



STATEMENT OF
NEW YORK STATE INSURANCE DEPARTMENT

BEFORE

U.S. HOUSE OF REPRESENTATIVES SUBCOMMITTEE
ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES AND THE
SUBCOMMITTEE ON OVERSIGHT AND
INVESTIGATIONS

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SUPERINTENDENT OF INSURANCE

I. Introduction

There is no question that the world we live in today is vastly different than the one we lived in only a few years ago. What was once possible only in a Tom Clancy novel or a Hollywood production is now being seen on the nightly news on a daily basis.

Individuals, groups, networks and tactics that were previously unknown to us are now part of our daily vocabulary. And this is true not just for the citizens of the United States; it is a global phenomenon. Individuals such as Ayman al-Zawahri, groups such as the Moroccan Islamic Combatant Group, alleged to have carried out the Madrid train bombings, concepts of fatwas and jihad, and places such as Fallujah, Iraq and Kandahar, Afghanistan are now household words around the world.

Recognition of this new world that we live in has been acknowledged by Congress through the passage of the Patriot Act and by the President through the creation of the Department of Homeland Security, among other initiatives taken in the last several years. While national security is clearly of paramount importance, Congress and President Bush also recognized, through the passage of the Air Transportation Safety and System Stabilization Act, the September 11th Victim Compensation Fund and the Terrorism Risk Insurance Act (TRIA), the need to protect our critical financial infrastructure in new, and previously unforeseen ways. I applaud the efforts of President Bush and Congress, working together on a bi-partisan basis during this period of national crisis, in successfully delivering the necessary measures to bring about a sense of security and stability to our individual and corporate citizens. While all the actions taken in Washington, D.C.—together with the action of our governors on the state level, are indeed a move in the right direction, we have not yet reached our final destination. Our

nation is still in the midst of searching for appropriate and permanent solutions to the challenges brought about by recent events and the rapidly changing dynamics of political and economic risk. We must be steadfast in our mission to protect our way of life, which at times, such as now, requires the making of short and long-term commitments of time and resources, both from the public and private sectors. From a public sector standpoint, it is critical that we address, on a timely basis, any issue that may cause instability to our nation or our national markets. Just as President Bush is advocating for renewal of the Patriot Act to protect the nation from physical threats, our responsibility as legislators and regulators of the financial services sectors is to ensure a timely resolution to the debate surrounding TRIA in order to stabilize and protect our financial marketplace.

Terrorism is a relatively new exposure for the homeland, but not for many other countries in the world. These countries have found permanent solutions to the terrorism exposure and most solutions include some level of public participation. As we deliberate the various alternatives and approaches to taming this exposure, we too need to consider the appropriate role and involvement of the public sector, be it federal, state or local governments.

Today, I will discuss the important provisions and key dates contained within TRIA and its impact on the marketplace. I will also focus on the implications of TRIA expiring at the end of 2005 and discuss alternatives to building capacity in the marketplace.

II. Impact of the Terrorism Risk Insurance Act on the Marketplace

The Terrorism Risk Insurance Act (Public Law No. 107-297), signed by the President in November 2002, was enacted to bolster a private insurance marketplace failing to provide adequate terrorism insurance coverage following the enormous losses of the September 11th atrocities. TRIA was designed to provide a bridge to a time when the private insurance markets were functional again; that is, when the risk from terrorism had abated and/or more long-term private market mechanisms were implemented to better manage the risk of loss from catastrophic hostile events. It was clearly understood that TRIA was intended to be a temporary program designed to stabilize the sectors of the economy that need terrorism coverages to be available at adequate coverage limits and at manageable rates, and stabilize the insurance market by giving the insurance industry an adequate amount of time to redevelop capacity and develop, with government, reliable alternatives in managing these risks. Following TRIA's enactment, terrorism insurance coverage became readily available. The primary reasons TRIA successfully improved the availability of terrorism insurance are:

- (1) the program requires that insurers offer terrorism insurance coverage to policyholders on the same terms and conditions as other property and casualty insurance ("make available" provision).
- (2) the program requires that the federal government share the risk of loss from certified terrorist attacks with the insurance industry.

