American Insurance Association

PROMOTING AN EFFECTIVE TERRORISM RISK INSURANCE PROGRAM AND EXPLORING CONCEPTS TO ENHANCE PRIVATE MARKET CAPACITY

1. **KEY OBJECTIVES OF ANY PROGRAM.** Contemplation of the efficacy of the current program or any modified or replacement program necessarily starts with the identification of its key objectives. AIA submits that the purpose of TRIA and of any modified or replacement program are:

   a. **Economic stability across the lifecycle of the terrorism threat.** Any terrorism recovery program must provide certainty and stability to the U.S. financial system and the real economy throughout the periods (i) before a terrorism event (so that lending can occur, buildings can be built, employers can employ and businesses can plan); (ii) during recovery from a terrorism event (so that victims and their families can be cared for and compensated, property can be restored, and businesses can endure interruption); and (iii) after a terrorism event (so that lending continues to occur, buildings continue to be built, employers continue to employ and businesses can continue to plan).

   b. **Preservation of the American way of life.** Any program must defend the societal, economic and cultural ambitions of our nation. A program could not be considered successful if it capitulates to the threat of terrorism through economic incentives that deny Americans vibrant cities, forestall investment in infrastructure, slow job creation, or unproductively drain resources from the U.S. economy.

   c. **Efficiency and fairness for all stakeholders.** Any program must meet its objectives through a fair and efficient allocation of the national burden brought upon us by the scourge of terrorism, considering (i) the root causes of the terrorism threat; (ii) the evolving and inherently unpredictable nature of that threat; (iii) public investments in, and acceptance of, measures for detecting and preventing planned acts of terrorism; and (iv) the capabilities each stakeholder possess that can be brought to bear to our collective fight against terrorists and their objectives.

2. **THE "FULL FAITH AND CREDIT" OF THE U.S. GOVERNMENT WILL ALWAYS BE AN ESSENTIAL COMPONENT OF PROVIDING TERRORISM RISK INSURANCE.** While some may want the U.S. government to play no role in the market for terrorism risk insurance, addressing threats to national security, providing for a common defense, and preserving a well-functioning U.S. economy are fundamental functions of the federal government. While we can explore ways to stimulate the growth of the private market, the presence of the United States as a financial "backstop" to catastrophic terrorism is critical to achieving the objectives outlined above.

3. **IMPROVING THE PROGRAM IS CURRENTLY THE BEST OPTION.** AIA supports TRIA (and has supported the various iterations of the program) because it effectively provides stability to the economy in a time of terror and assures a continuing supply of insurance at affordable rates for exposures with the highest risk to terrorism, all at very little cost to taxpayers. The TRIA program has worked well to allow U.S. businesses to readily purchase terrorism coverage, and to establish a level of predictability necessary for insurers to manage their terrorism risk aggregations in the context of their overall enterprise risk management strategy. In short, TRIA has provided market stability for an atypical, uninsurable risk, and facilitates an orderly economic recovery following a terrorist attack on U.S. soil. The importance of this role cannot be understated. In the 15 ½ years following the September 11, 2001 attack, it has become abundantly clear that sources of private capital have no interest in assuming the catastrophic backstop role the federal government has in TRIA and no available substitute to the federal government has been identified.

4. **ANY REVISIONS OR ALTERNATIVES MUST WORK FOR ALL INTERESTED PARTIES.** AIA believes that the program structure and elements should be reviewed now in order to consider improvements or other options that do not undercut the program, destabilize the private market, or create insurance capacity concerns. Any options must also reflect the fact that (1) the property-casualty reinsurance marketplace cannot provide sufficient reinsurance to address catastrophic terrorism losses, (2) the program itself is operating with insurer loss retentions that are at a "solvency management" level, (3) the underlying characteristics of terrorism risk have not evolved, and (4) while the U.S. has prevented another catastrophic terrorist attack since 2001, there can be no guarantee that another such attack won't occur.

