



TREASURY NEWS

FROM THE OFFICE OF PUBLIC AFFAIRS

FOR IMMEDIATE RELEASE

October 24, 2001

PO-719

**TERRORISM RISK INSURANCE
TESTIMONY OF THE HONORABLE PAUL H. O'NEILL
SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
UNITED STATES HOUSE OF REPRESENTATIVES**

Mr. Chairman, Congressman Kanjorski, 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.

1. 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 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 two months are critical. The insurance industry relies on a complicated structure of risk sharing. Risk is shared among primary insurers, reinsurers, and retrocessionaires (i.e., 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.

2. 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 non-terrorist 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.

3. 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 enemy 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, however, 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.

4. 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 under-invest 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 three 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 some other 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 non-economic 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.

5. 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.