Terrorism Threats and the Insurance Market

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Chairwoman Kelly, Chairman Simmons, Ranking Member Gutierrez, Ranking Member Lofgren, and Members of the Subcommittees,

Thank you for the opportunity to appear before you today to discuss the challenging issue of managing the cost of terrorism in the U.S. economy. My goal today is to provide perspective on the difficulties faced by the insurance industry, as financial intermediaries helping companies to pool and manage risk, including the risk of terrorism. My main observations are that terrorism is inherently a public risk, that terrorism is a challenging risk to understand and manage in the private markets, and that the risk of terrorism cannot be managed solely within the confines of the private sector but only in partnership with the federal government.

Terrorism Risk is a Public Risk
The primary issue before the Congress with respect to managing the impact of terrorism on the U.S. economy is to identify the most efficient means to finance the risk of terrorism. In private insurance markets, efficiency is achieved by ensuring that the premium charged for each policyholder is based on the amount of risk that each policyholder contributes to the overall pool – in other words, by aligning costs with responsibility. Once premiums reflect the underlying risk of the policyholder, risks can be pooled within an insurance portfolio and all policyholders can benefit from diversification – the reduction in volatility around each policyholder's expected loss.

In the case of terrorism, however, the origins of the terrorist threat obviously are not in the control of individual policyholders, but emanate from terrorist groups intent on launching strikes against the United States. With responsibility for countering the threat of terrorism in the hands of the U.S. Government, the alignment of cost and responsibility only can be achieved at the federal level, especially since government counterterrorism actions are unobservable. If left unaddressed, these unintended costs can shift production away from high risk areas to locations that are less efficient, creating a drag on the overall economy.

Terrorism is a Unique Risk

The foundation of private insurance rests on the ability to effectively pool the loss experience of policyholders exposed to relatively *homogeneous*, *random* and *independent* risks where the underlying sources of risk are *well understood* and, therefore, appropriately priced. The problem with terrorism is that it fails each of the prerequisites for pooling:

- Risks are not homogeneous – the risk of terrorism varies greatly by such factors as geographical location, industry, company reputation, and level of defensive preparation – with each of these factors dynamically changing over time in response to unobservable counterterrorism efforts,

- Risks are not random – unlike the random arrival of storms or accidents, terrorist attacks involve the purposeful, coordinated selection of targets based on the presumed objective of inflicting the greatest amount of damage while ensuring the highest likelihood of success. Terrorist tactics, methods, and targets are dynamically evolving in response to whatever defensive actions might be taken to protect policyholder assets.

- Risks are not independent – given the stated objective of terrorists to inflict a maximum level of physical destruction, economic disruption and fear, terrorism experts and federal officials have identified a large number of plausible terrorism scenarios that would involve losses of such a large scale that the attack would simultaneously impact a large proportion of any insured portfolio – threatening the very solvency of the insurance industry.

- Risks are not well understood – unlike other catastrophe risks like hurricanes and earthquakes where a tremendous amount of data is available on the probability and severity of loss events, no credible data or models exist to price or manage the risk of terrorism.

In short, large-scale terrorist attacks are not an insurable risk. Today, we simply do not have the ability to assess the likelihood of a terrorist attack, the form of such an attack, and the location at which such an attack could take place. The National Homeland Security's National Asset Database lists over 28,000 possible targets across the United States – suggesting that the next attack could be almost anywhere. At the same time, leading government experts on terrorism continue to assert that the threat of terrorism is real and growing, including the very real risk of terrorist attacks using nuclear, biological, chemical and radiological (NBCR) weapons.

The Challenge for Insurers

So how do insurance companies manage the risk of terrorism today? Insurance companies continue to offer terrorism coverage to customers through the "make available" provision within the Terrorism Risk Insurance Extension Act of 2005 (TRIEA). However, without the ability to model the likelihood of terrorist events, insurance companies cannot determine an actuarially-fair price to charge for terrorism insurance. Instead, insurance companies are forced to manage the risk of terrorism by limiting exposure concentrations in potential "high target areas." If terrorism exposure concentrations get too high relative to surplus, some insurance companies are forced to non-renew entire commercial policies to reduce the terrorism exposure – often creating hardships for the underlying policyholders. These exposure concentrations are especially difficult for certain lines of business like workers compensation and fire following coverage in certain states where exclusions for nuclear, biological, chemical and radiological attacks are not admissible.

