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# TERRORISM INSURANCE

## Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities

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<b>Abstract</b> The tragic events of September 11,2001 brought to light the huge potential exposures insurance companies could face in the event of another terrorist attack.Faced with continued uncertainties about the frequency and magnitude of future attacks,at the same time government and military leaders are warning of new attacks to come,both insurers and reinsurers have determined that terrorism is not an insurable risk at this time.As a result,in the closing months of last year insurers began announcing that they could not afford to continue providing coverage for potential terrorism losses.The effects of this trend have yet to be fully realized,but there is some indication that it has begun to cause difficulties for some firms in certain economic sectors.		
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Madam Chairman and Members of the Subcommittee:

The tragic events of September 11, 2001 brought to light the huge potential exposures insurance companies could face in the event of another terrorist attack. Faced with continued uncertainties about the frequency and magnitude of future attacks, at the same time government and military leaders are warning of new attacks to come, both insurers and reinsurers have determined that terrorism is not an insurable risk at this time. As a result, in the closing months of last year insurers began announcing that they could not afford to continue providing coverage for potential terrorism losses. The effects of this trend have yet to be fully realized, but there is some indication that it has begun to cause difficulties for some firms in certain economic sectors.

Considerable debate has taken place on what the federal government can do to keep commercial insurance companies involved in providing terrorism insurance, even without the protection that they normally receive from reinsurance. While this Committee and the House of Representatives did pass H.R. 3210, the Congress as a whole did not adopt legislation.

Today, two months into a new year, uncertainty and concerns continue, both in the insurance industry and the economy, over the issue of terrorism insurance. As you requested, my testimony today will describe how, in the absence of federal action, insurance companies and the marketplace have reacted to the events of September 11th. I will also present GAO's initial observations on the potential consequences these market changes may have, both in the event of another terrorist attack and, as we all hope, in the absence of one. Finally, I have included a discussion of the language developed by the Insurance Services Office (ISO) and adopted by most states to exclude terrorism from commercial property and casualty (P/C) coverage (appendix 1).

My statement today is based on discussions with a variety of insurance industry participants, regulators, policyholders, and other affected parties. Because many companies were deeply concerned about the possibility that their difficulties in getting terrorism coverage might become general knowledge, they spoke to us only on condition of anonymity. Finally, my statement primarily addresses the availability of terrorism insurance coverage. Despite rising prices in the remainder of the commercial P/C

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market, insurance coverage is still available, though at prices above those in effect prior to September 11, 2001.<sup>1</sup>

In summary, because insurance companies believe that neither the frequency nor the magnitude of future terrorist losses can be estimated, they are withdrawing themselves from the market. Insurance for losses from terrorism is disappearing, particularly for large businesses and those perceived to be at some risk. This withdrawal is happening fastest among reinsurers. Direct commercial P/C insurers' withdrawal has been slower and less complete because of regulatory constraints and legal requirements in some states that preclude insurers from excluding terrorism from coverage for workers' compensation and for fire (irrespective of its cause).

Because the insurers' withdrawal has been gradual, the extent of the potential economic consequences is still unclear. What is clear is that in the absence of terrorism insurance, another terrorist attack would dramatically increase direct losses to businesses, employees, lenders, and other noninsurance entities beyond those resulting from September 11th. Furthermore, should the government decide to intervene after a future attack, it would do so without readily available claims-processing and payment mechanisms that exist in the insurance industry.

Even in the absence of an actual terrorist event, however, there are growing indications that some sectors of the economy—notably real estate and commercial lending—are beginning to experience difficulties because some properties and businesses are unable to find sufficient terrorism coverage, at any price. If allowed to go unchecked, these difficulties are likely to increase as more insurance contracts come up for renewal over the next year. The resulting economic drag could slow economic recovery and growth.

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<sup>1</sup> Prices were already increasing for commercial coverage prior to September 11th. Industry participants have told us that the increases were a part of the underwriting cycle normal in this insurance market. Industry losses from the terrorist attack almost certainly exacerbated the rise in prices, as any major catastrophe would have. While there may be some examples of excessive price increases in the market, as long as insurance continues to be available, it is likely that competitive pressures will ultimately remedy that problem.