Not only has TRIA improved the availability of terrorism coverage, it has contributed significantly to the stabilization of the overall insurance marketplace in the wake of September 11th. While the market has not yet returned to pre-September 11th

levels in terms of rates, coverage limits or the balance of admitted and non-admitted market capacity, without TRIA the economic fallout from insurance coverage disruption would have been disastrous. Insurers would have faced the dilemma of either not writing terrorism coverage or exposing their capital to the potentially catastrophic risk of terrorism. TRIA allowed billions of dollars in stalled construction projects to proceed by allowing the project owners to satisfy the insurance coverage requirements imposed by their lending institutions. TRIA also allowed many small businesses to avoid making the difficult choice between “going bare” or closing their doors altogether. However, the crisis is far from over. Businesses that were forced to migrate to the surplus lines market after September 11th and before enactment of TRIA have not yet returned to the admitted market where rates and forms are subject to state supervision. The latest figures demonstrate that these businesses remain in the surplus lines market as excess line premium writings have tripled in New York over the last three years, from about \$685 million in 2001 to over \$2 billion in 2003.

We have also seen specific instances of businesses written in the surplus lines market where the entire annual premium was deemed by insurers to be fully earned at inception, which prevented such insureds from canceling their policies and shopping for cheaper TRIA coverage (when a premium is fully earned at inception, an insured is not entitled to any refund in the event of cancellation regardless of the length of time the policy is in force). Policies imposing a fully earned premium penalty at inception are not permitted on the admitted side because of state regulation. In New York, the Insurance Department ultimately succeeded in securing a recommendation from the Excess Lines Association of New York that surplus lines carriers would not earn more than 25% of the

premium at the inception of the policy, with the exception of premium finance policies which would be subject to the statutory 10% minimum earned premium. It should be noted that the statutory 10% minimum earned premium applies to policies where the premium is financed regardless of whether the policies are placed in the admitted market or the surplus lines market.

As you will recall, the events of September 11th, coupled with an already hardening market, created a sharp constriction in writings of insurance coverages across the property/casualty spectrum. These dynamics were compounded by the fact that reinsurers largely vacated the market for terrorism insurance coverage, creating an acute drain on capacity at the primary level. The market for reinsurance, essential for stability in the primary insurance market, had already begun to tighten prior to the events of September 11th, and, practically speaking, closed down entirely for terrorism coverage thereafter. Primary insurers, unable to spread the risk to reinsurers, resorted to either declining coverage or retaining the risk but charging exorbitant premiums. Commercial risks such as office towers, sports stadiums, government facilities, landmark buildings and other “trophy properties,” as well as businesses in close proximity thereto, were unable to procure the necessary coverages at any price. Further, risks located in places like New York, Boston, Washington, Chicago, and other major cities with the most concentration-of-risk issues were hardest hit by the lack of availability of coverage. Most of these risks had to resort to finding limited and overpriced coverage in the surplus lines market.

Lack of coverage also directly impacted the banking, securities and real estate industries as well. Construction projects stalled because project owners were unable to secure appropriate insurance. As a result, lending activities came to a halt.

Concentration of risk issues post-September 11th came to the forefront in the workers compensation area. Workers' compensation carriers, statutorily required to provide "all risk" coverage, are now compelled to consider the affect of a single large employer located in a single facility falling victim to a terrorist attack involving nuclear, biological, chemical or radiological weapons. The realization of this vast and catastrophic loss exposure over an extended period of time has resulted in some stark reversals in the approach to underwriting this coverage. TRIA did not address this issue to the extent it was hoped for by the industry.

