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Terrorism, TRIA, and a Timeline to Market Turmoil?

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Presentation Overview

- **Terrorism Insurability**
- **TRIA**
- **Timeline to Market Turmoil?**



Traditional Prerequisites For Insurability (in contrast with Terrorism)

- **Frequency:** Insurance relies on credible, predictive rate-making data (Terrorism: Almost no data, probabilistic terrorism modeling is nascent at best.)
- **Severity:** Insurers target very limited “risk-of-insurer-ruin” from one foreseeable insured loss. (Terrorism presents significant risk-of-ruin from possible attacks, particularly from WC).
- **Spread-of-Risk:** (Low terrorism insurance take-up = adverse selection.)
- **Random loss probability:** (Terrorism presents an almost unlimited number of possible attack modes with a dynamic shifting to interdependent “soft targets”)

Additional General Insurability Issues

- **Exposure Information:** Traditional Insurance assumes that emerging issue information is available and shared (Terrorism information sharing is “asymmetric” – Classified data is not shared).
- **Unique Role & Responsibility of Government:** Insurance is designed for policyholders’ insurable interests (Victims of terrorism are mostly surrogate targets for attacks mainly aimed at government, and the government is in a unique position to influence the likelihood of attack based upon foreign policy.)

Additional General Insurability Issues

- **Surplus Impairment Risk:** Statutory Accounting requires insurers to set aside reserves for the ultimate liabilities arising from the insurance policies they underwrite. (Insurers are *not allowed to post reserves for losses that have not occurred. Therefore, insurers are not allowed to post reserves specifically related to catastrophe losses from natural perils or terrorism until they actually occur. As a result, catastrophe losses deplete insurer's capital & surplus base intended for the security of all policyholders).*
- **Pre-Loss Funding:** Almost all insurance assumes that premiums are paid first, normally at the inception of the policy. (In terrorism programs or pools, private and public sector solutions, such as TRIA, often use a combination of pre-loss and post-loss funding.)

Terrorism presents unique insurability challenges for Workers Compensation

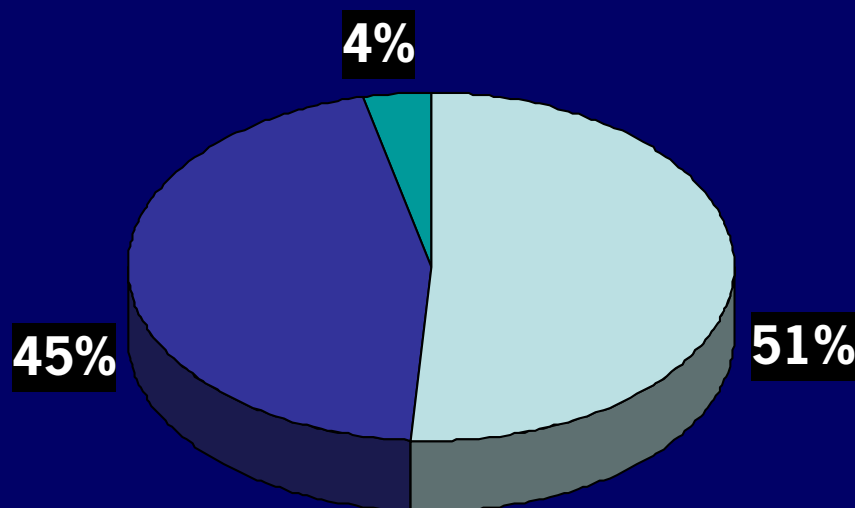
- **Unlimited risk-of-ruin due to uncapped medical obligations and lifetime income payments:** 9/11 transformed many WC underwriting decisions into capital management decisions.
- **WC insurers cannot exclude terrorism in any state. WC “take-up” ratio = 100%.** With the exception of PA state WC laws do not even permit exclusion of war.
- **Traditional statewide rating approach is completely unsuitable for pricing terrorism:** Office worker in Times Square = Same premium as office worker in Rochester? *A/so:* Lowest rated classes present disproportionate risk to terrorist loss (assuming an attack similar to 9/11): office, secretarial (8810).

