and Professor Froot are all in the audience.

We are considering doing Mr. Hubbard and then going over until after lunch, say to 2:15 p.m. We will finish Mr. Hubbard here before we adjourn for lunch and then go over and come back to resume. But I need to know whether there are any of the four people scheduled to appear on the concluding panel who would not be able to accommodate that to their schedule.

[Pause.]

Well, not hearing anything to the contrary, I believe we will call on Mr. Hubbard and then the Committee will recess until 2:15 p.m. We will resume with the concluding panel.

We want to give that panel ample time because it has been put together with—first of all, we very much appreciate the witnesses being willing to come on short notice, and we think it is a very balanced panel. We think it would give us the benefit of a lot of points of view, which the Committee is obviously trying to collect here this morning and tomorrow morning.

Chairman Hubbard.

## STATEMENT OF R. GLENN HUBBARD CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. HUBBARD. Thank you, Mr. Chairman. It was somewhat dangerous earlier when you suggested to a college professor little time limits. But I will not abuse that.

In fact, I thought this morning's *Wall Street Journal* editorial that you quoted was a nice summary and actually, pretty supportive of what the Administration wants to do.

What I would like to do——

Chairman SARBANES. Senator Gramm used to be a college professor and he has gotten very good at controlling his time.

[Laughter.]

Senator GRAMM. Fifty minutes on Monday, Wednesday, and Friday, and it was a hour and 15 minutes on Tuesday and Thursday.

[Laughter.]

Mr. HUBBARD. Exactly. And I promise to be even more abbreviated than that.

What I wanted to do, since the Secretary ably walked through the Administration's proposal, was to spend some time with you on the economic case of why we think this is so important and for the areas where we find a lot of flexibility in hoping to work with you.

I would like to begin by echoing what the Secretary said, that we are very grateful to the Committee for what it is done in the post-September 11 period and look forward to working with you on the terrorism risk insurance problem. The timing of these hearings is very significant, Mr. Chairman. Just to underscore what the Secretary said, it is not only important, but essential, that the Congress act on this issue before the end of the year.

In the simplest economic terms, one could think of the shocks to the economy that we have seen since September 11 as a kind of supply shock to the economy's ability to supply goods and services. It is in our interest as a Nation to contain the increase in transaction costs broadly that these attacks have raised.

A second feature that came up in discussion with Secretary O'Neill, is that the attacks also raised the uncertainty in the economic environment, uncertainty about the state of where the economy is, uncertainty about demand for particular goods and services like aviation to a myriad of other areas.

Commercial insurance, of course, lies directly at the intersection of these two forces. Property and casualty insurance is one mechanism by which private economies respond efficiently to the risks that are presented in the environment. Risks are spread, so that for each business, a potentially large and perhaps even unknowable, cost, is turned into a stream of smaller known premium payments. The events of September 11 induced quite a large revision in perceived risks. In normal circumstances, increased risks are simply translated into higher premiums. That is a useful thing. There is an often too quick criticism from an economic perspective to criticize higher premiums. That is a useful economic function of pricing risk. It leads the private sector toward those activities where the risk is worth it, and away from foolhardy gambles.

At the moment, however, we are not in normal times. The entire Nation is unsure about the likelihood of additional terrorist events. For insurance markets, unfortunately, the distinction between risk—that is, not knowing when an event will happen, but knowing a great deal about the odds of occurrence—and genuine uncertainty—where we do not know about the frequency of an insured event—is the key to being able to price efficiently. Experience with this new security environment will doubtlessly mitigate this difficulty over time. In the near-term, however, what we were concerned with in the Administration and what you have been concerned with in the Committee's efforts is the potential problem of a disruption in the property and casualty market in the short run.

An interruption of coverage is a particular and extreme version of this problem. It would be a very large potential increase in transactions cost.

We are all familiar by now with what happened in the commercial aviation sector—the disproportionate rises in insurance coverage or potential withdrawals of insurance coverage that hinder transitions to a new aviation operating environment. The phenomenon is more widespread. And here I want to walk through essentially the question Senator Corzine raised with the Secretary. Lenders typically require businesses of course to insure property before securing loans. So one immediate manifestation of the problem is to diminish bank lending for new construction projects. More important, perhaps, in the overall scheme of the economy is the impediment to transactions in existing commercial properties. That is, the resale of skyscrapers, pipelines, power plants, and other large assets. This changing hands, or recirculating assets, in the private economy is an important economic function. It goes to the heart of how we are able to reallocate capital in the economy.

From an economic perspective, then, there are really three issues. One is this new projects issue. Second is the issue of capitalizing costs in existing projects. We know that the 1990's were a period where, loosely speaking, we were willing to pay a lot for money in the future. Discount rates were low. The concern here is that abrogation or interruption in the insurance markets would raise discount rates capitalized into the value of existing assets, a serious problem, indeed.

A specific numerical example is that about 3 percent of domestic income is MC&P premiums, about $155 billion a year. That was for Year 2000 where, arguably, very little terrorism risk had been priced. If one thinks, then, a substantial increase would have been priced in the short run, you can get a sense of a very large flow cost to inaction.

And third, a well-functioning private insurance market has to be a core part of our financial infrastructure in the economy. And that is precisely why the Administration put together an approach and we look forward to working with the Committee and the Congress.

I think there are very important principles for any Federal Government involvement here. And the first I think received perhaps not the full attention it deserved in the earlier discussion.

I think the key and perhaps the most important element is that intervention should encourage and not discourage market incentives to expand the industry's capacity to absorb and diversify risk.

A lot of the concern here has been expressed about problems in pricing. I will come back to that. That is an important problem. But perhaps the more compelling role for any government involvement at all would be in the issue of capacity in the short run. Toward that end, again, going to the article the Chairman noted in the paper, it is precisely high short-term returns that induce investment in capacity and can be a positive thing.

A second principle is that any intervention should be temporary, permitting us and you to review in the future the ability of the industry both to price risks and absorb losses.

Third, private market actors should face appropriate incentives to encourage efforts to limit losses should such an event occur. And if I might digress for a moment, one of the problems with socializing all the costs that were discussed a little bit is that it simply provides no such incentive to the private sector, either to take responsible risks or for the insurance industry to process claims efficiently. I would submit that is a road down which you do not want to go.

The fourth principle is that private sector uncertainty about liabilities that arise from litigation should be reduced, and I want to come back to that in a few moments.

One thing that needs to be absolutely clear, and was missing even from the otherwise well-done *Wall Street Journal* editorial this morning, is that these principles do not imply providing government assistance to the property and casualty insurance industry. That is simply not the subject under discussion. The issue is mitigating short-run cost increases for an insurance scheme in an otherwise competitive market.

We believe that the Administration's approach—and I am using the word approach rather than proposal simply because we do want to work with you on all the elements—match those four principles. I am not going to go over the approach again in detail. The Secretary already did that.

But I will say again that the key element from an economic perspective is to mitigate short run, sudden increases in costs of insurance over the next year. The imposition of a deductible, Year Two in the scheme we are proposing, Year One perhaps in some of the proposals that the Committee is considering, and a subsequent increase in the deductible as we have proposed would permit the Federal Government to recede gradually from the market as the insurance industry adapts the measuring and pricing terrorism risk.

I asserted a moment ago that the Administration's proposal as the Secretary outlined was consistent with the principles. Let me just walk you through a quick economic argument as to why.

First, I think our approach is dead-centered on building private-sector capacity to absorb risk. It respects the insurance industry's proven ability to develop the capacity to price, to market, and to service products for new types of risks. I think it is important to keep some perspective here. In the past, there were naysayers who said that the private sector would not figure out natural catastrophe reinsurance. There are important differences in these occurrences, as I will come back to, but also some similarities. And I think experience has proven that the private sector has done very well. By providing a temporary bridge—3 years in our suggestion; we look forward to working with you on the length of that bridge—and steadily receding Federal presence and explicit sunset, we believe that the industry can grow, and it can grow well into this market.

Second, and going back to a point that I made a few moments ago, the Administration's proposal is centered on the idea that a key limitation in the industry—the primary insurance industry and the reinsurance industry—is one of total capacity to absorb risk. It is for this reason that we think the economic function here is limiting maximum exposures in the event of very large catastrophes which would necessarily generate large transactional cost increases for businesses. And let us be clear, that means prices for consumers.

A third reason we feel our proposal is consistent with the basic principles and economics outlined was that the industry is sharing in the losses, or skin in the game, in Senator Nelson's terms, up to a maximum loss, and the share that it shoulders rises over time. We can quibble whether it starts in Year One or Year Two, but I think I sense a pretty broad-spirited agreement on that point. And there will be an important profit motive for insurance companies to begin now to refine pricing models. Again, I think that profit motive is both good and essential to making that private market work. There are economic benefits to the efficient pricing of risks and that needs to be left to the industry. Now, having said all of this, the potential losses that face insurers, whether they are from a natural disaster like Hurricane Andrew or from a man-made disaster like a terrorist act, depend not only on the security environment we have been talking about, but on the legal setting as well.

And let me give you a quick numerical example and walk you through why we felt from the economics of the problem that some tort issues were important. The initial physical costs from Hurricane Andrew in 1992 of $6 billion became more than $20 billion, and still ticking, in part because of the cost of litigation.

The Administration wanted to include certain legal procedures that were designed to manage mass tort cases that might arise out of terrorism incidents. We believe very strongly that these procedures will bring damage claims closer to economic fundamentals and more importantly, from an economic perspective, reduce the uncertainty about the magnitude of potential claims. Much has been made in the discussion thus far this morning of uncertainty over costs of disasters, and that is an important problem. But go back to the Andrew costs. The morphing from 6 to 20 was not uncertainty about the hurricane. It happened only once. It was uncertainty about the legal system. We believe that consolidation of claims in a single Federal forum would help to ensure that the claims would be treated in a consistent manner, reducing uncertainty in the private sector and eliminating redundancy costs of litigating similar claims in multiple jurisdictions. We believe that limitations on punitive damages, obviously other than those that are directed literally against perpetrators and their betters, and proportional liability for noneconomic harm, reduces the potential for open-ended claims that would exhaust not only initial defendants' resources, but potential collateral defendants. This is the kind of uncertainty that we can work together to address, even while we are working together on the larger concern of terrorism.

We believe these reforms are not just add-ons to an otherwise good proposal. They are absolutely essential to getting a private market and insurance up and running, and that appears to be not only our goal, but I think the goal of all in the discussion thus far.

Let me say briefly a word about three roads not taken, at least in our approach that came up this morning. One was the issue of the monopoly pool model. Our concerns there were to—to put them in economic terms. One was, while I characterized the insurance business as, roughly speaking, competitive, we believe these pools could generate the potential for significant monopoly power. Let us be clear where that goes. It is a higher cost of doing business, higher prices for consumers. We view that as unnecessary, while still preserving a legitimate role for intervention you might take.

The second I referred to earlier—full government socialization. While it is possible to make an argument in that direction, I do not believe that argument holds much water upon closer inspection, precisely because of the failure to grant incentives both to individuals as managers of buildings and properties, and to the insurance industry as it processes claims.

The third that came up was the issue of charging premiums. One of the things that I hope we all can agree, or I hope we can all agree, is that we do not want the Federal Government in the long-term insurance business. We believe that the short-run issue of cost-sharing that the Secretary outlined earlier is a way to get private-sector participation and some of the costs borne directly in the P&C insurance base, without charging explicit premiums.

If we are all arguing among ourselves as to when we think the private sector will be able to efficiently price risk, let us ask the question when we think government officials would be able to do that. I think that would be close to a nonstarter.

To conclude, I think it is our view that the economy as a whole is very resilient. And we believe that the combined efforts not only of what the Administration is doing, but, importantly, its work with the Congress, can provide transitional public policies to make sure that what might otherwise be temporary disruptions do not become permanent. Again, I think the property and casualty industry raises important issues. These issues are not issues about the industry. They are issues about consumers and the businesses that provide goods and services for them.

Thank you, again, Mr. Chairman, for the opportunity and I look forward to yours, Senator Gramm's, or Members' questions.

Chairman SARBANES. Thank you very much. Is it your view that it is the cost of insurance that leads the insured to take steps against terrorism?

Mr. HUBBARD. Well, one appropriate—people, of course, have incentives for a variety of reasons to take measures against terrorism. The larger the financial incentive, the greater the incentive for hardening buildings, providing extra security systems, and so on, much as you might in your own home if you were faced with different pricing if you did different things.

Chairman SARBANES. It is your view that if the Government assumes the responsibility for paying the cost of terrorism, so that was then not factored into the insurance cost, that the insured would then be lax in guarding against terrorism. Is that your view?

Mr. HUBBARD. I think these are questions of degree.

You are painting them as poles. I think the question is, what are the incentives for me to harden a building that I own or to make sure that, if there is an act of terrorism, that the damage is not any larger than——

Chairman SARBANES. I understand that. And you think you need to put a cost into the insurance in order to get you to do that. Is that right?

Mr. HUBBARD. That is correct. I think there are two reasons for that cost.

One is for the private sector to face the right incentives. The other is for the industry to face the efficient incentives in processing claims.

Chairman SARBANES. Well, that is a different issue, the processing of claims. I recognize that point about using the expertise.

Mr. HUBBARD. Keep in mind——

Chairman SARBANES. In order to process the claims. But I am trying to get at apparently this view of yours that the really motivating factor to get building owners and managers to guard against terrorism is that it is factored into the cost of their property in casualty insurance. Is that your view?

Mr. HUBBARD. No. Keep in mind, Senator, that the difference between what is the premise of your question of what is in the Administration's proposal is 90/10 versus 100/0. So we are not talking about polar extremes.

Chairman SARBANES. That is right, which only underscores the thrust of the question.

Let me ask you this question. Why are you putting the Administration in on first-dollar damages? If you say that the problem the industry has is limiting the maximum exposure, that is what creates the problem for them. So they do not know. They might have some huge bill to pay and therefore, they have to guard against that, some enormous amount of money.

And I understand that argument. But why does the resolution of that argument require coming in for first-dollar damages on the part of the Government?

Mr. HUBBARD. The question is one of timing, Mr. Chairman It certainly is a long-run matter. If there were any role for government at all, it would be only on the back end, which is the premise of your question. But the problem we are facing is in the short run, in the market trying to figure out how to price things.

Our view was, particularly in the current economic situation, we wanted to have as minimal a disruption, as minimal and necessary increase in property and casualty rates to move to that new environment.

We have a deductible beginning in Year Two. You may well decide to do a deductible in Year One. But our philosophy was simply to keep the first year of this as blunting cost increases as possible.

Chairman SARBANES. And to ask the question that I asked earlier, how are you assured the companies do not use the premium boost in effect to overprice the risk to their pocket advantage?

Mr. HUBBARD. Well, I think the short answer to that is the single word, competition.

The longer answer would be that, in the short run, it is quite likely that an industry like this could underprice as well as overprice if the problem is uncertainty. And the increased premium——

Chairman SARBANES. How likely do you think it is that they will underprice in this circumstance?

Mr. HUBBARD. One does not know until we put a specific policy on the table. But I have no doubt that the industry in the long run would not have significant competitive price discipline.

In the short run, if the behavior you indicated happened, you would see a pretty rapid rebuilding of capacity in the industry precisely as the article that you referred to in *The Journal* suggests.

Chairman SARBANES. Well, the industry has very significant capacity now, does it not?

Mr. HUBBARD. Well, the P&C capital base is around $300 billion. There are different lines and commitments of that. But that is a pretty significant capital base.

Chairman SARBANES. Yes. Senator Gramm.

Senator GRAMM. Mr. Chairman, let me say that I do not know that it is an extraordinarily relevant point, but I think the argument that you are making against just Government providing the coverage——

Chairman SARBANES. I am not making that point.

Senator GRAMM. I know.

Chairman SARBANES. I am just trying to explore the parameters here so we get some idea of where they are coming from.

Senator GRAMM. The point I made earlier, if I knew we were getting into the insurance business, I would take it as a preferable alternative for 3 years.

The problem is getting out of it once you have gotten in it. Second, it gives you no bridge to get out of it. And you had added what I think is a very small factor in it, and that is, for example, as a business, and in some case, homeowners, you get lower insurance rates if you put in smoke and fire alarms.

You might say, well, your children are sleeping in this house. Why didn't you do that anyway? Well, the problem is, you figured, well, it may not be essential, but if I am going to get an immediate reward, I do it. People do respond to this. You get lower life insurance for not smoking. Only an idiot would smoke cigarettes, given everything we know. I know many idiots.

[Laughter.]

And respect them on all other subjects.

[Laughter.]

On that subject, they act like idiots. But, anyway, so much for antismoking.

[Laughter.]

Let me say that I strongly agree with you, Glenn, and I just want to emphasize it, on this liability. The Federal Government is stepping in—however we do this, there is going to be Federal Government exposure. And I think the taxpayer is going to want to be sure that we are providing this assistance to keep the economy going. And since we are giving this coverage, the idea that someone could sue us for punitive damages or that we would be subject to class-action lawsuits, or that a substantial amount of the cost could end up being what at least a person like me calls frivolous lawsuits, is almost unthinkable.

I think that is an important component here. And since we are backing up private money, if we do not give that coverage, at least in this interim program, to that money, it ends up being eaten up by those things and we end up being the payer sooner. So I think that is the important ingredient in your proposal, and I want to urge you to stand by it.

Let me just conclude, Mr. Chairman, by saying that I think that the Administration's proposal has a lot of good ingredients in it. I think if you just throw away the first year of your program and start with the second year the first year, you will be making a major step in the right direction.

Based on having listened to my colleagues today, we are not going on the hook for 80 cents out of the first dollar of loss. It may very well be a logical place for us to get together—and I think we can make it a bipartisan proposal, and if we can end up with something that the Administration supports, and we support it, it would be helpful.

I think we do not want—whatever agendas we have that have nothing to do with this, I think we all agree that we want to leave it out of this. I think that is the way to do it.

But I just want to thank you and the Administration for putting this, even though I do not support it, for putting together a very thoughtful and a very helpful proposal, and one that I think we can work on together, and I look forward to working with you on it.

Mr. HUBBARD. I think I will count you as a two-thirds supporter.

[Laughter.]

Senator GRAMM. Well, two-thirds is not bad.

[Laughter.]

You win a lot of elections with two-thirds. I have never achieved that total.

[Laughter.]

Thank you very much.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. Yes. Mr. Hubbard, I wonder if you have done any economic analysis if we do not act with regard to this. You talked about the categories of things that might be enacted in the economy. But have you done any runs of economic models to see how much it might actually cost the economy if we do not deal with this issue?

Mr. HUBBARD. Well, the quickest thing that we did that is to look again at the importance of premium domestic income and just make a range of assumptions about what might happen to premiums. The total amount of the premium paid is $155 billion in narrowest terms in the year 2000, a little over 3 percent of domestic income. So you can pick your favorite increase in that and get a sense of the cost hit to industry.

I think perhaps the more serious concern is the capitalization factor if discount rates in projects get changed because of a belief in the lack of insurance. That changes the value of existing skyscrapers, power plants, and so on.

Senator CORZINE. I am not sure I fully understand the analysis, but that sounds like you are pushing upward of 1½, 2 percent of GDP.

Mr. HUBBARD. I am not sure how you get to 1½. Just because the $155 billion——

Senator CORZINE. Knowing that is not going to be dollar for dollar translated through, and then you are going to have the secondary impacts with regard to the discounting numbers.

Mr. HUBBARD. Right.

Senator CORZINE. You are talking about a serious impact.

Mr. HUBBARD. That is a little too big. One hundred fifty-five billion dollars is what was actually paid before when arguing there were pricing risks at zero.

So the question is, how much do you think that would go up if you were pricing the terrorism risk? With 1½ percent of GDP, that is probably too extreme.

But that calculation misses, I think, the capitalization effects and the value of assets, and that is probably what slows down development the most, the fear that lenders have that the projects would be worth less.

Senator CORZINE. Even by that analysis, it is a very substantial amount.

Mr. HUBBARD. Yes.

Senator CORZINE. How much of the $300 billion of the capital base of P&C's do you believe has been designated for terrorism risk?

Mr. HUBBARD. You mean that is available to pay?

Senator CORZINE. No, no. We have other lines, as you suggested. So there are all kinds of other calls on that surplus.

Mr. HUBBARD. My understanding from Sheila is that they have not reserved.

Senator CORZINE. I think that is the point, when we talk about how healthy the industry is with regard to surplus. And I am not particularly in favor of no first dollar participation, the first dollar position that we have here.

I think that people take false security in thinking about $300 billion worth of surplus when we still have natural disasters and fires and other things that go on.

I also would like to know if your intent with regard to the legal recommendations that you are making are designed only to fit to the bridge proposal you have here, or are they intended to be long-term recommendations with regard to terrorism risk insurance?

Mr. HUBBARD. Well, that, of course, would be up to the Committee and the Congress. Our view is that they go hand-in-glove with a reform in this area. We are only considering——

Senator CORZINE. When they are proposed, do you expect that they would be proposed only limited to the proposal that you have and not deal with the overall context of terrorism insurance?

Mr. HUBBARD. If your question is beyond 3 years, if you decided to go the route of a more permanent program, I do not believe that the private market will function in the way we want and hope it will without these legal reforms.

Chairman SARBANES. So you are now reaching for permanent tort reform. Is that right?

Mr. HUBBARD. The question was if there were a permanent proposal. We are asking for a 3 year in our proposal set of packages. If you were designing a permanent system, it would be my advice to you as an economist that that system would not take off very well with private-market participation without these legal reforms.

Chairman SARBANES. You are complicating further a very complicated situation. I just want to make that observation. Tort reform is not a matter under the jurisdiction of this Committee, and it is a highly controversial issue. Now, in a sense, you are piggybacking it on here and we just have to take a look at that.

Mr. HUBBARD. If I might, Mr. Chairman, this is not a piggybacking. This is absolutely essential. If you go back to the argument that I gave you about Hurricane Andrew——

Chairman SARBANES. Well, some aspects of it may be and some may not be.

Mr. HUBBARD. No, that is right. What you need to do is take a look at what——

Chairman SARBANES. You are going to have one venue for hearing all these cases?

Mr. HUBBARD. Yes, Mr. Chairman.

Chairman SARBANES. Where would that venue be?

Mr. HUBBARD. It would be a single Federal jurisdiction.

Chairman SARBANES. Where?

Ms. BAIR. It would be the multidistrict panel on tort litigation.

Chairman SARBANES. Which is located, where?

Ms. BAIR. Federal Government court structure.

Chairman SARBANES. I know, but where is it physically located?

Ms. BAIR. Well, they would make the determination about where.

Mr. HUBBARD. How about Maryland?

Ms. BAIR. It would be in Federal Court. And this panel would make the determination depending on where the incident occurred.

Chairman SARBANES. You know, you all seem to assume that witnesses and aggrieved parties can travel all over the country in order to press their claims without experiencing great difficulties in doing that. I find that a fantastic assumption, if that is the premise of the system you are setting up.

Ms. BAIR. Senator, I think claims consolidation and punitive damages limits are very important.

Chairman SARBANES. No, no, you are adding other things in there. I am slicing this thing now.

Ms. BAIR. Right.

Chairman SARBANES. I am slicing it now to the venue. And as I understand it, you are going to have one venue nationwide. I am raising a very simple question, it seems to me; What does that do to litigants who would have to travel great distances at great expense and inconvenience in order to assert their legal claims? That is the question. What is the answer to that question?

Mr. HUBBARD. I am not an attorney. So the economic key to this is that you have a single jurisdiction. You can have different single jurisdictions, but there needs to be a single jurisdiction. The counter-argument to your claim is the venue shopping.

Chairman SARBANES. No, no. You suffer a terrorist problem and you live in Los Angeles, where it happened. And you have to go to Washington, DC or New York City in order to assert your claim. Do you see a problem connected with that?

Mr. HUBBARD. Well, again, you have a single jurisdiction per incident——

Chairman SARBANES. Do you think that has no problems connected with it?

Mr. HUBBARD. As opposed to the lack of consolidation of claims, then we are in an empirical argument, Mr. Chairman. The important thing is to reduce the transactions costs in the process so that the litigation costs do not wind up dwarfing the physical costs.

Chairman SARBANES. If you suffered the damage and you had to come all the way from Los Angeles to Washington in order to assert your claim, it would be an imposition on you, would it not?

Ms. BAIR. Senator, I just want to clarify. I do not think the Administration is talking about a single Federal district court to hear all terrorism claims. It would be per-incident, just the way consolidated claims in the Southern District of New York for the attacks in Manhattan.

On a per-incident basis, we would envision going forward that those claims would be consolidated, presumably, in the Federal district court where the incident occurred. But I think that is the kind of thing that we are talking about.

Chairman SARBANES. Well, that is a more sensitive and rational response to what I have been getting.

Do you have anything else, Senator Corzine?

Senator CORZINE. I am troubled by this context because if we think that this program is necessary to deal with a short-run problem by the industry and its inability to price this risk and, somehow or another, we are going to get greater comfort 2 years and 3 years from now, which I am not certain that I accept that assumption, but let us just do that for conversational purposes, and we are going to change the tort structure for the period of time while it is on, and then it is going to come off, how is the insurance industry going to learn anything?

Again, I am not arguing that we should do anything with regard to tort activities, but you are changing the whole rationale when you come back to go to the private market solution, pure private market solution, for the operation of this bridge.

That does not make sense to me. You say we want this so that we will be able to have the price discovery mechanism have enough time to go through it, but we are not going to allow for any discovery with regard to litigation that might come from personal liability, culpability, or other issues.

I do not think that the insurance companies are going to develop a book that allows them to be able to do that in that timeframe, unless you are arguing that we are basically for broad tort reform that goes beyond the timeframe of the bridge.

Mr. HUBBARD. I do not think that is any different from any other major element of the proposal. The theory is that you would review this in 3 years or whatever horizon you choose. That would include not only the legal process issues, but every other element.

I accept that uncertainty, but precisely for the reason that the Chairman indicated, we did not want to use this as an occasion to look for an entirely different permanent piece of legislation. We wanted to focus this on the property and casualty problem.

Chairman SARBANES. Well, obviously we will have to continue to explore this. I think we have to simplify this so that we have a better feel for what the ramifications or consequences are, and so that it is more easily explainable in terms of the public understanding.

But we will hear from the next panel, which I assume the Treasury will monitor. I certainly hope so, because I think the views expressed there will need to be taken into account. And we will hear from our two panels tomorrow and then see what we can sort out in terms of what is a reasonable and rational way to deal with the situation.

I want to say to the Chairman of the Council of Economic Advisers because I am looking here at an article by John Sweeney in this morning's paper, which you have probably seen. The essential thrust of it is that there is an inadequate consideration of the question of emergency jobless benefits for workers and emergency health care coverage for workers.

I think there is a growing danger that we are responding to this crisis and challenge in an unbalanced way. As someone said, actually, right at the witness table earlier today, the airline companies got help, but the airline workers did not get help. We are looking at trying to address a problem confronting the insurance industry, but there are other things that are not being done.

They are less directly related than the airline situation where they did one side and not the other. But, nevertheless, I think the Administration needs to give some additional and careful thought to having a more balanced response to this challenge, so that there is a sense in the country that it is equitable in how it is seeking to deal with the situation.

This is obviously bringing in a lot of issues that are not the focus of this hearing, and some that are well beyond the jurisdiction of this Committee. But I simply want to make that point to you, and I think the Administration needs to be thinking more broadly in those terms, in terms of having a balance in what they are putting forward and seeking that provides an assurance to the country that this is being done in a fair and equitable fashion. And I would leave you with that thought.

Mr. HUBBARD. Well, if I might just offer a quick thought in return, Mr. Chairman. The President proposed the displaced worker package that did indeed offer an expansion of unemployment insurance and increased the funding for national emergency grants, which would have provided a great deal of flexibility for Governors, not only in the jobless problem that we are now facing, but also in health insurance.

Chairman SARBANES. You are taking the CHIP money for health care for children and shifting it over, and a lot of us—it is not the purpose of this hearing to engage in that. But a lot of us think that that is just playing shell games.

We have some CHIP money out there that has been provided to the States to get health care for children. That is the approach. Some of that money has not yet been spent by the States because we are still gearing up to it, and so forth. And you are proposing to take that money and move it over here to get health insurance to unemployed people. Now we want to get health insurance to unemployed people, but I do not think we want to do it at the expense of taking it away from children.

Mr. HUBBARD. I am afraid I could not just let that comment stand, Senator. That is not really the intent at all. The CHIP program, for reasons we do not have to go into here, has a lot of inflexibility in it and does not well cover populations it is designed to cover. And this would improve that flexibility greatly.

Chairman SARBANES. Mr. Hubbard, look. We could go at this all day long. Let me just say this to you. I think there is a perception in the country on the part of a substantial number of people, and a perception in the Congress on the part of a substantial number of people, that what is being done does not have a full equity component.

I am just putting that to you in a sense, hopefully, of some friendly advice. Now you may choose not to act on it, and if so, I think this impression will continue to grow.

But this Committee has certainly tried very hard in order to do that, if you witness the speed, and I think the care as well, in which we acted on the money-laundering issue. I am just passing this along to you. You may simply consider it as gratuitous advice and proceed to ignore it.

Mr. HUBBARD. No, I appreciate it very much, Senator. Again, we are very grateful for the work the Committee did on the money-laundering front.

The one closing thought I would leave you with is, again, in your reference to the insurance industry, I would submit that is not why you wisely held this hearing. I think you wisely held this hearing about the cost of doing business in the country. And that is the problem that you are working toward and we hope to work with you.

Chairman SARBANES. We are trying to address this issue, otherwise, we would not have scheduled 2 days of hearings.

Thank you very much.

Mr. HUBBARD. Thank you, Senator.

Chairman SARBANES. The Committee stands in recess until 2:15 p.m., at which point we will take the panel that I indicated earlier that had been scheduled.

[Whereupon, at 1:05 p.m., the Committee was recessed, to reconvene at 2:15 p.m., of the same day.]

Chairman SARBANES. The Committee will reconvene.

I apologize to the witnesses. There are a lot of things happening all over the place here, as you can well appreciate.

I see we have some time constraints here. Professor Froot, you have to leave, I gather, at 3:30 p.m.

Mr. FROOT. 3:30 p.m. or 3:45 p.m.

Chairman SARBANES. Why don't we go ahead and hear from you first, and then we will pick up with the others.

And you, Ms. Sebelius, have to leave at 4:30 p.m. And we should be all right on that. Why don't we hear from you because then we will take the rest of the panel. And by that time, you may have to excuse yourself.

So why don't you go ahead?

## STATEMENT OF KENNETH FROOT ANDRÉ R. JAKURSKI PROFESSOR OF FINANCE HARVARD UNIVERSITY

Mr. FROOT. Mr. Chairman, Senator Gramm, and Members of the Committee, I appreciate the opportunity to appear before you and discuss the insurance and reinsurance markets in the aftermath of the events of September 11.

I come to this issue really as an academic economist, which I think of as a person who is good with numbers, but lacks the charisma of an actuary.

[Laughter.]

I am also very pleased to share with you this after-lunch session and note that it is an established fact that auto accidents peak between 1 p.m. and 3 p.m., after lunch each day.

[Laughter.]

What I would like to do is give you a little bit of a background on my own impression of the events surrounding Hurricane Andrew and Northridge and pull that forward to today.

I think we run the risk of considerable dislocation in these markets going forward, given especially the annual nature of reinsurance renewals. However, at the same time, we need to preserve the benefits of a vibrant insurance marketplace, high quality, evaluation, pricing, allocation, and mitigation of risk.

In the early 1990's, the United States experienced two very large natural disasters—Hurricane Andrew and the Northridge earthquake. The losses from these events were a shock to an industry that had rarely considered and had never seen losses of these magnitudes from natural perils. Firms were obviously stressed, along with their capital.

Let me spend a second of my testimony here tracing out the industry response. First, as one might expect, insurance and reinsurance prices rose spectacularly immediately following Andrew, doubling between 1992 and 1993.

The second point to make is that after these events, prices then fell steadily between 1994 and 1999, as the effect dissipated to about half of their level. Additional risk-bearing capital and new firms entered the reinsurance industry, increasing competitiveness, and approximately $10 billion of additional capital flowed into new reinsurers, much of which was the result of the attractive post-event prices.

I should comment that, in fact, as the stock prices we have seen in *The Wall Street Journal* today have increased, so, too, it has been regularly with natural catastrophes in the past, as the opportunities for insurers to write and as the demand increases following events. We see stock prices rise and capital then wanting to flow into that sector.

The third point I take from this is that the growth that has occurred through the creation of a variety of new instruments and new institutional reinsurance mechanisms. For example, there have been new prototypes for reinsurers domiciled in tax- and regulation-favorable countries. These have been developed and highly streamlined over this time period.

Fourth, additional sources of capital outside the reinsurance sector have become quite active. Cat bonds, and related financial instruments which could be purchased by investors became viable alternatives to reinsurance treaties as a way of transferring risk. Even though relatively few cat bonds have been issued, they have nevertheless promoted competition substantially in the industry.

Fifth, while this is hard to summarize in numbers, the entire discourse surrounding natural catastrophe events changed during the post-event period. Insurers, reinsurers, commissioners, regulators, rating agencies, brokers, consultants, third-party risk assessment firms, all of them became much more aware of the possibility of these events, where they might occur, what kinds of buildings were at risk, how construction techniques can be approved, et cetera. The language and vocabulary surrounding these events grew enormously, and that led, of course, to better pricing in the reinsurance and insurance markets and a better awareness, not just for risk allocation, but also for risk mitigation.

These changes have helped reduce the post-event price of reinsurance. But I think perhaps more importantly, they have also increased the amount of reinsurance protection that is commonly purchased today. If you look at the second graph of those color pictures, the ones down at the bottom labelled 4–D, it shows the fraction of reinsured losses covered at different levels of losses for the industry in 2000. The results are striking here. Before Andrew and Northridge, the most common layer of protection purchased against industry-wide events covered events of about $4 billion. As of 2000, the most popular level of loss protection had about tripled, to $12 billion. In addition, today substantial coverage has been extended to much larger levels. Protection against natural catastrophe losses of $25 billion or more is not uncommon. This is the legacy of Andrew and Northridge, and it is a permanent one, given the changes discussed above. What do I take from this little bit of retrospective for policy pointers for today?

First, I think it is very clear from this evidence that the reinsurance industry is efficient over the medium term. The industry can and does respond to large disasters. High prices certainly occur, but these motivate the response. Figure 4b shows prices have returned to their pre-Andrew levels, even as the lower Figure 4d shows that demand today for reinsurance has increased enormously. This is the sign of an economically efficient industry, one that can expand capacity, have financial innovation, and accommodate a large increase in demand with virtually no increase in price.

Second, there is evidence that this medium-term response time has grown shorter today. Following Andrew, the post-event spike in prices took several years to undo. But there are a number of reasons to believe that the response would be much faster now.

First of all, we built what I like to call hardware, institutions, Bermudan reinsurers, transformers, other financial institutional forms, including capital-market instruments, that can rapidly and smoothly incorporate new capital.

Second, there is the software around that hardware. The expertise and knowledge of the brokers, the investment bankers, the reinsurers, insurers, rating agencies, investors, regulators, all of whom are much more familiar and fluent in the activities of risk transfer in these areas.

I think there is plenty of direct evidence now that this hardware and software is at work. In just a month after these terrible events of September 11, one is aware of billions of dollars—to be precise, around $5 or $6 billion of committed funds already moving into the reinsurance sector.

We have alluded already to *The Wall Street Journal* article in the paper today that cites another billion dollars from AIG, Goldman Sachs, and one other firm. And I am aware of at least another billion and a half of funds that are in the process of being raised.

That would come to about $6 or $7 billion worth of funds, which is fully half of the entire industry requirement under the Administration proposal for the first year, all done, or not completely done, but all certainly moving very rapidly, and much of which is done in the first 6 weeks after these events, the first 6 weeks being of course the most shocking.

Third, I would say that any form of sustained provision of reinsurance by the Government will impede the kind of progress we have made in developing the software and hardware and the ability to process these kinds of issues. The decisions that need to be made throughout the economy affect exposure in real ways. What types of steel and concrete reinforcements help reinforce buildings of various heights? What kinds of physical barriers around buildings shall we have? What kinds of equipment for checking, opening, or possibly sterilizing mail would we expect? I think it is not really a question, as we heard earlier this morning, of whether we will rebuild downtown New York. The question is how will we rebuild it? What kinds of coverage will be available for specific types of buildings? I think that is going to lead, in the end, to more rational mitigation of risk and better risk allocation.

Fourth, the sheer level of uncertainty about the likelihood of terrorist attacks is not in itself a reason to replace market functions with Government programs. Critics of catastrophe modeling, of which there are many, including some of the most important reinsurance underwriters, argue that models provide false precision about the probabilities of disasters and that they are unknowable. The uncertainty surrounding the one-time potential impact of the

Year 2000 computer bug was certainly extreme. Yet, this did not stop the creation of private insurance dedicated to protecting against Y2K damages.

And in that event, of course, with respect to Y2K, one might expect as an insurer that the firm's purchasing insurance might know a good deal more and have considerable more control over their exposure to that bug than the insurer would know about. That certainly is not the case with respect to terrorist events.

In terms of the Administration's proposal, I support in a qualified way this approach of a limited, temporary, Federal intervention in the insurance market. A measured response is appropriate to assure continuity in the insurance markets and to support renewed economic growth. I agree with three of the basic principles of intervention that were discussed earlier, that intervention should generate appropriate price incentives, that it needs to encourage private market incentives to expand capacity as needed, and that it needs to help produce uncertainty about liabilities that are associated with litigation. In addition, I believe that if these three principles are to be satisfied, the sunset feature of the program is absolutely essential.

In that spirit, I would also strengthen the second principle of this program that deals directly with the sunset feature. In my view, it should read that the intervention shall be absolutely temporary and primarily intended to resolve severe, short-term dislocations of the market due to a sudden shift in risk and coverage perceptions. I believe that is what we have and I believe that is a concern, indeed, for January 1, but I believe that these concerns die away considerably over time. I do concur with Senators Gramm and Nelson that a greater participation by the industry in the first-year losses is, at least for the first dollar claims, is probably appropriate.

Over 1 or 2 years, however, I believe the market is fully capable of evaluating pricing and designing exposure to large risks. The existence of anything more than a targeted, highly temporary, Federal program is likely to forestall development of better insurance markets and pricing, better risk allocation, and mitigation decisions by the private sector.

Thank you, again, Mr. Chairman.

Chairman SARBANES. Well, thank you very much. We appreciate your statement and the effort that went into preparing it. And we very much appreciate your being with us.

Ms. Sebelius, we would be happy to hear from you.

**STATEMENT OF KATHLEEN SEBELIUS**
**PRESIDENT, NATIONAL ASSOCIATION**
**OF INSURANCE COMMISSIONERS**
**COMMISSIONER OF INSURANCE, THE STATE OF KANSAS**

Ms. SEBELIUS. Thank you, Mr. Chairman.

I am Kathleen Sebelius. I am the elected Insurance Commissioner from Kansas and serve this year as the President of the National Association of Insurance Commissioners. We appreciate the opportunity to be with the Committee Members today.

Today, I really want to focus on three basic points. First, the NAIC and our members believe there is presently a need for the Federal Government, working with the State regulatory system, to provide appropriate financial backup to the private insurance market in order to ensure that the Nation's economy does not falter due to a lack of insurance coverage for terrorism. Although we have not endorsed any specific proposal for Federal assistance, we have adopted a set of 19 principles that are attached to my testimony that we believe should form the basis of a sound program of the Federal Government.

Second, we believe Federal assistance should be a short-term solution to stabilize the commercial marketplace, while it regains the risk assessment and pricing equilibrium needed for private insurers to underwrite terrorism exposures. Any Federal terrorism insurance program should be limited in scope and duration.

And third, a Federal insurance program should maximize the use of market forces to add efficiency and reduce the risk of losses from terrorism and the potential cost to Federal taxpayers.

Let me just start by saying that we really do believe that the insurance industry is well capitalized and financially able to withstand the pressures created by the September 11 terrorist attacks, which right now are estimated to be upward of $30 billion. The industry is a $1 trillion business with assets of more than $3 trillion. And the preliminary loss estimates of $30 to $40 billion represents just 3 to 4 percent of the premiums written in the Year 2000.

As regulators, my colleagues and I will continue monitoring the process to make sure that insurance promises are kept. To do our job, we have an array of human and technical resources, including our center office, the NAIC, of 51 State insurance departments that collectively employ more than 10,000 people and spend about $900 million annually on insurance supervision. In addition, the State insurance guarantee funds have the capacity to provide up to $10 billion to compensate American consumers in the event of insuring insolvencies.

We would urge Congress to structure any Federal assistance program to take full advantage of the existing regulatory system. We have mechanisms in place to monitor solvency and to handle claims payment issues.

The business of insurance is about measuring risks and selling promises to cover them with a reasonable profit. Over time, insurance experts have demonstrated a remarkable ability to adapt to unforeseen circumstances, while making available the insurance products that are essential to the growth and productivity of American business. As expected in a free competitive market, individual companies may stumble, falter, and even fail when substantial adversity strikes. However, the industry as a whole has a long and proud record of finding ways to overcome new obstacles, while advancing its business goals and serving the interests of the insurance-buying public.

Thus, the NAIC believes Congress should begin its consideration of Federal assistance to the industry by recognizing the strength and adaptability of the private markets. Federal actions that disrupt or interfere with private market forces are likely to end up causing more harm than good for both consumers and taxpayers.

State regulators know from their own experiences that Government action can help the market recover when it becomes overwhelmed by changing risk factors or catastrophic losses. We found successful Government assistance involves tailoring actions to fix specific problems and keeping the program as narrow as possible.

State insurance regulators believe the current situation affecting the availability of insurance for active terrorism is similar in nature to other catastrophic events. Enacting a very temporary Federal solution will provide the necessary time to craft a more thoughtful, long-term solution.

Here are three market factors that we would like to keep in mind. First, following the September 11 attack, Government and commercial facilities across America have begun to add security measures to prevent acts of terrorism and limit potential damages. As commercial risk managers review these new precautions, it is likely that they will become more inclined to offer terrorism insurance because the possibility and extent of potential losses will be reduced. At that point, we expect market forces will start filling the gap by making terrorism insurance available through the private industry.

Second, the private market instills policyholder discipline to avoid insurance claims through the concept of coinsurance. Coinsurance means that policyholders are liable to pay part of any losses covered by insurance before expecting recovery from an insurer. It is a common concept known by everybody who buys car insurance or health insurance as a deductible, which you pay before receiving payment from the insurance company. And we think coinsurance should be considered by Congress as an important market discipline tool that works equally well with Government programs.

Third, the scope and duration of any Federal assistance program will itself become a factor in the private market. Even though Congress is considering special Government assistance intended to operate as a supplement to normal business channels, the very fact that you will pay certain costs of a commercial business becomes a factor to be taken into account when the private market decisions are made.

We think that it is appropriate in the short-term to have the Congress involved, but basically feel that it is appropriate to have that very short-term and very strategic and not disrupt the private market forces. We look forward to working with Congress, with insurers, with the Administration, so that the needs of individual Americans and our Nation's economy are met in a timely way.

Thank you.

Chairman SARBANES. Thank you very much.

Mr. Hunter, why do not we hear from you, and then we will conclude by hearing from the GAO.

**STATEMENT OF J. ROBERT HUNTER**
**DIRECTOR OF INSURANCE**
**CONSUMER FEDERATION OF AMERICA**

Mr. HUNTER. Thank you, Mr. Chairman. And thank you for holding this important hearing and I particularly thank you for doing the Nation's business in these hard days. We appreciate it.

This hearing seems very familiar to me since, when I was young man and starting out as Chief Actuary of the Federal Insurance Administration back in the early 1970's, I was asked to calculate actuarially sound rates for the riot reinsurance program that Congress enacted to keep insurance available and affordable in the inner cities of America in the riot era of the late 1960's. There is a lot to fear in uncertainty then, as now. We were very concerned about whether there would be markets for insurance.

Further, it is very familiar because the Banking Committee was where we held all the hearings where we developed the plan and implemented the plan. And Senator Proxmire, who was Chairman at the time, and others, were doing all of our oversight work. And so, here we go again together, Mr. Chairman, on another similar venture.

I would like to start off by saying that CFA supports a Federal backup of the insurance business for the peril of terrorism. We think that there is need. In the testimony that I provided for the record, was a list of the principles that consumer groups will use to measure the acceptability of any plan for terrorism coverage from the perspective of the consumer.

Chairman SARBANES. Let me say that all of the statements will be included in the record in full. I know that people are now in the process of summarizing prepared statements. But the entire prepared statements will be included in the record.

Mr. HUNTER. Key among our principles that you will see that the taxpayers as well as insurers should be protected. By this we mean that actuarial rates should be charged for any Federal backup coverage. "Cherry-picking" by insurers should not be allowed. And the claims presented for Federal payment should be subject to Federal audit. The second principle is that State consumer protection should be maintained. The third principle is that consumers should be protected by making sure affordable and available insurance for terrorism is maintained. Fourth, insurance prices must reflect security-enhancing incentives so that free Government reinsurance would undermine that goal. Fifth, terrorism must be clearly defined and national in application.

There are several serious flaws in both the industry approach and the Administration approach. Clearly, neither bill requires actuarial soundness. Indeed, insurers pay nothing for reinsurance in the first year of the industry program and never under the Treasury approach. Apparently, free Government reinsurance would even cover policies already in force for which insurers have been paid premium and are fully at risk today. This is a grossly improper use of taxpayer dollars. Neither approach is simple enough to be up and running on January 1, 2002, when the bulk of private reinsurance against the peril of terrorism expires.