Similarly, the Treasury's decision excluding group life insurance from TRIA coverage left a wide gap in TRIA's applicability, as group life insurance shares many of the same concentration of risk characteristics as workers' compensation. While TRIA did not specifically provide coverage for group life insurance, it directed the Secretary to conduct a study, on an expedited basis, to determine whether group life insurance should be included under TRIA. The Secretary, in August 2003, decided against extending coverage, citing no appreciable reduction in the availability of group life insurance coverage for consumers. It is worth pointing out though that, at the same time the Secretary made this finding, he noted that there was a general lack of catastrophic reinsurance coverage for companies that offer group life insurance. This general lack of catastrophic reinsurance cover continues to this day. Without this catastrophic reinsurance cover, carriers will find it increasingly difficult to assume this risk on their

own. Therefore, Congress needs to seriously consider mandatory inclusion of group life insurance policies under TRIA in any discussions surrounding its reauthorization.

The immediate effect of TRIA, and for many the singular purpose of TRIA, was that it made terrorism coverage available in the marketplace. The “make available” provision ensured that primary insurers offered terrorism coverage to their commercial insureds and it enabled commercial insureds to make an appropriate business decision as to whether or not to purchase such coverage. TRIA, by appropriately focusing on the insured deciding on whether to buy terrorism insurance rather than the insurer deciding whether to sell it, provided the economy and the industry with a balanced framework to sensibly underwrite the terrorism exposure.

Concerns that have been raised about the level of participation in TRIA may be misplaced for the following reasons. First and foremost, the take-up rate for purposes of terrorism insurance under TRIA is not the proper unit for measurement of its effectiveness or success. Commercial insureds located in low-risk areas, such as rural communities, will naturally decline coverage because the risk of a terrorist event is low. While some may call this adverse selection, this phenomenon is not unique to terrorism coverage and exists in all lines of insurance. Generally speaking, just as a building owner in Manhattan should have no need for crop insurance, a small farmer in an upstate rural community may have no need for terrorism insurance.

Another reason for electing not to purchase terrorism coverage is driven by the cost of the coverage. Businesses typically do a cost-benefit analysis in determining whether or not to purchase any product or service and in this respect, the decision to purchase or decline terrorism coverage is no different. In order for a business to purchase

this coverage, the cost of the coverage must be commensurate with the risk of a terrorist event.

Finally, in states that use the Standard Fire Policy, such as New York, any fire loss ensuing from a terrorist attack, whether certified or not, would be covered under the policy, even in situations where the insured has opted not to purchase the TRIA terrorism coverage. The practical effect of some ensuing terrorism losses being covered under the Standard Fire Policy has lessened the demand for TRIA coverage in such states.

For these reasons and as expected, participation in TRIA has been directly proportionate to the perceived need for the coverage. TRIA has operated exactly as Congress intended; those who needed the coverage purchased it; those who did not need the coverage declined it. Those who did take it up represent a significant segment of the economy of each major city in the country.

The participation level in TRIA does not in any way diminish the importance of the “make available” provision and its impact on market stability. During calendar years 2002, 2003 and the first quarter of 2004, mandatory availability of terrorism coverage paved the way for some capacity to return to the marketplace for all lines, not just the property lines. In fact, many in the industry believe that the hard market has peaked and that we are experiencing the beginning of a soft market cycle. I concur with this assessment, but only in part. The rate of premium increases has started to decrease and many lines are beginning to see rate stabilization or decreases. Availability of coverage across all property and casualty lines is easing and underwriting standards are becoming more relaxed, and property insurers are again posting positive operating results.

Policyholders, however, are increasingly concerned that terrorism insurance will again become scarce this year because, even though the terrorism insurance program does not technically expire until December 31, 2005, there are other provisions in TRIA that could result in the program expiring in fact a year earlier than its statutorily prescribed termination date.