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## Insurers Are Shifting Terrorism Risk to Property Owners and Businesses

Since the September 11th attacks, the key dynamic taking place in the insurance industry has been a shifting of the risk for terrorism-related losses from reinsurers to primary insurers and then to the insured. Reinsurers and insurers have begun shedding their exposure to terrorism risk as insurance contracts come up for renewal, leaving policyholders increasingly exposed to losses from a terrorist attack. Prior to September 11, 2001, insured losses resulting from terrorism in this country were extremely infrequent. Insurance companies considered the risk so low that they did not identify or price potential losses from terrorist activity separately from the general property and liability coverage provided to businesses. But after the September 11th attacks, insurance companies recognized that their risk exposure was both real and potentially enormous. As a result, they began to express concern about continuing to include terrorism coverage as an unpriced component of commercial P/C insurance contracts. Insurers pointed out that experience with major terrorist events has been so limited, and the potential losses so large, that setting an actuarially sound price for such coverage is virtually impossible. Many insurers now consider terrorism an uninsurable risk, at least for the moment. Their response to any risk they consider uninsurable, as many Californians living on fault lines have found, is not to offer insurance. This trend has become evident in the case of terrorism insurance.

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## Reinsurers Are Withdrawing from the Market for Terrorism Insurance

Reinsurers—companies that routinely take on some of the risk that direct primary insurers face in return for a share of the premiums—are now unwilling to participate in terrorism coverage because of the enormous losses they suffered after September 11th and the newly recognized difficulties of pricing terrorism insurance. Reinsurance is a vitally important element of the insurance industry's capacity to provide coverage to policyholders. As a mechanism for spreading the risks taken by insurance companies, reinsurance allows primary insurers to accept large risks and, by reinsuring a portion of those risks, to protect themselves from a potentially catastrophic loss. Like syndications of large loans by groups of lenders, reinsurance provides a way to insure large risks without exposing a single insurer to the possibility that its entire capital base would be wiped out because of a single event. Reinsurance companies also provide a channel through which investors can introduce capital to insurance markets without having to develop the extensive distribution channels required by direct primary insurers.

However, because reinsurance markets are global in scope and because reinsurance transactions are considered to be contracts between sophisticated parties, neither the prices nor the conditions of such

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coverage are subject to direct regulation. As a result, after September 11th, reinsurers had little difficulty excluding terrorism from coverage. Generally, these exclusions become effective on the policy renewal date. As stated by witnesses before this Subcommittee in October, a large share of those contracts expired at the beginning of January.<sup>2</sup> Industry sources confirm that little reinsurance is being written today that includes coverage for terrorism. There are exceptions. Low and medium risks, particularly in industries or geographic locations where there is little perceived exposure to a terrorist event, are the least affected. However, large companies, businesses of any size perceived to be in or near a target location, or those with some concentration of personnel or facilities are unlikely to be able to obtain a meaningful level of terrorism coverage at an economically viable price. Where coverage is available, it tends to have high deductibles and tight limits on the level of coverage. In general, reinsurers are being very selective on the exposures they will accept, if any. The higher the risk, the less likely it is that reinsurance coverage will be available. And even in those limited cases in which some reinsurance coverage for terrorism is still available, the prices are very high.

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### As Primary Insurers' Exposure Increases, They Also Are Excluding Terrorism Coverage

As reinsurers walk away from terrorism insurance, primary insurers' exposure increases, at least in the short run. However, while reinsurance contract renewals tend to be concentrated at the beginning of January and July, primary insurance contracts tend to renew at a relatively even rate over the year. As a result, industry observers and participants have told us that primary insurers' exposures have increased dramatically and will not fall unless and until they can, in turn, exclude terrorism from their coverage.

Faced with this kind of exposure and a risk they do not believe can be priced, industry observers and participants mentioned that primary insurers will need to emulate their reinsurance counterparts and exclude terrorism coverage from some commercial insurance policies. However, a number of factors are affecting both the speed and the extent to which primary insurers can insulate themselves from terrorism. First, in contrast to reinsurance, changes to the coverage provided<sup>3</sup> by direct insurers

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<sup>2</sup> Whether 70 percent of all reinsurance policies did in fact expire at that time, as was suggested, is difficult to determine. However, the consensus of industry sources is that the majority of reinsurance contracts did expire then and that reinsurance contract renewal cycles tend to be concentrated at the beginning of January and the beginning of July.

<sup>3</sup> Called "policy form" by state regulators.

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require regulatory approval in most states, at least for low- and medium-risk companies.<sup>4</sup> This regulatory hurdle caused ISO, acting on behalf of P/C insurers, to file a request in every state for permission to exclude terrorism from all commercial insurance coverage.<sup>5</sup> As of February 22, 2002, 45 states and the District of Columbia and Puerto Rico had approved the ISO exclusion, according to information received by ISO and the National Association of Insurance Commissioners (NAIC). The other five states either denied the suggested language from ISO or are still considering the language for approval or disapproval.<sup>6</sup> States that have not approved the ISO exclusion expressed concerns about various issues. Among them are the low thresholds for exclusion (\$25 million or 50 serious casualties); the all-or-nothing nature of the threshold (insurers pay nothing if either threshold is reached); the aggregation of all losses from multiple incidents within a 72-hour period and across most of North America into one event if they “appear to be carried out in concert or to have a related purpose or common leadership”; fear that the exclusion would leave some small and medium-sized businesses that could least afford the losses from a terrorist attack totally unprotected; and worry that the included definition of terrorism is overly broad. Nevertheless, because of regulatory concerns about the solvency of primary insurers who cannot get reinsurance, ISO’s exclusion language has been approved in 45 states and the District of Columbia and Puerto Rico. Primary insurers in those states can now exclude terrorism from coverage on various lines of commercial policies. While only five states have not (yet) accepted the ISO exclusion language, those five states account for more than 35 percent of the total U.S. commercial insurance market.<sup>7</sup>