That is another serious problem. The insurer plan is worse than the Administration plan in that it provides an end of rate regulation and overrides any remnant of State or Federal antitrust law and sweeps in tort reform and is basically a Christmas tree.

Unfortunately, the Administration plan shows that they do not really understand insurance, and if there are questions, I can explain at least two areas of what I mean. It is in my testimony that neither plan assures affordability or availability of coverage to reasonably secure risks. Congress should not rush to pass either of these severely flawed plans or a combination of such flawed plans.

CFA proposes a plan that is simple and is constructed so that Congress can easily have it up and running on January 1, 2002. In the written statement, I call it an interim plan, but since I put it forth at the NAIC yesterday and talked to a lot of experts, I think I am going to go bolder and say that maybe you could make it the plan. Here is the idea.

The industry today has $300 billion of surplus which could be applied to any risk. Surplus is nondivisible. It is available for any risk. Considerably more than is needed for an efficient market. That is why premiums have been falling. It is overcapitalized the insurance industry. Even after September 11, the vast majority of insurers could withstand easily another event of the magnitude of September 11. So we are sure that the plan need not cover first-dollar losses.

CFA proposes that a retention for each insurer of 5 percent of its surplus as of December 31, 2001, the end of this year, when the program starts, be used as a retention for each company group. This protects weaker insurers from insolvency risk and minimizes interference with insurance pricing decisions.

Terrorism must be defined clearly and a Federal official will determine the availability of the rest of the program, which is loans by the Government to insurers if losses exceed the 5 percent.

If a terrorist attack occurs and an insurer suffers claims greater than 5 percent of its surplus, the insurer would be eligible for Federal low- or no-interest loans—that is up to you all—the term of which would be negotiated for up to 30 years. This would spread the cost over time, an important goal.

For each insurer, the discounted value of the loan would be limited to an additional 5 percent of that insurer's surplus. This is needed, this limit, in order to make sure that individual company balance sheets are not impacted by very large losses and the companies become technically insolvent.

Amounts of money loaned in excess of the 10 percent of the surplus by a company would be repaid to the U.S. Treasury through a property casualty insurance industry-wide loan repayment mechanism. This loan repayment would be collected over a number of years sufficient to minimize the rate impact on consumers who would ultimately pay the cost of the coverage.

Let me give you an example. If there was a $100 billion loss, next year, the first 5 percent would roughly produce $15 billion that the industry would have to pay out of pocket. The next 5 percent, where the individual companies would come in, would produce another $15 billion. That would leave $70 billion for the spreading mechanism.

Seventy billion dollars happens to be about 20 percent of the premium charged last year. If you capped it at 2½ percent, then the loan would have to be repaid over an 8 year period and that would be passed through to consumers.

The loan would be repaid by the industry. It would be based on premium. And it would be piggy-backed. The States could collect it piggy-backed on the State premium tax mechanism, which is based on premium.

This plan leaves the regulation of insurance fully in the State hands. The States should be required by the bill to assure availability and affordability of the terrorism risk, using their usual regulatory methods, including pooling by State, if necessary. Such pools are actually in place in about 30 States.

Further, the States should be asked to assure that the plans enhance security through discounts or other incentives. Congress should set goals for the States in this regulatory effort, but the States should do it. This requires little, if any, new bureaucracy at the State level since much of the work is already part of the State insurance department responsibility.

And as to the Federal bureaucracy, the plan would require only a handful of people to monitor the request for loans, write up loan documents, advise the States on the amount of monies needed if the losses exceeded the 10 percent level, and monitor claims, which you must do under any, to make sure that they really meet the definition of terrorism.

If there is no terrorist attack after January 1, 2002, the program never becomes operative. But you have given surety to the insurance companies that they know exactly what their maximum annual loss is.

Congress should enact this plan, which protects the insurance industry, the consumer, and the taxpayer. It is certain, it has actuarially sound basis, it is simple, there is no hand-out, there is no bail-out, it works, and, more importantly, it can be fully operational on January 1, 2002.

Chairman SARBANES. Thank you very much. A very interesting statement.

Mr. McCool.

**STATEMENT OF THOMAS J. McCOOL**
**U.S. GENERAL ACCOUNTING OFFICE**

Mr. MCCOOL. Mr. Chairman, Members of the Committee, we appreciate the opportunity to discuss the response of the insurance industry to the losses resulting from potential terrorist attacks and the extent to which the Government should play a role in addressing these risks.

My testimony today presents features of selected insurance programs covering catastrophic or terrorist events, information on alternative mechanisms for funding insured losses, and outlines some broad principles or guidance that the Congress may wish to consider as it reviews possible ways to support the insurance industry in case of future catastrophic losses due to terrorist attacks.

Regarding the first point, my full statement has fairly elaborate discussion of existing insurance programs. But in my short statement, I will just say that a number of the programs exist in the United States and other countries to help insure that insurance will be available to cover risks that the private sector has been unable or unwilling to cover by itself, including losses from catastrophic events and terrorism. Certain insurance programs are completely controlled and managed by the Government, while others have little or no explicit Government involvement. Likewise, in many programs, the public and private sector share risks and go in several different ways.

With respect to the different mechanisms, funding mechanisms for funding insured losses, clearly one of the major issues that has been discussed in most of the testimonies today has to do with pricing. And again, I am restating something that was stated this morning, pricing for a program like this will be as difficult for the Government as it will be for the private sector, and maybe more so.

In any case, you must try to balance concerns about underpricing and potential issues of insolvency for the private sector or oversubsidy for the Government sector if the Government sector is doing the pricing versus concerns about overpricing and the potential distortions in the market that could result.

Part of the discussion that has come up in many of these programs is the extent that you engage in a pooling arrangement. Again, pooling arrangements can be pooled amongst private-sector parties or shared with the Government. And there is again a number of examples in some of the programs that exist currently throughout the world where the pooling arrangements are an important part of the program.

Another issue that has to be determined by any program will be whether you try to prefund losses or try to do after-the-fact assessment. And even within the option of after-the-fact assessments, one of the issues is whether you pay as claims come in or whether the Government provides when the initial claims come in and then the firms would pay these assessments over time through some type of a loan program.

So there are a number of different ways in which such a program could be set up, again, with or without pools and with or without prefunding, and all of these are options for consideration.

The Government could also fund any contingent liability in a variety of ways. It could charge a premium for the reinsurance protection it provides, accumulate a fund it could use to pay for losses. Alternatively, the Government could provide loans to the industry or fund its losses out of tax revenues, either with or without repayment requirements.

In conclusion, a financially secure insurance industry is essential to the smooth functioning of the economy. There have been reports that without insurance coverage against potential catastrophic consequences of a terrorist act, investors and providers of finance may not be willing to provide capital or may impose very stringent terms. Any mechanism established by the Federal Government to support the ability of individuals and businesses to get insurance for terrorist attacks should address many significant concerns.

First, the program should not displace the private market. It should create an environment in which the private market can displace the Government program. As a result, any program should be temporary. I think, again, these are principles that have been stated by others. And the third principle, which is one that GAO always supports, and again, it has been mentioned earlier, any program should be designed to ensure private market incentives for prudent and efficient behavior are not replaced by an attitude that says, do not worry about it. The Government is paying.

So, Mr. Chairman, that is my prepared remarks and I would be happy to respond to any questions you or the Members of the Committee may have.

Chairman SARBANES. Well, thank you very much, sir. First, let me ask, I want to ask each member of the panel what they think would happen if nothing were done. And why do not we take you in the order in which you delivered your testimony.

Mr. FROOT. If nothing was done at all, I think there would be a substantial dislocation because of the calendar effects associated with the January 1 renewals. My guess is that that would be resolved within a year. But that, in the first year—again, this is back to something we said earlier—I would not want to bet that we would not end up in a situation with extreme exposure in a few financial intermediaries or insurers, and perhaps some reinsurers, that was unable to be spread and therefore, in the event of a crisis, actually led to a severe collapse.

Chairman SARBANES. Do you think the people seeking insurance would be able to get it?

Mr. FROOT. I think in some circumstances, it would be very expensive. And, yes, I believe it would be hard to assure that insurance would be available in all cases.

Chairman SARBANES. So it would be expensive and it might not be obtainable? Is that what you are saying? Or it would be obtainable, but only at a very high cost?

Mr. FROOT. I do not think there is any guarantee that it would be unobtainable.

Chairman SARBANES. Ms. Sebelius.

Ms. SEBELIUS. Senator, In the short term, we have a real crisis in the commercial marketplace because I do not think that money is going to be available for the development or financing of large commercial properties without insurance.

We are already as regulators getting notices from companies who would like immediately to institute restrictions on terrorism coverage. Those are being filed across the country as we speak.

And if this were a different timing, I think if we were having this hearing in February or March, and we had gone through the renewal period, it is conceivable that the private market could figure out a solution by the renewals the following January. What we are faced with here is a calendar problem because the renewals are imminent. And I really think it is highly likely that it would be very difficult, if not impossible, to get any kind of coverage at any price for this risk in the short run without some program.

Chairman SARBANES. Both for existing buildings and for new development?

Ms. SEBELIUS. I am not the capital market expert. But we have been told that the real problem is not initially with the insurance itself. It is really without the guarantee that you could insure an attack in the future in the short run. Nobody is going to put substantial amounts of money down for ongoing financing or for new developments. So it would dry up the capital market. And I think that could happen very quickly.

Chairman SARBANES. Mr. Hunter.

Mr. HUNTER. It does hinge on what type of policy you are talking about. A company like State Farm, which is insuring homes and cars, many of them all over the country, a big spread of risk, probably would not have much of a problem dealing with not having terrorism reinsurance. It does not buy much reinsurance anyway because it effectively reinsures itself with the spread, and so on.

But when you get into the commercial accounts, that is where you would have the crunch, big accounts that this morning Senator Nelson called target risks, would have trouble getting insurance.

There would be applications made to the State insurance departments to allow the exclusion of terrorism. Now some States might disapprove those filings and therefore, then companies would have to make a decision whether to cancel the whole policy or not cancel, but nonrenew the whole policy. But that is a potential that—how do you put a number on it? I believe it is severe enough that Congress should worry about it.

Chairman SARBANES. Mr. McCool.

Mr. MCCOOL. Well, again, I think that the problem would exist, clearly. The question of how large it would be and how it would show up, there is a number of different ways it could show up.

Clearly, you could have cases of—there would be no doubt that there would be much higher premiums applied to commercial insurance in particular, and possibly there is going to be nonavailability of insurance.

I guess the next question would be, if someone did not have insurance, either it was not available to them or the price was so high that they would think about opting out, what would be the impact on someone providing financing to them?

And again, there would be ways for the financiers to adjust by asking for more upfront equity, by lower loan-to-value ratio, by asking for higher returns. But there would be a lot of different ways in which this could show up. And it would clearly have a potential significant impact.

Chairman SARBANES. I want to repeat the question I asked and get two of you to answer. Is there a divide or difference between getting the insurance for existing buildings and getting the insurance for new development, new buildings?

Mr. HUNTER. Again, it depends on the building. If you are talking about big target-type buildings, I think they would have trouble keeping the insurance they had and the new buildings would be even more problematic because they do not have the history of insurance.

Now, obviously, these big accounts also have some ability to self-insure and so on. So they may have some ways to get through that and find some kind of reinsurance at very high levels. But until the reinsurance market is assured, I think you would have trouble with those big accounts.

Mr. MCCOOL. Again, I would agree that new construction would probably be more affected. But I do not think that you could ignore the effects on existing structures.

Chairman SARBANES. I see my time is up and I yield to Senator Miller.

Senator MILLER. Just a couple of things, Mr. Hunter, help us to understand this better. What kind of distortions would there be in the insurance market if we created the Administration proposal? In other words, what happens to a market when you give away a Federal guarantee that does not cost the industry anything?

Mr. HUNTER. Well, it means that the rates can be much lower obviously than they might otherwise because the insurance companies do not have to find actuarially priced reinsurance protection. They know they have free reinsurance for 80 percent from dollar one, and a $12 billion maximum loss in a year.

That is a lot of assurance and it means the pricing of things like security would be less enhanced. There would be less reason for people to toughen their buildings and put security guards out there and spend that kind of money, whereas, if insurance was fully priced, there would be that additional incentive, besides saving lives and the other good things that happen. The financial incentive to do those, that would be weakened.

Senator MILLER. Thank you. Let me ask this question of everyone on the panel, except Mr. Hunter.

[Laughter.]

What do you think of Mr. Hunter's proposal?

[Laughter.]

Mr. FROOT. Let's see. I like it to the extent that allegations that parts of the insurance industry are over-capitalized are true.

That is, that, in certain sectors, mutuals in particular, it may be very difficult to reduce the amount of capital, even as risks decline. And so, therefore, putting that capital to work, in a sense, directly through this kind of program would make a lot of sense.

For companies that are not overcapitalized, it would be a mistake because, in the end, after the event, they would be burdened going forward with a substantial liability, additional liability, which would place them in a financially inflexible and relatively fragile position compared to where, judiciously, they would believe they should be.

Ms. SEBELIUS. Senator, I am not sure I can make a terribly well qualified review of Mr. Hunter's program. I have heard the basic outlines now twice. But there is a bit of misconception. Regulators want companies to build reserves. You want companies to build reserves as a policy program because without those reserves, they may end up not being able to pay the claim.

So I do think that we want to be careful about assuming that if they have assets in reserve, that somehow, that is extra money. That is there to back up the policies that are in force in the marketplace.

I think the concepts are interesting about the notion that there would be some repayment scheme at some level and probably is one that should be looked at by the Congress.

Some of these issues really are kind of insurance-related principles. Some of them are really public policy decisions. And I am not sure that, as an insurance regulator, I am very well qualified to suggest what your public policy decisions may be. And I believe a lot of what Mr. Hunter has outlined really falls into more the public policy area.

Is it a good idea that taxpayers should expect this money to be repaid? How much should the industry count on? We certainly support the notion that dollar one involvement from the Federal Government may not be the best way to approach this, a deductible system, setting a level that gets some insurance capital involved before there would be any kind of Government involvement may be a more appropriate approach, and that is part of what Mr. Hunter has talked about. So I do not know if that is helpful, but I do not know a lot about the plan.

Chairman SARBANES. Could I just ask a simple question? It is possible that if the reserves are built up too much, that they have been charging too much on the premium side, is not it?

Ms. SEBELIUS. That is something that regulators look at on a fairly regular basis when companies apply to us, that certainly more of that regulatory oversight is exercised in the personal lines market less than in the commercial market because we assume in a competitive market that the sophisticated buyer will essentially use the marketplace to drive rates down. And markets are pretty competitive at that level and they have the ability to do that.

Chairman SARBANES. Thank you. Senator Miller.

Senator MILLER. Let me ask Ms. Sebelius a question while she has the microphone. The industry's concern about the Administration's proposal is that they will not be able to price risk. Do you agree with this concern about their ability to price risk?

Ms. SEBELIUS. We have had this discussion, all the regulators in the country, frankly, who have been in town for the last couple of days, to look at the aftermath of September 11 events on the industry. We have talked a lot about the industry's really amazing ability to price anything. I mean, not that anyone would have foreseen September 11, but they have had lots of unforeseen issues in the past and have relatively quickly, as the Professor suggested, figured out a pricing mechanism. It may tend to be very conservative initially, over-reserving, charging too high, and then the market drives that down.

I think the issue here is how quickly can that happen? And our concern is that the timetable of the January 1 policy renewals are such that we do not have a lot of faith that can happen in that kind of timespan. But I am very optimistic that within the course of the next year, they can begin to appropriately price this risk, they will price it, and they will sell it.

Senator MILLER. Thank you. My time has run out.

Chairman SARBANES. No, go ahead, Senator.

Senator MILLER. Mr. McCool, do you have a statement on Mr. Hunter's proposal?

Mr. MCCOOL. Well, again, we do not endorse or die.

[Laughter.]

I think it has some interesting features. It does have first-dollar coverage, which again we think is something that is a good idea. It has a formula for allocating the first-dollar coverage on a firm-by-firm basis, which again is an attractive feature. Whether capital is the right basis or some other basis could be used, the fact that it does have an allocation formula on a firm-by-firm basis I think is a useful feature. Again, the fact that it repays the Government over time is something that the GAO would never be against.

[Laughter.]

And again, at what rate is up to you to decide.

Senator MILLER. That is an attractive feature. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Schumer.

Senator SCHUMER. Thank you. I appreciate the panel being here. I have looked at the testimony and I am sorry I could not be here the whole time.

Let me ask each of you, and particularly those who seem to like the Administration's proposal, how do we prevent "cherry-picking?" How do we prevent 5 percent of the most vulnerable, or at least as perceived, the most vulnerable properties from just being excluded and not getting insurance?

Professor Froot.

Mr. FROOT. I would have said that "cherry-picking" is a great problem when it comes to someone trying to buy for you life insurance or for themselves more extensive medical coverage, or any of those things. I think those are examples where, in those markets, the individuals have some control over the risk and they have some knowledge about the risk that the insurer would not have. That is where we tend to see "cherry-picking" most severely.

I do not think that is the case here. I do not think there is much risk that a particular building owner knows more about the risks of terrorist attack than can be easily established by someone looking to write a policy for that building.

Senator SCHUMER. I do not follow you. I do not understand. The Empire State Building, Disney World, the Hoover Dam might be places that might be much riskier.

Mr. FROOT. Much riskier.

Senator SCHUMER. To insure after September 11. And if we just say that the Government will pick up 80 percent of the costs of whatever insurance you write, some might say, well, 20 percent is still too much to be dangling out there for these type risky things. We are not going to insure them any more.

Mr. FROOT. But I tend to agree with Ms. Sebelius, that, basically, that there will be competition, there will be a desire to write that policy, and there will not be a concern that one is being adversely selected in writing that.

That is to say, that because you come to me and are willing to pay a very high premium, that means an even higher risk than I would have ever guessed.

Senator SCHUMER. Again, we are talking past each other. I am not worried about competition between the two. I am saying, if everybody comes to the conclusion that $10 a square foot to rent the Empire State Building in insurance, the owners will not be able to make any money and the building will go under, the building will not be insured. That is what I worry about. I worry about a significant portion of properties not being insured.

Ms. Sebelius.

Ms. SEBELIUS. One of the features that you may want to look at, as a possibility in partnership in this Government involvement, would be to disallow exclusions for terrorism coverage, which forces the risk to be spread, essentially, and tie that or tie any opportunity to participate in the Federal program to not having the exclusions. The issue we are dealing with right now State-by-State is really holding those to see what is going to happen.

Senator SCHUMER. That is a pool of a sort, but a pool you could live with.

Ms. SEBELIUS. But one of the issues may be spreading that risk so that every company is in the game from the outset and then you have a realistic possibility. If you let people begin to exclude out of the pool the price against the pool to, as you say, cherry-pick the properties, I think then you really have the potential of a very distorted marketplace very quickly.

Chairman SARBANES. Could I ask on that very point? You say in your statement, and I am now quoting, "Many people in Congress apparently think that States require private businesses to carry insurance against terrorism, and that failure of the private insurance market to offer terrorism coverage will result in violating State laws and regulations. We believe there is a misunderstanding of what State laws require and what State insurance regulators do." And then you say you did an electronic search of State laws and regulations with references to terrorism and you found nothing.

Now, maybe I have a misunderstanding. It was not my premise that the current law and regulations require terrorism coverage because, in a sense, it is not been at the forefront of our concerns.

But I thought that you could require that the State insurance regulators have the authority to require that the policies cover terrorism. Is that correct?

Ms. SEBELIUS. I do not think that is accurate, Mr. Chairman, without legislative intervention. For instance, legislators in some States have said health care policies must have the following features in it.

At the State office level—some of us have and all of us do not even have this authority, is actually to deny exclusions. We do it in reverse. When exclusions are filed with our office, there are statutes right now in some States that have deemer provisions. Unless you take some action and that could be administratively overruled, they go into effect. So it is really the reverse.

The issues that come as exclusions are looked at by our office, but there is really not an affirmative requirement that policies must have a variety of features in them unless that is something that the legislature has actually taken on as a legislative initiative.

Chairman SARBANES. But if you did not give the exclusion, wouldn't terrorism be covered?

Ms. SEBELIUS. At this point, that is the likelihood, that as a State insurance commissioner—most of us either could deny the exclusion or take some emergency rule to not allow the exclusion to exist. Now having said that, they do not have to offer the policy at all. I mean, that is step two. You could deny the exclusion, but that does not mean the company has to write the policy.

Chairman SARBANES. Well, I understand that.

Senator Schumer.

Senator SCHUMER. Just one other question. I think earlier, Senator Gramm said that he might consider supporting 100 percent insurance for 2 years, Federal, 100 percent coverage Federally—did he say this? Yes? I am surprised—to avoid the Federal Government being involved permanently.

Now, of course, if we had a series of terrorist incidents even at the end of Year 2, or after Year 3, we would have to come back, is my guess, of great magnitude. So I do not quite get it because that really depends on what happens post-September 11. But would any of you want to comment on that idea?

Mr. HUNTER. That is a terrible idea. Part of the reason it is bad to have no premium is it would undermine all the various normal market workings and incentives for more secure risks. You really want to have safer places out there.

Senator SCHUMER. Hunter says Gramm ignores free market.

[Laughter.]

Ms. SEBELIUS. Senator, I also think that we, at least, believe you really want the private market forces to get back in the game as quickly as possible and to begin to figure this out.

A 2 year hiatus with no risk, no capital, no anything, may really be exactly the wrong message to send. I believe very limited, very strategic backup help, but urging the private-market forces, essentially, to regroup quickly, recapitalize quickly, and sell the policies.

Senator SCHUMER. Could I ask each of you one final question?

First, in writing, if any of you have ideas on how you deal with this "cherry-picking" issue beyond what we have discussed today because, to me, it is a very vexing issue, could you send them?

Would that be okay, Mr. Chairman?

Chairman SARBANES. Sure. Certainly.

Senator SCHUMER. For a week. It is not mandatory, but if you have some good idea, I would love to hear it and I bet the Committee would as well.

My final question is, as you may have heard, if you were here earlier, I am very worried that people will not endeavor to begin large new projects if they are worried even if they know that in the first year there will be insurance, if they worry that there will not be in subsequent years. Is that a valid worry? And should that play a role in what we pass here, if we were to pass something?

Do any of the witnesses——

Mr. HUNTER. It is a valid worry. But you could set up a program that said, if you enter into a multiyear project, requiring multiyear insurance, you have to notify the Government, and perhaps you could even have a multiyear policy, even if the program ended. You still might be able to do something.

Senator SCHUMER. The policy could be backed up in Year One.

Mr. HUNTER. Either a policy or a loan guarantee, or however you do it, you could have a multiyear basis for that.

Senator SCHUMER. Right. Any other comments? Ms. Sebelius.

Ms. SEBELIUS. I did hear or was able to watch some of the hearing this morning and heard that concern voiced. I guess we are fairly confident and, again, it is based on looking at what happened after Northridge and Hurricane Andrew, what happened in various situations, that the multiyear funding issue is probably less a problem, assuming that we do not have a series of attacks, less of a problem than this strategic issue right now. I am fairly confident the market would rebound and be issuing policies in the future.

Chairman SARBANES. I take it it's your view that if this had happened next February, that the private sector might have been able to work it out by the end of the year, given the 9 or 10 month period within which to do it. Is that right?

Ms. SEBELIUS. Well, there has been some discussion that certainly the problem is really exacerbated by the timing, given the proximity to the January 1 expiration of virtually all—not all, but a large portion of the reinsurance treaties. We are in a particularly difficult time. I think what you would have had in a different timetable is at least several months to see how much capital came back in, what the market solutions were. We just do not have that luxury at this point.

Chairman SARBANES. Of course, one could then, carrying the logic of that out, say, well, we have a situation where we have to get over this hurdle or this hump that is facing us, and enough time to see how it works. If it does not work out, it could be revisited, I guess, would be the argument.

Ms. SEBELIUS. Well, that is certainly why we would support a firm sunset, a very short timetable, and the opportunity certainly is there to revisit or renew. But we think having a time certain where the program ceases of fairly short duration makes very good sense and it keeps pressure on everybody to figure out the solution.

Chairman SARBANES. Now, Mr. Hunter, let me try to take your proposal and see if I—and Mr. Froot, I know you have a time problem. So any time you have to go, just excuse yourself. We understand your situation and we very much appreciate that you came.

Not that these are minor differences, but is it accurate to say that you differ from the Administration in that you would require the industry, in effect, bear the burden upfront up to a certain amount? As I understand your testimony, your figure was I think $35 billion. Is that right?

Mr. HUNTER. That is what I said in my testimony. In the plan that I just outlined, it would probably be more like $30.

But, yes.

Chairman SARBANES. And then beyond that, the Government would come in to cover the loss, but it would do it on a loan rather than a grant basis. Is that right?

Mr. HUNTER. That is correct.

Chairman SARBANES. And then the industry would repay the loan over whatever terms you have worked out over an extended period of time.

Mr. HUNTER. Yes.

Chairman SARBANES. They would have to keep the premiums up in order to do that.

Mr. HUNTER. Yes. You could put a cap on how much that could be per year, like 2, 3, or 4 percent per year, so that the premiums would be maintained at a relatively low level for the loan repayment period.

For a typical homeowner's policy, you are talking maybe between $16 and $24 a year additional. Obviously, for a big target risk, it might be several thousand dollars a year.

Chairman SARBANES. What is your reaction, Ms. Sebelius, to that scheme—plan, I guess.

[Laughter.]

Ms. SEBELIUS. I guess, Senator, I do not know quite what my reaction is. I do think that it shifts a lot of the burden for terrorism coverage in the short-run particularly on to those Americans who are buying insurance policies and away from, if you accept the notion that, somehow, this is a public policy issue and the Government has some legitimate role, then I think having the taxpayers at large bear some of this burden as opposed to just the insuring consumers bearing it through the higher premiums they are paying, I think a lot of Mr. Hunter's concept really assumes that consumers who are buying insurance products over a longer period of time would be paying off the loans as opposed to the taxpayers at large paying them. That may be too narrow a focus for that to bear all that risk.

The insured public are also taxpayers. But, essentially, they would be picking up more of a burden than the average person who may not be buying car insurance, homeowner's insurance, having to develop property, whatever.

So I guess I do not find a great deal of—I do not have a real problem looking at the issues of public policy issues, saying a portion of this rightfully may belong to the Government, may be spread among taxpayers at large, and not require the repayment, which essentially gets transferred through higher premiums over a longer period of time just to insure the public.

Chairman SARBANES. Mr. McCool, do you have an analysis?

Mr. MCCOOL. In most of these issues, the GAO would prefer that the Government not be—I agree with Ms. Sebelius. You really are to some extent talking about over what base you are spreading the increase. There is probably a fairly large overlap between the taxpayers and the people who pay for insurance. It is not 100 percent, but it is probably fairly high.

Mr. HUNTER. But there is also a question of equity, of course. And that is, the people with the higher risks pay higher premiums and particularly will pay higher terrorism premiums in the future. And they will then bear the 2 percent per year burden more heavily than the average taxpayer. And that is fairer because they are the ones with the exposure.

Senator MILLER. One more question, Mr. Hunter. Let us say that the plan, as you put it, is not adopted. And instead, what is passed is something like what the Administration has offered. In your opinion, what kind of oversight capacities would be necessary for the Federal Government to engage in that kind of temporary reinsurance commitment with the private sector?

Mr. HUNTER. Well, first of all, you would have to write reinsurance contracts with the insurance companies because they would not certainly—they would want to have certainties, so they would want a policy. Even though there was no premium, I guess, you would still have to have some kind of a legal document that you would work with them that would define terrorism and explain who decides what. You would have to have a system of auditing the claims. You would have to have a bureaucracy. Claims is fairly complex. And of course, you would not ever get the taxpayer reimbursed, is my key problem with that system.

But I do think that—

Senator MILLER. There are no oversight provisions that you would propose that we write in there?

Mr. HUNTER. I still think that you could rely a lot on the States, although there is a lot of preemption in the insurance proposal of State regulations, so you would need some Federal thing to take the place of that in the insurance industry proposal.

But in the Administration proposal, there seems to be less override of the States. So you could still task the States with various things like assuring affordability, availability, making sure that there are surcharges or discounts that would enhance security. I think some of those things could be added to the Administration proposal.

Senator MILLER. Are you saying they should be added or could be added?

Mr. HUNTER. Should be.

Chairman SARBANES. Well, now, the Administration's own proposal has them withdrawing after 3 years, apparently on the premise that reinsurance would then be available to the primary carriers. Is that how you understand it?

Mr. HUNTER. Yes.

Chairman SARBANES. If you got through that period without a major terrorism attack, then the whole thing would be back in the private market and there would have been no Government cost. Correct?

Mr. HUNTER. Right. You still have to have the administrative costs of running the program.

Chairman SARBANES. Those would be relatively inconsequential.

Mr. HUNTER. Right. Yes.

Chairman SARBANES. Now what do you all think, if you read about this proposal that the insurance companies put forward.

Mr. HUNTER. I will start. It is terrible. I have a long list of complaints about it in my written testimony, including the fact that it is not an actuarially sound program because it has no premium the first year. Additionally, it allows "cherry-picking" of the worst sort. That is, individual companies can opt in or out of the plan. And the individual companies within a group can individually opt in and out of the plan.

So if you have these target risks that we have been talking about, you can put one company, reinsure that one with the Federal Government, and leave all your good business not for the Federal Government. And I do not believe the Federal Government should be put in a position of the taxpayers only picking up the bad risks and having the good risks left for the private sector.

The selection of Illinois as the sole regulator and creating, in effect, a cartel at the front end in Illinois, and overriding the bill, not only would there be no rate regulation, but there will be no residual Federal or State antitrust law enforcement against it. So it waives all those. There is no guarantee of affordability or availability and so on, and it is a very large overreach by the industry with a lot of their wish list in it.

Chairman SARBANES. Mr. McCool.

Mr. MCCOOL. Well, again, we have——

Chairman SARBANES. What does your analysis show? I know you have to frame it in terms of analysis.

Mr. MCCOOL. I was going to say, our list of concerns is not quite as long. But we are concerned about the pooling arrangement being in one State. Again, there is a certain monopolistic element to that.

There are again concerns about, in this case, what I guess would be "cherry-picking" as opposed to some other arrangement that we were talking about earlier. It is a problem, but it is a different one, that you could end up with the better risks in the pool and the worst risks outside the pool.

Chairman SARBANES. Ms. Sebelius.

Ms. SEBELIUS. Well, I think Mr. Hunter outlined a number of the key issues that would be of grave concern to regulators, "cherry-picking" not the least among them. The antitrust provision, there is fairly broad preemption of State laws and regulations.

We think it would abdicate a lot of consumer protection initiatives that are currently in place and they would cease to exist.

And I think the mandating of the pooling arrangement—I do think the industry has a keen interest in pooling risk, but it is something that we feel could be accomplished voluntarily. That is part of the kind of regrouping mechanism that they could go through. And I am not sure that you need a Federal law or a kind of bureaucratic structure to have that done and create a new company. I think that is very much a private market phenomenon that will happen.

Chairman SARBANES. Well, one of the issues that is raised here in the backdrop, so to speak, is, as you say, the preemption of various State requirements that have heretofore applied to the insurance industry.

Now, if that is going to happen, it seems to me, particularly if you are asking for a major contribution of resources from the Federal Government, there is going to have to be monitoring and oversight and, indeed, regulation at the Federal level. So I think one of the issues here is whether we are going to start down this path of altering the Federalism arrangement with respect to insurance.

Now I am prompted to say that because there are people moving around the halls of the Congress who want to do Federal insurance charters and so on. That is an issue, it seems to me, with far-ranging implications, which would need to be addressed on their own terms. I do not think we want to do it through the back door on a terrorism bill. So, presumably, the Association of Insurance Commissioners has some concern about that issue. Am I correct?

Ms. SEBELIUS. I think that is safe to say.

[Laughter.]

That we do have concern. We think, Senator, that the ability of the industry to pay the September 11 events is a strong testimony to the fact that the regulatory system in place works. The reserves are there. The companies are capitalized. They are monitored. The claims are going to be paid.

We think what you are looking at at this instant is a short-term problem dealing with recapitalization and availability of what is a bit of an unknown risk up until September 11. Hopefully, we will not know a lot more about it, but we can price it more accurately going forward.

A lot of the monitoring and oversight I think that would be required for any kind of Federal involvement frankly is in place right now around the country and could be detailed to the States to go ahead and do, following up on claims payments, auditing. Those are things that we have experts doing as we speak. We have actuaries. We have a variety of technical staff, both at the national office and locally.

We think it is appropriate in terms of preemption issues that you look at things like, one, uniform definition of terrorism. You clearly could not have 50 different definitions floating around. In fact, we have a group working on that very issue because we think we are going to need that one way or the other.

The issue about whether or not all companies would be required to, or would be disallowed from having terrorism coverage, is an issue that may appropriately rest with you.

So there are some issues that we would be very supportive of having uniform definitions across the country put in place very quickly. But in terms of a long-term need to either duplicate or preempt the State system that functions very well, we would urge you not to use this opportunity as a way to sweep away what is a 100-plus year-old regulatory system that actually functions pretty well. Totally unforeseen loss, nobody could have predicted it. They are up at the table paying the claims, and I think that is testimony to the fact that it actually works.

Chairman SARBANES. Does anyone else have any observation on that issue?

[No response.]

Now let me ask this question.

Mr. HUNTER. Let me just say, there is no question that if you adopt something like the industry approach, I think you have to get in there because, otherwise, there is going to be nobody checking the rates or anything. And you had better get in there because, otherwise, you are going to be handing away all this free insurance by taxpayers and you are not going to have any guarantee that the prices are affordable or anything. You need, it seems to me, some way of assuring that.

Chairman SARBANES. I take it all three of you would rate the Administration's proposal above the insurance industry's proposal, as you know those proposals. Is that correct?

Ms. SEBELIUS. Yes.

Mr. MCCOOL. [Nods in the affirmative.]

Mr. HUNTER. [Nods in the affirmative.]

Chairman SARBANES. And I take it that all three of you would also—there are modifications you feel can be made to the Administration's proposal which would make it better than it is. Is that correct as well?

Ms. SEBELIUS. Yes.

Mr. MCCOOL. [Nods in the affirmative.]

Mr. HUNTER. [Nods in the affirmative.]

Chairman SARBANES. Well, this has been a very helpful panel. I hope we can continue to call on you for your counsel and advice as we wrestle with this issue. You can be very helpful to the Committee. And, of course, the State insurance commissioners have a tremendous amount of expertise built up over the years. And Mr. McCool, we always look to the GAO around here. And Mr. Hunter, you have actually come in with some very imaginative and helpful suggestions. And so, we will continue to work with this issue.

Ms. SEBELIUS. Senator, we look forward to working with the Committee, with the Administration, on moving this issue forward. We think it is a high priority and we do think it is appropriate that the Federal Government play a role, and it is probably got to be done pretty quickly, given our timetable issue. But we look forward to helping in any way we can. We do have a lot of technical expertise that we would be happy to lend to the process.

Chairman SARBANES. I think, as we think about it, we need to try to—well, you can never deal with a complex issue necessarily in a simple way. I understand that complexity has to be met to some extent with complexity.

On the other hand, we need to get this thing down to the essentials and deal with the essentials. We need to push back overreaching, if that is, in fact, occurring.

And I do not know that we can take on other agendas that people of one sort or another that have been hanging around here and have not been acted upon, and then they fasten upon this vehicle to move that agenda. That is not what we are about. We are willing to try to address what everyone has said needs to be addressed on the problem. But if people start piling in on this, either with some long-standing agenda or seeking to overreach on the relevant agenda, we are going to have difficulty. We have to work through this toward a consensus we can close ranks on and move ahead.

But your testimony has been very helpful. And again, I want to express my appreciation. I know that people were given a lot of time to prepare and obviously, a great deal of care and thought has gone into these statements.

The Committee will resume its session. We will reconvene tomorrow morning at 10 a.m. in this room. The Dirksen Building where the Committee's hearing room is has not yet been opened. It may be opened by the end of the week or the first of next week. The Russell Building has been opened and the Hart Building apparently, which is where the Daschle office was and so forth, will remain closed while they continue to carry through on the environmental check-out.

Tomorrow, we have two panels. Panel One is: Robert Vagley, President of the American Insurance Association; Ron Ferguson, the CEO of General Ray, representing the Reinsurance Association of America; and John T. Sinnott, the CEO of Marsh, Inc., representing the Council of Insurance Agents and Brokers. That will the first panel.

And the second panel will be: Tom Donohue, President and CEO of the Chamber of Commerce; Ellen Baker, Chairman of Wacovia Corporation, who will be speaking for the Financial Services Roundtable; and Thomas Carr, President and CEO of Carr America Realty Corporation, representing the National Association of Realty Investment Trust.

And that will obviously give us an opportunity to hear from both the insurance industry itself and then the second panel, from broader representatives of the business community. I know it has been a long day for you. We very much appreciate your staying with us.

The Committee is adjourned until tomorrow at 10 a.m.

[Whereupon, at 4 p.m., the hearing was adjourned.]

[Prepared statements and additional materials supplied for the record follow:]

## PREPARED STATEMENT OF SENATOR JIM BUNNING

I would like to thank you, Mr. Chairman, for holding this important hearing, and I would like to thank Secretary O'Neill and Chairman Hubbard for testifying today. The tragic events of September 11 have had many repercussions. In addition to the obvious losses to those directly affected, the attacks wreaked havoc throughout our economy. One critical part of the economy the attacks have affected is the insurance industry. I am very grateful that Secretary O'Neill and Chairman Hubbard were able to come before this Committee and explain the Administration's insurance proposal. I believe there is a serious problem facing us that must be addressed by January 1. As my colleagues know, many insurance policies will be up for renewal on January 1.

If Congress does nothing, many of these policies will not be renewed, and many businesses and properties will not be able to purchase insurance. The Administration has a proposal that frankly gives me some heartburn. However, something needs to be done and done quickly and I have not seen a better plan. Hopefully today we can start to come up with some better ideas. However, I do agree with the Administration that there must be a sunset on assistance we give the insurance and reinsurance industry. This is absolutely critical. We must allow the market to figure out how to price this new risk.

We can help give the industry time to sort this out and collect data, but we can not set the market. We also must make sure this is not a way to create a backdoor federalization of insurance. I know there are many in Congress who would like a Federal insurance charter and a greater Federal involvement in insurance, but this is neither the time nor the place. It is also crucial that we make sure the industry assumes some of the risk. We cannot ask the taxpayer to pick up the entire bill.

I believe it is crucial that we act thoughtfully and we act quickly. We must do what we can to avoid the unintended consequences that could harm our vibrant insurance industry but we must also assist the industry so they can figure out how to price this new risk before the end of the year. If we do not, not only will we have businesses failing because of a lack of insurance, we may have the taxpayer completely on the hook if another catastrophic event hits our county, be it act of God or act of evil.

Thank you, Mr. Chairman.

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## PREPARED STATEMENT OF BILL NELSON

A U.S. SENATOR FROM THE STATE OF FLORIDA

Chairman Sarbanes, Members of the Committee, thank you for inviting me to address one of the many challenges facing us in the wake of the terrorist attacks on September 11, and the bioterrorism attacks since then. I hope my prior experience as Florida's insurance commissioner will be helpful as we grapple with the challenge ahead, which is to protect all of America's insurance consumers by making sure coverage remains available and affordable to protect them against such despicable acts.

We all know that insurance is one of the crucial engines of our economy. Without it, banks will not make loans for real estate or other ventures, and businesses will not invest or expand. Millions of jobs would be lost as the impact rippled through our economy. We cannot let that happen. Neither can we allow the insurance industry to use the September attacks as an excuse to shirk its rightful role and responsibilities. Already, reinsurance and insurance companies are saying they no longer will cover terrorist attacks after December 31 . . . when about 70 percent of the commercial insurance contracts in the United States are scheduled to expire.

I do not doubt that the industry's problem is genuine. In the immediate aftermath of September 11, it is virtually impossible for insurers to calculate their potential liability in the face of possible future terrorist attacks. But we cannot allow ourselves to be held hostage by high-pressure tactics of any industry.

Nor can we make the same mistakes we made with the airline industry. In that legislation we did not hold the industry's feet to the fire and make sure that they took care of their employees and the consumers.

I know from our experience in Florida that the insurance industry is more than willing to walk away from its biggest risks and turn them over to somebody else. Companies paid out $16 billion in claims after Hurricane Andrew slammed across South Florida in 1992—the costliest natural disaster ever. Then major players in the industry spent the rest of the decade trying to slip through State legislation that would shift responsibility for hurricane coverage to Florida's government and its taxpayers. We headed off every one of those efforts. And we fought the industry's attempts, since Andrew, to force unconscionable, ever-increasing rates on Florida's homeowners.

Homeowner insurance rates are now stabilized in Florida, and competition has returned—because we worked out a solution that will back up the industry if and when another mega-storm hits. But the emergency fund created by the State requires companies to pay for most hurricanes and to shoulder their share of cost of major storms. And it spreads the risk by building up reserves with premium dollars—not taxpayers' dollars.

Whatever solution we come up with at the Federal level on terrorist coverage, I believe the same principles of private enterprise must be applied. Government can play an important role in helping to resolve the immediate crisis—whose impact would be felt far beyond the insurance industry. For the most part, however, we should leave the business of insurance to the insurance business.

As you know, there are two basic plans so far—the White House proposal and another plan that seems to have broad support from the insurance industry. They are still being fleshed out, so we do not have the details needed to fully and fairly judge them. But, based on the information that has emerged so far, I have some major concerns. For example, what safeguards would be provided to prohibit insurers from doing what the industry calls "cherry-picking?" In other words, once Federal help is provided, what is to stop the companies from covering only those properties or businesses that are relatively safe from terrorism and leaving the bigger risks for someone else? And, what is to stop them from simply passing on any terrorism losses they might suffer in the form of sudden and steep surcharges against their customers? Or from finding ways, in the complex array of State regulations, of excluding acts of terrorism from the coverage consumers buy on their homes, their automobiles, or their lives?

I say that anything we do here, at the Federal level, must assume and require that companies cover the peril of terrorism—a peril that looms so much larger since September 11. Simply put, if taxpayer's help foot the bill, then the terrorism peril cannot be dumped by the insurance industry.

As I understand it, the Administration's plan would make the Federal Government responsible for paying 80 percent of the first $20 billion in claims, and 90 percent of the next $80 billion, resulting from any terrorist attacks in 2002. This proposal would increase the industry's liability from terrorist claims in the next 2 years, but still cap it at $23 billion in 2003, and $36 billion in 2004, with the Federal Government covering all remaining claims. I have strong concerns about requiring the taxpayers to assume, even on a temporary basis, such a large percentage of the cost—especially at the front end.

A more responsible approach, in my view, would be to require the companies to, cover terrorist-related losses up to a certain level before any Federal help would kick in. The primary insurer would cover up to a certain dollar retention level, and above that level, the risk could shift to the Federal Government. We should not support any proposal involving the use of taxpayer dollars unless we are convinced that the insurance companies have ample "skin in the game."

Under the separate, industry-backed proposal, insurers would pool their premiums through creation of a new Government-backed insurance company called the Homeland Security Mutual Reinsurance Company. Each participating company would retain 5 percent of terrorism and 5 percent of workers' compensation war risk, and leave the remaining 95 percent of each to the insurance pool.

I hold true to the belief that private market solutions are more desirable than Federal intervention. But—if I understand this plan correctly—the Federal Government would be responsible for covering 100 percent of any claims resulting from terrorism next year, while the new insurance pool begins building its capital.

As this debate progresses, we must constantly keep in mind that insurance companies are well equipped to handle most large-scale disasters. The industry is recognized by many financial rating agencies, institutional investors, and economists as one of the strongest in the global economy.

- Between them, the property-and-casualty and life-and-health insurance industries count nearly $3 trillion in invested assets.
- The National Association of Insurance Commissioners estimates that the industry has a capital cushion of more $550 billion to absorb unexpected downturns in the financial markets and adverse loss experience on its policies.

In other words, the industry is flush right now with huge surpluses. And, whatever our solution to this aspect of the terrorist crisis, we must require insurers to pay their fair share. As we consider the public policy implications of terrorism reinsurance, I believe we must proceed in a deliberative fashion. In my view, that means reaching agreement in the coming weeks on a short-term, interim solution—

no more than 1 year—to ensure that insurance protection against terrorist attacks remains available in 2002. And then resuming our work after January 1 to develop a more permanent plan.

That approach also would enable us to consider reform of the current system of insuring against natural catastrophic disasters. Despite our progress in Florida in dealing with the hurricane threat, the fact remains that no single State, nor any single industry, could cope with the kind of mega catastrophe we now know Mother Nature could bring our way.

In lieu of the perennial debate over establishing a Federally backed insurance pool, I am personally intrigued by proposals that would require insurers to set aside part of their profits for a rainy day. The idea is to let companies develop tax-deferred reserves and thereby increase their capacity to respond to catastrophic losses. I know this Committee takes a keen interest in these problems, as does the Commerce Committee.

I look forward to working with you on legislation—both short- and long-range solutions—that not only will keep our economic engines running but also protect the consumers we all serve.