TRIA is in its final year of mandatory availability. The “make available” provision, which played no small part in restoring availability to the marketplace, does not apply to calendar year 2005, unless the provision is extended by the Secretary of the Treasury, no later than September 1, 2004, through the final year of the program. Accordingly, I strongly urge the Secretary to extend the “make available” provision through 2005. Current speculation on how the Secretary will rule on this issue is rampant in the industry and the trade press and waiting until September 1, 2004 will cause further uncertainty in, and disruptions to, the marketplace. Moreover, the September 1, 2004 deadline is inconsistent with the operational needs of insurers who may be unable to comply with state mandated timeframes applicable to non-renewal or conditional renewals. Therefore, insurers, unsure about the statutory landscape, are already considering a variety of measures to address this dilemma, including attaching outright terrorism exclusions and conditional or pop-up endorsements to new and renewal policies. I, and my colleagues at the NAIC, stand ready to provide any and all assistance to the Secretary in quickly and effectively resolving this matter. In conjunction with extending the “make available” provision for the final year of the program, the other critical issue that needs to be addressed as soon as possible, and preferably by the end of

the year, is Congressional decision on whether or not to reauthorize TRIA and if reauthorized, in what form.

In this regard, TRIA directs the Treasury, in consultation with the NAIC, representatives of the insurance industry and of policyholders, to conduct a study to assess the effectiveness of TRIA and the likely capacity of the property and casualty insurance industry to offer insurance for terrorism risk after termination of TRIA. To be sure directing a comprehensive analysis of the TRIA program is not only a sound public policy but a very worthwhile market study. The statute, however, requires the Secretary to submit a report to Congress no later than June 30, 2005. The timing of this report is inconsistent with the commercial insurance business cycle and the operational needs of the industry and its customers. Insurers and their commercial policyholders will be required to make underwriting and purchasing decisions as early as the fall of 2004, without the knowledge of whether TRIA will be reauthorized, modified or allowed to expire. Therefore, I urge the Secretary, to expedite the study and issue his report to Congress as soon as possible. Again, I offer my full cooperation and that of the NAIC to the Secretary so that this vital report can be published in time to enable Congress to take meaningful action that will coincide with the market cycle. Again, irrespective of whether TRIA is reauthorized, modified or allowed to sunset, a timely and firm decision from Congress will bring decisiveness to actions in the marketplace.

It should be noted that extending the "make available" provision to the final year of the program without reauthorizing TRIA in some form will create uncertainty in the marketplace. This situation will result in mandatory coverage being offered in policies issued in 2005 that extend into 2006 without the benefit of a federal backstop because the

program expires on December 31, 2005. Beginning in 2005, insurers will be compelled to make difficult choices such as excluding terrorism coverage in 2006 through the use of conditional endorsements, not write any property coverage at all, or in states like New York which have not permitted terrorism exclusions outside the scope of TRIA, write the coverage and expose capital to catastrophic risk.

As I stated earlier, TRIA has fulfilled its overarching purpose of stabilizing the marketplace. Market disruptions have gradually diminished over the 17 months TRIA has been in existence. Coverages have become more affordable. However, pricing for terrorism coverage remains arbitrary and high in many instances. TRIA, by imposing discrete and industry-wide retention levels, should have improved the predictability of rates for the terrorism exposure, however, this is not in evidence in the marketplace. Also, reinsurance for the retention amounts mandated by TRIA continues to be largely unavailable.

Another intended purpose of TRIA was to allow the private market to rebuild capacity to absorb future losses. While most, if not all, of the capital lost on September 11th has been reintroduced into the marketplace, much of that new capital is discriminating capital, not available for underwriting traditional commercial lines, including terrorism. A variety of insurers filed to raise capital by issuing common and preferred stocks and bonds. New capital also began pouring in from investment bankers who traditionally target sectors with the potential for aggressive returns. The post-September 11th environment was a fertile breeding ground for new insurance companies. These companies, not burdened with September 11th losses, benefited from the higher rate levels that prevailed over the last few years. The estimated new capital raised is as

much as \$40 billion, if not more, with roughly an equal distribution between the primary and reinsurance markets. As the market softens, I expect some capital to shift from niche to traditional markets, but not to cover the risk of terrorism because of its catastrophic nature. And it will be some time before market capacity for traditional lines and a more proportionate allocation of capital between admitted and non-admitted markets are restored to pre-September 11th levels.