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<sup>4</sup> Many states do not require regulatory approval for “large” risks. The resulting contracts are sometimes called “manuscript” or “script” policies and are considered to be contracts between sophisticated parties.

<sup>5</sup> The blanket approval does not compel insurers to exclude terrorism from every contract, but it assures them of regulatory approval when they choose to exclude such losses.

<sup>6</sup> A description of the ISO terrorism exclusion can be found in appendix 1.

<sup>7</sup> There is no reliable information, however, on the share of the commercial P/C insurance market in those states that is actually affected by the rejection of the exclusion. Each of these states already exempts “large, sophisticated buyers” from the regulations governing the terms of insurance contracts. These buyers could, and many may already have, renewed insurance contracts without terrorism coverage.



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Second, even though direct insurers now have regulatory approval to exclude terrorism from commercial P/C insurance contracts in most states, such a change in coverage generally would have to wait until the renewal date. According to some insurance regulators with whom we spoke, losing reinsurance would not generally be a sufficient reason for canceling or changing coverage for policyholders during the policy period. Moreover, even when an insurance policy terminates, insurers generally have to give 30 to 60 days advance notice to policyholders before non-renewing a policy or making a significant change in coverage. As a result, it could be as much as a year after a direct insurer loses reinsurance coverage for terrorism before a similar exclusion could be passed on to all its policyholders.

Finally, even at renewal, laws existing in some or most states will affect the extent to which insurers can completely end their exposure to losses resulting from terrorist events. For example, laws in nearly all states preclude a workers' compensation insurer from excluding coverage for a particular type of event. Workers' compensation must cover all the risks to which an employee is exposed while at work, irrespective of the cause. Industry sources estimate that approximately 10 percent of the losses resulting from the World Trade Center attack will be due to payments for workers' compensation claims.

Similarly, insurance laws in approximately 30 states include what is called "standard fire policy" language, according to ISO officials. In that language, insurers are required to pay losses resulting from fire, irrespective of the cause. Thus, in an explosion like the World Trade Center attack, a terrorism exclusion would protect insurers from liability for losses resulting from the direct effects of the explosion, but not for the losses caused by the resulting fire. Estimates suggest that the fire, rather than the explosion itself, caused a substantial portion of the losses in the World Trade Center attacks. Industry sources have said that they expect an effort to change this requirement. In all of the states where the standard is written into state statutes, an act of the state legislature would be required to modify it.

Thus, even though many reinsurers can and have moved quickly to exclude terrorism from reinsurance coverage, primary insurers' ability to exclude terrorism is more limited, at least in the short run. However, the rapid submission of the ISO exclusion language to state insurance regulators, and their generally rapid and positive response, clearly indicate the urgency of primary insurers' desire to be able to exclude terrorism from commercial P/C insurance coverage. Early indications suggest that

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many businesses, particularly those in large metropolitan areas, are already beginning to experience difficulty obtaining terrorism coverage as their insurance policies come to renewal. In our discussions with insurance industry participants, observers, and policyholders, we found that large commercial enterprises were among the first to feel the impact of terrorism exclusions. Some large property owners or developers reported that they are having to underinsure or “go bare” by self-insuring for terrorist risks because of the lack of available coverage or very limited coverage for the quoted prices.

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## As Business Exposure to Uninsured Risks Rises, so Do the Potential Economic Consequences

While the extent of the negative economic impacts of a lack of terrorism coverage is not yet clear, the potential for more severe economic impacts is increasing as the level of uninsured risk climbs. Over the next year, the level of uninsured risk for terrorism-related incidents is expected to continue to rise as commercial policies renew between primary insurers and policyholders and insurers seek to exclude terrorism-related coverage from policies they cannot reinsure. Therefore, the economic burden of another terrorist attack would fall increasingly on policyholders as the insurance industry sheds or limits its risks to such exposures, raising the potential for more devastating economic consequences should such an event occur.<sup>8</sup> Additionally, as insurers exit the market for terrorism-related coverage, so too does their claims-processing capacity for administering recovery assistance to victims of a terrorist event.

