Statement of

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on

Proposals for Terror Reinsurance

before the

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Mr. Chairman, and members of the Committee, thank you for the opportunity to present our views on proposals for terror reinsurance. The 335,000-member National Taxpayers Union strongly opposes the proposals offered by the insurance industry and the Administration, both of which would violate key principles of sound insurance policymaking. These flaws would put lives and property in danger and expose taxpayers to unnecessary losses.

Congress should move cautiously as precedents may be created for Congressional responses to other large losses and major insurance industry difficulties.

Unless insurance companies have to pay--and pay a lot--for Federal reinsurance, they will compete by giving the coverage away to clients. This creates moral and security hazards. Second--and this is very important--they will have no incentive to underwrite individual risks with any caution, to avoid concentration risks or to help their clients reduce their risks. They will assume more risk for the government than they ever would have if their own money were at risk.

It is essential to limit the government's total liabilities, set firm limits per policy, clearly define terrorism and limit the government's exposure to certain types of loss (e.g., business interruption). Otherwise, we could be paying companies not to be going back to work for years. Of course, the insurers should have to pay enough of the claims, a minimum of 20 percent in the first year, to carefully monitor claims administration.

Too often legislation is passed as a quick response to a problem without addressing fundamental flaws in public policy. During our work over the last six years studying proposed legislation and public policy regarding natural disasters, we have found that a number of Federal and state laws and regulations greatly hamper the ability of the private sector to provide insurance for catastrophes.

Perhaps the most important impediment to affordable insurance against man-made or natural catastrophes is the Federal tax law, which contains a huge implicit tax penalty on businesses and homeowners who attempt to purchase such insurance. These same laws prevent insurance companies from deducting an amount equal to the risk of catastrophic natural disasters or terror attacks; amounts that we consider legitimate business expenses. We hope this problem will be corrected and urge the Committee to use the Policyholder Disaster Protection Act (HR 785), by Representatives Foley and Matsui, as a starting point.

It is not clear to us whether a Federal terror reinsurance program is needed at this time. Certainly it is completely unacceptable to enact a program that would increase risks to lives, property and federal finances.

Insurers are not claiming they are in trouble, only that the market <u>may</u> fail to respond to higher pricing with more capacity. That's dubious at best and there's a good case to be made that we ought to wait and see what happens in the market. Even if terrorism is excluded from some policies, life and business will certainly go on.

Since the Sept. 11 attacks, property and casualty insurers' stocks have significantly outperformed the S&P 500, and the stocks are up, not down. Insurance stocks' performance shows a great deal about market experts' view of the industry's future claims-paying ability, future risk, and the opportunities associated with expected higher pricing. It also shows--along with the new company announcements--that the capital markets have in no way restricted the industry's ability to raise capital and take on additional risk.

If Congress enacts such a reinsurance program, we strongly urge you to be guided by the following principles.

1. Any Federal capacity should offer the maximum amount of economic benefit to the nation as well as injured parties at the lowest possible cost to the taxpayer.

2. <u>Legislation must not erode strong incentives for wise underwriting and insurance company management of risks (e.g., proper security and escape contingency</u>

plans). If no reinsurance is available, then the insurance industry will continue to cover claims until their current policies expire or a time the current policy allows for modification of the coverage. Until then, the insurance companies have an extremely high incentive to help their clients take sensible steps to reduce their risk of terrorism loss. Likewise, if a business finds it cannot insure for terror risks when its policy expires, it too will take much more vigilant steps to secure its property, customers and employees. A blank federal reinsurance check would eliminate a very important incentive to increase security.

3. If Federal reinsurance capacity is offered, then there should be payment for the use of that capital and assumption of risk. Any plan that fails to collect premiums is a giveaway that will increase losses from any future attacks since it would undermine insurer incentives to boost security and create effective disaster control and reaction plans. It would be irresponsible to discourage effective safeguards that can reduce the number of lives and amount of property that could be lost from a terror attack. While no one knows how to price this risk since the market is not offering it now, the government should attempt to price it at a level that would likely be charged by the private sector after it emerges from this market disruption. The Treasury should use very conservative assumptions in pricing for that risk so that the private sector can retake this market as soon as possible.