The industry itself has failed to use the “breathing room” offered by TRIA to devise innovative, private solutions to address the problems in the marketplace. For example, neither state nor federal law prevents carriers from forming reinsurance pools to address their concerns regarding the deductible and coinsurance requirements specified in TRIA. No such pools have been formed to date. Other pooling arrangements, such as voluntary joint underwriting associations, would have enabled carriers to share the insured exposure, thereby alleviating concentration of exposure concerns. The Department not only invited the industry to form such entities, but also expected a flurry of activity in this regard since the passage of TRIA. It is discouraging that the industry has failed to exploit the full potential of this alternative despite explicit reference to this arrangement in a Department Circular Letter issued December 23, 2002. In order to promote availability, the Department, consistent with the Interim Guidelines issued by the Treasury, clarified in the Circular Letter that a voluntary joint underwriting association or a risk-sharing plan will be considered an "entity" included in the definition of "insurer" under TRIA. No constructive activity in this regard has been undertaken.

While the industry has not pursued some of the discussed alternatives, it is important to note that these alternatives, even if implemented, may not be sufficient to

address the terrorism exposure in the absence of some federal participation, be it in the form of an appropriate reinsurance or other pooling mechanism, including syndication, allowing primary insurers to spread the assumed risk to the government as TRIA now provides. Current marketplace dynamics will be seriously and adversely impacted if TRIA, in some form or another, is not reauthorized or if reinsurers that vacated the market for terrorism insurance coverage after September 11th, do not reenter the market. This is borne out by the fact that since September 11th there has been no meaningful coverage available for non-certified acts of terrorism.

III. Coordination between the Treasury and the NAIC

TRIA had as one of its structural underpinnings, the National Association of Insurance Commissioners as an integral part of its implementation. The NAIC began working immediately to assist in the rapid implementation of TRIA. The NAIC's Catastrophe Working Group developed a Model Bulletin in short order that provided immediate and relevant guidance on acceptable methods to implement TRIA. As a member of this working group, the Department participated in the discussions pertaining to the development of the Model Bulletin. The Model Bulletin included model disclosure and notice forms that were subsequently adopted for use by the Department of the Treasury.

The NAIC also created the Terrorism Insurance Implementation Working Group. This working group collaborated with the Treasury on a consistent basis to get the implementation of TRIA right. Working with the Treasury Department, this group reviewed all interim guidance and final regulations prior to promulgation by the

Treasury. As chair of the NAIC's Government Affairs Task Force, I have met with several Treasury officials responsible for the implementation of TRIA regarding its impact on the marketplace, including the effects of nonrenewal.

Key decisions were made by the Treasury after first discussing those issues with the working group. For example, the appropriate treatment of residual market mechanisms, captives, self-insured and group life insurance were made by the Treasury after conferring with the NAIC. Ultimately the decision to require captives to participate in the TRIA program was the correct one.

The Department also took decisive action in assisting the insurance industry in the implementation of TRIA in New York. Upon TRIA's enactment, the Department immediately initiated discussions and had several meetings, with insurers, producer groups and business organizations.

With respect to the Model Bulletin, although NAIC drafters made significant attempts to craft a document that could have applicability throughout the United States, and had, through "drafting notes," indicated a number of areas where individual state adjustments might be necessary, the overall guidance being provided appeared to have been crafted from the perspective of those states that had previously approved the use of terrorism exclusions. Since New York was among a handful of states that had not previously approved the use of terrorism exclusions, we found ourselves in a unique situation not fully addressed by the Model Bulletin. Ultimately, New York did not vote in favor of the adoption of the Model Bulletin. In lieu thereof, the Department, in consultation with New York's business community and the insurance industry, developed and issued Circular Letter No. 25 (2002) (copy attached) to address in a more specific

manner the pertinent terrorism insurance issues in our State. The Circular Letter garnered strong consensus from insurers, producer groups, business organizations and property owners, as they were involved early in the drafting stage.