Even in the absence of another terrorist event, adverse impacts due to the lack of adequate terrorism coverage appear to be surfacing, although their ultimate impact on the economy as a whole cannot yet be gauged. Additional cases of adverse economic impacts to individual firms caused by the absence or high price of coverage for terrorism-related events are likely to become more evident as policies continue to be renewed over the next year.

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<sup>8</sup> Of course, direct insurers are still bearing some of the risk and may not be able to shift all the risk to policyholders in the near term. If an event were to occur soon, this exposure could result in insolvency and failure for some otherwise healthy insurance companies, potentially affecting the availability of other kinds of insurance.

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## Another Terrorist Attack Could Have More Severe Economic Consequences

Many of the most severe potential negative consequences resulting from the lack of terrorism insurance coverage will only become evident if another terrorist attack occurs. The shifting of risk from reinsurers to primary insurers to commercial policyholders and other affected parties could place more risk and economic burden on businesses and the public at large should another terrorist attack similar to September 11th occur.<sup>9</sup> Consequently, a lack of such coverage in the event of another attack could have much broader effects on the economy.

Recent estimates of the losses paid by insurers as a result of the attacks on the World Trade Center are about \$50 billion, of which reinsurers are expected to ultimately pay about two-thirds. If another terrorist event of similar magnitude were to take place, all those losses would still be incurred. However, depending on the timing of the event, the effect would be very different, because even today the reinsurers would be responsible for a much smaller share of the losses. As the event moves farther into the future and primary insurers successfully exclude terrorism from insurance coverage, the losses will increasingly be left to the affected businesses and their employees, lenders, suppliers, and customers. Because these entities lack the ability to spread such risks among themselves the way insurers do, another terrorist attack similar to that experienced on September 11th could have significant economic effects on the marketplace and the public at large. These effects could include bankruptcies, layoffs, and loan defaults.

Another significant consequence of the insurers' exiting the market for terrorism coverage is the absence of a claims-processing mechanism that can effectively and efficiently respond to victims of an attack. After September 11th, insurance companies, working with public risk-management groups, are reported to have mobilized extensive resources to pay many claims quickly. The administrator of the special government program to compensate victims in the aftermath of the September 11th attacks has noted the challenges of creating a mechanism for identifying victims and properly disbursing aid, even several months after the attacks. If, without insurers, the government should emerge as a principal source of financial recovery after another attack, it would first have to create the

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<sup>9</sup> In this statement, we assume that another terrorist event would be property-damage intensive, similar to the World Trade Center attacks. Of course, a successful terrorist attack, such as a biochemical or nuclear incident, would pose significantly different challenges to the insurance industry and the economy, although the ISO language contains a total exclusion for nuclear, biological, or chemical attacks.

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infrastructure to process claims and disburse financial assistance to victims, duplicating the mechanism already in place in the insurance industry. Therefore, the potential economic impacts of another incident on the scale of a September 11th attack could become even more devastating absent insurance mechanisms to quickly help businesses recover and restore economic activity. The current movement by insurers to insulate themselves from terrorism-related losses, however, means that their involvement in the recovery process after another terrorist event would also likely be substantially lessened.

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### Some Examples of Adverse Impacts Are Surfacing Due to the Lack of Adequate Terrorism Coverage

Even if no other terrorist attacks occur, some adverse conditions are beginning to appear in the marketplace due to the lack of adequate terrorism coverage, though the impacts on the economy as a whole are still unclear. As noted earlier, commercial property owners and businesses are now facing higher P/C rates coupled with substantially reduced protection for terrorism-related risks as P/C policies renew over the coming year. Insurance industry observers and policyholders report that while limited coverage for terrorism-related losses is currently available at very high rates, full coverage is often not available at any price, forcing larger commercial policyholders to operate with little or no coverage for such risks. Cases of adverse economic impacts to individual firms caused by the absence or high price of coverage for terrorism-related events are likely to become more evident as policies continue to be renewed over the next year.

Some examples of large projects canceling or experiencing delays have surfaced, with the lack of terrorism coverage being cited as a principal contributing factor. Overall, it is still unclear to what extent financing arrangements for existing or planned projects will be jeopardized as lenders and investors are faced with the prospect of absorbing additional terrorism-related risks that cannot be insured. These financing arrangements encompass both development and resale markets, where financing is contingent upon full insurance coverage for collateral assets backing the loan or investment. Some industry observers believe private markets will eventually develop and expand the capital available for terrorism insurance coverage, but whether or how quickly an adequate market can materialize is not yet evident.