4. Federal coverage should certainly not insure against all industry terror losses. Coverage of the first dollar of losses is both unnecessary and unwise because this too will erode incentives to increase security. Lower levels of financial risk should remain in the private sector, which will attempt to price the insurance for the limited risk. Those price signals will provide important pricing information to the government for the use of its capacity. If the government provides coverage, we strongly recommend restricting coverage to property loss and workers' compensation only. If insureds also want business interruption coverage, they can go to the private sector for supplemental coverage.

5. Federal reinsurance capacity should be temporary, maximize the use of market mechanisms and encourage the reentry of private reinsurance at higher levels at the earliest possible date. We must rigorously avoid any establishment of a permanent entity. Insurance is available for many other large and highly uncertain risks and terror insurance will be more efficiently administered and priced by the private sector in the long run. It is too easy to make a mistake in haste, which could prove impossible politically to fix later.

6. Legislation must contain strong incentives to pay only valid claims. The Federal government's co-payment of claims should never exceed 80 percent, and 70 percent or less would be preferable. It is easy for insurance companies to keep customers happy if they have little or no financial incentive to monitor claims for fraud and overpayments.

7. The federal government's exposure must be capped to preserve America's national security options. The Federal government must not insure against unlimited terror or war risks. In the event of a war or a terror attack with weapons of mass destruction, the losses would be far more serious than those experienced in the September 11th attacks. The government needs to limit its liability so that it can preserve the fiscal flexibility needed to fight a war.

8. Incentives should be created to get the federal government out of this business and reduce its role to covering a higher layer of loss as early as possible.

9. A mediation panel is needed to quickly pay and settle claims for terror losses in a fair and inexpensive way. However undesirable it may be to spend taxpayer monies on terrorism losses of property, it will be completely unacceptable to pay large amounts to the trial bar in the aftermath of an event, and further slow the process of getting funds into the hands of rightful recipients. Any non-productive activity such as litigation, which slows the process of pricing the event, will lead to more uncertainty in repricing insurance for future events and will add to the ultimate cost of such events. Such a variation was included in the airline industry bailout. If people do not wish to waive their rights to sue, then they should purchase their own terrorism coverage, unsubsidized by the government.

10. Legislation should contain a clear definition of what is a terror loss, and all other losses should be excluded from coverage. The formulation of coverage will need to be quite specific or there will be lots of opportunities for financial mischief at taxpayers' expense. This definition would then need to be met on any private industry claim payment, prior to allowing either the customer or the insurance company to present the balance of the claim to the government. If this definition is not clear or not rigorously applied, there will be endless disputes. We strongly believe that any program should be limited to property coverage, where losses are easier to verify.

11. Federal law should override any state terror insurance regulations until the Federal capacity has disappeared.

The Administration Proposal

The proposal is a public-private sector program. In 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.

In 2003, the private sector would handle the first $10 billion of loss. Losses between $10 billion and $20 billion would be shared, with the government paying 50 percent and the private sector paying 50 percent. After losses exceed $20 billion, the government would cover 90 percent of losses, and the private sector would cover 10 percent.

In 2004, the private sector would cover the first $20 billion in losses. Between $20 billion and $40 billion of losses, the government and private sector would each cover 50 percent of the losses. At above $40 billion in losses, the government would pay 90 percent of losses.

Overall liability would be capped at $100 billion.

The Administration plan has some sensible provisions. We support the provisions that cap Federal liability, provide for cost sharing (though the shares are too high for the government) and eliminate the program after three years.

Still there are many serious problems with the Administration proposal.

1. If Federal reinsurance capacity is offered, then there should be payment for the use of that capital and assumption of risk. Any plan that fails to collect premiums is a giveaway that will increase losses from any future attacks since it would undermine insurer incentives to boost security and create effective disaster control and reaction plans.

