



NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

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**HEARING BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
AND
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
ON
“Protecting Americans from Catastrophic Terrorism Risk”**

Statement of the

**NATIONAL ASSOCIATION OF REALTORS®
AND THE
INSTITUTE OF REAL ESTATE MANAGEMENT**

SEPTEMBER 27, 2006

The National Association of REALTORS® (NAR), and the Institute of Real Estate Management (IREM) are pleased to submit this statement for the record to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Oversight and Investigations for their hearing on protecting Americans from catastrophic terrorism risk. We appreciate the time and effort that its members, including Subcommittee Chairs Kelly and Baker, have spent on this very important issue. IREM and NAR look forward to working with subcommittees to address to developing long term solutions to the challenges posed by creating a long term sustainable terrorism risk insurance program.

With over 1.3 million members, the National Association of REALTORS®, “The Voice for Real Estate,” is America’s largest trade association, including NAR’s five commercial real estate institutes, societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,500 local associations or boards, and 54 state and territory associations of REALTORS®. IREM is the only professional real estate management association serving both the multifamily and the commercial real estate sectors. With 81 U.S chapters and 8 international chapters, IREM is an international organization that serves as an advocate on issues facing the real estate management industry. Collectively, IREM members manage more than 6.5 billion square feet of commercial space and more than 13 million residential units totaling \$848.2 billion in real estate assets. Because of the importance of terrorism coverage to the health of the commercial real estate markets, NAR and IREM urge Congress to pass a long term terrorism insurance program that ensures the long term sustainability and availability of coverage.

Nature of the Threat of Terrorism and the Real Estate Industry Response:

Despite the valiant efforts by the U.S. Department of Homeland Security, security firms and property owners since 9/11 to better secure our nation’s private sector, we all realize that it is not possible to guarantee security at all locations all of the time due to our relatively free and open society. Last year’s terrorist attacks in London, Madrid and Israel prove that it is very difficult to thwart well-prepared, well-funded and determined terrorists from doing harm. Many security analysts believe that it is only a matter of time before suicide bombers and other terrorists refocus their deadly agenda on U.S. targets.

A study conducted by the RAND Corporation’s Center for Terrorism Risk Management Policy finds that “soft” targets, such as office buildings and retail centers are increasingly at risk from both Al Qaeda and domestic radical terrorist groups. This shift in emphasis comes from the realization that the “hard” targets, such as “iconic” office buildings (e.g., Empire State Building, Sears Tower), government centers and embassies have become more secure and harder to penetrate, and that attacking more vulnerable soft targets would still allow Al Qaeda to cause significant civilian casualties and economic disruption.

Because of the ever changing nature of terrorism threat, both IREM and NAR are members of the Real Estate Information Sharing and Analysis Center, a partnership created by the Department of Homeland Security and the real estate industry. The partnership facilitates

information sharing on terrorist threats, warnings, incidents, vulnerabilities and response planning — to counter terrorism and protect buildings and the people who occupy and use them. This important partnership helps the real estate industry stay aware of all the emerging threats facing each real estate sector, and enables property managers and other real estate professionals to take appropriate measures to protect those who work live and play in the nation's buildings.

The Importance of Terrorism Insurance to Commercial Real Estate:

Affordable and available terrorism insurance is a vital component of most commercial real estate transactions. It is estimated that 84% of outstanding commercial mortgage balances require terrorism insurance. Thus, if TRIEA were to expire, and insurers subsequently dropped terrorism coverage, those loans would be in technical default. The pricing and availability of coverage is an important component to both the commercial real estate transaction and the ongoing management of the property. The inability to obtain terrorism insurance may either limit the financing options of a particular transaction, or may jeopardize the transaction entirely. If terrorism insurance costs rise significantly, it will negatively impact the price of commercial real estate. Furthermore, the rising costs of terrorism insurance can outweigh any potential income from a particular property creating a disincentive to property ownership, and potentially forcing the property managers and owners to pass on the costs of the additional costs of terrorism coverage to tenants. If a property owner is unable to pass those increased costs, as for example in the case where a property is triple net leased (tenant assumes all costs), or as in the case with multifamily units receiving a public subsidy, the owner may be forced to operate the property at a potential loss.