Our contacts with various industry and regulatory sources indicate that some financial problems are surfacing due to the lack of terrorism coverage, though it is still too early to gauge how widespread these problems will become. Though we could not independently validate each

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Property Owners and  
Developers

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of the assertions provided, we found consistency among the sources in the reasons contributing to delays or cancellation of projects. These reasons can be attributed to uncertainty and an unwillingness among lenders and investors to accept risks that cannot yet be reasonably estimated and that insurance companies are unable to price.

Two of the most common adverse impacts being cited by commercial sources, particularly owners and developers, are the conditions of having to go bare or only partially insure assets against terrorism due to the inability to obtain meaningful terrorism coverage. Even when limited coverage is available, uncertainties about the frequency and cost of future events cause insurers to set premiums very high. This condition appears to be particularly acute for properties located in central business districts of major metropolitan areas.

Specifically, several property owners that we spoke to with properties across the United States reported not being able to purchase the amount of terrorism coverage they need because the capacity they require is not available in the current market. As a result, these owners are largely bare for terrorism risks and liable for any uninsured damages that would result from a terrorist attack on their properties.

For instance, a major North American commercial real estate firm that owns trophy<sup>10</sup> properties and office buildings in the central business districts of several major U.S. cities reported that it cannot find enough terrorism insurance to cover the value of its properties. This firm previously had a blanket property insurance policy providing \$1 billion of total coverage—including terrorism—that expired in October of 2001. Since that time, the firm has been able to find only one insurer who would offer it a quote for stand-alone terrorism insurance for a maximum \$25 million of coverage. The firm stated that minimal damage to its buildings could surpass \$25 million in claims and that this limit was inadequate.

In another example, a New York insurance brokerage firm reported that it tried to obtain terrorism coverage for a client's portfolio of non-trophy office buildings in New York City. The incumbent insurer agreed to provide \$100 million of insurance coverage on the portfolio that included

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<sup>10</sup> For purposes of this report, "trophy" properties are those properties that are sometimes regarded as icons of American business, culture or history, or that could be considered as representative of American culture or values. Because of their symbolic status, insurers consider them to be at high risk for a terrorist attack.

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terrorism, at double the cost of the previous year's \$500 million policy. The broker could not find more terrorism coverage for these properties. Industry consultants also reported that their clients were experiencing difficulty finding sufficient liability insurance for terrorism risk.

An owner and operator of a midwestern city's principal airport and several smaller area airports reportedly experienced a 280 percent increase in its aviation liability premium for 2002. The new policy does not include war risk. The insurer offered \$50 million in war risk and terrorism coverage back to the airport owner in a stand-alone policy for a premium of \$1 million. The owner needs \$500 million in coverage to satisfy its obligation to customers.

## Lenders and Borrowers

Property owners' search for terrorism coverage has been driven not only by the fear of personal liability for terrorist attacks to their properties, but also by the fact that lenders are requiring this coverage on the collateral backing existing mortgage loans. Therefore, the shifting of risk back to the policyholders is also creating adverse business conditions for lenders and investors. Lenders typically require borrowers to carry all-risk insurance coverage to protect the value of loan collateral.

Lenders and investors are now voicing their concern over their increasing exposure to terrorism-related risks as collateral assets on mortgages become uninsured for such risks. Post-September 11th, many lenders began notifying borrowers with properties considered at risk for terrorism of the requirement to carry insurance for the risk of terrorism. If borrowers cannot obtain the requisite terrorism coverage, lenders may find them in violation of their loan covenants. Lenders and investors are now being faced with the dilemma of either allowing their risk exposure to increase or acting to terminate existing loan agreements because terrorism coverage is not available to satisfy insurance requirements on the agreement. Overall, it is not yet clear how financial institutions will react to borrowers that cannot satisfy insurance requirements on existing loans.

In one case, a firm that develops large-scale buildings and that owns over a hundred non-trophy office and residential buildings both in the suburbs and central business districts of cities in several East Coast states reported that it cannot find enough terrorism coverage to cover the replacement value of its holdings and satisfy the lenders' insurance requirements. The firm currently has mortgage loans on each of its properties with over 30 different lenders ranging from local savings banks to investment banks, pension funds, and the securities market. All of the firms' lenders notified the firm that insurance policies on the properties must include the risk of

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terrorism. As the firm's current umbrella policy expires in March 2002, the firm began looking for the requisite insurance coverage to maintain compliance with the lenders' terms. For fiscal year 2001–2002, the firm had purchased a blanket property insurance policy covering \$300 million per property per occurrence for a premium of \$1 million. The firm reported that the same amount of coverage was available for 2002–2003 for \$5 million, but it excluded terrorism. The firm found only one insurer who would offer a quote for a stand-alone terrorism insurance policy. This quote specified a maximum coverage of \$75 million for a premium of 1.5 percent, or \$1,125,000. As \$75 million is not enough to cover the replacement value of any of the buildings it owns, the firm stated that it would be in technical default of its loan covenants when its current insurance policy expired.