2. Federal coverage should certainly not insure against all industry terror losses. Coverage of the first dollar of losses is both unnecessary and unwise because this too will erode incentives to increase security and monitor claims for fraud and overpayments. Coverage of the first dollar of losses for all insurance companies would also lead to an unnecessary increase in Federal bureaucracy, costs, and insurance waste. It is hard to find any consumer or business insurance policies that do not have some form of a deductible, and Federal terror reinsurance shouldn't eliminate this sound principle of insurance.

3. Legislation must contain strong incentives to pay only valid claims. The Federal government's co-payment of claims should never exceed 80 percent. The co-payment by the insurance companies must be substantial in order to guard against excessive claims payments.

4. The plan should clearly define coverage, and should not cover risks that are harder to verify such as business interruption and liability insurance.

We should note that the “industry” doesn’t insure anything; individual companies do, and these companies vary considerably in their capabilities and capacity. It isn’t apparent how the Administration’s plan would distribute the losses around the industry. Individual companies write individual risks that will incur discreet losses (some of which might be covered, some not under normal policy conditions), then claim payments are made as negotiated with each individual client. Risks and losses are not distributed proportionately around the market, as will be seen when the cost of September 11 is tallied.

The New York Times reported Oct. 22 that Berkshire Hathaway chief executive Warren Buffett said, “I think there is nothing wrong with having the industry lose a lot of money if something like [a terror attack] happens. We just have to keep it within the ability of the industry to pay. The industry can pay for a $10 billion loss. It can't price for a $500 billion loss.”

Lower levels of exposure should remain in the private sector, which will price the insurance for the limited exposures. Those price signals will provide important pricing information to the government for its reinsurance capacity.

Improving the Administration Proposal

The Administration proposal can be greatly improved with some key modifications. Clearly, the Federal government must charge for its reinsurance capacity and the coverage should kick in at higher levels.

In addition to the provisions contained in the Administration plan, these key provisions are needed:

1. Each individual company should have a retention amount (or deductible) for terror claims.

2. We recommend making the payment for the Federal reinsurance equal to one percent of each company's insured volume less the retention amount.

3. The reinsurance would pay 80 percent of all claims over the retention amount in the first year, and diminishing amounts in the second and third years.

4. To help build capacity in the private sector, the tax penalty against reserving for terror risks would be repealed for all insurance companies. This provision could be drafted by using the Policyholder Disaster Protection Act (HR 785), by Representatives Foley and Matsui, as a starting point. The phase-in provisions in this bill should be deleted.

5. The coverage should be clearly defined to cover only actual commercial property losses and workers' compensation.

6. A mediation panel is needed to quickly pay and settle claims for terror losses in a fair and inexpensive way.

While it may seem like a good idea for the Federal government to stay out of pricing, we must not lose sight of the fact that the Federal government is offering $88 billion in reserves against terror losses. It should certainly charge some reasonable amount for that risk.

If the insurance companies are covering only 12 percent of losses, then they should be receiving, on average, 12 percent of the associated premium. Since there is no traditional way to estimate or annualize losses, there probably should be a nominal "load" established to be added to every dollar of non-terrorism premium.

We strongly recommend that the first year of the program also require that the private sector cover at least the first $10 billion of losses. After that amount the government should cover no more than 80 percent of additional losses.

In 2003, the private sector should cover the first $15 billion of losses. Between $15 billion and $25 billion, the private sector should cover 50 percent of losses, and between $25 billion and $100 billion, the government would cover 70 percent of additional losses.

In 2004, the private sector should cover the first $25 billion of losses. Between $25 billion and $100 billion, the private sector should cover 50 percent of losses.

A Plan for a Public and Private Terrorism Facility, with Increasing Share Being Owned by The Private Sector at Higher Levels of Capacity

All of the proposed Federal terrorism reinsurance plans offered to date violate key principles of sound insurance policymaking. These flaws would put lives and property in danger and expose taxpayers to unnecessary losses.