   Indeed, the program leaves a loss exposure nearly the size of Hurricane Katrina with the industry – thereby allowing any private capacity for terrorism ample room to take on the risk most insurers would be more than happy to transfer under the current program. While it is possible that additional capacity is available from capital providers willing to accept a remote risk of ever paying, the current program's massive deductible and wide co-share structure imposes on insurer retentions far in excess of the retentions they typically accept for natural catastrophes. As a result, the working layer for terrorism reinsurance continues to be wide open to any available capital providers.

   Of course, the current program only provides a recovery following a terrorism event to policyholders that have purchased insurance that does not exclude the risk of terrorism. Under TRIA, all insurers are required to make such an offer. According to broker surveys, somewhere between one half and one third of businesses decline to be insured against terrorism through their property insurance policies – meaning that they have opted out of an available tool for economic restoration should the worst occur. To the extent any program incents additional policyholders to opt out, economic recovery following a terrorism event will be impaired. Any adjustments to the current program should encourage higher "take up" rates, but such encouragement should not be confused with ratcheting up mandatory obligations on participating insurance companies. In addition, as discussed further below, state rate "regulation" should be exercised in a way that allows commercial insurers to charge risk-based premiums in a competitive market environment.

5. **IN THE WAKE OF 9/11 AND AT EACH RENEWAL OF TRIA, AIA CONSIDERED A VARIETY OF OPTIONS, INCLUDING INITIALLY PROPOSING THE ESTABLISHMENT OF A U.S. EQUIVALENT TO U.K.'s POOL RE.** AIA has consistently looked at ways to develop additional private market capacity and stability, recognizing the unique, uninsurable characteristics of terrorism risk that require some level of government support, financial and otherwise. In fact, either independently or with other industry participants, we have explored a variety of substantive proposals in the years since 9/11, including but not limited to, the following:

   a. **<u>Terrorism Risk Pooling</u>** – AIA and its members offered draft legislation to the Bush Administration shortly following 9/11 that would have established a U.S. version of the United Kingdom's Pool Re for terrorism insurance – a pre-funded approach ultimately rejected by the Administration because of its perceived permanency and active federal involvement as a primary reinsurer. In 2004, Tillinghast Towers Perrin studied the feasibility of a private voluntary workers' compensation reinsurance pool for terrorism losses, but ultimately concluded that such a mechanism would be unable to create enough private market capacity to effectively handle a catastrophic terrorism event. The study reinforced the need for the TRIA program. That reality, and the existence of other complexities associated with the establishment of a terrorism risk pool (such as a reduction in individual underwriting discipline and hard-to-resolve intergenerational equity issues) would counsel against the establishment of such a mechanism.

   b. **<u>Reinsurance Facilities</u>** – AIA has worked with a variety of TRIA constituents to explore and design alternative reinsurance facilities that could be incorporated into the program to incent the development of a private layer of mezzanine financing at layers initially included in TRIA and now retained by the industry within the company retentions. These approaches faced challenges in actually encouraging the inflow of new private market capital (lack of demand) and faced structural obstacles in the legislative process (e.g., appearance of GSE structure, revenue collection).

   c. **<u>Risk Securitization</u>** – In 2005/2006, AIA led a cross-industry group that conducted a survey of the capital markets to gauge their interest in serving as an alternative risk-spreading mechanism. The survey revealed that the capital markets had very little interest in absorbing a risk that was not well understood, not insurable, unable to obtain a rating from a Nationally Recognized Service Rating Organization (NRSRO), and highly correlated with their other investment positions.

   More recently in 2013, spurred by the quest for higher yields in a persistent low interest rate environment, many pension funds and asset managers created or expanded their mandates to invest in insurance-linked securities (ILS). At the time, estimates indicated that total alternative reinsurance capacity – including catastrophe bonds, sidecars and other non-traditional financing vehicles – had grown to approximately $40b worldwide – comparable to the levels reached immediately after hurricanes Katrina, Rita and Wilma in 2005.

