AMERICAN ACADEMY *of* ACTUARIES

Statement by American Academy of Actuaries' TRIA Subgroup on Extending or Replacing the Terrorism Risk Insurance Act of 2002 (TRIA)

December 1, 2005

Introduction

The American Academy of Actuaries' TRIA Subgroup was formed to provide independent and objective information, analysis, and education on issues related to extending or replacing the Terrorism Risk Insurance Act of 2002 (TRIA). This was initially in response to requests from Congressional staff for analysis of specific TRIA alternatives that are not currently being considered for year-end adoption.

Statement on Extending or Replacing the Terrorism Risk Insurance Act of 2002 (TRIA)

The Academy's TRIA Subgroup has analyzed several proposals for extending or replacing TRIA, although it did not have access to drafts of either H.R. 4314 or S. 467, the bills currently being considered by Congress. Certain key results of the Subgroup's analysis are relevant to the further consideration of these bills. It is the purpose of this public statement to make these results available for wider consideration.

It is important to note that the quantification of policyholder and insurer terrorism exposure required by this analysis is extremely difficult. The probabilities associated with the occurrence of a terrorist attack remain judgmental and a key source of uncertainty.

Insurers use special techniques for managing exposure to catastrophes because of the high degree of correlation of such claims, whether the catastrophes are caused by nature or by humans (including events caused intentionally by terrorists). In June 2001, the Academy published a monograph on these techniques. The monograph (available on the Academy's website at www.actuary.org/pdf/casualty/catmonograph_june01.pdf) is a good resource for understanding how an insurer may react to a sudden change in its perceived exposure to catastrophes.

The Subgroup believes that such a change in the perceptions of many insurers is now occurring, as catastrophe modeling experts have continued to improve their ability to model the severity of potential terrorist events.

Terrorists with access to nuclear, biological, chemical, and radiological (NBCR) weapons of mass destruction have the potential to cause single-event catastrophic insured losses many times the size of the total insured losses from Sept. 11, 2001. Modelers now estimate that terrorists with such weapons could cause insured losses ranging up to about $700 billion, depending on weapon type and location.

This analysis includes claims from the following lines of business: auto, commercial property, residential property, workers' compensation, general liability, and group life.

This means that if TRIA is allowed to expire without replacement or extension, the insurance industry would be exposed to potential insured losses from terrorism far in excess of those it could sustain without significantly damaging its ability to continue providing all insurance coverages, including traditional homeowners and automobile coverages. Note that the U.S. property and casualty insurance industry total capital was reported to be a little over $400 billion as of June 30, 2005. This figure did not include consideration of the losses to insurance industry capital from the recent disastrous series of hurricanes.

The largest modeled terrorism event the Subgroup analyzed in detail was a $170 billion terrorism event. Such an event, or one even more catastrophic, could occur in any of our largest cities. Under current TRIA, that event would cost the industry about $73 billion, which is a staggering loss. Without TRIA, the full $170 billion would fall on the industry. The prospect of terrorism losses at a level of $170 billion or more as a result of TRIA's automatic expiration would be likely to cause many insurers to reevaluate their willingness to commit capital to covering terrorism exposure.

Terrorism reinsurance provided by private capital is not able to fill the shortfall the Subgroup has identified. Based on reinsurance market surveys, the Reinsurance Association of America estimates that the maximum private reinsurance for terrorism coverages available for the entire insurance industry in 2007 will be $9 billion, substantially higher than the maximum $6 billion estimated to be available in 2005, but far short of the amount that would be required to deal with very large terrorist events.

In addition, the Subgroup understands that the private terrorism reinsurance coverage that is available generally excludes NBCR events, which can potentially produce the largest terrorism insurance losses.

The Subgroup's key conclusion is the following: Because of the potential for terrorist attacks that cause very large losses, the Subgroup does not believe there is any strategy that could develop sufficient terrorism insurance capacity without some form of legislation to limit insurer liability should these events occur.

Although the Subgroup did not have access to the current bills during the development of its analysis, the Subgroup's analysis sounds a note of caution about making significant changes to a complex program without allowing sufficient time for analysis of the impacts of those changes.

For example, the Subgroup modeled two proposals — one to drop certain lines of business from coverage and a second to raise the individual insurer's percentage deductible. Both proposals had been designed to raise the insurance industry's share of terrorism losses. However, the Subgroup's study showed that in a number of potential terrorism events, the two factors actually offset each other, causing a reduction in insurance industry payouts. While this modeling effort was based on parameters different from those in either the current House or the Senate versions, one important point remains unchanged: Modeling and analysis (which are time consuming) are required for understanding the potential impacts of proposed changes in this legislation.

The Subgroup also reviewed proposals intended to facilitate or force the voluntary private insurance market to take on more terrorism insurance risk. The precise proposals the Subgroup considered do not appear in the current bills before Congress, but the Subgroup determined that the law of unintended consequences can be particularly disastrous when applied to attempts to design a new marketplace.

In summary, the Subgroup believes that the magnitude of potential insurance claims due to terrorist events makes permanent federal legislation necessary in order to make terrorism coverage widely and readily available. While a TRIA extension is critical in the short run, the Subgroup believes that any legislation extending TRIA should include a mechanism to develop recommendations for a permanent way of dealing with the risk of terrorism.

Once legislation extending or replacing TRIA is enacted, the Academy intends to review the new legislation and make our analysis publicly available. The Academy also extends the offer to work with policy-makers on efforts to develop an appropriate, permanent solution.

The American Academy of Actuaries is a non-profit, professional membership organization representing actuaries in all areas of practice in the U.S. The Academy's mission is to assist in the formulation of public policy by providing independent and objective information, analysis, and education, and to support the establishment, maintenance, and enforcement of high standards of actuarial qualification, practice, and conduct. Founded in 1965, the Academy has 15,000 members and is headquartered in Washington, D.C.