If Congress concludes it must do something to provide capacity and maintain insurance for terror risks, there is a better way to set up a terrorism facility. Our suggestion is an approach that would involve the industry financially and operationally while creating incentives to properly price and manage risks. The strength of this proposal is that it creates extremely powerful incentives for the facility to operate efficiently, minimize risks to lives and property and carefully pay claims.

Equally important, the industry and government have immensely powerful financial incentives to disband the facility after three years. A wonderful bonus of the dissolution would be a huge improvement in the capacity of the industry to pay for man-made or natural mega-catastrophes.

This facility allows the Federal backstop to constantly move up, farther from the risk as time goes on, with the Federal backstop eventually being eliminated entirely as a result of accumulating funds in the facility.

This facility was designed to last for three years, but could easily work for just one year or two years.

We welcome comments and suggested improvements to this proposal.

1. Each company would invest capital to prime the facility, with an initial investment of 2 percent of the previous year's annualized premium charges. This would give the facility about $6 billion of capital at its launch, and would serve to start the operation with no outlay of Federal funds.

2. The total capacity and liability of the facility would equal $100 billion, with the Federal Government providing the difference between the facility's capital and total liability. For example, after one year (if no losses occurred and ignoring investment income) the facility would have $36 billion, with Federal backstop loan availability of $64 billion.

3. If a Federal backstop loan is triggered, the Government would be repaid over a 20-year period at the then-prevailing interest rate for 20-year borrowings by an S&P rated AA financial institution.

4. The facility would be permitted to build reserves for terror risks on a tax-deferred basis.

5. The facility would cover only real and personal property loss and workers' compensation arising from a formally declared event and only for those losses defined in the facility's charter.

6. Each company would have a retention equal to 20 percent of its written premium as a self-insured loss, to be funded by it from its general revenue and investments. Individual companies would be free to reinsure this amount commercially if possible.

7. After the individual company retention, the facility would pay 80 percent of remaining losses, which would be pro-rated if total losses exceed $100 billion per year.

8. Terror losses eligible to be paid by the facility and the Federal government would be specifically declared and certified by the Secretary of the Treasury, and claims would be paid to/through individual companies after they had presented evidence of payment of their 20 percent share of any declared loss.

9. Quarterly, each company would collect from its customers and remit an amount equal to 10 percent of their gross written premium collections to the facility. These additional premiums would carry no agent or broker commissions and the insurers would make no administrative charge for collecting and remitting these funds. The premiums so collected would be specifically designated as funding the national terrorism facility, and insurers would be expressly and legally prohibited from charging customers any other premiums related to the coverage provided by the national facility. Absent any major loss after one year, this facility would have accumulated about $30 billion in added capital plus investment earnings of approximately $750 million. Investments could be limited to US government obligations. If no losses occurred, the facility would have private funding of $100 billion in less than 3.3 years.

10. To allow for coordination between companies to participate in the facility and to coordinate with each other to manage the terror risk, participating companies and the facility itself would receive an exemption from anti-trust laws as applicable to these specific activities.

11. State regulations regarding rates and coverages for terror risk would be preempted until the Federal backstop capacity is no longer in place.

12. Senior management's compensation would include a substantial bonus if Federal risk is reduced and other management goals are met. The management goals would include (other suggestions welcomed):

- Minimizing Federal exposure through securitizing risk through issuing catastrophe bonds or buying reinsurance.
- Efficient operations.
- Timely payment of claims.
- Accurate and fair claims administration.

5. To avoid any potential conflicts of interest, a Supervisory Board would be composed of the Treasury and industry officials with consumer and taxpayer representatives. The chairman and majority control of the Board would remain with Treasury officials until the industry has contributed $75 billion in capital and the facility had accumulated that much capital. At that time, the chairmanship and control of the board would switch to industry representatives.

6. The facility must at all times maintain an independent risk management function for controlling risk assessment, risk management, pricing, money management and claims assessments. It would report to management and the Board.