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## PREPARED STATEMENT OF PAUL H. O'NEILL

SECRETARY, U.S. DEPARTMENT OF THE TREASURY

OCTOBER 24, 2001

Mr. Chairman, Senator Gramm and Members of the Committee, I appreciate the opportunity to comment on terrorism risk insurance. These hearings are extremely important. We believe that there is a real and pressing need for Congress to act on this issue now. As I will discuss in more detail, market mechanisms to provide terrorism risk insurance coverage have broken down in the wake of September 11. Such coverage is now being dropped from property and casualty reinsurance contracts as they come up for renewal, with most policies renewing at year-end. If Congress fails to act, reinsurers have signaled their intention to exclude such coverage meaning that primary insurers may have to drop this coverage or institute dramatic price increases. As a result, after January 1 the vast majority of businesses in this country are at risk for either losing their terrorism risk insurance coverage or paying steep premiums for dramatically curtailed coverage. This dynamic can, in turn, be expected to cause dislocations throughout our economy, particularly in the real estate, transportation, and energy sectors.

### The Problem

The terrorist attacks of September 11 created widespread uncertainty about the risk and potential costs of future terrorist acts. Since September 11, we have endured this uncertainty every day as a country. It has permeated every sector of our economy.

A key part of the Federal Government's response to the events of September 11 is to ensure that our economic stability is not undermined by terrorist acts. Continued economic activity is dependent on well functioning financial markets—where the lifeblood of capital is provided to business enterprises. Financial markets allocate capital based on the potential success of a business. In doing so, financial markets rely on the insurance sector to mitigate certain types of risk that are not directly related to the plans or operations of a business.

Insurance companies manage risk in economic activity and facilitate the efficient deployment of capital in our economy by estimating probabilities of possible adverse outcomes and pooling risk across a large group. Since September 11 the uncertainty surrounding terrorism risk has disrupted the ability of insurance companies to estimate, price, and insure the risk.

We learned on September 11 that, while perhaps highly improbable, terrorists are capable of enormous destruction. Could such an event be repeated? As a country and a Government, we are doing everything in our power to prevent a repetition of anything like the events of September 11. But how does an insurance company assess this uncertainty? How does an insurance company price for it? At the moment, there are no models, no meaningful experience, no reasonable upper bound on what an individual company's risk exposure may be.

Insurance companies do not "take" risks. They knowingly accept and mutualize risks. They are private, for-profit enterprises. If they do not believe they can make money by underwriting a particular risk, they will not cover it. Because insurance companies do not know the upper bound of terrorism risk exposure, they will protect themselves by charging enormous premiums, dramatically curtailing coverage, or—

as we have already seen with terrorism risk exclusions—simply refusing to offer the coverage. Whatever avenue they choose, the result is the same increased premiums and/or increased risk exposure for businesses that will be passed on to consumers in the form of higher product prices, transportation costs, energy costs, and reduced production.

The consequences of uncertainties surrounding terrorism risk are already evident in the airline sector. The Department of Transportation's initial projection is that, as a result of the September 11 attacks, airlines will pay nearly $1 billion in premium increases for terrorism risk insurance in the next year despite a congressionally imposed cap on third-party liability. Within the next few months, similar increases can be expected for other forms of economic activity deemed "high risk"—if coverage is available at all. Higher premiums will divert capital away from other forms of business investment.

The need for action is urgent. From our conversations with insurance company representatives, State insurance regulators, policyholders, banks, and other entities which provide financing for property transactions, the next 2 months are critical. The insurance industry relies on a complicated structure of risk sharing. Risk is shared among primary insurers, reinsurers, and retrocessionairs (that is, providing reinsurance to the reinsurers). This structure has worked well in the past and greatly contributed to widely spreading losses associated with the events of September 11 across the insurance industry.

However, in light of the uncertainty created by September 11, reinsurers have told us that they will no longer cover acts of terrorism in their reinsurance contracts with primary insurers. And as I have said, most property and casualty insurance contracts are up for renewal at year end. This will create the following choices for insurers: assume all of the risk of terrorism coverage and raise prices to cover all of the associated, unshared costs; reduce coverage levels; or cancel coverage. Any of these choices has the potential to cause severe economic dislocations in the near-term either through higher insurance costs or higher financing costs.

**Objectives**

In grappling with this problem, we have had several objectives. First and foremost, we want to dampen the shock to the economy of dramatic cost increases for insurance or curtailed coverage. We also want to limit Federal intrusion into private economic activity as much as possible while still achieving the first objective. And we want to rely on the existing State regulatory infrastructure as much as practicable. Note that none of these objectives are directed at providing Government assistance to the insurance industry. The industry is absorbing the financial losses it contracted for as a result of the September 11 attacks, and is fully capable of making good on those losses. The industry is also capable of continuing to provide insurance for nonterrorist hazards. The problem, as I have said, is one of uncertainty about future terrorist risk. At the moment, there is no basis upon which to price terrorism risk and no sense of the upper bound on the risk exposure.

**Options**

Over the past few weeks, a variety of proposals have emerged to deal with the problem I have outlined. Before turning to the approach we have developed, I will briefly discuss a few of the alternatives we considered and some of the shortcomings we identified with each.

A case could be made to treat terrorism risk insurance like war risk insurance. During World War II, the Federal Government provided property owners with insurance protection against loss from attack. Similarly, the Israeli Government provides insurance for terrorism risk. This approach would recognize the terrorist threat as one made against all Americans and would establish the broadest possible risk pool for insuring against this risk. At the same time, such an approach implies a permanent Federal intrusion in the market so long as any terrorism risk remains.

A second approach, one suggested, in various forms by insurance industry representatives, involves the creation of a reinsurance company to pool terrorism risk. This model follows an approach developed in the United Kingdom in response to IRA terrorist activities. This approach has some appeal, especially in providing a vehicle for pooling the industry's risk while providing an upper bound on industry losses through a Government backstop. With more time, or in different circumstances, this approach may have been desirable.

In our judgement it has several significant shortcomings. First, the approach ultimately leads to the Federal Government setting premium rates by establishing the rate charged to the pool for the Government's backstop. If the basic problem is that the insurance industry whose business it is to measure and price risk—cannot currently price terrorism risk without distorting markets, why would we think the Government can do a better job?

Establishing a pool would also take time, and time is very limited since most policies expire at year-end. It is unclear how long it would take industry to capitalize the pool. In the interim, the Government's exposure could be substantial, insofar as it would be liable for 100 percent of losses that exceeded the pool's capitalization. In addition, we question whether the Government could move quickly enough on its end to establish the contracts, the pricing structure, and the regulatory structure needed to make the proposal work.

Finally, the pool approach creates a Federal insurance regulatory apparatus with some presumption of permanence and a potentially enormous pool of captive capital that we may never need to use. We believe that there will be less uncertainty about terrorism risk a few years from now and that uncertainty will be more manageable by the private sector than is the case today. Given that, why undertake the effort to create a monopoly reinsurer and give a new Federal regulator the power to both set prices and regulate insurance companies and their activities?

A third option would be to simply set a large industry deductible and let the Federal Government cover all losses from acts of terrorism past that point. For instance, the Federal Government could require the insurance industry to cover all losses up to, say, $40 billion in a given year and the Federal Government would pay all losses above that amount.

This approach has two substantial drawbacks. First, it does not address the fundamental problem: the industry has no basis for knowing—and hence pricing—terrorism risk. A large deductible would require them to assess premiums large enough to cover a large potential loss. In the absence of better information, we might well expect companies to price insurance as if they fully expected losses up to the deductible amount. Second, this approach makes it difficult to control losses above the deductible as insurance companies would have no incentive to limit costs once their deductible has been paid.

**A Shared Loss Compensation Program**

After reviewing these and other options, and discussing these issues with Congressional and industry leadership and the State insurance regulatory community, we developed an approach that we believe best accomplishes the objectives I set forth. Let me say at the outset that this approach reflects the current evolution of our thinking on this issue. We want to work with Congress to achieve the best possible solution. As I have said, the insurance industry can easily protect itself by eliminating coverage or charging very high premiums. What we are trying to do is craft a plan that will prevent the economic dislocations that will otherwise take place if private insurers follow the course they are now on. It is imperative that we find a solution that works in the marketplace. We must get it right, and we must get it right now.

When terrorists target symbols of our Nation's economic, political, and military power, they are attacking the Nation as a whole, not the symbol. This argues for spreading the cost across all taxpayers. Yet there are also reasons to limit the Federal role. If property owners do not face any liability from potential attacks, they may underinvest in security measures and backup facilities. In addition, the insurance industry has sufficient experience and capacity to price some portion of the risk associated with terrorism and has the infrastructure necessary to assess and process claims.

Under the approach we are suggesting, individuals, businesses, and other entities would continue to obtain property and casualty insurance from insurance providers as they did before September 11. The terms of the terrorism risk coverage would be unchanged and would be the same as that for other risks.

Any loss claims resulting from a future terrorist act would be submitted by the policyholder to the insurance company. The insurance company would process the claims, and then submit an invoice to the Government for payment of its share.

The Treasury would establish a general process by which insurance companies submit claims. The Treasury would also institute a process for reviewing and auditing claims and for ensuring that the private/public loss sharing arrangement is apportioned among all insurance companies in a consistent manner. State insurance regulators would also play an important role in monitoring the claims process and ensuring the overall integrity of the insurance system.

Through the end of 2002, the Government would absorb 80 percent of the first $20 billion of insured losses resulting from terrorism and 90 percent of insured losses above $20 billion. Thus, the private sector would pay 20 percent of the first $20 billion in losses and 10 percent of losses above that amount.

Under this approach the Federal Government is absorbing a portion—but only a portion—of the first dollar of losses, which we believe is important to do in the first year of the program. The key problem faced by insurance companies right now is pricing for terrorism risk. While this type of loss sharing approach does not completely alleviate that problem, it does provide insurance companies with the ability to evaluate potential losses on a policy-by-policy basis, with clearly defined maximum exposures. For example, on a $100 million commercial policy the insurance company's maximum exposure would be $20 million. If industry losses were greater than $20 billion that exposure would be reduced even further.

More importantly, price increases to policyholders should be lower under this approach than under an approach that requires companies to absorb 100 percent of losses up to a large, aggregate industry loss deductible. Under this approach, if an insurance company's maximum exposure was defined at $20 million on a $100 million policy, the insurance company could then price that $20 million exposure on the probability of a complete loss event occurring.

Suppose instead that the insurance industry had to absorb $20 billion in losses before any Government loss sharing began. Then, in our example, the insurance company's maximum loss exposure would be $100 million on that policy, not $20 million. Pricing to this maximum loss would create the economic dislocation we are trying to avoid.

The role of the Federal Government would recede over time, with the expectation that the private sector would further develop its capacity each year. As private sector capacity increases, the nature of the Government's loss sharing agreement would also change. Given more time and experience, we believe that the insurance industry could reestablish robust risk-sharing arrangements such as reinsurance that would enable the private sector to insure losses from terrorism before the Government loss sharing commenced.

Thus, in 2003, we would have the private sector be responsible for 100 percent of the first $10 billion of insured losses, 50 percent of the insured losses between $10 and $20 billion, and 10 percent of the insured losses above $20 billion. The Government would be responsible for the remainder.

In 2004, the private sector would be responsible for 100 percent of the first $20 billion of insured losses, 50 percent of the insured losses between $20 and $40 billion, and 10 percent of the insured losses above $40 billion. The Government would be responsible for the remainder.

To preserve flexibility in an extraordinary attack, combined private/public liability for losses under the program would be capped at $100 billion in any year. It would be left to Congress to determine payments above $100 billion.

The Federal Government's involvement would sunset after 3 years. It is our hope, indeed our expectation, that the market problem we face today will have been corrected by then so that the private sector will be able to effectively price and manage terrorism risk insurance going forward. Of course, should that prove not to be the case, Congress and the President can reevaluate the program in place and decide at that time on an extension of the program or establishment of another approach.

This approach would also provide certain legal procedures to manage and structure litigation arising out of mass tort terrorism incidents. This includes consolidation of claims into a single forum, a prohibition on punitive damages, and provisions to ensure that defendants pay only for noneconomic damages for which they are responsible. It is important to ensure that any liability arising from terrorist attacks results from culpable behavior rather than overzealous litigation. These procedures are important to mitigating losses arising from any future terrorist attack on our Nation, and are an absolutely essential component of the program I have outlined.

Finally, this approach requires a clear definition of an "act of terrorism." We suggest that the Secretary of the Treasury, with the concurrence of the Attorney General, and in consultation with other members of the Cabinet, be given authority to certify that a terrorist act had taken place for purposes of activating the shared loss compensation arrangement.

We believe that this approach dampens any adverse economic impact from a sudden increase in the cost from terrorism risk insurance over the next 12 months. The imposition of a deductible in the second year, and an increase in the deductible in the third year, permits the Federal Government to gradually withdraw from the market as the private sector adapts to measuring and pricing terrorism risk.

**Conclusion**

Mr. Chairman, for the reasons I have set forth, the Administration believes that the economy is facing a temporary, but critical, market problem in the provision of terrorism risk insurance. Keeping our economy moving must be our overriding concern. Leaving this problem unresolved threatens our economic stability. The approach I have outlined limits the Government's direct involvement, retains all those elements of our private insurance system that continue to operate well, and provides a transition period to allow the private sector to establish market mechanisms to deal with this insidious new risk that confronts our Nation.

There are no perfect solutions to this problem. We have developed what we believe is a sound approach. As I explained earlier, we do not believe that creation of a reinsurance pool can be accomplished under the time constraints we face, but we would be glad to explore modifications to our approach with the Committee.

I would be pleased to answer any questions the Committee may have.

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## PREPARED STATEMENT OF R. GLENN HUBBARD

CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

OCTOBER 24, 2001

Mr. Chairman, Senator Gramm, 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's 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 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 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 noneconomic 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 Principles**

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 3 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 noneconomic 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.

## PREPARED STATEMENT OF KENNETH A. FROOT

ANDRÉ R. JAKURSKI PROFESSOR OF FINANCE, HARVARD UNIVERSITY

OCTOBER 24, 2001

Mr. Chairman, Senator Graham, and Members of the Committee, I appreciate the chance to appear before you today to discuss the insurance and reinsurance markets in the aftermath of the tragic events of September 11. We run the risk of considerable short-term dislocation in these markets going forward, given especially the annual nature of reinsurance renewals. At the same time, we need to preserve the benefits of a vibrant insurance marketplace: the high-quality evaluation, pricing, allocation, and mitigation of risk. So the issue before the Committee is extremely important as well as timely.

**Some Useful Background**

This is not the first important upset in insurance and reinsurance markets. In the mid-1980's, as the U.S. courts entered new territory, large insurer and reinsurer exposure to product and environmental liability became apparent. Insurance prices rose rapidly. Some firms failed, and insurance and reinsurance capital was stressed by the additional liabilities. The industry responded by developing specialized contracts, and treaties to cover these liabilities. They developed schemes for pricing that, especially in the early years, proved remunerative. Major financial intermediaries came together to sponsor the creation of new major reinsurers to write new liability coverage.

In the early 1990's, the United States experienced two very large natural disasters, Hurricane Andrew and the Northridge Earthquake. The losses from these events (currently estimated at approximately $20 billion and $17 billion, respectively) were a shock to an industry that rarely considered, and have never before seen, such losses from natural perils. Once again, some firms were bankrupted and risk capital was stressed.

Let me trace out the industry response. First, as one might expect, insurance and reinsurance prices rose spectacularly immediately after Andrew, doubling between 1992 and 1993. Figure 4b shows an index of Rate on Line (ROL), the ratio of premiums to policy limits, for catastrophe reinsurance. ROL rose strongly in 1993. However, ROL actually understates the change in the cost of reinsurance. When the price of reinsurance goes up, buyers tend to purchase less, specifically by using higher deductibles. The expected claim against the policy goes down relative to the limit, thus making the protection more expensive than ROL makes apparent. The line labeled "price" adjusts for this effect. Price is the ratio of the premium paid to the expected loss. This is a much truer index of reinsurance cost. The event impact on price is considerably greater using this measure of price.

Second, after these very large post-event increases, prices fell steadily between 1994 and 1999. The effect of Andrew and Northridge dissipated. By 2000 prices were at half of their earlier values. Why did this occur? Additional risk-bearing capital and new firms entered the reinsurance industry, increasing competitiveness. Approximately $10 billion of additional capital flowed into these reinsurers, much of which is a result of the attractive post-event prices.

Third, this growth occurred through the creation of a variety of new institutional reinsurance mechanisms. For example, the basic prototypes for reinsurers domiciled in tax- and regulation-favorable countries—Bermuda in particular—were developed and streamlined. These tax and regulatory advantages benefit the U.S. insurance industry by providing more competitive reinsurance products.

Fourth, during this same period, additional sources of capital outside of the reinsurance sector became active. "Cat" bonds and related financial instruments, which could be purchased by investors, became viable alternatives to reinsurance treaties as a way of transferring risk. Even though relatively few "cat" bonds have been issued, they have promoted competition in the industry. Over the past 3 or 4 years there have been a number of episodes where major reinsurers have succeeded in undercutting the price of "cat" bonds. While it is unclear whether the motives have been tactical or predatory, what is clear is that competition has been enhanced.

Fifth, while hard to summarize in numbers, the entire discourse surrounding natural catastrophe events changed during this post-event period. Third-party firms specializing in building objective models of potential natural disaster losses grew and, unlike before, became popular with insurers, reinsurers, investors, and intermediaries. Critics of the objective models engaged them. Conferences and specialist groups began to discuss catastrophe risk both qualitatively and quantitatively. Insurers, reinsurers, commissioners, regulators, rating agencies, and even the general public became far more aware of the possibilities of these events, where they might occur, what kinds of buildings are at risk, how construction techniques can be improved, how damage can be contained, etc. Insurance and reinsurance prices increasingly impounded this information. The increase in awareness and planning has resulted in significant risk mitigation, better decisions about risk exposure and financial capital, and corporate, financial, and household sectors that are more stable.

These changes have helped reduce the post-event price of reinsurance. But, perhaps more importantly, they have increased the amount of reinsurance protection that is commonly purchased today. To see this, Figure 4d shows the reinsurance buying patterns of insurers who purchase reinsurance. Specifically, it shows the fraction of reinsurer losses covered at different levels of industry losses (in 2000 dollars). Because this chart covers only insurers who purchase protection, it is not representative of the entire insurance industry. Nevertheless, it is representative of the level of industry losses for which protection is purchased. And the results are striking. Before Andrew and Northridge, the most common layer of protection helped protect against events generating industry-wide losses of about $4 billion. As of 2000, the most popular level of loss protection had about tripled, to about $12 billion. In addition, today substantial coverage has been extended to much larger events. Protection against natural catastrophe losses of $20–$25 billion and more is not uncommon. This is the legacy of Andrew and Northridge, and it is a permanent one, given the changes discussed above.

**Some Implications for Today**

This brief retrospective provides context for policymaking in the aftermath of the latest, largest ever losses from September 11. First, it is clear that reinsurance industry is efficient over the medium term. The industry can and does respond to large disasters. High prices occur, but these motivate the response. Figure 4b shows that prices have fully returned to their pre-Andrew levels, even as Figure 4d shows that demand today for reinsurance has increased enormously. This is the sign of an economically efficient industry: financial innovation and capacity expansion have accommodated a large increase in demand with virtually no increase in price.

Second, there is evidence that the "medium term" has today grown shorter. Following Andrew, the post-event spike in prices took several years to undo. With the losses of September 11 following so closely thereafter, there are a number of reasons to believe that the response will be considerably quicker going forward.

- Bermudan reinsurers, transformers, and other financial institutional forms including capital-markets instruments can rapidly and smoothly impound new capital. A variety of vehicles allow investors to participate in the reinsurance function through equity in new or existing reinsurance companies, closed-end mutual funds, convertible close-end funds, bonds, convertible bonds, etc.
- In addition to the "hardware"—meaning explicit organizational forms, contractual and financial instruments—for transferring risk, much "software" has also been built. This includes the expertise and knowledge of brokers, investment bankers, reinsurers, insurers, rating agencies, investors, and regulators, who are much more fluent in the activities of risk transfer in property/casualty lines.
- There is direct evidence that the combination of this "hardware" and "software" works effectively today. As I write, I am aware of approximately $3.0 billion that has already been newly committed to reinsurance capacity directly as a result of the September 11 events. These additional capital infusions involve the expansion or creation of Marsh Axis Specialty Re, AIG, GE, Renaissance Re, Hartford Financial, QBE, Zenith National, Da Vinci Re. These are committed fund raising efforts, fully in place in less than 6 weeks.

At the end of the post-Andrew price cycle, prices had returned to where they began. However, durable progress had been made. The "hardware" and "software" create a kind of infrastructure. As a result, the catastrophe marketplace today has become more flexible and responsive. The risk associated with natural disasters is better mitigated and better spread as a result.

Third, any form of sustained provision of reinsurance by the Government will impede this kind of progress. Many decisions throughout the economy need to be made that affect exposure to terrorist actions. What types of steel and concrete reinforcements help reduce risk in buildings of various heights? What kinds of physical barriers around tall buildings, stadiums, public works projects are appropriate? What kinds of equipment for checking, opening, or possibly sterilizing mail should employees reasonably expect? What kinds of security is it appropriate for the travel and other industries to provide their employees and customers? Insurance and reinsurance markets help provide answers to these questions by evaluating and pricing risk, and formulating detailed policy requirements. The result is that risk is both mitigated and better spread throughout the economy.

Fourth, the sheer level of uncertainty about the likelihood of terrorist attacks is not itself a reason to replace market functions with Government programs. Critics of catastrophe modeling including some of the most important reinsurance underwriters—argue that the models provide false provision and that the probabilities of natural disasters are unknowable. The uncertainty surrounding the potential one-time impact of the Year 2000 computer bug was certainly extreme, yet this did not stop the creation of private insurance dedicated to protecting against Y2K damages. The history of the last 5 years strongly suggests that market can and does function even when risk is hard to evaluate.

**The Administration's Proposal**

I support and applaud the Administration's proposal of a limited, temporary Federal intervention in the insurance market. A measured response is appropriate at this time to assure continuity in insurance markets and support renewed economic growth. I am comfortable with all but one of the four key principles articulated by Chairman Hubbard in his earlier testimony. The intervention should encourage private market incentives to expand capacity as needed and diversify risk. It should generate appropriate price incentives to encourage the private sector to mitigate the losses and risk of a terrorist event. And it should help reduce uncertainty about liabilities that arise from associated litigation. In addition, I believe that if these three principles are to be satisfied, the short sunset feature of the program is absolutely essential.

In that spirit, I would strengthen the second of the Administration's principles, which deals with the sunset feature. In my view, it should read, "The intervention should be absolutely temporary, and primarily intended to resolve short-term dislocations in the market due to a sudden shift in risk and coverage perceptions." Given the magnitude of the change in expectations that we have just experienced, and the very tight calendar before year-end, I believe that an intervention is justified. The risk profile of major firms—both financial and nonfinancial—would be otherwise unbalanced and a deterrent to economic growth.

Over 2 or 3 years, I believe the market is fully capable of evaluating, pricing and designing exposure to large risks. If we experience losses beyond what the markets are willing and able to tolerate, then Government involvement is, at that point, virtually assured. This is, and has been, the case for natural disasters. There, private market policies are not open-ended; they extend to losses that are only so great. Since the largest events are often unknowable beforehand, the sensible approach is to define the intervention ex post, based on the then-existing circumstances. The existence of a Federal program ex ante is unlikely to forestall Federal actions after another event should that program then be considered inadequate. As I have argued, the existence of anything more than a targeted, highly temporary, Federal program is likely to forestall development of better insurance markets and pricing, and better risk allocation and mitigation decisions by the private sector.

Thank you again, Mr. Chairman, for the opportunity to express my views.

Figure 4b: Price of Reinsurance Relative to Actuarial Value, 1989-2000

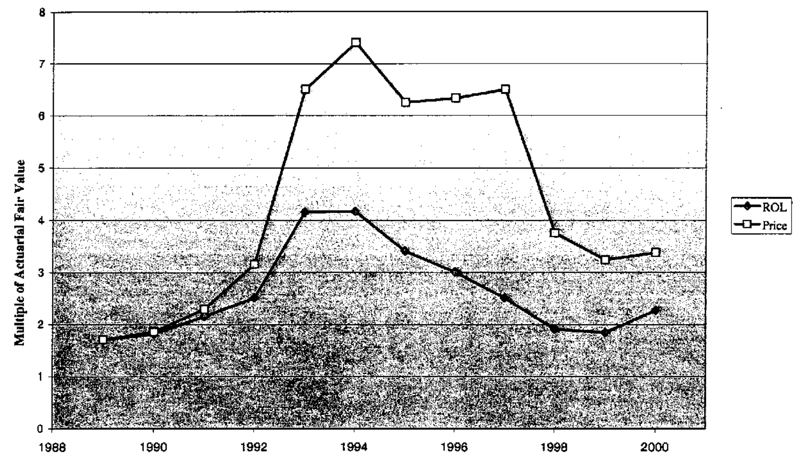
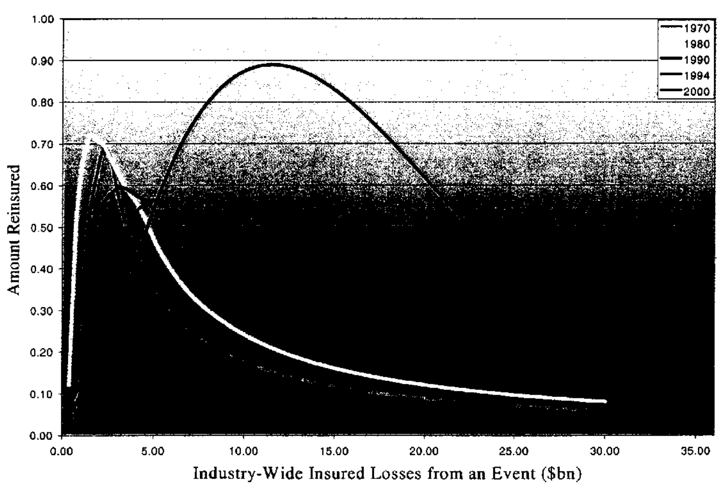



Figure 4d: Marginal Percent Reinsured 1970-2000



**PREPARED STATEMENT OF KATHLEEN SEBELIUS**

PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS
COMMISSIONER OF INSURANCE, THE STATE OF KANSAS

OCTOBER 24, 2001

**Introduction**

My name is Kathleen Sebelius. I am the Commissioner of Insurance for the State of Kansas, and this year I am serving as President of the National Association of Insurance Commissioners (NAIC). Speaking for myself and my fellow insurance commissioners, we appreciate the opportunity to testify regarding the potential role of the Federal Government in making sure that insurance against acts of terrorism remains available to American consumers and businesses.

Today, I want to make three basic points:

- First, NAIC and its members believe there is presently a need for the Federal Government, working with the State regulatory system, to provide appropriate financial backup to the private insurance market in order to assure that our Nation's economy does not falter due to a lack of insurance coverage for terrorism. Although NAIC has not endorsed a specific proposal for Federal assistance at this time, we have adopted a set of 19 guiding principles that we believe should form the basis of any successful Federal program. A copy of the NAIC's guiding principles is attached at the end of my testimony.
- Second, we believe Federal assistance should be a relatively short-term solution to stabilize the commercial marketplace while it regains the risk assessment and pricing equilibrium needed for private insurers to underwrite terrorism exposures. Thus, any Federal terrorism insurance program should be limited in scope and duration.
- Third, a Federal assistance program should maximize the use of market forces to add efficiency and reduce the risk of losses from terrorism and the potential costs to Federal taxpayers.

**The U.S. Insurance System Remains Fundamentally Sound**

Let me start by saying that NAIC believes the insurance industry is well-capitalized and financially able to withstand the pressures created by the September 11 terrorist attacks, despite losses projected to exceed $30 billion. The U.S. insurance industry is a $1 trillion business with assets of more than $3 trillion. Preliminary loss estimates of $30 billion to $40 billion represent just 3 to 4 percent of the premiums written in 2000.

America's insurance companies have time and again shown their ability to respond to huge disasters and successfully recover. Adjusted for inflation, Hurricane Andrew in 1992 caused $19.7 billion in insured losses, and California's Northridge Earthquake in 1994 cost $16.3 billion in insured losses. As with previous disasters, we believe insurers affected by the recent terrorist attacks will be able to pay their projected claims, as they themselves have said.

Insurance is the sale of a promise to pay claims when losses occur. As regulators, my colleagues and I will continue monitoring the process to make sure that insurance promises are kept. To do our job, we are backed by an impressive array of human and technical resources, including the NAIC and 51 State insurance departments that collectively employ more than 10,400 people and spend $910 million annually on insurance supervision. In addition, at this time State insurance guaranty funds have the capacity to provide up to $10 billion to compensate American consumers in the event of insurer insolvencies.

We would urge Congress to structure any Federal assistance program to take full advantage of the existing State regulatory system. We have the mechanisms in place to monitor insurer solvency and handle claims payment issues.

**Congress Should Not Disrupt the Power of Private Market Competition**

The international commercial property/casualty insurance market is very powerful, dynamic, and competitive. As a free market, it responds to new information quickly, and sometimes with great volatility. Like the stock exchanges, insurance market participants often react in unison to reach the same conclusion at the same time with regard to what products are viable and profitable, meaning that the price and availability of specific products will rise and fall in conjunction with the industry's collective willingness to sell them. Substantially negative information, such as the September 11 terrorist attacks, can disrupt the entire market until new information becomes available that makes insuring terrorist risks acceptable.

Given sufficient time to adjust, however, the commercial insurance market has found ways in the past to assess and insure extremely large and difficult risks that were initially considered uninsurable. During the 1980's and 1990's, the insurance industry weathered enormous financial losses from asbestos, medical malpractice, and environmental pollution claims against corporate policyholders that were not foreseen by insurers. In those instances, insurers said they had not reasonably expected to be held responsible for such colossal claims, and therefore had not collected sufficient premiums or established sufficient loss reserves to cover them.

In the short term, the insurance market responded to huge environmental exposures with policy cancellations, coverage limitations, exclusions, and increased prices, as is being threatened now with regard to terrorism risk coverage. In the longer term, coverage for these risks became available through a combination of aggressive risk management, self-insurance, captive insurance pools, other alternative risk-sharing mechanisms, and renewed interest by commercial insurers as they gained confidence in their abilities to adapt their policies and pricing to a level where they could underwrite the business profitably. Ultimately, the creativity and competitive discipline of the market overcame its initial period of contraction and volatility to provide viable insurance solutions for enormous risks that were previously considered uninsurable.

The business of insurance is about measuring risks and selling promises to cover them at a reasonable profit. Insurance experts who perform these tasks are exceptionally talented. Over time, they have demonstrated a remarkable ability to adapt to unforeseen circumstances, while making available the insurance products that are essential to the growth and productivity of American business. As expected in a free competitive market, individual companies may stumble, falter, and even fail when substantial adversity strikes, but the U.S. insurance industry as a whole has a long and proud record of finding ways to overcome new obstacles while advancing its business goals and serving the interests of the insurance-buying public.

Thus, the NAIC believes Congress should begin its consideration of Federal assistance to the insurance industry by recognizing the strength and adaptability of the private insurance markets. Federal actions that unduly disrupt or interfere with private market forces are likely to end up causing more harm than good for American consumers and Federal taxpayers.

**Appropriate Government Action Can Help the Private Market Recover**

State regulators know from their own experiences that Government action can help the insurance market recover when it becomes overwhelmed by changing risk factors or catastrophic losses. When the psychology of the market results in industry reactions that harm the public, Government has unique powers to alter the insurance marketplace for the benefit of consumers. We have found that successful Government assistance involves tailoring actions to fix specific problems and keeping the program as narrow as possible.

Hurricane Andrew provides a useful example of limited Government intervention that works. Following the tremendous losses from this hurricane in 1992, commercial reinsurers restricted their coverage for windstorms and raised prices. This caused a corresponding reaction from primary insurers, who moved to raise prices, cancel coverage for coastal properties, and increase deductible amounts for consumers having significant hurricane exposure. Within a couple of years, normalcy returned to the reinsurance market, and then to the primary market. The Florida Insurance Department assisted with the recovery of the industry by introducing a moratorium on policy cancellations and beginning the discussion of the need for a State catastrophe pool. The Florida legislature later adopted a Hurricane Catastrophe Insurance Pool that provides a State-based backstop for catastrophic windstorms in Florida. These collective actions have resulted in a robust and competitive market for homeowners insurance in the State of Florida.

State insurance regulators believe the current situation affecting the availability of insurance for acts of terrorism is similar in nature to other catastrophic events. Due to the magnitude and unpredictable nature of terrorism as it is currently perceived by insurers, a temporary level of Federal assistance to spread risk appropriately should provide time for the marketplace to adjust its thinking about how insurance coverage for terrorist acts should be handled. If the Federal Government and business customers make quick progress in lessening exposure from acts of terrorism, the insurance industry may start providing the coverage American businesses and families demand. Enacting a temporary Federal solution will provide the necessary time to craft a more thoughtful long-term solution.

**Three Important Market Factors for Congress to Keep in Mind**

As Congress considers what type of Federal assistance may be appropriate to steady the commercial market while it adjusts to new demands, the NAIC recommends that you keep in mind three very important factors. These factors will greatly affect the costs of any Federal program, as well as its lasting impact on America's consumers and private insurance markets.

First, risk management precautions that reduce the likelihood of losses from terrorist attacks will have a large impact on the willingness of private insurers to offer terrorism insurance coverage to customers. Risk management—the implementation of safety and security measures to prevent harm—is a standard part of insuring commercial and Government facilities that are most susceptible to terrorist attacks. Large firms have professional risk management departments whose mission is to reduce a company's exposure to potential accidents and intentional harm, thereby improving the company's chances to get insurance at the lowest rates possible.

Following the September 11 attacks, Government and commercial facilities across America have added security measures to prevent acts of terrorism and limit potential damages. As commercial risk managers review these new precautions, it seems likely they will become more inclined to offer terrorism insurance because the possibility and extent of potential insured losses occurring will be greatly reduced. At that point, we expect market forces will start working to fill the gap by making terrorism insurance available through private industry.

The NAIC recommends that Congress build-in strong incentives for insurers or companies receiving Federal assistance to implement and maintain effective risk management measures to prevent acts of terrorism from occurring. In that way, the Federal Government will be building upon standard risk-reducing steps that are well accepted in the private marketplace for insurance products.

Second, the private market instills policyholder discipline to avoid insurance claims through the concept of co-insurance. Co-insurance means that policyholders are liable to pay part of any losses covered by insurance before expecting a recovery from an insurer. Obviously, the higher the dollar amount covered by the policyholder himself, the greater will be his incentive to take steps to avoid losses. This concept is commonly understood by everyone owning a car or a home who agrees to bear the cost of a "deductible" before receiving payment from an insurance company. Co-insurance should be considered by Congress as an important market discipline tool that works equally well with Government programs.

Third, the scope and duration of any Federal assistance program will itself become a factor in the private insurance market. Even though Congress is considering special Government assistance intended to operate as a supplement to normal business channels, the very fact that Government will pay certain costs of a commercial business becomes a factor to be taken into account when private market decisions on terrorism insurance are made.

The NAIC urges you to keep in mind that Federal Government policy regarding terrorism insurance assistance will not occur in a vacuum. It will become a private market consideration affecting prices and availability of insurance, and it may impact insurance products having nothing to do with terrorism. The extent of the Federal influence on private market insurance products can be expected to be directly commensurate with the size, details, and length of the Federal assistance program.

**State Actions Are Not Driving the Market Demand for Terrorism Insurance**

The NAIC and its members have recently been asked to explain how requirements of State law impact the market demand for terrorism insurance. Many people in Congress apparently think that States require private businesses to carry insurance against terrorism, and that failure of the private insurance market to offer terrorism coverage will result in violating State laws and regulations. We believe there is a misunderstanding of what State laws require and what State insurance regulators actually do.

Let me say that States do not drive the private market for terrorism insurance. To our knowledge, no State currently requires that business entities maintain insurance against acts of terrorism. In fact, the NAIC recently performed an electronic search of State laws and regulation for references to "terrorism." We found nothing.

Furthermore, it is important to understand that State insurance regulators do not normally get involved in the details of property/casualty insurance policies for large business operations. These are considered to be the product of free market negotiations among sophisticated insurance underwriters, brokers, and professional corporate risk managers who rely upon the traditional powers of buyers and sellers to bargain for the best deal they can get. The State regulatory interest in such large transactions is mainly that they not impair the overall financial health of an insurer, since monitoring insurer solvency is a major responsibility of regulators.

Banks and investors typically use their private market influence to require that large business and Government entities maintain adequate property/casualty insurance coverage against foreseeable harm. As a result of September 11, foreseeable harm may now start to include possible terrorist acts in addition to normal hazards. However, terrorism coverage would usually be just one part of a comprehensive insurance package that insurers want to sell. Their desire to avoid terrorist risk exposures may be offset by their need to include it in order to sell a package of insurance coverage judged to be profitable overall.

**State Actions Having a Limited and Indirect Impact on Terrorism Insurance**

What, then, is the impact of State laws on terrorism insurance? Primarily, it falls into three areas—workers' compensation requirements, policy form regulations, and rate regulations. We believe these areas have a limited and indirect effect upon the price and availability of terrorism coverage in commercial property/casualty policies for large business projects that significantly affect the American economy. It is important to recognize that States are not initiating market requirements in these areas, but only reacting to market forces that threaten to deny consumers fair insurance coverage.

*Workers' Compensation Requirements*

State workers' compensation laws were developed early in the 20th Century. In the late 1800's and early 1900's, the number of occupational injuries and illnesses occurring in the American workplace was hindering the Industrial Revolution. Businesses were asking how they could assure that working men and women who are injured on the job get the care they need, while protecting industry and commerce from the financially crippling and demoralizing prospect of employees suing their bosses for every work-related injury. The question was answered with the State Workers' Compensation System, which covers employees' medical expenses and lost wages for work-related injuries and disease, regardless of who was at fault. In return, employees are limited to the benefits provided by the workers' compensation system as their exclusive remedy.

State workers' compensation laws require a set of benefits that are guaranteed by employers to their employees who are injured on the job. Insurers play a key role in the delivery of the benefits promised by employers. Typically, insurers assume by contract the obligation to provide the employer's share of medical benefits, rehabilitation benefits, and survivor's benefits in exchange for premiums the employer pays the insurer. Since State law obligates the employer—and therefore the insurer that has assumed the employer's obligations—to provide the benefits specified in a State's Workers' Compensation Act, the insurer cannot introduce either an exclusion for war or an exclusion for terrorist acts.

As a no-fault safety net for workers' injuries on the job, State workers' compensation laws do not permit coverage exclusions as a matter of public policy. Workers' compensation insurance is one part of the commercial coverage maintained by significant employers.

*State Policy Form Regulations*

Many States have statutory authority over insurance contract language through general policy form regulations. These requirements typically prohibit contract language that is misleading, illusory, inconsistent, ambiguous, deceptive, or contrary to public policy. Since no currently enacted State laws specifically prohibit an insurer's request to exclude coverage for terrorist acts, States would have to rely upon the general provisions above if they seek to deny an insurer's request to exclude terrorism coverage. Under State law, an adverse regulatory decision can be challenged by an insurer through the State insurance department's administrative process, with the right of appeal to State courts.

State insurance regulators are also charged with solvency oversight of insurers. Thus, an action to deny an exclusion of terrorist activities under general policy form provisions could cause financial difficulties for insurance companies. However, it is ultimately the insurer's choice whether to provide coverage for a specific business event or peril. Primary insurers may be hesitant to exclude coverage for terrorist acts because they know their business and individual customers will want assurances the coverage is provided. Reinsurers do not directly deal with businesses and families, and therefore do not face the same pressures to provide terrorism coverage.

*State Rate Regulations*

State rate regulations are primarily focused on protecting small businesses and individual policyholders. For commercial lines insurance products, only 13 States still require that the insurance department exercise prior approval requirement for most rate changes. The remaining 38 jurisdictions have some form of competitive rating mechanism that allows insurers to file and use rates, or use them even before they are filed with insurance regulators. Moreover, in recent years insurers have been successful in convincing State legislatures to create rate regulation exemptions for large commercial policyholders. The NAIC does not believe State rate regulations are preventing insurers from charging adequate rates for terrorism insurance.

**Conclusion**

The NAIC and State regulators believe the insurance industry remains strong, and that it retains tremendous strength to recover from the September 11 attacks and adjust its business practices to new conditions in the marketplace. State insurance regulators are working together to help assure that any glitches which occur do not disrupt the process of getting people's lives back in order and America's businesses back to work. The NAIC and its members plan to work closely with Congress and fellow regulators, as set forth in the Gramm–Leach–Bliley Act, so that the needs of individual Americans and our Nation's economy are met in a timely way.

# Guiding Principles for Federal Legislation Related to Property and Casualty Insurance Coverage for Losses Caused by Terrorism

The insurance industry has repeatedly encountered new, unexpected, and severe risks in the past and has always, given reasonable time and experience, been able to develop creative ways to price its products. However, certain events may exceed the capacity and willingness of the property and casualty insurance industry to provide future coverage for terrorism exposures. State insurance regulators recognize that federal legislation is urgently needed to provide a federal backstop to buttress the ability of the property and casualty insurance industry to protect Americans from financial losses associated with terrorism, while at the same time safeguarding insurer solvency so that insurance companies can continue to meet all of their other claims obligations. Outlined below are the governing principles and essential elements of any federal disaster insurance legislation that state insurance regulators support. The National Association of Insurance Commissioners (NAIC) urges Congress to take immediate action to enact legislation consistent with these principles.

For purposes of this document, the use of the word "terrorism" includes the war risk for workers' compensation that insurers are required to provide coverage for as a result of statutory provisions contained in state workers' compensation laws.

**A. The Role of a Federal Government Program**

1. Federal legislation in this area should "sunset" at a date certain of limited duration after enactment in order to allow a reevaluation of the need for and design of the program.

2. To take advantage of the substantial experience of state-based insurance regulation, the expertise of the NAIC should be made available to any federal program in this area and consideration should be given to including representatives of the NAIC as members of the governing body of such a program.

**B. The Content of a Federal Program**

3. Federal legislation should supplement but not replace other private and public insurance mechanisms where those mechanisms can provide coverage more efficiently.

4. Federal legislation should include clear and non-ambiguous definitions of terrorism to be applied to all policies nationwide.

5. Rates should consider all reasonable factors that can be feasibly measured and supported by theoretical and empirical analysis, including relative risk.

6. Federal legislation should encourage loss reduction and hazard mitigation efforts.

7. State residual market mechanisms and other pooling mechanisms providing coverage should be allowed to participate in any program established by federal legislation but in such a way as to not create incentives for business to be placed in those residual markets.

8. Federal legislation should recognize that terrorism exposures subject insurers to potential "adverse selection," *i.e.*, entities with lower risk are less likely to voluntarily purchase coverage, while those with greater risk are more likely to purchase coverage. If possible, the federal program should encourage the inclusion of both low-risk and high-risk entities to promote greater risk spreading in a way that does not subject risk-bearing entities, including the federal government, to adverse selection.

9. Federal legislation should address coverage and cost for all risks exposed to terrorism, regardless of geographic, demographic or other classification, such as "more-at-risk" or "less-at-risk."

10. There should be a safety net protection, within reasonable limits, for any private program created by federal legislation in the event of the insolvency of the program or its participants.

11. Tax law changes should be encouraged to avoid penalties on and encourage the accumulation of reserves for the portion of terrorism losses insurable in the private marketplace.

12. Federal legislation should not unnecessarily preempt state authority.

**C. Participation in the Program**

13. Federal legislation should encourage individuals and businesses to maintain private coverage for terrorism exposure.

14. Federal legislation should promote or encourage awareness that coverage is available for any property and/or casualty risk that meets reasonable standards of insurability.

15. Federal legislation should encourage or mandate that eligible entities participate in the program or run the risk of losing access to federal disaster assistance.

**D. Administration of the Program**

16. There should be an appropriate balance of the different private and public interests in the governance of regulatory oversight over the program.

17. Federal legislation should recognize the expertise of the states in insurance regulation with respect to such areas as licensing insurers, solvency surveillance, oversight of rates and forms in most jurisdictions, licensing producers, assisting policyholders and consumers during the claim settlement process and performing market conduct examinations.

18. To more efficiently achieve the objectives of any federal terrorism program, there should be coordination of state and federal regulatory responsibilities.

19. Jurisdiction over insurer claim settlement practices should remain with the states.

**PREPARED STATEMENT OF J. ROBERT HUNTER**

DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA

OCTOBER 24, 2001

Good day Mr. Chairman and Members of the Committee. My name is Bob Hunter. I am Director of Insurance for CFA. I previously served as Texas Insurance Commissioner and, of particular relevance to today's subject, as Federal Insurance Administrator under Presidents Ford and Carter.

I served at FIA between 1971 and 1980. My first task was to assist in establishing the Riot Reinsurance Program under the provisions of the Urban Property Protection Act. I encourage you to look at the Riot Reinsurance Program for guidance in your current important effort for reasons I will cover in the next few minutes.

In the late 1960's, the Nation faced great uncertainty from a form of terror from within. There were an awful series of riots in the land. If this were not bad enough for the people in the inner cities who were at the equivalent of what we now call "ground zero," the reinsurers panicked and began to cut off reinsurance protection from the American primary insurance market. The primary insurers, without their layoff arrangements were poised to pull out of the inner cities. Then lenders would have to call mortgages . . . the set up for a true crisis.

Congress, wisely, stepped in, creating the riot reinsurance program. The program adhered to good insurance principles, requiring the Government to charge full actuarial rates for the reinsurance and making sure that claims were appropriate for payment.