Similar to the NAIC's Model Bulletin, Circular Letter 25 provides an overview of TRIA including its "make available" requirements, description of its notice provisions pertaining to the nullification and reinstatement of exclusions, and the disclosure of the premium charged for covered acts of terrorism. The Circular Letter also describes the compensation provisions of the federal program.

In line with the NAIC Model Bulletin and the Treasury Guidelines, the NAIC model disclosure forms are expressly referenced in the Circular Letter for use in New York as safe harbors.

Because New York held the line and did not previously approve terrorism exclusions or limitations, the nullification and reinstatement provisions were not relevant to policies issued in the admitted market. However, to the extent that such exclusions and limitations were in force in the excess line market and in policies issued in the Free Trade Zone, the nullification and reinstatement provisions were applicable. In fact, with respect to the Free Trade Zone, the Department issued an opinion on May 17, 2002 (copy attached) clarifying that although rates and forms used in the Free Trade Zone are not required to be filed, the rates and forms remain subject to the rating and policy form standards set forth in the Insurance Law. Thus, even in the Free Trade Zone, rates cannot be excessive, inadequate, unfairly discriminatory, destructive of competition or detrimental to the solvency of insurers. In addition, policy forms cannot be misleading or violative of public policy.

Circular Letter 25 also covers the filing of policy forms and rates with the Department. TRIA preempted state prior approval or waiting period requirements until December 31, 2003 for terrorism risk insurance covered by TRIA. In our discussions prior to issuing the Circular Letter, some insurer representatives maintained that the federal preemption applied not only to rates and forms intended to provide coverage for terrorism risk but also preempted prior approval of exclusions and limitations pertaining to acts of terrorism. TRIA, however, treated the federal preemption as applying only to rates and forms implementing terrorism coverage, implying that prior approval was required for terrorism exclusions and limitations in accordance with state law. This position was based, in part, on the actual language of the legislation which applied the preemption to "rates and forms for terrorism risk insurance covered by this title." We read this language as clearly relating to the stated objective of TRIA to maintain availability and affordability of terrorism risk insurance through prompt implementation of the coverage and did not see it as designed to facilitate limitations or exclusions that reduced that coverage. This reading was also consistent with the Treasury Guidelines issued on December 3, 2002, which states that an insurer can offer coverage on different terms, amounts or coverage limitations after first satisfying the "make available" requirements of TRIA provided that "such offers do not violate any state laws or regulations." Finally, TRIA preserves the state's authority to engage in a subsequent review of forms implemented pursuant to the preemption.

Similarly, with respect to rates applicable to coverage provided under TRIA, the Circular Letter states that insurers may place such rates into effect without the Department's prior approval, however, it reserves the Department's authority to conduct

a thorough review of the data, assumptions and methodologies used in developing such rates.

Given the Department's position on prior approval of terrorism exclusions and limitations, we also clarified in Circular Letter 25 that the Department will consider for approval, on an expedited basis, filings for exclusions and limitations covering certified or "insured losses" under TRIA. Among other things, the Department required that such exclusions and limitations track the language of TRIA and that the insurer first satisfy the "make available" requirements of TRIA prior to implementation of such exclusion or limitation.

The Department also developed a procedure set forth in the Circular Letter covering filings for approval of terrorism exclusions and limitations pertaining to other than insured losses under TRIA or "non-certified losses." These procedures include the filing of rating classifications for approval that identify the basis and rationale supporting the classification. While the Department was, and continues to be, prepared to give due consideration to narrowly defined exclusionary provisions, insurers were cautioned to avoid language defining terrorism that might be interpreted as denying coverage for acts that have traditionally been insured under a policy's vandalism provisions. Similarly, exclusions for domestic acts of terrorism, which are not covered under TRIA, have to be narrowly and precisely crafted in order to distinguish such acts from events that have traditionally been covered within the scope of the vandalism peril.

The Circular Letter also describes, by way of example, acceptable criteria for underwriters to employ in rating, applying exclusions, or establishing sub-limits applicable to acts of terrorism. Unique buildings, occupancy, and security measures are

among listed characteristics of a risk's profile that may be given due consideration in developing objective guidelines for limiting coverage.