In another case, the owners of a major midwestern mall reported that when their all-risk insurance policy on the property expired at the end of 2001, they purchased a terrorism-excluded insurance policy because they could not find one that would cover the risk of terrorism. The mall's mortgage lender objected to the policy's terrorism exclusion and argued that it violated the "all-risk" insurance requirement stipulated in the loan documents. Consequently, the lender notified the owners that it had purchased a stand-alone \$100 million terrorism insurance policy to protect the mall from this risk. Furthermore, the lender demanded repayment by the mall of the \$750,000 premium. The mall owners protested the lender's action, arguing that they could not be required to purchase insurance that was not available to them or other owners of similar properties. The owners successfully sought a temporary restraining order from the courts to prevent the lender from forcing repayment of the insurance premium.

Similarly, another lender described the adverse business relationships created as the bank responded to the technical default of mortgages when full terrorism insurance was not in force. From the bank's perspective, it is being asked to absorb risk that it had not previously priced into the mortgages and is therefore putting pressure on its mortgage holders to obtain terrorism coverage. At the same time, the bank recognizes that the unavailability or increased cost of terrorism coverage will also negatively impact the mortgage holder's ability to service the loans. Consequently, the bank's likely course of action will be to review each loan on a case-by-case basis.

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in buying and selling properties reported that the lack of adequate terrorism coverage has delayed or prevented certain projects. Several developers, financiers, and insurance industry observers noted a number of examples where lenders or investors were reluctant to commit resources to projects that could not be insured against terrorist acts. A common financing requirement places the responsibility on borrowers to fully insure the assets used as collateral in lending arrangements. In these instances, lenders and investors were unwilling to supply financing because the buyer or seller could not obtain adequate terrorism coverage on the property.

For instance, a general contracting firm in New York City reported that its bank will not provide financing for a proposed construction project unless it obtains all-risk insurance that includes terrorism coverage. The planned project is a 30-story apartment building in a high-risk area in New York City. The firm reported it has not been able to find an insurer that will sell it terrorism coverage at any price. Without this coverage, the firm cannot obtain the financing needed to hire construction workers and begin construction. The firm stated it typically hires 500 construction workers for projects such as this one.

Similarly, a firm stated that it could not obtain mortgage financing on an office building it owns on the East Coast because the firm could not purchase enough terrorism insurance to cover the replacement value of the property. Only one insurer offered a quote—for a premium of \$800,000, at a level far below what the lender is requiring. Before September 11th, the insurance for this building, including terrorism coverage, was \$60,000 for \$80 million of coverage. The firm stated the mortgage lender refused to lend the money, despite the fact that the building had a guaranteed multimillion-dollar cash flow for the next 20 years. Without this loan and others like it, the firm's future growth potential is severely limited.

In another case, an insurance broker stated that a client who was interested in purchasing a major property found terrorism coverage available in the needed amount to satisfy the lender, but the coverage was too expensive to make the deal economically viable. This buyer needed \$300 million in terrorism insurance to cover the replacement value of the asset and satisfy the lender's insurance requirements. According to the broker, the buyer received a quote of \$6 million for a \$300 million stand-alone terrorism insurance policy. Although the buyer was able to find coverage, he was unable to purchase it, as the building in question generates only \$75 million annually in rent. The buyer had budgeted \$750,000 for all of the building's insurance needs. Given all the other



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expenses associated with the building's operation, maintenance, and loan service, the buyer believed that he could not afford terrorism insurance at that price. However, without that insurance, the buyer could not obtain financing for the deal and it was not completed.

Again, a mortgage broker reported that a client interested in the purchase of a trophy property in New York City could not obtain the \$200 million necessary to finance its purchase. The broker stated that arrangements for financing with one lender were almost complete before the events of September 11th. After the terrorist attacks, the lender's credit committee reportedly decided it would not approve the loan unless the client could get enough terrorism coverage to cover the replacement value of the property. The prospective buyer could not find coverage or another bank that would lend the money without it.

In some cases investors have been unwilling to buy securities when the availability of terrorism coverage on assets backing the securities is uncertain. One example included a large insurance company with a loan of approximately \$250 million on an office building in New York. An investment firm reported that this loan was scheduled for securitization as a way for the company to reduce exposure. Potential investors in the loan reportedly said they would not buy shares of the loan without terrorism coverage. The investment firm stated that since the insurance company cannot reduce its exposure in this type of loan, it is unlikely to provide capital for similar projects in the future unless terrorism coverage becomes available. In a second example, a capital management firm stated that it led the marketing effort for a domestic commercial mortgage-backed securities deal in the United States at the end of 2001. Investment firms in the United States and Europe chose not to purchase these securities primarily out of concern that terrorism insurance would not be available in the future.