The Terrorism Insurance Risk Extension Act (TRIEA) has, by and large, kept insurance available and affordable, but at the end of next year we will again face the uncertainty associated as it is set to expire at the end of 2007. The debate on the future of TRIEA is set against the backdrop of ever increasing problems of either unavailable or unaffordable property and casualty insurance throughout many areas of the country. NAR and IREM urge Congress to limit the effects of economic uncertainty associated with the looming expiration of TRIEA by passing a permanent fix early next year. NAR supports the concept of creating a chartered mutual reinsurer that could be housed in the treasury department and that would eventually be sustained by fees paid by insurance firms.

The Success of TRIA and TRIEA, and the Uncertainty of Insurance Availability After 2007

The passage of the Terrorism Risk Insurance Act of 2002 helped stabilize the commercial real estate markets following the disruptions of the September 11, 2001 terrorist attacks by making terrorism coverage available and, over time, more affordable. Commercial property owners, brokers, managers, leasing agents and lenders throughout the country have all benefited from having sufficient affordable terrorism insurance in place. Development projects and related loans are no longer held up due to inadequate coverage; leasing of office, industrial and multifamily properties has gone uninterrupted; and lenders no longer have to "force-place" coverage for their clients in order to satisfy loan agreements.

Yet, while TRIA has been effective in stabilizing the insurance markets in recent years, a private reinsurance market had not demonstrated the capacity to fill the breach if TRIA's federal backstop had expired. Initially driven by a concern that the private insurers would not be able to provide terrorism coverage on their own, in June 2004 the Treasury Secretary extended the make available requirement of TRIA ensuring that insurers would continue to offer terrorism coverage in the final year of TRIA's three year program.¹ During 2005, it became evident that private insurers would be reluctant to provide terrorism coverage should TRIA sunset and the reinsurance market had not yet become strong enough to cover insured losses. In June 2005 the RAND Corporation released a study which suggested that if TRIA were permitted to expire, premiums would likely rise and "take up rates", i.e. the number of businesses purchasing coverage would decline.² Yet, this decline in coverage would come at a time of continued uncertainty about the specter of terrorist attacks in the United States. At the same time, a Treasury Department report recommended that TRIA be allowed to sunset to enable the market to develop without the interference of a federal backstop.³

The Terrorism Risk Insurance Extension Act of 2005 (TRIEA) strikes a balance between the two views. TRIEA extends the federal backstop program for an additional two years and increases reliance on the private sector. TRIEA specifically increases the trigger point at which the federal government will provide assistance from \$5 million in 2005, to \$50 million in 2006, and \$100 million in 2007; while also raising insurer deductibles to 20% by the end of 2007.

NAR and IREM are concerned that reinsurance market has not yet developed the capacity to handle losses associated with a terrorist attack without a federal backstop in place. It is estimated that the reinsurance capacity is between \$6 and \$8 billion, which given the potential magnitude of a coordinated terrorist attack seems fairly small. Because of this continued weakness in the reinsurance market, and the importance of terrorism insurance to the continued health of the commercial real estate markets, NAR and IREM fear that the expiration of TRIEA at the end of 2007 will again cause uncertainty in the insurance markets and make terrorism coverage either unavailable or unaffordable. For these reasons, NAR and IREM support the concept of creating a mutual reinsurance pool within the department of Treasury.

The Challenges of Terrorism Insurance:

Long-Term Availability and Affordability of Terrorism Risk Insurance

The development of private reinsurance capacity to spread catastrophic risk is necessary to adequately insure against terrorism risks. Although Treasury's June 2005 study acknowledges the role of reinsurance in an insurer's capacity to absorb losses, the study did not adequately address the issue of developing long-term private reinsurance capacity. Nevertheless, the study

¹ The Treasury Secretary extended the "make available" provision of TRIA through 2005 on June 18, 2004. <http://www.treas.gov/press/releases/js1734.htm>

² RAND Center for Terrorism and Risk Management Policy, "Trends in Terrorism: Threats to the United States and the Future of the Terrorism Risk Insurance Act."