Terrorism presents unique insurability challenges for Workers Compensation

- **New Exposure Basis:** Employees by location – not yet formally embraced by rating agencies – new underwriting & exposure management systems now required.
- **Catastrophe Reinsurance:** Prior to 9/11, life insurers provided low-cost WC reinsurance over single event insurer retentions of \$10 million or less – with no Terrorism or NRBC exclusion. New Bermuda capacity has not replaced the life reinsurers, who exited market after 9/11. No NRBC is available to today for national account insurers.

Only slightly more than half of P&C Premiums are in Commercial Lines – TRIA excludes Personal Lines

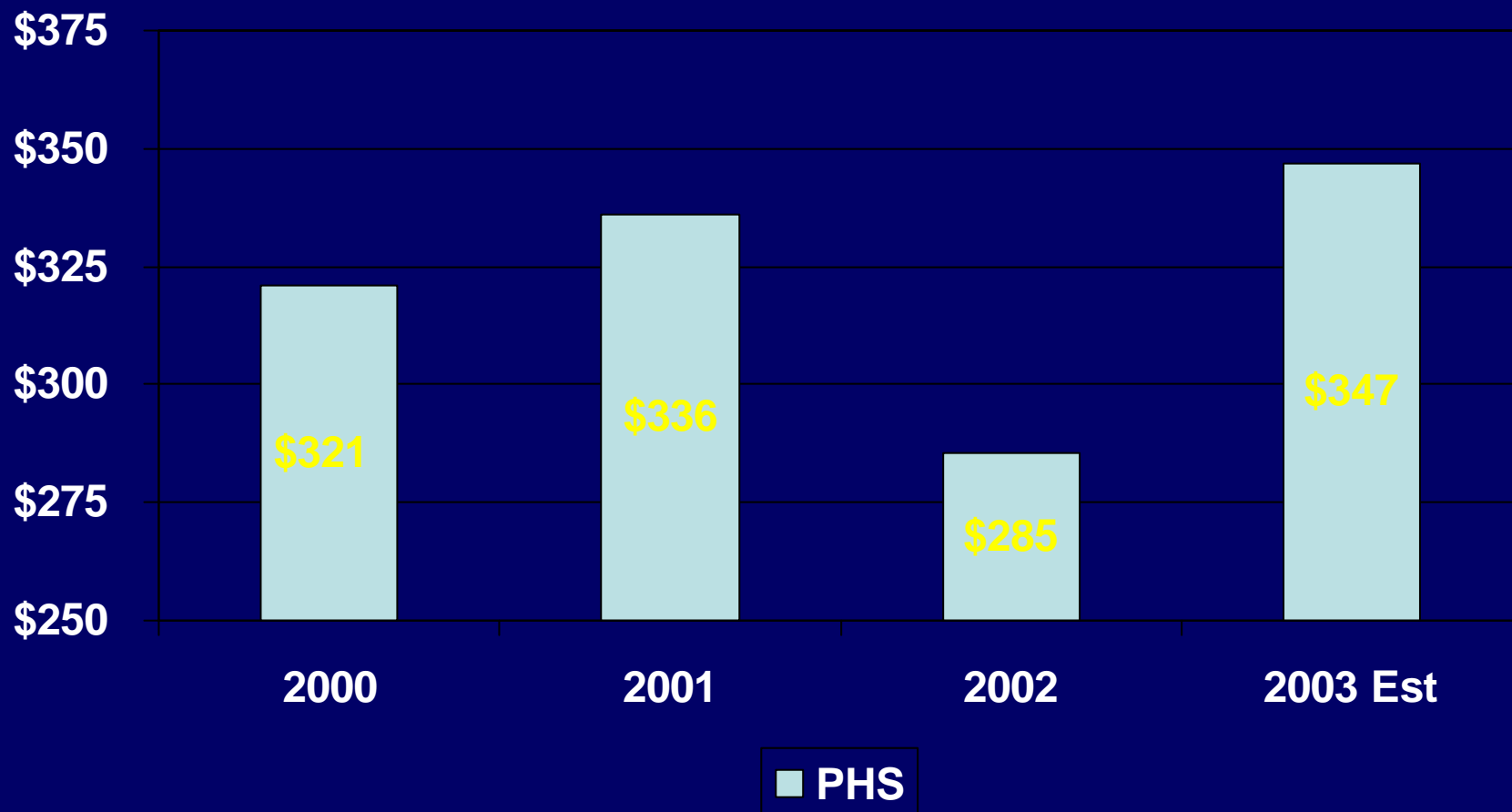
■ Commercial Lines ■ Personal lines ■ A&H