The examples cited above do not allow definitive conclusions about the ultimate economic effects of the ongoing risk shift from reinsurers to insurers and on to property owners and businesses. However, they do indicate greater uncertainty, which may affect both financial decisions and real economic activity.

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## The Potential Negative Consequences of Not Having Terrorism Insurance Are Cause for Concern

Our government leaders continue to warn of imminent and credible terrorist threats. Should one of these threats become a reality in a world where insurers are no longer the first line of protection for businesses, the economic consequences could be very different from those following September 11th. As businesses both large and small are faced with uninsured losses that threaten their ability to survive, Congress could be faced with a time-critical decision to intervene or not. A decision not to act could have debilitating financial consequences for businesses, together with their employees, lenders, suppliers, and customers. At the same time, a decision by Congress to act could be difficult to implement quickly—and extremely expensive.

Even if, as we all fervently hope, another terrorist attack does not occur, there are indications that the lack of adequate terrorism insurance is beginning to affect firms in some sectors of the national economy. The ultimate scope of these effects is uncertain at this time, but they could become potentially significant in an economy recovering from a recession. Deciding whether Congress should act to help businesses obtain insurance against losses caused by terrorism is properly a matter of public policy. The consequences of continued inaction, however, may be real and are potentially large.

Madam Chairman, this concludes my statement. I would be happy to respond to any questions that you or other members of the Subcommittee may have.

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## Contacts and Acknowledgments

For further information regarding this testimony, please contact Richard J. Hillman, Director, or Lawrence D. Cluff, Assistant Director, Financial Markets and Community Investment Issues, (202) 512-8678. Individuals making key contributions to this testimony include James Black, Rachael DeMarcus, Thomas Givens III, Ronald Ito, Stefanie Jonkman, Monty Kincaid, Barry Kirby, and Angela Pun.

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# Appendix I: Information on the Insurance Services Office (ISO) Exclusions for Terrorism and War Risk

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The Insurance Services Office (ISO) develops standardized policy contract language - forms and endorsements - for use by property-casualty (P/C) insurers. Last October, ISO developed terrorism exclusion language and filed the language with each state's insurance department for use by its insurer-customers. ISO also offered the use of these endorsements for free to insurers that were not its clients. Insurers operating in states that have approved ISO's endorsements can choose to incorporate them into their insurance policies; insurers operating in states that have rejected or have not yet approved ISO's endorsements typically cannot.

Generally, ISO's endorsements describe, among other things, events that are considered "terrorism" and "war," define various thresholds that trigger the exclusion of insurance coverage, and describe events that would trigger the exclusion of all insurance coverage. For terrorism events, ISO wrote endorsements that could be used for different lines of insurance to explain when claims are not covered by an insurance policy. These endorsements contain essentially the same language. Concerning commercial property insurance lines, two endorsements were written - one for states that have statutory requirements for fire coverage and one for states without such a requirement. Another endorsement was written for commercial general liability policies.

As of February 22, 2002, forty-five states, the District of Columbia and Puerto Rico have adopted ISO's terrorism exclusions, while five states have either rejected the exclusions or are still evaluating them, according to NAIC officials. To gain further insight at the state regulatory level, GAO interviewed NAIC and several state regulators.

According to NAIC officials, ISO initially developed very broad exclusionary language and filed it with insurance regulators across the country. State insurance regulators raised concerns about the overly broad exclusionary language and recommended that ISO develop more consumer-friendly language that did not endanger insurer solvency. Late last year, when NAIC assessed that Congress would not be passing a federal solution, NAIC facilitated communications between ISO and state insurance regulators to narrow the impact of the exclusionary language. ISO has amended that language.

NAIC and many state regulators that GAO interviewed said that their primary motive for adopting the ISO endorsements was to protect insurer solvency. NAIC officials also told GAO that they have worked with ISO in developing a level of coverage that individual insurers could bear. NAIC agreed with insurers that without reinsurance, insurers' solvency could be

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at risk if they were required to provide insurance for terrorism. However, regulators told us that they were uncomfortable with ISO's original proposal to exclude all terrorism, from the first dollar of losses, because of the potential to exclude acts that may not be the result of terrorism. NAIC officials stated that the \$25 million threshold was acceptable because it reflected the maximum losses that a single company could absorb. They told GAO that losses of \$25 million born by a single insurer would threaten the solvency of 886 insurers representing approximately 44% of the P/C insurance companies writing commercial lines of insurance in the United States.

Some state regulators have not yet adopted ISO's terrorism exclusion endorsements for various reasons. These states include California, Florida, Georgia, New York and Texas. GAO interviewed these state regulators to obtain their views and concerns. In general, their concerns were related to the definition of terrorism, the loss thresholds for which coverage would apply, and the impact that such exclusions would have on small businesses in their states.