Finally, with respect to both "certified" and "non-certified losses," the Circular Letter clarifies that TRIA has no impact on coverages provided under statutory mandates. Accordingly, no terrorism exclusion or limitation is permissible for coverage with respect to the peril of fire that is subject to section 3404 of the Insurance Law, motor vehicle liability policies satisfying the financial responsibility requirement of the Vehicle and Traffic Law, including no-fault coverage, and workers' compensation insurance.

Circular Letter 25 was supplemented on February 19, 2003 (copy attached) to provide additional guidance to New York insurers on the method for making appropriate disclosures under TRIA.

There is no question that a productive and effective working relationship has been established between the Treasury, the NAIC and my office. We will continue to capitalize on this relationship in implementing whatever decisions are made at the federal level with respect to stabilizing the marketplace including extension and/or reauthorization of some or all of the provisions of TRIA.

IV. Supplemental and Alternative Solutions

There are various market options that could be considered as Congress deliberates reauthorization of TRIA. Some of these options are available solely to commercial policyholders, while others can be implemented by the industry or the public sector, including state and federal government. The options can be implemented individually or

programs can be constructed that combine two or more options, including creating a renewed partnership between the public and the private sectors.

Commercial insureds can and have formed captive insurance companies to insure their own exposures, including the terrorism exposure. A captive insurance company is a subsidiary of a parent corporation that is established to underwrite and manage the risks of its owner and affiliated companies. Many businesses and public entities have seen the benefits that captive insurance companies can offer, such as:

- Reducing insurance costs: A captive saves money through lower overhead than a commercial insurer thus putting a greater percentage of premium dollars into paying claims. Further, a parent of the captive retains all underwriting profits and investment income on loss reserves. A captive also provides direct access to the reinsurance markets.
- Optimizes risk management activity: A captive increases internal focus on risk management and loss prevention, thereby lowering loss costs.
- Provides greater flexibility: A captive affords insurance coverage regardless of market conditions especially when coverage is either not available or is overpriced in the traditional commercial market, conditions we experienced in the wake of September 11th. Also, a captive allows the tailoring of coverage to fit the risks faced by the parent as opposed to a “one size fits all” policy offered by commercial insurers.

New York’s Metropolitan Transportation Authority, the parent of New York’s first captive insurer in 1997, has experienced all of these benefits. Each day more of New York’s businesses and public entities are calling for the ability to form a captive and take

advantage of the great benefits of captive insurance. New York has been successful in offering businesses a practical and sensible solution to their risk management strategies and a viable alternative to the traditional insurance markets.

Captives are an ideal vehicle for large commercial entities in securing their terrorism risks. Many captives domiciled in New York have specifically taken advantage of the protections offered by TRIA. Two captives were formed solely to provide TRIA terrorism coverage to their parents while seven other captives included TRIA terrorism coverage along with other traditional coverages. This was only made possible because of the federal backstop and the mandatory inclusion of captives in TRIA coverage by the Treasury in its December 18, 2002 directive. In the absence of a federal backstop or appropriate reinsurance coverage, these captives may not be able to continue providing terrorism coverage to their parents.

The primary industry has few options, but the rate structure, to replenish their reserves after a catastrophic event. Further limitations on this ability are imposed to the extent that past catastrophic losses cannot be included in the loss experience to develop future rates because catastrophes are, by definition, considered isolated incidents not predictive of future loss experience. In addition, many jurisdictions do not allow insurers to include an additional load in the rating formula for future catastrophes. The singularly most empowering tool for the primary industry in creating capacity for catastrophic events would be to enable it to set aside tax-deferred catastrophe reserves. Catastrophe reserves can serve as a supplement or an alternative to the reinsurance markets, which are largely unregulated, and reduce or eliminate capacity crunches after major disasters. This tool is currently unavailable to primary insurers in the United States because the federal

tax code does not recognize reserves created for events which have not yet occurred. This alternative merits serious consideration by Congress because of the significant potential in creating a permanent private market solution in accordance with the Congressional intent set forth in TRIA. While accumulation of sufficient catastrophe reserves will take time, working in conjunction with a federal backstop, we could devise a program that will diminish federal participation to the extent that capacity is being built in the catastrophe reserves. We are cognizant of the budget implications of creating tax-deferred catastrophe reserves, but these implications must be viewed in the context of the diminishing role and the potential removal of the federal government from the backstop program.