I was tasked with the job of coming up with actuarially sound rates for the Riot Reinsurance Program. This was about as fearful a job as I ever faced. There was great uncertainty. But actuarial soundness is not defined as precise prices. It relates to procedures such as using the best information available, making reasoned judgements and basically doing your best. We did that, full well expecting to be too high or too low since future events such as riots are hard to predict.

I met with insurers, actuaries from the actuarial societies and other interested parties and came up with prices. Insurers thought they were OK since they bought the reinsurance. The taxpayer was protected and, indeed, profited from the transaction. Sound insurance principles require proper prices and require adequate supervision of the claims payment process.

**CFA Supports a Federal Reinsurance Program for Terrorism**

CFA supports a sound program of reinsurance for the terrorism risk underwritten by the Federal Government.[1] I attached a list of principles CFA developed for Congress to consider when developing the program. Foremost among the principles are that the insurance industry must be able to purchase affordable reinsurance and that the taxpayer be protected.

**Interim Terrorism Insurance Proposal**

CFA understands that creation of the permanent plan we espouse below might take more time than we have to protect insurers as of January 1, 2002, when most reinsurance runs out. We, therefore, suggest that an interim, actuarially sound plan be developed.

Simply, we believe that most insurers could withstand at least another event of the magnitude of the September 11 tragedy. So we do not think that the interim plan should cover first dollar losses. CFA proposes that a retention be used for each insurer of 5 percent of surplus, as of December 31, 2001. "Terrorism" must be defined for this interim plan and should be determined by a Federal official.

If a terrorist attack occurs and an insurer suffers claims greater than the retention amount, the insurer would be eligible for Federal low or no interest loans, the term of which would be negotiated up to 30 years. This would spread the cost over time, an important goal. For each insurer, the discounted value of the loan would be limited to an additional 5 percent of surplus.

Amounts of money loaned in excess of the 5 percent of surplus by company would be repaid to the U.S. Treasury through a property/casualty insurance industry-wide loan repayment mechanism. This loan repayment would be collected over a number of that years are sufficient to minimize the rate impact on consumers (Congress should set the maximum surcharge, perhaps at about 2.5 percent per year, until the

[1] This testimony relates to property/casualty insurance. The life insurance industry has requested a Commission to study if they need backup. CFA believes that a Commission is not needed. The life insurance industry should make its case for when they might need help and Congress should call hearings to critique that analysis. CFA looks forward to participating in that separate process.

loan is repaid). The surcharge would be collected by the States as a piggyback on their State premium tax mechanism and forwarded on to the U.S. Treasury. This step is needed in order to make sure that individual company balance sheets are not impacted by very large losses due to terrorist activity.

This plan leaves the regulation of insurance fully in State hands. The States should be required to assure availability and affordability of the terrorism risk, using their usual regulatory methods, including pooling by State, if necessary. Further, the States should be asked to assure that the plans enhance security through discounts or other incentives. Congress could set goals for the States in this effort. This requires little, if any, new bureaucracy since much of this work is already part of the State insurance department responsibility.

**Needed Protections for the Taxpayer**

Any longer term plan should protect consumers and taxpayers in the following manner: First, insurance companies should pay full actuarially sound rates for any reinsurance protection they enjoy. Any plan that requires no premium is not actuarially sound. The insurers need a plan to protect their interests—they do not need a hand out. Insurers should be loathe to set a precedent where inadequate premiums are acceptable when they are paying the premium, if they do not expect consumers to press for inadequately priced home, auto, life, and other coverages. When the insurers offer free insurance to us, we will consider free reinsurance for them.

Free insurance is particularly galling in Year One of the coverage. Do not forget the insurers made contracts with Americans to cover terrorism fully. These contracts are being entered into even as we speak. So, for a year for policies being written today and for an average of about 6 months for policies already in force, there would be terrorism coverage even if Congress did nothing. To come in after-the-fact and give away insurance to the industry, which is a very healthy industry [2] even after September 11, would be foolish.

Actuarial soundness is possible. The taxpayer can be assured that, over time, the program would, at worst, cost the taxpayer nothing. Here is how to do it:

- Congress should require actuarially sound reinsurance premiums. That does not mean precision, it means doing the best you can to set a price you think is based on reason.
- The plan should include assessments against the industry if terrorism reinsurance claims exceed certain dollar thresholds. During the riot reinsurance days, the industry had to agree to a 2.5 percent of their total premium assessment provision in the reinsurance contract.
- The plan should have a provision stating that if the taxpayer has paid more into the plan than the premiums and investment of premiums, the premium collection aspects of the plan will stay in effect until the taxpayer is made whole. Just as in the Riot Reinsurance Program, the plan can be self-sustaining over time. Uncertainty will end and the costs shifted to taxpayers during the uncertain times can be recouped as certainty returns.
- The plan should include a wise payout plan that minimizes taxpayer exposure. The second year of the White House proposal is a good start. That should be the first year of the program. The industry can easily afford a first layer of coverage where they are 100 percent at risk for tens of billions. I would set it at $35 billion [3] for Year One. The industry could easily afford three such events even today.
- The Federal Government should have a claims audit role to assure that only claims that meet the definition of terrorism and are within the contractual provisions of the reinsurance policy are paid.

Second, private insurers should not be able to "cherry-pick" against the taxpayer. By "cherry-picking" I mean sending bad risks to the Federal reinsurance program and keeping good risks for the industry accounts. Thus, all primary insurance companies should be required to participate in the reinsurance program. At the very least, groups of insurers should not be allowed to reinsure one company with "target" risks (for example the Empire State Building) but not reinsure another company in the group (say, insuring farm risks).

[2] At year-end 2000, the property/casualty industry had surplus of $321 billion and net premium written of $303 billion. The rule of thumb for a very safe industry is a ratio of $1 of surplus for each $2 of net premium written. Thus, the industry had "excess" surplus of $170 Billion. ($321 − $303/2). So, even if the industry has another WTC event they can afford it.

[3] Some have maintained that this is difficult to do since some who suffered loss early would be more exposed than those with later claims. This is a red herring. What you should do, I think, is to allocate the deductible by insurer based on the sorts of risks they have and their surplus level. Then a smaller insurer might be paid even if a terrorist loss was relatively small but in the locus of the exposure that that insurer wrote.

*State Consumer Protections Should NOT Be Impacted by Any Reinsurance Plan*

One of the beauties of reinsurance by the Federal Government is that it is simply a contractual arrangement with the insurer, it does nothing to interfere with the carefully constructed system of State regulation in place.

*There Must Be a Degree of Bureaucracy To Administer the Program*

While it can be minimized, you need staff to develop the contract and administer the claims payment process. You cannot just pay claims. If you do, the taxpayer will be ripped off. You need a small but not insignificant staff (maybe 50) to do this job. The setting of the premium charge and the collection of the reinsurance premium requires very few staff (maybe 5).

*Availability and Affordability of Insurance Must Be Assured*

The reason for Congress to step into this situation with Federal backup is to make sure that the economy is not frozen by lack of insurance for the terrorism risk. To write a plan that does not do the necessary to assure that insurance is written and the price is reasonable would be foolish.

This means that the plan should include a requirement of continuation of direct provision of terrorism coverage by insurers as part of the "deal" for taxpayer backup for those risks that meet minimum security standards. Further it means that the rate charged for primary insurance should be correlated with the reinsurance charges so that there is no gouging by insurance companies at this time of national emergency. Congress should not infringe on the ability of State regulators to assure that price gouging for primary insurance does not occur.

**Critique of Industry Proposal**

The Consumer Federation of America strongly opposes the industry drafted "Insurance Stabilization and Availability Act of 2001." This proposal is a massive overreach that unnecessarily exposes taxpayers to billions of dollars in risk. There are several serious problems with the industry approach:

- The bill does not require actuarial soundness. Indeed, insurers would pay nothing for reinsurance for the first year of the program, until the mutual insurance company created under the bill builds up a $10 billion net asset base. Apparently, this free Government reinsurance would even cover policies already in force for which insurers are fully at risk today. This is a grossly improper use of taxpayer monies.
- Insurers can "cherry-pick" risks since they could opt in or out of the reinsurance program at will. One insurer of a group of companies could be set up to take all of the "bad" risks and buy the reinsurance, effectively adversely selecting against the taxpayer. Further, "cherry-picking" is allowed in that the insurers can decide whether to reinsure personal risks and commercial risks separately.
- The selection of Illinois as the sole regulator of the new Federally backed mutual insurer puts consumers at risk. Illinois, unlike most other States, does not control prices. Congress should not interfere with normal insurance protections afforded business and personal consumers. If Congress decides to interfere, a Federal agency should be empowered to regulate the insurers, including the rates charged for the reinsured coverages, to assure that no price gouging occurs. (Why enact a terrorism reinsurance program to make insurance affordable and then let insurers charge whatever they want for the coverage?) If one State were to be used to regulate the rates and policies offered (something CFA does not favor), the most advantageous for consumers would be the largest State, California. Studies show that California insurance oversight has been the best in the country over the last decade.
- The bill would cover war events only for workers' compensation. The bill should cover war for all lines of insurance and the reinsurance program should be so constructed.
- The bill waives the application of all Federal and State antitrust laws. This is unnecessary and inappropriate.
- The bill allows territorial differences in pricing, which means that New York City will likely pay much higher rates than other cities, particularly if there is no Government review of insurer pricing decisions, as the bill proposes.
- There is no guarantee of affordability or availability of coverage to reasonably secure risks.

We urge you to reject the insurance industry proposal and, instead, use the very successful Urban Property Protection Act of 1969 as the precedent for this program, as reflected in the principles developed by CFA (printed below).

**Critique of the White House Proposal**

The White House proposal is flawed for several reasons. First, it is actuarially unsound. The taxpayer should not give away reinsurance.

Second, the first year payout plan shows a fundamental misunderstanding of insurance. The 80/20 percent split starting at the first dollar of terrorism loss will actually leave the taxpayer exposed to 100 percent of the risk. This is because the plan will reinsure the reinsurers. So, the primary insurers will reinsure the 20 percent the taxpayer is not on the hook for with the reinsurers. The reinsurers will then "buy" (for no premium) the 80/20 percent cover. This will increase the taxpayer share to 96 percent (100 percent − [20 percent*20 percent]). But that is not the end of the reinsurance process. The reinsurers will again reinsure (called "retrocession") with other reinsurers (possibly including the primary carriers themselves). The taxpayer share will then go to 99.2 percent (100 percent − [20 percent*20 percent*20 percent]). If they reinsure again (there is no limit on how many times the risk can be ping-ponged to lay off risk on the taxpayer) the taxpayer share would be 99.8 percent. And so on. This could be corrected by not exposing the taxpayer to private reinsurance payouts.

A better approach would be to change the plan to have a large deductible. As indicated earlier, I think that amount should be $35 billion. Over that, there should be sharing as in Year Two of the White House plan . . . but no reinsurance should be allowed on private reinsurance claims even in that scenario. The White House plan also does not guarantee affordability or availability of coverage to reasonably secure risks.

**Conclusion**

Congress can and should backup the private insurance market with reinsurance for the peril of terrorism. It can and should do it in a wise way that protects the taxpayer and, over time, assures that the taxpayer is reimbursed for the costs of the program so that the cost goes to ratepayers rather than to taxpayers.

CFA looks forward to working with the Congress on this most important effort.

**Guiding Principles for Insurance Legislation Related to War and Terrorism**

1. CFA supports the concept of Federal backup of the private insurance industry for the perils of war and terrorism. We suggest the riot reinsurance program as a precedent for this backup.

2. Legislation should supplement but not replace other private and public insurance mechanisms where those mechanisms can provide coverage more efficiently. However, all insurers should be required to reinsure against the perils of war and terrorism through the Federal Government at the outset of the program. In time, as conditions warrant, private reinsurance should be encouraged. To avoid undue taxpayer exposure, however, the program should include a requirement of minimum extended terms for reinsured insurers with claims paid to allow taxpayers to recoup some of the losses.

3. There should be a reasonable coordination and structuring of State and Federal regulatory responsibilities with respect to a Federal terrorism reinsurance program that achieves the objectives of the program without unnecessarily compromising or preempting State regulatory authority and consumer protections. Necessary preemption of or limits on State regulatory authority should be compensated by requisite Federal oversight.

4. There should be an appropriate balance of different private and public interests in the governance of regulatory oversight over the program. Consumers (business and personal), insurers, reinsurers, and State regulators of insurance should be on the board of advisers for such program.

5. All records relating to the program, including the records of the reinsured insurance companies should be available for Federal audit and, to the maximum extent possible, made public.

6. Rates for the war and terrorism perils charged for the Government reinsurance should be actuarially sound and should consider all reasonable factors that can be feasibly measured and supported by theoretical and empirical analysis.

7. The Federal Government should assure that the cost of terrorism/war coverage charged by reinsured insurance companies to the consumer is actuarially based and correlated in price with the reinsurance offered by the Government.

8. The legislation must clearly define "terrorism" and "war" and exclude any coverage beyond those definitions. A top Federal official should determine if a specific event falls into either of those definitions.

9. Anti "cherry-picking" provisions such as the following should be included: Legislation should recognize that many war or terrorism exposures subject the Government to potential adverse selection as insurers with less catastrophe risk are less likely to voluntarily purchase coverage, while those with greater risk are more likely to purchase coverage. If legislation were to create a Government reinsurance program, the program should encourage the inclusion of both low-risk and high-risk insureds to promote greater risk spreading in a way that does not subject the Government to adverse selection.

10. Legislation should promote or encourage coverage that is available to any property that meets reasonable standards of insurability. Federal security requirements should be met within reasonable time periods by insured risks and policed by inspection by reinsured insurers.

11. State residual market mechanisms and other pooling mechanisms for insurance should be allowed to participate in the entity established by legislation to provide war and terrorism insurance, in such a way as to not create incentives for business to be placed in the residual market. To the extent that a risk meets the minimum security requirements, it should be able to get war and terrorism coverage through some source . . . a residual market if necessary.

12. Jurisdiction over claim settlement practices should remain with the States.

13. Tax law changes should be encouraged to avoid penalties on and encourage the accumulation of reserves for war and terrorism losses.

14. Legislation should encourage loss reduction and hazard mitigation efforts through enhanced security.

United States General Accounting Office

GAO

Testimony

Before the Senate Committee on Banking, Housing and Urban Affairs United States Senate

For Release on Delivery
Expected at
10:00 a.m. EDT
on Wednesday
October 24, 2001

# TERRORISM INSURANCE

# Alternative Programs for Protecting Insurance Consumers

Statement of Thomas J. McCool
Managing Director, Financial Markets and Community Investment

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GAO-02-199T

Statement

# Terrorism Insurance: Alternative Programs for Protecting Insurance Consumers

Mr. Chairman and Members of the Committee:

The tragic events of September 11, 2001, bring to light numerous areas of concern within the financial services sector, especially as threats of future terrorist attacks continue. One area of concern voiced by various industry groups and the Congress is how the insurance industry should respond to risks posed by potential terrorist attacks and the extent to which the government should play a role alongside the industry to address these risks. We appreciate the opportunity to discuss this issue.

Prior to September 11$^{th}$, insurance coverage for losses from terrorism was included as a normal feature of insurance contracts. According to industry analysts, this was because insurers' experience suggested that domestic exposure to terrorism, both in the number of occurrences and the magnitude of losses, was limited. The September 11$^{th}$ attacks have changed insurers' perception of their potential risk exposure. Insurance companies have indicated that they will pay their share of the losses from these tragic events. However, both insurers and the reinsurers who share the industry's risks, have indicated that they don't know how much to charge for this coverage going forward because they cannot predict future losses. As a result, it has been reported that industry leaders may exclude insurance for terrorism from future insurance contracts unless the federal government provides some form of assistance to the industry.

A financially strong insurance industry is essential to the smooth functioning of the economy. Industry officials have indicated that insurance coverage for catastrophic events such as a major terrorist act is necessary for investors and other financial decision-makers to be willing to provide capital to promote continued economic growth and stability. If the federal government chooses to provide financial backing to this industry, the primary driving force should be to safeguard the economy's access to necessary insurance protection. At the same time, care needs to be taken to ensure that the interests of both the federal government and American taxpayers are safeguarded, and that the industry is assuming its fair share of risks.

Any mechanism established by the federal government to support the ability of individuals and businesses to get insurance for terrorist acts should address several significant concerns. Most importantly, the program should not displace the private market. Rather, it should create an environment in which the private market can displace the government program. Second, it should be temporary, at least initially. Finally, any program should be designed to ensure that private market incentives for prudent and efficient behavior are not replaced by an attitude that says, "Don't worry about it, the government is paying."

In the aftermath of the September 11th terrorist attacks, the Congress is considering whether and how to provide financial backing to the insurance industry so that insurance is available for losses due to terrorist acts. As requested, we will present (1) features of several existing insurance programs, both domestic and international; (2) alternative mechanisms for funding insured losses; and (3) some broad principles or guidance that the Congress may wish to bear in mind as it considers possible ways to support the insurance industry in case of future catastrophic losses due to terrorist acts. My observations are based on publicly available information on a variety of insurance programs within the United States and other countries and from prior GAO work.

## Features of Selected Insurance Programs Covering Catastrophic or Terrorist Events

Today, a number of insurance programs exist in the United States and other countries to help ensure that insurance will be available to cover risks that the private sector has been unable or unwilling to cover by itself, including losses from catastrophic events and terrorism. Certain insurance programs are completely controlled and managed by the government, while others have little or no explicit government involvement. Likewise, in many programs the public and private sectors share risks, though in several different ways.

For this testimony, we are highlighting features from selected insurance programs, including some established by the federal government as well as some from other countries, the states, and others. For example, the federal government insures individuals and firms against natural disasters under the flood and crop insurance programs and bank and employer bankruptcies under the deposit and pension insurance programs. Some federal programs cover political risk insurance for overseas investment activities, third-party claims for nuclear accidents, and protection against war-related risks. Other countries and organizations have also developed insurance programs covering catastrophic or terrorist events. These programs can provide useful insights in developing an appropriate insurance mechanism to cover losses from terrorist acts.

For government insurance programs, the question of long-term cost and program funding needs to be addressed before the program is established. Some federal insurance programs have the statutory intent to provide subsidized coverage, while others are intended to be self-funding. As noted in some of GAO's previous work, whatever merits the federal government has as an insurer, the same characteristics that inhibit private insurance firms from covering certain events could also make a federally-sponsored insurance program a costly undertaking.[1]

In some cases, the federal government subsidizes insurance programs in order to achieve a public policy objective. For instance, catastrophic coverage under the crop insurance program is subsidized in an attempt to reduce reliance on ad hoc disaster assistance. In other cases, the federal government may set up premium and fee structures intended to cover the full cost of providing insurance. However, regardless of statutory intent, if federal insurance is underpriced relative to its long-run costs and the federal government pays the difference, a government subsidy results. For example, under the Flood Insurance Program, program operating losses have been financed through borrowings from the U.S. Treasury or covered by appropriated funds.

## Selected Insurance Programs Established by Federal Statute

The federal government's size and sovereign power provide it with the unique ability to offer insurance when the private market is unable or unwilling to do so. Currently, the federal government has a variety of mechanisms, including insurance programs, to cover risks that the private sector has traditionally been unable or unwilling to cover. Appendix I, table 1, highlights key features of several selected programs. We will describe some of them further today.

### Insurance for Catastrophic Nuclear Accidents

*Features:*

- *Mandatory participation*
- *Liability of the private sector is limited*
- *Implicit government backing*

A system that limits liability and provides indemnification for operators of nuclear reactors was established through the passage of the Price-Anderson Act of 1957. Specifically, the act limits the total liability of individual reactor operators for any accident. First, the operators must obtain insurance up to the maximum amount of private insurance available to the operator, which is currently about $200 million per reactor per accident. In addition, in the event of an accident at any single reactor that results in losses exceeding $200 million, all operators of the 106 commercial nuclear power reactors in the United States would be required to provide additional protection by paying into a secondary insurance fund. Depending on the amount of the claims, these contributions could be as high as $88.1 million per reactor per accident. Following an incident, the operators of commercial power reactors would be required to pay as much as $10 million annually for 9 years to complete the secondary

[1] Budget Issues: Budgeting for Federal Insurance Programs, (GAO/AIMD-97-16), September 1977.

insurance fund. For the 106 reactors in the United States, the nuclear industry's current exposure to third-party liability claims would be approximately $9.5 billion before the Congress intervenes.

In the event of an accident that involves damages that exceed the amount in the secondary insurance fund, the government is not explicitly required to fund the balance. Rather, Price-Anderson commits the Congress to investigate the accident and to take whatever action it deems necessary. This action could include, among other things, appropriating funds or requiring the nuclear industry to provide additional funding to satisfy remaining claims. No nuclear accidents have occurred since Price-Anderson was enacted that cost more than was provided by the available private insurance. As a result, the industry has never had to pay into the secondary insurance fund, nor has the Congress been required to take action on excessive losses.

### Insurance Against Overseas Political Risk

*Features:*

- *Voluntary participation*
- *Federal government is the insurer and risk bearer*

The Overseas Private Investment Corporation (OPIC), which began operations in 1971, was established to facilitate private investment by U.S. investors in developing countries and countries with emerging markets. OPIC insurance programs reduce the risk to U.S. investors in these countries by offering protection against several political risks. In general, the coverage offered by OPIC is more comprehensive both in scope and duration than the coverage currently available from private sector insurers. OPIC operates as a self-financing government agency. A significant portion of its income is derived from premiums and fees, but the program is also backed by $100 million in borrowing authority from the U.S. Treasury. Premium rates are based on a standard pricing table for different business sectors, with adjustments for project-specific risks. The risk assessment methods OPIC uses to establish insurance reserves and set premium rates rely heavily on expert judgment and are not highly quantitative. According to OPIC officials, no standard actuarial model exists for quantifying political risks. Over the life of OPIC, the government has made money on the insurance provided.

**Insurance Against Urban Riots and Civil Disorder**

*Features:*

- *Voluntary participation*
- *Encouraged states and the private sector to provide insurance in urban areas*
- *Offered federal reinsurance for insured property in urban areas*

The National Insurance Development Program was established by the Housing and Urban Development Act of 1968 (P.L. 90-448). The program sought to ensure the availability and affordability of fire, crime, and other property insurance to residential and commercial owners located in high-risk urban areas. The act created a Federal Insurance Administrator within the Department of Housing and Urban Development to administer the reinsurance program, but responsibility was later transferred to the Federal Emergency Management Agency. The program was a response to the urban riots and civil disorders of the 1960s, when many of America's cities suffered major property losses.

As a result of these losses, insurers became reluctant to underwrite property insurance in communities considered to be at risk for such events. The program had two purposes. First, the program encouraged state insurance regulators and the industry to develop and carry out programs to make property coverage more readily available. Second, it provided a voluntary federal program of reinsurance for urban property owner relief against abnormally high property insurance rates in private markets. Under this program, federal reinsurance was made available to property insurance companies operating in states that voluntarily adopted Fair Access to Insurance Requirements Plans. Insurers were required to retain a small portion of the liability,[2] which had to be paid first in the event of a claim. Insurers could transfer most of the remaining risk by making a premium payment to the federal government, which then assumed the remaining liability. This liability ranged from 90 to 98 percent of the remaining insured amount, and coverage increased as losses grew. The program was backed by $250 million in borrowing authority from the U.S. Treasury.

The program also included a requirement that states share in program losses with the federal government.[3] According to a former program official, state sharing of program losses was a feature designed in part to keep states from setting property insurance premiums too low. At the

[2] A "net retention amount" of not more than 2.5 percent of the premiums paid by owners, calculated on a state-by-state basis, depending on the line of insurance offered. Insurers purchasing reinsurance could also be assessed an amount in the event of losses in excess of all reinsurance premiums paid nationwide.

[3] If federal reinsurance payments exceed premiums from the property-casualty companies in a state, the state must pay an amount up to 5 per cent of the aggregate property insurance premiums earned in that state during the preceding year of those lines of insurance reinsured by the federal government.

program's inception, federal reinsurance was to last less than 5 years. However, former officials reported that the program made money because claims never reached the anticipated levels and, beginning in the early 1970s, the program premiums were used to subsidize a crime insurance program. Reinsurance was discontinued in 1984 because of the small number of insurers participating.

**Insurance Against Floods**

*Features:*

- *Voluntary participation*
- *Federal government is the insurer for flood risk*
- *Subsidized rates offered to encourage mitigation*

The National Flood Insurance Program, which was established by the National Flood Insurance Act of 1968, makes federal flood insurance available to property owners living in communities that join the program. Some of the key factors that led to the program's establishment were private insurers' reluctance to sell flood coverage, increasing losses from floods because of floodplain encroachment, and high federal expenditures for relief and flood control. This program, which is financed primarily through premiums, fees, and interest income, aims to reduce federal spending on disaster assistance. By design, this program is not actuarially sound, because it does not collect sufficient income from premiums to build reserves to meet long-term expenditures on flood losses. Though the Federal Insurance Administrator is authorized to subsidize a significant portion of the total policies in force, its annual appropriations do not cover these subsidies. As a result, the Congress has appropriated funds for the program from time to time. In addition, the Federal Insurance Administration has periodically borrowed from the U.S. Treasury to finance operating losses.[4] The program is backed by $1 billion in borrowing authority from the U.S. Treasury.

## Selected Insurance Programs of Other Countries

Many other countries have government-sponsored insurance programs that cover catastrophes, terrorist events, or both. Some of these programs are essentially run by the government, while others have little or no government backing. Appendix I, table 2, highlights key features of such programs in Israel, Japan, Switzerland, and the United Kingdom. We will briefly discuss these programs.

[4]Flood Insurance: Information on Financial Aspects of the National Flood Insurance Program, (GAOT-RCED-00-23), October 27, 1999.

## Japan's Insurance Against Earthquakes

*Features:*

- *Mandated insurer participation*
- *Private/public risk sharing*
- *Government share increases as losses increase*

Japan's earthquake insurance program, originally conceived in 1966, arose out of a major earthquake in that country in 1964. The insurance is purchased as a supplement to residential fire insurance and covers homes and household goods. Private insurers and the government share in any losses that result from a disaster according to a three-tiered payment system. Under the first tier of coverage, private insurers are responsible for the first $625 million[5] of damages before government assistance is triggered. This initial amount effectively acts as a deductible. Losses above this amount trigger a second tier of coverage, for damages up to $6.821 billion. The Japanese government pays 50 percent of the losses in this second tier. The third tier of coverage involves losses of between $6.821 billion and $34.166 billion, with the government paying 95 percent of losses exceeding $6.821 billion. The Japanese government receives reinsurance premiums from primary insurers, but its total liability is not necessarily limited to the total amount of premiums received.

Japan's program has several distinguishing features. First, the private sector is responsible for the initial portion of losses. This feature helps to ensure the development of a private market for earthquake insurance that is unencumbered by a monopoly. Additionally, industry pool arrangements are mandated under the program. The government takes on an increasing share of losses as they rise, up to a maximum cap on the total amount of exposure, but the private sector still bears some cost even at higher levels. This feature helps to ensure that risk of disaster is spread throughout the entire country and economy. Finally, the Japanese program was not established to provide coverage for all potential losses, but rather as a first step toward providing some level of coverage, with the government and private sector working together.

[5] Dollar figures presented are based on the conversion of yen to dollars from documents on the program provided by Japan's Board of Audit.

**United Kingdom's Insurance Against Terrorist Events**

*Features:*

- *Voluntary participation*
- *Created because of withdrawal of private reinsurance*
- *Insurers pay 110 percent of premium received before government pays*

The United Kingdom's Pool Reinsurance (Pool Re) program was established in 1993 to provide insurance against losses and damages caused by terrorists attacks on industrial, commercial, and residential properties located within the British mainland. There are several distinct layers of coverage. All policyholders who buy basic property coverage from insurers have the option of buying additional coverage from the same insurers to protect against terrorism. Insurers are responsible for the first 100,000 pounds of coverage per coverage type, with no reimbursement from the government. Claims exceeding 100,000 pounds are paid from premiums accumulated within a pool made up of insurance companies and Lloyd's syndicates. (The British government and the insurance trade group established a mutual company from these companies and syndicates to provide terrorism reinsurance.) If the pool of funds is exhausted, all participating insurers face a call of up to 10 percent of the premiums they have collected during the year. Beyond the 10 percent call, the pool investment income is tapped, and the government meets any claims in excess of this. According to United Kingdom officials familiar with the program, the government has not yet had to bail out the pool as the reinsurer of last resort.

**Israel's Insurance Against Terrorist Attacks**

*Features:*

- *Mandatory participation*
- *Government bears all risk*
- *Funded by tax revenues*

Israel has two programs for covering losses resulting from a terrorist attack. The first is the Property Tax and Compensation Fund, which covers property and casualty insurance. The second is the Law for the Victims of Enemy Action, which covers life and health insurance. The Israeli government funds and administers both programs. Under the Property Tax and Compensation Fund, the Israeli Income and Property Tax Commission levies a national property tax predominantly on Israeli businesses. The commission pays claims on property damages that are the direct result of a hostile terrorist attack (including losses of business inventory), on the basis of the market value of a property immediately before the attack. All indirect damages, including those for business-interruptions, must be covered through private insurance. Private supplemental coverage or additional state coverage can be purchased to cover the difference between a property's current market value and the cost of rebuilding (known as the replacement value). State coverage is capped by implementing regulations.

The second program, the Law for the Compensation of Victims of Enemy Action, is a state-run program administered by the National Insurance Institute (NII) and is also funded by the government. The NII is similar to the U.S. Social Security Administration. Coverage is provided for medical care, lost wages, extended payments to the families of attack victims, and personal injury. Coverage also extends to visitors and tourists who are in

Israel. Coverage amounts for this program are again determined by implementing regulations.

**Switzerland's Insurance Against Selected Catastrophic Events**

*Features:*

- *Mandatory participation*
- *No government risk exposure*

Switzerland's Catastrophe Insurance program was established to insure against natural disasters, including storms, hail, floods, landslides, and avalanches. Earthquakes are not covered under this program. This program does not set up a separate catastrophic insurance fund, but instead obliges insurers to include coverage for specified catastrophes in fire insurance policies for buildings and their contents at a statutorily fixed rate. These compulsory premiums are the sole means of financing the catastrophe insurance program. Although this scheme does not set up a separate catastrophe insurance fund, Swiss insurers have created a reinsurance pool where these additional premiums are deposited. Membership in this pool is optional for insurers, but currently 85 percent of claims are ceded to it. Should claims exceed the funds in the pool, the difference would be payable from the insurers' capital and assets. There is no government involvement or exposure associated with the operation of the program, since the Swiss government does not provide any guarantee. For this reason, the private sector has an incentive to reduce risks. Insurers that participate in the pool are also subject to a cash-call in proportion to their participation in the pool to cover claims that exceed pool capacity.

## Insurance Programs Sponsored by States or Other Entities

Other insurance programs that may provide useful insights in developing insurance coverage for terrorist acts include those established by state governments and private sector entities. Appendix I, table 3, highlights the features of several state and private sector insurance programs, and I will describe these programs here.

**State Insurance/Guarantees Against Insolvent Insurers**

*Features:*

- *Mandatory participation*
- *Funded by post event assessments*
- *Operated by industry*
- *No explicit subsidy*

Every state has guaranty funds to protect policyholders when an insurance company fails. These funds exist for property-casualty as well as life-health insurers. While there are differences between the funds for the two insurance sectors, in general they operate similarly. Insurance guaranty funds are not really funds. In nearly all states, the money used by guaranty funds to pay policyholders of failed insurers is collected through post-failure assessments. After an insurance company is found to be insolvent by a state regulator, the regulator and the guaranty funds in each state where policies were sold determine by how much the failed company's policyholder claims exceed the value of the company's assets. The guaranty funds then provide sufficient funds to ensure that all claims are paid (up to each state's statutory limits). Guaranty funds are not operated by state governments, nor are they funded by public money (i.e., there is no explicit subsidy).

However, the funds were created by statute and operate as part of the insurance regulatory system. Even though no appropriated funds are used to fund the guaranty funds, insurers do not bear the entire cost of guaranty fund assessments. While tax treatment varies among states, many states allow the insurers to offset their premium taxes for assessments paid to guaranty funds. Where this tax credit is permitted, insurers can usually reduce their premium tax bill by 20 percent each year for 5 years. Other states allow insurers to recoup assessments by increasing or adding a surcharge to policyholder premiums.

**California's Insurance Against Earthquakes**

*Features:*

- *Participation based on statutory requirements*
- *Funded by assessments on insurance companies*
- *No public funding*

The California Earthquake Authority was established to insure California residents against losses caused by earthquakes. The Earthquake Authority was set up by state statute. The state of California, however, does not contribute any funding to the authority. After the Northridge, CA earthquake in 1994, insurance companies determined that the premiums they had been charging for earthquake coverage were inadequate. Furthermore, the companies did not know how to set an actuarially sound price. Insurance companies attempted to stop selling insurance against earthquake damage, but were opposed by the state. After negotiations, insurers were permitted to exclude earthquake coverage from their property-casualty policies if insurance companies representing at least 70 percent of the market agreed to participate in the Earthquake Authority.

Participation meant agreeing to pay an initial assessment totaling $717 million plus two additional assessments of $2.15 billion and $1.434 billion after certain levels of earthquake-related losses occurred. Thus, potential Earthquake Authority losses are to be funded by a multilayered financing arrangement involving insurer contributions, premiums, conventional reinsurance, and pre-established debt financing. In early 2000, these layers totaled about $7 billion. In the event that all authority funds were expended, claims payments would be prorated. The Earthquake Authority currently provides virtually all of the earthquake insurance available in the state of California.

### Ship Owner Insurance For Ocean Pollution

*Features:*

- *Voluntary participation*
- *Risks are pooled and funded by pre and post assessments*
- *No government involvement*

The International Group of Protection and Indemnity Clubs (Group) includes the 14 protection and indemnity associations or "clubs" that insure about 90 percent of the world's seagoing tonnage. The individual clubs are nonprofit-making mutual insurance organizations that cover third-party risks of shipowning members. The American Steamship Owners Mutual Protection and Indemnity Association, Inc., known as the American Club, was established in New York State in 1917 and is the only U.S. domiciled member.[6] The American Club has no government subsidy. The Group arranges collective insurance and reinsurance that covers risks such as those arising from oil spills and other polluting substances. The program uses primarily a prefunded approach to pool funds through advance calls of premium. The advance premiums paid by shipowners are 80 percent of estimated claims for the policy year. Premiums are invested by the Group. Should loss experience prove higher than anticipated, the program also encompasses other reinsurance and a post assessment call feature.

The pooling arrangement is a four-layered system. Claims of less than $5 million are essentially risk of loss retained by the club member shipowners. The program then enables the pooling of claims from $5 million to $30 million between clubs based on a formula incorporating tonnage size, premium income, and claims record. The next layer, called "excess of loss reinsurance," is reinsurance purchased by the Group for third-party claims incurred in a single incident in excess of $30 million—up to $1 billion in the case of oil pollution liabilities and up to $2 billion for all other liabilities. Finally, the program encompasses an "over spill" layer to cover claims in the $2 billion to $4 billion range. This layer is funded through a post assessment of club members.

[6]The American Club became a signatory to the Pooling Agreement in February 1998. Prior to that, the American Club was reinsured with the Group via the London Club. Protection and Indemnity is the traditional name for insurance to cover ship owners and ship chartering firms against their legal liabilities to third parties.

## Alternative Mechanisms for Funding Insured Losses

In order to pay claims when an insured event occurs, a mechanism must exist to ensure that the funds will be available when they are needed. Currently, there are two possible models for such a mechanism. First, insurers can prefund for expected losses by estimating potential liabilities (establishing a reserve liability) and collecting assets (premiums) to pay claims when an insured event occurs. Alternatively, under certain circumstances, after an insured event when losses are known with certainty, assessments can be levied to provide the necessary funds. Both models, and in many cases a combination of the two, are widely used in the insurance industry.

### Prefunding Versus Post Assessment

The deposit insurance provided by the Federal Deposit Insurance Corporation (FDIC) is an example of a prefunded system. Banks pay premiums into a fund. When a bank fails, the deposit insurance fund is used to make up the difference between the bank's remaining assets and customer deposits, up to a legal limit. Of course, if the deposit insurance fund falls below a certain level because of large payouts, banks must pay additional amounts into the fund to ensure that sufficient funds are available for future failures. In contrast, most of the state insurance guaranty funds described earlier are examples of post assessment plans. After an insurance insolvency, the remaining insurance companies in each state where the company operated are assessed the difference between the failed insurer's legal obligations to its policyholders and its assets. Some of the programs described earlier in this statement include a combination of both prefunded and post assessment mechanisms, including the British Pool Re and the California Earthquake Authority.

For ordinary, noncatastrophic events, insurance companies set up reserves (liabilities) that measure their expected losses[7] and set aside assets to offset those liabilities. For catastrophic events, when both the timing and magnitude of losses are difficult or impossible to predict, insurance companies generally do not set up reserves.[8] These losses are

[7] For a reserve to be established by an insurance company, the losses must have already occurred (either reported but unpaid, or incurred but not reported), or be "probable" and "estimable."

[8] Accounting standards and tax law discourage the establishment of "contingency reserves." That is, insurers must usually build such contingency reserves from after-tax income (retained earnings). As a result, it is unusual for insurers to establish contingency reserves for events like hurricanes, since it is impossible to measure either the probability of such occurrences or the expected loss that is likely to occur during the current accounting period, irrespective of the long-term predictability of the event.

generally paid out of the company's ongoing premium stream, the company's capital, or both. If income from premiums is too low or losses are too high, an insurer's capital can be depleted, and the insurer may become insolvent. In the long run, if an insurer does not become insolvent, it can recoup catastrophic losses by adjusting the premium rates charged to policyholders. Thus, even insurance companies postfund some of their insured losses. Both prefunding and post assessment are reasonable ways to fund the exposure to losses from large catastrophic events, including terrorism. Both mechanisms have advantages and disadvantages. Used together, they could provide a multilayer mechanism for funding levels of risk exposure that otherwise could limit the availability of needed insurance.

## Reinsurance: A Further Means of Protection

Insurance companies that insure catastrophes can also reduce the potential for insolvency by purchasing reinsurance. The insurer remains liable for any claims when they are presented, but is later reimbursed by the reinsurer for the portion of the liability that was reinsured. The problem for the insurer then becomes one of liquidity rather than solvency. Of course, over time both the insurer's and the reinsurer's solvency depend on a reasonable correspondence between premium income (plus investment income) and losses.

Reinsurers remain in business if the direct insurer can charge premiums that provide sufficient income to pay claims and related expenses and to record a profit. If a reinsurer does not believe an insurer is capable setting a price commensurate with the risk, or of generating enough premium income to pay those risks, it will not reinsure that business. According to the insurance industry, it is now facing that situation in the aftermath of the September attacks. One possible solution would be for a group of insurers to establish a pool to take the place of the unwilling reinsurers. In this case, losses from any terrorist event that affect only one or a few members can be spread across the entire pool, reducing the likelihood that individual members will become insolvent. However, while the pool may take the place of the reinsurers, the pool faces the same difficulties in establishing catastrophic (contingency) reserves as the individual insurers. It would also be holding the same risks that the reinsurers were unwilling to accept. Hence, the desire to add the government to the equation.

## How the Federal Government Can Support Insurers Facing Catastrophic Losses

The federal government could help the insurers in a number of ways. It could allow the pool to build tax-free, multiyear reserves for potential losses that do not have a measurable probability or estimable value. Such a pool arrangement has been used in Britain for the purposes of increasing pool assets for catastrophic losses. This tax-free status would increase the pool's ability to pay for future terrorist events. However, if the insured event occurs before the pool builds up substantial reserves, or if the prices insurers are charging for coverage turn out to be too low, the pool's reserves would still be depleted. If so, the member insurers would still risk insolvency, since they would be obligated to pay all legitimate claims whether they could recover the funds from the pool or not. To alleviate this possibility, the government could also stand behind the pool as a risk-bearer. In this case, if the pool's assets were depleted, the government would assume the contingent liability, using its resources to pay additional losses and reducing the risk of insolvency for the insurance companies.

The government could also fund its contingent liability to the pool in a variety of ways. It could charge the pool a premium for the reinsurance-like protection it provides, accumulating a fund it could use to pay for losses. Of course, any premiums charged to the pool would reduce the pool's assets and accelerate both the time when the government would have to begin covering losses and its total exposure. Alternatively, the government could fund its losses out of tax revenues, either with or without repayment requirements.

Given that the problem currently facing the insurance industry is an inability to correctly price the risk of a terrorist act, prefunding may not generate sufficient funds to fully pay potential insured losses from major terrorist events. A postfunding (post assessment) mechanism could be used either to substitute for or to augment a prefunded reserving mechanism. Post event assessments could be a feature of the pool, of the government mechanism, or both. Pool Re, the British plan for public/private sharing of terrorism risk, includes a call on each member-insurer after the private pool is exhausted, in an additional amount equal to 10 percent of the total premium that insurers collected for terrorism coverage. Alternatively, the government could pay that portion of the losses that exceed the pool's resources and then assess the member companies over time in order to recoup part or all of its expenditures. In this variant, the government would be lending the insurance companies part or all of the cash needed to meet liquidity demands resulting from the terrorist event, but not bailing the industry out.

## Principles to Consider When Providing Financial Assistance

At this point, we would like to discuss some broad principles that we have drawn from lessons learned over several decades of supporting congressional efforts to assist industries and firms in moments of crisis, including the savings and loan industry and, most recently, the aviation industry.[9] These principles may provide guidance as you consider whether the government should take actions to ensure the continued availability of insurance and reinsurance for terrorist-related acts. We believe that the following three principles are key to such efforts:

- Clearly define the problem to be solved.
- Ensure that the program protects the government and taxpayers from excessive and unnecessary losses.
- Avoid a self-perpetuating program, that is, the government's involvement should be temporary.

### Defining the Problem the Industry Faces

The industry and federal government need to work together to clearly define the specific nature of the problems confronting the industry, separating short-term needs from long-term challenges and wants from genuine needs. It seems clear, given insurers increased recognition of their exposures in the aftermath of the unprecedented events on September 11, 2001, that coverage for terrorist acts is not now amenable to normal insurance underwriting, risk management, and actuarial techniques. As a result, insurers and reinsurers are concerned about their ability to set an appropriate price for insurance coverage for terrorist acts. Given this uncertainty if this kind of insurance were to be offered at all, it is likely that either the prices insurers set would be prohibitively high or so low as to invite insolvency. However, even if we conclude that insurers cannot price and, therefore, cannot sell this kind of insurance, defining the nature of the problem facing both the economy and the insurance industry is a critical first step. Many important questions need to be addressed. Among them are:

- What is the appropriate definition of a terrorist act?
- How would the lack of insurance coverage for terrorist events affect other sectors of the economy?
- What are the public policy objectives to be achieved by an assistance program?

[9] Commercial Aviation: A Framework for Considering Federal Financial Assistance (GAO-01-1163T, Sept. 20, 2001).

## Protecting the Government From Excessive Losses

Whatever program or mechanism is put in place, protecting the government—and, therefore, taxpayers—from inefficiency and excessive costs needs to be a primary objective. When the government becomes involved in providing insurance, it is usually because the private insurance market is having difficulty underwriting and pricing certain risks. For instance, some risks are difficult to predict and can be catastrophic in size. Additionally, some risks may not be independent—that is, the losses may strike a large number of insured individuals or entities at the same time. Furthermore, spreading the risk to a large and diverse population may be difficult. This difficulty sometimes results from adverse selection, which occurs when those with the highest probability of loss tend to purchase insurance, while those with the least risk opt out.

While these factors may provide a basis for government intervention in the market, they also complicate efforts to measure the government's exposure to loss. Nevertheless, the government can take steps to control and limit losses. For example, any program should have keep market incentives where they belong—with private firms. As long as private firms have their own money at risk, the private market is a better choice than the government for handling traditional insurance functions such as setting prices, underwriting policies, and handling and adjusting claims. If the government is bearing all or most of the risk, private firms will not have the same incentives to maximize efficiency.

Thus, any government program must be structured to ensure that private insurers have the same incentives they would have if the government were not involved. For example, firms should have an incentive to set the best prices they can (even in an environment of insufficient information), to require risk mitigation on the part of their customers in exchange for a reduced premium, and to carefully investigate losses to ensure that claims payments are appropriate. Creating a mechanism that places part of each company's capital at risk—as well as premium income—could serve to maintain the correct incentive structure. If insurance companies believe that their own exposure to losses is insignificant, they are not likely to behave the same way they would if their own money was at stake.

## Reevaluating Future Government Involvement

Finally, in the current crisis environment any government solution should be temporary and needs to be revisited periodically. Congress may decide that ensuring the continued ability of the insurance industry to serve all its customers is in the national interest. However, given the lack of information about the scope and nature of the long-term problem, it does not seem prudent to establish such assistance in a program that may become permanent. However, government programs that are not carefully designed tend to become self-perpetuating. We can find examples of such programs in our own government experience and in some of the foreign programs we have described today. Fortunately, several strategies are available to minimize the possibility that a program will perpetuate itself. First, government bureaucracy should be kept to a minimum. An established bureaucracy tends to find reasons for its own continued existence. Second, any program should have an exit strategy from the beginning. An exit plan will provide the insurance industry and program administrators with congressional guidance on how the industry should emerge from the assistance program. Finally, a primary goal of any federal insurance program must be to create an environment in which the private market can and will be reestablished.

## Conclusions

The government may have an important role to play in helping the insurance industry establish insurance coverage for losses from terrorist acts. GAO believes that should any assistance program be established it would be most successful if based on the principles we have described today. Following these principles will help ensure that assistance addresses market problems, protects taxpayers from excessive and unnecessary losses, and does not displace the private market for providing such insurance coverage.