   The maturation of the ILS market over the past dozen years was a welcome development. The ability of primary insurance and reinsurance companies to access new sources of capital to fund peak natural catastrophe exposures – the main recipient of these capital investments – helped keep capital costs down and traditional insurance more affordable. However, the ILS market has not proven to be a substitute for traditional insurance and the ILS market has not been willing to underwrite risks that are not being underwritten by the traditional reinsurance market. Moreover, investors may be reluctant to buy terrorism bonds due to their correlation with the broader equity markets and the potential for adverse selection. The reluctance of the rating agencies to rate terror bonds further restricts potential investor interest. As a result, to date, we are not aware of any securitizations of property catastrophe terror bonds in the market despite this influx of capital. With terrorism risk largely uninsurable, we may never see a significant market for terror bond securitizations.

6. **TRIA COVERAGE OF COMMERCIAL PROPERTY-CASUALTY LINES.** AIA maintains that TRIA should continue to apply to those commercial lines currently in the program. There are different reasons – by broad line – for that support.

   a. For **<u>workers compensation</u>** insurance, because of the regulatory restrictions, there are no options for insurers to exclude or sublimit terrorism risk. Therefore, elimination of the federal shared loss aspect of TRIA would force workers compensation insurers to ration the availability of workers' compensation insurance based on terrorism risk aggregations. As a result, in the absence of the program, one would expect center city employment to suffer as employers seek a diminished supply of workers compensation insurance available for high-rise office workers.

   b. For **<u>commercial property</u>** insurance, TRIA serves an important purpose by providing business continuity and support for construction and other commercial lending transactions. In addition, TRIA's inclusion of commercial property insurance provides the underlying coverage necessary to enable commercial mortgage-backed securities (CMBS) transactions to go forward. Failure to have the federal backstop, as Fitch noted in its 2013 report, could stall many of the CMBS transactions necessary for such commercial real estate development projects.

   c. In the **<u>commercial liability lines</u>**, the size of the payment from the 9/11 Victims Compensation Fund, coupled with the expansion of that fund to include first responders, demonstrates both the scope and potential nature of tort claims that might be leveled in the wake of another terrorist attack.

   d. In addition, certain **sectors such as <u>transportation, communications, and energy</u>** face higher exposure to terrorism than other sectors.

   e. Given the history of TRIA and the narrowing of lines included in the program, it may be worth examining whether terrorism risk for certain liability lines (or for certain sectors within the liability lines) can be managed more effectively within the program, perhaps utilizing one or more of the policy options under review. A number of questions would need to be answered before AIA members would be comfortable supporting any sort of liability-specific mechanism within the confines of TRIA.

7. **PROGRAM ACCESS AND INSURER RETENTIONS: BALANCING INDUSTRY AGGREGATE LOSS WITH INDIVIDUAL INSURER RESPONSIBILITY UNDER TRIA.** As TRIA has evolved, it has become clearer that it is not a government backstop for all acts of terrorism, but a shared responsibility program where the industry has been asked to manage, through a series of individual company retentions and industry aggregate loss targets, the consequences of significant terrorist events that can produce losses of a magnitude of 9/11 or greater without triggering a federal government payout.

   On the other hand, the industry has never been comfortable with the uncertainty surrounding terrorism events at mega-catastrophic levels or attacks using unconventional means. TRIA attempts to balance the need for federal government financial intervention at mega-catastrophic levels, while maintaining certainty and stability in the private market to enable insurers to provide sufficient capacity to address non-catastrophic terrorism events that might occur. As the industry's understanding of how to effectively deploy capital to provide protection against these non-catastrophic events improves, consideration of certain revisions to TRIA may make sense to put on the table for discussion:

   a. **Program Access (Certification Threshold/Aggregate Loss Program Trigger):** Elimination of the $5 million industry aggregate loss certification threshold (to be deemed a covered "act of terrorism") and changes to the escalating $200 million industry aggregate loss program event trigger could be considered. With respect to the certification threshold, it has been swallowed by the higher loss program trigger and now serves only to confuse the public about what constitutes terrorism or, worse, becomes a pawn in a political chess game to maximize available insurance coverage (and bypass policyholder decisions of whether or not to purchase terrorism coverage made available under TRIA). Congress should consider eliminating the threshold as a relic of the earlier post-9/11 debate separating acts of vandalism from foreign acts of terrorism perpetrated on U.S. soil.