Source: AM Best Aggregates & Averages 2003

The Policyholders' Surplus (PHS) of P&C Insurers is almost equally divided between Personal Lines & Commercial Lines (Billions)

“Surplus” is a measure of underwriting capacity. It is analogous to “Owners Equity” or “Net Worth” in non-insurance organizations.



Net of Estimated Loss Reserve Deficiencies and Professional Reinsurers, we estimate only about \$87 B in total PHS supports the domestic Commercial Insurance Market.

- **Est. 2003 Commercial PHS: \$ 190 B**
- **Less Est. 03 Prof. Reinsurers' PHS: \$60 B***
- **Less Est. Reserve Deficiency: \$43 B****
- **Equals Estimated Commercial \$87 B PHS**, available for the protection of all policyholders.

Even if it were available in the aggregate to all insurers, our estimated net commercial PHS is only slightly more than twice the estimated \$40 B loss on 9/11 (net of Professional Reinsurers and estimated loss reserve deficiencies).

Source: *AM Best Aggregates & Averages 2003 reported \$47 B in 2002 ** Morgan Stanley Jan 2004. AM Best estimated reserve deficiency is \$24 B as of year end 2003.

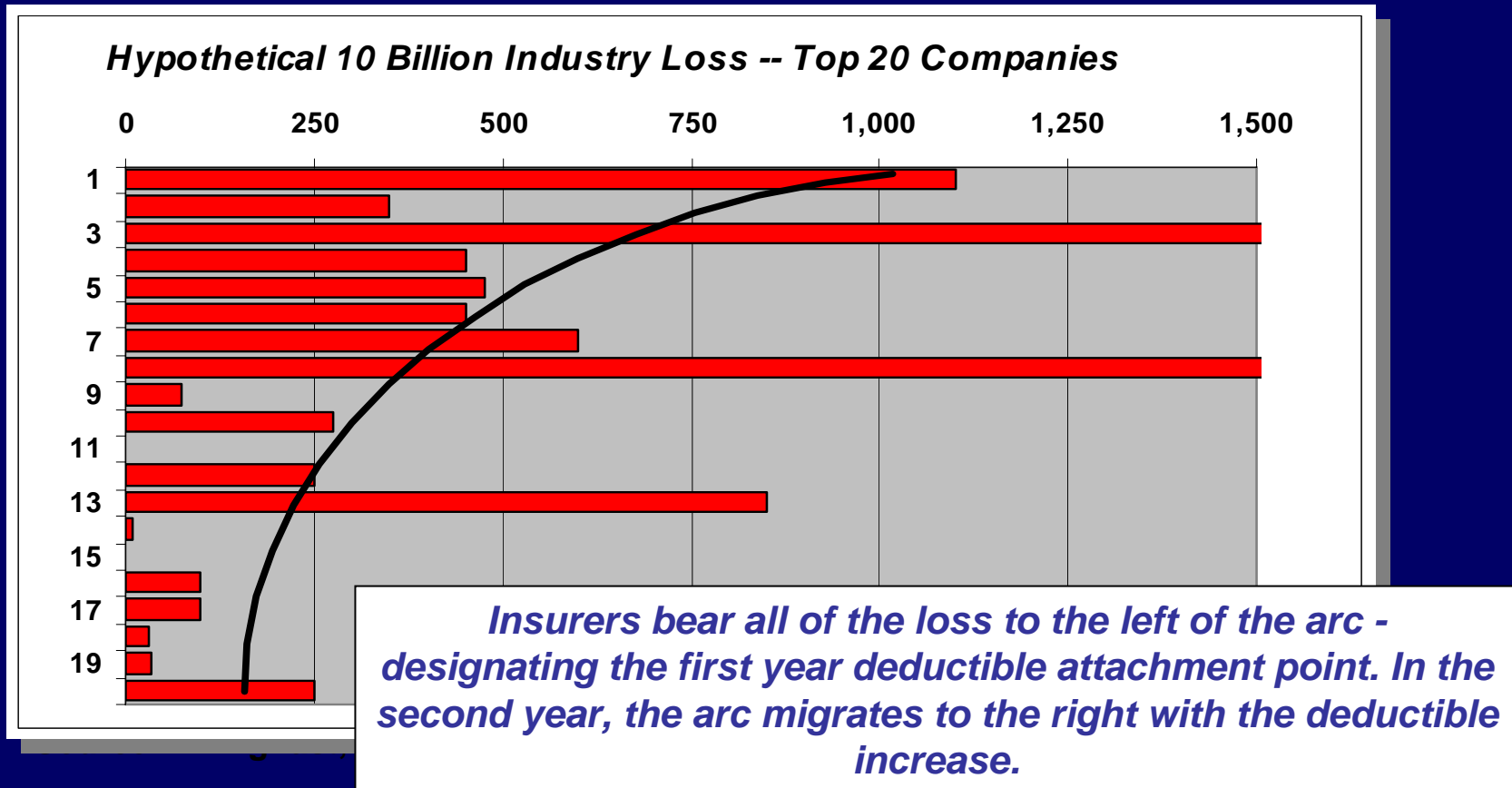
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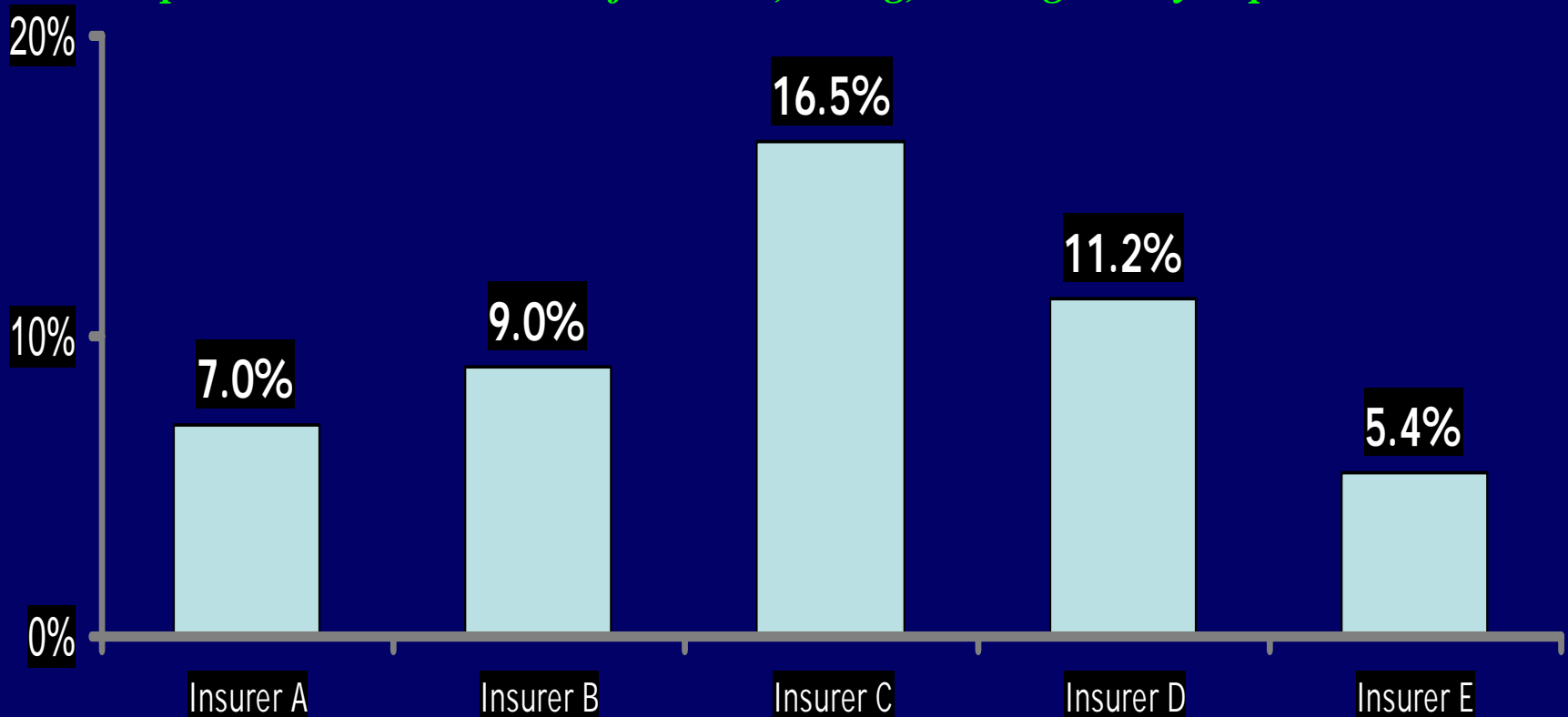
Set at 7% of the prior year's Direct Earned Premium, the 2003 TRIA deductible left insurers with significant financial risk.