7. A mediation panel would quickly resolve any disputed claims for terror losses in a fair and inexpensive way. This would ensure that victims would receive quick payment of disputed claims and minimize non-productive litigation. Quick and fair resolution will lead to more certainty in pricing insurance for future events and will therefore both reduce the ultimate cost of such events and allow the private sector to more quickly reenter the market.

8. If losses were minor, the facility would disband after three years. If the facility disbands, then its capital (including accumulated investment income), after payment of Federal income taxes at the then-prevailing corporate tax rate, would be distributed to each company according to the amount invested. Using this formula, if the facility had $100 billion in capital for distribution, the Government would receive approximately $35 billion prior to the return of the funds to the contributing insurers. The after-tax capital would then be distributed to the insurance companies with a requirement that it be placed in a special tax-deferred reserve fund at each company. These reserves could only be used to pay for man-made or natural mega-catastrophe losses in a manner similar to the provisions of the Policyholder Disaster Protection Act (HR 785), by Representatives Foley and Matsui.

A facility of this type would require a small number of very capable people to operate; probably outsourcing most labor and computer intensive functions so as to keep fixed overhead at a minimum. All administrative and operating expenses could be paid using a very small percentage of the accumulated funds.

At a minimum, this new facility should be the provider of terrorism coverage for all commercial enterprises and subject to mandatory participation by all property and casualty companies. Carriers could provide coverage themselves for personal lines risks or for risks outside the precise coverage definition approved by Treasury if they want to, (perhaps even take reserves offshore,) but they would still need to pay for this facility if they conduct any business in the United States.

The Insurance Industry Proposal

We are strongly opposed to the industry bill as presented in its most recent draft, which is riddled with both short and long-term flaws. It is completely contrary to at least principles 1-10 listed above on pages 2-4.

The proposal appears to create an unlimited liability for the Federal government for terror risks. The legislation also covers an unclear amount of war risks. As noted previously, the Federal government must have complete flexibility during war because the most important function of our government is to defend the country. We cannot and must not create an entitlement program to insure against all terror or war risks, which may cripple the financial capacity of the government to win the war.

This proposal initially offers no payment to the Federal government for its reinsurance capacity, and it is quite possible that no payment would ever be forthcoming. We are strongly opposed to any such giveaway. Just because it is difficult to properly charge for the risk doesn't mean that nothing should be charged.

The pool concept is fundamentally flawed, and there are better alternatives. It allows companies to be looser in their underwriting and increases moral hazard problems compared to alternatives. Companies could shift risk in an undetectable manner to the pool.

Another key concern is that the proposal would set up a permanent bureaucracy that would greatly expand its mission over time, concentrating risk and displacing a healthy reinsurance market.

This facility would have enormous advantages that no other firm could match, including tax-free reserving, explicit access to Federal credit and a location in one of the least-regulated states in the country. At the end of its "life" there is to be a report on the state of capacity in the industry, not just for terror, but for other large risks currently handled by the private sector such as natural disasters.

We understand that the proposal has a sunset clause, but are not reassured. Once federal programs start, they rarely disappear, and this entity will have powerful allies who will likely seek to dump their other least attractive risks on the taxpayer. Important sectors of the industry have been trying for years to push legislation through the Congress to set up a natural disaster insurance corporation, and this entity could well take on that role as it is about to supposedly expire.

The inherent advantages of the proposed "Homeland" insurance entity would make it almost impossible for the private sector to move back into the business of insuring against terror risks as it could not compete against Homeland's awesome advantages in amassing tax-free reserves and accessing Federal credit.

Conclusion

Proposals for Federal insurance for terror and war risks are both politically and economically risky and should be subjected to extensive examination and comment before being enacted into law. We strongly urge the Committee to remember that even the best-intentioned programs can have budget-busting consequences. In this case, a poorly designed program would also place more lives at risk and conceivably harm the financial ability of the government to defend the country. Congress must move carefully in this highly complex area to ensure that it does not create a fiscal disaster, unwisely interfere with private markets or violate sound insurance principles.