      Regarding the higher loss program trigger, the certainty that losses beneath the event trigger will be paid by the private market (coupled with increasing confidence that available capital can be effectively deployed) may encourage reinsurers to provide reinsurance and other capacity beneath the event trigger. Tailoring the program trigger to conventional events may further reinforce market certainty. However, any consideration of the program trigger must recognize that there is no current indication that such capital is readily available. In addition, as discussed immediately below, conversation about the utility of the program trigger may need to occur in the context of insurer retentions.

   b. **Conditions for Program Access:** While insurers, including AIA's members, have made peace with the "mandatory availability" provisions of the program, we are concerned that, over time, those provisions may migrate to mandatory purchase standards if the private market does not evolve or Congress becomes impatient with the pace of private market development. AIA believes that it would be worth having a discussion about finding the right balance for terrorism risk insurance. Particularly with the high potential damage severity that would accompany unconventional acts of terrorism, coupled with the human behavior and intent components associated with terrorism risk, we believe that there will always be a need for a federal government financial partnership to manage the broader social and economic consequences. In AIA's view, it is better to have the conversation now, ahead of the political pressures of TRIA renewal, with all interested stakeholders.

c. **Individual Insurer Retentions (Deductibles/Co-Shares):** Under the current program, individual insurer deductibles (calculated as a sizeable percentage [20%] of prior year direct earned premiums [DEP] on all covered commercial lines) bear no relation to the terrorism risk exposure that is backed by premium dollars. As a result, rather than providing an industry incentive to maximize the amount of terrorism risk insurance capacity written in the private market and backed by reinsurance, the deductible ensures that companies will only manage terrorism risk exposure for financial solvency reasons. The existence of an additional co-share obligation of 20 cents/dollar above the deductible to the program cap only increases the uncertainty attached to an insurer's insured terrorism loss retention obligations. AIA would recommend that the Committee consider shifting the conversation to a loss retention that is based on an actual terrorism disaster scenario that is utilized by companies to manage their exposure (e.g., a 5-ton conventional truck bomb). If done appropriately, adopting a scenario-based parametric retention would: (1) be consistent with individual insurer terrorism risk management, (2) provide the basis for a more realistic program trigger, and (3) provide a more effective threshold to grow a private terrorism risk insurance market backed by reinsurance and separate that market from the catastrophic and unconventional acts of terrorism that require a federal government backstop.

8. **THE DISCUSSION ON TRIA IMPROVEMENTS SHOULD PROVIDE TRANSPARENCY ON CYBER-TERRORISM.** Cyber risk is a critical, evolving and unique line of business that deserves additional discussion and potential clarity**.** While the application of TRIA's mandatory availability provisions to cyber-risk may be unambiguous, to date, additional guidance has not answered open questions about the scope and nature of the program and its responsiveness to cyber-terrorism written on a standalone basis.

9. **IMPROVEMENTS BEYOND TRIA: POTENTIAL SHIFTS IN STATE REGULATORY PERSPECTIVE.** Given the national security and economic issues, there will always be a federal interest in terrorism risk insurance, even in the unfortunate event that the program expires. Assuming that the program is renewed, even with revisions, there are aspects of state regulation that should be examined to determine whether or not they are consistent with overall TRIA objectives. Two aspects that immediately come to mind are the existence of state statutory fire policies (SFP) and rate regulation. With respect to SFP jurisdictions, AIA's concern stems from the required coverage for "fire following" an unconventional (NBCR) terrorism act that may otherwise be excluded. This is particularly concerning in the commercial property

insurance context, where these are business-to-business transactions. As discussed above, government mandatory coverage obligations tend to distort competitive markets and to stunt private market development. With regard to rate regulation (again in the commercial insurance context), to the extent that government rate review and approval displace competitive market pricing and the evolution of insurer understanding of the dynamics of terrorism risk, this will in effect become a form of government subsidy that will accelerate federal government financial exposure to terrorism risk. Even worse, the inability to receive an appropriate rate for assuming terrorism risk may cause insurers to manage their terrorism exposure by restricting capacity. If that occurs, uninsured businesses will still look to the federal government to provide disaster assistance to jump-start economic recovery, and one of the primary goals of TRIA will be undercut.