



AMERICAN ACADEMY *of* ACTUARIES

**Committee on Banking, Housing, and Urban Affairs
U.S. Senate
Hearing on
Terrorism Insurance**

**Statement of Steve Lehmann, FCAS, MAAA
Vice President for Property/Casualty
American Academy of Actuaries**

October 25, 2001

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

Introduction

The American Academy of Actuaries appreciates the opportunity to provide comments on issues related to insurance and the threat of future terrorist acts. The Academy hopes that these comments will be helpful as the Committee considers related proposals.

The Academy is the non-partisan public policy organization for the actuarial profession and assists policymakers through presentation of clear actuarial analysis. For more than thirty years, membership in the Academy has been a hallmark of professional quality for U.S. actuaries. Academy members are bound by rigorous professional standards for conduct, practice and qualification, and discipline.

The actuarial profession is uniquely qualified to examine issues relating to insurance and reinsurance of catastrophes. Academy members who practice in the insurance field typically have a broad understanding of insurance risk and company financial management, and they are well equipped to evaluate reinsurance arrangements. Many Academy members also have extensive practical experience in evaluating the financial risk associated with natural disasters and other catastrophic events and in pricing related coverages for the private marketplace.

Given this expertise, the actuarial perspective is particularly valuable in examining the fundamental aspects of insurance and in describing policy considerations associated with proposals to address the impact of terrorism on the insurance industry.

Defining the Problem

In the aftermath of Sept. 11, insurers and insureds face a significant problem with respect to future coverage of terrorism risk, due to both the nature of insurance and the nature of the threat involved.

Insurance is at the foundation of a free market system, because it gives entrepreneurs and businesses the freedom to focus their resources on the conduct of their business without concern over the magnitude and volatility of potential fortuitous losses. Insurers accept that risk as long as it is quantifiable and can be appropriately priced. Where that is not possible, insurers become reluctant to accept the risk.

A dramatic change occurred on September 11, when a new risk of terrorism emerged from an event that had never even been imagined by insurers or insureds. The risk of terrorism involves prospective losses of unknown but potentially very high severity and unknown frequency. This makes risk quantification very difficult. Furthermore, it reaches beyond first-party property coverage to involve other coverages (such as workers compensation, liability, and business interruption) that are also difficult to quantify.

Even building a new risk model to define the scope of potential losses from acts of terrorism will be extremely difficult. This difficulty is aggravated by the inapplicability of existing models and the total absence of any historical data.

As a result of the September 11 events, there is enormous strain on the entire insurance system. Insurance mechanisms have to bear previously existing risks as well as the unknown and unpriced risk associated with terrorism. Additionally, though the industry may have retained significant surplus following the September 11 attacks, such surplus is needed to support all of the risk assumed by insurers for all of the lines of business they have written.

Given these difficulties, in the short-term at least, insurers are being driven to avoid losses that could occur from acts of terrorism in order to preserve their own financial security. From a public policy perspective, however, lack of coverage for such losses is not an acceptable outcome.

Private-Sector Solutions

Because insurance coverage plays such a vital role in our economic system, various proposals have emerged to provide some limitation on the aggregate risk from terrorism to be borne by the private sector. The immediate actuarial problem of pricing this new risk can be diminished by limiting the losses that would have to be paid by the private insurance market.

In considering solutions to the problem, considerable discussion has focused on the concept of a terrorism reinsurance mechanism, that in turn raises a number of important concerns. For example:

- How would such a mechanism be funded? Would it be funded prospectively by premiums charged to the participant insurers, retrospectively by assessments to the participant insurers, or through some combination of these approaches?
- How would liquidity be assured so that funds would be immediately available to pay claims when they occur?
- How would the terrorism trigger be defined so as to preclude coverage disputes between participating insurers?
- Would this mechanism be voluntary or mandatory? Would it be available to non-insurer, risk-assuming entities such as self-insured municipality pools?
- Will governmental protection be available as a backstop above a finite limit of loss?

Answers to each of these questions and perhaps others will be necessary before a pricing model can be developed.

Broad-based participation by insurers is critical to spreading terrorism risk if a private-sector mechanism is adopted. If the mechanism is voluntary, there must be adequate incentives to entice insurers to participate. Voluntary participation in any mechanism also brings up issues of potential adverse selection (i.e., only high-risk insurers and businesses participate).

It has been suggested that it would be appropriate for government to provide coverage for terrorism losses above a certain limit. In view of the magnitude of potential losses, it is difficult to conceive of any effective mechanism that would not have to involve the federal government, at least in the short-term.

However, any short-term solution will undoubtedly require future modification to reflect an increased understanding of the risk involved as well as subsequent experience gained in addressing it. All of the proposals currently being considered sunset in less than 10 years.

A sunset period is necessary to provide time for the insurance industry to develop adequate risk assessment techniques while providing protection for insurers and insureds in the interim. A new mechanism may also be needed to address terrorism risk over the long-term.

Conclusion

Some mechanism is needed now to ensure stability of insurance coverage. Some level of government intervention appears to be necessary and appropriate in the short-term. Over time, the insurance industry should be able to develop tools and techniques to help quantify and assess the risk of terrorist attacks more effectively.

Public policy-makers evaluating any proposal designed to assist insurers in achieving that objective and to protect insureds from the threat of terrorism should carefully weigh the following considerations:

- Incentives for participation in voluntary mechanisms;
- Potential for adverse selection;
- Funding source and liquidity of mechanism; and
- Level of government involvement in the short-term and long-term.

The American Academy of Actuaries is available as a resource to the Committee as it seeks to address this important concern.