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or other members of the Committee may have.

## Contacts and Acknowledgments

For further information regarding this testimony, please contact Richard J. Hillman, Director, or Lawrence D. Cluff, Assistant Director, Financial Markets and Community Investment Issues, (202) 512-8678. Individuals making key contributions to this testimony included James Black, Emily Chalmers, Darryl Chang, Ryan Coles, Rachael Demarcus, Jeanette Franzel, Thomas Givens III, Rosemary Healy, Ronald Ito, Stefanie Jonkman, Monty Kincaid, Barry Kirby, Robert Pollard, and Angela Pun.

# Appendix I: Summary of Alternative Programs

**Table 1: Summary of Insurance Programs Sponsored by the Federal Government**[1]

| Program | Description | Government subsidy | Sources of financing |
|---|---|---|---|
| Castrophic Nuclear Accidents | Insures operators of commercial power nuclear reactors from large liability claims from a major nuclear accident regardless of cause such as terrorism, negligence, and natural disasters. | Unclear | Operators of commercial power nuclear reactors obtain maximum amount of private insurance available. After an accident occurs, they pay into a secondary insurance fund. |
| Overseas Private Investment Corporation (OPIC) Political Risk Insurance | Insures the investments of U.S. companies in developing countries against several political risks, including expropriation, currency inconvertibility, and political violence. | No. Self-financing but guaranteed by the full faith and credit of the U.S. government. | Premiums, insurance claim recoveries, and interest earnings. |
| National Insurance Development Program<br><br>(Riot Re) | Insures against property losses due to riot and civil disorder. Provides owners with affordable insurance in high-risk urban areas. | Provided federal reinsurance mechanism. Capped Treasury borrowing authority at $250 million. | Deposited insurer premiums into a Treasury account. Required states to provide funds for program losses. |
| National Flood Insurance | Insures buildings and contents against losses due to flooding in communities nationwide that enact and enforce appropriate flood plain management measures. | Yes | Premiums, interest earnings, and appropriated funds. |
| Bank Insurance Fund | Insures deposits up to a specified amount. | Deposits up to a specified amount, backed by the full faith and credit of the U.S. government. | Premiums, recovery of assets acquired in receivership, deposit assumption transactions, and interest earnings. |
| Aviation War-Risk Insurance | Insures against losses resulting from war, terrorism, and other hostile acts when commercial insurance is unavailable on reasonable terms and conditions and continued air service is in the interest of U.S. policy. | No. Self-financing from premiums for assumption of anticipated risks. | Premiums, interest earnings, and one-time registration fees for nonpremium insurance. |
| Federal Crop Insurance | Insures against crop damage from unavoidable risks associated with adverse weather, plant diseases, and insect infestations. | Yes | Premiums and appropriations.[2] |

[1] Sources of information for these program summaries included (GAO/AIMD-97-16) and various publicly available documents describing the programs.

| Program | Description | Government subsidy | Sources of financing |
|---|---|---|---|
| Maritime War-Risk Insurance | Insures losses resulting from war, terrorism, and other hostile acts when commercial insurance is unavailable on reasonable terms and conditions and continued service is in the interest of U.S. policy. | No. Self-financing from premiums for assumption of anticipated risks. | Premiums, interest earnings, binder fees, and claim reimbursements. |
| National Credit Union Share Insurance | Insures member shares (deposits) up to a specified amount. | Deposits backed by the full faith and credit of the U.S. government up to a specified amount. | Premiums, interest earnings, and 1-percent deposit from insured credit unions. |
| Pension Benefit Guaranty Corporation Insurance | Insures retirement benefits of workers and beneficiaries covered by private sector-defined benefit pension plans. | No. Self-financing from premiums paid by employers on behalf of their employees. | Premiums, assets from terminated plans, and investment income. |
| Savings Association Insurance Fund | Insures deposits up to a specified amount. | Deposits backed by the full faith and credit of the U.S. government. | Premiums, recovery of assets acquired in receivership, deposit assumption transactions, and interest earnings. |
| Service-Disabled Veterans Insurance | Provides life insurance to veterans with service-connected disabilities. | Yes | Premiums, interest on policy loans, policy loan repayments, and appropriations. |
| National Vaccine Injury Compensation | Provides compensation for vaccine-related injury and death. | No | Excise tax on manufacturers and interest earnings. |

[2] The Federal Crop Insurance Corporation is authorized under the Federal Crop Insurance Act, as amended, to use the funds from issuance of capital stock, which provides working capital for the Corporation.

**Table 2: Summary of Insurance Programs Sponsored by Other Countries**[3]

| Program | Description | Government subsidy | Sources of financing |
|---|---|---|---|
| Japan's Earthquake Insurance | Provides a public/private, three-tiered payment system for damages resulting from an earthquake. | Not presently known | Participating insurer and reinsurer premiums; some government tax revenue. |
| United Kingdom's Pool Re | Insures against losses resulting from terrorism. | Self-financing from premiums, pool members, and the government as last source of funds. | Premiums, collections from pool members, investment income, and government contributions. |
| Israel's Insurance for Victims of Enemy Action | Provides government-funded property/casualty and health/life insurance for victims of a terrorist attack. | Yes | Government property taxation, and premiums for additional state coverage. Although not explicitly stated, general tax revenues stand behind the primary funding sources. |
| Switzerland's Catastrophic Insurance | Insures against losses from natural disasters (excluding earthquakes). | No. Intent was that it would be self-financing from premiums for assumption of anticipated risks. If claims exceed premium payments, the difference would be payable from the insurer's capital and reserves. | Premiums on buildings and their contents. |

[3] Information on these program summaries was collected from a United Nations document and various publicly available sources describing the programs.

**Table 3: Summary of Insurance Programs Sponsored by States or Other Entities**[4]

| Program | Description | Government subsidy | Sources of financing |
| --- | --- | --- | --- |
| State Insurance Guaranty Funds | Protects policyholders when an insurance company fails. | No. However, in some states companies can deduct assessments from state taxes or recoup by increasing insurance premiums. | In all states but New York, insurers are only assessed after a failure occurs. In New York, insurers pay a premium into a state guaranty fund, similar to the way federal deposit insurance is funded. |
| California Earthquake Authority | Insures California residents and businesses against losses associated with earthquakes. | No subsidy. | Funding is provided by a multilevel mechanism, including insurance premiums, insurance company assessments, and debt financing. |
| The International Group of Protection and Indemnity Clubs | Insures shipowners against third-party claims for oil spills and other risks | No subsidy. | Member contributions via pre- and post-funding mechanisms. |
| Workers Compensation Residual Market Reinsurance Pool | National Council on Compensation Insurance (NCCI) is operating mechanism for paying claims from a pool fund. | No subsidy. | Premiums and additional contributions from member carriers in the state when pool funds cannot pay claims. |

[4] Information on these program summaries was collected from various publicly available documents describing the programs.

**STATEMENT BEFORE THE SENATE BANKING COMMITTEE ON THE AVAILABILITY OF TERRORISM INSURANCE COVERAGE**

**October 24, 2001**

**On Behalf of the Following Associations and their Members:**

**American Council for Capital Formation**
**Associated General Contractors of America**
**American Resort Development Association**
**Building Owners and Managers Association International**
**International Council of Shopping Centers**
**Mortgage Bankers Association of America**
**National Apartment Association**
**National Association of Industrial and Office Properties**
**National Association of Real Estate Investment Trusts**
**National Association of Realtors**
**National Multi Housing Council**
**Pension Real Estate Association**
**The Real Estate Board of New York**
**The Real Estate Roundtable**

Mr. Chairman, we commend you for the much-needed attention that you and the Committee are bringing to this important issue by holding a hearing today. It is clear that the Committee clearly recognizes the importance of this issue and its potential effect on the U.S. economy. We thank you for your leadership in addressing insurance-related problems as a result of the events of September 11, and we also appreciate the White House efforts to remedy a potential insurance coverage crisis. The real estate and construction industries, which account for over a quarter of the nation's gross domestic product, could face severe economic dislocation in the coming months if the federal government does not immediately address insurance-related issues tied to terrorism.

To continue to operate in the normal course of business, these industries need to continue to have insurance for risks that have traditionally been insurable, including damage associated with terrorism. The insurance industry recently testified before the full Committee that without Federal support, it will not be able to provide terrorism coverage in the future. Further, as the nation expands its mission against terrorism, the line between terrorism and war will likely become increasingly blurred from an insurance standpoint.

**The Problem**

On September 26, the CEOs of several major insurance companies testified before your committee that the insurance industry expects to be able to pay claims associated with the September 11 terrorist attacks. However, they also said that insurers would not be able to provide terrorism coverage for future terrorist acts. The reason is that reinsurance for terrorist risks is generally unavailable in the current marketplace.

We take the insurance industry's warnings seriously and the Congress must as well. The lack of adequate reinsurance in the current market means that coverages our members need could very soon become unavailable to large segments of the U.S. economy. A significant percentage of owners of commercial properties open to the public, including shopping centers, offices, apartments and hotels, renew their insurance coverage on January 1 of each year. Many construction projects, including a number of new power plants, are slated to begin early and throughout next year. Many of the owners and developers already have been advised that their policies may not be renewed or that their new policies will exclude terror/war risks. Further, some owners have been advised that their current coverage may be terminated before their policies were set to expire, after the insurers provide the required advance notice (usually 90 days).

On October 15, a senior Bush Administration official said: "Without coverage against terrorist acts, banks will not lend to new construction; it will be difficult to sell major projects such as new pipelines, new power plants, skyscrapers. So we do think there is a problem that needs to be addressed." We could not agree more.

Mr. Chairman, the property owners among our members (including many pension funds that provide retirement security for their workers and families) cannot buy, sell, or finance the acquisition or construction of a commercial building unless it is covered by adequate insurance. Before September 11, adequate insurance was readily available. Neither property nor general liability policies in the U.S. excluded losses stemming from terrorist attacks. They excluded only acts of war. It now appears that terrorism coverage will not be available and that war risk coverage, which did not previously seem imperative, is now necessary to the extent any future attacks could be viewed as war-related.

The real estate and construction industries are leading pillars of the U.S. economy. Without adequate insurance, it will be difficult, if not impossible to operate or acquire properties, to construct new properties, to refinance loans, or sell commercial mortgage-backed securities (of which $350 billion is currently outstanding). Disappearance of coverage for terrorist acts could severely disrupt the U.S. economy.

The effects on our members of losing their insurance coverage are potentially severe. First, building owners and operators will be fully exposed to property damage losses from terrorist attacks and will be powerless to do anything about it. Worse, some state insurance regulators may not permit insurers to exclude terrorism coverage, raising the possibility that insurers will withdraw completely from such states and leave our members without any coverage at all.

Second, our members will also be exposed to third-party liability claims for terrorism and war risks. Without adequate insurance, they will be forced to choose between incurring these risks or closing their buildings to avoid them.

Third, virtually all of our members have clauses in their financing agreements requiring that minimum levels of insurance coverage on the property be in place. Without the required coverage, lenders would be free to foreclose because the loan would be in default without required insurance. Even more importantly, without adequate insurance coverage, lenders would not approve new loans to finance new construction or property sales, or refinance existing debt. This lack of liquidity could lead to the same severe problems the real estate and construction industries confronted after the savings and loans crisis when property values fell more than 30% largely because sources of capital dried up. Any similar liquidity crunch could have severe consequences on employment and state and local property and sales tax collections.

Further, portfolio lenders would be confronted with the possibility of limiting operations. The ability to finance commercial real estate transactions by institutional investors such as pension funds and life insurance companies would be at risk. These mortgage lenders have a fiduciary duty of prudence in investing money, and investing funds without adequate insurance would breach this duty. A lender refusing to make a loan without adequate insurance is not being arbitrary, it is acting in the best interest of the investor, whose money the lender is investing.

Fourth, the property owners among our members are likely to find that they cannot complete their construction projects, or begin new projects, until terrorism coverage can be restored. Lenders are unlikely to approve construction loans until our members can obtain builders risk insurance that is broad enough to cover acts of terrorism. This will affect not only our members, but also the U.S. economy as a whole. As you know, the construction industry is enormous and our economy was already struggling at the time of the terrorist attacks. The volume of construction that our members were putting into place had already begun to decline. Without government action to resolve this insurance problem, many construction workers are at risk of layoffs.

Fifth, apartment residents would see higher housing costs as real estate operating costs would increase significantly in the absence of continuing coverage of acts of terrorism. Even before September 11, multifamily owners and operators were facing year-over-year increases of 25-100% in their property and casualty insurance costs. Typically, these significant operating cost increases are reflected in higher market rents, especially in major urban markets with strong renter demand. In the absence of federal government involvement to provide for continuing coverage of terrorist acts, apartment renters, many of them low- and moderate-income families, will be forced to absorb a disproportionate share of heightened insurance costs and more-limited coverage. Federal government risk-sharing and the continued provision of coverage for acts of terrorism are needed to help moderate the impact on housing costs that renters will face as a result of the events of September 11.

Sixth, loss of coverage may lead to an increase in the cost of mortgage financing, especially in the commercial mortgage-backed securities (CMBS) market, as the result of an additional, difficult-to-quantify catastrophic risk to the real estate assets serving as security for the CMBS offerings. CMBS offerings are usually priced in the same manner as bonds and other fixed-income securities, heavily dependent on credit ratings issued by the major securities-ratings agencies. The rating agencies, and the fixed-income investment community in general, are very sensitive to any possible circumstances that could impair the cash flow available for payment of the securities in question. Of course, uninsured damage caused by terrorism could, as we have all seen, terminate, interrupt, or otherwise materially impair cash flow; that risk would loom particularly large to the extent that it is difficult to quantify.

An increase in the cost of mortgage financing could, in turn, cause otherwise viable projects not to be undertaken, and reduce income throughout the industry, leading to further lessening of demand and economic activity.

The war exclusions that have been included in our members' insurance policies for years mean that our members have always been exposed to losses resulting from acts of war. They cannot purchase war risk coverage separately in the market. This has not previously been a major concern because it was thought that the likelihood of losses related to acts of war on U.S. soil were quite remote. However, the events of September 11 and subsequent U.S. military activities in Afghanistan will cause the property owners among our members, and possibly their lenders, to reconsider whether it is acceptable to be exposed to such risks. The line between acts of war and acts of terrorism is in danger of blurring and our members cannot afford to be exposed to either risk. Henceforth, they must have adequate insurance protection for both risks. As of now they do not.

With many real estate businesses facing insurance policy cancellations and modifications on or before January 1, and both power plants and other construction projects ready to begin, the government must act now. Without government action, our industries will likely face the prospect of breaking promises to lenders, partners and others, of operating without necessary insurance coverage, and of watching the construction of new facilities slow down. Since operating a business without adequate insurance in many cases is not feasible, and is certainly unwise, real estate businesses will confront the possibility of ceasing or limiting operations until insurance once again becomes available. Without Federal action, the ability to finance, construct, buy or sell properties across the nation may be at risk.

**Proposed Solution**

We understand that the Committee will wish to ensure that the Federal government does not take action that will ultimately interfere with or displace the private insurance markets. We share that concern. However, it is not clear when, or if, the private insurance markets will be able to meet our members' needs for terrorist insurance coverage.

The Federal Government must play a role in ensuring that commercial property owners can continue to obtain coverage for damage for acts of terrorism. This is especially true in the near-term while we wait to see whether and how the private markets will adjust to the new post-September 11 realities and risks. Further, given the increasing possibility that a court could conclude that future damages caused by a terrorist actions is excludable as damages resulting from a state of war, the Government must also play a role, at least in a standby capacity, in ensuring the availability of coverage for damages arising from the actions undertaken by terrorists such as al Qaeda or their allies.

There is ample precedent for the Federal Government filling the insurance or reinsurance gap: (1) crime and riot insurance programs were created for urban business owners following the social unrest of the late 1960s and early 1970s; (2) flood and crop failures are insured under Federally sponsored programs; (3) standby war risk coverage already exists for certain aviation and maritime operations (including a post-September 11 expansion of the aviation war risk program); and (4) during World War II, the Government authorized a program, administered by private insurers, which insured property against "enemy attack."

The insurance industry has put forward a proposal to establish a special, state-chartered reinsurance company that would accept terrorist risks from companies wishing to cede risks to it. That company would then reinsure 95% of these terrorism risks to the federal government. That proposal builds upon a model in the United Kingdom where a special reinsurance pool for terrorist risks was created in the early 1990s in the wake of IRA bombings in the City of London. The U.K. Government provides a backstop to that pool, but has not been called upon to pay any losses to date.

The Bush Administration has outlined a proposal to deal with the current problem that would involve a three-year program under which the Federal Government and the insurance industry would share, in declining proportions each year, the risks of terrorist acts. While the details of this proposal must be made clear, including the scope of acts covered within the definition of terrorism, we believe it represents a positive step towards addressing this issue.

We commend both proposals to your careful consideration. In the end, however, we emphasize that the problem must be addressed in a satisfactory and timely manner. A critical criterion in measuring the effectiveness of any solution is whether the financial community will continue to provide capital necessary to buy, sell, construct or refinance properties. Since real estate is a long-lived asset, real estate financing tends to be long-term. Accordingly, the finite duration of federal involvement must not prevent lenders from making these long-term commitments. Further, the insurance industry's primary coverage should not be rendered immaterial by unrealistic retention amounts (*i.e.*, deductibles) imposed on insureds.

The Congress must not fail to act. The real estate and construction industries welcome the opportunity to work with the Administration and Congress to achieve a workable solution to this immediate problem this year. To discuss these issues in greater detail, please contact Tony Edwards at NAREIT at (202) 739-9400 or tedwards@nareit.com or Chip Rodgers at The Real Estate Roundtable at (202) 639-8400 or crodgers@rer.org.

# TERRORISM RISK INSURANCE

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**THURSDAY, OCTOBER 25, 2001**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10 a.m. in room SC–5 of the Capitol Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

## OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. If the witnesses will take their seats, we can get the hearing underway. Mr. Baker, I understand you have a time constraint so why don't we move you up from the second panel to this panel, and that will give us an opportunity to hear from you. By what time do you have to leave?

Mr. BAKER. Around noon.

Chairman SARBANES. Oh, well, we are in good shape here. I might even have kept you on the second panel.

[Laughter.]

But we will not want to take that chance. Today we continue our consideration of the question of terrorism insurance in light of the attacks of September 11. We began our examination of this issue on yesterday, both morning and afternoon as you are probably aware, and we had a very informative hearing and the opportunity to explore a variety of views, including hearing from the Administration and in particular Secretary O'Neill.

I believe we gained a number of valuable insights as the Committee seeks to deal with this issue. And, of course, we have been exploring the extent to which the events of September 11 threaten the availability of terrorism coverage for commercial property owners. If such coverage should be unavailable, what impact that would have on the functioning of the economy. And, is Federal intervention necessary to prevent any such disruption? If so, what form should that intervention take? We are increasingly focusing on the last question there, but we would appreciate the witnesses helping to build a record by walking us through the other issues as well.

We have been looking forward to hearing from this panel. I want to assure the witnesses at the table that we are here to hear you with a very open mind, so this headline here in the *Financial Times* ought not to set you back or dissuade you, which says, "Industry plan to aid insurance groups labeled nonstarter." That was not a statement by me, and I do not think—we have a more open mind than that. So we are happy to hear any plan that you might want to put forth.

We will have two panels this morning. The first panel will include Robert Vagley, President of the American Insurance Association; Ron Ferguson, CEO of General Re Corporation, representing the Reinsurance Association of America; and John Sinnott, CEO of Marsh, Inc., representing the Council of Insurance Agents and Brokers. And they have been joined on this panel by Leslie M. Baker, the Chairman of Wachovia.

The second panel, which will follow immediately after we conclude with this one, will include Tom Donohue, President and CEO of the U.S. Chamber of Commerce; Tom O'Brien, Chief Financial Officer of LCOR, who is representing the Real Estate Roundtable; and Walter Knorr, Chief Financial Officer of the City of Chicago.

I just want to take a moment before we go into this panel to express my very deep appreciation to my colleagues on the Committee and even more so to the Committee staff on both sides, Members' staff, for the extraordinary work that has been done with respect to the Committee's agenda over the last few weeks.

This afternoon we are scheduled to vote on and presumably—not only presumably, but certainly pass the antiterrorism legislation which will contain within it a title on money laundering, which was the work product of this Committee and our colleagues over on the House side. And that represented an incredible concentrated effort on the part of the staff working through the night on a number of occasions over a 2 week period in order to complete that legislation and resolve the differences with the House and move it forward. We think that is an important piece in the fight against terrorism.

We believe it is carefully worked out and considered legislation. We sought to consult with all interested parties. All interested parties did not get exactly what they wanted. That is never possible. But we do think it will provide an effective framework for our authorities to crack down on money laundering and do it in a way in which the banking industry will be able to work in a cooperative fashion. They will have to assume some additional burdens, but the whole country is assuming additional burdens at this point. And so I want to thank the staff for this terrific work.

And we have also, of course, tried to move ahead on the issue that we are considering this morning. Hearings are now being held elsewhere on the Hill as well. But, of course, we launched these hearings yesterday. We are carrying them on today. We seek to distill out of all of what we are hearing hopefully a consensus position. We need to work out something that commands the general support or at least acceptance if we are to move forward on this issue in the time period that is remaining.

Having said that, Mr. Baker, why don't we go with you first? We are really moving you up.

[Laughter.]

Chairman SARBANES. We moved from your panel, and now we are going to move you to the front of this panel. And we would be happy to hear from you, sir, and then we will go to Mr. Vagley. Am I pronouncing it correctly?

Mr. VAGLEY. Right.

Chairman SARBANES. We would be happy to hear from you, Mr Baker.

**STATEMENT OF LESLIE M. (BUD) BAKER, JR.**
**CHAIRMAN, WACHOVIA CORPORATION**
**REPRESENTING**
**THE FINANCIAL SERVICES ROUNDTABLE**

Mr. BAKER. Mr. Chairman and Members of the Committee, thank you for the opportunity to testify on a critical matter. My name is Bud Baker, Chairman of Wachovia, here on behalf of the Financial Services Roundtable.

I am also here today to tell you that without cooperation between our Government and America's private industry in support of insurance activities, there could be major disruption in the marketplace and potential harm to the economy.

On October 10, thirty chief executive officers from Roundtable member companies signed a letter to the Congress expressing concern over the impending lack of terrorism coverage and urging Congress to act this year. It is important to note that 22 of those 30 signatories are bankers, including Wachovia.

The President of the United States, the Chairman of the Federal Reserve, the Secretary of the Treasury, and many Members of Congress have recognized that our economy needs an economic stimulus package. Without Congressional action to provide a Federal backstop for terrorism insurance, efforts to provide an economic stimulus could be rendered ineffective. This is an issue about the ability of the United States to recovery from the terrorist attacks of September 11 and the ongoing issues of uncertainty which now weigh upon the economy.

Without insurance coverage for terrorist acts, it will be much more difficult for bankers to extend or renew commercial loans or lines of credit for business purposes, construction, or development. If the insurance industry cannot offer adequate insurance to a borrower or a bank because it cannot properly price or reinsure the risk, the bank is faced with a serious risk assessment problem. Is it prudent to make a loan to construct a pipeline or a power plant, a large shopping center or office building when the potential for the borrower to repay is diminished by inadequate insurance coverage? For most banks, the answer will be "no." In many cases such a loan most assuredly would be considered unsound.

Wachovia is one of the five largest commercial real estate lenders in the United States. Our company has total commercial exposure of approximately $252 billion, including real estate and small business loans. I am particularly concerned about the impact on small business customers who are already experiencing wide disparity in quoted premiums due to insurers' inability to price products consistent with standard actuarial analysis. In the case of large or small business, only the Federal Government can provide the insurance industry with the breathing room it needs to return to a stable, rational market. Without a Federal backstop, businesses will have to self-insure, putting their capital and ours at risk. Magnify that potential loss of capital across the domestic banking sector to gain an appreciation for the dramatic impact a loss of insurance could have on our economy.

Mr. Chairman, it is impossible to determine if, when or where a terrorist might strike. But it is quite clear what the business ramifications can be. We are certain, however, that the lack of insurance coverage for terrorism will mean fewer loans, and that will mean constriction of the economic activity across the country. When a loan is not made, the jobs that build the plant or run an office cannot be created. With appropriate support and assistance from the Federal Government, the insurance industry can be in a position to accept the risk associated with terrorist attack, and our economy can continue its march to recovery.

The Roundtable is familiar with the various proposals that have been developed. We have deliberately not stated a preference for any particular one. From my perspective, any proposal must pass a simple test: It must return predictability to the market. I am certain that given the close collaboration between the Congress, the Administration, and the industries affected, we can work together to develop a fine solution.

Thank you very much, Mr. Chairman. I would be pleased to answer any questions.

Chairman SARBANES. Thank you very much.

Mr. Vagley.

## STATEMENT OF ROBERT E. VAGLEY PRESIDENT, AMERICAN INSURANCE ASSOCIATION

Mr. VAGLEY. Thank you very much, Mr. Chairman. My name is Robert Vagley and I am President of the American Insurance Association, a leading property and casualty trade association in the United States. Before beginning my formal remarks, Mr. Chairman, I would like to thank you so much for your willingness to consider this matter and to thank you and Senators Gramm, Dodd, and Schumer for your leadership on this issue.

Mr. Chairman, the tragic events of September 11 forever changed our collective understanding of and concern about terrorism. We lost many valued business colleagues and dear friends in the attacks on the World Trade Center and the Pentagon, and no discussion of this subject should proceed without a heartfelt remembrance of them. Mr. Chairman, the new post-September 11 world is fundamentally different than that which existed before, surely for Americans in general, and very specifically for property/casualty insurers and our customers.

Current estimates of total insured losses resulting from the September 11 attacks are between $30 billion and $60 billion, although the final number could end up being higher. The September 11 attack is by far the most costly insured event in history. The amount of losses from September 11 may well exceed the entire U.S. property/casualty industry's net income for the past 3 years.

Notwithstanding the enormity of this loss, the insurance industry is committed to meeting our promises to policyholders affected by the events of September 11. We are paying claims quickly and fully, and have received in excess of $20 billion in declared claims to date. We are not seeking any financial assistance to meet these obligations.

Looking ahead, however, we are very concerned about what will happen if, heaven forbid, there are additional terrorist attacks on our country. The financial capacity of our industry, while sizable, is limited and finite. Unfortunately, the potential harm the terrorist can inflict is both totally unpredictable in frequency and almost infinite in severity. These two factors combined make terrorism risks uninsurable.

There is another important aspect to this issue. Over two-thirds of annual reinsurance contracts 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. They are not to blame for this. These risks are no more insurable for them than for us.

Primary carriers do not have the same flexibility as reinsurers with respect to our own products, because we are subject to tighter regulatory controls. 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 denied, the insurers would be left to shoulder 100 percent of future terrorist losses, which we simply cannot afford to do. Our only remaining option, and one we would prefer not to consider, is to simply withdraw from certain markets and/or lines of coverage.

So we face a very difficult dilemma. How can we remain solvent and still serve the real needs of our customers for financial protection against terrorism? We believe that the only course of action is enactment of legislation to create a Federal financial backstop for losses that result from future terrorist attacks. This backstop could be temporary, but must be enacted before Congress recesses in order to avert the market crisis that will occur on January 1.

This is not—repeat, not—a bailout for the insurance industry. In fact, the primary beneficiaries of such legislation would be our customers and the U.S. economy. The purpose of the legislation would be to ensure that adequate insurance coverage remains available to American businesses. There are a few ways in which this can be done. One is the British-style reinsurance pool concept which we have advanced. Another is the quota share approach recently offered by the Administration. A third could involve some industry-wide deductible or retention. We are not wedded to the details of any particular proposal, not even our own, though we do believe it offers the best hope for restoring this market. However, in order for any legislative plan to be successful in averting the looming economic crisis, it must be drafted in a way that improves predictability, stabilizes the market, and preserves insurer solvency.

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, and the higher the retention, the higher premiums will have to be.

Mr. Chairman, terrorism has become uninsurable in the private marketplace as currently structured. Appreciating that an immediate stopgap solution may be somewhat imperfect, we expect that dislocations will still occur as insurers may cautiously reenter 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 commercial 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.

Thank you for your attention.

Chairman SARBANES. Thank you very much, sir. Before I turn to Mr. Ferguson, what percent of the property and casualty insurance companies belong to the AIA?

Mr. VAGLEY. Of the affected losses, probably about 70 percent of the affected companies.

Chairman SARBANES. And just as a general picture, the total coverage?

Mr. VAGLEY. The total coverage, including personal lines and lines that are unaffected, probably about 35 percent.

Chairman SARBANES. Okay. Mr. Ferguson, we will be happy to hear from you.

## STATEMENT OF RONALD E. FERGUSON CHAIRMAN, GENERAL RE CORPORATION REPRESENTING THE REINSURANCE ASSOCIATION OF AMERICA

Mr. FERGUSON. Thank you. Mr. Chairman, Senator Gramm, good morning. I am Ron Ferguson. I am one of the 2,400,000 people that work in the insurance business in the United States. I am proud of our industry. I am proud of the role we play in our society and our economy.

As you well know, the insurance business was front and center in the tragedy of September 11 in terms of claim dollars, which we will talk about, but also in terms of lives lost. We will individually and collectively as a Nation recover from this and move forward. We will get back on our feet. We are all working to do that under the leadership of President Bush, Congress, the heroes on the ground and now overseas, we are assured of doing that.

I have five main messages here this morning, Mr. Chairman: One, the September 11 claims will be paid. Two, there is a crisis brewing right now, today, on the availability of terrorist coverage. Three, I believe that in time we will win the war on terrorism and we will see a return to a normal private sector insurance market for these coverages. Four, we do need a transition period that, in my humble opinion, will inevitably involve the Federal Government in a backstop role. Five, as we go down this path, I believe there are a few principles that we need to articulate and follow. If I may, Mr. Chairman, I would like to elaborate just a bit on each of those five headlines.

Chairman SARBANES. Certainly.

Mr. FERGUSON. Thank you. As for the September 11 claims, there is no way to measure or dimension the grief, but we can tote up the insurance dollars. As Mr. Vagley said, analysts indicate that the range of insured losses for all lines, including life insurance, is likely to be between $25 billion and $40 billion. A lot of guesswork, but that is the best guess. My own personal opinion, which should be accorded no special weight or credibility, is that we are going to be at the high end of that range.

How will these losses be paid? First, there was never a nickel of premium collected for these coverages because no one expected them to happen. That is the plain and simple truth. Second, there are no assets on insurance company balance sheets or reserves that are earmarked for this coverage. Third, there are no hidden reserves in the balance sheet of the insurance industry. These losses will be paid out of the capital account, out of the shareholder, or in case of mutuals, policyholder funds.

Let us talk about those funds for a moment. Broadly speaking, the entire insurance industry—life, health, casualty and all lines—has policyholder surplus or net worth of about $500 billion. The property/casualty industry, which bears the great bulk of these claims in this instance, has a policyholder surplus of about $300 billion at June 30. But we need to narrow the focus and analysis a little more, and we have to talk about, as Mr. Vagley did, the affected companies—those companies that write the commercial lines business, the workers' compensation, the property that indeed generated these losses.

If you then go down from the $300 billion to the affected companies and lines of business, I believe that the capital account that supports that business is about $125 billion. So we quickly have to go from the $500 billion headline down to the surplus that is directly supporting these lines of business, and that is about $125 billion. Tillinghast, which is a very well respected actuarial firm, has actually come up with an even lower number than I did, and they estimated it at $80 to $100 billion capital that is supporting these lines of business.

In any event, numerically, you can certainly make the argument, and I am here to do that, that the losses of $25 to $40 billion can be funded out of that capital account. But that capital account, it must be understood, also supports other operating risks, other investment risks. And so now it has been reduced or impaired and we have to collectively ask the question, "and then what?" What happens after this? What if there are multiple events?

All of the normal actuarial pricing and predictive models do not hold up here. We have one horrific data point. That is all we have to go on. The rational response for individual companies, Mr. Chairman, is likely to be that they will either restrict the amount of terrorism coverage they write or they may not offer it at all in certain cases, or they may try to simply underwrite around it and not provide insurance in certain targeted areas. And different companies will choose different paths, and it is very hard if not impossible for me to dimension that for you. But I think absent some backstop and plan to go forward, it is inevitable that will happen and it is starting to happen today.

Chairman SARBANES. Mr. Ferguson, have you ever been at a stoplight when it was red and wished you could go on through?

[Laughter.]

Mr. FERGUSON. Yes. That is the way I feel right now.

Chairman SARBANES. Well, I am telling you here we can give dispensation. So just ignore that red light.

Mr. FERGUSON. No ticket?

Chairman SARBANES. No ticket.

Senator GRAMM. But do not forget it is there.

[Laughter.]

Mr. FERGUSON. And it can come back at a moment's notice.

Chairman SARBANES. Yes. Do not get carried away, but we are really very anxious to get the benefit of what you gentlemen have to tell us.

Mr. FERGUSON. I will try to move along. I understand. I appreciate it. Thank you, sir.

So we do have an availability crisis in the making. It is not just a January 1 problem. It is easy to slip into that thinking. It is a today problem. All those policies that were out there on September 10 and exposed on September 11 still exist today. It could happen again this afternoon.

Steve Bartlett from the Financial Services Roundtable said it in the shortest possible way. He said, "No insurance, no lending; no lending, no economy." I could not improve on that short statement.

Chairman SARBANES. Steve is pretty good.

[Laughter.]

Mr. FERGUSON. In time we are going to win this war. We are going to win the war on terrorism and the markets are going to return to normal. They always do. We have the examples of the nuclear energy business which in the late 1950's had to set up some special pools and a Government backstop. We had the urban riots in 1965. But it takes time. It takes time to run these transitions. But with a Federal backstop program, it can be done. The nuclear risk matter was handled successfully in the 1950's. The urban riot insurance was handled successfully. And today, there is little or no Federal involvement in either of those areas, because the private market has come back in.

Now we have several models in play today, as Mr. Vagley said. I am not wedded to any one particular model. I am only wedded to the idea of going forward from here. I do have a couple of principles I would like to articulate very quickly before the red light comes on again.

Chairman SARBANES. No, no. Do not worry about that. You take your time.

Mr. FERGUSON. You are very kind. I would like to offer a few principles that need to be agreed on, I think and followed.

One, we need to very clearly define the problem and the objectives lest we get into objective creep and unintended consequences.

Two, we need to make sure that all the interests—the insurance companies, the insureds, the policyholders, the State regulators, and the Government—that we have a plan that aligns all of those interests. We need a plan that is workable at the micro level. What I mean by that is, it is companies and it is underwriters and companies that make the decisions every day. It is not the industry as a whole. And we need to provide for the people at the companies, the underwriters that price this risk and make the go/no-go decisions every day have reasonable certainty as to what they are signing onto, that they have an agreed definition of what terrorism is so we do not end up with 51 different definitions, 52 counting the Federal Government. We need to have consistency there.

Three, we need some latitude in the ratemaking from the traditional rate regulatory system that is applied at the State level.

Four, I believe any plan must allow for current and future private sector response. It will come back. It is just a question of time.

Five, any plan—this is the tricky part—it has to be long enough to restore the confidence and the predictability Mr. Baker was talking about but short enough to avoid being institutionalized. And that is the hard part of this.

My boss is Warren Buffett. And Warren Buffett has a truly remarkable way of cutting through complex issues and putting them into common sense, everyday words. He did that the other day in *The New York Times* on this issue. He said two things I would like to share with you. He said, number one, "We do not want to write coverages. We do not want to make promises as an insurance company, as Berkshire Hathaway, unless we are absolutely certain we can fulfill those promises. Otherwise, it is a cruel hoax."

Number two, he said that, "This is not a bailout of the insurance industry, it is a bail-in. Let's find out how we can get together and bail-in and find the way forward." I wish I could turn phrases the way he does. I cannot, so I can only quote them. Mr. Chairman, we can do the job, but we need your help for now. Thank you for your time and thank you for the dispensation on the traffic ticket.

Chairman SARBANES. Thank you very much, sir.

Mr. Sinnott.

**STATEMENT OF JOHN T. SINNOTT**
**CHAIRMAN AND CEO, MARSH, INC.**
**REPRESENTING**
**THE COUNCIL OF INSURANCE AGENTS AND BROKERS**

Mr. SINNOTT. Thank you, Mr. Chairman. I would like to explain what Marsh, Inc. is because some people cast us as an insurance company. We are not. We are the largest risk advisor and insurance broker in the world with 35,000 employees with offices in about 100 countries around the world.

We represent and advise clients, the consumers of insurance. We represent all aspects of all levels of business clients, from the smallest business client up to the Global 1,000 if you will. We also serve private clients. And finally, we also serve as a reinsurance broker and service provider for insurance companies.

So I am speaking today from a different perspective that my colleague is. I am speaking from the consumer standpoint, both the insurance consumer and the reinsurance consumer, who needs the reinsurance. And we have a very good perspective as to what the current conditions are in the world today. And we think we have a very good perspective as to the immediate future.

I should also say that I speak today not just representing Marsh, Inc., but I also speak as a member firm of the Council of Insurance Agents and Brokers. That is our national industry association. It represents about 245 of the larger firms which comprise somewhere in the neighborhood of 75 to 80 percent of the commercial insurance transacted in the United States.

I will not repeat some of the points already made. However, there are really two problems as we see it. First of all is the size of the event that took place on September 11. I might disagree with

Ron. I would say that our best estimates are that, yes, it will be at the top end, and maybe even more because of the uncertainty that still exists. That is twice as large as the next largest catastrophe event that ever occurred, more than twice.

Looked at another way, if we added to Andrew, which was the next largest, the next five largest catastrophe claims that took place in the last 10 years and we aggregate those together, that in my estimation will equal September 11. So we have a very significant severity problem.

Second, the problem is uncertainty. And insurance is an important social instrument, and it is used to dealing with uncertainty. That is the nature of its business. But if the uncertainty gets to such size and the probability of losses becomes so large, then it creates a situation where the instrument does not respond. And that is what we have today.

And January 1 is a very key date. But I can tell you that right now, working for our clients in putting together their insurance programs, some of which renew prior to January 1, we are already faced with exclusions for terrorism.

So what we see here is that the primary insurers will not be able to provide our clients with what they need if the reinsurers that back them, that provide the spread of risk, feel that they cannot underwrite this particular risk. Simply stated, without sufficient insurance coverages, businesses and other entities will be handcuffed at a time when they are already wrestling with a slowdown in the economy.

My message is fairly simple. When there is a cure for the current environment, and that cure will only take place if there is a partnership between the Government and the private industry, business doing its best to better secure its environment, Government working to secure the country's environment, I am convinced, we will be back to where what we are talking about today will not be needed.

I will make one final comment. Marsh was in the World Trade Center in 1993 when the first terrorist attack took place. Fortunately, we did not lose a single employee. And the insured loss—because we are also an insurance consumer, and quite a large insurance consumer—the insured loss that we collected was less than $5 million on our property and business interruption.

On September 11, we lost almost 300 colleagues. I mean, that is the real tragedy, and that is what we carry as we walk through our office and all my colleagues around the world, that is what we are carrying today.

But in addition, the insured claim that we will have to submit to our insurers will not be measured in a few millions, it will be measured in the hundreds of millions, and that is not the type of exposure or occupancy that the market would ever have expected from our type of business. We are an office occupancy.

So I think that best explains the change of environment that was created on September 11. Whatever is done here, we believe must be a partnership between the Government and private industry. It should be short-term. We need something that gets us beyond January 1. And as my colleagues have said already, the devil is in the details. But our view is that we do not like Government involved in our business. That is not good for us because we are in the risk advisory business. And when the Government takes over part of that, that gets into our advice piece. The same thing is true with the risk-bearing part. If they constantly give off risk to the Government, they are losing part of their business. This has to be temporary, but right now, for the consumer, we need a partnership between the Government and private industry.

Thank you, Mr. Chairman.

Chairman SARBANES. Well, thank you very much. I thank all of the panel. And Mr. Sinnott, we understand, of course, that the first plane that hit the towers hit directly into your offices.

Mr. SINNOTT. That is right.

Chairman SARBANES. And we certainly extend our sympathies to your corporate family. I understand that you lost 295 people out of 1,900. You had offices in both towers?

Mr. SINNOTT. In both. Everyone got out of the south tower. We had about 900 there, which was where the second plane hit. But anyone who was on our floor in the north tower, no one got out.

Chairman SARBANES. I am going to ask a few questions just to try to get some sense of the parameters of this. What percent of the loss that you are estimate—you say 25 to 40, you took the high figure. I mean, who knows, in a sense, but in any event—is property and casualty and what percent would be life and health? Do you have any idea?

Mr. VAGLEY. Yes. We have estimates, Mr. Chairman. Let us stick with the 40 for the minute, and I certainly take Mr. Sinnott's point of view, it could be higher. But let us stick with that for the moment. The estimate would be about $5 billion of that 40 would be life and health.

Chairman SARBANES. Is what we would do here set a precedent for what we might have to do for life and health? Since we are now worried about bioterrorism, chemical, things of that sort. Do we have to keep that in mind as we work on this problem?

Mr. VAGLEY. My opinion would be yes.

Mr. SINNOTT. I am less sure. Because even with the life insurance industry which is a vast industry with individuals—let's face it, it happens every day. We have not to date had the same issues raised on the life side that we have had on the property/casualty side.

Chairman SARBANES. Yes, I know. But this event, this terrorist event was one that by its nature impacted financially at least more greatly I think on the property and casualty side. But you could have a terrorist event, as we are now seeing as we deal with anthrax. If you refer back to the chemicals in the Tokyo subway and things of that sort, which would come down heavy on the life and health problem.

Mr. FERGUSON. May I add that I think the key phrase that Mr. Sinnott used is "to date." And the life industry will handle this one just fine. But you are absolutely right, Mr. Chairman. I think we have to think beyond this particular event. And I almost hate to say it, we have to think about nuclear terrorism where then the life insurance industry could be very seriously affected.

We all tend to think about the life insurance industry as being huge, which by some measures it is. But I must tell you that the capital base of the life insurance industry in round numbers is about $200 billion. It is not the behemoth that many of us might think it is. And you can imagine, as you have just started to, terrorism scenarios where it would affect the life insurance industry.

Chairman SARBANES. Mr. Vagley, you said in your—and I am just trying to get a sense of the parameters here. We have to understand the lay of the land. You say on in your testimony, "Our only remaining option—this is if something were not done here . . ." and ". . . one we would not prefer to consider would be to simply withdraw from certain markets, and/or lines of coverage." What markets would you anticipate insurers would withdraw from?

Mr. VAGLEY. Again, Mr. Chairman, with the same reluctance that Mr. Ferguson shared, because you almost hate to identify these areas for fear that somebody will act on them. But certainly there are a number of American companies that are icons, that are very visible targets. There are a number of American industries that it would not require a great stretch of the imagination to believe would be exposed. Certainly large office buildings in major cities, transportation networks, electric utilities, petroleum facilities. There are a number of businesses that would seem to be more at risk than others.

Chairman SARBANES. And lines of coverage?

Mr. VAGLEY. Well, lines of coverage, some of the most exposed here, workers' compensation would be a very precarious line of coverage. I think the losses coming out of the World Trade Center for workers' compensation could indeed be staggering and could even reach or exceed some of the commercial property losses. And some of these markets, Mr. Chairman, already are firming up and are considered hard markets.

Chairman SARBANES. Yesterday the NAIC President, Kathleen Sebelius, who is the Insurance Commissioner in Kansas—this goes to the duration issue that someone raised at the table—she said, "Well, you know, if this had been February instead of September, that there might have been enough time for the industry to have sorted it out before the renewal questions came up." What is your reaction to that?

Mr. FERGUSON. In a very narrow sense, you can make that argument. But I would have to broaden it and say that it is a problem today. You know, all those policies, as I mentioned a moment ago, that were in existence on September 10 are still affording this coverage today. And if we have a couple of more events like September 11, you are going to have a serious impairment of the capital of the property/casualty business. That could be February, that could be October. It would not matter.

So in the narrow sense, I agree with her. There is a little broader issue here, the financial solidity of the industry which is exposed every day of the year.

Mr. SINNOTT. I would add to that. I would say that 10 extra months would help because there would be the opportunity to develop more capacity and capital in the market. By the same token, the environment is still the same today as if this had happened in February. And we are no more secure in that regard. So there is two parts to this. There is the environment and the ability to secure. I do not think we will ever get back to the way we were before September 11.

Remember in 1993 when we had the terrorist attack, no one was sitting here saying we needed help, because there was not a perception that the environment had changed that radically. So that is an important issue as well in the timing.

Chairman SARBANES. I am going to impose on my colleagues and go on with just a couple of more questions. Mr. Baker, I wanted to ask you, from the banker's point of view, is there a difference on the insurance question between existing structures and new development as you would evaluate the insurance issue?

Mr. BAKER. Mr. Chairman, we will look at all of our customers the same way. In other words, we will go forward with existing customers. The question I suppose that is apparent right now is the need to renew policies as we go forward and the changing of the risk structure for these people, not just because of their loans from us but because of their position and their own risk evaluation in the marketplace.

So our view of them will not change. I think as we look forward, this becomes an economic issue as we try to think about what can be done for our customers. So I do not believe there will be any disparity in how we treat existing customers or new ones. We do have this renewal issue coming up where we have a lot of policies that will come up for renewal between now and the end of the year, and that is what gives some urgency to this.

Chairman SARBANES. There is some discussion about whether the Government should share upfront. That was discussed here yesterday and has been debated by others.