Tillinghast: Many insurers would likely be exposed to large losses below TRIA deductibles.



The estimated 2004 TRIA deductible is a large percent of the GAAP book value of most insurers. The increase from 10% of DEP to 15% next year means that most insurer deductibles will raise by at least 50%.

Note: Most reinsurance treaties today give the reinsurer the right to cancel coverage within one month if the insurer's statutory surplus drops by 20% or more. This could present material adverse financial, rating, and regulatory implications.

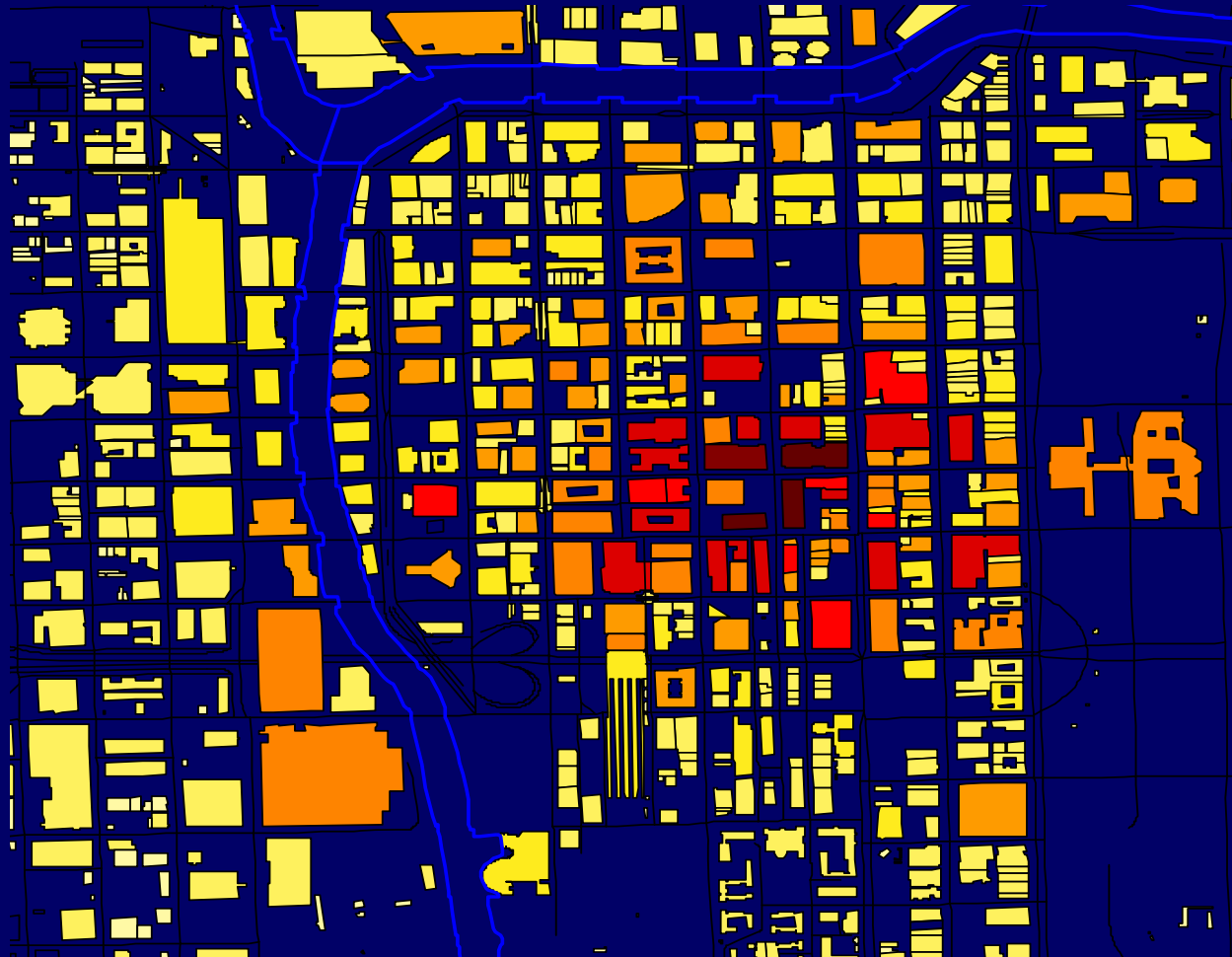


Underwriter's Viewpoint: Despite some limitations, TRIA is an outstanding success.

- **NRBC**: Covers Nuclear, Biological, Radiological, & Chemical Attacks.
- **Quantifies Insurer PML**: Provides insurers with quantified financial parameters within which we can manage our exposures (albeit at high levels).
- **Stabilized Commercial Market**: Returned the commercial market to a relative state of “normalcy” in perceived high risk locales.
- **Limits Insurer Solvency Risk**: Provides the business community assurance regarding the financial reliability of the traditional insurance market.
- **Includes Alternative Market**: direct writing domestic captives and RRGs.

Importantly, TRIA has given insurers time to develop new catastrophe management skills while stabilizing the commercial market.

Five-Ton Truck Bomb in Chicago



Despite TRIA's success, three critical issues need to be addressed...

- **Low Take-Up Ratios = Less Insurance?:** Despite the success of the “Make Available” requirement, low take-up ratios mean that a recurrence of 9/11 could ironically result in a *larger uninsured Property & Business Interruption loss*.
- **“Basis Risk” / Lack of Commercial Reinsurance :** The estimated \$40 billion insured loss on 9/11 was shared by almost 200 domestic and foreign insurers and reinsurers. Today, a similar loss would be retained almost entirely net by quite possibly only a few dozen domestic insurers or less. Almost no reinsurance is available for perceived high risk locations or NBC or R attacks. Without TRIA or some new form of federal backstop relief, this risk in many locales will be considered uninsurable, exceeding the capital bases of even the largest insurers.
- **Pricing “Catch 22”:** TRIA permits state regulators “look-back” discretion on insurer filings. Creates a “Catch 22” for insurers: No losses mean any price was arguably a high price. Lack of an accepted common rating basis enables regulators to reject filings on any basis they deem appropriate. If a loss does occur, low take-up ratios suggest that accumulated TRIA premiums will be nowhere near adequate to cover probable loss.