Another approach to creating capacity in the marketplace is to allow for, or encourage, syndication. Syndication involves structuring a layered program, vertically and/or horizontally, to cover insureds, locations, or lines of businesses that present a catastrophic exposure. Each layer of the syndicated program could be covered by a different entity, including insureds through retentions and coinsurance, primary insurers, reinsurers, state government, regional state pools/compacts and the federal government. Syndication is particularly well suited for addressing the concentration of risk issue in workers' compensation insurance, the catastrophic nature of a nuclear, biological or chemical event, or exposures with latent manifestation of injury such as asbestos or nuclear radiation. In fact, in New York, Governor Pataki, in his workers' compensation reform bill, has proposed permitting syndication, for workers' compensation, a mechanism historically available to all other lines of property and casualty business.

The primary industry in the U.S. cedes approximately 62% of total business to reinsurers domiciled in foreign jurisdictions, mainly in Europe and Bermuda. These reinsurers are not subject to any domestic regulatory oversight and therefore cannot be required to participate in any remedial efforts to create capacity in the marketplace. Incentives, such as the elimination or reduction of income taxes, may encourage reinsurers to write lines that are critical to a robust insurance marketplace.

V. Conclusion

The stated goal of TRIA is to provide a temporary federal backstop for terrorism-related losses. There is no question that TRIA has had a positive impact on the availability of terrorism coverage, and has provided significant stability to the overall insurance marketplace following the events of September 11th. TRIA offered businesses the opportunity to secure terrorism coverage necessary to complete and expand various projects thereby contributing to the economic recovery that is currently underway. In order to maintain the stability in the marketplace, it is essential that the Treasury Secretary extend the “make available” provision to the final year of the program. If the “make available” provision is not extended, terrorism insurance will again become difficult, if not impossible, to obtain one year before the expiration of TRIA. This could have a devastating impact on our national economy. Either way, this decision must be made as soon as possible so that the insurance industry and their commercial insureds will have sufficient time to issue new or renewal policies and to avoid any disruption in the marketplace.

In addition, Congress needs to consider this year whether to reauthorize TRIA and, if reauthorized, in what form. In making this decision, I urge Congress to consider the alternatives noted above. Catastrophe reserves, for example, may provide the private market with the ability to create sufficient capacity over time which should ultimately reduce, if not eliminate, the federal government's role in providing a federal backstop to the market. Indeed, this may very well be the permanent solution that Congress was looking for when TRIA was first enacted.

If the Secretary decides to extend the "make available" provision to the final year of the program, insurers will be required to offer terrorism coverage to their commercial insureds. This decision will maintain the status quo for another year. However, extending the "make available" provision to the final year without a decision on renewal of the program will create uncertainty in the marketplace. This situation will result in mandatory coverage being offered in policies issued in 2005 that extend into 2006 without the benefit of a federal backstop because the program expires on December 31, 2005. Beginning in 2005, insurers will be compelled to make difficult choices such as excluding terrorism coverage in 2006 through the use of conditional endorsements, not write any property coverage at all, or in states like New York which have not permitted terrorism exclusions outside the scope of TRIA, write the coverage and expose capital to catastrophic risk.

I commit to you here today that the Department stands ready to assist the federal government, the insurance industry and consumers in any way possible to maintain the market's currently stable environment. In doing so, I am hopeful that all parties involved

will be mindful of the ultimate goal of this exercise - increasing availability and affordability of terrorism coverage throughout the nation.

Thank you.