I take it from the industry point of view, of course you do not want the figure to be large—you would rather it be smaller than larger—but it is important to you to have a figure that would represent your exposure. Then you could calculate. Is that correct?

Mr. FERGUSON. In a word, yes.

Chairman SARBANES. I mean, whether it was $20, $30, $40 billion, whatever. If you knew that and whatever the formulas were that the balance then would go off on the Government, at least you could calculate where you are. Is that correct?

Mr. FERGUSON. Yes. You begin to have some certainty and you could begin with admittedly crude pricing and underwriting tools to try to do it.

Chairman SARBANES. Now on the question of certainty, the Treasury's proposal, if you get over $100 billion says—and I am looking at their chart—"discretion of Congress." Now that is not a lot of certainty I would think.

[Laughter.]

Chairman SARBANES. On the other hand, the figure is very large—very large. Now how would you handle that? Essentially figure, one, we may never get there? And two, if we do get there, Congress will, in fact, do something, and therefore it is taken out of the pricing equation?

Mr. FERGUSON. Well, you have correctly framed the bet that you as a company would have to make. And I cannot predict how individual companies would react. You have framed the argument exactly. Some companies would look at it and say the $100 billion is sufficiently large. The risk of a frequency, a number of events is sufficiently remote that we feel we can underwrite and accept risk in this environment. Other companies may look at it and say it is not enough. It does not give me enough certainty.

So we cannot, Mr. Chairman, in advance predict how individual companies would react. Sorry to give you kind of a wishy-washy answer.

Chairman SARBANES. This may be an admission against interest, but if I were trying to calculate how much of a burden I think the industry should carry, given its financial position, what figures would I look at? What indices would I look at in order to make some calculation in that regard?

Mr. FERGUSON. I would start, respectfully, with Exhibit A in my attachment to the prepared testimony where I make the case that the capital base on September 10 for the affected lines of business is about $125 billion. And as I say, some experts think my number is a little high, but let us stick with it for discussion purposes.

So we need to look at that. You know, that capital base is supporting all of the commercial business, commercial lines insurance business in the United States. All the operating risks that attend that business, investment risks that attend that business. So it is not a huge capital base. It is big, but it is not huge. So that would be one of the indices that I would look at.

Another statistic to look at is the amount of premiums in the commercial lines insurance sector and in round numbers—this is workers' compensation, property, general liability, and so on, business interruption insurance, add it all up—in round numbers, it is about $145 billion of premium annually. So that is another factoid or another statistic that enters the equation.

But to me, the important one is the first one. What is the capital base that is supporting this business? And how many September 11's can we handle? And the answer is, we can do this one, but I do not know what happens after that on the existing capital base.

Mr. SINNOTT. I might——

Senator DODD. You ought to review these numbers, by the way. The first number on the capital is very important.

Mr. SINNOTT. Did that number, represent just U.S. companies?

Mr. FERGUSON. Oh, yes. U.S.-licensed companies.

Mr. SINNOTT. Okay. Therefore, it does not include capital outside the United States?

Mr. FERGUSON. That is correct.

Mr. SINNOTT. I would add to that, the fact that our business is a global business. Reinsurance carriers, alien carriers who provide capital need to be included. So if I calculated it, I think my number might be up. The United States has at least half of the surplus that exists in the world, about half is what it is.

So you could make a calculation. I might come up with something higher, but it is still not some of the numbers that have been thrown out as to the assets and such that the industry has.

Mr. VAGLEY. Mr. Chairman, if I could add further, clearly a part of the calculation could be, should be, how much more pain can the industry bear? But the focus really ought to be on what will it take to restore the marketplace. And simple economics will suggest that the higher the amount the industry is required to retain, the more reluctance the industry will have to move comfortably back into this market, even uncomfortably back into this market, and the greater the retention levels, the greater will have to be the price of that coverage to the policyholders. I mean, there is no way to escape those fundamental economic principles.

Chairman SARBANES. Well, if you knew what your exposure was, you could calculate what the premium level had to be to cover that exposure, could you not?

Mr. VAGLEY. Well right now the exposure is infinite.

Chairman SARBANES. No, no. I understand that. If you are dealing with an infinite.

Mr. VAGLEY. Just some plan to be sure. And the more that retention is constrained and made definite and comprehensible, the greater will be the ability of the industry to move back into those markets and to take on those risks.

Chairman SARBANES. Now are you suggesting—well, I will wait and do it on the next round. I yield to Senator Gramm.

## STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Thank you, Mr. Chairman. Let me just say in terms of capital levels, we have to be very careful. A witness at these hearings yesterday suggested that the existing capital level of the industry told us something about our ability to extract that as part of some kind of mandatory process. The bottom line is, no matter what your capital is, you are not going to invest it unless you believe that ultimately you can end up selling a viable product.

It is always tempting to say, well, let us pool the assets of this industry and then I will be able to afford these things. The problem is, it is other people's money.

I do not expect any insurance company to put its capital at risk in an enterprise that has no hope of being successful. We had better be sure we organize what we do based on that thesis.

Let me make a couple of comments and then I want to pose a question or two since I missed the opening statement. First of all, I would like to say that I think the insurance industry has been about as responsible as any industry in America. And people often accuse me of being pro-business. Actually, I am pro-free enterprise, and I agree with Adam Smith's observation that, "Never do two merchants meet even for merriment lest the topic turn to conspiracy and restraint of trade."

[Laughter.]

Senator GRAMM. So I am not free with my compliments to businesspeople, and I just want to say that I think the position of the insurance industry and the people who run it has been about as admirable as any business that has dealt with this crisis. You are not at the heart of it like firemen and policemen in New York, but in terms of the secondary effect, pretty substantially affected.

We had a talk this morning with Jose Montemayor, who is our Insurance Commissioner in Texas. And in our State, you can cancel a policy with 7 days' notice. We are already beginning to see some terrorism policies canceled with regard to private aviation, which makes it very difficult for these charter companies to fly into big airports. So we are already beginning to see an effect. I do think it is interesting. My State is about as proud of its rights as any State in the Union. We were a country at one time.

[Laughter.]

Senator GRAMM. But here are the points that our insurance commissioner made about the whole State sovereignty issue. That as long as whatever we are doing is limited to terrorism, he is not worried about infringements on States' insurance powers. And as long as it is limited to 2 or 3 years, he is not worried about it. And I think that is pretty important. I am not saying he speaks for every insurance commissioner in the country, but I think that is relevant. That if it is very narrowly defined terrorism where we are going to define it in law and perhaps have a panel—the Secretary of the Treasury, the Attorney General and the head of the Federal Reserve Bank—based on that law, make a determination when an act occurs, is this terrorism, and we are not going to let the media decide whether it is terrorism or not, on that basis, what we do there is going to be a lot more acceptable within those narrow limits than if we were talking about a Federal action in insurance that was going to have a profound and lasting effect on the States. And, if we are talking about a 2 or 3 year emergency program, I think people understand and they do not see it as a precedent for the Federal Government taking powers away from States.

It is clear from our hearings we had yesterday that on a bipartisan basis that for us to do a bill—and I think *The Wall Street Journal* article says it correctly. In fact, I said a similar thing before I read it and I totally agree with what they said. And that is, my guess is that we might be able to get through this thing without a Federal program. I just think the risk of doing that is too great. And I am not willing to take the risk.

I think listening to the people we listened to yesterday on this Committee on a bipartisan basis, we are going to have to have some degree of retention so that the Federal Government is not the first dollar payor. We could debate as to what that was going to be. The Administration has a proposal where that is the case in the second year, not the first. And a simple way of bringing us together with the Administration would be just to make their second year program the first year program.

The President's proposal, other than the first year, has a lot of good features and it is a very good start for us to work with. And for us to do something in 2 weeks, there is no way we are going to write a program and get into a debate with the Administration or get involved in any partisanship and get that job done. It is distinctly possible we might not get it done. And that it is important that everybody make an effort to make it happen. I just want to assure you of my best faith effort to see that we do get it done.

Let me ask you a question. In 1993, we had a group of terrorists try to blow up the World Trade Center. What happened to insurance property and casualty rates after that? What happened to them in 1994 and 1995?

Mr. SINNOTT. I do not recall a great impact. I mean, it was a catastrophe, but, you know, it was not as big as Hurricane Andrew or some of the other catastrophes like Northridge Earthquake. In total, it was less than $1 billion.

Senator GRAMM. No, I am not talking about the cost in paying out of your reserves. I am talking about changing expectations. I mean, we had had a terrorist attack. People had tried to blow up the World Trade Center. Did anybody reevaluate—is there any evidence that anybody reevaluated and said, well, if we are going to provide terrorist insurance, maybe there should be a change in the rates that we charge? I am just trying to see how sensitive the market was to that.

Mr. SINNOTT. From a broker's standpoint, we did not see a change. The result of terrorist acts has been covered in the United States under insurance policies. That is not necessarily the standard in all parts of the world, but here it has been. And I think the World Trade Center at that time, as I recall, was viewed as, okay. That is what insurance is all about.

Senator GRAMM. So you did not see any change in premiums?

Mr. FERGUSON. That is my recollection as well. It did not create much of a ripple in the market. It should have been a wake-up call, but it was not. And to take Mr. Sinnott's point, it was regarded as a discrepancy, and it was not of such a magnitude that it caused huge problems for the industry. What we are facing now, of course, is a whole different category where we see a systematic aura of terrorism. No one thought that in 1993. Maybe we should have, but we did not. The short answer to your question is, it did not really create much of a ripple in the industry.

Mr. BAKER. Senator, I think it is important to remember that in that incident also the system worked. The industry kept going. Insurance was available. We did not have any problems.

Senator GRAMM. Let me say, Mr. Chairman, that I think again what we are going to have to decide is are we willing to take the risk that we are going to have a huge spike in insurance rates and generate an economic ripple in the economy of some substantial size? Or can we come up with a workable, short-term program to help us build a bridge to where hopefully we will eliminate much of the threat, and that ultimately this can be built into the structure of the system, and the Federal Government can get out? I think that is everybody's goal. I had not heard anybody on this Committee or in Congress or anybody I am talking to talking about getting the Federal Government permanently into the insurance business.

## STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. [Presiding.] Thank you. Senator Sarbanes will be back. Let me again apologize to my colleagues for not being here yesterday. But I had a staff member who had been with me a long time who lost her mother, so I was at a funeral in upstate New York all morning and afternoon yesterday. So I apologize.

I think for us not to act is too high a risk in my opinion. What we do has to be done carefully because we are dealing with 100 Members of this body and 435 in the other. And apparently there is some reluctance on the part of the House to move on some legislation here. I hope that mood is changing a bit. I know that people have been talking to them.

I worked with Bob Bennett of Utah on the Y2K Committee. We spent 2 years urging business and industry, Governmental entities to make corrections and to get up to speed. And when the clock turned, the world did not collapse. And there were some who looked around and said, well, what did we waste our time doing that for? It is always hard to prove a negative I suppose, except that I can tell you the other day I was in Ground Zero in New York at the operations center there.

The fellow who took me around had no idea that I had been involved in the Y2K issue but volunteered and said, you know, I do not know who was responsible for it, but had it not been for that effort made on this Y2K stuff, this operation center would not exist. Because the Federal Government pushed us to modernize, to update, to correct our systems, we were able to put in place a system here that has allowed us to respond to this savage attack in ways we could not have even imagined without the Y2K effort.

And so my hope would be we will act, and in doing so, will avoid the kind of problems that have occurred. I am sure there will be those who then say, well, you did not need to act. So I agree with Phil Gramm that for us not do something here would be highly irresponsible. We are talking about stimulus packages that are going to be passed to try and shore up a weak economy. And in my view, it would be a huge mistake if we were to take some sensible action there and not do something here.

Ron, it was in your statement—I believe it was in yours. No, Les Baker. There you are right there. You said this. I think it is true. Is it prudent to make a loan to construct a pipeline, a power plant, an airplane, or a ship, a large shopping center, or an office building when the potential for the borrower to repay the loan is diminished by inadequate insurance coverage? For most banks, the answer will be no. And that is the real danger we face here.

So this is really—we have insurance here. We are going to hear from Tom Donohue and others—but this is far more of an economic issue than an insurance issue. And there is a tendency to talk about this in insurance terms, which is obviously important, because the industry is involved directly. But the people who are going to be adversely affected here if the insurance does not show up in January with 70 percent of these contracts are up for renewal in about 8 weeks, and if they are not renewed, the insurance industry will be here. The question is, is whether or not those other industries out there that depend upon that insurance are going to be able to survive.

So when we have our hearings about the effects of all of this, we will have a very viable insurance industry at the end of all of this, but we may not have a viable economy or economic interests as a result of our failure to act.

So my hope is that we will. There is no perfect plan, and it ought to be relatively short-term in my view if we are going to do something in a way that we can come back and during that period of time review maybe on a longer-term basis what steps need to be taken to improve the potential for the damage to be caused by terrorist acts.

So the question of capacity I was going to raise with you which you have already indicated where we stand with the capacity issues, but let me ask this panel if I can, first of all just quickly, two questions. One is, I mentioned short duration. We have been talking about 2 years with a possible third year with the President giving that authority. I would like you to comment on whether or not that is adequate or too long. And then second, I would like you just to mention and respond if you could to the effects on the economy, what your own thoughts would be in terms of what this could mean if we do not act here and come up with a plan that works.

And then last let me just say, my view is the economic interests always are important, but I worry deeply. This economy begins to crater more. You are going to watch a public reaction that is going to have an impact on policy setting in dealing with September 11 and other events. You have unemployment rates going up. You have interest rates and all of these problems that are going to create tremendous pressures on our society, and that is we have to be very mindful of. And we do not want to make the perfect enemy of the good here, and we realize we are sailing in some uncharted waters, but it is my hope we would be willing to take a chance and do something that I think would protect against a far greater tragedy occurring if we did not act.

So with that, Mr. Chairman, I thank you immensely for holding these hearings. They have been very worthwhile. And my hope is that we will move very quickly now and come up with a proposal here that we can present to our colleagues, and hopefully one that will enjoy broad-based support. All of us who have been around here any length of time will tell you, at this stage of the year, the clock is the 101st Senator and a tiny group of people could be highly disruptive in terms of stopping something from happening. And my hope is that our colleagues will recognize the potential dangers here of not acting and will help us construct a plan here that will provide the needed assurance and help. And I again want to compliment the industry for acting so responsibly. Just those two questions if you want to comment on duration and economic impact.

Mr. VAGLEY. Senator Dodd, thank you very much. And in your absence and Senator Gramm's absence, I really thank you and would like to do so again for your extraordinary leadership, your joint leadership on this very important issue.

I certainly agree with the sentiments that you both have expressed in the last several minutes and the challenges to restore some stability in the commercial insurance marketplace. It is not about saving insurance companies. We do not need to be saved in that respect. The consequences really fall more broadly on the American economy.

With respect to your two questions, I think from our standpoint, longer is better than shorter because it does correlate with stability. But the kind of architecture that you and Senator Gramm have described is perfectly adequate in light of the business and the political circumstances and would provide a sufficient bridge to get us through this period, and perhaps in the calm of the fullness of time, the industry could get more comfortable with this, the marketplace could settle down, and private mechanisms could begin to move in, or there might be a determination made that some additional support needs to be provided.

I think with respect to the economic dislocations, there are others on the panel who are better suited to speak to that than me. But without engaging in too much hyperbole, we are on the frontlines of a growing economic crisis. We are seeing it already in the lack of reinsurance availability, which is washing back on us, and that is translating currently into the lack of insurance availability, and that message is beginning to impact the business community at large. But there may be a lag time there in terms of the kinds of communications you are hearing from businesses generally, but I promise you it is there and it is going to wash over that community very soon.

Mr. FERGUSON. Senator Dodd, as to the period, my personal opinion is, 2 to 3 years is the minimum. I hope and think that can work. If we look for historical precedent and look back at the nuclear energy reinsurance program and the urban riot reinsurance program, it did take longer. I am not saying that is a perfect precedent, but it did take about 10 years for those things to settle down. I certainly hope that is not the case here. We as citizens cannot afford to wait that long. So I think 2 to 3 years is the minimum is the short answer.

As for the economy, obviously the frontline where you are going to see it first, as Mr. Baker indicated and Mr. Bartlett has indicated in comments, is going to be in lending. Quickly behind that, the real estate industry. And then you get into kind of the confidence factor, and then the second and third order effects that I do not know how to judge any better than anyone else, but it really gets to the confidence and predictability factor that Mr. Baker was talking about before.

Mr. SINNOTT. On the duration question, I have two answers to that. If the environment does not change, let us say we are sitting here a year from now and there is no change in the environment, in my view, will there be more private capacity available? Yes, there will be more capital. There is more capital coming in now in general across the board. And that will include, the ability to mitigate the withdrawal that is taking place. That will be very slow. And as I said earlier, if there is no change in the environment, however, a year from now, it is a matter of degree. There will still need to be Government involvement.

If however the environment is secure, and we no longer see on television the "Attack on America" and we are some way able to get back anywhere close to the way we were before, then, we can accelerate the withdrawal of the Government. But, you know, there are two issues there.

And on the investment side, Mr. Baker probably has the best answer on this or the best information, but I can think of one, and that is large construction projects, which involve not just physical assets but significant numbers of workers, so you have both workers' comp and you have big asset values. If there is not adequate insurance for those particular projects, they will not go forward.

Senator DODD. Mr. Baker.

Mr. BAKER. Mr. Chairman, I would make a brief comment on the duration issue from a banking standpoint simply to say that a great deal of our financing is in the 2 to 3 year range, and so when we look at projects, it could be a big project, a large office building or a power plant, typically things take a while to get built. So you have to begin to think of this link to projects. That is the best guidance I can give you on duration that you are trying to bring stability to the market over time.

On the economy, I would like to address this, because I think it is critically important at this time. I would like to say first that I am an absolute optimist on the American economy. I believe that when you look at the demographics, for example of North America, the population will increase about 40 percent over the next 50 years. It virtually assures us of a growing, sound economy over the first half of this century. So put me in the optimist column.

Right now the weakness that we are seeing is a global weakness in the economy. It is lower nominal growth within our domestic economy, and now it is very severe employment pressure. We lost something on the order of 77,000 jobs out of the economy in the last week alone. So my sense of this is, it is a very critical point right now, because I believe the American consumer is in the process of making up his or her mind about where this economy is going to grow. And so stability is important. And what we do not want to see happen is to see the economy lapse back into a self-defeating proposition. We do have this global weakness in Europe, Latin America, and Asia.

I would like to finish my comments by saying that I think particularly this is a small business issue. We tend to focus on large power plants and things like that, but I think this is particularly difficult for small business. I think you should consider the business interruption insurance. That is a small business issue if there ever was one. So that is the critical thing on the economy. The economy is going to grow. It is going to be good, but it is a very critical point right now.

Chairman SARBANES. [Presiding.] Thank you very much.

Senator Corzine.

**STATEMENT OF SENATOR JON S. CORZINE**

Senator CORZINE. Thank you very much, Mr. Chairman. I apologize to the panel for being late. I was at another hearing, but I too would like to give my congratulations and laud you for how the industry has reacted in the post-September 11 time. It has been very responsible.

I have a question with respect to the knowledge base that you think you will have gained over the next 2 or 3 years in this exercise of bridging which we are about. Is this the kind of activity that we can bring actuarial knowledge and applications to in a way that you might be able to deal with natural disasters? I am very much of the view that the long-run solution may have to wait so that we can be careful about the short-run. I am troubled with the assumption that somehow or another we are going to have actuarial knowledge with regard to crazy behavior that comes from terrorism. I would love to hear your propositions on that.

Mr. Baker, you talked about 2 or 3 year financing programs through the banking industry, but as you know, there are other capital markets that have longer duration, and what kind of impact do you think a short duration program may have with regard to the free flow of capital? And have we seen any indication that that may be drying or at least dampening down? I do believe this is a serious economic dislocation issue that needs to be addressed, and the business interruption issue with regard to small business, I would love to hear your comments.

And I would love to be respectful to my colleague, Senator Stabenow, who had to leave, but she was very interested in understanding whether if we implemented this bridge program for 2 or 3 years, do you anticipate insurance rates for consumers in particular would stay the same or go up? Would you be withdrawing from lines? I ask any and all of you to take on any piece of that.

Mr. BAKER. Senator, you are the expert on debt markets, and so I will not try to——

Senator DODD. He would like you to bring that microphone and say that again.

[Laughter.]

Mr. BAKER. I think there are markets where financing is of longer term, but the point should be made that these markets are very sensitive. And when we have issues that come up, we see debt markets that have cracked almost immediately. We see difficulties in risk assessment. So what plea I would make here this morning is as we are looking for continuity and stability in the underlying economy, that is what keeps debt markets going.

Senator CORZINE. The commitment committee process that you have at a bank on an interim financing basis is not unlike what you would have in putting together a prospectus of investors.

Mr. BAKER. I was just trying to logically think about the kind of project time that you have when you build a building or a power plant. On your point, if I may say so, about risk assessment, there are pretty startling things going on in that field, so my guess is we will learn a lot from this and other events as we go forward.

Mr. SINNOTT. I will comment on the rates and the actuarial question. Ron would probably have good ideas on this. We do it through our reinsurance broking operation. We do modeling, and that is catastrophe modeling for earthquakes, hurricanes. And to do that modeling, you do need some frequency. So I will have to go back and ask some of my modeling experts. But I am a bit skeptical. We do not want frequency, that is for sure here.

I think that they would probably say if we do not have that frequency, which we hope we do not, it is very difficult to model something like this, and if you cannot model it, it is difficult to come up with any actuarial precision.

The second part as to the consumer, the business consumer in this particular case, what will happen with rates? Rates have gone up very significantly already. Since September 11, we have seen property rates go up on average, that includes business interruptions, 65 percent sometimes 100 percent, sometimes 150 percent. Do I expect if I were sitting here a year from now that will have moderated? No, I do not think it will have moderated.

We went through 13 years of a very soft market from 1987 on to 2000, and if you look at the loss experience, and again, my colleagues here can speak to that directly since they were impacted, but if you look at the loss record for the industry up to that point absent September 11, particularly in property, it was not good to say the least.

So I would have said I do not expect that we are going to see another 65 percent, but I am just saying I do not think we are going to see a moderation of rate increases. And I guess the question is, are we dealing with that with our clients? Yes, we are dealing with that.

Three aspects: There is capacity, the scope of coverage, and there is cost. We do not play loosely with our clients' money. But scope of coverage is the thing that can really be extremely harmful to the security that insurance is supposed to provide. And what we are talking about here is scope of coverage.

There is capacity loss as well. The capacity issue we can deal with, capacity across the board, not just for terrorism. There is a reduction in capacity. So that is my view, Mr. Chairman.

Mr. FERGUSON. Senator Corzine, first with respect to your colleague's question, I agree with Mr. Sinnott. It is important that we realize there are two things going on here. We are coming off a sustained period of poor returns in the insurance business that has nothing to do with the tragic events of September 11. If it had never happened rates would still be going up for that fact.

It is awfully hard, as you would note, to break that envelope apart. You know, which part is going to be attributable to the September 11, and which part is attributable to the fact that the industry was earning subpar returns?

With respect to the actuarial point, if I may, you are absolutely right. There is no actuarial technique. There is no statistical extrapolative process that allows you to deal with one horrible data point. We can try to take the Bayesian approach, and if we get two data points maybe we will make something of it, but we all hope that we only have one data point. So my real answer to your question is this. As long as the actuaries and the underwriters can put this in a box—by that, I mean know with reasonable certainty what they are signing up for when they write a risk—they will be willing to exercise their collective judgment. It will not be actuarially based. It will not be statistically based. It will be the judgment of underwriters and pricers who have been doing this, admittedly not terrorist coverage, for decades.

The insurance business kind of lives by its wits in that there is not a nice black box. You do not know the cost of goods sold, let us put it that way, beforehand. But if we know what the box is, you are going to find underwriters that are willing to step up to the challenge, even though it will not be actuarially based.

Mr. VAGLEY. There is little I can add to the views of the businesspeople, Senator. In terms of actuarial experience, I am reminded by something I read recently which was, in the light of the IRA attacks in Central London, it took the London market about 5 years to get comfortable with doing that business again. So there is a period of experience that will promote stability if here, assuming, again, and the important assumption of no additional terrorist acts, which could create even further angst and anxiety.

And in terms of rates, maybe juxtaposing what might happen on January 1, which is commercial insurance for some risks simply will not be available is a way of making the comparison. There may well be in the absence of support no rate which is acceptable to an underwriter to write that risk.

Chairman SARBANES. Senator Reed.

**COMMENT OF SENATOR JACK REED**

Senator REED. Thank you very much, Mr. Chairman. Gentlemen, thank you for your testimony. This is a critical issue that is in need of your attention and your testimony today. Let me just ask a few questions. Unlike my colleagues, I am not an expert in debt.

[Laughter.]

Senator DODD. We are all involved in debt.

Senator REED. But I cannot make money on my debt.

[Laughter.]

Chairman SARBANES. He is an expert on other people's debt.

Senator REED. Let us talk about other people's insurance for the moment. Both proposals are on the table. You have a proposal from the White House and you have a proposal from the industry. I apologize if I am covering ground that has already been trodded, but is there any way that if either of these proposals is adopted we can guarantee affordable, available coverage to reasonably secure risk?

Mr. Sinnott.

Mr. SINNOTT. Yes. In my view, if there is coverage in the broadest sense as there has been, as I said a moment ago, yes, prices have gone up, but I deem that to be something that can be dealt with by the business consumers.

Senator REED. So your view is that if we enact either one of these points that we can create a climate where it might be more expensive but only marginally so, that we effectively could secure in a reasonable way the risk we face going forward?

Mr. SINNOTT. Yes. Because particularly where you are looking at a situation that maintains competition, and there still is competition out there amongst the insurance companies, and they are looking at their rates, yes, I think we can.

Senator REED. Now again, these plans are rather complicated, but the industry plan as I understand it would set up initially a pool which would take the risk, and if the pool is exhausted, the Government would step in. So in a sense, the first industry proposal has the industry absorbing risk to a certain limit and not the Government. The White House plan, and again, I stand to be corrected if necessary, would have the first dollar of risk paid for by the Government. Is that a fair——

Mr. FERGUSON. In a word, yes. It is an 80/20 quota share, yes.

Mr. REED. Again, this goes to the notion which is common of someone paying a deductible first before the Government steps in or the insurance company steps in. Could you elaborate the industry's rationale for your proposal and why it might be better, different, or more effective than the White House proposal?

Mr. VAGLEY. There are a number of proposals, Senator. The industry proposal was really advanced, it was really based on the British model and the British experience and the experience of other nations after they became unfortunate members of the terrorism-at-home club. Our model is predicated on their concept, which is called Pool Re. It simply is a way of taking risks that would be unfathomable for any particular company, a tall office building in a major metropolitan area, and in the absence of reinsurance, available commercial reinsurance coverage, in effect spreading that risk through a pooling mechanism, in effect creating a mutual insurance company into which all primary insurers would pool their risks, and that would be reinsured by the Government, acting itself as a reinsurer.

That proposal has been effective in the United Kingdom. To my knowledge, the British government has not paid out a pound in liabilities. The Administration's proposal, which Ron described as a quota share, would provide at least in the initial year an 80/20 sharing of risk, Government and industry. In that proposal, although in our view perhaps not as efficient as the pool proposal, would also be effective because it would allow underwriters in a real sense to get their arms around the defined liability.

Then there is a third proposal which has been discussed but not reduced to legislative form, which is in effect the deductible approach. That may be a little more difficult. And the industry may have to determine and create some mechanisms to deal with the retention level underneath it, because it does in a way present the same kinds of difficult underwriting risks that the status quo presents in terms of a real reluctance to write those big risks upfront because you could be eating 100 percent of it instead of just 20 percent of it, say, in the Administration's proposal. But it can be made to work.

And I guess our view, and this picks up on Senator Dodd's and Senator Gramm's statements is, there are the business imperatives which we understand very well, and then there are the political imperatives, which you understand far better than we do, and the challenge for us and I think the challenge for all of us is to find the common ground there. It may be that the proposals we think are the most efficient are simply indigestible in terms of the remaining time and the body politic.

Senator REED. Let me ask one final question or two if the time allows, certainly one. In essence, I know this is not designed to be a bailout of the industry. I know the purpose here is to allow ranges of business from small drycleaners to large office complexes to buy insurance at reasonable rates. But essentially, from a business perspective, you all will be laying off risk to other people. Typically, you pay for that in your industry. You pay a fee, you take your risk. In any of these proposals, would the industry be essentially paying a fee or paying anything to the Government to absorb risk?

Mr. VAGLEY. The pool proposal does provide for payments by the industry to the Government for reinsurance.

Mr. REED. Mr. Ferguson.

Mr. FERGUSON. Just as a footnote on that, interestingly enough, the Pool Re in the United Kingdom, they had a different twist on it. Once the Pool Re accumulated assets of $1 billion I believe, then they were going to start to pay the reinsurance they were getting from the U.K. government. It was a slight twist on it.

Mr. REED. Thank you, Mr. Chairman.

Chairman SARBANES. Thank you.

Senator Carper.

**COMMENTS OF SENATOR THOMAS R. CARPER**

Senator CARPER. They gave us two microphones so we can talk out of either side of our mouths.

[Laughter.]

Senator CARPER. Maybe you do not do that in Connecticut, I do not know. But I think they do.

[Laughter.]

Senator CARPER. To our panelists, welcome. I have just come from another hearing. We all serve on a bunch of different committees, and as former Congressman Bartlett knows, you cannot be present at all of them, and I am going to ask you if I can just cover some ground that you have already covered that, but to the extent if you could do and do it quickly, I would be most grateful.

Secretary O'Neill was here yesterday and laid out the Administration's proposal, which I thought had a fair amount of merit. They had obviously given it a good deal of consideration. If each of you could just take 30 seconds to add briefly to it please, what you like about it and what you do not.

Mr. BAKER. Senator, I am here representing the banking industry. From the standpoint that the economy is dangerously weakening, and this is a time when we probably need to work together to resolve that, we really have no view on the particular programs themselves or the merits of them, other than we probably need to do something sooner rather than later. And our own recommendation would be it should have a time limit and certain constraints put on it, as all these programs should.

Senator CARPER. In your testimony, did you lay out a number of principles? Someone did.

Okay. Please.

Chairman SARBANES. We moved Mr. Baker up from the next panel. In fact, Mr. Baker, if you need to excuse yourself, you ought to go ahead.

Mr. SINNOTT. Our reaction to the Treasury proposal is favorable for these reasons. It can be enacted quickly. It is the least intrusive from a Government standpoint, the easiest to unwind. You do not need to staff up on the Government side to do this, and it is the least complex.

The others are complex. Anytime you have an industry aggregate, there is questions as to who gets what and how the aggregate is accumulated. Having said that looking at it from the consumer standpoint, it should be seamless. As long as the industry and the Government are in partnership on this and it provides the ability for the insurance policy to not be restricted, then it becomes an internal seamless issue.

I would say, though, that the one thing we would want to look at it again, because we also act as a reinsurance broker to the insurance companies, is how this mechanism would work. To make sure that it maximizes the amount of private industry you can get back into the market.

Senator CARPER. Thank you. Thirty seconds.

Mr. FERGUSON. First, I thought Secretary O'Neill just did a fantastic job of laying out the issues. I really applaud him. Second, any of the three proposals that are in play and being discussed could in theory work. Third, the devil is in the details. You might want to arm wrestle about whether the 80/20 and the way it goes in the second year and the third year is the right parameters, but in theory, can it work? Yes, it can work.

Senator CARPER. Thank you. Twenty-nine seconds. That was good.

Mr. VAGLEY. Senator, I thought what was perhaps most important about the Administration's proposal was clearly the recognition of the need that this was not a trivial or frivolous subject and another in a succession of industries seeking relief from the events of September 11. That was an important recognition. I think in terms of its basic structure, it is workable, it is relatively straightforward. In our view, the retention levels in the outyears are high. It would not necessarily promote the objectives of the legislation.

Having said all that, however, I would like to indicate again, lest we seem to be preferring one plan over another, though perhaps we do, that we are for any plan that will help stabilize this market and that is politically feasible and are not wedded to the details of any particular proposal.

Senator CARPER. Thank you. I have been wrestling with a couple of different terms looking at a statement of Mr. Ferguson where you talk about adjusted commercial U.S. insurance property and casualty, possibility of a surplus of $126 billion. We have a staff briefing that was given to us where they talk about that surplus number is close to $300 billion. I have a hard time reconciling that.

Chairman SARBANES. He has a table. He has worked that down.

Mr. FERGUSON. I can reconcile it very quickly. The $300 billion is a correct number. Fire and life plus property and casualty, it is $300 billion. If you take the surplus that goes along with the companies that predominately write personal lines of business, your personal automobile, your homeowners and so on, and make a couple of other adjustments—I will not go through them, but you come down to the $125 billion. I can reconcile them.

Senator CARPER. Thanks. I would just observe in closing that we do not have a whole lot of time before the end of the year in terms of oversight and things. We need to move forward with some dispatch. And I will not quibble with what the Administration has proposed. It probably will change it to some extent. But it does have simplicity. And if I can understand it, it is a pretty good sign that others could as well. And to the extent that we can agree on something that is fairly simple and straightforward, we might actually be able to pass it to the House through the Senate and work it out with the White House and get it done in a timely matter.

Thank you very much.

Chairman SARBANES. Well, gentlemen, thank you very much. Mr. Baker, you had better go. I am worried about you.

[Laughter.]

Chairman SARBANES. I want to put a couple of questions to the others, so if you want to slip away. I want to ask a couple of very simplistic questions. If you have a major property or casualty loss in some geographic area of some sort which is in the ambit of the industry handling it on its own, do you then raise rates across the country to all your clients in order to make up for that hit, or do you localize the rate increase?

Mr. SINNOTT. A combination really. The individual policy that has sustained the loss at renewal, that is going to be recognized, just as good loss experience is recognized. But if the overall loss experience, as it has been, as we mentioned in the property area, is across the board, then everyone will have some degree of increase.

Chairman SARBANES. All right. I want to get a handle on the magnitude of this problem. What is the premium flow into the property and casualty business?

Mr. FERGUSON. For the commercial lines business, which would be the relevant base here, sir, that would be about $145 billion. That is for everything.

Chairman SARBANES. One hundred forty-five billion dollars. Well, now the Treasury's proposal in Year Three would have the industry exposed for $36 billion.

Mr. FERGUSON. Correct.

Chairman SARBANES. Leaving aside for the moment the problem of in excess of $100 billion, which we discussed before, putting that to one side, and that was left in this black hole called the discretion of Congress.

[Laughter.]

Chairman SARBANES. But putting that to one side, now, an increase as I calculate here of about 23 percent uniformly in your premium flow would cover that exposure. Is that correct? Do you cover it 100 percent or do you cover it a factor of 100 percent?

Mr. FERGUSON. Your mathematics are impeccable. That is correct. The problem——

Chairman SARBANES. I know you have the problem that that is not exactly how you do it, but I am just trying to get a sense of——

Mr. FERGUSON. Your math is correct, but in practice, it would not work out that way because, of course, in some States and in some classes of business, it would be thought that they are not particularly targeted for terrorism and so they would have much less increases and others would have more. But I do not mean to quibble with your arithmetic.

Chairman SARBANES. The 150 is not homeowners.

Mr. FERGUSON. Correct. The 145 to 150 is commercial lines only. My best guess, Senator Gramm. Commercial lines only, workers' comp, property, general liability, roll it all up, about $145 billion.

Chairman SARBANES. All right. Now one other question. I did not understand Mr. Vagley. On the one hand, you say we should preserve rate review by appropriate State regulators. On the other hand, you seem to want to alter their process. Is that correct?

Mr. VAGLEY. I think we would like to alter the process with respect to terrorism and rate review. However, there are State regulators who disagree with that.

Chairman SARBANES. Let me just say this just as observation. I have not discussed this with my colleagues. I am frank to tell you the simpler you keep this and the less you seek to change current arrangements, whatever they may be, I mean, the NAIC yesterday talked about consumer protection provisions. If this is envisioned as a vehicle for getting other type changes, it is going to significantly complicate it. You have a problem on the tort issue in my opinion. First of all, we do not have jurisdiction over that. We may run into a serious problem in that regard.

Senator DODD. That has never stopped the Committee up here before.

[Laughter.]

Senator DODD. We claim the whole world as jurisdiction.

Chairman SARBANES. I understand, but it is highly relevant as we consider this, since we may have to assert jurisdictional lines in order to keep moving forward so we do not undercut our own case, if I may say so. But in any event, I just wanted to make that observation. People who have things up on the shelf they have been wanting to get and then they want to take them off the shelf and put them into this pot, that greatly complicates the stew.

Senator DODD. Let me just say that I agree with Senator Sarbanes on that point, too. That is something all of us feel. If we are going to get something done here, it has to be done very tightly. But I would put on the rate issue, we talked about this already, with the exception of some 12 States, and I may be wrong on that number, writing commercial insurance, that you set the rates and then the States-by-State law determine whether or not that rate is justifiable. And I do not know why you would want to change that.

Mr. VAGLEY. We do not. As a matter of fact, it really was in recognition of precisely what you described; that this should be narrowly focused on terrorism risks and not seek to advance any other legislative agenda. That the proposal that we advanced was in compliance with that.

And with respect to the two areas of potential State regulatory interference, even the State regulators are in agreement that it is necessary in the one instance to have a common definition of terrorism, for instance, where States cannot require greater coverage, so that in the worst of all worlds, there is incongruent coverage. And my understanding is even the States agree that a pricing mechanism such as we have advanced which does kind of cut the baby in half, it is a final use system consistent with what Senator Dodd said is understandable and agreeable, and we are not seeking any additional leverage or advantage even though we might prefer to do so. Our understanding, Senator, Mr. Chairman, is that this bill, if it is to advance, with all the difficulties of the remaining time available and all the circumstances surrounding the issue, must really be laser-like and focused on this principal issue.

Chairman SARBANES. Let me ask one other question just for my own enlightenment. What is your reaction if someone says why doesn't the Government just assume the responsibility for terrorism on the premise that one of the things the Government ought to be able to do is protect the society against terrorism, so we are not going to put this in the private sector. And if we have a terrorism attack and a loss, the Government will pay for it and the industry will go on about its business of ensuring the other kinds of risks that do not relate so directly to, in a sense, our national security.

Mr. FERGUSON. Senator, that argument can be advanced. I think it comes down to the philosophical issues. My own answer would be let us construct a plan where the private sector has the opportunity to return to normal and not put the Government permanently in the insurance business. But I recognize others will have different viewpoints.

Mr. SINNOTT. If I can add to that, there are other perils called riots, civil commotion, that governmental bodies, whether it is the local police force, are responsible for securing. I think that they are all manageable. They can all be dealt with in the private sector. Terrorism is another part of that. It can be dealt with so long as we are not in the situation that we are currently in.

Senator GRAMM. Mr. Chairman, first let me say that in terms of a Government program, We could do that, and there is some programs that could be adopted that would be, in my opinion, worse than a Government program. The problem is transitioning, the problem is how do you get out of it, and I know you are not proposing a Government program.

Chairman SARBANES. I am just trying to feel for the parameters of this.

Senator GRAMM. I think having tried to think through that in terms of my own preferences, the problem is not that the world would come to an end if the Federal Government said, in these narrowly defined areas, we are just going to cover it directly. The problem is how do we get out of it and how do we get the private sector into it. And then over time how do we keep it from growing where people want to broaden the definition of terrorism. So, at least, in my own mind, that is why I have rejected that.

I would like to say that I think your point you made is the key to us getting this bill written, and that is if somebody wants to put something in here, the heavy burden of proof on them is you have to prove that it will not work or work well without it. I think if we begin with that premise, writing this bill will be doable, and there is not any other way to do it. I think Senator Dodd and I have felt for several years now that we had a real problem, if we had a major hurricane and we had an earthquake in the same year, and at some point, we have to come to grips with that. And I would prefer to do it by changing tax policy and letting you build up reserves rather than the Federal Government getting permanently into protecting against cataclysms. But on the other hand, if we bring any extraneous issue into this, we are lost.

Mr. SINNOTT. Mr. Chairman, can I bring up one issue on that that was mentioned earlier that I do not think is extraneous. At the hearing I was at yesterday, I was not aware of the fact that the Treasury or the Administration, which is of course the Treasury proposal, covered property insurance but somehow did not include business interruption. That is a very serious impediment.

Senator GRAMM. They are very concerned about the potential cost of it, the open-ended nature of it, and that is why I am not saying I agree with them, but that is why they did it.

Mr. SINNOTT. Business interruption is important and I can give you a list of corporations that do not purchase it. There are some very large corporations that do not purchase this coverage.

Senator DODD. Here is the problem you get into with that. We talked about it. There is an easier one. Where the car service, because it serves a particular industry that was hit, it goes out of business because it does not have the capital to sustain it. The other business interruption is where some of us on the plane have some place to go and sign a contract. Then you get into that business interruption. You have a broad definition of that and boy, it becomes a nightmare.

Mr. SINNOTT. I agree but I think that the definitions are fair under the policy. There is an insurance policy with terms and conditions and that coverage has been there for as long as I have been around, and it is adjustable. So I do not know why, if the insurance industry has been able to deal with that, via it's accounting, the Government could not deal with it too. It would create a serious defect to excuse business interruption.

Senator DODD. It is a challenge, just by the way——

Chairman SARBANES. Actually, you are making a very important point.

Senator GRAMM. If you can narrow it, you can make the point, but you are going to have to do that.

Chairman SARBANES. If you leave it out, then you have left out an important aspect of the coverage, or leave it out altogether.

Senator DODD. Let me ask you two other quick questions. We are talking property and casualty here but you know the questions come up about life and health. It seems to me I do not know how you are going to avoid particularly the health area, the life. There may be some other argument you can make, but the health insurance issues are going to be hard to exclude from this calculation. That is one question.

The second, how do you define an act of war as it is usually defined and terrorism. When does an act of terrorism become an act of war or not an act of war? Do you think we can draw that distinction well enough?

Mr. SINNOTT. It is most of the definition. When you have an agent acting in concert with a government, a foreign government, in other words, acting at the direction of that government, that can be construed as a war risk rather than a terrorist risk. On the other hand, in most cases, it is up to the government. The government is the one who really declares whether a state of war exists.

Chairman SARBANES. We have another panel. Unless there is anyone who has a question, this has been an extremely helpful panel. And we really appreciate your coming. Thank you.

If the other panel will come forward.

[Pause.]

Chairman SARBANES. We are very pleased to have this panel. I know we held you a bit but you can tell we were having a pretty interesting and helpful session. We will just go straight across the panel. Mr. Donohue, it is nice to see you again. We are pleased to have you back with us and we will be very happy to hear from you.

## STATEMENT OF THOMAS J. DONOHUE PRESIDENT AND CEO, U.S. CHAMBER OF COMMERCE

Mr. DONOHUE. Thank you, Senator. I am here because the American consumers and businesses require the financial security provided by terrorism insurance to get the economy moving again. I am not an expert in insurance the way many of you are, but I do understand the challenges facing American businesses.

The problem is the recent events are making adequate terrorism insurance hard to come by, and the Government temporarily needs to be part of the solution in whichever way you think is appropriate. September 11 will result in the largest one day insured loss in U.S. history. My understanding is the industry will lose $30 to $60 billion in claims, easily surpassing the previous record of $30 billion from Hurricane Andrew.

And, without adding any of my other views about the role of the class action and trial lawyers, let me say that depending on the activities of the Government, some of which have been very positive in locating where these matters will be resolved and who gets involved in it, that number could be significantly higher, and it is a matter to be concerned about, but I am sure not resolved in this legislation.

The insurance industry is committed to meeting its obligations and I think they were very forthcoming. The Administration was talking about war. These people walked in and said we are going to pay our bills. No one was asking the Government to bail out the industry, or to take care of its established obligations.

The problem, however, is in the wake of our events of September 11, insurers and reinsurers feel compelled, as you have heard, to reduce terrorism coverage or not to offer it at all, and that is where you get the complication. If you do not have it, whose crawling all over your circumstances? And they are bankers and they are investors and they are partners and everyone else that wants to know what happened if I put my money on the line and we either have an activity or we create one, how are we going to be sure that if there is an overt act of terrorism that we are going to be paid?

This market disruption caused by a lack of terrorism insurance coverage, if it is not provided, could have deep and potentially devastating effects. Let me list them quickly. First, businesses that cannot get the coverage may have to cut back their operations or stop what they are doing in a particular business area; trucking firms, railroads, airlines, ships, may all be compelled to say, I am not going to carry this, I am not going to go there, I am going to limit my business activities to protect my interests or to meet the requirements of my bank or my other financial partners.

Second, the lack of such coverage could prevent many businesses from obtaining financing. Or it could accelerate in what happens with existing financing, in that people are going to come to them and say, okay, you don't have the insurance, you have to pay me in a certain amount of time, or I have to increase your costs, or I am going to close down your line, and this is a real serious problem. A lot of loans require evidence of terrorism insurance. If you do not have it, the loan is not a performing loan.

Finally, businesses that are left with no choice but to self-insure against this risk are going to have to really think very hard. They are going to find it very difficult. But I want to pass a thought on to the Committee. Let us assume we do not do this. Let us assume people go bear or people deal with all these issues. If we have another major terrorist incident, I mean something of the magnitude we have had, you are going to pay for it anyway.

It is very clear that if we are sitting here a year from now and some terrible, horrific thing happens, and the people sitting up and down this table say, every single one of the major casualty insurance companies in this country are going to go bankrupt, you are going to take care of it. So what you are really doing is like the guy with the oil filter. You are going to cover me now or you are going to cover me later.

