NATIONAL ASSOCIATION OF REALTORS®

REALTOR®

The Voice For Real Estate®

500 New Jersey Avenue, N.W.
Washington, DC 20001-2020
202.383.1194 Fax 202.383.7580
www.realtors.org/governmentaffairs

Pat Vredevoogd Combs, ABR, CRS, GRI, PMN
President

Dale A. Stinton, CAE, CPA, CMA, RCE
EVP/CEO

GOVERNMENT AFFAIRS
Jerry Giovaniello, Senior Vice President
Walter J. Witek, Jr., Vice President

HEARING BEFORE THE SENATE BANKING COMMITTEE

ON

"Examining the Terrorism Risk Insurance Program"

Statement of the

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

FEBRUARY 28, 2007

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 Senate Banking Committee. We appreciate the time and effort that its members, including Chairman Dodd and ranking member Shelby, have spent on this very important issue. IREM and NAR look forward to working with committee to ensure that a long term solution that will ensure the availability of terrorism insurance is in place following the expiration of the Terrorism Risk Insurance Extension Act.

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. Given 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.

NAR and IREM urge Congress to enact legislation that:

1. Ensures the long term availability of terrorism insurance;
2. Creates a backstop program that would cover chemical, biological, nuclear and radiological events and require insurers to make this coverage available;
3. Makes no distinction between foreign and domestic acts of terrorism; and
4. Authorizes a Treasury managed trust fund that would be capitalized by insurance premiums that would be used prior to taxpayer funds to cover losses in excess of insurer deductibles.

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

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, etc.), 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.

As the result 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 in order 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:

The story of a property manager, responsible for over three million square feet in the Washington, DC region, exemplifies the importance of terrorism insurance and its long term availability.

Following the September 11th attacks and prior to the enactment of TRIA, the property manager was unable to find terrorism coverage at a reasonable cost. Following the enactment of TRIA, the property manager was able to find coverage, however, insurance costs rose from 11 cents a foot prior to 9/11 to 50 cents a foot following the bill's enactment. Though the initial premiums following the enactment of TRIA were high, during the subsequent years, terrorism insurance costs have moderated somewhat. However prices fluctuated during periods of uncertainty as in 2004 when the "make available" requirement was in question for TRIA's third year (2005), and the uncertainty as to whether TRIA would be extended in 2005. Today, there is concern that the uncertainty of the future of the terrorism insurance program may cause prices to fluctuate, and prompt insurers to drop terrorism coverage should a more permanent terrorism insurance solution not be in place by year's end.

Affordable and available terrorism insurance is a vital component of most commercial real estate transactions. It is estimated that 84 percent of outstanding commercial mortgage balances require terrorism insurance. Thus, if TRIEA (Terrorism Risk Insurance Extension Act) 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.

TRIEA has, by and large, kept insurance available and affordable. However, at the end of this year we will again face the same economic uncertainty. 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 long term solution before within the first half of the year.

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 multi-family 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

---

[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."

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. In fact, the President's Working Group on Financial Markets, acknowledged in its report that insurers had little confidence in their ability to model terrorism risk. As a result insurers and reinsurers are unable to gauge the proper level of capital reserves to cover such risk. 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.

Given 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 a long term extension of a federal backstop program.

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 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 to consider long-term solutions to the availability and affordability of terrorism risk insurance.

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).

---

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

When, in a 2005 survey, 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] 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. Since 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.

Legislative Principles for a Long Term Solution:

The legislation that succeeds TRIEA should promote the long term availability of terrorism insurance, ensure that insurance availability for lines of coverage that the private sector is unable to provide (such as CNBR) and maximize long term capacity by encouraging the entry of new capital into the program.

Foreign vs. Domestic Acts:

The legislation should remove the problematic distinction that excludes coverage for domestic acts of terrorism. Terrorism, regardless of its source can have a profoundly destabilizing effect on the nation's economy. The legislation should reflect the nebulous nature of the threat of terrorism in that the direct source of influence behind a terrorist act may not be readily apparent and that terrorist acts may be developed and executed by individuals who may be citizens.

Coverage of CNBR and Non CNBR:

NAR believes that the legislation that succeeds TRIEA should cover all potential terrorist acts, including CNBR. However because insurers are unable to model or price CNBR risk, the legislation should create a distinct federal backstop program to cover CNBR losses. Insurers should also make CNBR lines of coverage available. However, because the private market can not price this risk, the legislation should eliminate or significantly reduce insurer deductibles and co-pays. This would help ensure that the pricing of CNBR coverage will be affordable.

The backstop program for non-CNBR events, with its make available provision, should be continued. Because there is some reinsurance capacity for non-CNBR events, and because

---

[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.

there is a history of fairly consistent pricing under TRIA and TRIEA, Treasury should be authorized to create a segregated trust fund that would offset government exposure. The fund would be capitalized by insurance premiums and to a lesser extent, policy holder surcharges. This fund would be used prior to taxpayer funds to cover losses beyond insurer deductibles and co-pays.

The program trigger should not be higher than the current $100 million, with a possible exception for smaller insurers. NAR believes that Congress should consider lowering the trigger for smaller insurers to that coverage that is offered is also affordable.

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.

IREM and NAR's members work in every commercial real estate market across the country, and broker and manage properties of every size and class – from large marquis trophy properties in major urban centers, to small family owned retail centers in rural areas. The consistent and affordable pricing of insurance is critical to all of NAR and IREM members.

The legislation that succeeds TRIEA must be designed to ensure the continued availability and affordability of terrorism coverage. Since the terrorism threat is ever changing, NAR asks Congress keep these legislative recommendations in mind. By keeping terrorism coverage available and affordable, it is hoped that the number of firms acquiring terrorism coverage continues to grow, thereby adding an extra layer of economic security in the face of an ever changing terrorist threat.

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