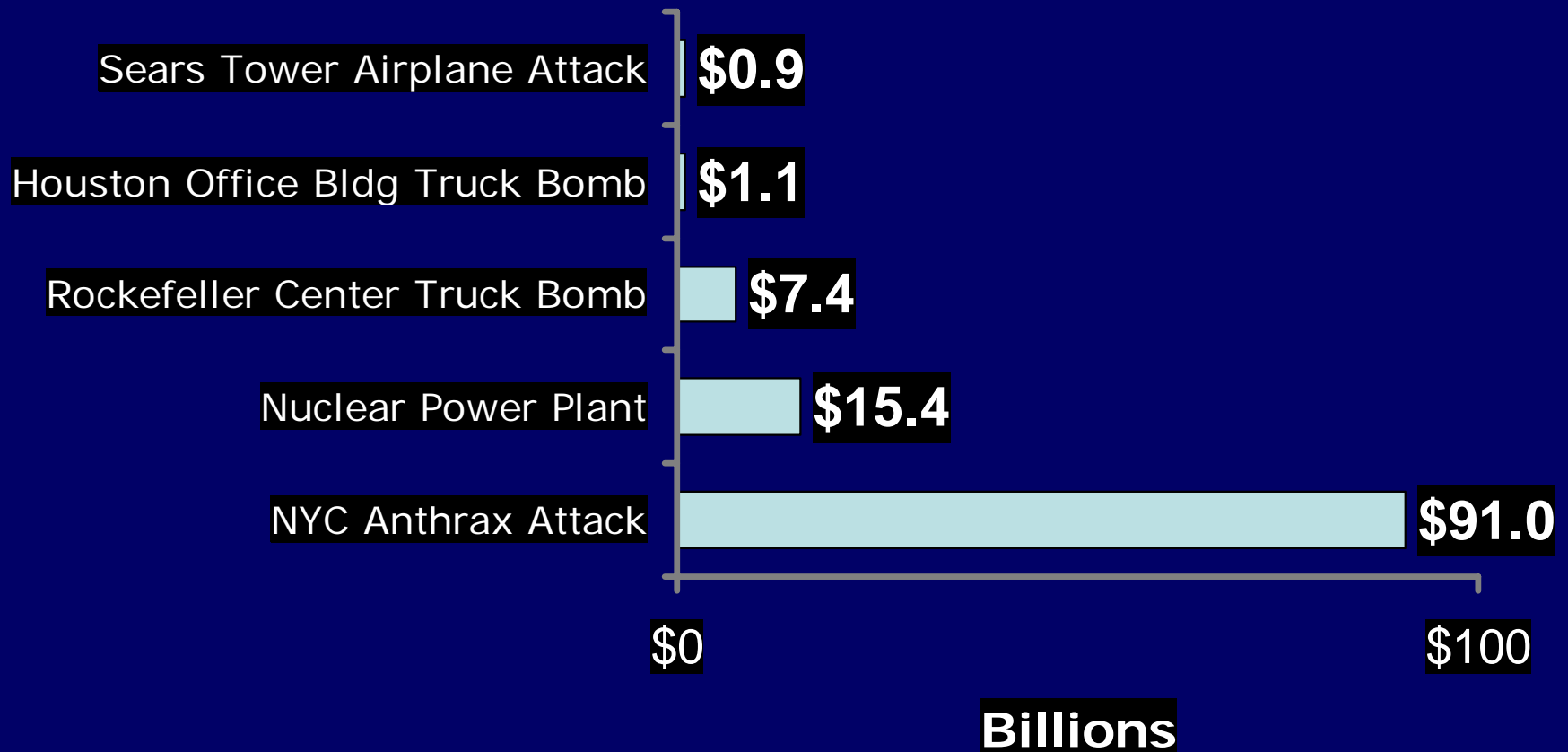
“Basis Risk”: The financial stability of even the largest WC insurers could be tested by an attack against a trophy building with one or two large employers.



State	Avg. Fatality Benefits*	9/11 Recurrence Fatality Loss (c. 2,950)
DC	\$613,000	\$1,808,350,000
Connecticut	\$589,000	\$1,737,550,000
New York	\$462,000	\$1,362,900,000
New Jersey	\$451,000	\$1,330,450,000
Maryland	\$417,000	\$1,230,150,000
Pennsylvania	\$389,000	\$1,147,550,000
Ohio	\$382,000	\$1,126,900,000
California	\$300,000	\$885,000,000
Illinois	\$295,000	\$870,250,000
Virginia	\$225,000	\$663,750,000

**ACE Actuarial based on Reported NCCI fatalities*

RMS Estimated Possible WC Losses exceed almost all individual Commercial Insurer's PHS



Source: Risk Management Solutions, Inc.