Senator GRAMM. You are buying insurance.

[Laughter.]

Mr. DONOHUE. You are buying insurance and what you are doing is you are keeping the private sector in this right up to their necks about as far as they can go, so the water does not get where they are drowning. And what this is, and by the way, I am a private sector guy, and I am opposed to creating some massive, new Federal deal that covers this thing for now and forever. What we are talking about is a bridge and we would better make it a bridge that damn well finds a way to get to the other end of it, or as Senator Dodd said, and you said as well, Senator Gramm, we are going to be adding more and more ornaments to this Christmas tree in a big hurry.

Anyway, I came up here with a very simple message. I am not an expert on the insurance issue and not an advocate for one solution or the other, other than it ought to be as much private as we can so that the private sector does all of the background work, carries all of the administrative work; we do not need another Government agency. We need the Government to insure itself from what it is eventually going to do if it has to.

And I want to congratulate the Committee. It has been extraordinary for me in the last couple of weeks to see how people have said, wait a minute, we have a political agenda, but let us sit down and figure out how we are going to handle these things. I just came back, for just a half a second, I just came back from the APEC meetings in China, and I was with business leaders and government leaders all around the country and around the world. It is a very simple thing over there. Everybody figured out they made a big mistake. Those guys just got their act together, they are all playing the same music, they are walking the same step, and I give you great credit for what you are doing.

But I will tell you this is something else you have to do and you need to find a way to do it so that it is done in the private sector. You take the least amount of risk, but you understand if you do not do it, you are going to do it anyway.

Thank you very much.

Chairman SARBANES. Mr. O'Brien.

Senator DODD. We have Donohue, O'Brien, and Knorr. Are you Irish?

Chairman SARBANES. He is from the City of Chicago.

Senator DODD. It sounds like a Dublin law firm up there.

[Laughter.]

## STATEMENT OF THOMAS J. O'BRIEN SENIOR VICE PRESIDENT OF FINANCE AND CHIEF FINANCIAL OFFICER, LCOR, INC. REPRESENTING THE REAL ESTATE ROUNDTABLE

Mr. O'BRIEN. Thank you, Mr. Chairman. My name is Tom O'Brien. I am Chief Financial Officer of LCOR Inc. As such I am responsible for companywide oversight of LCOR's finances, risk management and insurance activities which includes the $700 million U.S. Patent and Trademark Office's new headquarters in Alexandria, Virginia; the JFK Airport terminal port facility in New York, a $1.2 billion airport terminal developed and operated by a private consortium, and various other offices and multifamily homes located throughout the country but primarily from New York to Washington.

I am what Mr. Sinnott earlier referred to as an insurance consumer. LCOR is a national real estate development, management company. We specialize in structuring and implementing public, private development. We have completed projects in 15 States and the District of Columbia including one for 16 million square feet of space and 18,000 residential units.

The company has completed developments or has under construction projects totaling $4.4 billion and over $1.6 trillion in predevelopment. LCOR is and has been involved in some of the Nation's largest most complex and most creative developments. We are currently active throughout the United States as well as Pennsylvania, where we are headquartered. I feel well-represented by the Senators on this Committee based on that.

But I am here today as a longstanding member of the Real Estate Roundtable and on behalf of a number of real estate agencies and trade groups that are submitting to this Committee written testimony. As many of you are aware, the tragic events of September 11 triggered the withdrawal of virtually all new insurance on property and casualty. This is caused by the insurance industry's inability to predict future man-made catastrophic insurance losses. This will be increasingly apparent throughout the industry on January 1 when approximately 70 percent of the policies are up for renewal.

I am personally involved in transactions of more than $2 billion that have been impacted by the eliminating of terrorism coverage. By way of example, since September 11, our JFK Terminal Four Project has already had its liability coverage for terrorism revoked. We are told that we will lose our properties' terrorism coverage and that our current policy limit will be pushed upward 50 percent. Our premiums will be doubling and our revenues have been drastically affected due to reduced capacity in volume.

As CFO of a commercial and residential real estate development and a property owner, I know from my 20 years of experience that it is not possible to buy, sell, or finance a property unless it is adequately covered by insurance. A significant percentage of privately owned properties are open to the public including shopping centers, offices, hotels, and they will need to renew their insurance coverage on or before January 1. Many of these owners have been advised that the policies may not be renewed or that the new policies will exclude exposures currently insured, including terrorism. These owners have also been advised that they will all likely have to absorb significant increases in premiums. They have also been advised that there are greatly expanded uninsured exposures due to policy exclusions. Without adequate insurance, it would be difficult, if not impossible, to develop, operate, or acquire properties, refinance loans, and sell commercial mortgaged-backed securities.

Since real estate transactions are primarily based on prudent risk-taking, the disappearance of coverage for terrorism acts will affect the underwriting of real estate and other businesses which could severely disrupt the economy. It will not only effect real estate owners and lenders, but also their tenants, who lease facilities, their employees and customers, and lenders and also anyone who rents an apartment or buys a new car. I am very concerned about the short- and long-term future of the real estate industry, unless the Federal Government creates some type of mechanism to help provide this coverage.

The scale of the industry is immense. Estimates are $4.6 billion of real estate and as the current policies expire, there is tremendous uncertainty about the status of debt in this sector. Mr. Baker spoke to some of those concerns on the banking side. But obviously it goes well beyond that. Before September 11, property and general liability policies typically covered losses including business interruption costs from terrorism and similar acts. However, as other testimony has shown, future policies will likely exclude coverage for terrorism and sabotage in addition to the current exclusion practices of war.

As Secretary O'Neill and others have stated already, the Federal Government needs to help insure the commercial property owners and other businesses that cannot continue to obtain insurance coverage for losses related to terrorism in the future. I must also add that action needs to be taken as soon as possible, because there are policies expiring every day and new transactions pending which are being heavily impacted by the lack of resolution.

I am not really familiar with the traffic signals, but I know red means stop. May I go on?

Chairman SARBANES. For a little bit.

[Laughter.]

Mr. O'BRIEN. We have already said that 70 percent of the policies terminate on January 1.

Chairman SARBANES. The light gets less waivable the more we move through.

Mr. O'BRIEN. That is fine. I am almost through. I think it is key that we talk about some of the necessary characteristics of a workable plan. From a real estate perspective, we believe they include the following duration. Real estate is a long-lived asset and is generally financed over a long period of time, generally 10 to 30 years. Thus, if a program is created of insufficient length that may not be able to provide the stability in the long term, so any program created must be of sufficient duration to provide reasonable certainty of the future availability of this coverage.

The second point is the definition of terrorism. The line between terrorism and acts of war has certainly been blurred since September 11. The President, as well as the media, have focused on our current war against terrorism. We believe any program created must cover an expansive notion of terrorism so that future events along the lines of September 11 and similar acts are covered, are not excluded from coverage in the future.

The third point is development of deductibles and limits of coverage. The real estate industry is concerned about what could be dramatic increases in deductibles to property owners, which could be tantamount to no insurance coverage at all. And accordingly, any program must carefully apportion loss exposure between property owners, lenders, insurers, and the Federal Government.

One last thing in terms of premium cost disclosure. You may have heard earlier that property and casualty rates have already been predicted to skyrocket prior to the attack on America. We believe insurers should be required to separately disclose the cost of comparison coverage and impact on the overall insurance rates; otherwise it will be impossible for insurance consumers to discern the actual increase in the policy as a result of the difficulty in writing the terrorism coverage versus the increase as a result of normal market conditions.

Finally, our Congress must not fail to act. The real estate industry welcomes the opportunity to work with the Administration and Congress to achieve a workable solution to this immediate problem and help our company get back to its core mission of creating better places to live, learn, work, and play.

Thank you for the opportunity.

Chairman SARBANES. Thank you very much, Mr. O'Brien. That was a helpful statement. I think you actually made a couple of important points toward the end. Afterwards, you might consult with Mr. Donohue. He is a pro. You notice he came in right on the mark.

[Laughter.]

Chairman SARBANES. When the light turned he was right there, but he has had a lot of experience in doing this.

Mr. O'BRIEN. Yes, Mr. Chairman. This is my first Committee meeting, much less appearance, so I apologize.

Chairman SARBANES. You did a good job. We appreciate your comments. Mr. Knorr, the Chief Financial Officer of the City of Chicago. We are very pleased to hear that you want to get this perspective. I also have a statement for the record sent to us by Marc Morial, the Mayor of New Orleans, who is President of the U.S. Conference of Mayors.

Without objection, we will include that in the record, and the Mayor is urging us to take immediate legislative action.

Chairman SARBANES. Mr. Knorr.

## STATEMENT OF WALTER K. KNORR
## CHIEF FINANCIAL OFFICER, CITY OF CHICAGO, ILLINOIS

Mr. KNORR. Thank you, Mr. Chairman, for inviting me to testify today. My name is Walter Knorr. I am the Chief Financial Officer of the City of Chicago. I appreciate the opportunity to present to the Committee a matter of great concern to the City of Chicago, and I am sure to other cities throughout America. The price of war and terrorism liability insurance, as a result of the tragic acts of September 11, has escalated to incredible levels, if available at all. The insurance industry is uncertain about the risk of terrorism and therefore appears unable to assess and price that risk.

In Chicago, our insurance carrier recently cancelled our war and terrorism liability insurance coverage for Chicago O'Hare International Airport and Chicago Midway Airport. Prior to September 11, we paid an annual premium of $125,000 for $750 million of war and terrorism liability coverage. If we want to renew our coverage, it will cost us $6,950,000 for $150 million of war and terrorism liability coverage. I will repeat those figures to you. Our premium has risen from $125,000 to $6,950,000. Our coverage has dropped by $600 million. That is a premium increase of over 5,000 percent for substantially less coverage.

Putting it another way, the cost of $1,000 of coverage has risen from 16 cents to $46.33 per $1,000. This is an astronomical increase, almost 29,000 percent. This extraordinary cost increase would be passed along primary to our tenants at O'Hare and Midway airports, namely the airlines operating out of those airports.

The financial problems of most airlines have been well publicized. A cost increase of this magnitude would negate the city's efforts to cut costs of airport operations to benefit the airlines and keep them viable. It would also undue the efforts of this Congress to assist the airlines financially during these uncertain times.

Chicago is not alone in this. We are aware of a number of other major airports across the country that have received equally exorbitant quotes for war and terrorism liability coverage. In addition, the Chicago airports have been warned that their premiums for property and liability insurance may double, triple, or even quadruple and deductibles will increase significantly.

The problem extends beyond the airports. It includes infrastructure. The City of Chicago insures a toll bridge that connects Interstate 94 to the Indiana Tollway. Our most recent annual premium was $406,000 for $386 million of coverage. In mid-September, the city received a nonrenewal notice for this bridge with the ominous indication that the insurance carrier could not quote a new rate but that the rate will increase by more than 30 percent and potentially much higher. One would expect insurance costs associated with terrorism to increase substantially for many other public and private structures, existing buildings, buildings under construction, public meeting areas like sports stadiums and convention centers and other prominent infrastructure.

The increased insurance costs will undoubtedly be passed along to the tenants and users of these assets. If those costs were significant, and I think they could be, they could have an extremely negative economic impact. Tenants would have to decide whether to pay those higher costs or leave the city and take jobs with them.

The insurance crisis hits major cities the hardest because cities would appear to be the most likely targets for terrorist attacks. While terrorists may pick out individual targets, the attacks are directed at the Nation as a whole, and the risk should be spread to the Nation as a whole. In these uncertain times, the Federal Government should act as an insurer for future terrorist attacks and catastrophic losses. There are two proposals before this Committee and the City of Chicago is not taking a formal position on the two proposals. The City does believe it is imperative that the Federal Government act on the insurance problem to provide certainty of insurance at reasonable rates, and hopefully mitigate the cost to Government and business.

Thank you again for this opportunity. I will be available for questions that you may wish.

Chairman SARBANES. Thank you very much for these statements. When do these policies whose figures you quoted come up for renewal?

Mr. KNORR. We received a 7 day cancellation after September 11 on war and terrorism. So as I mentioned, I know of nine other major airports across the country that are in the process of examining these quotes for these levels of coverage to substantially reduce levels of coverage. We are all in the same position.

Chairman SARBANES. Do you have coverage at the moment under the old terms?

Mr. KNORR. Under the old terms.

Chairman SARBANES. When do you lose that coverage?

Mr. KNORR. We lost it with a cancellation so right now we are in a position where we will have to rely on sovereign immunity or we basically would be in a position to have to piggyback onto the war risk insurance that is attached to airlines as vendors.

Chairman SARBANES. In other words, you are not covered?

Mr. KNORR. With this terrorism insurance, yes.

Chairman SARBANES. They also said you could keep it at these figures?

Mr. KNORR. These are the quotes we have given back in exchange for $750 million for $150 million.

Chairman SARBANES. So you are examining the implications of that?

Mr. KNORR. I would say so.

Chairman SARBANES. Senator Dodd.

Senator DODD. I thank you as well. It has been very helpful testimony. It makes the case that maybe we should have had you on first in a way because this really is an economic issue.

As someone pointed out earlier, here they come again, this crowd, always showing up at the trough taking advantage of tragedy on September 11 to raid the Treasury. I do not believe that is occurring. I do not believe it occurred in the airline industry, but you have heard that from certain quarters.

What we are talking about here is not providing any assistance at all to the insurance industry. What we are trying to do is to encourage the industry to stay in the business, to see to it they are going to provide the insurance to public and private entities around the country so that they can borrow money, they can do the things that are necessary for the economy to continue to operate. So the testimony here is very important so the case can be made.

I can see already the words they are using, the word bailout. I know what a bailout is. I have seen them around here. This does not even come close to falling into that category. But the mantra has developed somehow, it becomes almost a cliche, and I think your testimony about the implications here, and I will make the point, I probably did not make as well as I would like to, but I get very worried. I am very worried about the condition of our economy anyway. When you add the events of September 11 and the events of the last several weeks, I worry that we are going to be able to hopefully sustain the level of public support for what needs to be done in order for us to successfully deal with the issue of terrorism. That will require a population that is willing to support the kind of expenditures and efforts that are going to be necessary over a long period of time.

I believe the President is absolutely correct. This is not a conflict that is going to be resolved quickly. You can only resolve it if its representatives have the support of their people for continuing to invest in that effort. And if you have a weakened economy, if you have high unemployment rates, if you have people worried about those conditions, it will be harder to sustain the kind of effort that will be necessary.

I suspect that those who are responsible for the attacks on September 11 in some small way will count on an eroding public support, and the quickest way that happens is a weakening economy. So I am not convinced that everything we are going to do in this area is right.

Grover Norquist, who I do not necessarily associate with on too many occasions——

[Laughter.]

Senator DODD. ——but he had the best piece of advice I have heard given by anybody. He was asked 2 or 3 weeks ago what advice he would give a Member of the Senate these days. I thought, oh, boy, here it comes. I can just imagine what this advice is going to be. And he said, if I were a U.S. Senator, I would read every bill. And that is pretty good advice. It is good advice at any time anyway, but we are legislating quickly here and maybe we ought to be careful about what gets included. But I think that this is a very critical element for us to have on the table and done. It may not be everything everyone would want, but it is a very needed piece in this puzzle or this pattern we are putting together here, to try and prosecute successfully the war on terrorism but also see to it that our own country is going to remain strong.

I thank you. And, Mr. Chairman, I do not really have any specific questions. I just want to thank you for your testimony.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. I very much appreciate the real world look at what the cost of this is and what implications it would have for business or the public sector. I would like to ask Mr. O'Brien again, because I am troubled by our focus on a limited duration program, do you believe that you will have access, do you think your industry will have access to credit if we come up with a 1 or 2 year program with cancellation clauses and other kinds of options that insurance carriers undoubtedly will write here. How do you feel that is going to impact your ability to finance some of the kinds of projects you have talked about?

Then let me compliment you. I think the concept of making sure that the terrorism premium is disclosed so that we are not mixing apples and oranges in here is a very insightful and responsible point. And then I would love to hear your comments on the business interruption issue as well.

Mr. O'BRIEN. Thank you, Senator.

I have had some first-hand discussions this week with longer-term lenders and bond underwriters and bond insurers because many of our larger public-oriented projects end up being in bond financing. And on Monday of this week, I was asked that specific question. Okay, talk to me about the next 12 months, or talk to me then about the next 28 years, because that is what I am underwriting. I am agreeing to accept the exposure to today's bondholders. This is the underwriter saying to me, how do I know that there is going to be availability of some product that is going to protect me from this unknown, unquantifable risk, and it clearly focuses much more on the fact we have a 3 year development cycle. In cases at patent and trademark headquarters, we actually fixed the rental rate for the Government 2 years ago.

So 2 years ago, the Government asked for bids, we gave our final best offer, we fixed the rental rate. This month or probably next month we will hopefully go forward on starting construction. Some 3½ years later, the Government will pay the first dollar of rent to us and they will pay rent during the next 20 years. Throughout that 5 year period, 2 years back and 3 years forward, we are bearing tremendous uncertainty in terms of construction costs, interest rates, but now suddenly, in the last month-and-a-half, the cost of insurance availability and terms has become predominant. And what you could say, some might look at it as a mundane area of the business in terms of insurance, at least from a real estate developer's perspective. Suddenly, it has become front and center.

So I certainly am concerned about a reasonable certainty as to future availability. I am not proposing by any means that the program would last 20 plus years, but there is certainly a need to look beyond the 12 month time horizon. Many of the insurers have the luxury of deciding every 12 months whether they are going to renew the coverage. But investment decisions are made on a much longer period of time, and I cannot look back 12 months, 24 months from now, it is too late. So it is definitely a concern of ours.

As far as the premium side, I said we clearly were already aware that premiums were rising quite dramatically and Mr. Knorr's comments I can share. The percentages may vary but all premiums are really skyrocketing, and to the extent there is a way to quantify the portion of the increased cost that ultimately is passed on to us and the buyers, the insurer does not bear the ultimate cost. He is the balance sheet in between the loss and the ultimate recipient or beneficiary being us, the insurance buyer. So ultimately they are going to pass the cost along to us in one form or another, and we would at least like to know that it is a fair, calculable sum, so I appreciate the question because it did come up in the first panel, and I really think it is an important one.

Senator DODD. Jon, let me just interrupt. You made this point. In your previous life you know how quickly these questions do come up. Putting this aside, just going back in your earlier incarnation, how quickly these issues arose.

Senator CORZINE. Nobody is going to write a prospectus now without the question of terrorism being one of the risk characteristics that you have to address. And it is going to, it is either addressed because we have insurance and that is going to impact the bottom line of the company, so it is going to end up impacting stock valuations, or if you do not have insurance, then you are going to pay a spread that is dramatically broader for getting access and credit, if you can get it at all. And by the way, it is just as true for Mr. Knorr and the City of Chicago with regard to bridge financing or any—I do not mean bridge in the financial context, but between Indiana and Illinois. I do not think people get how big a problem this is with regard to the financial interlacing, and I could not agree with you more. We are going to need to have a sustainable economic environment to fight this broader terrorism, and if we do not address these kinds of issues, I do not want the perfect to be the enemy of the good, but I think somehow or another we are not thinking about the duration issue.

Chairman SARBANES. I think it is an important point. The Pool Re approach, which the insurers put together, he knows what that problem is. I understand it because you have this pool and it can go on. You know, the one in England has gone on now for a number of years. The Government's never actually had to pay anything.

Senator DODD. It is a million dollars. It is a rather very small program.

Senator CORZINE. But the Government is the backstop for the insurance.

Senator DODD. And the actuarial efforts are much easier under that scenario.

Chairman SARBANES. That approach takes care of Mr. O'Brien's problem as I understand it.

Mr. O'BRIEN. To the extent I understand it, Mr. Chairman I think it really comes back to no one has all the answers but we cannot look at this as a 12 month issue or even a 2 month issue. I disagree with the statement this morning that if this had happened in March it would not be a problem. That is just not the real world. It is a problem. That is because the industry is really not able to quantify and charge for what is an unquantifiable risk.

Senator you had asked a second question about business interruption and it was something that I had given some thought to over the last few days. Because, as we have all seen, in New York in particular, the recovery and the acts of private and Governmental parties have been phenomenal, but on the private side, none of that would have been possible without business interruption and some of the property coverages that are currently in effect.

If it would happen without any type of terrorism coverage, things would just stop because there would be no funds from the private sector to do any of the kinds of things like reopen some of the neighboring buildings and restore the economy in that part of New York City.

Senator CORZINE. Senator Clinton, at a Budget Committee hearing this morning, and I wish I had the sheet, I wrote it down, but said that the businesses that were interrupted in the immediate area were like 300 but if you take south of Canal Street, which has been completely interrupted by the process, it is over 1,200 and most of that is small business and it is a devastating concept to think we leave business interruption out of these kind of packages.

Chairman SARBANES. Anything else, Jon.

[No response.]

Senator DODD. I think while Jon was asking that question, Mr. O'Brien, you had a very clear good example of how this can get way out of hand very quickly.

Mr. O'BRIEN. Thank you, Senator.

Chairman SARBANES. Gentlemen, than you very much. Mr. O'Brien, for your first time you made a very substantial contribution. We appreciate it very much.

Mr. Knorr, do not tell the mayor about this Irish problem.

[Laughter.]

Chairman SARBANES. This hearing stands adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

**PREPARED STATEMENT OF LESLIE M. (BUD) BAKER, JR.**

CHAIRMAN, WACHOVIA CORPORATION
REPRESENTING
THE FINANCIAL SERVICES ROUNDTABLE

OCTOBER 25, 2001

Mr. Chairman and Members of the Committee, thank you for the opportunity to testify on this critical matter. My name is Leslie M. Baker, Jr., Chairman of the Wachovia Corporation, here on behalf of the Financial Services Roundtable, of which I am the Immediate Past Chairman. The Financial Services Roundtable is a trade association for the Nation's largest integrated financial services companies. Our 100 members are drawn from the ranks of the banking, insurance, and securities companies.

I am here today to tell you that without full cooperation between our Government and America's private industries in support of insurance activities there could be major disruption in the marketplace and harm to the economy.

On October 10, 2001, 30 chief executives from Roundtable member companies signed a letter to the Congress expressing concern over the impending lack of terrorism coverage and urging Congress to act this year. It is important to note that 22 of those 30 signatories are bankers, including Wachovia. This makes the point further that this is not an issue solely about the insurance industry. Mr. Chairman, I ask your consent to have the letter entered into the record.

The President of the United States, Chairman of the Federal Reserve, Secretary of the Treasury and many Members of Congress have recognized that our economy needs an economic stimulus package. Without Congressional action to provide a Federal backstop for terrorism insurance, efforts to provide an economic stimulus could be ineffective. This is an issue about the ability of the United States to recover from the terrorist attacks of September 11 and the ongoing issues of uncertainty, which now weigh upon the economy.

The possibility of further terrorist acts in the United States places uncertainty into many sectors of our economy. Without adequate insurance coverage, our Nation could face economic, market, and employment disruption. To assist in revitalization and to avoid an economic downturn in the United States, the Financial Services Roundtable urges this Committee to create some form of Federal assistance for insurance losses due to acts of terrorism.

**The Nature of the Problem**

Property and casualty insurance coverage is one of those subjects that normally attracts little public attention. However, it is a vital part of our economy and affects large and small companies in industries from banking to real estate, and beyond. Insurers assume risks that other parties cannot. For example, insurers shield developers from the risks associated with major construction; they protect shippers transporting goods and commodities; they cover losses associated with homes and cars; they protect employees through workers' compensation programs and disability coverage; and they protect businesses from legitimate claims arising from business interruption.

The property and casualty insurance industry has announced that it is paying all private sector claims associated with the September 11 attacks. These costs apparently could reach $50 billion or more. Additional acts of terrorism are unpredictable and, as the attack on the World Trade Center illustrates, the losses from such attacks can be massive. Acts of terrorism are "human acts" rather than acts of nature. As such, there is no existing actuarial analysis available to evaluate such risk. Risk that cannot be priced or managed translates into the inability of primary insurers to offer policies or get reinsurance. Thus, if primary carriers cannot transfer risk for acts of terrorism through the reinsurance market then they cannot sell polices that include coverage for such acts. If they are unable to sell polices that include terrorism coverage; a lender may be precluded from making loans due to increased exposure to uninsured risk.

**A Banker's Perspective**

As I stated earlier, without insurance coverage for terrorist acts, it will be much more difficult, for bankers to extend or renew commercial loans or lines of credit for business purposes, construction, or development. To assess the viability of a particular loan, a bank must carefully assess the risk of the loan and price it commensurate with that risk. Obviously if the risk is too great, the bank cannot grant the loan at all. One way borrowers reduce risk to themselves and the bank is to acquire insurance protection against a number of risks. Purchasing appropriate insurance is standard business practice for anyone attempting to obtain financing in the United States.

If the insurance industry cannot offer adequate insurance to a borrower or a bank because it cannot properly price or reinsure the risk, the bank is faced with a serious risk assessment problem. Is it prudent to make a loan to construct a pipeline, or a power plant, or an airplane, or a ship, or a large shopping center or office building when the potential for the borrower to repay the loan is diminished by inadequate insurance coverage? For most banks, the answer will be no. Indeed in many cases such a loan, most assuredly, would be considered unsound.

As part of the underwriting process a bank must gain understanding of likely sources of repayment in the normal course of events and under catastrophic circumstances. A normal part of the underwriting process is to make certain that appropriate insurance coverage is available. This risk protection is good for the customer as well. In the absence of insurance there must be adequate cash reserves in place to provide for the retirement of debt. Without insurance, however, such cash reserves would lock up capital that our customers need to grow their business and create jobs. Either way, a loan may not be approved without one of these provisions in place and this is not an acceptable outcome for an economy already dangerously slowed.

Wachovia is one of the five largest commercial real estate lenders in the United States. Our company has total commercial exposure of approximately $252 billion including real estate and small business loans. Specifically, Wachovia's exposure to commercial loans secured by real estate is $49 billion and our exposure to small business is $12 billion. It is important that we continue to serve our customers. In particular, I am concerned about the impact on small business customers who are already experiencing wide disparity in quoted premiums due to insurers' inability to price products consistent with standard actuarial analysis. In the case of large or small business, only the Federal Government can provide the insurance industry with the breathing room it needs to return to a stable, rational market. Without a Federal backstop, businesses will have to self-insure putting their capital—and ours—at risk. Magnify that potential loss of capital across the domestic banking sector to gain an appreciation for the dramatic impact a loss of insurance could have on our economy.

Mr. Chairman, it is impossible to determine if, when or where a terrorist might strike, but it is quite clear what the business ramifications can be. I am certain, however, that the lack of insurance coverage for terrorism *will* mean fewer loans and that will mean constriction of economic activity throughout the country. When a loan is not made, the jobs that would have been created to build a plant or run an office will not occur.

### The Solution

Mr. Chairman, these economic problems need not arise. With appropriate support and assistance from the Federal Government, the insurance industry can be in a position to accept the risk associated with terrorist attack, and our economy can continue its march to recovery. However, something must be done immediately before reinsurance contracts expire at the end of the year.

The Financial Services Roundtable is familiar with the various proposals that have been developed. As an organization, we have deliberately not stated a preference for any particular one. There are insurance experts in the private and public sector working to develop details of a plan that can best address the problem. From my perspective, any proposal must pass a simple test: it must return certainty to the market. As such, the program must be in place for an adequate amount of time, and must give primary insurers a chance to understand changes in the marketplace and explore adequate alternatives for reinsurance. I am certain, given the close collaboration between the Congress, the Administration, and the industries affected we can develop a workable solution.

Thank you Mr. Chairman. I would be pleased to answer any questions.

## PREPARED STATEMENT OF ROBERT E. VAGLEY

PRESIDENT, AMERICAN INSURANCE ASSOCIATION

OCTOBER 25, 2001

Chairman Sarbanes, Senator Gramm, and other Members of the Committee, my name is Robert E. Vagley, and I am President of the American Insurance Association, the leading property and casualty insurance trade organization in the United States, representing more than 410 insurers that write over $87 billion in premiums each year. AIA member companies offer all types of property and casualty insurance, including those most impacted by the horrific events of September 11: commercial liability, commercial property, and workers' compensation. Before I begin my formal remarks, I would like to thank you for the outstanding leadership you have shown on this issue, and for this opportunity to testify before the Banking Committee at this crucial time.

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 certain 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.

Current estimates of total insured losses resulting from the September 11 attacks stand at between $30 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 3 years (1999, 2000, and 2001). On that single day, 3 years of industry profits, including investment income, were wiped out.

I want to be very clear about our response to the horrific attack on the World Trade Center. Notwithstanding the enormity of this loss, the insurance industry 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 war exclusions, despite the militaristic nature of, and rhetoric surrounding, the attacks. We are paying our claims quickly and fully. We have received claims in excess of $20 billion to date. And, unlike other industries who were directly affected by the attacks, we are not asking for any financial assistance from legislators or regulators to meet our obligations.

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.

The financial capacity of our industry, while sizeable, is limited. Unfortunately, the potential harm that terrorists can inflict is both totally unpredictable in frequency and unlimited in severity. As Warren Buffet, CEO of Berkshire Hathaway, recently stated, "Terrorism today is not at all like terrorism 25 years ago. And now you have something where the nature of the risk, the power to inflict damage, has gone up a factor of—who knows what—10, 50 . . . you cannot price for that." Put simply, that which is not quantifiable is not insurable in the traditional sense.

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 own 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 controls. 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 simply cannot afford to do. Our only remaining option—one we would prefer not to consider—would be to simply withdraw from certain markets, and/or lines of coverage.

So we face a very difficult challenge: how can we remain solvent, and still serve the real needs of our customers for financial protection against terrorism? I am proud to say that insurers are working hard with you, your colleagues in the House, 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 only 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 only for as long as it is needed. The legislation must be enacted before Congress recesses for the year, since so many reinsurance contracts which cover this risk will expire on January 1.

The legislation we are seeking is not, repeat *not,* 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 enough to pay all potential claims, whether from terrorism acts or the other ordinary and extraordinary events that affect our business.

The goal of needed legislation is 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. A third would involve some industry-wide deductible or retention. We are not wedded to the details of any particular proposal; not even our own. However, in order for any legislative plan to be successful in averting the looming economic crisis, it must be drafted in a way that improves predictability, stabilizes the market, and preserves 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, on a short-term basis, to comanage this risk—a risk whose dimensions changed fundamentally and exponentially on September 11.

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 nonconcurrence 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 cannot 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 preserves rate review by the appropriate State regulator, but does not subject the rates to any review or approval prior to or in connection with the timely 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. Also, the higher the retention, the higher prices will have to be.

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 commercial 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.

## PREPARED STATEMENT OF RONALD E. FERGUSON

CHAIRMAN, GENERAL RE CORPORATION

REPRESENTING

THE REISSURANCE ASSOCIATION OF AMERICA

OCTOBER 25, 2001

I am one of the 2,400,000 people that work in the American insurance industry—life and health, property, and casualty—day in and day out. I am proud of our industry. I am proud of the role we play in our society and in our economy. I am proud of our team, the 2,400,000 people who are working hard, along with every other American, to get this great country back on its feet. And I am proud of the way we have stepped up to the losses of September 11 without complaint.

Our sympathy and condolences go to the families and friends of all who have suffered tragic losses in the September 11 terrorist attacks on our country. We also express our deep gratitude and respect for the courageous emergency services, military personnel, and volunteers for their heroic efforts in this time of national pain.

I might add that for a lot of us in the insurance industry this is not just about business, it is personal. We lost a lot of friends. People who worked in the insurance industry accounted for at least 490 of those killed in the World Trade Center. My family was fortunate—our son-in-law was among those who escaped unharmed.

General Re, a wholly owned subsidiary of Berkshire Hathaway Inc., is among the four largest reinsurers in the world, and a market leader in the United States. While General Re is also in the life reinsurance business, I am here today to talk mainly about the property and casualty insurance and reinsurance business.

Let me first say that I believe that the U.S. insurance and reinsurance industry will be able to meet its policy and contract obligations, and to pay the losses arising out of the September 11 terrorist attacks. Insurers and reinsurers do not need a bailout for those losses from the Federal Government, and are not asking for one.

We all know that the terrorist attacks of September 11, 2001 resulted in unprecedented losses of life, personal injury, and property damage. It is difficult to estimate the total insured losses that the U.S. property and casualty insurance and reinsurance industry will ultimately pay as a result of those terrorist attacks. In addition to the normal problems involved in estimating large or catastrophic losses, in this case there may be liability issues that may take years to fully resolve.

Some recent analysts' reports have suggested that $25 billion to $40 billion is a reasonable range of estimated total insured losses (property, casualty, life, and health) from the September 11 terrorist attacks. Some analysts have even suggested that the total insured losses could exceed the range of numbers I just mentioned. My own view is that total insured losses (property, casualty, life, and health) will be at the high end of the $25 billion to $40 billion range.

Before September 11 the threat of terrorism within our borders seemed remote. Because of that, no insurance or reinsurance premiums were collected for terrorism coverages, and no assets or reserves were allocated to terrorism exposures. That means that the September 11 terrorism losses must be paid from the industry's capital account. The total capital and surplus of the U.S. property and casualty insurance and reinsurance industry at June 30, 2001—including both personal lines and commercial lines writers was $298 billion. That figure includes $26.6 billion of capital in separately capitalized U.S. domestic professional reinsurers. That total industry capital consists of required regulatory risk-based capital, as well as the additional capital needed to support operating and investment risks and to meet the reasonable expectations of policyholders and claimants, rating agencies, stockholders, and others.

The exposure to loss from the September 11 terrorist attacks is not spread evenly across the total insurance industry capital base. The great bulk of those losses will fall on the capital base of the commercial lines insurers and reinsurers.

One way of looking at the commercial lines capital base is set out in Exhibit A. It shows that—after subtracting personal lines capital, the Berkshire Hathaway capital that is not allocated to the affected lines, and the pre-September 11 third quarter declines in common stock values—the affected property and casualty commercial lines insurers and reinsurers (U.S. and non-U.S.) had a September 10 estimated combined total capital base of $126 billion. That $126 billion capital base has now been reduced by $25 billion to $40 billion of losses—pre-tax and gross of non-domestic reinsurance.

Tillinghast, in a just-released study for the American Insurance Association, noted that the September 11 losses might rest on an even smaller capital base—perhaps $80 billion to $100 billion.

Three things stand out as being very clear to me:

First, the commercial lines capital base can obviously fund a total September 11 insured loss of $25 billion to $40 billion—or an even larger loss from that event.

Second, many actuarial and underwriting principles and practices will have to change. While not a complete list, here are five things that will change:

- We will have new and different notions about the size, shape, and trends of insured losses and the required risk loads
- Most lines of business will require a greater capital allocation
- Risk-based capital standards will be revised by regulators and rating agencies to incorporate terrorism risk
- The cost of capital for the insurance business will, other things being equal, go up
- We need to rethink risk diversification or its opposite, the correlation of risk

And there will be other actuarial and underwriting changes.

Third, the commercial lines capital base cannot take the hit from another sizeable terrorist event without seriously compromising the ability of the property and casualty commercial lines industry to meet its commitments for losses arising from other underwriting and balance sheet risks.

The simple fact is that, on its own, the U.S. insurance and reinsurance industry cannot afford to take on the potentially unlimited exposure to loss arising from insuring against terrorist acts. The commercial lines capital base I have described, while able to absorb the losses from the September 11 attacks, simply will not be able to sustain multiple events like those attacks. No one at present can reasonably predict either the number or scale of future terrorist attacks we might face before our war on terrorism is won.

We support and applaud the steps that the Federal Government is taking to combat terrorism. But until those efforts have borne the fruit of significant reduction in the potential for terrorist attacks, it is close to impossible for many insurers and reinsurers to responsibly underwrite or assume terrorism risk. We simply cannot evaluate the frequency and severity of terrorism losses using traditional underwriting and actuarial techniques. There are no models that would let us price the risk with confidence, and the consequence of error is ruin. That is why as an industry we need to explore alternative ways to cover losses arising from terrorism.

The September 24, 2001 edition of *The Wall Street Journal* featured this quote from Warren Buffett, Berkshire's Chairman:

> I think in the future, the Government is going to have to be the ultimate insurer for acts of terrorism . . . An industry with very large, but finite, resources is not equipped to handle infinite losses.

In some very important ways, insurance is the grease that lubricates the American economic machine. Insurance and reinsurance coverage for terrorism risks is necessary for our economic recovery—so that lenders will lend, and builders will build, and employers will hire. It is that simple.

Going forward, we need to find a way to provide insurance against terrorist acts that assures both the continued financial viability of the U.S. insurance and reinsurance industry, and the continued availability and affordability of the wide range of products and services provided by that industry.

In a rare—if not unique—show of unity, the property and casualty insurance and reinsurance industries universally agree that the best way to do that is to have the Federal Government act as the "reinsurer of last resort" for terrorism insurance and reinsurance coverage, similar to the plan used in the United Kingdom.

Federal Reserve Chairman Alan Greenspan appears to agree. On October 17, 2001, he said:

What hostile environments do is induce people to withdraw, to disengage, to pull back. It is quite conceivable you could get a level of general hostility that would make viable market functioning very difficult, . . . I can conceive of situations [where] the premiums that would be necessary to enable a private insurance company to insure against all those risks and still get a rate of return on their capital would be so large as to inhibit people from actually taking out that insurance, . . .

Therefore you are led to what is an unusual conclusion that the viability of free markets on unusual occasions, when you are dealing with violence, . . . [that it is necessary that] the costs of insurance are reinsured by the taxpayers, . . .

Free markets and Government reinsurance, in this very unusual circumstance they are indeed compatible . . .

(Source: Bloomberg)

It is increasingly clear that State regulators, the Administration, Members of Congress, and a broad swath of Americans and American businesses also agree that we need a solution.

All of these interests may not currently agree on the right way to structure that Federal reinsurer role—we have all heard the several proposals that have been advanced. But there is nearly universal agreement on the fact that this is a significant and urgent problem that needs to be solved before Congress recesses.

While the size and scale of the September 11 terrorist attacks are unprecedented, there are precedents for Government involvement—here and abroad—in the solution of temporary insurance market disruptions. The Federal Government ran an insurance program during World War II. FAIR plans were developed to deal with insurance scarcity in the wake of the 1960's urban riots. More recently, the United Kingdom and other countries have developed government-backed solutions to terrorism insurance.

When the need for these kinds of programs abates, they tend to fade away. When we are successful in our war against terrorism, we fully expect that any Federal terrorism insurance solution also fade away as normal market solutions return.

We are eager to work with this Committee, other Members of Congress, the Administration, State insurance regulators, and others to find a solution that makes sense for the country and for the faltering economy, which badly needs an injection of confidence. The solution must also make sense for frustrated and injured policyholders and claimants, for the insurance industry and its regulators, and for you. Insurance is, after all, a critical part of the central nervous system of this economy and this society.

We are not looking for a bailout for the insured losses flowing from the tragic events of September 11. We are looking for a way forward to serve our clients and fulfill our role in the economy.

I am reminded of a quote from Winston Spencer Churchill, one of my personal heroes. Slightly more than 60 years ago, as Britain was engaged in the early stages of World War II, Churchill said, "Give us the tools. We will do the job."

As we face a different kind of war, and as we find the way forward for the insurance industry, I could not possibly say it any better to you and to the Congress: give us the tools.

I am grateful for the opportunity to speak to you today, and would be pleased to answer any questions you may have.

**Exhibit A**

**Exhibit A**

| | United States Insurance Industry Capital & Surplus ($US billions) | |
|---|---|---|
| | Consolidated Property & Casualty Industry Surplus (June 30, 2001) | $ 298 |
| less | Personal Lines Policyholders' Surplus | (131) |
| less | Berkshire Hathaway Policyholders' Surplus | (36) |
| less | Estimated Decrease in Common Stock Values (after-tax)* | (5) |
| | **Adjusted Commercial U.S. Insurance Property & Casualty Policyholders' Surplus** | **$ 126** |

* From July 2, 2001 through September 10, 2001

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## PREPARED STATEMENT OF JOHN T. SINNOTT

CHAIRMAN AND CEO, MARSH, INC.

REPRESENTING

THE COUNCIL OF INSURANCE AGENTS AND BROKERS

OCTOBER 25, 2001

Mr. Chairman and Members of the Committee, I am John T. Sinnott, Chairman and CEO of Marsh, Inc, headquartered in New York City. Marsh is the world's largest risk management and insurance brokerage firm. We have 35,000 employees and serve clients in over 100 countries around the world. We also serve virtually all of the major insurance firms with reinsurance broking and related services through our Guy Carpenter unit. My testimony is on behalf of my firm as well as the member firms of the Council of Insurance Agents and Brokers.

I would like to thank you, Mr. Chairman, for giving me this opportunity to testify today on the topic of burgeoning terror insurance availability crisis in the wake of the September 11 attacks. While it has been said many times before, I think it bears repeating that the events of that day have changed the United States, and that life and business as we once knew it will never be the same. The events of that day were singularly devastating on one industry—the financial services industry—not only in business terms, but also in human terms.

The World Trade Center housed several companies from the banking, securities, and insurance industries that must now deal not only with the new business challenges facing them as a result of the attacks but also with the loss of colleagues and employees. Within the insurance industry, the brokerage community was hit particularly hard. Marsh maintained offices in both of the World Trade Center towers and the space that we occupied in the North Tower comprised the floors directly struck by the first aircraft. No one in those offices at the time escaped. In fact, of the 1,900 members of the Marsh & McLennan Companies working in both towers, and who were visiting that day, 294 were lost. Another colleague was a passenger aboard one of the aircraft. The world's second largest brokerage firm, Aon, also had a large presence in Tower 2. They lost 200 of their colleagues. While our first response was to focus on our people and the families of those lost, we also realized that we had to begin the job of our affected clients in resuming their usual business operations.

The events of September 11 have changed the landscape of commercial insurance in a way that I have not seen in my 36 years in the business. To be sure, there have been trying times in the past—the liability crisis in the mid-1980's, the property catastrophe coverage problems in the early 1990's following Hurricane Andrew, to name a couple. Marsh rose to the occasion during both those crises to help our clients secure the coverage that they needed to adequately protect their businesses. This is a function that is quite common in the brokerage community—not merely selling insurance products, but identifying client needs and developing new and innovative products or programs to address coverage shortfalls and to make our clients more successful.

In response to the mid-1980's liability crisis, Marsh played a leading role in the creation of the insurance and reinsurance companies ACE Limited in 1985 and XL Capital in 1986. These companies were formed to provide excess liability and directors' and officers' liability coverages at a time when the market could not provide the necessary capacity. These companies were very successful in providing much-needed market capacity. They exist as major insurers today. Similarly, Marsh played a role in the creation of Mid Ocean Limited during the property catastrophe reinsurance crisis following Hurricane Andrew in 1992. This company has also done very well in meeting the needs voiced by our clients.

It was in this same spirit of responding to customer needs that MMC Capital, our sister company, recently announced the formation of AXIS Specialty Limited, a new insurance and reinsurance company formed to provide capacity needed in the wake of the September 11 attacks. AXIS has an initial capitalization in excess of $1 billion, and will begin underwriting later on this quarter.

Our firm is proud to be able to continue our tradition of responding to supply and demand imbalances in the insurance and reinsurance markets. But I must tell you in all candor that what your Committee heard has been hearing over the past 3 weeks is true—there is an immediate crisis that demands your attention. In the current unique, and hopefully short-term, environment of uncertainty, the private sector alone will not be able to provide the insurance capacity America's businesses need to conduct their operations. Government involvement is needed until the environment becomes secure and returns to a state of more normalcy.

The problem with what happened on September 11 is that it presented a risk that no one had could conceive would happen. When the buildings were built, loss scenarios did contemplate the impact of one Boeing 707, the largest commercial aircraft at the time, however the idea of two, fully fueled 767's hitting both towers was unimaginable. Thus, we arrive at the problem presented by terrorism: the magnitude and severity of potential future events.

There has been considerable discussion about the scale of the World Trade Center and associated losses of September 11. While it will be some time before the total costs of the tragedies are computed, we all know that they represent the largest-ever losses in the insurance industry, by far. The previous largest insured loss was Hurricane Andrew at nearly $20 billion—or less than half of the losses of September 11. Some further context—the most recent catastrophic losses for the insurance industry—including Hurricane's Andrew and Hugo, the Northridge and Kobe earthquakes and the Lothar and Martin windstorms in Europe—totaled $53 billion in losses. Chances are that the losses stemming from the attacks at the World Trade Center will exceed that number—perhaps significantly.

The true cost of these events will not be known for years, because some types of insurance, such as business interruption and workers' compensation, do not constitute one-time payments but are rather ongoing for longer periods of time. While the industry has stated it can cover the severity of losses from this event, it is very unclear that the industry will be able to meet any frequency of future losses that may occur. We are told by Federal authorities to expect retaliatory strikes against America and that it is virtually impossible to completely shield ourselves from the assaults of those who disregard their own lives.

We have already seen massive and virtually unanimous signs of the unwillingness to take on such risks that are unquantifiable. As our commercial clients' policies have come up for renewals, we have seen a majority of insurers add terrorism exclusions to their policies. Of the top 25 property insurers with whom we trade, 17 have stated that terrorism exclusions will apply effective immediately and most of the others can also be expected to apply exclusions.

While most insurers will be unwilling to underwrite terrorism risks going forward, there may be a few companies who will be willing to take on those risks. However, even if they are willing to provide the coverage, it is not clear that they will do so at prices which are affordable by most businesses. And clearly, such efforts will involve adverse selection, in that many businesses that are considered most vulnerable probably will not be able to secure coverage at any price from any insurer, absent Federal intervention.