With the extension of TRIEA, insurance companies are better able to manage these exposure concentrations, albeit within very large company retentions. The primary benefit of TRIEA for an insurance company like The Hartford is that the program would help finance losses associated with very large-scale terrorist attacks, most notably attacks carried out with NBCR weapons. Without TRIEA, we would be forced to reconsider how much exposure to the threat of terrorism is appropriate, and what additional actions are necessary to further reduce the company's exposure. In fact, with the rating agencies starting to impose implicit limits on insurance company exposures to terrorism, the lapse of TRIEA at the end of 2007 could cause substantial market disruptions and withdrawals of coverage[1].

The best glimpse of a post-TRIEA environment for terrorism insurance may be the current market for terrorism reinsurance, where companies do not face the same level of regulatory oversight or make available provisions. Citing many of the same issues identified above for primary insurance companies, reinsurance companies offer extremely limited capacity for terrorism risks, and generally no coverage for terrorist attacks committed with NBCR weapons. In fact, both the Reinsurance Association of America (RAA) and the 2005 Treasury Report on the Terrorism Risk Insurance Act of 2002[2] estimated that the total market capacity for terrorism reinsurance is only $6-7 billion, less than 10% of the reinsurance market capacity for natural catastrophe events. Moreover, most of this reinsurance is allocated to small and regional companies for portfolios considered to be less exposed to the risk of terrorist attacks.

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[1] See for example, "Catastrophe Analysis in A.M. Best Ratings," A.M. Best Company, Inc., April 2006.

[2] See Exhibits, 6.6-6.8, Assessment: The Terrorism Risk Insurance Act of 2002, The United States Department of the Treasury, June 30, 2005.

For a national carrier like The Hartford, reinsurance capacity for certified terrorism losses on property coverage ranges from extremely limited to non-existent. For example, The Hartford's 2006 TRIEA retention is just over $1 billion. Within this TRIEA retention, reinsurance protection against property losses from certified terrorism events is effectively unavailable. In contrast, for natural catastrophe losses, The Hartford's principal catastrophe reinsurance treaty alone provides more than $600 million in coverage for individual loss events in excess of a $175 million retention.

What about the Capital Markets?

Finally, I would like to offer some perspective on the oft-made suggestion that "the capital markets" should be able to finance the risk of terrorism. I can assure the subcommittees that virtually no meaningful capacity exists today to securitize terrorism risk in the burgeoning insurance-linked securities (ILS) market. Having established and maintained an insurance-linked securitization program for natural catastrophe risks since 2004, The Hartford has spent considerable time and energy in internal research and in canvassing modeling firms, bankers, and investors to determine whether the same technology can be leveraged to help finance the risk of terrorism. While not foregoing the potential for future development, our conclusion from these efforts was that no material market capacity exists today for terrorism risk-linked securitization. Unfortunately, the same obstacles inhibiting the development of the reinsurance markets – lack of credible modeling, non-insurable nature of the risk, and aversion to the correlation of terrorism risks to the general market – has prevented the development of the terrorism ILS market. As a result, the capital markets have yet to securitize a single terrorism-linked security for property or workers compensation risks. The expiration of TRIEA will do nothing to improve this prognosis.

Conclusion

In conclusion, based on the best information available from terrorism experts on the threat of terrorism, it is apparent that the threat of terrorism is real and is continuing to grow – imposing an unintended cost on the entire U.S. economy. Recent events around the world continue to underscore the dynamic nature of the terrorist threat, making efforts to quantify or manage the risk of terrorism extremely difficult, especially for a private market that does not have the same level of access to information on the nature of the threat as the federal government. Hence, absent a fundamental change in the nature of the terrorist threat, terrorism will remain an uninsurable risk for the private market and any credible solution for financing the risk of terrorism will require a continued public-private partnership with the U.S. Government.

Thank you.