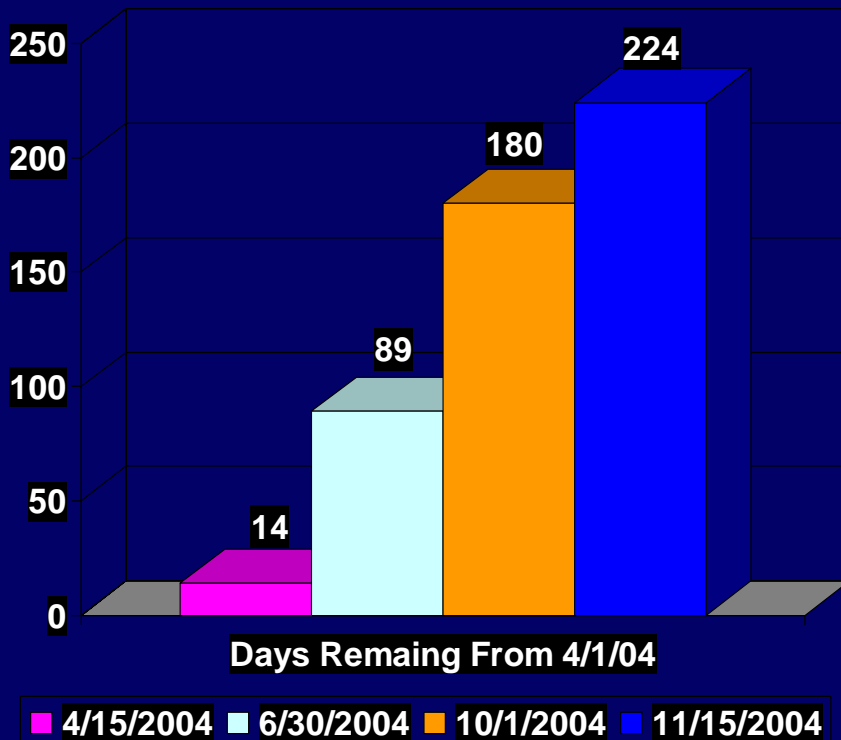
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The Trouble with TRIA: Timing.

- **TRIA ends at one of the *worst possible times*:** Al Qaeda has a history of returning to thwarted attack plans - New Year's Eve plot was prevented on 1/01/2000.
- **Insurance policies are normally in-force for 12 months.** Policies with inception dates of 1/2/05 or later present increasing non-concurrent coverage challenges (with the first part covered by TRIA and no TRIA coverage as of 1/1/06).
- **ISO & insurers are now developing “conditional endorsements”** to recognize TRIA's “hard ending” to clarify exactly what terrorism coverage applies (if any) in the remainder of the policy year.
- **Within 4 to 5 months, underwriters must make difficult portfolio decisions** assuming no TRIA extension, in particular WC, Property and Surety.

TRIA Expiration - Timeline for Market Turmoil?



Key Date	TRIA Milestones & Insurer Deadlines
04/015/04	ISO starts filing “conditional endorsements” stating TRIA coverage ends with end of law & giving alternatives post-TRIA (x NBC & R).
06/30/04	Estimated probable last day for Federal Legislative action on TRIA prior to Presidential election.
10/01/04	Underwriters begin to address portfolio management and renewal decisions (in many cases requiring 60-90 day notice).
11/15/04	Underwriters begin quoting accounts with effective dates on or after 1/2/05, earning into 06
12/31/05	TRIA expires on New Year’s Eve: Former Al Qaeda target date

Positive Recent Developments

- CIAB reports 80% of P&C agents and brokers support a TRIA extension.
- NAIC supports an extension.
- House FSC is holding TRIA hearings on April 28, 2004.
- P&C industry groups are united in the need for TRIA re-authorization.
- New Tillinghast report presents a detailed WC prototype for a possible permanent public & private sector solution to insuring terrorism (supported by 14 insurers). This report is available at: <http://www.towersperrin.com/tillinghast/>
- Several key Republican and Democrat Congressmen and Senators are reportedly positive (or open to considering) a TRIA re-authorization.
- RAND's new Center for Terrorism Risk Management Policy has commenced initial studies including TRIA and the insurability of terrorism.

Conclusions

- **“Make Available”**: Treasury will likely extend to third year.
- **TRIA**: All stakeholders should ask their representatives *now* to back a minimum two year extension.
- **Extension period (through 2007)**: should include public & private sector task force to develop options for a permanent solution to insuring terrorism including Federal government as the “reinsurer of last resort” (similar to approaches in UK and other countries).