One state regulator maintained that ISO's definition of terrorism is overly broad, and could exclude insurance coverage of relatively minor incidents such as vandalism. ISO officials told us that the \$25 million threshold, in effect, addresses lower levels of events that may come from domestic terrorism or vandalism. Another state regulator said the \$25 million threshold is too low and that a minor incident in a central business district would trigger the total loss of coverage. One regulator found the exclusion language reasonable, but was concerned about the exposure small businesses would bear because they are least able to afford terrorism insurance.

ISO endorsements contain several key elements. One key aspect of the endorsements is its definition of terrorism. ISO's definition of a terrorist act provides that:

Terrorism means activities against persons, organizations or property of any nature:

1. That involve the following or preparation for the following:

- Use or threat of force or violence; or
- Commission or threat of a dangerous act; or
- Commission or threat of an act that interferes with or disrupts an electronic, communication, information, or mechanical system; and

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2. When one or both of the following applies:

- The effect is to intimidate or coerce a government or the civilian population or any segment thereof, or to disrupt any segment of the economy; or
- It appears that the intent is to intimidate or coerce a government, or to further political, ideological, religious, social or economic objectives or to express (or express opposition to) a philosophy or ideology.

Although ISO's endorsements are commonly referred to as terrorism exclusions, they also contain language to define acts of war and to exclude war from coverage. While the endorsements' definition and application of the war exclusion did not change the war risk exclusion already used for commercial property lines, its application of the war exclusion was greatly extended for commercial general liability lines. ISO officials explained that historically, the war exclusion was limited to contractual liability in commercial general liability insurance lines, but now it will be applied much more broadly, similar to its application in commercial property lines.

A second key element of the ISO terrorism exclusion endorsements relates to the thresholds at which losses are excluded from coverage. The endorsements for both the commercial property and commercial general liability lines contain a \$25 million loss threshold. Along with this threshold, the terrorism exclusion threshold for commercial general liability lines will also be met if an event causes death or serious injury to fifty or more people. Specifically, if a terrorism event causes aggregate damages of \$25 million or less, insurance will cover insured property losses to policyholders.<sup>1</sup> However, if aggregate damages exceed \$25 million, insurers will not be liable for any resulting losses, not even the first \$25 million. In some urban centers the value of many individual buildings, even those not considered to be trophy properties, exceed \$25 million.

The \$25 million threshold has a geographic component, an insured damage and business interruption losses definition, and a timeframe definition. The geographic component specifies the geographic location of the damages that would aggregate towards the \$25 million threshold. For

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<sup>1</sup> Property damages and interruption losses at the damaged property.

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commercial property lines of insurance, insured damages to all types of property located in the United States and its territories and possessions, Canada, and Puerto Rico would be included. For commercial general liability lines of insurance, ISO officials said damages anywhere worldwide would be included. The exclusion also states that "...all insured damages...and business interruption losses" would be added towards the \$25 million threshold. ISO officials explained that "all insured damages" means damaged property that is covered by personal and commercial property insurance plus damage that would be covered by any insurance but for the application of any terrorism exclusions. "Business interruption losses" would be limited to properties that were damaged by a terrorism event. The exclusion further states that multiple events that occur within seventy-two hours and that appear to be carried out "in concert" are considered to be one incident. ISO officials explained that "in concert" means terrorism events that appear to be working together.

ISO exclusions provide an alternative fifty-person threshold for commercial general liability policies. If a terrorist event causes death or serious physical injury to fifty persons or more, insurance will not cover any losses to the policyholder, not even for the first fifty persons killed or seriously injured, and not even if aggregate damages are \$25 million or less.

The thresholds do not apply to events of war, and use of nuclear, biological, and chemical agents of terrorism, any of which can trigger the exclusion of all commercial property and general liability coverage to the policyholder. For an exclusion of coverage, the ISO endorsements look at the intent of a terrorism event involving biological or chemical agents. If the intent of the terrorism is to release biological or chemical agents, insurance will not cover any losses to the policyholders. However, if biological or chemical agents were released in the course of any other incident, the \$25 million threshold would apply, and the fifty-person threshold would apply for commercial general liability policies.

In an interview with the GAO, the National Association of Insurance Commissioners (NAIC) stressed that the ISO exclusionary language was meant as an interim solution to bring some level of certainty to the insurance marketplace while awaiting enactment of federal legislation. Accordingly, NAIC recommendation includes a sunset clause. Specifically, the sunset clause provides that the approval be withdrawn fifteen days after the President signs into law a federal backstop to address insurance losses attributed to acts of terrorism, consistent with state law.