Similarly, there is now a new definition of what a maximum insured loss may be. There are not many people who would have ever believed that the Twin Towers of the World Trade Center could or would be completely destroyed, turned into a pile of dust and rubble, with nothing of value left, and with thousands of deaths and injuries. We know now that it is possible, and that the concept of a maximum insured loss post-September 11 does not in any way resemble the concept we had before that date. Threats can come from anywhere in the world, not just from one's business partners or from Mother Nature. The scope of risks we must plan for has changed as well.

This change in the perception of risk will have great repercussions in the pricing of policies going forward. Before September 11, the insurance industry was already experiencing what is known as a "hard market," meaning that premium rates were rising. That trend has now accelerated significantly. We are now seeing average rate increases in the area of 65 percent to 75 percent coupled with dramatically increased deductibles, and a contraction of available limits and coverages. Some price increases exceed 100 percent.

It is for this reason that I would urge the Congress to address the market contraction that we are facing before it adjourns for this year. We are facing a deadline at the end of the year for reinsurance contract renewals that will begin to exclude terrorism coverage. If insurers cannot cede this risk to a reinsurer, they will be unwilling to take it on themselves and will refuse to offer the coverage. That is why I am delighted that proposals to address the insurance problems we face are being advanced.

We all are familiar with the two major proposals—the 80/20 plan and the pooling arrangement. There are others as well. Until there is a cure for the current environment of uncertainty created by the prospect of terrorism, the insurance coverage our clients need cannot be obtained from the private sector solely. In this somewhat unique—and hopefully short-term environment, it is critical that the public and private sectors collaborate. Then, once the environment has stabilized, and we achieve a state of greater normalcy in the environment, it should be practical for Government involvement to decline and ultimately be withdrawn.

As mentioned above, my firm has been severely affected by the events of September 11. The first aircraft directly struck our offices in the World Trade Center and we lost 295 members of our corporate family. That was the real tragedy and is still with us in our offices and hallways.

We also incurred huge losses of property and equipment. So I speak here today from painful personal experience—and perhaps with a deeper understanding of what our clients face as they look to an uncertain future.

Mr. Chairman, let me restate that we are on the brink of an availability/affordability crisis insurance caused by the terrorist events. I commend you for holding this hearing, for your efforts to create a solution that restores and strengthens the private marketplace, and I urge you to work with your colleagues in Congress and the Administration and within our industry to find workable answers.

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## PREPARED STATEMENT OF THOMAS J. DONOHUE

PRESIDENT AND CEO, U.S. CHAMBER OF COMMERCE

OCTOBER 25, 2001

Good morning, Mr. Chairman and Members of the Committee. I am Thomas J. Donohue, President and Chief Executive Officer of the U.S. Chamber of Commerce and Chief Executive Officer of the U.S. Chamber Institute for Legal Reform. The U.S. Chamber is the world's largest business federation, representing more than three million businesses and professional organizations of every size, in every business sector, and in every region of the country. The central mission of the Chamber is to zealously represent the interests of the entire business community before Congress, the Administration, the independent agencies of the Federal Government, and the courts. The mission of the Institute for Legal Reform is to reform the Nation's State and Federal civil justice systems to make them simpler, fairer, and faster while maintaining access to our courts for legitimate lawsuits.

I welcome this opportunity to testify before you on the urgent need for prompt Congressional action to help make sure that insurance coverage for terrorism is available. I also ask that my full statement be inserted into the record.

The terrorists who attacked our Nation September 11 deliberately struck at the center of U.S. finance and commerce. Congress has acted promptly to help address a number of the immediate needs raised by the September 11 attacks by passing the Air Transportation Safety and System Stabilization Act as well as providing much needed emergency funding to help with the immediate recovery. Unfortunately, more work is needed to help shore up our economy, and passage of Trade Promotion Authority and an adequate economic stimulus package would represent significant steps. But even those efforts will be inadequate if American business is unable to move forward secure in the knowledge that the potential risks associated with future terrorist attacks will not cripple them beyond the point of recovery.

The attacks have had a significant impact on the insurance industry. September 11 will result in the largest insured loss in U.S. history. It has been estimated that the insurance industry will pay between $30 and $58 billion in claims, and some estimates are even higher. To put the magnitude of this event in perspective, it easily surpasses the $30 billion, without adjusting for inflation, paid for claims because of Hurricane Andrew. The insurance industry has indicated that it remains committed to meeting its obligations to policyholders for the events of September 11. These claims for terrorist losses will be paid directly by the primary insurers operating in the United States, with a major portion of the costs ultimately shared throughout the global insurance and reinsurance community.

The problem, however, is that in the wake of these events, insurers and reinsurers are examining how to manage the heightened level of terrorism risk they are facing and are reevaluating what coverage, if any, they may provide for it. The September 11 attacks fundamentally changed assumptions about the scope of risks and losses associated with terrorism. It now seems that any commercial enterprise, from Main Street-type small businesses to multinational American "icon" corporations, could become targets of or affected by the next terrorist attack on American soil. As a result of the potentially astronomical increase in liability, the insurance industry has begun to indicate that it cannot cover losses associated with future terrorist attacks.

A single-day event of the magnitude experienced on September 11 is a substantial hit to the capital base of many companies as well as the worldwide insurance industry as a whole. While the attack may strain many insurance companies, current indications are that the majority of companies will be able to meet their obligations. However, in the short run, the United States and global reinsurance industry does not have the capacity to provide protection against another major incident, or a continuing series of incidents. Companies with significant losses stemming from the terrorist attack will need to raise fresh capital in order to maintain their capacity to insure against all other risks covered by their contracts. Uncertainties regarding losses from future terrorist attacks will likely make raising fresh capital problematic. As a result, because of the unprecedented scope and nature of the losses sustained last month and the unpredictability of future liabilities, insurance coverage against future acts of terrorism will become virtually unobtainable for the vast majority of policyholders.

Major reinsurers have already alerted their clients that they intend to sharply reduce or eliminate their coverage for terrorist attacks, particularly policies on large commercial risks such as office towers, transportation hubs, sports arenas, and the aviation industry. The lack of reinsurance would leave primary insurance companies on the hook for all of the risk of a terrorist attack, a position they cannot assume. This, in turn, will force primary insurers to eliminate the availability of such coverage. Therefore, because the majority of American businesses traditionally renew their insurance contracts each January 1, businesses of all sizes and kinds could be left without insurance against terrorist acts.

What does that mean? If not corrected, this market disruption in insurance coverage will have deep, widespread, and potentially devastating ripple effects throughout the entire U.S. economy. Businesses that cannot secure full insurance coverage, including coverage for terrorist acts, may decide that risks from a lack of complete coverage leave them too vulnerable thus forcing them to reduce operations that would be considered too likely to be terrorist targets. This would result in layoffs and the elimination or decreased availability of a variety of products and services. For example, without adequate coverage, trucking firms, railroads, airlines, and ships may be unable to transport many types of cargo or limit their destinations.

In addition, a lack of terrorism insurance coverage could significantly harm the ability of many businesses to obtain financing or otherwise buy or sell properties, businesses, or projects. Furthermore, it is important to note that this is not only a prospective problem. For example, the terms of most loans require evidence of adequate insurance. If adequate insurance is no longer available, borrowers may find themselves in technical default of their loan terms. As a result, lenders would be in the position of potentially having to try to find adequate insurance coverage for their borrower that may not exist or either accelerating payments under the terms of the loan or calling-in the loan in its entirety. They may also be forced to cut down on the amount of available credit as they build their reserves in the event of additional terrorist attacks. Finally, if businesses decide to self-insure the risk of future terrorist attacks, they may find it difficult, if not impossible, to attract their own reinsurance or even new capital.

The principle upon which insurance rests is the ability to spread risk so that no single person or entity is forced to bear the full impact of an economic loss. Without this ability to spread risk, individual American businesses cannot afford to take on the potentially unlimited exposure to loss arising from uninsured terrorist attacks. Without some appropriate partnership between the insurance industry and the Federal Government, the looming constriction in the insurance and reinsurance markets threatens to inflict serious injury to the U.S. economy. This would potentially result in American businesses and citizens incurring substantial losses even if we do not suffer a future terrorist attack.

It is critical that the business community, the Administration, and Congress come together before the end of this year's Congressional session to develop and implement an appropriate Federal financial backstop for terrorism exposure. If such a backstop is not created, our Nation's economic recovery will be seriously jeopardized. Whatever approach is developed, it should support ongoing efforts of the private insurance and reinsurance markets to return to their proper role of underwriting risks while recognizing a Government backstop may be necessary for a period of time.

The Chamber recognizes that there are a number of ways in which this issue could be addressed and we stand ready to work with all of the stakeholders to ensure that a workable mechanism is developed so that we can avoid a widespread economic crisis and keep American businesses in business. I would be happy to answer any questions you may have. Thank you.

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## PREPARED STATEMENT OF THOMAS J. O'BRIEN

SENIOR VICE PRESIDENT OF FINANCE AND CHIEF FINANCIAL OFFICER, LCOR, INC.

REPRESENTING

THE REAL ESTATE ROUNDTABLE

OCTOBER 25, 2001

My name is Thomas J. O'Brien, and I am the Senior Vice President of Finance and Chief Financial Officer of LCOR. As a member of LCOR's Management Committee, I am responsible for the company-wide oversight of LCOR's finances, risk management, and insurance activities—including those of the JFK International Air Terminal LLC—a $1.2 billion air terminal redevelopment project and its related operations.

LCOR is a national real estate development, asset management, investment, and operations management company, specializes in structuring and implementing public/private developments. We have completed projects in 15 States and the District of Columbia, including more than 1.6 million square feet of commercial space and 18,000 residential units. The company has $4.4 billion in developments completed or under construction, and over $1.6 billion in predevelopment. As the leader in public/private development, LCOR is, or has been, involved in some of the Nation's largest, most complex, and creative developments. LCOR's operating offices are in New York City, Washington, DC, New Jersey, Dallas, Denver, and Berwyn, Pennsylvania, where the company also has its corporate office.

I am here today as a long-standing member of The Real Estate Roundtable and on behalf of a number of real estate organizations and trade groups that are separately submitting written testimony.

The tragic events of September 11 have triggered a withdrawal of virtually all commercial property and casualty insurance coverage for terrorist damage. While this will become readily apparent throughout the economy on January 1, when approximately 70 percent of the policies on commercial properties are scheduled for renewal, it is already a problem in our market.

As the CFO of a commercial property owner, I know that it is not possible to buy, sell, or finance a commercial building unless it is covered by adequate insurance. A significant percentage of owners of commercial properties open to the public, including shopping centers, offices, and hotels renew their insurance coverage on January 1 each year. Many of these owners have been advised that their policies may not be renewed or that their new policies will exclude terror/war risks.

Without adequate insurance, it will be difficult, if not impossible, to operate or acquire properties, refinance loans, and to sell commercial-backed securities. Disappearance of coverage for terrorist acts for real estate and other businesses could severely disrupt the economy. I am very concerned about the short-term future of the real estate industry unless the Federal Government creates some type of mechanism that would provide this coverage.

The scale of the real estate industry is immense—with income-producing real estate representing an estimated $4.6 trillion—with $2.05 trillion in institutional-grade real estate. In the institutional real estate market—which includes office, retail, hospitality, multifamily, and industrial—there is total equity of $372.7 billion—largely supplied by REIT's (39.3 percent) and pension fund investors (38.6 percent)—and total debt of $1.67 billion—with 42 percent held by commercial banks, 14.8 percent held by CMBS investors, and life insurance companies holding 13 percent. This does not include approximately $6.7 trillion in owned homes (single family, condominiums, and co-ops).

As these policies expire, there is tremendous uncertainty about the status of debt to the sector, with some $700 billion in commercial bank debt, $350 billion of loans in CMBS, $220 billion of loans held by life insurance companies that ran the risk of being in nonmonetary default without the availability of terrorist coverage. This lack of coverage raises profound liquidity concerns not only on existing loans and the institutions that hold them but on the ability of borrowers to secure financing going forward.

Before September 11, property and general liability policies covered losses stemming from terrorist acts. But as confirmed by insurance industry CEOs' testimony before the House Financial Services Committee on September 26, future policies will exclude coverage for both terrorist acts and acts of war. Additionally, they stated that reinsurance for terrorism is currently unavailable in the marketplace, Without reinsurance, there will likely be no primary insurance covering terrorist damage. As a result, the real estate and construction industries, which account for over a quarter of the Nation's gross domestic product, could face severe economic dislocation in the coming months if the Federal Government does not immediately address insurance-related issues tied to terrorism.

The Federal Government should play a role to ensure that commercial property owners and other businesses can obtain insurance coverage for damage from acts of terrorism. It is important to act before these policies terminate on January 1 to ensure that insurance coverage for terrorist acts is available in the future. Necessary characteristics of a workable plan include the following:

*Duration:* Because real property is a long-lived fixed asset, it is generally financed over a long term—typically 10–30 year term. Thus, if the program created is of insufficient length, it may not provide sufficient stability in the short term. Any program created must be of sufficient duration to provide financial certainty for these long-term lenders.

*Definition:* The line between "terrorism" and "acts of war" has been blurred significantly since the September 11 attacks on the World Trade Center and the Pentagon. President Bush and news media have been focused on our current "war against terrorism." The real estate industry is concerned that the next incident in this ongoing conflict may be considered an "act of war" by the insurance industry and therefore be excluded from coverage. Accordingly, any program created must cover an expansive notion of terrorism so that future events along the lines of September 11 are covered—and are not excluded from coverage in the future as an act of war.

*Deductible:* The real estate industry is concerned that a dramatic and unsupportable increase in deductibles to property owners could be tantamount to no insurance coverage at all. For example, if a real estate owner plans to acquire a $10 million property with $3 million of equity and $7 million of debt, an insurance policy with a deductible of $3 million or more, effectively would wipe out the real estate owner's equity and would militate against investment in the property. Accordingly, any program created must carefully consider apportionment of loss exposure among property owner, lender, insurer and the Federal Government.

*Disclosure:* With property and casualty insurance rates already skyrocketing prior to the attack on America, insurers should be required to separately disclose the cost of terrorist coverage to avoid any misunderstanding as to the program's impact on overall insurance rates. Otherwise, it would not be possible to discern the actual increase in the policy as a result of the difficulty in writing terrorism and act of war coverage and the result of other issues.

The Congress must not fail to act. Our industry welcomes the opportunity to work with the Administration and Congress to achieve a workable solution to this immediate problem this year.

Thank you for the opportunity to be here today.

**PREPARED STATEMENT OF WALTER K. KNORR**

CHIEF FINANCIAL OFFICER, CITY OF CHICAGO, ILLINOIS

OCTOBER 25, 2001

Thank you, Mr. Chairman for inviting me to testify today. My name is Walter Knorr and I am the Chief Financial Officer of the City of Chicago. I appreciate the opportunity to present to the Committee a matter of great concern to the City of Chicago and, I am sure, to other cities throughout America.

The cost of war-and-terrorism liability insurance as a result of the tragic acts of September 11 has escalated to incredible levels. The insurance industry is uncertain about the risk of terrorism, and therefore unable to assess and price that risk.

In Chicago, our insurance carrier recently canceled our war-and-terrorism liability insurance coverage for Chicago O'Hare International Airport and Chicago Midway Airport. Prior to September 11, we paid an annual premium of $125,000 for $750 million of war-and-terrorism liability coverage. If we want to renew our insurance, it will cost us $6.95 million for $150 million of war-and-terrorism liability coverage. I will repeat those figures for you. Our premium has risen from $125,000 to $6,950,000. Our coverage has dropped by $600 million. That is a premium increase of over 5,000 percent for substantially less coverage. Expressed another way, the cost of $1,000 of coverage has risen from 16 cents to $46.33—an increase of 28,956 percent. This extraordinary cost increase would be passed along primarily to our tenants at O'Hare and Midway, namely the airlines operating out of those two airports. The financial problems of most airlines have been well publicized. A cost increase of this magnitude would negate the city's efforts to cut the costs of airport operations to benefit the airlines and keep them viable. It also would undo the efforts of this Congress to assist the airlines financially during these uncertain times.

Chicago is not alone in this. We are aware of a number of other major airports across the country that have received equally exorbitant quotes for war-and-terrorism liability coverage. In addition, the Chicago airports have been warned that their premiums for property and liability insurance may double, triple, or even quadruple—and deductibles will increase significantly.

The problem extends beyond airports. The City of Chicago insures a toll bridge that connects Interstate 94 to the Indiana Tollway. Our most recent annual premium was $406,000 for $386 million of coverage. In mid-September the city received a nonrenewal notice for this bridge, with the ominous indication that the insurance carrier could not quote a new rate, but that the rate will increase by more than 30 percent and potentially much higher. One would expect insurance costs associated with terrorism to increase substantially for many other public and private structures: existing buildings, buildings under construction, public meeting areas like sports stadiums and convention centers, and other prominent infrastructure. The increased insurance costs would undoubtedly be passed along to the tenants and users of the these assets. If those costs were significant—and I think they could be—they could have an extremely negative economic impact. Tenants would have to decide whether to pay those higher costs or leave the city and take jobs with them.

The insurance crisis hits major cities the hardest because cities would appear to be the most likely targets for terrorist attacks. While terrorists may pick out individual targets, the attacks are directed at the Nation as a whole and the risk should be spread to the Nation as a whole. In these uncertain times, the Federal Government should act as an insurer for future terrorist attacks and catastrophic losses.

There are two proposals before this Committee, and the City of Chicago is not taking a position on the two proposals. The city does believe it is imperative that the Federal Government act on the insurance problem to provide certainty of insurance at reasonable rates, and hopefully mitigate the cost to Government and business.

Thank you again for this opportunity. I will be available for any questions you might have.

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**STATEMENT OF STEVE LEHMANN, FCAS, MAAA**

VICE PRESIDENT FOR PROPERTY/CASUALTY

AMERICAN ACADEMY OF ACTUARIES

OCTOBER 25, 2001

**Introduction**

The American Academy of Actuaries appreciates the opportunity to provide comments on issues related to insurance and the threat of future terrorist acts. The

Academy hopes that these comments will be helpful as the Committee considers related proposals.

The Academy is the nonpartisan public policy organization for the actuarial profession and assists policymakers through presentation of clear actuarial analysis. For more than 30 years, membership in the Academy has been a hallmark of professional quality for U.S. actuaries. Academy members are bound by rigorous professional standards for conduct, practice and qualification, and discipline.

The actuarial profession is uniquely qualified to examine issues relating to insurance and reinsurance of catastrophes. Academy members who practice in the insurance field typically have a broad understanding of insurance risk and company financial management, and they are well equipped to evaluate reinsurance arrangements. Many Academy members also have extensive practical experience in evaluating the financial risk associated with natural disasters and other catastrophic events and in pricing related coverages for the private marketplace.

Given this expertise, the actuarial perspective is valuable in examining the fundamental aspects of insurance and in describing policy considerations associated with proposals to address the impact of terrorism on the insurance industry.

**Defining the Problem**

In the aftermath of September 11, insurers and insureds face a significant problem with respect to future coverage of terrorism risk, due to both the nature of insurance and the nature of the threat involved.

Insurance is at the foundation of a free market system, because it gives entrepreneurs and businesses the freedom to focus their resources on the conduct of their business without concern over the magnitude and volatility of potential fortuitous losses. Insurers accept that risk as long as it is quantifiable and appropriately priced. Where that is not possible, insurers become reluctant to accept the risk.

A dramatic change occurred on September 11, when a new risk of terrorism emerged from an event that had never even been imagined by insurers or insureds. The risk of terrorism involves prospective losses of unknown but potentially very high severity and unknown frequency. This makes risk quantification very difficult. Furthermore, it reaches beyond first-party property coverage to involve other coverages (such as workers' compensation, liability, and business interruption) that are also difficult to quantify. Even building a new risk model to define the scope of potential losses from acts of terrorism will be extremely difficult. This difficulty is aggravated by the inapplicability of existing models and the total absence of any historical data.

As a result of the September 11 events, there is enormous strain on the entire insurance system. Insurance mechanisms have to bear previously existing risks as well as the unknown and unpriced risk associated with terrorism. Additionally, though the industry may have retained significant surplus following the September 11 attacks, such surplus is needed to support all of the risk assumed by insurers for all of the lines of business they have written. Given these difficulties, in the short term at least, insurers are being driven to avoid losses that could occur from acts of terrorism in order to preserve their own financial security. From a public policy perspective, lack of coverage for such losses is not an acceptable outcome.

**Private-Sector Solutions**

Because insurance coverage plays such a vital role in our economic system, various proposals have emerged to provide some limitation on the aggregate risk from terrorism to be borne by the private sector. The immediate actuarial problem of pricing this new risk can be diminished by limiting the losses that would have to be paid by the private insurance market. In considering solutions to the problem, considerable discussion has focused on the concept of a terrorism reinsurance mechanism, that in turn raises a number of important concerns. For example:

- How would such a mechanism be funded? Would it be funded prospectively by premiums charged to the participant insurers, retrospectively by assessments to the participant insurers, or through some combination of these approaches?
- How would liquidity be assured so that funds would be immediately available to pay claims when they occur?
- How would the terrorism trigger be defined so as to preclude coverage disputes between participating insurers?
- Would this mechanism be voluntary or mandatory? Would it be available to non-insurer, risk-assuming entities such as self-insured municipality pools?
- Will Governmental protection be available as a backstop above a finite limit of loss?

Answers to each of these questions and perhaps others will be necessary before a pricing model can be developed. Broad-based participation by insurers is critical to spreading terrorism risk if a private-sector mechanism is adopted. If the mechanism is voluntary, there must be adequate incentives to entice insurers to participate. Voluntary participation in any mechanism also brings up issues of potential adverse selection (that is, only high-risk insurers and businesses participate).

It has been suggested that it would be appropriate for Government to provide coverage for terrorism losses above a certain limit. In view of the magnitude of potential losses, it is difficult to conceive of any effective mechanism that would not have to involve the Federal Government, at least in the short term. However, any short-term solution will undoubtedly require future modification to reflect an increased understanding of the risk involved as well as subsequent experience gained in addressing it. All of the proposals currently being considered sunset in less than 10 years. A sunset period is necessary to provide time for the insurance industry to develop adequate risk assessment techniques while providing protection for insurers and insureds in the interim. A new mechanism may also be needed to address terrorism risk over the long term.

**Conclusion**

Some mechanism is needed now to ensure stability of insurance coverage. Some level of Government intervention appears to be necessary and appropriate in the short term. Over time, the insurance industry should be able to develop tools and techniques to help quantify and assess the risk of terrorist attacks more effectively.

Public policymakers evaluating any proposal designed to assist insurers in achieving that objective and to protect insureds from the threat of terrorism should carefully weigh the following considerations:

- Incentives for participation in voluntary mechanisms;
- Potential for adverse selection;
- Funding source and liquidity of mechanism; and
- Level of government involvement in the short term and long term.

The American Academy of Actuaries is available as a resource to the Committee as it seeks to address this important concern.

## STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURERS

OCTOBER 25, 2001

The ACLI is the principal trade association for the life insurance industry, representing 426 companies, which account for 80 percent of the life insurance premiums and 81 percent of annuity considerations in the United States among legal reserve life insurance companies. ACLI member company assets account for 80 percent the total assets of legal reserve life insurance companies. We appreciate the opportunity to present this statement to the Committee on Banking, Housing, and Urban Affairs on the topic of insurance coverage for terrorist acts.

As the collateral effects of the attacks of September 11 continue to unfold, much attention has been focused on the financial condition of the insurance industry. In this regard, the property/casualty insurance business will ultimately incur losses estimated at between $30 to 50 billion, while the life insurance industry losses will be in the $4 to 6 billion range.

Both segments of the insurance industry have repeatedly sought to assure the public and Members of Congress that they have adequate resources to cover these losses. However, the threat of additional and perhaps more widespread terrorist attacks, with even more devastating losses, dictate that Congress examine the capacity of the insurance system to respond to such previously unthinkable scenarios. We commend the Committee for its timely examination of this critical issue.

Thus far, the property/casualty industry has been the focus of efforts to develop a private sector/Government partnership to underwrite the risks associated with expanded terrorist losses. This is appropriate as the property/casualty industry has obviously had to absorb a much greater impact on its available capital reserves as well as a more immediate response from its reinsurers that terrorist coverage would be severely limited or unavailable in the future.

Because the life insurance industry has more than $3.2 trillion in assets and processes, on the average, about 10,000 death claims each day, the losses of life resulting from the September 11 attacks, while tragic, do not pose a threat to the solvency of the life insurance industry. However, the potential for continued acts of terrorism to result in substantially more significant adverse effects on mortality, and by that we mean the potential for mass death and disability on a much larger scale than we have previously experienced or imagined, gives rise to questions that we believe must be considered by Congress as well as the life insurance business. Will there continue to be a viable private sector market for life insurance products that cover risks of terrorism? Put differently, will life reinsurers continue to enter into reinsurance treaties covering catastrophic risks that include acts of terrorism? Additionally, if there are realistic prospects of an act of terrorism of sufficient magnitude to adversely affect the overall solvency of the life insurance business, is there a justifiable need for some mechanism to address that situation, and, if so, what form might such a mechanism take? The uncertainty surrounding these questions suggests a need for the Committee to evaluate the potential needs of the life insurance industry, including its customers, as part of its current inquiry.

At this time, we are not seeking the establishment of a mechanism similar to those under consideration for property/casualty insurers. Indeed, it is not clear at this point that such a mechanism would be necessary or useful for life insurers. Nor is there any agreement within our industry as to what such a mechanism should look like were it deemed to be necessary. We think it is prudent, however, to start the process of asking "what if?" and to begin doing it now, before events necessitate a last-minute, crisis-driven reaction that might not be entirely in the best interests of the life insurance industry or its customers.

In that regard, the ACLI has developed a proposal to create a study commission comprised of Government and private sector representatives to assess the potential effects on the life insurance industry of further terrorist activities. The proposal is designed to be included in whatever legislation the Congress develops to address property/casualty insurance issues. This is not a request for Government assistance. It is instead our industry laying down a marker to reflect the need to examine this issue thoughtfully, hopefully without the risk of being overtaken by events.

Briefly, the proposal would work as follows. A nine member study commission would be appointed to assess: (1) possible steps that could be taken to encourage and sustain the private market for life insurance products covering death or disability resulting from acts of terrorism and the threat of such acts; and (2) possible steps or mechanisms to sustain or supplement the ability of life insurers to cover losses due to death or disability resulting from acts of terrorism that significantly affect mortality experience or jeopardize the solvency of the industry as a whole.

This study commission would be comprised of five representatives from Government (two from Treasury, one from Commerce, one from the Office of Homeland Security, and one from the ranks of State insurance regulators) and four from the private sector (two representing life insurers, and two representing life reinsurers). Any affirmative recommendations by the study commission would have to have the concurrence of at least two-thirds of the commission members to assure that such recommendations have at least some support from the life insurance business.

The study commission would have 30 days to organize itself and another 90 days to complete its work. The report of the commission would be submitted to the President pro tempore of the Senate and the Speaker of the House, with a copy to the White House. The legislation would direct Congress to give "prompt and deliberate consideration" to any recommendations for Federal legislative action contained in the report. The study commission would be disbanded within 60 days after submission of the report.

To reiterate, by advancing this study commission, the ACLI is simply suggesting that the question of how acts of terrorism, or even the threat of such acts, will affect the life insurance business is a critical matter warranting prompt and thoughtful consideration by both the private sector and Government. The events of September 11 have unquestionably introduced great uncertainty into the life insurance business. This uncertainty involves concerns over the way in which the risk of terrorism will be covered in insurance policies, how that risk will be quantified, how attendant pricing decisions will be made, and whether future events that even a few months ago were unimaginable carry with them the potential to overwhelm the solvency of our business. Given this uncertainty and the gravity of the issues at stake, we believe a study as outlined in the attached draft language is an appropriate response at this juncture.

**ACLI Concept Draft:**
**Study & Report on Potential Effects of Terrorism on the U.S. Life Insurance Business**

Draft of October 24, 2001

**Section ___. Study and report on potential effects of terrorism on U.S. life insurance industry**

(a) Establishment.--Not later than 30 days after the date of enactment of this Act, the President shall establish a Commission (in this section referred to as the "Commission") to study and report on the potential effects of an act or acts of terrorism on the U.S. life insurance industry and the markets it serves.

(b) Membership.--

(1) Appointment.--The Commission shall consist of 9 members, as follows:

(A) The Secretary of the Treasury, or the Secretary's designee;

(B) The Deputy Secretary of the Treasury, or a designee appointed by the Secretary of the Treasury;

(C) The Secretary of Commerce, or the Secretary's designee;

(D) The Director of the Office of Homeland Security, or the Director's designee;

(E) Five members of the public appointed by the President, two of whom shall be representatives of direct underwriters of life insurance within the United States; two of whom shall be representatives of reinsurers of life insurance within the United States; and one of whom shall be an officer of the National Association of Insurance Commissioners.

(2) Vacancy.--A vacancy on the Commission shall be filled in the same manner in which the original appointment was made under subsection (b)(1).

(3) Chair.--The President shall designate one of the members of the Commission, who is also an officer or employee of the United States, as the chair.

(c) Operations in general.--

(1) Staff.--The chair of the Commission may appoint and fix the compensation of a staff of such persons as may be necessary to discharge the responsibilities of the Commission, subject to the applicable provisions of the Federal Advisory Committee Act (5 U.S.C. App.2) and title 5 of the United States Code.

(2) Coordination with General Services Administration.--To the extent permitted by law, and requested by the chair of the Commission, the Administrator of General Services shall provide the Commission with necessary administrative services, facilities, and support on a reimbursable basis.

(3) Support from represented departments.--The Secretary of the Treasury, the Secretary of Commerce, and the Director of the Office of Homeland Security, shall, to the extent permitted by law and subject to the availability of funds, provide the Commission with such facilities, support, funds and services, including staff, as may be necessary for the effective performance of the functions of the Commission.

(4) Agency cooperation.--The Commission may request any Executive agency to furnish such information, advice, or assistance as it determines necessary to carry out its functions. Each such agency is directed, to the extent permitted by law, to furnish such information, advice or assistance upon request of the chair of the Commission.

(5) Compensation.--All members of the Commission who are not officers or employees of the United States shall serve without compensation for work on the Commission. All members of the Commission who are officers or employees of the United States shall serve without compensation

in addition to that received for their services as officers or employees of the United States.

(6) Expenses.--While away from their homes or regular places of business in the performance of duties of the Commission, members of the Commission shall be allowed travel expenses, including per diem in lieu of subsistence, as authorized by law for persons intermittently in the Government service under section 5703 of title 5 of the United States Code.

(d) Study.--The Commission shall conduct a study of the U.S. life insurance industry to identify:

(1) Possible steps to encourage, facilitate and sustain provision by the U.S. life insurance industry of coverage for losses due to death or disability resulting from an act or acts of terrorism, including in the face of threats of such acts; and

(2) Possible steps or mechanisms to sustain or supplement the ability of the U.S. life insurance industry to cover losses due to death or disability resulting from an act or acts of terrorism--

(A) In the event that such act or acts of terrorism significantly affect mortality experience of [for] the U.S. population over any period of time;

(B) In the event that such losses jeopardize the capital and surplus of the U.S. life insurance industry as a whole; or

(C) In the event of other consequences from such act or acts of terrorism that the Commission determines may significantly affect the ability of the U.S. life insurance industry to cover independently such losses.

(e) Recommendations.--Based on the results of the study conducted under subsection (d), the Commission shall develop such recommendations as may be appropriate for changes in statutes, regulations and policies to--

(1) Encourage, facilitate and sustain provision by the U.S. life insurance industry of coverage for losses due to death or disability resulting from an act or acts of terrorism, including in the face of threats of such acts; and

(2) Sustain or supplement the ability of the U.S. life insurance industry to cover losses due to death or disability resulting from an act or acts of terrorism in the case of any event described in subparagraph (A), (B) or (C) of subsection (d)(2).

Recommendations developed under this subsection shall require the concurrence of at least two-thirds of the Commission's members.

(f) Report and Action.--Not later than 120 days after the date of enactment of this Act, the Commission shall submit to the President pro tempore of the Senate, and the Speaker of the House of Representatives a report describing the results of the study conducted under subsection (d) and recommendations developed under subsection (e). A copy of such report shall be submitted to the President of the United States. Upon receipt of such report by the President pro tempore of the Senate, and the Speaker of the of the House of Representatives, the Senate and House of Representatives shall give prompt and deliberate consideration to any recommendations for federal legislative action contained in the report.

(g) Termination.--The Commission shall terminate 60 days after submission of the report as provided for in subsection (f).

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October 10, 2001

The Honorable Thomas A. Daschle
United States House of Representatives
The Capitol S-221
Washington, DC 20510

Dear Majority Leader Daschle:

We are writing as CEOs of the nation's largest financial services companies to express our strong support for a federal program to assure the availability of insurance against risks associated with terrorism. This is a matter of great urgency that pertains directly to the economic well being of our country after September 11th.

The tragic events of September 11th have brought clearly into focus the vital role that the insurance sector plays in our country. We are proud that the industry is processing claims without delay and is striving to help make victims and their families whole again. However, the possibility of subsequent events prompts us to strongly urge that you consider a federal mechanism to ensure that insurance continues to exist for acts of terrorism.

This is not an issue only for insurers and insurance company shareholders. Rather, it is an economic issue. The U.S. economy cannot possibly recover without the full availability of insurance. As it stands, policies for acts of terrorism are impossible to price, and therefore impossible to write.

We believe that this matter demands the urgent attention of the federal government and feel that action is needed before Congress adjourns. Without such action, it could become impossible for primary insurers to renew contracts with reinsurers at year's end, thereby putting further downward pressure on economic activity and possibly curtailing the benefits of the Congress' efforts to stimulate the economy.

We appreciate your attention to this important matter.

Sincerely,

Eugene A. Miller
Comerica Incorporated

Edward B. Rust, Jr.
State Farm Insurance Companies

William F. Aldinger
Household International, Inc.

Rufus A. Fulton
Fulton Financial Corporation

John J. Amore
Zurich North America

Jerry A. Grundhofer
U.S. Bancorp

Ramani Ayer
The Hartford Financial Services Group

L. Phillip Humann
SunTrust Banks, Inc.

James H. Blanchard
Synovus Financial Corp.

Thomas A. James
Raymond James Financial, Inc.

J. Kerry Clayton
Fortis, Inc.

Susan C. Keating
Allfirst Financial, Inc.

Kenneth R. Dubuque
Guaranty Financial Services

Richard M. Kovacevich
Wells Fargo & Company

Richard W. Evans, Jr.
Cullen/Frost Bankers, Inc.

William L. Marks
Whitney Holding Corporation

Martin G. McGuinn
Mellon Financial Corporation

Thomas A. Renyi
The Bank of New York Company, Inc.

Alan G. McNally
Harris Bankcorp, Inc.

C. Dowd Ritter
AmSouth Bancorporation

Jackson W. Moore
Union Planters Corporation

James E. Rohr
The PNC Financial Services Group

Youssef A. Nasr
HSBC USA, Inc.

Donald J. Shepard
AEGON USA, Inc.

Kenneth T. Neilson
Hudson United Bancorp.

Harrison F. Tempest
ABN-AMRO North America, Inc.

Dean R. O'Hare
The Chubb Corporation

Gary L. Tice
F.N.B. Corporation

Aubrey B. Patterson, Jr.
BancorpSouth, Inc.

G. Kennedy Thompson
Wachovia Corporation

## STATEMENT OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA

OCTOBER 25, 2001

This testimony is submitted on behalf of the Independent Insurance Agents of America (IIAA). IIAA is a nonprofit trade association that represents over 300,000 independent insurance agents and brokers and their employees nationwide. IIAA's membership is composed of large and small businesses that offer consumers a wide array of products in every State, city, and town in the country. The independent insurance agent and broker industry sells 75 percent of all commercial lines policies in the country. In essence, independent agents and brokers write coverage for America's businesses, and through this unique prism of expertise and for the reasons outlined below, we strongly urge the passage of legislation to ensure the availability and affordability of essential business insurance products in the aftermath of the horrific acts of September 11.

The terrorist acts of September 11 have had a profound impact upon all of us, with the insurance industry being hit particularly hard, both physically and financially. IIAA has over 20 agency members in Lower Manhattan, including one that was previously located in the South Tower of the World Trade Center, and many more had valued customers who were located in the complex. In the days and weeks that have followed the attacks, countless victims and survivors have begun putting their lives back in order, and the insurance industry has played a pivotal role in this recovery-and-rebuilding process. We are proud and pleased by the manner in which our industry responded to the events of September 11, and the best news was that things worked as they were intended. The insurance industry has honored its commitment to thousands of Americans in their greatest time of need—and the industry is proving that it has the resources needed to quickly and fully pay claims.

Although the insurance industry has responded efficiently and effectively to these attacks, we must now work to ensure that the industry is in a position to respond in similar ways to future terrorist attacks. In order to address these new challenges, we will need the leadership and assistance of the U.S. Congress and the Bush Administration to ensure that appropriate insurance coverage remains available. The issue of terrorism reinsurance is so vital to the future of American businesses—large and small alike—and to the health of the Nation's economy that it needs Washington's immediate attention. The time for action is now. Congress and the Administration need to address this important national policy issue as soon as possible.

The possibility of further terrorist attacks elucidates the need for mechanisms to assure the continuing availability of coverage for these risks. Although the insurance industry is prudently managed and well capitalized, it cannot and should not be expected to provide coverage for an uncertain number of attacks in the future (that cannot be scientifically modeled) without the establishment of a Government mechanism that can provide a backstop for losses caused by terrorism. While most insurance policies today exclude damage from war, they typically do not include terrorism exclusions.

The problem now is that many understandably skittish domestic and foreign reinsurers stated that they would not cover terrorist acts when contracts come up for renewal on January 1. Primary insurers warn they cannot support repeated terror claims, especially if reinsurers exclude such losses from coverage. Without reinsurance, insurers will leave markets, exclude terrorism coverage or charge premiums that, in essence, will make insurance coverage unaffordable and largely unavailable. The specter of any of these options has dire ramifications for commercial consumers of insurance products that need the financial protection offered by insurance to stay in business and on commercial life insurers, agents, and brokers that serve them. Failure to address this potential coverage gap will thus not be felt only within the insurance industry but on the national economy as a whole.

Development of a terrorism reinsurance pool to cover commercial policies is critically important not just to insurance companies, agents and brokers, but also to the future viability of literally hundreds of thousands of small and large U.S. businesses. Without some kind of mechanism to cover terrorism losses, insurance protection would be difficult—if not impossible—to find, financiers would be reluctant to lend, and businesses would be hesitant to invest. The end result is an economic shockwave to the U.S. economy. No one wants to return to an insurance market like the mid-to-late 1980's when the lack of available or affordable insurance altered the business and personal activities of Americans. Therefore, the issue of terrorism reinsurance is critical.

For this reason, IIAA supports the creation of a Federal backstop to ensure that the industry will be able to continue offering coverage for damages caused by terrorism. In establishing such a backstop, we will be able to restore coverage for the millions of businesses that will otherwise be unable to renew their current insurance policies and we will be able to restore the confidence customers rely upon in securing their needs through all insurance policies.

When insurance industry representatives testified before the U.S. House of Representatives Financial Services Committee on September 26, the panelists' concerns focused more on the future than the present, and all seemed to agree that the U.S. Government must play a role in addressing the need for terrorism reinsurance. IIAA believes that Congressional action is necessary, and we believe the creation of a Federal backstop is a necessary element of any proposal that attempts to address these issues. The establishment of a Federal backstop would help ensure the continued solvency of the insurance industry, stabilize premiums, allow reinsurance companies to have renewed confidence to underwrite primary insurers, and make terrorism coverage available to the buyers who urgently need it. Regardless of whether it is the stability expected from the proposed establishment of a U.S. Treasury Federal backstop that the insurance industry agrees upon, a division of future terrorist claims between the insurance industry and the Federal Government suggested by the Administration, or a hybrid proposal, the core objective must be to insure that mechanism are instituted to enable small and large businesses to purchase insurance policies that might otherwise be unavailable or unaffordable in the wake of the September 11 attacks. IIAA pledges to continue working with the Administration, Members of this Committee, consumers, our industry colleagues, and any others to ensure that an appropriate solution is attained. The issue of terrorism reinsurance is so vital to the future of American businesses and to the health of the Nation's economy that it needs the immediate attention of Congress. Without a backstop for acts of terrorism, most insurance companies have two options stop writing many types of commercial insurance or charge significantly higher premiums. The specter of either option has dire ramifications for many business owners and agents and brokers. The impact on independent agents and brokers and their business clients is such a major concern that IIAA believes prompt Congressional action is absolutely necessary. We are very pragmatic when it comes to drafting and moving legislation to address this national issue. While interested parties may have differing opinions on how such a mechanism should work, we believe it is far more important to expeditiously work through differences to achieve the timely enactment of a proposal that can meet the immediate and long-term needs of the customers of independent agents and brokers, We stand ready to work with you on this important national issue.

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## STATEMENT OF MARC H. MORIAL

MAYOR OF NEW ORLEANS, LOUISIANA AND
PRESIDENT, U.S. CONFERENCE OF MAYORS

My name is Marc H. Morial, and I serve as the Mayor of New Orleans, as well as the President of the U.S. Conference of Mayors. I appreciate the opportunity to submit this statement in support of Federal legislation to create a reinsurance mechanism to help manage future terrorism risk.

The U.S. Conference of Mayors has been in Washington this week meeting with Governor Ridge regarding the efforts of the Office of Homeland Security to protect our Nation from heinous terrorist acts such as the World Trade Center and Pentagon attacks of September 11, and the more recent distribution of anthrax through the U.S. mails.

We are hopeful that the Office of Homeland Security, as well as the other fine efforts of Congress and the Administration, will prevent future terrorist attacks on U.S. soil. However, in the event that such attacks may occur, insurance is critical to the ability of cities like New Orleans to protect themselves, their residents, and the businesses located within them from ruinous financial harm.

Unfortunately, the possibility of further terrorist attacks has made property/casualty insurance against the terrorism risk virtually unobtainable. This market crisis will be greatly exacerbated very soon, since many reinsurance and commercial insurance contracts come up for renewal each January 1. Reinsurers already are saying they will exclude "acts of terrorism" from coverage on a going-forward basis. Primary insurers may soon seek to follow suit. Such exclusions would leave municipalities and airports, as well as their residents and business citizens, greatly exposed to future losses. The immediate enactment of Federal terrorism reinsurance legislation is needed to avert this market crisis. Cities like New Orleans need to focus their efforts on preventing future terrorist attacks, not on struggling to find insurance in a market that does not have the financial capacity to address our needs.

The need for a Federal terrorism reinsurance program affects us at several levels. First, our Nation's economy is in turmoil and was in trouble before the September 11 tragedy. Now in the aftermath, we recognize that certain economic sectors are further imperiled. It is important for Congress to enact an economic stimulus program. America needs to create new jobs for its workers and help keep the people who have jobs employed. But this effort may be all for naught if there is no insurance. Insurance is a critical element supporting our Nation's economic infrastructure. We can talk stimulus all we want but without insurance no one is going to build new buildings, no one is going to invest capital in new ventures, no one is going to employ the people who live in our cities and towns. Our economic well being is dependent on the availability of insurance.

Second, many cities carry private sector insurance for our municipal properties, municipal workforce, and liability exposures. In the absence of insurance, we simply do not have programs in place to manage terrorism risk. Moreover, even assuming we can obtain coverage, if the price of insurance skyrockets because insurers have no way to even begin to quantify this exposure, these cost increases must be passed through to our taxpayers, at a time when many of them have seen their income drop as a result of the indirect effects of the September 11 tragedy. While we recognize that Federal legislation is not going to remove this risk entirely from our portfolio, a Federal backstop to private insurance will help us to better manage this risk.

Third, our residents and corporate citizens need to obtain their own insurance coverage. While this need exists nationwide, based on the attack on the World Trade Center some people perceive that the cities in our Nation have a greater terrorist threat. If businesses which choose to locate in urban areas cannot obtain insurance, they may relocate to suburban or rural areas, robbing us of critical economic development and the resulting tax base. For cities like New Orleans that rely heavily on tourism, it is also critical that hotels and other tourist destinations in urban areas can get insurance, or they may be forced to shut their doors, robbing us of the revenue that tourists bring to establishments throughout our city.

Fourth, cities throughout the United States rely on insurers to invest in municipal bonds. In 2000, the par value of municipal bonds held by the insurance industry in the United States totaled $212,443,600,509 (102,368 issues), and for the State of Louisiana, $2,590,746,580 (1,835 issues). Moreover, nearly two-thirds of the property/casualty insurance industry's assets, or over $500 billion, are invested in governmental bonds, with the vast majority of these at the municipal level. These bonds are essential in allowing State and local governments to finance everything from schools, parks, highways, sewer, and water facilities to airports and senior citizen housing. If another major terrorist attack occurs, and insurers do not have adequate capacity, insurers would be faced with selling billions in bonds. This, in turn, could depress the value of bonds as huge volumes are liquidated, particularly in an economic downturn environment, making it more difficult for State and local governments to finance new projects or to rebuild.

For cities like New Orleans, the consequences of the impending terrorism insurance market failure are real and serious, from the perspective of our own risk management programs, the preservation of our tax base, and the viability of our municipal bond offerings. I urge Congress to take immediate legislative action to address this issue as part of our Nation's efforts to enhance homeland security.