AMERICAN ACADEMY *of* ACTUARIES

December 5, 2001

Dear Senator:

On behalf of the American Academy of Actuaries, I appreciate the opportunity to provide an actuarial perspective on the issues involved in legislative proposals to address the effect of potential terrorist attacks on the insurance industry.

The Academy is the non-partisan public policy organization for the actuarial profession. Academy members have a broad understanding of insurance risk, and they are well equipped and uniquely qualified to evaluate insurance and reinsurance arrangements related to catastrophic events. The actuarial perspective is particularly valuable in examining the policy considerations associated with proposals to address the impact of terrorism on the insurance industry.

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.

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.

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. 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 financial security and thus continue to protect their policyholders against other losses. From a public policy perspective, however, lack of coverage for terrorism losses is not an acceptable outcome.

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.

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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.

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.

In conclusion, some mechanism is needed now (i.e., prior to the end of 2001) 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 them quantify and assess the risk of terrorist attacks more effectively.

Thank you for your consideration. Please contact Todd Tuten, Director of Public Policy, or Greg Vass, Casualty Policy Analyst, at (202) 223-8196, if we may be of assistance to you.

Sincerely,

Steven G. Lehmann
Vice President, Casualty