³ United States Department of the Treasury, "Assessment: The Terrorism Risk Insurance Act of 2002."

seemed to assume that private market capacity would grow in the absence of a federal backstop. Insurance industry experts believe that the federal reinsurance backstop provided under TRIA is responsible for the existing private market capacity. There has been no evidence to suggest that private market capacity will increase following the expiration of TRIA. In fact, the American Insurance Association noted that “[g]iven the continued grave uncertainty and potentially catastrophic levels of loss, insurers simply lack the tools to underwrite and price this risk without a new mechanism to provide capacity.”⁴ The federal government possesses substantially more expertise concerning terrorism risks than the insurance industry. Accordingly, federal participation in a long-term solution is appropriate. In the continued absence of such evidence, we urge Congress, as we have urged the Presidential Working Group on Financial Markets, to consider long-term solutions to the availability and affordability of terrorism risk insurance which involves a combination of the private insurance industry, the private sector and federal participation.

The Challenge of Chemical, Nuclear, Biological, Radiological Coverage

There is currently little affordable coverage for CNBR events caused by terrorism. It appears most terrorism risk insurance coverage excludes CNBR events, except where such coverage is expressly required under state law (e.g., with respect to workers’ compensation coverage). When NAR asked members whether CNBR was included in their terrorism coverage, most indicated that it was not.

Insurance industry representatives believe that CNBR events are not conducive to modeling, and likely to trigger greater losses than conventional terrorist acts. The AIA notes that “[i]nsurance models suggest that the potential loss is so enormous that accumulation management techniques—essential to managing conventional terrorism risk—are of little practical value.”⁵ In fact, the American Academy of Actuaries (AAA) noted that “after anthrax was sent through the U.S. mail in 2001, the cost of cleaning up the postal facilities alone exceeded the structural value of those facilities.”⁶ It is estimated that the reinsurance capacity for CNBR coverage lags behind that of terrorism at between \$1 and \$2 billion. Because the value of the insurance claims would exceed the value of the real estate affected, and due to the near impossibility to appropriately measure risk and price coverage, insurers are unlikely to offer coverage without federal assistance.

Support for a Public Private Partnership Solution

As noted above, NAR and IREM believe the solution to the long term challenges posed by terrorism coverage necessitates the continued presence of a federal backstop. However, we believe, consistent with TRIEA that the reinsurance and the insurance industries should

⁴ Testimony of Debra T. Ballen, American Insurance Association at “NAIC Public Hearing on Terrorism Insurance Matters” March 29, 2006.

⁵ Ibid.

⁶ Statement of Michael G. McCarter, FCAS, MAAA Chairperson of the Terrorism Risk Insurance Subgroup, American Academy of Actuaries, before the Terrorism Insurance Implementation Working Group of the National Association of Insurance Commissioners.

gradually generate more capacity to provide terrorism coverage until a federal backstop is no longer necessary. It is clear at this time, a continued phasing out of a federal backstop program is necessary following the expiration of TRIEA at the end of 2007. We believe that, like we believed at the end of 2005, that the expiration of TRIEA will result in a dramatic run up in terrorism insurance premiums, and the complete lack of coverage in certain markets. This looming potential crisis will only compound the severe problems many commercial real estate practitioners already have in obtaining and affording property and casualty coverage.

The Real Estate Roundtable has taken an important first step in the debate on the future of terrorism insurance by proposing the creation of Homeland Security Mutual (HSM) a not-for-profit mutual reinsurance company to be housed in the Treasury Department. HSM would offer reinsurance coverage for the following lines of terrorism risk; 1) domestic and foreign based terrorism, 2) CNBR coverage, 3) group life, 4) workers compensation and 5) commercial property and casualty. HSM would be funded through initial assessments on insurers, private retrocessional insurance, pre-event alternative capital sources such as catastrophe bonds, and other policy surcharges. HSM would provide reinsurance for events over \$100 million in losses – the same trigger as in TRIEA. The federal government would provide a retrocessional backstop until the capacity of HSM reached \$30 billion dollars. NAR and IREM generally support this concept as it ensures the continued availability of terrorism coverage, while creating additional reinsurance capacity that will eventually replace the federal backstop program.

Conclusion

Affordable and available terrorism insurance is an integral part of the health of the commercial real estate markets. Given that the reinsurance industry has not yet been able to develop a long term solution that would eliminate the need for some form of federal assistance, IREM and NAR are concerned that the sunset of TRIEA will result in a spike in terrorism coverage premiums, and cause coverage to become unavailable in numerous markets. The concept of a mutual reinsurance pool, such as HSM proposed by the Real Estate Roundtable that could further phase out the federal government's backstop program, presents an important first step in the debate on the future of terrorism coverage, one that we hope that Congress and Treasury consider carefully.

Thank you for this opportunity for us to express our views on this very important matter.